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Public Policy Issues Raised by Bank Securities Activities*

SECURITIES INDUSTRY ASSOCIATION

For the past fifty years commercial banking and investment banking activities were separated pursuant to the Glass-Steagall Act. The Securities Industry Association presents its perspective on various legislative proposals currently being considered to redefine the role of commercial banks in the securities field.

OVERVIEW

The commercial banking industry and the securities industry each play a crucial role in our financial system, the stability and efficient functioning of which are vital to our national well-being. For the past half-century, it has been declared national policy to foster and preserve the soundness of our financial system by separating commercial banking and investment banking. Subject to limited exceptions, banks have been legislatively prohibited from engaging in the securities business, while securities firms have been prohibited from entering the banking business.

Despite the long-established congressional policy of separating commercial banking from investment banking, recent years have witnessed increasing instances of efforts by major commercial banks to engage in securities activities. Moreover, now pending

* [Editor's Note] The *San Diego Law Review* is again pleased to provide a forum for the publication of the Securities Industry Association's (SIA) *White Paper* on bank securities activities. The *Review* was unsuccessful in its attempts to elicit a response to this article from the banking industry. Because of the *Review*'s desire to present a diversity of quality opinion, such a response would still be welcome. Interested and responsible parties should address their manuscripts to the San Diego Law Review Association, University of San Diego School of Law, San Diego, California 92110.

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before the Congress are a number of legislative proposals which, if adopted, would represent a significant departure from the long-standing policy of sharply limiting the permissible securities activities of commercial banks. This article is intended to present the perspective of the securities industry on these proposals in a way that will promote intelligent and informed consideration by those responsible for resolving this issue.[1]

Any scheme of restrictive regulation deserves revisiting periodically in light of current conditions. Moreover, this is unquestionably a period of significant change in the financial services industry. Recent combinations of non-bank financial institutions, the emergence of money market mutual funds, and the announced intention of the holding company of the Nation's largest commercial bank to acquire the largest discount brokerage firm[2] bear witness to the truth of this broadly shared perception. It is, therefore, both timely and appropriate for Congress to reexamine the Glass-Steagall Act as well as the other laws and regulations that govern the banking and securities industries.

To recognize the important changes that have occurred over the last fifty years, however, is not necessarily to conclude that the policy of separating commercial banking from investment banking is no longer valid. In fact, the Securities Industry Association (SIA) firmly believes that a full examination of these developments and of the legal regimes governing the banking and securities industries will result in reaffirmation of that policy. The SIA, therefore, welcomes such a thoroughgoing congressional review.

First Principles

An informed assessment of legislative changes that would permit banks to enlarge their securities activities requires, at the outset, recognition of several fundamental realities.

First, because of their importance as financial intermediaries, banks have been accorded a variety of privileges designed to reduce their costs of intermediation and hence enable them to make credit available at a lower cost than is available from other financial institutions. Included among such privileges are favorable tax treatment and the ability to obtain funds readily at low cost from depositors, from other banks in the federal funds

1. This article, written in the spring of 1982, updates a more detailed discussion paper setting forth the legal and policy underpinnings of the SIA's position, entitled *Bank Securities Activities: Memorandum for Study and Discussion*, *reprinted in* 14 SAN DIEGO L. REV. 751 (1977) (hereinafter referred to as *SIA Discussion Paper*).

2. *See infra* text accompanying note 27.

market, and from the Federal Reserve's discount window. Each of these privileges is paid for by taxpayers and bank depositors and is provided to banks for the intended benefit of those in need of credit; not for the purpose of enhancing the ability of banks to engage in non-banking activities. Yet, because of these and other advantages, banks possess an enormous edge when they compete with other types of enterprises in non-banking businesses. As long as banks are permitted to keep these advantages, talk of a "level playing field" on which banks and non-banks are to compete head-to-head is at best disingenuous.

A second important factor to be weighed in judging the proper scope of bank activities is the enormous economic power of the major commercial banks. Commercial banks control in the aggregate $1.8 trillion in assets and provide a very substantial portion of all external corporate financing through bank loans.[3] Accordingly, the implications, both for our economy and our political system, of measures that would increase the role of banks in our financial markets must be carefully weighed.

A third key factor is preservation of the stability of the banking system. To the extent that entry by banks into non-banking areas gives rise to conflicts of interest threatening the soundness of individual lending decisions or undermines depositor or public confidence in the banking system, the stability of the system is jeopardized. Similarly, if bank earnings become subject to volatile fluctuations resulting from undue dependence upon revenues from brokerage and underwriting, which are inherently cyclical, stability is undermined.

It should also be borne in mind from the outset that despite the commendable general movement towards deregulation of United States business, financial institutions are always likely to be subject to governmental oversight and regulation to a substantial extent. In light of their role as custodians of the funds of others and their pivotal importance to the functioning of the economy, it would be unrealistic to expect and unwise to promote total deregulation. This is not to say that there are not many aspects of the regulation of financial institutions that require elimination or reform, for clearly there are. The point is that today's presumption against regulatory restraints should not prevent consideration of the Glass-Steagall Act's restrictions as part of a larger regulatory

3. FDIC, 1980 BANK OPERATING STATISTICS (1981).

scheme. Indeed, that scheme surely will require further adjustments if Glass-Steagall is modified materially, to be certain that there will be no regulatory inequality.

These and other considerations are important to reasoned congressional deliberation on the legislative proposals now pending and others that may be proposed in the future that would alter existing restraints on permissible bank securities activities. The outcome of congressional consideration of these measures can have profound and irreversible effects throughout our financial system. Indeed, a material relaxation of the restrictions on bank securities activities could well result in a fundamental restructuring of the system into one in which commercial banks effectively control access to the credit markets. In light of the generally acknowledged inflexibility of many European national credit markets, where such a condition now generally exists, the potential long-term consequences of congressional action on this subject must not be minimized. On the immediate horizon, congressional action on this subject could have direct and substantial impact on the economic revitalization program Congress put in place in 1981—a program whose success will depend in great part upon the ability of the capital markets to efficiently supply vast quantities of investment capital.

Legislative Alternatives

Although the SIA believes that the separation of commercial banking and investment banking mandated by the Glass-Steagall Act continues to be sound public policy, significant recent developments in the financial services industry make the comprehensive review now under way in both houses of Congress entirely appropriate. The SIA expects that this review, which is a necessary precondition to informed action on any legislation that would materially alter the lines of Glass-Steagall, will result in reaffirmation of the existing law and recognition of the continued wisdom of its policy underpinnings. Nevertheless, if Congress should conclude that changes are in order, there are three alternative approaches that legislation could take.

One alternative, in theory, would be outright repeal of the Glass-Steagall Act, thereby removing the principal legislative restrictions inhibiting banks from full engagement in the securities business and securities firms from involvement in commercial banking. Because such an approach would represent high-risk radical surgery and would fail to address the concerns that occasioned enactment of the Glass-Steagall Act, it would seem to be

an unwise approach not likely to enjoy widespread support in Congress.

A second approach, embraced by a number of pending bills,[4] would be to authorize banks to directly engage in one or more activities now proscribed by Glass-Steagall. Although this approach would avoid some of the apparent shortcomings of the first alternative, if only because it is more limited, it too would present several significant drawbacks unless accompanied by provisions stripping banks of the special advantages accorded them because of their role as financial intermediaries and placing them on the same regulatory footing with securities firms when engaging in the newly authorized activities. Without such accompanying provisions, banks would be permitted to make use of special tax and other cost advantages accorded at the expense of taxpayers and depositors in support of activities that do not require public subsidy and would enjoy an unwarranted and unfair advantage over competing securities firms.

A third option would be to authorize bank participation in the securities business through a separate bank holding company subsidiary that would be subject to the same regulatory and tax treatment as applies to other firms engaged in comparable activities, with safeguards to prevent the relationship between the bank and the affiliate from giving rise to conflicts of interest, unfair competitive advantages, and threats to bank stability. Should Congress, after completion of its review, conclude that relaxation of the Glass-Steagall restrictions is in the public interest, the SIA believes that this overall approach is conceptually most sound. While this is the general approach proposed initially in 1981 by the Reagan administration, the SIA has a number of reservations about the specifics of that proposal, centering on the workability and adequacy of safeguards against the problems dealt with elsewhere in this article.[5]

In the sections which follow, we briefly review the history of congressional policy regarding permissible activities of commercial banks, identify the principal securities activities in which banks have engaged or attempted to engage, analyze bank conten-

4. *See infra* note 30.
5. *See Securities Activities of Depository Institutions: Hearings on S. 1720 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 438 (1982) (statement of Edgar Jannotta, SIA Chairman).

tions that other financial institutions have invaded their domain, and discuss the policy considerations which must be addressed in examining proposed relaxations of the Glass-Steagall Act. The final section seeks to impart the necessary perspective to the current debate concerning amendment of the Glass-Steagall Act by explaining the relationship of the Act to the larger body of legislation and regulation which governs the banking and securities industries.

HISTORY OF CONGRESSIONAL POLICY DEFINING PERMISSIBLE ACTIVITIES OF COMMERCIAL BANKS

Since enacting the National Bank Act in 1864,[6] Congress repeatedly has expressed its determination that the public policy of the United States must be to separate the business of commercial banking from unrelated areas of economic or commercial activity. In fact, the history of federal bank regulation largely has been an effort to restrain the domination of commercial banks over non-banking sectors of the economy. Although Congress has willingly accorded banks a number of special privileges that support and reinforce their position as principal suppliers of credit to the private sector, recognition of their central role and concerns about excessive concentrations of power, security of depositors' funds, conflicts of interest, and unfair competition have produced a generally cautious congressional attitude toward bank expansions into unrelated areas of business.

In 1933, Congress recognized the dangerous involvement of commercial banks in non-banking fields, particularly in the securities industry, and decisively moved to terminate such activity. In enacting the Banking Act of 1933,[7] the securities provisions of which are commonly known as the Glass-Steagall Act, Congress prohibited banks from entering the securities field as well as other non-banking areas. It enumerated the direct powers of national banks in Section 16 of that Act[8] and described certain limited incidental powers that would be permitted in order for the business of banking to be conducted efficiently.[9] The Act further

6. National Bank Act, ch. 106, 13 Stat. 99 (1864) (codified as amended at 12 U.S.C. § 38 (1976)).

7. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12, 15, and 39 U.S.C.).

8. 12 U.S.C. § 24 (1976 & Supp. IV 1980), *amended by* Act of Aug. 13, 1981, Pub. L. No. 97-35, 95 Stat. 743.

9. Among those incidental powers is a very narrowly circumscribed ability to purchase and sell securities limited only to: "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock." 12 U.S.C. § 24 (Supp. IV 1980).

prohibited an entity that issues, underwrites, sells or distributes securities from engaging in the banking business and forbade member banks of the Federal Reserve System from being affiliated with securities firms, either directly or through interlocking directorships.[10]

The Glass-Steagall Act was a product of congressional indignation over the role of national banks in fostering the pre-panic speculation leading to the national financial crises of the 1920's and 1930's:

> The outstanding development in the commercial banking system during the pre-panic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds. The effects of this situation in changing the whole character of the banking problem can hardly be overemphasized. National banks were never intended to undertake investment banking business on a large scale, and the whole tenor of legislation and administrative rulings concerning them has been away from recognition of such a growth in the direction of investment banking as legitimate. . . .[11]

As viewed by the Supreme Court, the Glass-Steagall Act reflected a "determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers' " that arise when commercial banks engage in such activities proscribed by the Act as general securities trading.[12] We believe these "hazards" and

10. 12 U.S.C. §§ 377, 378(a)(1) (1976).

11. S. REP. No. 77, 73d Cong., 1st Sess. 8 (1933). This purpose is also reflected by the comments on the Senate floor of Senator Glass, the Senate sponsor of the Act:

> Not only has the Federal reserve banking system been used in an inordinate measure in stock-market transactions but there appears to have been an extraordinary misconception by the administrators of the [Glass-Steagall] act of its real purpose. In large degree the system has been transformed into an investment banking system, whereas the fixed purpose of Congress was to set up a commercial banking system and to preclude speculative operations . . . .

75 CONG. REC. 9884 (1932) (statement of Sen. Glass). Furthermore, Representative Steagall, co-sponsor of the bill, stated in debate:

> [T]he purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again upon demand.

77 CONG. REC. 3837 (1933) (statement of Rep. Steagall).

12. Investment Co. Inst. v. Camp, 401 U.S. 617, 630 (1971). For a review of the legislative history of the Glass-Steagall Act as well as the Bank Holding Company Act of 1956 and the Bank Holding Company Act Amendments of 1970, discussed

"financial dangers" are as real today as ever, since no evidence yet tendered suggests that investment bankers have discovered a way to eliminate financial risks from the underwriting business, or a method of distributing securities without promotional activity.[13]

Although the Glass-Steagall Act is the principal legislative constraint to bank involvement in the securities industry, the larger theme which it sounded—the necessity of separating banking from other areas of commerce—has predominated subsequent bank reform legislation. The Bank Holding Company Act of 1956[14] was intended, among other things, to separate banking from other areas of commerce. Such separation was felt necessary to prevent banks from utilizing in non-banking enterprises funds entrusted by depositors and to guard against banks taking unfair advantage in competing with non-banking enterprises.[15]

These same concerns, as well as fear of undue concentration of power in bank holding companies, led to enactment of the Bank Holding Company Act Amendments of 1970.[16] The principal purpose of the 1970 amendments was to close the 1956 Act's one-bank holding company loophole to preserve the basic separation of bank and bank-related activities from other business activities.[17] As indicated in the following colloquy occurring during Senate floor actions on the amendments, the Congress was careful to avoid any narrowing of the restrictions of the Glass-Steagall Act:

> MR. WILLIAMS of New Jersey. . . . I wonder whether there was any intention to imply that the very securities-related activities forbidden to banks directly may nevertheless be engaged in by bank-holding companies or their non-banking affiliates.
>
> MR. SPARKMAN. The answer to the Senator's question is that there clearly was not.[18]

Thus, on the three occasions over the past half-century when the Congress has directed concerted attention to the issue—1933,

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infra notes 14-19 and accompanying text, see *SIA Discussion Paper*, *supra* note 1, at Appendix I.

13. The best demonstration of the risks that remain inherent in underwriting was provided by the offering in 1979 of $1 billion of IBM debentures. An unexpected increase in interest rates immediately after the issue was priced left the underwriting synidcate with large losses that were never publicly disclosed but which have been estimated to range from $10 million to $20 million.

14. Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1844, 1846-1848 (1976 & Supp. IV 1980)).

15. *See SIA Discussion Paper*, *supra* note 1, at 803, 804.

16. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified as amended at 12 U.S.C. §§ 1841-1843, 1849, 1850, 1971-1978; 31 U.S.C. §§ 317(c), 324, 324(b), 324(c), 391, 405(a)(1) (1976 & Supp. IV 1980)).

17. S. REP. No. 1084, 91st Cong., 2d Sess. 2, 3, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 5519, 5520-22.

18. 116 CONG. REC. 42,430 (1970) (statements of Sens. Williams and Sparkman).

1956 and 1970—it has in each instance concluded that the range of non-banking activities in which commercial banks and their affiliates should be permitted to engage must be carefully circumscribed in the interest of sound public policy. Nonetheless, in recent years commercial banks have expanded their operations into numerous non-banking fields. Among the businesses in which they have engaged, or attempted to engage, are operating an insurance agency, providing financial and management consulting services, operating travel agencies, and providing data processing services.[19] And, as is described in the next section, their role in various aspects of the securities business undoubtedly has developed beyond anything dreamed of when the Glass-Steagall Act was adopted.

SECURITIES ACTIVITIES OF BANKS

At the time of enactment, the regime established by the Glass-Steagall Act seemed unequivocal and unambiguous—a sharp separation of the commercial banking and securities industries with limited and very tightly defined exceptions.

By way of example, the Act clearly contemplated that banks could continue to execute so-called "accommodation transactions" on behalf of their existing customers.[20] This exemption initially was viewed to be quite narrow—to cover situations where no brokerage house was located in a particular community.[21] The Act also contained an exemption permitting banks to continue to

19. According to Senator Proxmire's statement introducing the Competition in Banking Act of 1975:

> [I]t appears that banks have engaged, or attempted to engage, in the following nonbanking activities: (1) operating an insurance agency; (2) underwriting securities other than those exempt under section 24 of Title 12; (3) privately placing non-exempt securities; (4) providing financial counseling services; (5) providing investment advisory services to closed-end investment companies; (6) operating mutual funds; (7) providing securities brokerage services; (8) operating travel agencies; (9) providing armored car services; (10) providing data processing services; and (11) leasing automobiles.

121 CONG. REC. 37, 943-47 (1975).

20. *See supra* note 9.

21. Despite early rulings of the Comptroller of the Currency interpreting this exemption restrictively, subsequent revisions by the Comptroller have considerably expanded the original notion. *See, e.g.*, Ruling of the Comptroller of the Currency, Jan. 8, 1980, *reprinted in* [1981-82 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,210 (national banks authorized to act as agents for customers in open-end investment companies shares transactions).

underwrite and distribute United States Government obligations and general obligations of state and municipal governments.[22] These were the only express exceptions to the otherwise prevailing prohibition against bank involvement in the securities business.

Despite the apparent expectations of Congress in adopting the Glass-Steagall Act, the years since its enactment have witnessed extensive and increasing involvement by commercial banks in the securities business. Although certain of these activities are admittedly peripheral to the underwriting and marketing functions with which the Congress was most concerned,[23] others clearly are close to the core of investment banking activity.[24]

The following subsections briefly describe the principal activities of commercial banks in the securities area. Although there is substantial question concerning the legality of certain of these functions,[25] it should be apparent from the range of described activities that banks hardly are straitjacketed by existing law, as applied by the bank regulatory agencies.

Investment Advisory Services

Apart from their own assets, banks are responsible for the management of more funds than any other type of financial institution. In their capacity as fiduciaries, banks manage the assets of pension and other employee benefit plans and of trusts and estates of individuals. In their capacity as agents, they manage the portfolios of a variety of individual and corporate customers. In addition, banks serve as investment advisers to both open-end and closed-end investment companies and also act as investment advisers to real estate investment trusts ("REITs"), which, in many cases, they initially sponsored.

Brokerage Related Services

Banks offer their customers several brokerage-related services, such as dividend reinvestment plans under which shareholders of a participating corporation may request that their dividends be paid directly to a bank, which pools the dividends received and purchases additional shares of the corporation's stock in the open market. Besides pooling funds, some banks perform a more tradi-

22. 12 U.S.C. § 24 (1976 & Supp. IV 1980).

23. Included among these activities are bank trust advisory services and syndication of long term loans.

24. Such activities include bank marketing of commercial paper and acquisition of brokerage firms with independent customer pools.

25. *See SIA Discussion Paper*, *supra* note 1, at 760-65.

tional type of brokerage by executing agency transactions for their trust and other managed accounts, as well as for banking customers, through a registered broker-dealer.[26]

Developments in late 1981 signaled a potential giant step in bank involvement in the brokerage business. In November 1981, BankAmerica Corporation, the holding company of the nation's largest commercial bank, announced its intention to acquire Charles Schwab & Company, Inc., the nation's largest discount brokerage firm. Shortly thereafter, Security Pacific National Bank, the ninth largest commercial bank, announced an arrangement under which brokerage services would be actively marketed by Security Pacific, with execution of orders to be performed by Fidelity Brokerage Services, Inc.[27]

Investment Banking Services

Under the Glass-Steagall Act, commercial banks may underwrite and distribute to the public certain specified debt instruments, including obligations of the United States, general obligations of states and their political subdivisions for housing, university or dormitory purposes, and a limited number of other government securities.[28] In recent years, however, the Comptroller of the Currency has permitted commercial banks to underwrite and distribute instruments which do not fit squarely into any of the Act's circumscribed categories.[29] Legislation now pending, if enacted, would remove entirely the Glass-Steagall Act's limitations on commercial bank underwriting, and would permit commercial banks to underwrite and deal in all federal,

26. In a related context, two federally chartered savings and loan associations (as to which application of the Glass-Steagall Act is uncertain) recently applied for regulatory permission to organize, through a service corporation, a registered broker-dealer that could effect securities transactions for customers of similar thrift institutions around the nation. *See* SEC. WEEK, Jan. 25, 1982, at 11.

27. At the time of this writing, no regulatory determination on either of these proposals—which raise substantial legal as well as policy issues—had been made.

28. 12 U.S.C. § 24 (1976 & Supp. IV 1980). These banks reportedly purchase more of their syndicate participation for their own accounts than they distribute. E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 12 (1975).

29. *See* 12 C.F.R. §§ 1.3-1.5 (1982); *see also* Ruling of the Comptroller of the Currency, *reprinted in* [1981-1982 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 82,201 (obligations of private non-profit corporation formed at the request of the state issued to purchase student loans from originating banks are obligations issued by a state for university purposes).

state and local government revenue and general obligation bonds of investment grade, except industrial revenue bonds.[30]

Apart from underwriting, the investment banking activities of commercial banks generally take two forms, the rendering of financial advice to corporations and the funding or furnishing (or both) of funds for the long-term capital needs of corporations.

Financial counseling may be provided for a fee either on a long-term basis or for specific projects (e.g., the financing of a new plant) and generally comprehends the customer's total need for financing, ranging from short-term borrowings to permanent capital.[31] Where funds are to be obtained other than through the bank itself, the bank frequently will assist its customer in preparing the necessary documents for a private placement[32] or selecting and negotiating with an underwriter in the case of a public offering. Banks also furnish advice in connection with corporate reorganizations, including mergers and acquisitions, and sometimes perform appraisal services in connection with such transactions.

Banks also serve directly as a source of long-term funds, either through their own lending facilities or by arranging private placement of securities with other lenders. At the time the Glass-Steagall Act was enacted, bank lending typically was short-term in character, ranging from demand to ninety-day loans. Since then, banks have gradually increased the maturity of their loans, so that term loans (those exceeding one year in maturity) now constitute a very substantial proportion of industrial and commercial loans of major commercial banks.[33] Frequently, these loans are made through syndicates of banks, which contain from a handful to a substantial number of domestic, and sometimes foreign, banks. Syndicated bank loans are effected for domestic and foreign borrowers and are extended both by United States banks and their overseas affiliates.[34]

In addition to providing long-term funds themselves, banks have become quite active in arranging, for a fee, private placements of securities of all types, from long-term bonds to equities,

30. *See* S. 1720, 97th Cong., 1st Sess., 127 CONG. REC. S11,254 (daily ed. Oct. 7, 1981); H.R. 4040, 97th Cong., 1st Sess., 127 CONG. REC. H4048 (daily ed. June 26, 1981); H.R. 2828, 97th Cong., 1st Sess., 127 CONG. REC. H1143 (daily ed. Mar. 25, 1981).

31. In two private interpretive letters dated Nov. 11, 1974 and Jan. 15, 1975, the Comptroller authorized the provision of financial counseling services by national banks. *See SIA Discussion Paper*, *supra* note 1, at Appendices IIA and IIB.

32. *See id.* In those same letters, the Comptroller also authorized limited bank involvement in private placement activities.

33. *See* 62 FED. RES. BULL. A23 (1976).

34. *See* exhibits in *SIA Discussion Paper*, *supra* note 1, at Appendix III.

with a variety of institutional lenders.[35] Although some of the commercial banks most active in the private placement of securities do not report the extent of those activities, during 1980 those banks which did report were involved in over $800 million of private placements.[36] In some instances, banks participate in private placements they have arranged by purchasing for portfolios under their management a portion of the securities to be sold. On occasion a bank will assemble for a customer a financing package consisting of a medium-term loan from the bank itself, together with a private placement to provide the ultimate long-term financing and "take-out" the bank.[37]

In 1978, Bankers Trust Company of New York inaugurated a new business for commercial banks by underwriting and marketing third-party commercial paper (i.e., short-term, unsecured corporate obligations). In July 1981, the United States District Court for the District of Columbia invalidated a ruling of the Federal Reserve Board which had sustained this practice as being consistent with the Glass-Steagall Act.[38]

Since the Glass-Steagall restrictions do not apply to their foreign securities activities, banks based in the United States have been engaging in an ever-increasing range of investment banking activities overseas. These banks participate in large syndicated bank loans to foreign borrowers and Eurobond underwriting systems through foreign branches, Edge Act corporations,[39] and investments in foreign banks; in addition, they offer financial counseling services.[40] And, under regulations adopted in 1981 by

35. *See* private interpretive letters of the Comptroller, *supra* note 31.

36. INVESTMENT DEALER'S DIGEST, Mar. 3, 1981, at 36.

37. *See* E. HERMAN, *supra* note 28, at 47-48.

38. *See* A.G. Becker, Inc. v. Board of Governors of Fed. Reserve Sys., 519 F. Supp. 602 (D.D.C. 1981), *appeal docketed*, No. 81-2070 (D.C. Cir. Sept. 2, 1981).

39. Edge Act corporations are corporations organized under 12 U.S.C. §§ 611-631 (1976 & Supp. IV 1980):

> for the purpose of engaging in international or foreign banking or other international or foreign financial operations, or in banking or other financial operations in a dependency or insular possession of the United States, either directly or through the agency, ownership or control of local institutions in foreign countries, or in such dependencies or insular possessions as provided by sections 611-631 of this title [which may] act when required by the Secretary of the Treasury as fiscal agents of the United States, [and which] may be formed by any number of natural persons, not less in any case than five . . . .

Id. § 611.

40. Eurobonds are securities publicly offered by an international underwriting syndicate in more than one country. Of the 173 Eurobond offerings in 1975, it was

the Federal Reserve Board,[41] these banks are now able to engage in international banking through on-shore "international banking facilities"—the income from which is exempt from state and local taxes—unfettered by the reserve requirements and interest rate limitations otherwise applicable to their domestic operations.

If history is a guide, major commercial banks will continue to extend their activities in the securities industry under existing law. Now pending are a number of proposals which collectively would largely eviscerate the Glass-Steagall prohibitions against commercial bank involvement in the investment banking business. In addition to the proposal to permit bank underwriting and distribution of municipal revenue bonds, others would permit them directly to underwrite all types of corporate obligations[42] and to establish, operate and sell interests in money market mutual funds.[43]

BANK ALLEGATIONS OF ENCROACHMENT BY OTHER FINANCIAL INSTITUTIONS

In support of their efforts to eliminate Glass-Steagall Act limitations, bankers are increasingly heard to argue that changed circumstances and developments unforeseen by Congress in enacting Glass-Steagall have rendered its restrictions both anachronistic and unnecessary. Frequently cited examples are the emergence of money market mutual funds and special brokerage accounts featuring automatic investment of idle balances in a money market fund, combined with access to funds so invested, or borrowed on margin, by check or credit/debit card ("asset management accounts"), as well as recent corporate combinations of non-bank financial institutions.[44] Bankers contend that in light of these developments, Glass-Steagall restrictions are unfairly restraining banks while securities firms and other financial institutions are given free rein to encroach on the banking business.

While it is easy to cite many materially changed circumstances

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reported that Manufacturers Hanover Ltd., an affiliate of Manufacturers Hanover Trust Company, participated in 159, Citibank's foreign affiliate in 128, Bank of America's in 99, Bankers Trust's in 48 and First Chicago's in 36. *Lessons the Banks Learned From Overseas Misadventures*, BUS. WK., Apr. 19, 1976, at 104.

41. *See* 12 C.F.R. § 211 (1982).

42. *See, e.g.*, H.R. 4040, 97th Cong., 1st Sess., 127 CONG. REC. H4048 (daily ed. June 26, 1981).

43. *See, e.g.*, S. 1720, 97th Cong., 1st Sess., 127 CONG. REC. S11,254 (daily ed. Oct. 7, 1981).

44. *See Competition and Conditions in the Financial System: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 240-47 (1981) (statement of Gordon T. Wallis, Pres., N.Y. Clearing House Ass'n).

since enactment of Glass-Steagall, perhaps the best example of which is the high inflation that has beset our economy and the record interest rates it has engendered, to acknowledge this reality is not necessarily to conclude that the restrictions of Glass-Steagall have lost their validity. In fact, the examples cited by the bankers, upon examination, have little if any bearing on whether the Glass-Steagall Act requires amendment.

To assess these contentions, it is well to bear in mind the essential attribute which distinguishes the business of banking from the activities of other financial institutions. The extension of credit alone is not the distinguishing feature since for many years business loans have been made by non-bank institutional lenders, such as insurance companies and pension funds, and retail credit has been available from charge card issuers, as well as from consumer finance companies and individual retail establishments.

Rather, what distinguishes banks is that they extend credit from the proceeds of deposits received from their customers. The acceptance of deposits, which gives rise to a debtor-creditor relationship between banks and their customers and which in turn provides the assets to support bank lending, has long been the generally recognized hallmark of the banking business under state and federal law. With this essential distinction firmly in mind, one can examine the bankers' specific contentions regarding money-market mutual funds, asset management accounts and mergers of non-bank financial institutions.

Prior to the advent of money market mutual funds, money market instruments such as short-term commercial paper, certificates of deposit and Treasury bills were generally beyond the investment reach of small investors because of their large denominations.[45] What the money market funds have done is make it possible for small investors to hold continuing interests in a diversified and changing portfolio of money market instruments, with the potential of realizing high yield and diversification of risk not previously possible. For investor convenience, many money market funds also offer a "check redemption" procedure whereby a shareholder may write a check payable to a third party against a checking account maintained by the fund with a commercial bank.

The shareholder's investment in a money market fund takes the

45. *See id.* at 1177 (statement of the Investment Company Institute).

form of shares of common stock in the fund upon which dividends are declared and paid daily. The value of the shareholder's equity fluctuates directly with the value of the fund's portfolio, which is comprised of short-term money market instruments. This type of investment is sharply distinguishable from a bank deposit, in which the depositor is a creditor entitled to a fixed rate of return and deposit insurance up to a prescribed ceiling.

If banks have legitimate grounds for concern about money market mutual funds, it is not that they encroach upon banking, since to the extent they have a feature resembling banking—redemption checking—commercial banks are utilized. Rather, it is that they are attracting the assets of potential depositors away from the banks, in large part because of extraordinarily high interest rates. If the banks require governmental action to redress the situation, they should be seeking accelerated removal of ceilings on interest payable by banks or a lowering of interest rates through economic revitalization, not authority to engage in investment banking, which will not increase bank deposits but will subject banks to all of the risks inherent in investment banking.

Many of the same points apply to asset management account programs. These programs combine traditional broker services with a money market mutual fund and provide access to the investors' assets and the margin account via either a check or a credit/debit card. Again, a commercial bank is utilized in implementing both the checking and credit/debit card features.

In effect, an asset management account is no more than a packaging of several services that have been offered separately for some time. To the extent it incorporates a service traditionally offered by banks, the service is performed by a bank. As the many unsuccessful legal efforts to challenge these programs attest, they do not involve broker encroachment upon the business of banking as traditionally defined.[46] As with money market mutual funds, they do, however, have obvious attractiveness to investors. To the extent bankers are apprehensive about the relative unattractiveness of bank-offered packages of financial services attributable to the disparity between earnings realizable through an asset management account and those from bank deposits, the solution lies in seeking to eliminate this disparity, not by permitting banks to engage in the securities business.

Bankers also cite recent corporate combinations of non-bank financial institutions to support weakening of the Glass-Steagall

46. *See, e.g.*, Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46 (1981) (Federal Reserve regulation authorizing bank holding companies to act as investment advisors upheld).

Act.[47] It is difficult to see how such mergers are relevant to the separation of commercial banking and investment banking established by Glass-Steagall. No one claims that such combinations have injected securities firms into the business of banking. To the extent the bankers' argument is directed at any potential anticompetitive effects of these combinations, there has been no indication that the antitrust laws will not provide adequate protection. If, on the other hand, bankers feel they are entitled to some new opportunities to enter other lines of business to "compensate" for these mergers, their argument, for what it may be worth, should be directed at the Bank Holding Company Act, not Glass-Steagall.

EXAMINATION OF POLICY ISSUES

This section will explore some of the fundamental policy issues raised by bank participation in securities activities, starting with a discussion of national policy objectives for the banking and securities industries.

Public Policy Objectives

In assessing the advisability of adjustments in the Glass-Steagall Act, it is necessary to identify the goals of a national policy regarding the banking and securities industries. We believe an appropriate list of major policy objectives would include the following: (a) to promote maximum efficiency in the capital markets;[48] (b) to create an environment in which financial institutions have both the incentive and flexibility to meet the

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47. *See Competition and Conditions in the Financial System: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 243-44 (1981) (statement of Gordon T. Wallis, Pres., N.Y. Clearing House Ass'n).

48. The Report of the Joint Conference Committee on the Securities Acts Amendments stated:

> The securities markets of the United States are indispensable to the growth and health of this country's and the world's economy. In order to raise the enormous sums of investment capital that will be needed in the years ahead and to assure that that capital is property allocated among competing uses, these markets must continue to operate fairly and efficiently. The increasing tempo and magnitude of the changes that are occuring in our domestic and international economy make it clear that the securities markets are due to be tested as never before. Unless these markets adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the Nation will suffer.

rapidly changing demands of our economy;[49] (c) to create a climate in which public trust in intermediating institutions is high;[50] (d) to encourage widespread direct public ownership of American industry;[51] (e) to promote fair competition not only within markets but between markets for substitute products;[52] (f) to limit the concentration of economic and political power of any one sector;[53] and (g) to protect investors and depositors against improper practices which might jeopardize their investments and savings.[54]

These goals frequently may be in conflict; nevertheless, a workable reconciliation among them should be attainable. For example, a reasonable balance between promoting economic efficiency and limiting concentration can be struck by limiting the areas of direct competition between different types of institutions (i.e., commercial banks and investment banking firms) while encouraging these institutions to offer close substitutes for each other's products and providing for ease of entry by new competitors into each of the markets.

The remaining subsections discuss the desirability of separating the banking and securities industries to maximize attainment of the above policy objectives. For the reasons set forth, we believe that further erosion of the Glass-Steagall Act's basic tenets, by legislation or otherwise, will seriously frustrate a balanced realization of the above goals.

Economic Advantages Given to Banks by Government

Financial intermediation by banks involves the accumulation of savings as deposits and the lending of those funds to those with

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H.R. REP. NO. 229, 94th Cong., 1st Sess. 91 (1975), *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 321, 322.

49. *Business Week* estimates that during the decade 1975-84, $4.5 trillion in capital investment will be needed by the economy, nearly three times the $1.6 trillion consumed in the 1965-74 decade. *The Capital Crisis*, BUS. WK., Sept. 22, 1975, at 42.

50. *See* J. Lorie, Public Policy for American Capital Markets 4-5 (Feb. 7, 1974) (prepared for submission to the Secretary and the Deputy Secretary of the Treasury).

51. *See id.*

52. *See* Lewis v. BT Inv. Managers, Inc., 447 U.S. 27, 46-47 (1980) (Florida statute prohibiting out-of-state banks from owning business within state providing investment advisory services held violative of commerce clause).

53. *See id.*

54. The preamble to the Securities Exchange Act of 1934 states in part:

> For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . to insure the maintenance of fair and honest markets in such transactions.

Securities Exchange Act of 1934, ch. 404, § 2, 48 Stat. 881, 881-82 (codified as amended at 15 U.S.C. §§ 77-78 (1976 & Supp. IV 1980)).

capital needs. This transfer process is a primary economic function of financial intermediaries. There are essentially two cost elements in the intermediation of funds: (1) the rate of return required to induce holders of excess funds to deposit them; and (2) the costs of the intermediation process. The privileges that banks enjoy, at the expense of both taxpayers and depositors, are intended to lower those costs so that those who need funds may obtain them relatively inexpensively.

For example, federal deposit insurance serves to lower the rates of return required to attract depositors by making bank deposits up to prescribed levels virtually "risk free." Such rates of return also have been kept artificially low through governmental action setting interest ceilings on deposits at levels below the rate that market forces would otherwise dictate, or in some cases prohibiting interest on certain types of deposits. Another significant example is the so-called "All Savers" program recently authorized by the Economic Recovery Tax Act,[55] under which commercial banks and other depository institutions are issued risk-free certificates bearing interest at a rate equal to 70 percent of the one-year Treasury bill rate, such interest being tax-free to individuals up to substantial levels ($2,000 for individuals filing a joint return). Moreover, the direct costs of intermediation are reduced through the favorable tax treatment accorded banks for interest expenses[56] and loss reserves,[57] which increases their after-tax

55. Economic Recovery Tax Act, Pub. L. No. 97-34, §§ 302(a), (d)(1), 95 Stat. 267, 270-71, 274 (1981) (to be codified at 26 U.S.C. § 128).

56. Banks are permitted to deduct interest expenses incurred to hold tax-exempt municipal bonds. Rev. Rul. 61-222, 1961-2 C.B. 58. This issue has become particularly relevant in connection with the quarter-century-old demand by money center banks to underwrite municipal revenue bonds. Addressing the Subcommittee on Select Revenue Measures of the House Ways and Means Committee in April, 1981, on the ability of banks, unlike other taxpayers, to deduct the cost of interest to maintain a position in tax exempt securities, Assistant Secretary of the Treasury John Chapoton said:

> The treatment of banks under section 265(2) [of the Internal Revenue Code] creates other serious problems. For example, banks, which in most situations are not subject to section 265(2), compete in underwriting activities with broker-dealers, which, as a group, do not enjoy this exception. We believe that this matter should be reconsidered in the context of the current discussion of whether banks should be permitted to underwrite municipal revenue bonds.

Revenue Procedure 80-55: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 97th Cong., 1st Sess. 4, 7 (1981) (statement of John Chapoton, Assistant Secretary of the Treasury).

57. Although this provision is being gradually phased out, banks are permitted

income.

In addition, banks have ready access to short-term capital at low cost through access to the federal funds market and the Fed's discount window. The cost to banks of long-term capital is also lower because of reduced risks associated with investment in the banking business. Such reductions in risk result in part from the readiness of the Fed to provide low cost credit through the discount window to meet banks' temporary liquidity problems.

Economists would classify these special advantages and privileges—deposit insurance, access to the discount window and the federal funds markets, interest rate ceilings and tax breaks—as "subsidies," the purpose of which is to lower the cost of intermediation of funds and thus to lower the cost of funds to borrowers. These subsidies are paid for directly or indirectly by the public.

The subsidies are provided to banks in the expectation they will be passed on to borrowers of funds, thereby reducing borrowing costs, making credit more freely available and stimulating economic growth. It would constitute a clear departure from the purpose of the subsidies for banks to employ them in securities or other non-banking activities. In effect, it would represent a diversion of a public subsidy from its intended purpose, and would accord banks, which already enjoy a position of concentrated power, an unwarranted advantage that would frustrate competition and innovation in the securities business.

Other Competitive Advantages of Banks

Increasing bank involvement in securities activities is likely to produce several other anti-competitive effects, making it extremely difficult for others to compete on equal terms. These include regulatory inequality and heightened potential for tie-ins.

Section 3(a)(4) of the Securities Exchange Act defines the term "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others, *but does not include a bank*."[58] This statutory exclusion was based on the congressional understanding that banks were prohibited from engaging in the business of dealing in securities under the Glass-Steagall Act. Those who are classified as "brokers" under the Securities Exchange Act are required to conform to a comprehensive system of governmental and self-imposed regulation developed over the years for the protection of investors. Among

to reserve against future loan losses and to deduct such reserve from gross income. I.R.C. § 585 (1976).

58. 15 U.S.C. § 78c(3)(a)(4) (Supp. IV 1980) (emphasis added).

the standards and safeguards provided under this system, but inapplicable to banks and thus unavailable to their brokerage customers, are those relating to advertising, broker training, suitability, prompt and best execution, prompt delivery of securities and confirmations with regard to each transaction, disclosure of adverse information, and insurance under the Securities Investor Protection Act. Despite the recommendations of a special report to Congress on the bank "broker-dealer" exemption completed by the Securities and Exchange Commission (SEC) in 1977,[59] the bank regulators have taken only the most tenuous steps to provide meaningful protection for bank securities customers.[60] Thus, banks enjoy a substantial regulatory advantage over securities firms inasmuch as they are not subject to the strict regulation to which securities firms are subject,[61] which adds to the operating costs of these firms, while affording less protection to those who invest in securities through banks. If Glass-Steagall's restrictions are to be attenuated significantly, regulation of

59. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 95TH CONG., 1ST SESS., REPORTS ON BANKS SECURITIES ACTIVITIES OF THE SECURITIES AND EXCHANGE COMM. 289 (Comm. Print 1977) (final report of the Securities Exchange Commission on bank securities activities).

60. The bank regulatory agencies have not even attempted to address certain key recommendations of the SEC. For example, bank securities personnel still are subject to no testing or licensing requirements or to any regulations governing their substantive knowledge of the securities business or its legal requirements. Moreover, the limited steps that have been taken by bank regulatory agencies do not come close to approximating the system of broker-dealer regulation designed for the protection of investors. In 1979, in response to the SEC's recommendations, the banking agencies adopted regulations governing recordkeeping and confirmation requirements and requiring banks to establish written policies and procedures providing for, among other things, the assignment of responsibility for supervision of securities personnel. 12 C.F.R. § 12 (1982) (Comptroller); 12 C.F.R. § 208 (1982) (Federal Reserve Board); 12 C.F.R. § 344 (1982) (FDIC). There are a number of discrepancies between these rules and the rules of the SEC, however. For example, the SEC's confirmation rule requires that broker-dealers generally must send customers a written confirmation of a securities transaction within five days of the transaction. Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10 (1982). The rules of the bank agencies provide several exceptions to this requirement that are not present in the SEC's rules, such as permission for quarterly confirmations where the bank exercises investment discretion over an account in an agency capacity. In addition, unlike the regulations applicable to broker-dealers, no particular procedures are specified to ensure adequate supervision of employees effecting securities transactions for customers. In sum, the rules of the banking authorities tend to be considerably more general than those of the SEC, in many cases relying on reference to "sound banking practices" rather than the more specific regulations applicable to securities firms.

61. *See SIA Discussion Paper*, *supra* note 1, table 2, at 781-82.

bank securities activities would be best performed by a single regulator: the Securities and Exchange Commission.

Another important competitive advantage wielded by banks when they market securities services derives from the ability of commercial banks to extend credit, the availability of which can be "tied" to use of the bank's securities services. These tie-ins may be explicit or implicit,[62] but in either case they involve the linkage of bank credit facilities with securities services.

A bank may condition the availability of its credit facilities on an issuer's patronage of the bank's private placement or commercial paper services. For example, most commercial paper is backed by a bank line of credit. This gives banks the opportunity to tie the availability of a credit line to use of the bank as distributor of commercial paper for the issuer.

Similar potential for a tie-in arises when a bank extends a letter of credit to support a certain type of tax exempt housing revenue bond issue underwritten by a syndicate co-managed by a bank. These instruments, known as "option bonds" or "put bonds," give the holders the right to have their bonds redeemed at par on certain dates up to thirty years in the future regardless of the current market value. The letter of credit is provided, at a very substantial fee, to fund payments to bondholders exercising their redemption option. The large money center banks have the unique ability to condition the granting of the letter of credit on being awarded managing underwriter status and reportedly have done so frequently.[63]

In light of these key advantages, together with the exclusive privileges banks enjoy as intermediaries, creation of a "level playing field" would require far more than simple repeal of Glass-Steagall limitations.[64]

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62. The opportunity for implicit tie-ins, which can be the most insidious, was discussed and illustrated by Richard W. McLaren, then Assistant Attorney General in charge of the Antitrust Division, in testimony before the Senate Banking and Currency Committee when it was considering the 1970 one bank holding company legislation. *See SIA Discussion Paper*, *supra* note 1, at 783 n.94.

63. Examples of this practice are discussed in Carrington, *Wall Street Officials Tell Senate Panel Securities Bill Gives Banks Unfair Edge*, Wall St. J., Feb. 11, 1982, at 6, col. 1.

64. In announcing the Administration's "separate subsidiary" proposal, Treasury Secretary Regan recognized the inequalities and other problems inherent in the approach taken in S.1720 (and other pending proposals) which would authorize banks directly to enlarge their securities activities and sharply distinguished the Administration's approach:

> Our proposed bank holding company securities subsidiary would have the same tax treatment as an independent securities firm, the same regulators and the same access to outside financing and outside customers. In contrast, leaving securities activities submerged within the corporate structure of a commercial bank as S.1720 presently does would afford the

Preserving the Stability of the Banking System

There are three primary requisites to a stable banking system that are becoming increasingly threatened as banks are permitted to become extensively involved in securities activities: (1) the making of prudent and disinterested loans and investments; (2) the maintenance of a relatively stable flow of revenue; and (3) the continued confidence of depositors and the public generally.[65]

Disinterested lending is the bedrock of commercial banking. It is a critical function of banks to make loan and investment decisions solely on the basis of the financial prudence of each transaction. The conflicts of interest that arise when banks also engage in securities-related ventures severely undermine a bank's ability to continue making disinterested banking decisions.[66] As an example, at the height of activity of the REIT[67] industry, it was a common bank practice to extend loans to a REIT to which the bank or its affiliate was providing investment advisory services and sponsorship. Although the amount of such loans has declined significantly with the general decline in REITs, they illustrate the dangerous temptations to which banks may succumb in promoting securities services.[68]

> bank several advantages in the securities business. The bank's securities activities would have preferential tax treatment, particularly as regards the carrying of securities in inventory; they would be regulated by the Federal bank regulatory agencies for which securities activities are only a limited aspect of bank business; they would have access to financing based on the cost of the bank's insured deposits; and they would have opportunities for the non-arm's length linkage of traditional bank services to the securities business of the bank. There are too many inequalities here to satisfy the goal of equal treatment for all financial institutions doing the same kinds of business.

Financial Institutions Restructing and Services Act of 1981: Hearings on S. 1638, S. 1703, S. 1720 and S. 1721 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong., 1st Sess. 16 (1981) (statement of Donald T. Regan, Secretary of the Treasury).

65. *See supra* notes 48-54 and accompanying text.

66. This was a specific focus of the Supreme Court in its review of congressional concern in this field. *See* Investment Co. Inst. v. Camp, 401 U.S. 617, 630-34 (1981).

67. *See supra* text accompanying notes 25-26.

68. After a lengthy review of the legislative history of the Glass-Steagall Act and the possibility of serious problems that could result from the involvement of banks in the securities field, the Supreme Court in *ICI v. Camp* stated:

> In sum, Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment bankers' pecuniary stake

Similarly, should an issuer for whom a bank has effected a private placement find itself in unexpected financial difficulty, the bank may feel obliged to extend a loan which might not otherwise conform to its normal credit standards. It understandably would seek to avoid possible embarrassment and damage to its reputation among the institutions which had purchased the private placement or the possibility of threatened litigation by the purchasers under the securities laws.

Also, if a bank selling commercial paper is unable to place the paper successfully, it must buy or keep the remainder for its own account. This could result in a significant allocation of the bank's assets to issuers whose credit is the most difficult to place, i.e., those whose paper is least acceptable to buyers of commercial paper.

The second key element of bank stability is a steady source of revenue. The commissions and underwriting revenues earned by securities brokers are inherently cyclical.[69] In addition, although banks are now permitted to underwrite general obligation bonds because relatively few risks were involved, even this area of the securities industry entails significant risks for banks: shortly before its demise, the Franklin National Bank lost $5.6 million in the value of securities carried in the bank's security trading account or bond dealer operations.[70] Even greater risks exist in the case of commercial paper since it is not backed by the taxing power of a governmental entity.

Moreover, because banks and brokers appear to be similarly affected by the business cycle, greater participation in the securities business would tend to accentuate fluctuations in a bank's income from its banking business. These fluctuations in bank earnings erode public confidence (as is now occurring with thrift institutions), which in turn undermines the financial system.

A third element of bank stability is depositor confidence. Any serious loss of public confidence quite conceivably could lead to major withdrawals of corporate and personal bank deposits, the consequent diminution of the funds available for credit, and the possibility of bank failures. Depositor confidence may be affected adversely if banks become active in promoting a variety of investment vehicles that traditionally have been the province of securi-

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> in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.

401 U.S. at 634.

69. *See SIA Discussion Paper*, *supra* note 1, at 751, 790-91.

70. Foldessy, *Franklin New York Puts Deficit at $60 Million in First Five Months*, Wall St. J., June 21, 1974, at 3, col. 1.

ties firms. For example, if banks promote closed-end mutual funds, REITs or commercial paper issues which fail to meet investor expectations—a not unlikely possibility since such investments certainly are not risk-free—the image of banks as riskless, deposit-accepting institutions may be irreparably tarnished in the minds of the public.[71]

Depositor confidence may also be shaken if the public perception of banks as a source of disinterested financial advice is destroyed. The conflicts of interest that arise when a bank performs various securities activities create the temptation for the bank to act in a less than disinterested manner toward its depositors and other customers.[72] For example, although most trust departments undoubtedly strive to conduct their businesses in full compliance with the high standards imposed by fiduciary law, serious conflicts can lead to unconsciously distorted judgments. Even where a "Chinese wall" is in place, a bank's trust department might be inclined to purchase for its accounts securities being distributed by the bank which, other things being equal, it would not deem the best investment for such accounts.

In addition, the confidential financial information a bank frequently requests in connection with its commercial lending functions may be disclosed to its affiliated investment advisor and may influence the bank in providing investment banking advice to other customers. Such a potential conflict is apparent in cases where the financing for a cash tender offer is arranged by the same bank that serves as lender to the target company. In such cases major commercial banks acquire confidential nonpublic information concerning a particular corporation and are able to pass this information to other corporations to assist them in planning a tender offer. The banks receive substantial fixed and contingent fees from the offeror and act as lead banker and finance the tender offer, often disregarding the fiduciary duties they owe to their longstanding credit customers. This practice has led the SEC to request Congress to initiate legislation prohibiting such a role for banks.[73]

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71. Loss of public confidence in the stability of the banking system resulting from its involvement in securities activities was a primary concern of Congress in enacting the Glass-Steagall Act. *See* ICI v. Camp, 401 U.S. 617, 630-34 (1981).

72. *Id.* These concerns, as well, motivated Congress in passing the Glass-Steagall Act.

73. *See* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 96TH CONG.,

In the area of municipal bonds, commercial banks seem to have put themselves in an extremely awkward position because of the multitude of roles they perform concurrently for municipal issuers. These roles include underwriter to the municipality, depository of its funds, investor in its securities, trustee of its bond and note issues, lender to the municipality and, lastly, its financial adviser. The combination of all of these activities in one institution creates a situation where the potential conflicts cannot be resolved, for when the bank must act in order to protect its depositors, it may not be acting in the best interest of its municipal client.

Other examples of potential conflicts of interest are easy to cite.[74] The point is that when members of the public perceive these conflicts they may begin to wonder about the character of the banking entity to which they entrust their funds.

Preventing Bank Domination of Financial Services

If the movement of major commercial banks into the securities business goes unchecked, it is likely that they will come to dominate several aspects of the industry. The sheer size of the money center banks in relation to the securities industry suggests that the latter would be unable to compete successfully against the wealth of resources available to these banks. For example, bank holding companies quickly became leading participants in the personal finance and mortgage banking fields after being permitted to engage in such activities. The magnitude of the major banks in comparison to the securities industry is illustrated by the fact that as of December 31, 1980, Citicorp and BankAmerica Corporation, the two largest bank holding companies, had combined equity capital of $7.8 billion, or 47 percent more than all New York Stock Exchange member firms doing a public business.[75]

2D SESS., SECURITIES AND EXCHANGE COMMISSION REPORT ON TENDER OFFER LAWS 8 (Comm. Print 1980).

74. A potential conflict may be said to exist where a bank does an extensive business in investing money for clients as fiduciary, but at the same time has other divisions that could benefit or suffer from the decisions of the fiduciary arm. The disposition of brokerage commissions, for example, might be used to attract broker deposits to banks. If the brokerage commissions could also be used to benefit the fiduciary accounts instead of the bank, a potential conflict of interest would arise out of the structural arrangements and relationships of the institution. Even if there were no way in which the brokerage commissions could be used in the interest of the fiduciary accounts, a potential conflict would exist, based on the value of the brokerage to the institution and its cost to the trust accounts.

E. HERMAN, *supra* note 28, at 7.

75. CITICORP, CITICORP ANNUAL REPORT AND FORM 10K 1980 35 (1981); BANK-

The securities industry's inability to compete against the economic advantages and sheer size of the money center banks would result in decreased competition in financial services, with consequent reduction in the efficiency and responsiveness of the capital markets in meeting financing demands. The commercial banker offers a variety of commercial loan packages, funded by one or more banks, while the investment banker offers a variety of securities packages, funded by investors through public or private offerings. The diversity of loans and securities packages offered is, in large part, due to the competition between the two industries. If commercial banks are allowed to offer both products, and come to dominate both financing alternatives, development of innovative financing vehicles will be stifled. Further, a few money center banks in effect will control access to the capital markets by American industry, a situation not unlike that which now prevails in many European countries. This not only would disadvantage the customer seeking to raise capital in the most efficient and least costly manner, but would also distort the economy's delicate capital allocation process. Even if additional competition in the securities industry were desirable, in view of the above considerations it should not be provided by banks. In fact, however, the brokerage industry is already highly competitive.[76]

The structural characteristics of a competitive industry commonly accepted by economists include: (1) low seller concentration; (2) lack of significant barriers to entry; and (3) low product differentiation. The brokerage industry scores high on all three counts.

First, the brokerage industry's membership is diffuse and relatively non-concentrated. Second, there do not appear to be substantial barriers to entry. Generally, such barriers include the absolute cost advantages discussed above, significant economies of scale, and high product differentiation. Although banks enjoy absolute cost advantages over members of the securities industry, there are no apparent cost advantages enjoyed by members of the securities industry over potential entrants. Furthermore, empirical studies suggest that there are no significant economies of

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AMERICA CORPORATION, 1980 ANNUAL REPORT 33 (1981); NEW YORK STOCK EXCHANGE, NEW YORK STOCK EXCHANGE FACT BOOK 1981 54 (1981).

76. *See* Schaefer & Smith, *Economies of Scale: An Unsettled Issue*, 5 SEC. INDUSTRY TRENDS 10 (1979).

scale in the securities industry.[77] Finally, there is relatively little product differentiation in the securities industry. What little product differentiation existed in the industry as a result of the service competition in which brokers engaged during the period of fixed commission rates[78] has waned as price competition has resulted from the May 1, 1975 unfixing of commissions. Moreover, the sharp decline in commission charges of many firms since that date attests to the intensity of competition in the brokerage business.[79]

Indeed, the employment by major commercial banks of their unique advantages in the securities industry is likely to produce non-productive, and even detrimental, competition in that industry. The risk of increased economic concentration and the possibility of significant damage to the capital-raising mechanism argue strongly for maintaining the lines established by the Glass-Steagall Act.

It is impossible to predict with certainty what will occur if banks are permitted to expand their securities activities. Nevertheless, the risks of undue concentration of resources, unfair competition, inadequate investor protection, and possible damage to confidence in the banking system cannot be taken lightly. Measured against the principal policy objectives set forth above, it seems clear that the economy has little to gain and much to lose from such a gamble.

THE NECESSARY PERSPECTIVE FOR CONSIDERING RELAXATION OF THE GLASS-STEAGALL ACT

It should be apparent that proposals to change the Glass-Steagall Act cannot be assessed adequately in a vacuum but require evaluation from a number of perspectives. The importance of assuring comprehensive congressional review and study was underscored in a document entitled "Financial Institutions in a Revolutionary Era,"[80] prepared in 1981 by the staff of the House Committee on Banking, Finance and Urban Affairs at the request

77. *See id.*

78. Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, in PROMOTING COMPETITION IN REGULATED MARKETS 301, 310 (A. Phillips ed. 1975).

79. *See* SEC, *The Effect of the Absence of Fixed Rates of Commissions*, SECURITIES AND EXCHANGE COMMISSION REPORT 3 (1975).

80. 127 CONG. REC. H8194 (daily ed. Nov. 10, 1981). Similarly, the need for comprehensive review of the nation's financial regulatory structure was stressed by SEC Chairman Shad, who proposed the creation of a non-partisan task force for this purpose in recent Senate testimony. *See Securities Activities of Depository Institutions: Hearings on S. 1720 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 28 (1982) (statement of John S.R. Shad).

of the chairperson and ranking minority member of the committee. In this section, we identify a number of vantages from which proposed changes in the Glass-Steagall Act should be assessed.

Structure of Our Financial System

To a large extent, our existing financial system derives its structure from the proscriptions of the Glass-Steagall Act. Significant redefinition of the role of banks in the securities business will have deep and lasting effects on our financial structure and on the functioning of the capital markets. While these consequences would merit the most careful attention in any event, such study is particularly crucial in light of the central importance of the capital markets to the success of the economic recovery program.

As noted previously, money center banks are sufficiently well capitalized to dominate any financial services business in which they are permitted to engage.[81] Thus, it would be impossible to redraw the Glass-Steagall line without potentially precipitating major unpredictable changes in our financial structure. Naturally, such changes could be expected to have a significant impact on the efficiency and responsiveness of our capital markets. For example, any change which would have an effect on the ability of small regionally-based securities firms to survive should not be taken lightly. As the SEC has found,[82] such firms are a vital part of the capital-raising process for newly emerging companies. Similarly, as noted earlier, the widespread takeover of investment banking firms by banks would diminish an independent source of innovative financing methods.[83] In short, any changes in the Glass-Steagall Act should be recognized as having potential for a significant restructuring of the investment banking industry and the capital markets it serves.

Regulation of Financial Institutions

Another critical element of our financial system is its regulatory

81. *See supra* text accompanying note 75.
82. *See* SBA & SEC, *Initial Offerings of Common Stock: The Role of the Regional Broker-Dealers in the Capital Formation Process*, SMALL BUSINESS ADMINISTRATION AND SEC PHASE I REPORT 2 (1980); SBA & SEC, *The Role of Regional Broker-Dealers in the Capital Formation Process: Underwriting, Market-Making and Securities Research Activities*, SMALL BUSINESS ADMINISTRATION AND SEC PHASE II REPORT 2 (1981).
83. *See supra* text accompanying notes 75-79.

structure. Despite the general trend toward deregulation of American industry, financial institutions—because of their vital role in the economy—probably always will and should be regulated to some extent. As long as financial institutions are permitted to maintain custody of the savings and investment of the general populace (e.g., banks, pension funds and insurance companies), government will insist on scrutinizing their use of these funds, their liquidity, and other aspects of their operations. Perhaps equally important is the dependence on these institutions by American industry for capital. Thus, the financial industry is unlikely ever to be deregulated in these respects.

Any proposed changes in the Glass-Steagall Act's prohibitions which might restructure the financial system should therefore be considered from a regulatory viewpoint as well. In particular, the congressional goal should be to ensure that all institutions permitted to perform the same function are not only subject to the same scheme of regulation but are also under the aegis of the same regulator. A regulatory structure which permits multiple regulatory patterns or multiple regulators for different institutions engaged in the same activity invites "charter shopping" and "competition in laxity," as bank regulators vie to expand their turf by offering the regulated entities fewer and less onerous burdens.

As noted above, the disparity of regulation between securities firms and other types of financial institutions which seek to perform securities functions has been historically significant. Congress clearly cannot let such a situation exist if Glass-Steagall is to be amended. For example, if banks were no longer to be subject to Glass-Steagall restrictions, their exemption from broker-dealer registration under the Securities Exchange Act would no longer be supportable.

Taxation of Financial Institutions

A similar point should be noted with respect to the application of our federal income tax laws to financial institutions. Under the present structure, various tax advantages described have been afforded to commercial banks to encourage them to provide funds in a particular way. Thus, as noted above, banks—but not brokers—are permitted to deduct interest costs for carrying tax-free portfolios and the reserves for loan losses. Although these and other tax advantages may be appropriate under the existing structure, they clearly must be reexamined if the separation imposed by Glass-Steagall is to be altered.

Competitive Balance Between the Securities and Banking Businesses

It is not only the Glass-Steagall Act which separates commercial and investment banking. The Bank Holding Company Act also serves to separate these businesses through its general provisions restricting the non-banking activities of bank holding companies. Any proposed revisions to the Glass-Steagall Act therefore must be viewed in the broader context of Congress' determination to separate commercial banking from unrelated commercial activities. It would be unfair to permit banks to expand their activities into the securities area through relaxation of Glass-Steagall's proscriptions without providing equal opportunity for the securities industry to expand its commercial banking activities.[84] Such expansion could not be achieved equitably, however, if the Bank Holding Company Act were left intact and securities firms were required to divest their non-banking activities as a prerequisite to expanding their banking-related services. Any changes in the Glass-Steagall Act would therefore necessitate reexamination of the Bank Holding Company Act and the entire issue of the separation of banking and non-banking activities.

CONCLUSION

In light of the important changes that have occurred in the nation's financial services industry over the past half-century, congressional reexamination of the Glass-Steagall Act is certainly appropriate, and should proceed in the context of a comprehensive review of the laws and regulations bearing upon the structure of our financial institutions. For the reasons advanced earlier in this article, the SIA believes that the Glass-Steagall Act and its underlying policy have not lost their validity and, indeed, have contributed importantly to the current overall soundness of the nation's financial system. In the event that Congress, after com-

84. The need for such parity of treatment for securities firms is recognized in the Administration's proposal. Thus, in his testimony announcing the proposal, Secretary Regan noted "[W]ith regard to competitive equality, a securities firm dealing only in federal, municipal, or mutual fund obligations could establish a holding company and own a commercial bank within it." *See Financial Institutions Restructing and Services Act of 1981: Hearings on S. 1638, S. 1703, S. 1720 and S. 1721 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 15 (1981) (statement of Donald T. Regan, Secretary of the Treasury).

pleting a comprehensive review, should conclude that some change is appropriate, the SIA believes that the "separate subsidiary" approach appears to represent the most sensible conceptual starting point for redefinition of the role of banks in the securities field. Should Congress follow this course, it must simultaneously assure that viable safeguards are established against the hazards addressed above and that the securities industry is afforded comparable opportunity to engage in commercial banking activities.