Rethinking Glass-Steagall

The case for allowing bank holding company subsidiaries to underwrite and deal in corporate securities

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Introduction

A basic premise of public policy in the United States is that competition promotes the public good by reducing costs and stimulating innovation. Artificial barriers to competition, according to this principle, should be shunned in the absence of evidence that the public interest requires them.

More than fifty years ago, a significant barrier to competition in the U.S. capital markets was erected by the Glass-Steagall Act,* which barred commercial banks and their affiliates from underwriting and dealing in corporate securities. Since passing the Act in 1933, Congress has not thoroughly examined whether Glass-Steagall has served any purpose that outweighs the public interest in promoting competition to achieve economic efficiency.

Fundamental changes in our economy, important shifts in demand for financial services, and the resulting competition among different classes of financial institution in recent years have produced what is aptly termed a revolution in the financial services market. In this environment, competitive inequities inherent in the rigid segmentation of the financial industry provide another compelling reason to rethink Glass-Steagall.

This study analyzes the major issues raised by proposals to allow bank holding company subsidiaries to underwrite and deal in corporate debt and equity securities. It first examines the arguments most commonly made to justify preservation of the artificial barriers to competition imposed by Glass-Steagall and finds these arguments to have little merit. Historical research reveals that the Act did not play a major role in restoring the stability of the banking system; review of the risks and rewards entailed in corporate securities activities shows that permitting bank holding companies to diversify in this way would enhance, not diminish, the system's stability; and analysis suggests that no unmanageable conflicts of interest would arise from the affiliation of banks and securities firms. Finally, the study examines the critical issue of how society would benefit from increased competition in securities markets, which are now significantly concentrated.

The study concludes, and Morgan believes, that there is no valid reason to preserve the securities industry's protected position in U.S. capital markets. Revision of the Glass-Steagall Act, by enabling bank holding companies to adapt to rapidly changing customer demands and competitive realities, would strengthen the banking system—the primary aim of the Banking Act of 1933, of which Glass-Steagall is a part. Most important, revision would promote the development of an efficient financial services industry, with consequent benefits for the American economy.

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* Sections 16, 20, 21, and 32 of the Banking Act of 1933 are referred to in this study as the Glass-Steagall Act.

Summary

Examination of the roots and consequences of the Glass-Steagall Act, which largely severed investment from commercial banking, reveals that the Act does not serve the public interest. Bank holding company subsidiaries should be permitted to underwrite and deal in corporate securities for four important reasons:

- More competition in the significantly concentrated securities industry would benefit small and large companies that use investment banking services, as well as individual and institutional investors.
- Permitting bank holding companies to own securities subsidiaries would strengthen these companies and the financial system of which they are a part, by providing opportunities to add new sources of holding company revenue at relatively low risk.
- Potential conflicts of interest that may arise from a bank holding company subsidiary's underwriting and dealing activities can be regulated in the same way that similar potential conflicts in both the banking and securities industries are regulated now.
- Structural defects in the banking system and financial abuses that existed in the 1920s and early 1930s were corrected by the strengthening of the Federal Reserve, the creation of federal deposit insurance, and the regulation of securities markets. The separation of investment from commercial banking was not necessary to achieve or maintain these reforms.

Historical perspective

The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities. Careful analysis of the Act reveals that it was too sweeping, however, and that the problems it was meant to solve were addressed more effectively by other legislation.

The securities activities of commercial banks had little, if anything, to do with the collapse of the banking system. The banking crisis was caused by the system's structural defects: there were too many inadequately supervised, poorly managed, and undercapitalized banks. The onset of the depression dealt a devastating blow to smaller banks. Failures among them eventually undermined depositor confidence and put intense pressure on the larger, more stable banks, which were forced to dump their assets on the market to achieve greater liquidity. Inevitably, this drove down the value of their remaining assets. The deflationary cycle, rather than overly risky portfolios or underwriting losses, led to the collapse of the banking system. The establishment of federal deposit insurance and the strengthening of the Federal Reserve were highly effective responses to the conditions that had led to the banking crisis. The Glass-Steagall Act was not.

Abuses in the financial markets did require congressional attention, and they received it when Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Moreover, the abuses Congress believed were peculiar to commercial banks' securities activities and to their relationships with securities affiliates were addressed by existing law and by other provisions of the Banking Act of 1933 far more effectively than by the Glass-Steagall Act.

Bank safety and soundness

Allowing bank holding companies to expand their securities activities would strengthen these companies by enabling them to diversify revenue sources through profitable activities that carry relatively low risk. In fact, the risk involved in underwriting and dealing in corporate securities—th securities will decline in value during the short period of time that they are held—is no different froı the risks entailed in securities activities that banking organizations already pursue in the U.S. government and municipal bond markets and the Euromarket. Corporate securities activities are nc riskier than traditional bank lending, which involves credit exposure for a number of years and relatively illiquid assets.

The Securities Industry Association provides convincing evidence of the favorable risk and retı characteristics of corporate securities activities in its reports of the profits earned each year by secur firms from underwriting and dealing in both debt and equity securities. Banks have also reported favorable results from underwriting and dealing in U.S. government, municipal, and Eurobond securities, in which they are major market participants. Moreover, no failure or forced merger of a securities firm of significant size during the postwar period has been caused by losses from underwri or dealing in securities; neither has any bank failed during the period because of its securities activiti

Analysis of all SEC-registered common stock offerings of $5 million or more since 1976 indicat that they generate substantial net underwriting revenues each year for securities firms. Such analysis also indicates that during the period there were relatively few issues on which underwriters may hav sustained actual losses, and that the largest loss indicated for any single underwriter was not large enough, relative to the underwriter's capital base and other revenues, to have had a destabilizing effe

If, despite the low level of risk involved in securities activities, a bank holding company securiti subsidiary did encounter financial difficulties, the effect on a sister bank would be minimal. Any loss incurred by a securities affiliate would not impair the bank's capital because of the affiliate's status as separately capitalized subsidiary of the holding company rather than the bank. This subsidiary woul be obliged to meet the net capital requirements established by the Securities and Exchange Commiss Bank loans to an affiliate would be strictly limited by Section 23A of the Federal Reserve Act. These and other regulatory provisions would insulate a bank effectively from its securities affiliate.

Experience indicates that permitting a bank holding company subsidiary to underwrite and dea corporate securities would not increase the risk that depositors might lose confidence in an affiliated bank, because the bank's solvency would not be perceived to depend on the fortunes of the securities firm. Furthermore, for the reasons discussed above, a securities affiliate is unlikely to sustain losses tl would threaten either its stability or that of its holding company. In addition, any losses it did sustai would be quickly identified and measured, since all securities must be marked to market; thus no uncertainty about the ramifications of any loss would affect market confidence in a parent bank hold company, much less in an affiliated bank.

Conflicts of interest

An effective and economically sound approach to controlling conflicts of interest—based on disclosu regulation, and judicial remedies rather than on the separation of activities that might cause such conflicts—has been developed under the U.S. securities laws. Moreover, economic incentives to maintain the good will of clients are strong and significantly limit the exploitation of conflicts of inteı in any business. Analysis indicates that affiliation between a bank and a securities firm would not present conflicts of interest greater than or substantially different from those now faced by either enti individually, and that the existing regulatory framework would deal effectively with these potential conflicts. There is no need to prohibit bank affiliates from underwriting and dealing in corporate securities because of such potential conflicts.

No inherent conflict exists between banking and promotional activities, including those associat with underwriting and dealing. Banks, like other financial institutions, sell a variety of financial products and services. Federal securities laws and regulations effectively control the potential conflic that exist when a firm both sells securities and provides investment advice to customers.

The concern that banks might purchase for their trust accounts securities underwritten or dealt in by their affiliates ignores the clear legal and moral duty of a trustee to refrain from self-dealing. This potential conflict is no different from that faced by securities firms that provide fiduciary and investment advisory services and engage in underwriting and dealing activities. Moreover, banks have long faced this potential conflict in their municipal securities activities with no evidence of abuse.

The securities laws effectively control the potential abuse that could occur if a bank securities affiliate underwrote securities of a financially unsound company to obtain repayment of bank loans. The securities affiliate would be subject to civil and possibly criminal liability under the federal securities laws if it failed to disclose all material facts about the financial condition of the issuer and the use of proceeds of the offering.

If a bank made imprudent loans to customers for the purchase of securities underwritten by its affiliate, the bank would jeopardize its own assets so that its affiliate could earn a small fraction of the value of those assets on the sale of securities. The possibility of such imprudent lending was considered and rejected as "not be[ing] rational" by the Federal Reserve Board in its recent order approving a holding company acquisition of a discount securities broker, and would be equally irrational if the securities affiliate acted as principal rather than agent.

Similarly without merit is the concern that a bank would make unsound loans to a company because the securities of that company had been previously underwritten by an affiliate of the bank. A bank would have no economic incentive to make such loans.

Competitive impact

The Glass-Steagall Act bars a major class of qualified competitors—bank holding company subsidiaries—from participating in U.S. corporate underwriting and dealing markets despite significant concentration in those markets, high securities industry profits, and limited availability of underwriting and market-making services for small business enterprises. These is no public policy reason to preserve the securities industry's protected position in these markets. Removal of Glass-Steagall's barriers to competition would significantly improve capital-market efficiency in the U.S.

The number of competitors in both national and regional markets has declined during the past 20 years, and there is evidence of a trend toward increased concentration that has accelerated since the promulgation of SEC Rule 415 in mid-1982. A small number of national firms control the underwriting and large-block-transaction dealing markets for major corporations, while a decreasing number of regional firms serve smaller companies as underwriters and market-makers. Data indicate that the investment banking firms that engage in corporate underwriting and dealing report very high profits and that concentration levels and costs to issuers and investors are higher in these markets than in comparable markets in which commercial banks compete. In addition, because underwriting and dealing expertise is often considered a qualification for advising corporations on related financial matters, such as mergers and acquisitions, Glass-Steagall restrictions also stifle competition in areas of the capital markets that technically are open to all competitors.

Major bank holding companies have the resources and skill to create securities subsidiaries that could compete with the leading national firms both for the underwriting business of major corporations and as dealers in large block transactions. Smaller bank holding companies could both participate in underwriting the securities of large companies and extend existing relationships to provide underwriting and market-making services to smaller and emerging corporations. The addition of new competitors would be likely to lead to reduced concentration, lower costs, increased innovation, and improved liquidity in those markets.

Competition from bank holding company affiliates would not produce increased concentration or other anticompetitive consequences. Lending markets are less concentrated than corporate underwriting and dealing markets, and banks do not dominate markets in which they now compete with securities firms. Bank securities affiliates would not possess any inherent advantages that would enable them to become dominant competitors, and there is no evidence to support suggestions that commercial banks would engage in illegal or anticompetitive practices in order to gain unfair advantage for their securities affiliates.

Historical perspective on the Glass-Steagall Act

Congress passed the Banking Act of 1933 in response to the collapse of the banking system early that year. Legislators designed the Act to restore public confidence in the system and to protect depositors by insuring the stability of commercial banks. In establishing federal deposit insurance and expanding the powers of the Federal Reserve Board, the Act remedied basic flaws in the structure of the banking system. The Act also included provisions that substantially separated commercial banking from investment banking, the benefits of which have proved dubious. These divorce provisions today are commonly referred to as the Glass-Steagall Act.

Structural defects in the banking system and abuses in the financial markets obviously required congressional attention in 1933. In view of the economic crisis confronting the nation and the public hostility toward the financial community engendered by the stock market crash, the banking collapse, and disclosures of questionable financial practices, it is not surprising that Congress was receptive to sweeping financial reform. Indeed, many of the measures introduced at the time—the creation of federal deposit insurance, for example—have had enduring positive effects.

In banishing commercial banks from the corporate underwriting and dealing markets, however, the Glass-Steagall Act imposed unduly broad restrictions. Its provisions, based on a theory of sound banking practice that Senator Carter Glass had championed for years, won support because of unproved assumptions about the roots of the banking crisis—specifically, that commercial banks' securities activities were an important cause of the banking system's failure. We know now that such activities had little, if anything, to do with the banking crisis. Structural flaws—poor capitalization and inadequate supervision, in addition to external economic factors—led to the breakdown. While certain provisions of the Banking Act of 1933 addressed these problems, the divorce provisions did not.

Finally, it is important to recognize that the securities laws enacted in 1933 and 1934 addressed the problems that had developed in the marketing and trading of securities—problems that were not limited, of course, to commercial banks' securities activities. These statutes supplied the foundation for a regulatory structure that has proved extremely effective to this day in controlling abuses in the securities markets.

The political background

Senator Carter Glass—the principal force behind the adoption of the Glass-Steagall Act—approached the banking crisis that developed in the early 1930s with a predisposition toward a radical, structural solution. He believed that commercial and investment banking were inherently incompatible and that commercial banks should confine themselves to making short-term, self-liquidating loans to finance commercial transactions.[1] As commercial banks and their affiliates became increasingly active in the securities markets during the first three decades of this century, Senator Glass became more and more concerned with what he regarded as a departure from principles of sound banking practice. He

1 *See, e.g.*, U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, A-12-A-15 (1975); Perkins, "The Divorce of Commercial and Investment Banking: A History," 88 *Banking L. J.* 483, 490-505 (1971). The theoretical basis of Glass' views was the "real bills" doctrine. This doctrine held that if banks made only short-term, self-liquidating loans to finance commercial transactions "the expansion of bank money [would] be in proportion to any extension in trade that [might] take place or to 'the needs of trade,' and that, when trade contract[ed], bank loans would be correspondingly paid off." L. Mints, *A History of Banking Theory*, 9 (1945). A closely associated doctrine held that "if only commercial loans [were] made, the currency [would] have a desirable elasticity and the banks [would] at all times be in a liquid position." *Id.* Although this theory enjoyed some influence during the early stages of federal banking regulation in the nineteenth century, it never had much influence at the state level, at least with respect to the desirability of enforcing a separation of commercial and investment banking. Moreover, by the early 1900s the barrier between commercial and investment banking had eroded at the federal level as well, marking a decline in the influence of the theory in this regard.

was critical of the McFadden Act, adopted in 1927, which confirmed national banks' authority to underwrite certain investment securities. Later, he observed:

> "[*W*]*hen we have had occasion to propose modifications of either the Federal reserve act or the national banking act it has seemed to me that instead of creating a national standard of sound banking which the State systems might be induced to follow, we have introduced into the national banking system some, if not many, of the abuses of the State systems, in order to enable national banks to compete with State banks.*" [2]

At the Brokers' Loans Hearings in 1928 Glass expressed concern over the volume of commercial banks' loans to brokers. He stated that the proponents of the Federal Reserve Act, of which he had been a principal architect, thought "we should have a system that would meet the requirements of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as an unproductive operation of stock and commodity gambling."[3] In short, Glass thought that commercial banks' securities activities were inconsistent with sound banking practice.

Congress' consideration of Glass-Steagall

The stock market crash in October 1929 provided the initial impetus for Glass' efforts to make commercial banking practice conform with his theories. In May 1930 the Senate approved S. Res. 71, which authorized the Senate Committee on Banking and Currency "to make a complete survey" of the national and Federal Reserve banking systems, with particular attention to banks' involvement in speculative securities activities through investments, through the extension of credit to support such activities, and through the formation of "investment and securities trusts."[4] One month later, Senator Glass introduced a bill that included certain provisions to which the origins of the Glass-Steagall Act can be traced. Although the relevant provisions in this package of reforms bore little resemblance to the legislation that ultimately became the Glass-Steagall Act, the bill did contain a provision somewhat similar to section 16 of the Act, which prohibits banks from underwriting or dealing in corporate securities.[5] The bill also provided for the regulation of affiliates by requiring member banks to file reports on each of their affiliates with the federal regulatory authorities. The term "affiliate" was defined broadly to include, among other things, a "finance company, securities company, investment trust, or other similar institution" controlled directly or indirectly by a bank "or by the shareholders thereof who own or control a majority of the stock of such bank." [6]

No immediate action was taken in response to the passage of S. Res. 71 or to the introduction of Glass' bill. In late 1930, however, an increase in the rate of bank failures provided further impetus for congressional action in the banking field. Of the 1,350 banks that failed in 1930, more than 600 of them failed in November and December of that year. Moreover, the failure of the Bank of United States in December shook the confidence of depositors. The failure not only was the largest in history at that time, but also involved a bank whose name caused many people to think it had a special, official status.

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2 *Operation of the National and Federal Reserve Banking Systems: Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 71st Cong., 3d Sess. 14 (1931) (statement of Sen. Glass) [hereinafter S. Res. 71 Hearings].

3 *Brokers' Loans: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 113*, 70th Cong., 1st Sess. 53 (1928) (statement of Sen. Glass).

4 *See* 72 Cong. Rec. 8335 (daily ed. May 5, 1930) (Senate approves S. Res. 71). S. Res. 71 had been reported to the full Senate by the Committee on Banking and Currency in April 1930. *See* S. Rep. No. 493, 71st Cong., 2d Sess. (1930). The resolution had been introduced in May 1929 by Senator King. *See* S. Res. 71, 71st Cong., 1st Sess., 71 Cong. Rec. 1830 (daily ed. May 24, 1929).

5 12 U.S.C. sec. 24. Section 16 governs the activities of national banks. Section 5(c) of the Banking Act of 1933 applied the restrictions of section 16 to state member banks. *See* 12 U.S.C. sec. 335.

6 S. 4723, 71st Cong., 2d Sess., 72 Cong. Rec. 10,973 (daily ed. June 17, 1930).

Against this background a subcommittee of the Senate Committee on Banking and Currency chaired by Senator Glass conducted in early 1931 the first major set of hearings on the subjects ultimately covered by the Glass-Steagall Act.[7] Under Glass' direction, the subcommittee focused on commercial banks' participation in speculative securities activities through the extension of credit to support such activities, through investment practices, and through securities affiliates. In an appendix to the hearings, the subcommittee suggested that "[t]he experience of the past 10 years lends spectacular confirmation to the view that the more intensive participation by commercial banks in the capital market exaggerates financial and business fluctuations and undermines the stability of the economic organization of the country."[8] In a section of the appendix devoted to securities affiliates, the subcommittee stated that such affiliates were engaged in a variety of activities, ranging from acting as a real estate holding company to underwriting securities.[9]

Referring generally to securities affiliates, the subcommittee identified a number of ways in which the operations of such an affiliate might affect adversely the position of a bank. It is difficult to determine the precise nature of Congress' concerns, and more particularly the specific problems that were peculiar to bank underwriting affiliates, since Congress had such a broad conception of the functions of "securities" affiliates. The subcommittee appears to have been most concerned, however, about loan transactions between a bank and its affiliate. The subcommittee suggested that such debtor-creditor relationships were "very prevalent" and asserted that these relationships were the "most direct manner in which the affiliate [might] impair the liquidity of the bank. . . ."[10] Ultimately, the question of potentially harmful securities or loan transactions between a bank and its affiliate was addressed by section 13 of the Banking Act of 1933, which added a new section 23A to the Federal Reserve Act.[11]

Following the hearings, there was again a lull in efforts to curb the underwriting and investment activities of commercial banks. The continued deterioration of the banking system during 1931, however, increased the pressure for some congressional action. After a respite in early 1931, a "spate of runs began in March . . . and reached a high point in June, attacking the Midwest, Pennsylvania, and New York in particular, intensifying with the collapse of the major European central banks."[12] The situation was aggravated by Great Britain's abandonment of the gold standard in September. All told, there were 2,290 bank failures during 1931.

In March 1932 the Senate Committee on Banking and Currency held the second major set of hearings on the subjects ultimately covered by the Glass-Steagall Act.[13] Glass' original bill had gone

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7 *See* S. Res. 71 Hearings, note 2 *supra*.

8 *Id.*, at 1001.

9 *Id.*, at 1057. The subcommittee's discussion highlights the broad scope of the term "securities affiliate" as used by Congress during its consideration of the Glass-Steagall Act. The subcommittee stated that securities affiliates served as: 1) wholesalers of security issues; 2) retailers of securities; 3) holding and finance companies; 4) investment trusts (engaged in buying and selling securities acquired purely for investment or speculative purposes); 5) assets realization companies (used to take over from the parent bank loans and investments that proved to be doubtful or illiquid); 6) mediums for supporting the market for the bank's own stock; and 7) real estate holding companies. The subcommittee noted that "in most cases" the securities affiliates "exercised a combination of these functions, and in some instances they have exercised all of them." *Id.*

10 *Id.*, at 1064. *See also id.*, at 1063-64 (subcommittee's discussion of other ways in which the operations of an affiliate might affect adversely the position of a bank).

Despite the critical view of affiliates taken by the subcommittee in the appendix to the hearings, it is noteworthy that Senator Glass apparently still had doubts about the feasibility of separating affiliates from commercial banks. At one point during the hearings he had stated: "Well I myself . . . rather question the feasibility maybe of abolishing [securities affiliates] because they have been permitted for so long to exist. It might create a confusion and embarrassment that would be worse than the evil itself." *Id.*, at 40. But Glass did say that if it were not possible to control securities affiliates, "[he] should be agreeable to prohibiting them." *Id.*, at 41.

11 For a discussion of this provision, see page 11 *infra*.

12 S. Kennedy, *The Banking Crisis of 1933*, 19 (1973).

13 *See Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. (1932).

through two revisions, and the proposal that was the subject of the hearings included provisions that were more extensive and severe in their treatment of commercial banks' securities activities than the provisions in the bill Glass had introduced in June 1930. The new provisions were designed to separate commercial and investment banking. Representatives of the financial community opposed the bill and criticized it as extremely deflationary. In addition, the Federal Reserve Bank of New York characterized as "unwise" the provisions calling for "a divorce of the banking system and the capital market." Governor Harrison stated that these provisions would "disturb the mechanism of the capital market, the free functioning of which is now so important to a recovery from existing business conditions."[14]

Testifying for the Federal Reserve Board, Governor Eugene Meyer acknowledged that "affiliations between member banks and security companies have contributed to undesirable banking developments."[15] Meyer noted, however, that there were "difficulties in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply."[16] In this light, the Board was "not prepared . . . to make a definite recommendation. . . ." Meyer did offer a tentative suggestion, however, in the form of a proposal providing for the divorce of securities affiliates from member banks after three years.[17] Meyer stressed the tentative nature of this proposal:

> *"It is fair to say that, while the board is in agreement on the views stated, there has been a good deal of discussion of the thought that the question of divorce of affiliates might perhaps be better deferred, instead of acting at this time to be effective three years from now, and in the meantime to get reports and make examinations and then enact a law later. However, the suggestion here was agreed upon as the best we could think of at the present time in the light of existing information, or I might say in the absence of full information on the subject. We do not feel, in the absence of more definite information, any too great confidence in any recommendation that we or anyone else could make. But this is a suggestion for your consideration, which was the best we could evolve in the board with the assistance of our experts."* [18]

Later, Meyer stated that "the question as to separation of affiliates, in our minds, is in the realm of the unknown to a certain extent, because of the absence of full information, and the board offers no strong recommendation, although it submits a suggestion."[19]

Following the hearings, Glass again revised his bill and incorporated Meyer's suggestion. The committee report accompanying S. 4412 stated that "[t]he outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds."[20] The report also stated that "a very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of various institutions have been so extensively 'tied up' in long-term investments."[21] In contrast, it is interesting to note that

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14 *Id.*, at 501 (letter of George L. Harrison, Governor, Federal Reserve Bank of New York). Governor Harrison's letter had been unanimously approved by the directors of the Bank. *See id.*, at 499.

15 *Id.*, at 388 (statement of Eugene Meyer, Governor, Federal Reserve Board).

16 *Id.*

17 *Id.* Congress ultimately seized upon Meyer's proposal in formulating section 20 of the Glass-Steagall Act.

18 *Id.*

19 *Id.*, at 400. In response to questions, Meyer had stated that "it is impossible to classify absolutely all affiliates that deal in securities as wicked and vicious." *Id.*, at 393.

20 S. Rep. No. 584, 72d Cong., 1st Sess. 8 (1932).

21 *Id.*

at the hearings in 1931, the Comptroller of the Currency made the following statement: "I think it can fairly be said that I know of no instance where the shrinkage in value of collateral or bank investments as far as national banks are concerned, has been responsible for any bank failure or very, very few of them."[22]

Finally, the report on S. 4412 was very critical of bank affiliates. It stated that such affiliates "in many cases [devote themselves] to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank."[23] The report did not offer any specific examples of these problems. In fact, there was no evidence that commercial banks failed because of their own or their affiliates' underwriting activities. As the President's Council of Economic Advisers has observed, "there is no evidence to support [the] proposition [that] bank failures in the early 1930's were [attributable] to the role of banks in the securities business."[24]

The Senate debated S. 4412 in May 1932. In addition to the provisions of interest here, the bill included a broad range of proposals unrelated to the securities activities of commercial banks. During the debate, Glass mentioned the banking community's continued opposition to the separation of securities affiliates from commercial banks, but suggested that "[t]he committee ascertained in a more or less definite way—we think quite a definite way—that one of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression was made by these bank affiliates."[25] Glass stated that the affiliates "sent out their high-pressure salesmen and literally filled the bank portfolios of this country with these investment securities."[26] Glass offered no specific evidence to support these claims. In fact, the implication that the smaller banks were failing because of their investment in unsound securities forced upon them by the larger banks was not justified.[27]

Although Glass tried repeatedly to persuade the Senate to vote on S. 4412, the Senate did not act before the end of the session. Spurred by President Roosevelt's election and a continued deterioration of the banking system, the Senate did pass S. 4412 in January 1933 during the lame-duck session of the 72nd Congress.[28] The House, however, failed to act on the bill.

In the early months of 1933, several events helped Glass considerably in his efforts to secure enactment of these proposals. First, the Pecora hearings on stock exchange practices focused public attention on questionable financial dealings.[29] The hearings revealed, among other things, that one commercial bank and its affiliate had failed repeatedly to disclose material facts to investors, that the affiliate had engaged in high-pressure sales tactics, that the affiliate had traded in the stock of the bank and participated in a range of manipulative activities, that the bank had provided the affiliate with customers, and that the bank had used the affiliate to relieve the bank of bad loans to the alleged

22 S. Res. 71 Hearings, note 2 *supra*, at 12 (statement of J. W. Pole, Comptroller of the Currency). It should be noted that the shrinkage in value of collateral and bank investments did become a widespread problem as the depression and the banking crisis deepened. In the face of runs by depositors, banks were forced to achieve greater liquidity by dumping their assets on the market. For a discussion of the causes of the banking crisis, see pages 8-12 *infra*.

23 S. Rep. No. 584, 72d Cong., 1st Sess. 9 (1932).

24 *Economic Report of the President*, 148 (1984). For further discussion of this issue, see pages 9-11 *infra*. Moreover, the problem of an affiliate's maintaining a market for the bank's own stock was addressed by the Securities Exchange Act of 1934. *See* page 12 *infra*.

25 75 Cong. Rec. 9887 (daily ed. May 10, 1932) (statement of Sen. Glass).

26 *Id.*

27 For a discussion of this issue, see page 10 *infra*.

28 *See* 76 Cong. Rec. 2517 (daily ed. Jan. 25, 1933).

29 *See generally Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 239*, 72d Cong., 2d Sess. (1933).

detriment of shareholders.[30] Most of the abuses revealed by the Pecora hearings were addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934.[31]

In addition, in early March 1933 the National City Bank and the Chase National Bank decided to drop their securities affiliates.[32] In making the announcement for the Chase, Winthrop W. Aldrich, its new chairman, went on to propose several major reforms designed to separate commercial and investment banking.[33] In this regard, it appears that Aldrich was primarily responsible for the inclusion of the provision that was to become section 21 of the Glass-Steagall Act,[34] which prohibits entities that underwrite or deal in corporate securities from receiving deposits.[35] These events represented a significant break in the banking community's opposition to Glass' bill.

In the end, the development of a full-blown banking crisis in late 1932 and early 1933 was probably the most important event leading to enactment of the Glass-Steagall Act. From 1921 to 1933, there had been more than 10,000 bank failures. Until 1932, the failures basically had been confined to small, rural, state-chartered banks. Senator Glass offered the following description of the 8,221 banks that had failed during the eleven-year period from 1921 to 1931:

> *"There are approximately 22,000 institutions called banks; but thousands of them were little pawnshops that never should have been chartered either by the Federal Government or by State governments. Fifty-nine percent, or 4,861 of these suspended banks had a capital of $25,000 or less; 25½ per cent, or 2,175 of these banks had a capital exceeding $25,000 but not exceeding $50,000; and of the 8,221 failures, only 37 banks, or four-tenths of 1 per cent, had a capital of as much as $1,000,000. Over 60 per cent of these failures occurred in communities with a population of less than 1,000 inhabitants, and over 90 per cent of these failures occurred in cities and towns with a population of less than 25,000 inhabitants.*
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> *"It is, therefore, obvious that the problem is largely one of small rural bank failures."*[36]

During 1932, however, the failures began to spread and at the end of that year and in early 1933 entire state banking systems began to collapse. The escalation of the panic put intense pressure on the New York banks, which were faced not only with demands for cash from their local depositors, but also with withdrawals by the interior banks. By early March 1933 bank holidays had been declared in about half the states, including New York and Illinois. Finally, President Roosevelt declared a national bank

30 *See* F. Pecora, *Wall Street Under Oath*, 70-123 (1939).

31 *See* page 12 *infra*.

32 In March 1933, "[m]any other affiliates were . . . in process of liquidation, or had been previously dissolved, either because final passage of the Glass bill was anticipated or because banks welcomed the opportunity to rid themselves of affiliates which they had thought necessary or highly desirable during the twenties." Peach, "The Security Affiliates of National Banks," in *Wall Street and the Security Markets*, 158 (V. Carosso ed. 1975). The investment banking business had dropped off substantially, and "no one was prepared to predict how soon, if ever again, this commercial banking sideline might be able to pay its own way." Perkins, note 1 *supra*, at 522.

33 *See Wall Street Journal*, Mar. 10, 1933, at 8; *New York Times*, Mar. 9, 1933, at 1. *See also Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 3977 (statement of Winthrop W. Aldrich, Chairman, Chase National Bank).

34 *See id.*, at 4016, 4032 (statement of Sen. Glass) (colloquy between Sen. Glass and Winthrop W. Aldrich); A. Johnson, *Winthrop W. Aldrich*, 156 (1968). It is likely that Aldrich's announcement, and section 21 in particular, were directed at particular competitors. *See* S. Kennedy, note 12 *supra*, at 212-13; J. Brooks, *Once in Golconda*, 149, 211 (1970). 8 *St. John's L. Rev.* 193, 195-96 (1933); *New York Times*, Mar. 9, 1933, at 1; *Wall Street Journal*, Mar. 10, 1933, at 8. As Arthur Schlesinger has noted, "Aldrich's [announcement] was interpreted as a Rockefeller assault on the House of Morgan. . . ." A. Schlesinger, *The Age of Roosevelt: The Coming of the New Deal*, 434-35 (1958).

35 12 U.S.C. sec. 378.

36 75 Cong. Rec. 9892 (daily ed. May 10, 1932) (statement of Sen. Glass).

holiday. Combined with Congress' enactment of emergency banking legislation in early March,[37] this stabilized the situation and permitted the reopening of most of the surviving banks. A consensus had developed, however, on the need to reform the banking structure.

At the beginning of the 73rd Congress in March, Glass introduced a bill similar to the one that had passed the Senate in January. This bill was revised and a new version was introduced in May. The new version, S. 1631, included provisions substantially similar to all four sections of the Glass-Steagall Act.

In mid-May, the Senate Committee on Banking and Currency reported S. 1631 to the full Senate. The report accompanying the bill was similar to the one that had accompanied the bill that the Senate had passed in January, and, in fact, contained some language identical to language in the earlier report.[38]

The Senate debated S. 1631 in late May. The statements of the bill's proponents were not much different from the ones they had made on prior occasions. At one point, for example, Senator Glass stated:

> *"[T]hese affiliates, I repeat, were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since. They ought to be separated, and they ought speedily to be separated, from the parent banks; and in this bill we have done that."* [39]

The Senate passed S. 1631 without a record vote on May 25, 1933.[40] Following a House-Senate conference on the legislation, which for present purposes basically resulted in adoption of the Senate bill, the Senate and House both approved the conference report on June 13.[41] The legislation was enacted on June 16, 1933.

Analysis of Congress' reasons for adopting the Glass-Steagall Act

The proponents of the Glass-Steagall Act advanced four reasons for separating commercial and investment banking:

- commercial banks' securities activities had contributed to, if not caused, the stock market crash and the depression;
- commercial banks' securities activities (investment and underwriting) had caused the collapse of the banking system;
- there were problems associated with relationships between commercial banks and securities affiliates; and

37 This legislation, among other things, granted the President certain emergency banking and currency powers; provided for the appointment of conservators for certain national banks with impaired assets; permitted the Reconstruction Finance Corporation to buy preferred stock, capital notes, and debentures of banks; and provided for emergency issues of Federal Reserve Bank notes. *See* M. Friedman & A. Schwartz, *A Monetary History of the United States 1867-1960*, 421-22, 427 n. 4 (1963).

38 *Compare* S. Rep. No. 77, 73d Cong., 1st Sess. 8-10 (1933) *with* S. Rep. No. 584, 72d Cong., 1st Sess. 8-10 (1932).

39 77 Cong. Rec. 3726 (daily ed. May 19, 1933) (statement of Sen. Glass).

40 *See id.*, at 4182 (daily ed. May 25, 1933). This discussion has focused on activities in the Senate because the House, at least with respect to the provisions of interest here, basically followed the Senate's lead. *See, e.g., id.*, at 3835 (daily ed. May 23, 1933) (statement of Rep. Henry Steagall). The House always had been more interested in federal deposit insurance than in the Glass-Steagall provisions. The debates on the Glass-Steagall provisions in the House were very similar to those in the Senate. *See, e.g., id.* It should be noted, however, that the House passed its version of the Banking Act of 1933 on May 23, 1933, two days before the Senate took final action. *See id.*, at 4058 (daily ed. May 23, 1933).

41 *See id.*, at 5863 (daily ed. June 13, 1933) (Senate); *id.*, at 5898 (daily ed. June 13, 1933) (House). *See also id.*, at 5861 (daily ed. June 13, 1933) (statement of Sen. Glass); *id.*, at 5892 (daily ed. June 13, 1933) (statement of Rep. Steagall).

• commercial banks had been involved in objectionable practices in the marketing of securities.[42]

If each of these reasons is analyzed carefully, however, it becomes clear that none of them provided adequate justification for separating commercial and investment banking. In some instances, Congress had no support in the record for the conclusions it drew. Moreover, to the extent that there were problems with the banking system and abuses associated with commercial banks' securities activities, they were addressed far more precisely and effectively by legislation other than the Glass-Steagall Act.

The stock market crash and the depression Although economists disagree about which elements were most important in causing a depression of such unprecedented severity, there is general agreement that commercial banks' securities activities were not a significant factor. The gamut of opinion on the dominant causes is spanned by the Keynesian and monetarist viewpoints. The Keynesian view emphasizes the collapse in aggregate demand:

> *"The shrinkage of employment, real output, and real income during the depression ... reflected the failure of the prevailing economic system to translate the wants and desires of the people into a level of spending, or aggregate money demands for output, sufficiently high to make it profitable for business firms to employ all available labor, to utilize other existing productive resources, and to invest in new capital."* [43]

The monetarist view focuses on the decline in the money stock. Two monetarists note:

> *"The monetary collapse was not the inescapable consequence of other forces but rather a largely independent factor which exerted a powerful influence on the course of events. . . . Prevention or moderation of the decline in the stock of money, let alone the substitution of monetary expansion, would have reduced the contraction's severity and almost as certainly its duration."* [44]

Neither of these polar views nor any of the diverse opinions in between attributes the economic collapse to the securities activities of commercial banks. This supports the view that Congress vastly overstated the extent to which commercial banks' securities activities contributed to the development of the economic crisis.

It is also important to recognize that there was nothing particularly insidious about the securities activities of commercial banks, conducted either directly or through affiliates. Investment banking houses also were involved in the securities markets. Any problems or abuses that developed were not confined to the activities of commercial banks.[45] Moreover, to the extent that there were abuses that contributed to the crash, or aggravated its effects, they were addressed far more directly and effectively by the Securities Act of 1933 and the Securities Exchange Act of 1934 than by the Glass-Steagall Act, which simply limited the market participation of commercial banks. The Securities Act dealt broadly with the issuance and distribution of securities to the public. The Securities Exchange Act subjected the

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42 In *Investment Company Institute* v. *Camp*, 401 U.S. 617 (1970), and *Securities Industry Association* v. *Board of Governors*, 104 S.Ct. 2979 (1984), the Supreme Court reviewed the legislative history of the Glass-Steagall Act and noted Congress' perception that commercial banks' securities activities threatened the stability of the commercial banking system and led to undesirable banking practices. The Court conducted this review to determine Congress' intent in passing the legislation and the Court's conclusions appear to have influenced significantly the decisions in these cases. It is important to recognize, however, that the Court's determination of legislative intent based on a review of the legislative history does not address, let alone confirm, the accuracy of the perceptions and assumptions on which the Glass-Steagall Act was based.

43 L. Chandler, *America's Greatest Depression: 1929-1941*, 1-2 (1970).

44 M. Friedman & A. Schwartz, note 37 *supra*, at 300-01.

45 *See, e.g.*, V. Carosso, *Investment Banking in America*, 317-18, 322-29 (1970) (discussions, among others, of the practices of Lee, Higginson & Co. and Halsey, Stuart & Co.); J. Galbraith, *The Great Crash 1929*, 38-57 (1979).

exchanges to government regulation, outlawed fraudulent and manipulative stock exchange practices, and authorized the Federal Reserve to regulate the extension of credit to purchasers of securities.

The banking crisis The collapse of the banking system was attributable principally to basic defects in the American banking structure. These flaws were revealed in the more than 5,000 bank failures that occurred from 1921 to 1929 during a period of apparent economic prosperity. Banks' investment or underwriting activities did not cause these failures: rather, factors such as poor management, inadequate supervision, undercapitalization, the depressed state of staple agriculture, and improved methods of transportation, which had put larger, more efficient banks within easy reach of many of the smaller banks' former customers, created the banks' problems.[46]

Even after the wave of failures that hit the nation during the 1920s, there were 24,912 separately incorporated unit banks scattered across the country in June 1929. Of these banks, 72% had capital of less than $100,000. The devastating effects of a significant economic downturn on such a weak banking structure are not hard to imagine. The failure of these small banks led to an erosion of depositor confidence, to hoarding, and to runs.[47] The pressure created by these conditions made it difficult for even the soundest banks to survive. In 1932, Senator Glass noted:

> *"[The failure of small banks], notwithstanding their inconsequential activities in some respects, created a psychology which was extremely detrimental to the whole banking and business community. When three or four small banks in any given section of the country in any State fail, the fact of the failure of three or four banks in that section, however small they may be, begins to create consternation, to undermine public confidence, and to create runs on the larger and stronger banks."* [48]

As Senator Glass recognized, the system was vulnerable to runs, and once the runs started they were hard to stop. In the face of actual or anticipated runs, banks were forced to achieve greater liquidity by dumping their assets on the market. This had the predictable effect of reducing the value of the banks' remaining assets and making them all the more vulnerable to assaults by depositors. Two commentators describe the phenomenon this way:

> *"[A]ny runs on banks for whatever reason became to some extent self-justifying, whatever the quality of assets held by banks. Banks had to dump their assets on the market, which inevitably forced a decline in the market value of those assets and hence of the remaining assets they held. The impairment in the market value of assets held by banks, particularly in*

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46 *See, e.g.*, S. Res. 71 Hearings, note 2 *supra*, at 7 (statement of J. W. Pole, Comptroller of the Currency): S. Kennedy, note 12 *supra*, at 16; M. Friedman & A. Schwartz, note 37 *supra*, at 240; C. Bremer, *American Bank Failures*, 47 (1935). Eighty-two percent of the banks that failed during the 1920s were small, state-chartered, rural institutions. *See* S. Kennedy, note 12 *supra*, at 205. Of the banks that failed, 39% had capital of less than $25,000, and 88% had capital of less than $100,000. *See* C. Bremer, *supra*, at 47. Moreover, "about 70 per cent of all bank failures . . . occurred in twelve agricultural states of which 41 percent consisted of banks situated in seven Western grain states." H. P. Willis & J. Chapman, *The Banking Situation*, 315 (1934). *See also* S. Res. 71 Hearings, note 2 *supra*, at 3-7 (statement of J. W. Pole, Comptroller of the Currency): S. Kennedy, note 12 *supra*, at 16; M. Friedman & A. Schwartz, note 37 *supra*, at 240, 249: C. Bremer, *supra*, at 57.

47 Two commentators have suggested that "the growth of postal savings deposits from 1929 to 1933 is one measure of the spread of distrust of banks." M. Friedman & A. Schwartz, note 37 *supra*, at 308 n. 8. In November 1914, postal savings deposits totaled $57 million. By August 1929 they had grown by only $100 million. In October 1930 they stood at $190 million. Between then and March 1933 they increased to $1.1 billion. *Id.*

48 75 Cong. Rec. 9889 (daily ed. May 10, 1932) (statement of Sen. Glass).

their bond portfolios, was the most important source of impairment of capital leading to bank suspensions, rather than the default of specific loans or of specific bond issues. "[49]

Similarly, the President's Council of Economic Advisers has stated:

> "*It is now widely asserted that the length and severity of the banking collapse of the 1930s was not the result of overly risky bank portfolios. Rather, many economists argue that these failures became widespread, initially, because of the reluctance of the Federal Reserve System to engage in aggressive open market operations to counter the conversion of deposits to currency and, later, because of the Federal Reserve's failure to assure adequate liquidity to banks experiencing runs on their deposits. As banks scrambled to liquidate their assets to meet the demands of their depositors for currency, their asset values fell, thus creating insolvencies.*"[50]

This analysis suggests that there was no validity to Glass' notion that banks' "overinvestment" in speculative securities had led to the collapse of the banking system.[51] It also indicates that there was no substantial evidence to support the argument that bank underwriting affiliates had contributed significantly to the failure of smaller correspondent banks by pressuring them into purchasing unsound securities. It is, in fact, implausible that underwriting affiliates were able to create artificial demand for securities. Rather, the increased demand for securities was attributable to factors such as the decline in banks' commercial loan business.[52] The business boom during the 1920s had put many American businesses in a cash-rich position. Moreover, the public had developed an intense interest in investment securities. These conditions made it possible for businesses to pursue "internal and external financing not involving bank loans."[53] There also is no reason to believe that investment banking houses would not have met commercial banks' demand for securities in the absence of bank underwriting affiliates. Finally, to whatever extent these affiliates sold unsound or speculative securities to unwitting correspondent banks, the problem was addressed by the portion of section 16 of the Glass-Steagall Act

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49 M. Friedman & A. Schwartz, note 37 *supra*, at 355. In support of their position, Friedman and Schwartz cite a study showing that from the middle of 1931 to the middle of 1932 railroad bonds lost nearly 36% of their market value, public utility bonds 27%, industrial bonds 22%, foreign bonds 45%, and United States government securities 10%. *Id.*, at 355 n. 65. Friedman and Schwartz go so far as to suggest that "[i]n the absence of the provision of additional high-powered money, banks that suffered runs as a result of the initial failure of 'bad' banks would not have been helped by holding solely U.S. government securities in addition to required reserves." *Id.*, at 356-57. They state: "If the composition of [the banks'] assets did not stop the runs simply by its effect on depositors' confidence, the banks would still have had to dump their government securities on the market to acquire needed high-powered money, and many would have failed." *Id.*, at 357. *See also* J. Galbraith, note 45 *supra*, at 158-59 ("Since the early thirties, a generation of Americans has been told, sometimes with amusement, sometimes with indignation, often with outrage, of the banking practices of the late twenties. In fact, many of these practices were made ludicrous only by the depression. Loans which would have been perfectly good were made perfectly foolish by the collapse of the borrower's prices or the market for his goods or the value of the collateral he had posted .... A depression such as that of 1929-32, were it to begin as this is written, would also be damaging to many currently impeccable banking reputations.").

50 *Economic Report of the President*, 117 (1983).

51 To the extent that Congress was concerned about the volume of bank investments, irrespective of quality, it is interesting to note that the Glass-Steagall Act had little effect on this "problem." Under the terms of the Act, banks were free to continue to invest in all types of debt securities. Obligations of the United States or general obligations of States or political subdivisions were not subjected to the restrictions of section 16. Moreover, banks could invest in other debt securities, including corporate debt, eligible for investment under criteria promulgated by the Comptroller

52 From 1920 to 1929, commercial banks' deposits increased by 35.8% and their investments increased by 67.1%. Their loans, however, increased by only 27.2%. For national banks, the trend is even more pronounced. From 1920 to 1929, national banks' deposits increased by 25.8% and their investments increased by 64.3%, while their loans increased by only 9.7%. *See* Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics* (1943).

53 M. Friedman & A. Schwartz, note 37 *supra*, at 244-45. *See also* M. Nadler & J. Bogen, *The Banking Crisis*, 15-17 (1933).

that provided for regulation of certain bank investments by the Comptroller, and by the disclosure requirements of the Securities Act of 1933.[54]

Any notion that commercial banks failed because of their own underwriting activities is belied by the years of experience preceding the stock market crash and the depression. State banks and trust companies had been involved in the investment banking business since the latter half of the nineteenth century with no serious adverse effects. National banks had been participating in the securities markets since the turn of the century, with The First National Bank in New York creating the first securities affiliate on record in 1908. These activities do not appear to have threatened the stability of banks.

It is noteworthy that the legislative history of the Glass-Steagall Act does not reveal any large bank failures attributable to the marketing or underwriting activities of a bank's securities affiliate. It is true that the failure of the Bank of United States was commonly attributed to the activities of its "securities affiliates."[55] Fraud, however, was primarily responsible for the failure of that bank. Moreover, the bank's affiliates were used principally to conduct the personal, and highly speculative, business ventures of the bank's officers, particularly in real estate. The affiliates were involved in the securities business only to the extent that they were used by the bank's officers to trade in the bank's own stock and to engage in other manipulative activities.[56] In short, the failure of the Bank of United States provided no support for separating commercial and investment banking.

Other provisions of the Banking Act of 1933 were far more responsive to the structural defects that led to the collapse of the banking system than the Glass-Steagall Act. In this regard, two commentators have asserted that "[f]ederal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War."[57] In the words of another observer:

> *"Federal insurance of bank deposits, even to this day, has not been given full credit for the revolution that it has worked in the nation's banking structure. With this one piece of legislation the fear which operated so efficiently to transmit weakness was dissolved. As a result one grievous defect of the old system, by which failure begot failure, was cured. Rarely has so much been accomplished by a single law."* [58]

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54 It is interesting to note that Senator Glass apparently was not very familiar with the Securities Act of 1933 and displayed little interest in the legislation. *See* J. Seligman, *The Transformation of Wall Street*, 69 (1982).

55 *See, e.g.*, S. Res. 71 Hearings, note 2 *supra*, at 1054.

56 *See, e.g.*, P. Temin, *Did Monetary Forces Cause the Great Depression?*, 91-94 (1976); Perkins, note 1 *supra*, at 496-97; Werner, "Biggest Bank Failure," *Fortune*, 62 (Mar. 1933). In recent testimony before Congress, the Securities Industry Association cited examples of bank securities affiliates that incurred substantial losses. Richard H. Jenrette, Chairman, Securities Industry Association, Statement Before the Senate Comm. on Banking, Housing and Urban Affairs (Mar. 7, 1984). The examples were drawn from testimony at the Stock Exchange Practices Hearings, note 33 *supra*, in late 1933 and 1934. It is not clear that the losses were attributable to conventional underwriting or dealing activities. Although available information is limited, it is likely that the losses were attributable in large measure to depreciation in the affiliates' long-term investment portfolios. *See, e.g.*, Stock Exchange Practices Hearings, note 33 *supra*, at 4981 (statement of Ferdinand Pecora, quoting the 1930 annual report to the stockholders of the Guardian Detroit Union Group) ("The Guardian Detroit Co. and Keane, Higbie & Co., in common with most securities companies and individual investors, have seen the market price of their inventory decline to a figure below values which should obtain under normal business conditions. This inventory might be divided into two general classes: First, securities which have been purchased for resale; second, securities which were purchased to give us a more or less permanent position, where we have a special interest, and which we expect to hold for institutional benefit, regardless of market fluctuations. Most of the depreciation in inventory values has occurred in this latter class of investments. From the standpoint of operations, that is, the purchase and sale of securities, both of these companies during 1930 made an operating profit").

57 M. Friedman & A. Schwartz, note 37 *supra*, at 434.

58 J. Galbraith, note 45 *supra*, at 170.

The elements of the Banking Act of 1933 that provided for a stronger Federal Reserve also were more important to insuring the stability of the commercial banking system than the Glass-Steagall provisions. As the President's Council of Economic Advisers has observed:

> *"Glass-Steagall now makes no important contribution to the protection of the public against bank failures or undue concentrations of economic power. Other government measures, such as Federal deposit insurance and broadened and strengthened Federal supervision, appear to have been more effective in that role."* [59]

Perceived problems with links between banks and securities affiliates The problems Congress thought were associated with relationships between commercial banks and securities affiliates were addressed more precisely by legislation other than the Glass-Steagall Act. Section 13 of the Banking Act of 1933 added a new section 23A to the Federal Reserve Act that imposed limitations on a member bank's transactions with its affiliates. This new section addressed concerns about potentially harmful securities and loan transactions between banks and their affiliates. By strictly limiting such transactions, the section also reduced substantially the possibility that depositor confidence in a bank might be shaken by the existence of an unprofitable affiliate. In addition, the provision addressed the fear that an affiliate, in the knowledge that it had access to a bank's resources, would make hazardous investments. Under the terms of the section, the affiliate's access to those resources was limited. Moreover, the use of an affiliate to manipulate the price of a bank's own stock was addressed by the Securities Exchange Act of 1934. By authorizing the Federal Reserve to regulate the extension of bank credit to purchasers of securities, this legislation also reduced to a considerable extent any difficulty banks might have had in insisting upon the maintenance of adequate margins on loans to customers to purchase securities distributed by the bank's affiliate. Finally, rules already established at the time of the passage of the Glass-Steagall Act addressed Congress' concern that the existence of a securities affiliate might affect adversely the independence with which fiduciary duties would be exercised by a bank's trust department.[60] In fact, during the debate on S. 4412 in May 1932, Senator Robert Bulkley pointed out that "[i]t is a long-established rule of English and American law that a trustee may not profit by dealing with his trust estate."[61]

Abuses in the marketing of securities There is no doubt that there were abuses in the marketing of securities during the 1920s. These objectionable practices, however, were not confined to the marketing activities of commercial banks. They were common to the securities industry as a whole. These general abuses, such as failures to disclose material information and market manipulation, were addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934. Banks would be no more likely than investment banking houses to engage in those practices now.

Conclusion

The Glass-Steagall Act was not a finely tailored response to the problems confronting the banking system in 1933. In fact, the Act did not correct the basic structural defects that had led to the collapse of the banking system. These defects, as well as the problems and abuses Congress had identified in the marketing of securities and in the relationships between commercial banks and securities affiliates, were addressed far more precisely by legislative provisions other than those included in Glass-Steagall. While it is understandable that Congress was persuaded that financial abuses and the country's economic ills called for drastic action, the divorce of investment and commercial banking was an imprecise and overly broad legislative remedy.

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59 *Economic Report of the President*, 122 (1983).

60 *See generally* "Conflicts of interest" *infra*.

61 75 Cong. Rec. 9912 (daily ed. May 10, 1932) (statement of Sen. Bulkley). *See also, e.g., Albright v. Jefferson County Nat'l Bank*, 292 N.Y. 31, 40 (1944).

Bank safety and soundness

One of the most critical public policy issues raised by proposed revision of the Glass-Steagall Act is how the change might affect the stability of the U.S. banking system. The public interest in preserving a safe and sound system is unquestionable. That interest would be furthered, not undermined, by allowing bank holding company subsidiaries to underwrite and deal in corporate securities: the ability to diversify by offering profitable services in response to market demand would strengthen bank holding companies without introducing greater risks than those associated with activities they already pursue.

Risks associated with corporate securities activities

Underwriting and dealing in corporate securities present the same kinds of risk as underwriting and dealing in U.S. government, municipal, and Euromarket securities, in which banks already engage. Banks also face similar risks in foreign exchange, gold, and other dealing activities. Moreover, the risks involved in underwriting and dealing in corporate securities are assumed for very short periods of time—often a few hours and seldom longer than a few days—and the assets involved are highly liquid. In contrast, bank lending activities frequently involve credit exposure for a number of years and relatively illiquid assets.

Underwriting and dealing activities generate substantial revenues despite occasional losses in individual transactions, just as most loan portfolios produce net profits. And just as banks limit exposure to any one borrower to control credit risk, an underwriter or dealer limits its position in particular securities. Finally, the SEC's net capital rules restrict the activities of securities firms, just as a variety of regulatory requirements constrains bank activities.

Underwriting and dealing In underwriting or dealing in corporate or government securities, the fundamental risk involved is that securities purchased as a principal may not be sold at a profit.[1] In underwriting, the maximum profit that may be earned is determined by agreement with the issuer or seller of securities. This constraint does not exist in dealing, where profits are entirely market-related. The ability to resell securities at a profit depends upon successfully assessing the market value of the securities (price risk) and managing exposure to market risk and firm-specific risk between the time the pricing decision is made and the securities are sold.

Price risk reflects the possibility that an underwriter or dealer may misjudge, at the time the pricing decision is made, the price the market will pay for the securities.[2] In the case of debt securities, the underwriter or dealer determines the price based on the market's perception of the company's credit quality. In the case of equity securities, the underwriter or dealer determines the price based on the market's perception of the company's future prospects.[3] In pricing both debt and equity securities, the underwriter or dealer must consider aggregate demand in the market for the particular securities. An underwriter or dealer may inaccurately assess these factors or for business or competitive reasons may price the securities too aggressively.

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1 Because securities are held for short periods of time by an underwriter or dealer, potential default and insolvency problems are not a significant risk in conducting these activities. Banks, of course, purchase for their portfolios corporate debt securities that qualify as "investment securities" and have substantial exposure to default risk through their commercial lending activities.

2 Debt securities represent more of a "commodity" than common stock and are priced in relation to the U.S. government securities market and against each other based upon investment rating and perceived quality differences within a particular rating.

3 The underwriters' pricing of additional shares of an already traded equity security will generally be at or slightly below the quoted market price for the outstanding shares at the time of the offering. The underwriters' pricing of an initial public offering (IPO) of equity securities involves greater risk. To compensate for this, an IPO is usually brought to market at an attractive price to the investor. This tends to result in a successful underwriting and a favorable secondary market price. Issues that may involve greater risk because of size, uncertainty about the company's prospects, or general market conditions usually carry a larger underwriters' spread to compensate for these risk factors.

After the pricing decision has been made, events may affect the price at which the securities can be sold. Market risk involves events that affect the level of securities prices in general, such as interest rate trends and the economic outlook. Firm-specific risk involves events, such as the introduction of new products, that affect the value of a particular company's securities, independent of general market trends. Market risks in underwriting and dealing frequently can be controlled by various hedging techniques, most of which have become available only in recent years.

Dealers generally can control the duration of their exposure to market risk and firm-specific risk, and the period of time during which underwriters are exposed to these risks is usually short. During the registration period of a traditional negotiated underwriting, the underwriters distribute preliminary prospectuses to, and receive "indications of interest" from, institutional investors who normally purchase the major portion of corporate debt and equity offerings. Once the issue is priced, the underwriting agreements signed, and the registration statement declared effective (typically within hours), the underwriters confirm sales to these investors. As a result, the underwriters frequently have the entire issue sold on the effective date.[4]

Risk and return characteristics Data published by the Securities Industry Association present convincing evidence of the favorable risk and return characteristics of underwriting and dealing in debt and equity securities. Total industry "profits" from these activities (defined by the Securities Industry Association to include gross underwriting and trading revenues less losses and certain direct expenses) were $2.9 billion in 1979, $4.5 billion in 1980, $5.8 billion in 1981, $8.3 billion in 1982, and $10.4 billion in 1983. Moreover, as indicated in Table 1, substantial profits were derived each year from underwriting and dealing in both debt and equity securities.

Another measure of the risks involved in underwriting and dealing activities is whether individual securities firms, despite the overall profitability of the industry, have gone out of business or have been forced to merge with other firms because of underwriting and dealing losses. Since World War II, no failure or forced merger of a securities firm of significant size has been reported to have been caused by losses incurred in underwriting or dealing in corporate securities. Instead, securities firms have typically failed or merged because of managerial and back-office problems, undercapitalization, and fraud or employee misconduct.[5]

Banks, like securities firms, have enjoyed favorable results in underwriting and dealing in U.S. government and municipal securities.[6] Appendix A provides the annual securities trading profits, as defined by the federal banking agencies, of the 10 largest banks in the U.S. during the period 1979-1983. Again, since World War II, no failure or forced merger of a bank of significant size has been reported to have been caused by losses incurred in underwriting or dealing in U.S. government and municipal securities.

4 In a shelf registration under the SEC's Rule 415, the registration statement is already effective before the underwriters bid for, or negotiate the price of, the securities. However, before bidding or negotiating the underwriters would have previously taken "soundings" in the market, and the duration of their exposure to market risk and firm-specific risk is generally no greater than in a traditional underwriting.

5 *See, e.g.*, Securities and Exchange Commission, *Study of Unsafe & Unsound Practices of Brokers & Dealers*, H. Doc. 92-231, 92d Cong., 1st Sess. 27 (1971); Special Subcommittee on Investigations, House of Representatives, Committee on Interstate & Foreign Commerce, *Review of SEC Records of the Demise of Selected Broker-Dealers*, 92d Cong., 1st Sess. App. B(1971); and Securities Investor Protection Corporation (SIPC), *1982 Annual Report*, 28 (1983).

6 In recent years, the volume of new issues in the municipal market has increased dramatically. New issues of long-term municipal securities in 1983 totaled $83 billion, far more than the $50 billion in new issue corporate bonds; in comparison, the volume of all corporate bonds, common stocks, and preferred stocks issued in 1983 totaled $96 billion. *The Bond Buyer* (Dec. 6, 1984); *Corporate Financing Week*, "1983 Underwriting Totals" (special supplement) (Jan. 9, 1984). Issues of U.S. government securities offered in 1983 totaled $186 billion (net). Board of Governors, Federal Reserve System, *Flow of Funds Summary Statistics* (Nov. 23, 1984).

Table 1 **Profitability of securities activities**

Profits earned by securities firms from securities underwriting and trading, 1979-1983[a]

(In millions)	1979	1980	1981	1982	1983
Underwriting[b]					
Equity	$ 177	$ 405	$ 428	$ 330	$ 754
Debt	594	925	1 145	1 992	2 783
Trading[c]					
OTC equities	440	666	609	658	1 381
Other securities [d]	557	577	551	839	1 045
Debt securities	1 161	1 896	3 083	4 463	4 418
Total	$2 929	$4 469	$5 816	$8 282	$10 381

a Source: Securities Industry Association, *Securities Industry Trends*, Table 1 (1973-78) (June 29, 1979); *id.*, at Table 3 (1979-82) (June 1, 1983); *id.*, at Table 1 (1983) (Oct. 12, 1984).

b The SIA defines underwriting profits as the difference between the proceeds of securities sold and their purchase price, adjusted for discounts, commissions, and allowances received from or given to other brokers. Direct expenses associated with a specific underwriting may also be deducted from the proceeds of securities sold. Unrealized losses on securities unsold at the time the underwriting account was closed are considered as a deduction from the proceeds of securities sold. *See* Securities Industry Association, *Securities Industry Trends*, 8 (June 29, 1979).

c The SIA defines trading profits as the gain (or loss) realized upon the sale of securities held by a securities firm for its trading account, together with interest and dividends received on trading account inventories. However, in calculating trading profits, the SIA apparently does not subtract expenses such as securities firms' cost of funds and direct expenses associated with trading activities.

d Consists of all listed equities and all other non-debt securities, including commodity futures, futures on stock indices, and options traded on national exchanges. *See* Securities Industry Association, *Securities Industry Trends*, 7 (July 30, 1984); *id.*, at Table 1 (Oct. 12, 1984).

Banks' municipal securities activities are not only functionally similar to corporate debt securities activities but also involve, in certain respects, greater risks. Greater depth and liquidity usually exist in the market for corporate debt securities than in the market for municipal securities. Unlike corporate debt securities, the vast majority of municipal issues are sold in serial form, each maturity being relatively small in amount and trading as a separate issue. The resulting lack of depth is evidenced by the wide spreads in the secondary market. Opportunities to hedge exposure in municipal securities are also more limited than in corporate debt issues. In addition, price variations in the municipal market are sometimes exaggerated, compared to the corporate market, because the tax-exempt status of municipal securities results in lower coupons and thus greater changes in price for a given change in yield.

In the Euromarket, merchant bank subsidiaries of major U.S. banks are successful competitors in underwriting and dealing in the securities of corporate and sovereign issuers. Although the majority of these issues are straight debt securities, denominated in U.S. dollars, substantial amounts are denominated in foreign currencies and some issues have equity features. The risks banking organizations face in these activities are comparable to, and in some ways greater than, the risks they would face in engaging in corporate securities activities in the United States. There is considerably less depth and liquidity, and hedging techniques are more limited, in the Euromarket than in the U.S. The favorable performance of bank affiliates' underwriting and dealing activities in the Euromarket indicates that bank safety and soundness would not be jeopardized if such activities were authorized for subsidiaries of bank holding companies in the United States.

Underwriting common stock Although the securities industry reports aggregate profits each year from underwriting equity securities, it is useful to examine in more detail the risk and return characteristics of this activity because it is generally considered "riskier" than underwriting debt securities. There is no publicly available information, however, on the results of individual underwriting transactions. Only the underwriters know whether the syndicate successfully placed the entire issue at the public offering price, and therefore earned the full underwriters' gross spread, [7] or sold some of the issue at a lower price.

Nevertheless, an indication of the revenues and losses from these transactions (including the number of transactions in which losses may have been experienced) can be obtained by comparing secondary market trading prices of common stock issues shortly after the offering date with the public offering price and underwriters' gross spread for such issues.[8] Such secondary market prices are relevant because underwriters generally dispose of unsold positions as quickly as possible after syndicate price restrictions are terminated, which normally occurs on the offering date or on the following business day.[9]

Secondary market price data on the first, fifth, and tenth business days after each SEC-registered common stock issue of $5 million or more during the period from 1976 through September 30, 1983 were reviewed.[10] For each issue, the amount per share of any decline from the public offering price on each of these three days was subtracted from the underwriters' gross spread per share. The result was then multiplied by the number of shares in the offering to determine the total net underwriting revenues generated by the issue. The first business day after the offering date (*i.e.*, the second business day of the offering period) was selected because most syndicates terminate price restrictions and dispose of any unsold underwriting positions by this day. The fifth business day after the offering date was selected because most syndicates pay the issuer or other seller of the securities on that day and then begin to incur the direct cost of carrying any unsold positions. The tenth business day was chosen to provide an additional reference point, although underwriters rarely have any securities left to sell by this day.

Two assumptions were made in comparing the secondary market prices of an issue on these three days with the public offering price and underwriters' gross spread:

- If the secondary market price was at or above the public offering price on each of these trading days after the offering, it was assumed that the underwriters successfully placed the issue and earned the full underwriters' spread. Secondary prices would rarely, if ever, exceed the public offering price if there were underwritten securities to be purchased at the lower public offering price. In addition, secondary prices generally would not remain at the public offering price if the underwriters had not placed the entire issue at that price, because of the selling pressure that occurs when underwriters dispose of unsold securities.
- If the secondary market price was lower than the public offering price on any of these trading days after the offering, it was assumed that the secondary price represented the price the underwriters received in disposing of the *entire* offering. This assumption greatly overstates any negative results experienced by the underwriters in these transactions for two reasons. First, the entire issue may have been sold at the public offering price on the offering date, in which case any lower secondary market price on the first, fifth, or tenth days after the offering date would not reflect the price received by the underwriters for the securities. Second, even if the entire issue were not sold on the offering date (or before price restrictions were terminated), it is likely that at least some portion would have been sold at the public offering price rather than at the secondary market price utilized in the study.

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7 Underwriters' gross spread is the difference between the public offering price of the issue and the price at which the underwriters buy the issue from the issuer (or other seller). The spread is subdivided within the underwriting syndicate into three parts: a special fee for the managers; a fee received by each member of the syndicate in proportion to the size of its underwriting commitment (less a deduction for syndicate expenses); and the selling concession retained by the syndicate members (or other broker/dealers) as compensation for the securities they sell to the public.

8 It was not possible to obtain comparable information on the results of underwriting corporate debt securities. Accurate post-offering secondary market trading prices are not available for debt securities because the vast majority of trades are over-the-counter transactions that are not publicly recorded.

9 The underwriters promptly dispose of unsold positions in order to free up their capital and to comply with SEC net capital rules. Before syndicate price restrictions are lifted, the underwriters are required to sell the securities at the public offering price.

10 These data were furnished by Abrahamsen & Co. It has collected such data since 1976.

The results of this analysis are summarized in Table 2, which shows the substantial net underwriting revenues generated each year when aggregate price declines are deducted from the underwriters' gross spread. The total value of price declines on the first day during the nearly eight-year period represents approximately 15% of the total underwriters' gross spread. The total value of price declines on the first day relative to the total underwriters' gross spread was greatest in 1980, at approximately 21%. Thus, even in 1980, the underwriters would have realized at a minimum 79% of the total gross spread.

Table 2

Underwriting revenues

Potential effect of changes in price on the first, fifth, and tenth days after the offering date of SEC-registered common stock issues of $5 million or more, 1976-1983[a]

Year	Value of all issues at public offering price	Total under-writers' gross spread	Value of price declines below public offering price: Day 1	Day 5	Day 10	Net revenues resulting from subtracting the value of price declines from total underwriters' gross spread: Day 1[c]	Day 5	Day 10
(In millions of dollars)								
1976	7 161	269.25	30.64	79.69	−130.75	238.61	189.56	138.50
1977	5 540	184.14	21.04	38.40	−54.73	163.10	145.74	129.41
1978	5 392	192.97	−29.32	−79.04	106.24	163.65	113.93	86.73
1979	4 978	209.51	24.38	−69.54	−91.95	185.13[b]	139.97	117.56
1980	12 044	537.59	112.75	−221.60	−314.44	424.84[b]	315.99	223.15
1981	12 919	619.21	84.38	−49.06	−65.22	534.83[b]	570.15	553.99
1982	13 547	487.25	−91.04	−184.18	185.12	396.21[b]	303.07	302.13
1983	28 613	1 323.59	−185.28	−475.63	620.64	1 138.31	847.96	702.95
1976-1983	90 194	3 823.51	−578.83	−1 197.14	−1 569.09	3 244.68	2 626.37	2 254.42

a Results for 1983 are through September 30.

b The total annual net revenues in this table exceed the profits compiled by the Securities Industry Association for all equity issues, which are shown in Table 1, because certain direct expenses associated with specific underwritings are subtracted in calculating underwriting profits in those data. In this table, no expenses are deducted to calculate the net underwriting revenues.

c For the reasons previously noted, the revenues on the first day after the offering are likely to be more indicative of actual revenues than on the other two days.

The number of common stock underwriting transactions in which secondary price declines exceeded the underwriters' gross spread (thereby creating the possibility that the underwriters sustained actual losses) was also examined. Table 3 shows that, for the entire period, the number of transactions in which such declines occurred on the first day after the offering date is only 4.4% of the total number of issues.

Table 3

Frequency of significant secondary market declines of common stock issues [a]

Year	Number of issues	Number of issues with price declines in excess of underwriters' gross spread		
		Day 1	Day 5	Day 10
1976	169	5	18	34
1977	120	1	5	15
1978	165	9	27	35
1979	172	3	24	38
1980	363	22	59	85
1981	450	17	9	13
1982	340	18	55	64
1983	806	38	131	163
1976-1983	2 585	113	328	447

a As in Table 2, analysis includes SEC-registered common stock of $5 million or more, 1976 through September 30, 1983.

Tables 2 and 3 indicate that common stock underwriting generates substantial net revenues and involves relatively few offerings in which the underwriters may have sustained actual losses. There remains, however, the theoretical possibility that one or more major unsuccessful underwriting transactions could place an individual underwriter in serious financial difficulty. To examine the possibility of such large destabilizing losses, the price that underwriters paid for the securities was compared with secondary prices on the three trading days after the offering.

As shown in Appendix B, there have been only four common stock issues from 1976 to September 1983 in which the secondary price declines (multiplied by the number of shares in the issue) exceeded the aggregate underwriters' gross spread by more than $10 million. The largest indicated loss ($45.3 million on the tenth day after the offering) was associated with the Phibro-Salomon offering of July 6, 1983. However, further investigation reveals that the entire Phibro-Salomon offering was sold at the public offering price on the offering date and that syndicate price restrictions were terminated on that date. Price declines on the fifth and tenth days, therefore, did not affect the underwriting syndicate's results. The next largest indicated loss shown in Appendix B involved the offering on October 21, 1982 of 2,995,600 shares of Eastman Kodak. But even if the syndicate's actual loss in this transaction was as large as indicated in Appendix B ($18.5 million on the fifth day), the largest single underwriter's share of this loss would have been approximately $5 million. A loss of this size, while not insignificant, would not have a destabilizing effect on an underwriter able to assume a major position in such an offering. Such an underwriter's capital base and its revenues from other underwriting activities would clearly enable it to withstand such a loss.

Insulating the bank from the securities affiliate

As discussed earlier, corporate securities activities do not involve greater risks than existing securities activities of commercial banks. Appropriate insulation of the bank from the affiliate would assure, moreover, that in the rare instance that a bank securities affiliate experienced financial difficulties, their impact on the bank would be minimal.

Separate capital As required under legislative proposals to permit banks to underwrite municipal revenue bonds and sponsor mutual funds, a bank securities affiliate would be a holding company subsidiary rather than a bank subsidiary. As a result of the affiliate's separate capitalization, any losses it incurred would not impair the capital of the bank. An affiliate would also have to maintain sufficient capital, in relation to the nature and volume of its securities activities, to comply with the net capital requirements of the SEC. In addition, current legislative proposals would give the Federal Reserve Board authority to disapprove a bank holding company's proposed investment in an affiliate if the Board determined that the capital resources or the management of the holding company and the proposed affiliate were insufficient to support the anticipated business activities.

It is also implausible that a bank's capital would be reduced to an unsafe level as a result of the payment of dividends to a parent organization in order to aid a troubled securities affiliate. In addition to the responsibility of bank management to maintain adequate capital and the constraints imposed by the marketplace, the International Lending Supervision Act of 1983[11] strengthened the powers of the federal banking agencies to establish minimum levels of capital for banks. In view of the severe penalties that can be imposed for failing to comply with minimum capital requirements, it is virtually inconceivable that a bank's management, without consulting with bank regulators, would reduce capital below the required minimum through the payment of dividends.

Limitations on loans to an affiliate The Congress that passed the Glass-Steagall Act was concerned that banks could be injured by making loans to or investments in troubled securities affiliates. The Banking Act of 1933, in adding a new Section 23A to the Federal Reserve Act, directly addressed this concern by placing limits on transactions between banks and their affiliates. Strengthened in 1982, Section 23A limits "covered transactions" with a single nonbank affiliate—including loans, extensions of credit, purchases of assets, and investments in the securities of an affiliate—to no more than 10% of bank capital. The amount of such transactions with all nonbank affiliates may not exceed 20% of bank capital.

Under Section 23A, loans and extensions of credit to nonbank affiliates must be fully collateralized to protect the bank from loss. Moreover, the purchase of low-quality assets from an affiliate is generally prohibited. Finally, Section 23A requires that all transactions between a bank and its affiliates must be conducted in a manner consistent with safe and sound banking practices.

Depositor confidence and funding Public confidence is the foundation of a safe and sound banking system. This confidence, in the case of any one institution, depends ultimately on the belief that a bank is solvent and will be able to meet its obligations. If a bank reports significant losses, if public fears about its financial condition develop, and if these fears are not allayed, the resulting loss of depositor confidence may lead to a run on the bank.[12]

Permitting bank securities affiliates to underwrite and deal in corporate securities would not increase the risk of loss of depositor confidence for at least three reasons.[13] First, it is highly unlikely that any loss incurred by a securities affiliate would be large enough to impair its capital, let alone the capital of its parent bank holding company. As discussed earlier, securities activities do not produce

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11 Pub. L. No. 98-181, sec. 908, 129 Cong. Rec. 10,659 (daily ed. Nov. 18, 1983).

12 The considerable body of evidence available on the funding experiences of banks that incurred losses in their own operations indicates that banks have been able to overcome short-term funding difficulties, provided the market perceived that they would remain solvent. In these cases, while some institutional depositors have withdrawn funds and others have required interest rate premiums, banks have generally been able to replace any temporary loss of deposits by obtaining funds from other banks. Insured retail depositors generally have not withdrawn funds to any significant degree.

Major funding problems do arise when doubts of a bank's solvency become widespread. For example, in the case of Continental Illinois, continued deterioration in the bank's portfolio and the poor quality of reported earnings led depositors to doubt whether the bank would continue to be solvent, and a massive withdrawal of uninsured liabilities occurred.

13 In *Investment Co. Institute* v. *Camp*, 401 U.S. 617 (1971) [hereinafter *ICI v. Camp*], the Supreme Court cited the legislative history as indicating congressional concern that public confidence in a bank would be impaired if its affiliate fared poorly. *Id.*, at 631.

large, destabilizing losses but instead generate healthy profits. Second, any loss incurred by a securities firm can be measured readily, because the value of all securities must be marked to market;[14] no uncertainty about the possible ramifications of a loss for the firm or its parent company would ensue. In contrast, the effect of loan losses on the value of a bank's total portfolio cannot be assessed with similar accuracy. Third, losses incurred by a securities affiliate would not threaten the bank's solvency because the capital and assets of the bank would be insulated from the affiliate, as shown earlier. In sum, it is unlikely that a bank would experience any significant funding problems as the result of a securities affiliate's activities.[15]

Banking system benefits

Bank holding companies would be strengthened rather than weakened by operating securities subsidiaries, which would provide holding companies with opportunities to diversify assets and revenue sources through activities that are highly profitable in relation to the risks assumed. As shown in Table 4, the annual after-tax return on equity in recent years for large investment banks was approximately twice the annual after-tax return on equity for the ten largest bank holding companies.

Table 4

Return on equity

Comparison of the annual after-tax rates of return on equity capital for investment banks and bank holding companies

	1979	1980	1981	1982	1983
Large investment banks[a]	19%	30%	30%	30%	24%
Ten largest bank holding companies[b]	16	16	14	13	13

a Securities Industry Association, *Securities Industry Trends* (May 30, 1980; May 19, 1982; June 16, 1982; and May 14, 1984).

b Weighted average. Calculated from data obtained from Keefe, Bruyette & Woods, Inc., *1984 Keefe Banking Manual.*

14 Securities that are marked to market are valued for accounting purposes at their closing market price.

15 There are only a few cases that illustrate the funding experience of banks when their affiliates suffered losses. The recent experience of American National Bank & Trust Company of Chicago illustrates how the market can differentiate between a bank and an affiliate that is experiencing difficulties. The losses and funding problems of Walter E. Heller & Company in 1981-1983 did not result in any funding difficulties for its bank affiliate, American National.

In the most extreme case of bank funding problems caused by losses elsewhere in the holding company, Beverly Hills National Bank reportedly experienced a 15% loss of deposits during December 1972 and January 1973 after its parent company, Beverly Hills Bancorp, defaulted on a portion of its $13.6 million of outstanding commercial paper. In view of the insolvency of the parent company, which subsequently entered bankruptcy proceedings, and doubts about its management, the bank, which remained solvent, was sold by the Comptroller of the Currency to Wells Fargo Bank for $12.2 million, a premium over the bank's book value.

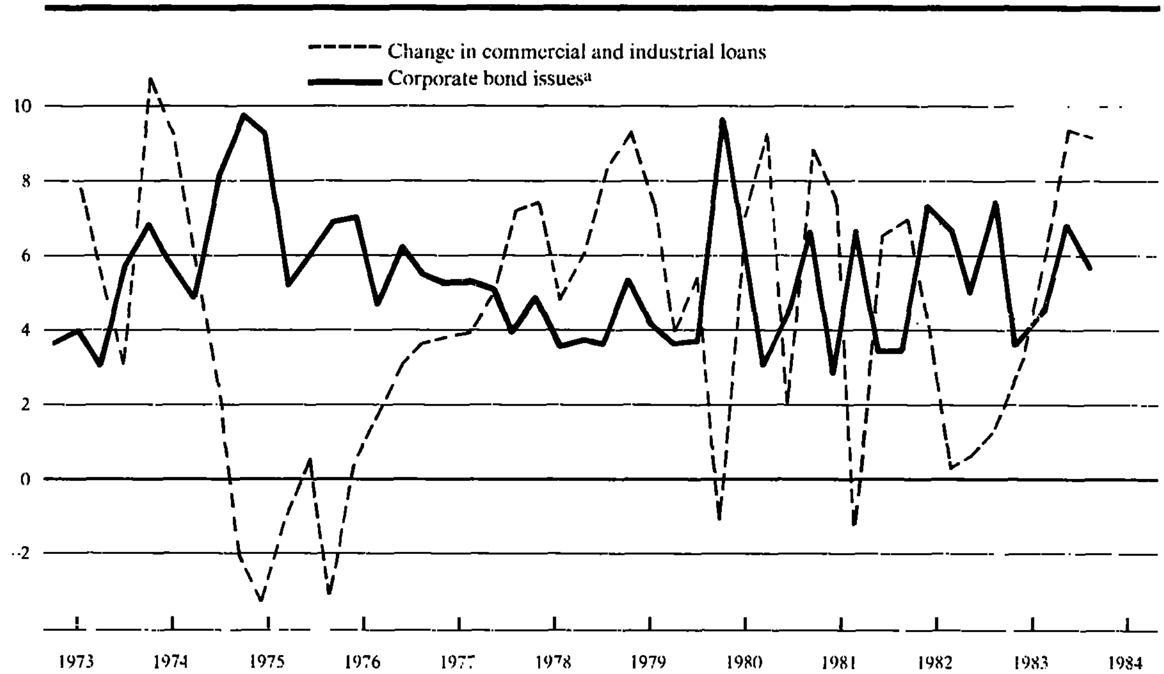
The failure of Hamilton National Bank of Chattanooga in 1976, which is sometimes cited as an example of a bank failure caused by an affiliate, did not result from funding difficulties caused by an affiliate's losses. The bank itself became insolvent as a result of its purchase of low-quality real estate loans from an affiliate, a practice now prohibited by Section 23A of the Federal Reserve Act. 12 U.S.C. sec. 371c.

Not only is the securities business more profitable than the banking business, but commercial bank entry into corporate securities activities would also allow banks to diversify their sources of revenue and reduce earnings volatility. As shown in the chart below, for example, corporate bond issuance and the growth of bank commercial and industrial loans are negatively correlated. When bond issuance is high, the demand for bank loans is low; when bank loan demand is high, bond sales tend to drop off. Thus involvement in the corporate securities business might well prove beneficial in enabling bank holding companies to even out swings in earnings associated with changes in loan demand.

Corporate bond issuance vs. loan demand

Volume of publicly offered corporate bond issues compared with change in bank commercial and industrial loans, 1974-1984

(In billions of 1972 dollars)



a Publicly offered non-convertible debt, largely comprising corporate debt issues. Excludes syndicated agencies, federal, state, and local issues as well as tax-exempt pollution control financings and swaps; includes a limited number of underwritten offers by federal agencies.

Increased earnings generated by corporate securities activities would augment the capital resources of bank holding companies and facilitate their efforts to raise additional capital in the market. Additional capital in turn would enhance the safety and soundness of the banking system. Banks' ability to raise equity capital has been constrained by the low prices of bank holding company stocks, which persistently have sold at a discount from book value in recent years. In contrast, the market—as represented by Standard & Poor's index of 400 industrial company stocks—typically trades at a premium over book value, as shown in Table 5. The differential reflects in part the poor returns (adjusted for risk) that the market anticipates for bank holding companies in their current lines of business.

Table 5

Market valuation of bank stocks

Comparison of ratios of market value to book value of bank stocks and large industrial company stocks[a]

(At year end)	1979	1980	1981	1982	1983
S&P 400 Index	1.23	1.43	1.18	1.33	1.53
35 large bank holding companies	0.76	0.80	0.78	0.79	0.90

a The Standard & Poor's 400 Industrials stock index is a subset of the broader, better known S&P 500 Composite stock index. The S&P 400 is used in this comparison because the S&P 500 includes several large bank holding companies. Sources: Standard & Poor's, Inc., *The Analyst's Handbook* (1983); Salomon Brothers, *A Review of Bank Performance* (1981); *id.* (1982); *id.* (1984). Bank data not comparable across years as universe changes.

Conclusion

Corporate securities activities generate substantially higher returns on capital employed than commercial banking activities and carry no greater risk. Expanding the range of permissible bank holding company activities to include underwriting and dealing in corporate securities would create opportunities for such companies to develop substantial new sources of earnings. A reliable revenue stream, generated by a diversified range of financial activities, strengthens a bank holding company's capacity to absorb current losses and make adequate provision against future losses. It also enhances the company's ability to generate the additional capital needed to support asset growth and to retain the confidence of the markets in which it operates. Far from jeopardizing the safety and soundness of the banking system, permitting bank affiliates to underwrite and deal in corporate securities would increase the system's stability.

Appendix A

Bank trading account net profits, 1979-1983[a]

(In thousands)	1979	1980	1981	1982	1983
Bank of America	$ 38 451	$ 56 093	$114 723	$151 985	$ 89,652
Bankers Trust Co.	76 872	104 680	120 853	217 740	186,334
Chase Manhattan Bank	22 501	49 211	72 749	83 052	71,445
Chemical Bank	(25 674)	(28 550)	12 418	23 037	73,633
Citibank	166 597	209 259	435 511	406 000	401,000
Continental Illinois	32 746	32 140	53 640	63 805	40,609
First Chicago	9 055	14 230	40 516	38 816	29,014
Manufacturers Hanover	14 925	17 640	26 267	46 554	75,571
Morgan Guaranty	56 712	84 199	100 179	137 875	124,304
Security Pacific	13 508	27 285	31 219	47 337	20,255

a Source: Federal Deposit Insurance Corporation and Federal Reserve Board Year-End Reports of Condition and Statements of Income. The federal banking agencies define bank "trading account net profits" as the revenues banks receive from their dealing activities in securities held for dealing purposes, minus any losses realized from dealing activities. Trading account net profits also include interest paid to banks with respect to securities held in their trading accounts and commission income from underwriting and certain agency activities. However, in calculating trading account "net profits," the banking agencies do not subtract from these revenues expenses such as banks' cost of funds or various direct expenses associated with bank trading account activities.

Appendix B

Common stock issues in which aggregate secondary price declines exceed cost of issue to underwriters by more than $10 million

Date	Name	Offer price (per share)	Underwriter cost (per share)	Market price minus underwriter cost (per share) Day 1	Day 5	Day 10	Number of shares (in millions)	Aggregate difference between market price and underwriter cost ($ millions) Day 1	Day 5	Day 10	Maximum
7/06/83	Phibro-Salomon	$35 63	$34.43	1.33	0.30	7.55	6.00	8.0	- 1.8	45.3	- 45.3
10/21/82	Eastman Kodak	94.75	94.28	2.03	- 6.16	−1.78	3.00	-6.1	18.5	5.3	- 18.5
3/06/81	Cetus Corp	23.00	21.65	0.65	1.65	-2.65	5.22	- 3.4	8.6	13.8	13.8
3/04/83	Fortune Systems	22.00	20.55	0.55	−2.30	2.68	5.00	−2.8	11 5	−13.4	13.4

Conflicts of interest

Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Regulation rather than prohibition of activities, however, is the method of controlling potential conflicts developed under the federal securities laws, and this less restrictive approach would deal effectively with the potential conflicts of interest encountered by bank securities affiliates. Moreover, economic incentives to maintain the good will of clients are strong and would also significantly limit the exploitation of potential conflicts.

Economic disincentives to exploit potential conflicts

The exploitation of potential conflicts of interest by any company would jeopardize the company's reputation with its clients. The good will that a firm has developed with clients is essential to its continued ability to attract business and generate earnings; therefore, a strong economic incentive exists to refrain from actions that might harm the firm's good reputation. While exploitation of a conflict of interest might boost profits in the short run, over the long term such exploitation would cause clients to take their business elsewhere, threatening the firm's future growth and profits. As one study concluded:

> *"[I]t is imperative to recognize that the self-serving opportunities present in conflict-of-interest situations are usually not exploited. If such were not the case, fiduciary relationships would seldom have survived, regulations would rarely be intact, and the law would have had to intervene far more frequently than it has."* [1]

Regulation vs. prohibition

Banks have long faced potential conflicts, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser. In a 1936 study of the broker and dealer functions of securities firms, the SEC recognized the potential conflicts that exist when a firm acts in both capacities, noting that

> *"the over-the-counter house which conducts a brokerage business and which also takes underwriting positions . . . is under temptation to induce brokerage customers to purchase securities which it is anxious to sell. . . . Whenever the broker and dealer functions are thus combined the profit motive inherent in the latter may be sufficient to color investment advice or otherwise affect the brokerage service rendered to customers."* [2]

However, the drastic remedy of divorcing certain business activities from others because of potential conflicts is generally rejected because it imposes unnecessary economic costs on society. The SEC's 1936 study recommended against enacting legislation to separate the broker and dealer functions, and since that time Congress has relied on disclosure and regulation of potential conflicts rather than risk the economic consequences of separating these activities. [3]

Continued separation of commercial from investment banking is justified only if disclosure, regulation, and judicial remedies would provide inadequate protection against the potential conflicts that could arise from the affiliation of a bank and a securities firm. Analysis indicates that this justification is clearly lacking.

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1 E. Herman, *Conflicts of Interest: Commercial Bank Trust Departments*, xv (1975).

2 Securities and Exchange Commission, "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker," 75-76 (1936).

3 *Id.*, at 109.

Potential conflicts An examination of the potential conflicts of interest that the affiliation of banks and securities firms might present reveals that these conflicts are not substantially different from or greater than those faced by banks or securities firms individually. These conflicts, which are described in Glass-Steagall's legislative history and in *ICI v. Camp*,[4] are discussed in the following pages.

Promotion vs. disinterested advice At the time the Glass-Steagall Act was passed, the promotional role of the investment banker was viewed as incompatible with the "obligation" of a banker to give disinterested investment advice.[5] Regardless of whether some depositors in an earlier era may have looked to their commercial bankers for investment advice, commercial bankers have neither an express nor implied obligation to their depositors to provide them with such investment advice. The view that it is inappropriate for banks to have a "salesman's stake" in promoting a particular product or service ignores the realities of today's marketplace, in which banks, like other financial institutions, provide substantial investment advisory services and promote the sale of a variety of financial products and services to the benefit—not the detriment—of their customers. The narrow view of appropriate banking activities expressed in the legislative history and in *ICI v. Camp* must be reexamined both in light of the fundamental changes since 1933 in the laws and regulations governing securities activities and in light of market developments in the financial services industry that have radically altered the banking business.

The comprehensive securities laws and regulations that have evolved subsequent to the Glass-Steagall Act effectively control the potential conflicts that exist when a securities firm has "a promotional stake" in the sale of securities and at the same time provides investment advice to customers. These laws and regulations would apply in all respects to a securities firm affiliated with a bank and would provide to bank customers that do business with the securities affiliate the same protection currently received by customers of securities firms.

Disclosure requirements,[6] antifraud provisions,[7] and related rules and regulations insure that promotional incentives do not override the broker-dealer's duty to its customers. They establish standards for both general business conduct and the suitability of recommendations to customers regarding the purchase of securities,[8] and they regulate discretionary accounts.[9] Public confidence and concepts of fair dealing are critical to the securities business, as they are to the banking business. As described by the president of the Securities Industry Association:

> *"The securities business rests on public confidence, confidence that the brokers and dealers with whom the public transacts business are . . . held to standards of fair dealing. . . . Public confidence is clearly enhanced by rules ensuring that brokers . . . are required to 'know' their customers and to make only those recommendations that are suitable for those customers, and so forth."* [10]

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4 401 U.S. 617 (1971). In *ICI v. Camp*, the Supreme Court cited various hazards involving potential conflicts of interest that could arise if banks were to engage in certain investment banking activities.

5 *See* 75 Cong. Rec. 9912 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

6 *See* 15 U.S.C. secs. 77g, 77j (sections 7 and 10 of the Securities Act of 1933 [hereinafter the 1933 Act]); *id.*, at sec. 78l(b) (section 12(b) of the Securities Exchange Act of 1934 [hereinafter the Exchange Act]).

7 *See id.*, at sec. 77q(a) (section 17(a) of the 1933 Act); *id.*, at secs. 78i(a)(4), 78j(b), 78o(c)(1) (sections 9(a)(4), 10(b), and 15(c)(1) of the Exchange Act); *id.*, at Sec. 80b-6(3) (section 206(3) of the Investment Advisers Act of 1940 [hereinafter the Advisers Act]). *See also* 17 C.F.R. secs. 240.10b-5, 240.15c1-6.

8 *See id.*, at secs. 240.15b10-2, 240.15b10-3; New York Stock Exchange Rule 405.

9 *See* 15 U.S.C. sec. 80b-6(3) (section 206(3) of the Advisers Act); 17 C.F.R. secs. 240.15cl-7, 240.15b10-5.

10 E. O'Brien, "In the Middle of the Regulation-Deregulation Road," in *The Deregulation of the Banking and Securities Industries*, 134 (1979).

The same regulatory framework is relied upon to control potential conflicts even when a securities firm is a paid investment adviser and thus has a fiduciary duty to its client.[11] For example, an investment adviser acting as principal in the purchase from or sale of securities to a client must disclose fully all material facts regarding the potential conflict of interest and must obtain the client's consent to the transaction.[12]

The banking business has changed significantly since 1933. Within the current legal framework, banks and their affiliates engage in extensive promotional activities involving not only deposit instruments but also a great variety of financial products and services, including municipal and government securities and fiduciary and other investment advisory services. Promotional activities have increased in recent years partly as a result of the deregulation of interest rates, as many banks and their affiliates seek to supplement net interest income with greater fee income and to diversify revenue sources by offering additional products and services. Such promotional activities have served to educate consumers about investment alternatives and thereby foster competition. Moreover, during the past decade, bank affiliates have become active in underwriting and dealing in corporate securities in the Euromarket and, therefore, are already engaged in promoting the sale of corporate securities. In short, banks and their affiliates have long been performing services and offering products in which they have a "salesman's stake" or pecuniary incentive without any adverse effect upon the banks or their customers.

Fiduciary responsibility The concern that banks might sell to their trust accounts securities that were underwritten or dealt in by their affiliates ignores the clear duty of a trustee to refrain from self-dealing, *i.e.*, putting itself in a position where its interest is or might be in conflict with its duty.[13] The proscription against self-dealing also applies to affiliates or subsidiaries of the trustee.[14] A trustee that breached its duty of undivided loyalty to the trust by dealing with itself or an affiliate would be required to repay the misapplied trust funds with interest. The trustee would be liable even if the transaction were fair to the beneficiaries when consummated and any losses on the investments were not caused by self-dealing on the part of the trustee.[15]

Some states have codified the common law prohibition against self-dealing by state chartered bank trustees,[16] and the Comptroller of the Currency has adopted regulations prohibiting self-dealing by

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11 Both the courts and the SEC regard a paid investment adviser as a fiduciary who owes his clients an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts." *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963). *See also* 46 Fed. Reg. 41,771 (1981) (SEC Investment Advisers Act Release No. 770 (Aug. 13, 1981)); 11 Fed. Reg. 10,997 (1945) (SEC Investment Advisers Act Release No. 40 (Jan. 5, 1945)).

12 Section 206(3) of the Advisers Act, 15 U.S.C. sec. 80b-6(3), makes it unlawful for an investment adviser

> *"acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."*

Similarly, an underwriter is under a duty to make full disclosure and obtain the consent of its client before selling securities as principal to an account over which it has investment discretion. *See* 17 C.F.R. sec. 241.10181.

13 *See, e.g., In re Ryan*, 291 N.Y. 376, 407 (1943).

14 2 A. Scott, *The Law of Trusts*, sec. 170.13 (3d ed. 1967).

15 *See, e.g., In re Peck's Will*, 273 N.Y.S. 552, 555 (Surr. Ct. West. Co. 1934); *In re Gerken's Will*, 254 N.Y.S. 494, 497 (Surr. Ct. Kings Co. 1931). Similarly, the trust beneficiaries could require the trustee to disgorge any profits made by the trustee as a result of self-dealing.

16 *See, e.g.*, N.Y. Banking Law sec. 100-b, subd. 1.

national banks.[17] In addition, self-dealing constitutes a "prohibited transaction" under the Employee Retirement Income Security Act of 1974 ("ERISA"),[18] and substantial penalties are imposed for violations by fiduciaries of employee benefit plans.[19]

Even in a situation in which the trustee is expressly authorized by the trust instrument or by the trust beneficiaries to engage in transactions with itself or its affiliates, this authorization will not be upheld unless it can be determined that it was given knowingly, by persons fully competent to make an informed decision, and that the trustee acted honestly and in good faith.[20] Moreover, banks' fiduciary activities are subject to supervision by bank regulators through on-site examinations and periodic reports. Transactions in which an affiliate has an interest are scrutinized, and any violation of the prohibition against self-dealing would not only have a serious effect on the bank's reputation as a fiduciary, but could also subject the bank to regulatory sanctions and liability for losses.

The potential conflicts of interest that may arise when a bank acts as trustee and its affiliate underwrites or deals in corporate securities are no different from those that are faced by securities firms that provide fiduciary services and engage in underwriting and dealing activities as principal. The same potential conflicts are also present when a bank acts as trustee and the bank or its affiliate underwrites or deals in U.S. government or municipal securities. A 1975 study by the Department of the Treasury noted that "while the potential for conflicts exists, there is no record of actual conflicts arising from commercial bank underwriting of general obligation municipals during the past 40 years that they have engaged in such activity."[21] The study stated that this issue was "probed extensively" in 1967 hearings before a Senate subcommittee, and concluded: "Opponents of commercial bank underwriting of revenue bonds were unable to present a single instance where a bank had been guilty of a conflict of interest in underwriting and dealing in general obligation issues."[22]

Underwriting to salvage loans Another objection raised by those who oppose affiliation between banks and securities firms is that a bank may utilize its securities affiliate to underwrite securities of a

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17 The Comptroller of the Currency's regulations provide:

> *"Unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a national bank as fiduciary shall not be invested in stock or obligations of, or property acquired from, the bank or its directors, officers, or employees, or individuals with whom there exists such a connection, or organizations in which there exists such an interest, as might affect the exercise of the best judgment of the bank in acquiring the property, or in stock or obligations of, or property acquired from, affiliates of the bank or their directors, officers or employees."*

12 C.F.R. sec. 9.12(a). In addition, the self-dealing prohibition is extended to purchases of securities from another member of a syndicate of which a trustee or an affiliate is a member, while the syndicate is open, if all members are responsible for a share of any unsold securities (i.e., an "undivided" syndicate). Comptroller of the Currency, TBC-19 (Sept. 25, 1981). The self-dealing prohibition is even applied to transactions between a trustee and itself or an affiliate that involve agency rather than principal transactions. The Comptroller of the Currency's recent policy statement on brokerage transactions states that national banks may effect such transactions through an affiliate on behalf of fiduciary accounts only if they are performed on a nonprofit basis. Comptroller of the Currency, TBC-23 (Oct. 4, 1983).

18 29 U.S.C. sec. 1106; 26 U.S.C. sec. 4975(c).

19 29 U.S.C. sec. 1109; 26 U.S.C. sec. 4975(a), (b). Moreover, a fiduciary is permitted to purchase securities from another member of a syndicate of which the fiduciary or an affiliate is a member only if neither is a manager of the syndicate and if certain other restrictive conditions are met. 40 Fed. Reg. 50,845 (1975) (U.S. Dept. of Labor Prohibited Transaction Class Exemption 75-1 (Oct. 31, 1975)).

20 *See, e.g., In re Balfe's Will,* 280 N.Y.S. 128, 130 (1935). *See also* 2 A. Scott, *The Law of Trusts,* sec. 170.13 n. 13 (3d ed. 1967).

21 U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities,* 35 (1975). Similarly, there have been no allegations of self-dealing in connection with banks' activities as dealers of certificates of deposit or bankers acceptances.

22 *Id.,* at 35 n. 41.

financially unsound company to facilitate the repayment of loans to the bank.[23] Underlying this objection is an assumption, highly questionable in this litigious society, that a bank securities affiliate would fail to comply with the rigorous disclosure requirements and antifraud provisions of the federal securities laws. The Securities Act of 1933 and Securities Exchange Act of 1934 as well as securities regulations impose upon an issuer, its directors, and the underwriters of an issue a duty of full disclosure of all material facts. These parties would subject themselves to civil and possibly criminal liability under the 1933 and 1934 Acts if they failed to disclose adequately in the prospectus for an offering the financial condition of the issuer, the intended use of proceeds of the offering, and the benefits that any of these parties would directly or indirectly derive from the offering.[24] In any judicial action involving securities underwritten by a securities affiliate for the purpose of obtaining repayment of loans to the bank, a court is likely to examine rigorously the underwriter's adherence to its duty of full disclosure.[25]

Disclosures mandated under the securities laws also assist the rating agencies in making their determination of the credit quality of the securities and enable investors to determine whether the investment return appropriately reflects the risks involved. Both debt and equity securities are primarily purchased by institutional investors, who are fully qualified to analyze the information disclosed.

Imprudent lending Any concern that a bank may make imprudent loans to customers for the purchase of securities underwritten by its affiliate is based on the assumption that a bank would jeopardize its own assets so that its affiliate could earn a small fraction of the amount of those assets on the sale of securities, whether as agent or principal. The possibility of such imprudent lending was considered and rejected by the Federal Reserve in the application by BankAmerica Corporation to acquire The Charles Schwab Corporation, a retail discount brokerage firm. In its order approving this acquisition, the Board of Governors stated:

> *"The possibility that Bank might make unsound loans to Schwab customers to maximize Schwab's profits is not substantial and is neither based on evidence nor reasonable. Moreover, it would not be rational for Bank to place its own funds at risk in an unsound loan merely to increase brokerage commissions earned by Schwab."* [26]

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23 A related concern associated with the existence of a banking relationship between a company and a bank affiliated with a securities firm is that the securities firm might obtain access to confidential information submitted by the company to the bank in connection with the latter's lending activities. The possible misuse of nonpublic information presents a potential conflict that banks and securities firms have confronted for decades. Both banks and securities firms have adopted "Chinese Wall" arrangements to prevent their investment management departments and trading departments, respectively, from obtaining access to nonpublic information submitted by clients in connection with lending or underwriting activities. Similar procedures may be necessary to prevent a securities firm from obtaining access to nonpublic information submitted to its affiliated bank. For a thorough discussion of this potential conflict faced by securities firms and a proposed solution, see Lipton & Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms," 50 *N.Y.U. L. Rev.* 459 (1975).

24 The 1933 Act requires that a registration statement state the purposes for which the securities are to be offered and the approximate amounts to be devoted to such purposes See Item 4 of SEC Forms S-1, S-2 and S-3, incorporating Item 504 of Regulation S-K of the Securities and Exchange Commission, 17 C.F.R. sec. 229.504. *See also In re Maumee Oil Corp.* [1949] Fed. Sec. L. Rep. (CCH) para. 76,020 (prospectus found to be deficient for failure to disclose the amounts to be paid to persons in a material relationship to the issuer). Sections 11(a), 12(2) and 15 of the 1933 Act, 15 U.S.C. secs. 77k(a), 77l(2) and 77o, and sections 10, 18 and 20 of the Exchange Act, *id.*, at secs. 78j, 78r and 78t, impose civil liability and section 24 of the 1933 Act, *id.*, at sec. 77x, and section 32 of the Exchange Act, *id.*, at sec 78ff, impose criminal liability.

25 Similarly, disclosure requirements would effectively prevent a bank from selling its bad loans by packaging them as pass-through securities for sale by a securities affiliate. Incomplete or misleading disclosure of the quality of loans contained in the pass-through security issue could lead to civil and possibly criminal liability, as discussed above.

26 *BankAmerica Corporation,* 69 Fed. Res. Bull. 105, 113 (1983). The Board's order has been affirmed by both the U.S. Court of Appeals for the Second Circuit and the Supreme Court, *Securities Industry Ass'n* v. *Board of Governors,* 716 F. 2d 92 (2d Cir. 1983), *aff'd,* 104 S. CT. 3003 (1984). Although Schwab acts as an agent, not a principal, the Board of Governors' logic applies to the relationship between a bank and its securities affiliate when the latter acts in either capacity.

It is also well recognized that few investors (other than broker-dealers) borrow to buy corporate bonds, that most loans to purchase equity securities (excluding loans to finance major corporate acquisitions) are smaller loans made to individuals rather than larger loans to institutional investors, and that loans to purchase equity securities are subject to the margin regulations promulgated under the 1934 Act.[27] The margin regulations apply to both bank and nonbank lenders financing the purchase or carrying of margin stock[28] when such lenders are secured directly or indirectly by margin stock. The regulations restrict the amount of such loans to the maximum loan value of the collateral, which in the case of margin securities is currently half its market value. The federal securities laws further limit the possibility of abuses in securities lending by prohibiting a securities firm from arranging for a loan, whether from its bank affiliate or otherwise, to a customer on a security underwritten during the preceding thirty days by the firm.[29]

Some observers also voice the concern that a bank may lend imprudently to a company whose securities are underwritten by the bank's securities affiliate. This concern is based on the assumption that a bank would be prepared to make an unsound loan to a company simply because securities of the company had previously been underwritten by an affiliate of the bank. While a bank may at times make additional loans to a company experiencing financial difficulties in order to protect outstanding loans to that company, no similar economic incentive exists where a prior underwriting by an affiliate is involved. Such conduct is not expected of an underwriter or its affiliate, and there is little reason to believe it would be expected of, or engaged in by, a bank that has a securities affiliate. There was no substantial evidence during the Glass-Steagall hearings that such lending actually occurred, and the theoretical possibility of abuse is even more remote now, given the changed nature of investment banking relationships. Today, companies are more likely to use more than one investment banker for different transactions and, in the case of highly rated companies, to employ shelf registrations, in which the underwriters are often selected competitively. As a result, it is extremely unlikely that a bank-affiliated underwriter, even if it served as the manager of the syndicate, would feel obliged to assist an issuer experiencing financial difficulty by encouraging its bank affiliate to make loans that would not otherwise be justified.[30]

Conclusion

Strong economic incentives to preserve good will and reputation, assets critical to the long-term financial health of any business enterprise, would serve as powerful constraints on the exploitation of potential conflicts of interest that might arise from the affiliation of banks and securities firms. Based upon the premise that various methods of control short of absolute separation of functions prevent abuse effectively, a regulatory framework has been established during the past fifty years under the federal securities laws to deal with potential conflicts. Disclosure requirements concerning the existence of conflicting interests provide investors with sufficient information to make informed decisions, and regulatory supervision and judicial enforcement remedies, both public and private, deter actual abuses and provide appropriate redress in those limited instances when abuses occur.

As discussed in the first section of this study, Congress reacted to the banking crisis facing the country in 1933 with sweeping prohibitions, when more precise and less restrictive remedies have proved effective in addressing problems prevailing at the time. The need to separate commercial from investment banking activities because of potential conflicts has never been demonstrated and does not justify preservation of the Glass-Steagall Act.

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27 12 C.F.R. secs. 207, 220 and 221 (promulgated pursuant to section 7 of the Exchange Act, 15 U.S.C. sec. 78g).

28 "Margin stock" under the regulations includes equity securities registered or having unlisted trading privileges on a national securities exchange, certain OTC stocks, warrants to buy margin stock, and debt securities convertible into margin stock. 12 C.F.R. sec. 221.2.

29 *See* 15 U.S.C. sec. 78k(d)(1) (section 11(d)(1) of the Exchange Act); 17 C.F.R. sec. 240.11d1-1.

30 Similarly there is no economic rationale for a bank to make unsound loans to a company whose securities an affiliate is planning to underwrite in order to enhance the marketability of such securities. A bank would be placing its own assets at risk in amounts which greatly exceed the potential earnings of the securities affiliate. Moreover, loans to an issuer prior to the time of the underwriting by an affiliate of the underwriter would have to be disclosed in the prospectus.

Competitive impact

Research shows that corporate underwriting markets are concentrated and that legal barriers to competition in these markets result in high costs and other adverse conditions for issuers of securities, as well as unusually high profits for the securities industry. Permitting bank holding company subsidiaries to underwrite and deal in corporate securities should increase the number of competitors in these markets, with commensurate benefits for issuers and investors. In the absence of compelling reasons to protect this sphere of economic endeavor from competition, the costs of restricting competition cannot be justified.

Concentration in corporate securities underwriting and dealing markets

In traditional negotiated underwritings, corporations select a lead or managing underwriter, and occasionally co-managers, to advise on the nature, price, and timing of an issue. The managers typically organize other participating underwriters into a syndicate that shares in the risks and rewards of purchasing the securities from the issuer and reselling them to the public. In shelf registration offerings made pursuant to SEC Rule 415, a single underwriter often assumes the risk of purchasing the entire issue and promptly resells it—often in large blocks to institutions and other major investors. Underwriters also deal in corporate debt and equity securities in order to make secondary trading markets for investors, trading profits for themselves, and to facilitate initial distributions.

National markets United States underwriting markets are concentrated and have been so for many years.[1] A group of approximately six firms dominates the origination and management of public offerings. Another 15 to 20 underwriters manage some offerings but more frequently engage in distribution activities as syndicate members.[2] The leading firms tend to serve the country's largest corporations.

Barriers to entry into the upper echelons of underwriters are high because of the value corporations place on an investment bank's reputation, track record, personnel quality, areas of specialization, and size.[3] The effects of this emphasis on reputation are compounded because most corporations solicit public funds infrequently, and they consider the success of public offerings critical to their future well-being. Barriers to entry are also reinforced by underwriters' desire for cooperative relationships in assembling and running syndicates. This tends to encourage repeated reliance upon the same small group of firms when syndicates are formed. Rule 415 transactions require substantial capital resources as a precondition of participation, which has limited the number of firms competing to

1 *See, e.g.*, S. Hayes, A. Spence & D. Marks, *Competition in the Investment Banking Industry* (1983); V. Carosso, *Investment Banking in America* (1970); I. Friend, *et al.*, *Investment Banking and the New Issues Market* (1967); Schneider, "Evolving Proof Standards Under Section 7 and Mergers in Transition Markets: The Securities Industry Example," 1981 *Wisc. L. Rev.* 1 (1981).

2 The top firms (which in recent years have included Drexel Burnham, First Boston, Goldman Sachs, Merrill Lynch, Morgan Stanley, Salomon Brothers, and Shearson Lehman/American Express) are referred to in the industry as the "special bracket," the "super-bracket" or the "bulge group" because their names typically appear at the top of the tombstone advertisements of public issues. The second group is typically referred to as "major bracket" because their names appear just below the top firms in those advertisements.

3 In 1983, only 49 firms lead-managed more than two offerings, while the top five were lead managers for an average of 133 issues each. *See* Investment Dealers' Digest, *Directory of Corporate Financing* (1983).

manage these transactions.[4] The most significant barrier to entry into the upper brackets is, of course, the artificial one erected by the Glass-Steagall Act, which has "effectively excluded the best-positioned potential competitive entrants"—subsidiaries of major bank holding companies.[5]

Table 1 shows the percentage of the total dollar volume of issues managed by the top underwriters for the period 1979-1983, using figures that give full credit to the lead manager of an issue. Underwriters and industry observers use such figures to describe corporate underwriting market share and concentration because of the power, prestige, and profits that managing underwriters gain from originating and marketing issues. These data do not take into account the distribution activities of participating underwriters. Table 2 reflects these activities, however, showing the percentage of total industry underwriting revenues earned by the top securities firms.

Table 1

Concentration of corporate underwriting

Percentage of the total dollar volume of U.S. corporate debt and equity underwriting managed by the largest securities firms[a]

	1979	1980	1981	1982	1983
Largest firm	18%	19%	19%	16%	16%
Top 3 firms	45	42	49	47	40
Top 5 firms	63	62	65	68	59
Top 10 firms	85	86	85	89	83
Top 15 firms	94	95	93	95	91
Top 25 firms	98	99	97	98	96

a Source: Investment Dealers' Digest, *Annual Directory of Corporate Financing* (1979); IDD Information Services, Inc. (1980-1983). Figures used give full credit to the lead manager handling the books.

Table 2

Concentration of underwriting revenues

Percentage of total securities industry underwriting revenues earned by the largest securities firms[a]

	1971	1975	1980	1981	1982	1983
Top 4 firms	15%	25%	28%	–	–	–
Top 8 firms	25	38	41	–	–	–
Top 10 firms	–	–	–	50%	58%	46%
Top 16 firms	40	56	60	–	–	–
Top 25 firms	52	67	68	74	81	76

a Securities and Exchange Commission, *The Securities Industry in 1980*, Exhibit VI-3 (Sept. 1981) (1971-1980 data); Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 4, at 10, Table 9 (July 30, 1984)(1981-1983 data). Data omitted is not publicly available. The lessening of concentration from 1982 to 1983 can be attributed to a dramatic increase in underwriting revenues, from $2.3 billion to $3.5 billion, and a surge in common stock offerings, *id.*, at 8-9. This increase was particularly notable for initial public offerings, which increased from $1.4 billion in 1982 to $12.6 billion in 1983. *Id.*, at 9.

4 "The Traders Take Charge," *Business Week*, 58, 60-61 (Feb. 20, 1984).

5 S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 24; *see also id.*, at 22.

There has been a reduction in the overall number of competitors since 1970, and there is some evidence of a trend toward increased concentration in the industry as a whole even as the size of the market has grown dramatically.[6] While 410 firms acted as managing underwriters in 1970, only 282 firms did so in 1983.[7] A recently published study has found that corporate underwriting markets are highly segmented by type of issuer as a result of specialization by the leading firms.[8] The supply of underwriting services thus may be even more concentrated than industry-wide figures suggest.[9]

Many industry participants believe that SEC Rule 415, governing shelf registrations, has made the corporate underwriting management and distribution process more concentrated since its promulgation in March 1982.[10] Under Rule 415, a public offering may be pre-registered by the issuer without the assistance of an underwriter and then may be placed "on the shelf" for up to two years. The issuer usually decides to sell the securities when market conditions appear particularly favorable. Under Rule 415, underwriters negotiate or bid competitively to purchase and resell securities off the shelf in large blocks with little prior notification. Only a few firms have sufficient capital resources to compete to manage these distributions.[11] Time constraints have also made it difficult to assemble syndicates, reducing their size and increasing the proportion of the securities taken down by lead managers at the expense of smaller and regional firms.[12] The recent trend among leading investment banks to merge with larger companies has been attributed to a need for increased capital resources to permit participation in Rule 415 offerings and block trading.[13]

Most securities offered under shelf registrations have been resold to institutional rather than individual investors because of time constraints, the need for virtually instantaneous decision-making by investors, and the fact that most shelf registrations involve corporate bonds.[14] These developments

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6 The total dollar volume of underwritings was $21.9 billion in 1969, $79.0 billion in 1982, and $102.4 billion in 1983. *See* Investment Dealers' Digest, *Directory of Corporate Financing* (1960-69, 1982, 1983).

7 *See* Investment Dealers' Digest, *Directory of Corporate Financing* (1970, 1982). *See also* S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 29-44; National Association of Securities Dealers, *Small Business Financing: The Current Environment and Suggestions for Improvement*, 24, 38-44 (1979).

8 *See* S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 67-77, 79-80. Eighteen investment banks formed four "quite distinct" competitive groups based on client attributes. *Id.*, at 69.

9 *See id.*, at 78-79.

10 *See* "The Traders Take Charge," note 4 *supra*, at 61 (top six underwriters managed 80% of Rule 415 volume in 1983 versus 65% of all corporate underwritings); "The 1984 Corporate Sweepstakes," *Institutional Investor*, 162, 164 (Mar. 1984) ("Indisputably, the top half-dozen firms are steadily gaining larger shares of all issues"). *See also* Letter of John C. Whitehead, Senior Partner, Goldman Sachs & Co. to John S.R. Shad, Chairman, Securities and Exchange Commission, 4 & Exhibit 4 (Sept. 12, 1983) (SEC File No. 57-979); 47 Fed. Reg. 39,803, 39,805 (1982) (dissenting comments of SEC Commissioner Thomas on Rule 415's extension). *But see* 48 Fed. Reg. 52,889, 52,893 (1983) (SEC adoption of final rule, stating that increased concentration and institutionalization stem from factors other than Rule 415).

11 *See* "The 1984 Corporate Sweepstakes," note 10 *supra*, at 163, 164; Wayne, "New Pressure in Investment Banking," *New York Times*, Apr. 15, 1984, Section 3 at 1, 24. *See also* Letter of Gordon S. Macklin, President, National Association of Securities Dealers to the Securities and Exchange Commission, 8 & n.10 (Sept. 26, 1983) (SEC File No. 57-979).

12 *See* Adams, "Salomon's Number One," *Investment Dealers' Digest*, 8, 9 (Jan. 17, 1984). (The top 12 managers took down 36% of debt issues and 25% of equity issues before Rule 415 was introduced; afterward, the percentages jumped to 57% for debt and 42% for equities. For the top six managers, the percentages were 24% for debt and 13% for equities before Rule 415 and 40% for debt and 20% for equities thereafter; 25% of the dollar volume of Rule 415 transactions involved no syndicates.) *See also* Letter of S. Parker Gilbert, President, Morgan Stanley & Co. to the Securities and Exchange Commission (Sept. 12, 1983) (SEC File No. 57-979) (average syndicate size decreased from 50-125 members to 20-40 after promulgation of Rule 415). Final Rule 415, which is more restrictive than the original rule, permits shelf registrations only for offerings of high-quality debt securities of major issuers, those qualified to use short form registrations, and for "traditional" shelf offerings. 48 Fed. Reg. 52,889 (1983). This should not materially affect Rule 415's effect on concentration since short-form registrants already accounted for 94% of debt offerings and 90% of equity offerings filed under Rule 415 from March 1982 to September 1983. Poser, "A Green Light for Shelfs, But With If Clauses," *Investment Dealers' Digest*, 11 (Jan. 10, 1984).

13 *See* Wayne, note 11 *supra*, at 1, 24.

14 *See* Letter of the Securities Industry Association to the Securities and Exchange Commission, 10-12 (Sept. 12, 1983) (SEC File No. 57-979).

have made the underwriting of major public issues under Rule 415 very similar to large block trading activities and have enhanced the market power of firms with the largest capital resources and greatest distribution capabilities.[15]

Dealing activities by investment banking firms have become more important in recent years because bond portfolio managers have become much more active traders of debt securities and because institutional investors have come to dominate secondary trading markets in equity securities of major issuers.[16] These investors cannot readily make large block trades on national securities exchanges without the assistance of intermediary dealers. The leading investment banks and securities firms act as dealers in corporate bonds and as intermediaries in large block transactions. They purchase large quantities of securities and redistribute them, as quickly as possible, to new purchasers. The ability to deal in corporate securities is also integral to corporate underwriting activities, which often require purchases of securities for the underwriter's own account—particularly in Rule 415 distributions. Participation in such trades requires substantial capital resources, well-developed contacts with potential buyers, and the ability to assume and rapidly redistribute substantial securities positions. Consequently, as with shelf offerings, only a very few top firms participate.[17]

Market share data for dealing activities is limited. However, Table 3 shows the percentage of trading revenues earned by 21 major securities firms for the period 1980-1983. It shows a high degree of concentration and an increase in these firms' combined market shares over the period.

Table 3 **Concentration of trading revenues** [a]

Percentage of total securities trading revenues earned by large securities firms[b]

	1980	1981	1982	1983
Ten large investment banks	35%	44%	45%	38%
Eleven national full line firms	30	29	38	44
Top 21 firms	65	73	83	82

a Total securities trading revenues taken from Securities and Exchange Commission, *The Securities Industry in 1981*, 17 (Exhibit II-2) (Oct. 1982) (data for 1980 and 1981) and Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 6, at 4 (Table 1) (Nov. 25, 1983) (data for 1982 and 1983); revenues of large investment banks and national full line firms taken from Securities and Exchange Commission, *The Securities Industry in 1980*, 41 (Exhibit III-2) (Sept. 1981) (data for 1980); *The Securities Industry in 1981*, 26, 40 (data for 1981); and Securities Industry Association, unpublished estimates (data for 1982 and 1983).

b The staffs of the Securities and Exchange Commission and the Securities Industry Association identified, for purposes of statistical analysis in the years included in this table, "ten large investment banks" (Bear Stearns, Dillon Read, First Boston, Goldman Sachs, Kidder Peabody, Lazard Freres, Lehman Brothers, Morgan Stanley, Salomon Bros., and Wertheim) and "eleven national full line firms" (Prudential/Bache, A. G. Becker, Dean Witter, Drexel Burnham, A. G. Edwards, E. F. Hutton, Merrill Lynch, Paine Webber, Shearson/American Express, Smith Barney, and Thomson McKinnon). The shares of trading revenues earned by each group are the best publicly available data showing concentration in those markets. It should be noted, however, that these 21 firms may not be those with the largest shares of trading revenues. Thus, concentration of trading revenues may be even higher than these figures indicate.

15 *See* "The 1984 Corporate Sweepstakes," note 10 *supra*, at 163, 164; Wayne, note 11 *supra*, at 24; "The Traders Take Charge," note 4 *supra*, at 60-61; "Salomon Brothers Led Competitors in '83 With $15.76 Billion in U.S. Underwritings," *Wall Street Journal*, Jan. 6, 1984, at 27; "SEC Shelf Rule Proves a Boon to Brokers," *Wall Street Journal*, Oct. 18, 1983, at 35.

16 Trading revenues have increased as a percentage of total industry revenues from 19.2% in 1979 to 24.1% in 1983. Securities and Exchange Commission, *The Securities Industry in 1983*, Ex. 1 (1984). *See also* Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 3, at 8 (Table 4) (June 1, 1983) (large block transactions accounted for 43.3% of the total volume of securities transactions in the first quarter of 1983); National Association of Securities Dealers, *Analysis of Economic Impact of Market Maker Reserves*, 12 (Table 6) (June 1983) (in 1980 institutional trading accounted for 64.9% of all shares traded and 72% of their dollar value).

17 *See, e.g.*, Wayne, note 11 *supra*, at 1; "SEC Shelf Rule Proves a Boon to Brokers," note 15 *supra*, at 35.

Regional markets Regional broker-dealers historically have served as managing underwriters for securities of smaller and emerging corporations and as distributors of issues managed by the leading firms.[18] Regional firms also have made markets in stocks of small and emerging corporations. The number of such firms has substantially declined over the past 20 years, primarily as a result of mergers, stemming in part from reductions in stock exchange commission rates after fixed rates were abolished in 1975. More recently, regional firms have been weakened by their exclusion from Rule 415 offerings, as described above. With some notable exceptions, remaining firms lack the capital resources and personnel to engage in the full range of underwriting, research, and market-making activities essential to serve the financing needs of these corporations.[19] As a result, many geographic areas have no local firms to act as underwriters and no active market-makers in securities of local interest.[20]

Industry observers believe that this absence of regional underwriters and dealers makes public offerings by small and medium-sized companies unduly difficult and expensive, and discourages investment in their securities because of the illiquidity of secondary markets.[21] The NASD has stated:

> *"It was these local/regional broker-dealers that brought many local businesses public and provided secondary markets for their securities. Their demise will long be felt by those developing companies that will need their services in the future. Steps must be taken, therefore, to encourage and promote the re-emergence of this vital link in our nation's capital-raising system."* [22]

The President's 1983 report on *The State of Small Business* stated that "[i]nnovation in the financial service industry will be the most important factor affecting small business in the next few years" and expressed the hope that financial market deregulation would lead to improved access to capital for small companies.[23] In the absence of Glass-Steagall barriers, regional banks would be logical new entrants competing to serve as underwriters of public issues and as dealers in securities for these companies.

Performance It appears that artificial barriers to commercial bank entry imposed by the Glass-Steagall Act have caused underwriting markets for corporate securities to be more concentrated than comparable underwriting markets in which commercial banks can compete. There is also evidence that the limited number of competitors in corporate underwriting and dealing markets has resulted in high profits for the securities firms that supply these services and in excess costs to issuers and investors.

Concentration levels are lower in markets where commercial banks now compete with investment banks than in similar markets where they do not. The Euromarket, in which U.S. and other major commercial banks compete, is much less concentrated than the domestic corporate debt market, from which banks are barred, as shown in Table 4.

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18 *See* Schneider, note 1 *supra*, at 66-67 & n. 246, 83-84 & nn. 312-314; Securities and Exchange Commission & Small Business Administration, *Initial Public Offerings of Common Stock: The Role of Regional Broker-Dealers in the Capital Formation Process, Phase I Report* (Mar. 1980); Securities and Exchange Commission & Small Business Administration, *The Role of Regional Broker-Dealers in the Capital Formation Process: Underwriting, Market-Making and Securities Research Activities, Phase II Report*, ii (Aug. 1981) (in the period 1979-1980, regional firms managed 92% of offerings of issuers with under $10 million in revenues and 79% of initial public offerings).

19 *See id.*, at 4 (only 23% of regional securities firms that responded to a 1980 survey stated that they had managed initial public offerings, engaged in underwriting or research, or made markets in over-the-counter stocks).

20 *See* National Association of Securities Dealers, note 16 *supra* (14 states have no market-makers; 10 have only one or two; NASDAQ market-makers were reduced from 482 to 407 in 1982 alone); "Congressmen Introduce Bill Creating Profit Reserve for Market-Makers," *Securities Week*, 3-4 (Sept. 19, 1983) (total number of market-makers was cut in half in the past 15 years).

21 *See, e.g.*, National Association of Securities Dealers, note 7 *supra*, at 1-4, 7; *Access to Equity Capital and Business Opportunities: Hearings Before the Subcomm. on Tax of the House Comm. on Small Business*, 98th Cong., 1st Sess., 22 (1983) (statement of Walter B. Stults, President, National Association of Small Business Investment Companies).

22 National Association of Securities Dealers, note 7 *supra*, at 4.

23 *The State of Small Business: A Report of the President*, xv (Mar. 1983).

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The municipal general obligation bond market, in which commercial banks compete, is also considerably less concentrated than the municipal revenue bond market from which they are largely excluded, as shown in Table 5.[24] This is notable because both the Euromarket and the general obligation bond market are smaller in terms of total underwriting volume, and one therefore might expect them to be more concentrated.

Table 4

Concentration in corporate underwriting: Euromarket vs. U.S. market

Percentage of the total dollar volume of corporate debt securities underwriting managed by the largest securities firms in the U.S. and the Euromarket, 1980-1983. [a]

	1980		1981		1982		1983	
	Euro	U.S.	Euro	U.S.	Euro	U.S.	Euro	U.S.
Top 4 firms	30%	58%	40%	65%	43%	59%	35%	60%
Top 8 firms	42	86	54	88	59	88	52	89
Top 10 firms	47	90	59	93	65	92	58	92
Top 16 firms	59	99	72	99	75	97	70	97
Top 20 firms	66	100	78	100	80	99	75	98
Total issues	225	495	275	459	337	571	296	605
Total dollar amount (millions)	$11 680	$41 345	$15 823	$40 514	$25 194	$43 645	$21 121	$52 162

a Austin-Billinghurst Associates (Euromarket). IDD Information Services, Inc. (U.S. market). Figures used give full credit to the manager handling the books. Figures of 100% result from rounding.

Table 5

Concentration in municipal bond underwriting

Percentage of the total dollar volume of general obligation and revenue bond underwriting managed by the largest securities firms, 1980-1983[a]

	1980		1981		1982		1983	
	G.O.	Rev.	G.O.	Rev.	G.O.	Rev.	G.O.	Rev.
Top 4 firms	15%	23%	14%	27%	14%	27%	18%	27%
Top 8 firms	26	39	24	45	24	44	27	43
Top 10 firms	31	43	29	50	29	50	32	49
Top 16 firms	43	53	42	59	42	60	42	60
Top 20 firms	50	57	49	64	50	65	49	64
Total issues	2 938	2 630	2 220	2 459	3 132	3 133	3 018	3 528
Total dollar amount (millions)	$13 805	$33 915	$12 396	$34 520	$20 739	$55 281	$21 468	$63 626

a Public Securities Association *Statistical Yearbook of Municipal Finance: The New Issue Market (1980-1983 editions).* The figures used give proportionate credit to co-managers. Commercial banks are eligible to compete in selected revenue bond submarkets (those for housing university or dormitory purposes and those indirectly backed by the taxing power of the municipal entity). The revenue bond figures used in computing this table include those submarkets. Indeed, one commercial bank was in the top 20 and 7 were in the top 50 revenue bond underwriters. Therefore, this table tends to understate the impact on concentration of commercial bank exclusion from underwriting other types of revenue bonds.

24 *See also* Hopewell & Kaufman "Commercial Bank Bidding on Municipal Revenue Bonds: New Evidence" 32 *J. Finance* 1647 (Dec. 1977); Clark & Saunders "Glass-Steagall Revisited: The Impact on Banks, Capital Markets, and the Small Investor" 97 *Banking L.J.* 811 822 (1980).

Major investment banking firms earn very large profits, which may result from lack of competition in many segments of their business, including corporate underwriting and dealing. Their returns on capital typically are disproportionately greater than those of companies in other industries, and very high earnings are concentrated in the most prominent firms.

After-tax return on equity for the 10 largest investment banking firms was 24% in 1983 and 30% in each of the preceding three years; in 1983 several major firms were reported to have earned pretax returns on equity of as much as 100%.[25] Moreover, after-tax return on equity for the securities industry overall was 19.8% in 1983, making it the most profitable industry group in the country.[26] In contrast, after-tax return on equity for the 10 largest bank holding companies in 1983 was 13%; for all banks and bank holding companies it was 11.6%.[27] The median for major U.S. industries in 1983 was 12.6%.[28]

An important component of the profits of the leading investment banking firms is derived from activities from which commercial banks are not barred by Glass-Steagall, including providing advice on private placements, mergers and acquisitions, and other corporate finance transactions. Users typically consider expertise in securities underwriting and dealing, however, an important aspect of a firm's skill in providing these other corporate finance services. Thus, commercial banks' exclusion from securities underwriting and dealing also effectively restricts competition in, for instance, the mergers and acquisitions area.[29] It is not surprising that the same few investment banks that dominate the underwriting and dealing markets also handle the bulk of major corporate mergers. The extremely large fees paid to investment banks for their services in multibillion-dollar corporate acquisitions have been widely reported; to take a recent example, Merrill Lynch and Salomon Brothers will share some $45 million and Morgan Stanley will receive nearly $18 million in connection with the $13 billion acquisition of Gulf Oil Corporation by the Standard Oil Company of California.[30]

A recent article on Goldman Sachs gives some indication of the sizable earnings of the leading investment bankers:

> *"75 partners earned an average of $5 million each ... [and] ... an estimate that more than 400 Goldman executives* below *the partnership ranks earned more than $200,000 last year 'is not a wild guess,' according to one partner."* [31]

Officers of publicly held firms also did well, with 17 top executives reportedly receiving $1 million to $2 million in compensation in 1983.[32]

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25 *See* Table 4, page 20 *supra* (return on equity for top 10 investment banks, 1979-1983); "Brokerage," *Forbes*, 36th Annual Report on American Industry, at 71, 72 (Jan. 2, 1984).

26 Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 4, at 5 (July 30, 1984).

27 See Table 4, page 20 *supra* (return on equity for 10 largest bank holding companies, 1983); "Profitability of Insured Commercial Banks in 1983," *Federal Reserve Bulletin*, 802, 809 (Nov. 1984).

28 "Who's Where in the Industry Groups," *Forbes*, 36th Report on American Industry, 249 (Jan. 2, 1984).

29 Bleakley, "The Mergermakers' Spiraling Fees," *New York Times*. Sept. 30, 1984 Section 3, at 6, 24 (identifying eight firms as handling almost all major deals of more than $500 million in value); "Investment Banking Proves a Tough Field for Commercial Banks," *Wall Street Journal*, Sept. 19, 1984, at 10.

30 "Gulf's Defeat and Its Lessons," *New York Times*, Mar. 10, 1984, at 35.

31 McGoldrick, "Inside the Goldman Sachs Culture," *Institutional Investor*, 53, 55 (Jan. 1984) (emphasis in original).

32 Paikert, "Making It At The Top," *Investment Dealers' Digest*, 7, 9 (May 15, 1984).

No data are available on the excess costs resulting from Glass-Steagall barriers to entry by commercial bank affiliates into corporate securities underwriting and dealing markets. There are, however, indications that deregulation would result in savings to issuers and investors. Deregulation of brokerage commissions and Rule 415's liberalization of underwriting regulations have shown that inefficiencies and excess costs have prevailed in the securities industry when regulations have presented barriers to competition. Following the deregulation of brokerage commissions in 1975, both commission rates and commission revenues dropped sharply.[33] Similarly, both the SEC and the SIA have concluded that Rule 415 has increased competition among underwriters for shelf offerings and has produced cost savings for registrants and their shareholders[34] as well as innovation in the form of new financing products.[35]

Fee reductions resulting from the increased competition created by Rule 415 probably have been limited by the small number of effective potential competitors, since underwriters need large capital resources to participate in these large offerings.[36] Glass-Steagall exacerbates this problem by preventing large commercial banks from competing for Rule 415 distributions. The SEC's recent study on the impact of Rule 415 noted:

> *"An inverse relationship between the intensity of competition among underwriters (as proxied by the number of underwriters bidding on an issue) and lower issuing costs has been extensively documented...*[37]

A number of analysts have compared costs in the general obligation bond markets, in which commercial banks can compete with investment banks, to the municipal revenue bond market, in which they largely cannot. Most academic research has concluded that commercial bank participation has generated significant cost savings to issuers in the municipal general obligation bond market.[38] In a review of 12 studies conducted between 1959 and 1979 that investigated the impact on borrowers' costs of commercial bank eligibility to compete for competitively bid municipal issues, William Silber found

> *"a remarkable degree of consistency in the findings of previous investigators of the link between eligibility and borrowing costs. Statistically significant impacts of bank eligibility on municipal borrowing costs emerged from virtually every research effort."* [39]

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33 *See, e.g.*, Securities Industry Association, "A Primer on Discount Brokerage," *Securities Industry Trends*, Vol. IX, No. 1, 3-4 (Mar. 4, 1983) (after fixed commission rates were abolished on May 1, 1975 [Mayday], commissions charged to institutions dropped to one-third the retail level); Securities Industry Association, "An Industry Data Base As An Analytic Tool," *Securities Industry Trends*, Vol. VIII, No. 7 (Chart 3) (Mar. 15, 1982) (showing a sharp drop in indexed commission profit revenues over the 1976-77 period following commission deregulation).

34 These benefits have been enjoyed primarily by larger issuers, of course, since issuing debt securities under Rule 415 is not practical for most small companies. In addition, Rule 415 is not available for equity issues. The introduction of new bank-affiliated competitors as underwriters and dealers thus represents one of the few possible means to gain the benefits of greater competition for smaller issuers.

35 *See* Securities and Exchange Commission, Office of the Chief Economist, *Information Memorandum: Update—Rule 415 and Equity Markets*, OCE-84-09 (Sept. 4, 1984) (issuing costs for syndicated shelf offerings are 13% less than for comparable non-shelf issues and for non-syndicated offerings are 51% less; price performance of shelf issues in the secondary market is less than 1% worse than the performance of traditional offerings, a statistically insignificant difference); Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 5, at 3, 13 (Aug. 22, 1984) (underwriting spreads on equity issues are 28% lower and issuance costs are 25% lower than for comparable non-shelf issues; however, the SIA claims that poorer price performance by shelf issues than by non-shelf issues outweighs these savings); *see also* 48 Fed. Reg. 52,889, 52,891 (SEC adoption of final Rule 415); "Investment Banking's Changing Face," *Wall Street Journal*, Jan. 4, 1984, at 24 (stating that under Rule 415 for equity underwritings, "[s]preads earned on raising money are narrowing to just those earned on large block trades.").

36 *See* Wayne, note 11 *supra*, at 24; "The 1984 Corporate Sweepstakes," note 10 *supra*, at 164.

37 Securities and Exchange Commission, note 35 *supra*, at 5.

38 *See, e.g.*, U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, 34 (1975) ("No systematic quantitative study that refutes these conclusions has been conducted").

39 W. Silber, *Municipal Revenue Bond Costs and Bank Underwriting: A Survey of the Evidence*, 6 (Salomon Brothers Center for the Study of Financial Institutions, 1979). The studies suggest that borrowing costs are reduced because both the number of bidders for an issue and the marketability of an issue are increased by commercial bank involvement.

When Silber applied alternative sets of relatively conservative assumptions to 1977 data, he estimated that the overall annual savings to municipalities resulting from commercial bank participation would have been in the range of $80 million to $369 million.[40]

There are also indications that the increased competition resulting from banks' involvement as advisers in the private placement market may have lowered prices for advisory services. A 1978 report by the staffs of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation stated:

> *"it is quite possible that the commercial bank presence in the market for private placement services may, through competitive pressures, actually have reduced the cost and improved the quality of assistance provided by investment banking firms."* [41]

Industry observers have suggested that transaction costs in large block trades and in regional market-making could be reduced and that trades could be executed more efficiently if there were more dealers in those markets.[42]

There is also evidence that the market for initial public offerings (IPOs) of equity may be inefficient. The initial public offering prices of new equity issues in general have been significantly lower than their secondary market prices immediately after issuance, indicating that issuers received less for their securities than the market later indicated investors would have paid.[43] One study concluded, for example, that IPOs were underpriced 18.8% on average from 1960 through 1982. In periods that were identified as favorable for new offerings, this study found that IPOs on average were underpriced 42.1%; for periods identified as unfavorable, the figure was 9.2%.[44]

In addition, a recent survey of companies that went public during the period 1978-1983 indicates considerable dissatisfaction with the quality of service provided by the underwriters of initial public offerings. While most companies surveyed (92%) felt they made the right decision to go public, almost half (44%) would not use the same managing underwriter again.[45]

Impact of bank holding company subsidiaries' entry

Removal of Glass-Steagall barriers will not result in the formation or acquisition of securities underwriting and dealing subsidiaries by all bank holding companies. But it will allow holding companies that perceive these new market opportunities as consistent with their long-range strategic plans to expand their product mix. It will remove serious legislative and regulatory inequities that permit securities firms to compete in many banking markets but bar bank holding companies and their subsidiaries from engaging in most securities activities. Creation of a "level playing field" will increase competition in all financial markets by removing regulatory barriers that may have led to unnecessary costs and limitations on innovation. It will also permit existing investment banking and brokerage firms to establish or to acquire full-service bank affiliates that complement their existing operations.

40 *See id.* (estimated present value of interest cost savings).

41 Comptroller of Currency, Federal Deposit Insurance Corporation & Federal Reserve Board, *Commercial Bank Private Placement Activities*, 11 (1978).

42 *See* "SEC Shelf Rule Proves a Boon to Brokers," note 15 *supra*, at 35; Shaefer and Warner, "Concentration Trends and Competition in the Securities Industry," *Financial Analysts J.* 29, 32 (Nov.-Dec. 1977); Securities and Exchange Commission & Small Business Administration, Phase II Report, note 18 *supra*, at 41-44, 63 (discussing studies showing that inadequate research coverage and numbers of market-makers result in inefficient and illiquid markets).

43 This underpricing reduces the risk of underwriting, increases the marketability of new issues, and presumably results in a lower underwriting spread (the difference between the offer price and the price the underwriter pays the issuer for the securities); therefore, the loss of revenue for issuers is probably less than the raw data on underpricing suggest. Also, particularly in well-received issues, higher secondary market prices immediately after the offering may reflect the buying activity of investors who failed to receive the number of shares they originally sought.

44 Ritter, "The 'Hot Issues' Market of 1980," *Journal of Business*, 57, at 214-240 (Apr. 1984).

45 *A Study of the Attitudes of Companies Toward Going Public*, Lobsenz-Stevens Inc. (1984); *see also* "Study Finds Widespread Dissatisfaction with IPO Underwriters," *Corporate Financing Week*, Vol. X, No. 15, at 1,9 (Apr. 16, 1984).

Allowing bank holding company subsidiaries to enter corporate underwriting and dealing markets will increase the number of actual and potential competitors, which should improve the performance of these concentrated markets. Both the Department of Justice and the Federal Trade Commission have supported repeal of Glass-Steagall limitations on the securities activities of bank affiliates because they recognize that

> *"despite the general prohibitions of Glass-Steagall, there has been increasing competition between commercial banks and securities firms in recent years. These developments have demonstrated that increased competition from new entrants . . . increases innovation and results in the offering of services at the lowest possible cost to consumers."* [46]

Prior to Glass-Steagall passage, commercial banking firms were the most effective competitors of investment banks in offering underwriting services, and they could become so again.[47]

National markets A number of major commercial bank affiliates should be able to enter national underwriting and dealing markets as effective competitors with the top five national investment banking firms. The largest U.S. commercial banks are, of course, familiar with the operations and capital requirements of the country's major corporations. They are already engaged through subsidiaries in underwriting and dealing in securities in international capital markets. One U.S. bank affiliate was among the top 10 Eurobond managers and three others were in the top 30 in 1983.[48] They also act as advisers in the domestic private placement market[49] and as underwriters and dealers in state and local government general obligation bonds, where commercial banks comprised nine of the top 20 underwriters in 1983.[50] Some commercial banks have also provided advice to corporations on corporate finance and mergers and acquisitions. All of these activities have given commercial bankers knowledge, contacts, and experience that will facilitate their entry into domestic corporate underwriting and dealing.

As many of the largest bank holding companies would be likely to enter corporate underwriting and dealing markets by creating *de novo* subsidiaries, the total number of competitors for the underwriting business of major corporations would be increased. While it would be naive to assume that bank holding company subsidiaries could easily penetrate existing markets, major bank holding companies possess sufficient resources to capitalize independent subsidiaries at a level that would enable them over time to compete effectively with leading underwriters. Adequate capitalization would also make it possible for these subsidiaries to undertake dealing activities in large block transactions and to compete for Rule 415 distributions.

Regional markets Securities subsidiaries of many smaller bank holding companies could become effective competitors by augmenting the supply of underwriting services to smaller corporations, including the so-called middle market, which George Ball, president of Prudential-Bache Securities, has noted "Wall Street has perhaps ignored."[51] In contrast to the depleted ranks of regional broker-

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46 *Competition in the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 410, 419 (1983) (statement of William F. Baxter, Asst. Attorney General, Antitrust Division, Department of Justice); *id.* at 438-441 (statement of George W. Douglas, Commissioner, Federal Trade Commission).

47 *See* S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 22, 24.

48 These figures are based on data, provided by Austin-Billinghurst Associates, that give full credit to the manager handling the books.

49 Two commercial banks were ranked among the top 15 private placement advisers in 1983. O'Toole, "The Commercial Banks Move In," *Investment Dealers' Digest*, 7 (Apr. 10, 1984).

50 *See* Public Securities Association, *Statistical Yearbook of Municipal Finance: The New Issue Market in 1983*, 22 (1984).

51 Osborn, "Will America Embrace Universal Banking" *Institutional Investor*, 91, 101 (Feb. 1982, International Ed.).

dealers, there are hundreds of commercial banks with strong regional networks and customer bases. These institutions already serve smaller corporations as lenders and are familiar with their capital requirements.[52] They also serve their communities as depository institutions, and a growing number are providing discount brokerage services.[53] For the stronger and more imaginative regional banks, expansion into underwriting and market-making activities would be a logical product market extension, absent Glass-Steagall barriers.

The presence of additional financial intermediaries in widely dispersed locations will give small and regional businesses the same access to capital markets now enjoyed by localities whose general obligation bonds are underwritten by local banks. Additional entrants will be well positioned to locate and assist companies that need public financing and to provide the research coverage and market-making capabilities vital to the maintenance of efficient secondary markets. It is likely to be more cost-effective and efficient for local bank holding company subsidiaries to provide such services than for distant national investment banking firms to do so. A narrowing of underwriting spreads for smaller companies, which now pay more for underwriting services than larger corporations, may also result.[54] If more regional broker-dealers made markets in the stocks of smaller corporations, the interest of individual investors in committing capital to local enterprises could increase, and such companies could improve their ability to raise capital. Removal of Glass-Steagall barriers could also strengthen small existing regional securities firms by allowing them to affiliate with local and regional banks.

Absence of bank dominance Entry by commercial bank holding company subsidiaries is unlikely to result in bank dominance or in increased concentration of securities markets. The commercial banking industry is generally much less concentrated and far more competitive than the securities industry.[55]

Bank holding company capital resources would not make their securities subsidiaries overwhelming competitors of existing participants in corporate underwriting and dealing markets, as is sometimes suggested. The substantial capital resources of banks have not led them to dominate either the domestic or the international securities markets in which they now participate. Commercial banks' share of the general obligation bond market declined during the 1970s,[56] and in 1983 the top 50 general obligation bond managers included just 18 banks, which managed only about 31% of the dollar volume of issues managed by the top 50.[57] The commercial bank share of the private placement market has been modest, never exceeding 10%.[58] And U.S. commercial banks have not overshadowed U.S. investment banks in international markets.[59]

52 "Banks' Rising Interest in Commercial Finance Reshapes the Industry," *Wall Street Journal* at 1, 18 (Dec. 22, 1983).

53 Approximately 600 banks and thrifts had entered the discount brokerage business by December 1982. *See* Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 1, 1 (Mar. 4, 1983).

54 *See* Osborn, note 51 *supra*, at 103 (stating that the middle market pays much wider spreads than larger corporations for public offerings (8-10% versus 3-4%) and for private placements ($\frac{3}{4}$% to 1% versus $\frac{3}{8}$%)). This is justified to some extent by greater risk and distribution difficulty.

55 The top 20 bank holding companies, for example, made only 41.5% of total commercial and industrial loans in 1983. Data Resources, Inc., *Bank Analysis Service*.

56 *See* Bovenzi & Feinberg, "Issues Concerning Commercial Bank Participation in Selected Securities Activities," *Issues in Bank Regulation*, 27 (Summer 1982); Welles, "Wall Street's Last Gold Mine," *Institutional Investor*, 36 (Feb. 1978).

57 *See* Public Securities Association, note 50 *supra*, at 22.

58 Calculations for 1979-83 derived from O'Toole, "The Commercial Banks Move In," *Investment Dealers' Digest*, 7-8 (Apr. 10, 1984) (each of the top four investment banks has a larger market share than all competing commercial banks); Christie, "A Record First Half," *Investment Dealer's Digest*, 22-30 (Oct. 11, 1983); Christie, "1981—An Innovative Year in the Private Sector," *Investment Dealers' Digest*, 20-21, 38-39 (Mar. 30, 1982); Christie, "Private Sector in Slump During 1980," *Investment Dealers' Digest*, 34-36, 52-53 (Mar. 3, 1981); Christie, "Private Placements Decline in 1979," *Investment Dealers' Digest*, 20-22, 42-44 (Apr. 8, 1980); Comptroller of Currency, Federal Deposit Insurance Corporation & Federal Reserve Board, note 41 *supra*, (Table 2); Federal Reserve Board Staff Study, *Commercial Bank Private Placement Activities*, 31 (June 1977).

59 *See* "The 1984 International Financing Sweepstakes," *Institutional Investor*, 209 (Mar. 1984) (listing three U.S. commercial bank affiliates and five U.S. investment bank affiliates in the top 25 international bond managers, using data giving full credit to each manager).

Moreover, possession of adequate capital resources is only one of the prerequisites for entry into major underwriting and dealing markets. A firm's reputation, personnel, and experience are critical to its ability to obtain clients.[60] A bank holding company's total capital also has little or no bearing on the capitalization that would be made available to its securities subsidiary. Bank holding companies must make the most economically efficient use of their resources possible, and recent increases in bank capital requirements will further reduce any alleged incentive to overinvest capital in securities affiliates. Banks have not overcapitalized their existing Euromarket underwriting affiliates, and they have not made disproportionate investments in their domestic discount brokerage operations.

Concerns have been raised that removal of the anti-affiliation provisions of the Glass-Steagall Act might lead to increased concentration in the securities industry, through acquisitions or affiliations between major bank holding companies and the leading securities firms. Such combinations, however, would be subject to scrutiny for potentially anticompetitive market impact under existing banking and antitrust laws.[61] Moreover, limitations on acquisitions that tended to increase concentration within the securities or banking industries could be adopted, upon repeal of the anti-affiliation provisions of the Glass-Steagall Act, if this were deemed by Congress to be in the public interest. Such legislation could also address issues raised by recent combinations of leading securities firms and by the merger of such firms with major corporations in the financial services, retailing, and insurance industries.

Nor would bank holding company securities subsidiaries possess unfair competitive advantages with respect to underwriting and dealing activities. These subsidiaries would be taxed on the same basis as other securities firms. Bank holding company restrictions on inter-affiliate dealings would insure that underwriting subsidiaries could not borrow at preferential rates from affiliated banks. Bank holding company securities subsidiaries would also be subject to all of the same regulatory requirements as their competitors.

Banks would not refuse to make loans to investment banking firms because they compete with the banks' securities affiliates, as has sometimes been asserted. Refusals to deal predicated upon anti-competitive objectives are prohibited by the Sherman Act.[62] There is also no reason to believe that a bank with a securities affiliate would desert the broker loan market, which has always provided opportunities for banks to employ funds productively. A bank officer would be well aware that his counterpart at a competitor bank would lend to brokers if he did not.

Concern has sometimes been expressed that banks might unfairly condition corporations' access to loans upon their use of the services of their holding companies' securities subsidiaries. Banks, however, are expressly forbidden from tying access to loans to the purchase of investment banking or other services by Section 106 of the Bank Holding Company Act, as amended in 1970.[63] Concern has also been expressed about bank market power resulting from so-called "voluntary tie-ins" by corporations seeking both loans and underwriting services. There is little evidence that voluntary tie-ins have ever occurred in connection with bank lending or that they have been an issue in connection with bank

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60 *See* McGoldrick, "How Rule 415 Has Put CFOs in the Catbird Seat," *Institutional Investor*, 88, 90-91 (Apr. 1984); *see also* S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 48-49 (noting that many retail securities distributors and their acquirors have expended substantial resources in unsuccessful bids to break into the upper ranks of originating underwriters).

61 *See, e.g.*, 12 U.S.C. secs. 1843(c)(8), 1842(c); Clayton Act, sec. 7. Mergers that served to diminish perceived potential competition or to entrench the power of existing competitors might be barred. *See generally* Department of Justice, 1984 Merger Guidelines, Sec. 4, 2 Trade Reg. Rep. (CCH) par. 4494 (1984); P. Areeda & D. Turner, 5 *Antitrust Law*, par. 1101 (1980).

62 *See generally Otter Tail Power Co. v. United States*, 410 U.S. 366, 377 (1973); Zito, "Refusals to Deal: The Sherman Antitrust Act and The Right to Customer Selection," 14 *John Marshall L. Rev.* 353 (1981).

63 12 U.S.C. sec. 1972. *See also* H. Rep. No. 1747, 91st Cong., 2d Sess., 18 (1970).

offerings of private placement advice and other services to corporations. [64] The credit markets are sufficiently open and competitive that loans from a particular bank rarely constitute a uniquely desirable product; instead bankers compete vigorously for corporate lending business.

It is much more likely that investment banking firms will continue to play a major role in corporate underwriting and dealing than that bank holding company subsidiaries might dominate these businesses. Investment banks' long-standing relationships with corporations, their experience, and their ability to offer a wide range of corporate finance services will continue to give them a substantial competitive advantage over new entrants. [65] In markets where commercial banks and investment banks now compete, issuers have exhibited a preference for using their traditional investment bankers for many products.[66] Further, amendment of Glass-Steagall would make it possible for investment banking firms to affiliate with banks and to offer a full range of commercial banking services in addition to their existing range of products if access were felt to provide a substantial competitive edge to those offering underwriting and dealing services to corporations.

Conclusion

Available evidence suggests that the high level of concentration in corporate underwriting and dealing markets results in higher costs to issuers and in poorer access to capital markets for smaller, less well-known companies than would be the case if artificial barriers to entry in these markets did not exist. Issuers and investors would benefit from the increased competition and innovation that would be the likely result of entry by bank holding company subsidiaries as new competitors in both national and regional markets. At the same time, there is no evidence that bank affiliates' participation in the corporate securities underwriting or dealing business would lead to increased concentration or other anticompetitive consequences. The benefits of increased competition in the securities markets make the wisdom of retaining Glass-Steagall's artificial barriers highly questionable. Removal of such barriers would reduce the costs and increase the quality of services to corporations and investors; keeping them preserves an investment banking monopoly, with classic negative consequences.

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64 The Federal Reserve Board rarely finds evidence of a potential danger of voluntary tying due to the competitive nature of credit markets. *See, e.g., In re Citicorp,* [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) par. 98, 708 (Apr. 16, 1982). *See also* Welles, note 56 *supra,* at 36 (quoting the treasurer of a large corporation as saying "[i]f any of my commercial bankers told me I ought to give them my private placement business just because I've got some loans out from them, I'd laugh in his face").

65 *See e.g.,* Federal Reserve Board Staff Study, note 58 *supra,* at 48-62 (correctly predicting that commercial bank private placement activities would not be likely to lead to commercial bank dominance or to increased concentration because commercial bank competitive advantages resulting from lending capabilities were offset by unique competitive advantages of investment banks).

66 *See generally* Greenwich Research Associates, *Investment Banking 1983, Report to Participants,* 19 (1983) (survey of over 1,000 major corporations indicated commercial banks lagged behind investment banks in most of the 12 service markets in which both participate, particularly in the financial advisory and merger and acquisition areas).