SECURITIES ACTIVITIES OF COMMERCIAL BANKS:
AN EVALUATION OF CURRENT DEVELOPMENTS
AND REGULATORY ISSUES

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1. Introduction

A long established principle underlying the American financial institutional structure is that dealing in deposits (or commercial banking) and new-issue activities in nongovernment securities (or investment banking) must be carried on by separate entities. The resultant prohibition against the entry of commercial banks into the private securities business was an extreme policy when compared with the policies of laissez-faire and discretionary regulation. However, it was the logical outcome of the application of the "commercial loan" theory of banking [1] and the unsettling experience of periodic bank failure, financial crises, and economic downturns which were thought to occur whenever the separation principle was ignored [2]. Financial losses by the public during periods of speculative excess were attributed in large part to conflicts of interest that seemed inevitably to arise when the banks engaged both in commercial banking and investment banking activities [3].

The main embodiment of the separation principle is the National Banking Act of 1933 [4], popularly called the Glass-Steagall Act. This statute maintains the principle by means of restrictions on the permissible activities and affiliations of both commercial and investment banks. Taken altogether, these restrictions underscore the Congressional intent to protect the financial resources of commercial

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banks and to ensure the impartiality of the investment advice given by commercial banks to their customers.

Examination of the statute reveals that there are several types of securities activities that are neither specifically permitted to be engaged in by commercial banks nor expressly disallowed to them. These activities, the subject matter of this paper, fall into what we call a "twilight zone" of activities. Within this zone, commercial banks have repeatedly sought means by which to increase their participation in the securities industry. Currently, the most sought after means of entry are private placement of corporate securities, sales of mutual funds participations, and underwriting of a broader set of state and municipal revenue bonds.

In the course of this paper we shall provide background material for the Glass-Steagall Act and the several currently popular means of entry into the securities business. We shall describe the relevant statutory restrictions upon commercial bank security activity and the devices the banks have used to circumvent these restrictions. Finally, we shall evaluate the devices both in terms of their objective desirability and their chances of success. Our perspective will be policy oriented, and so the analyses will focus upon policy issues.

2. Historical background of the National Banking Act of 1933

The Glass-Steagall Act is largely based upon the nineteenth-century English banking system model. In that model, investment banking is considered an inherently risky and speculative venture and thus, an improper business pursuit for commercial banks, i.e. financial institutions entrusted with the savings of the general public. Commercial banking is necessarily a conservative business, according to the model, and investments should take the form of self-liquidating short-term loans [5].

In contrast to the English model there is the German model. This alternative model permits the conscious mix of both commercial and investment banking by a single financial institution. The mix is permitted for two reasons. First, greater efficiency is achieved by the mix because the information needed and the decision-making skills required by financial institutions are similar whether the loans made by the institutions are short-term (with continuous renewals) or long-term. Secondly, greater security for the institutions' asset portfolio is achieved by the mix because the asset portfolio can then be diversified. In Germany, this mix has resulted in the growth of a relatively small number of very large and broad-based financial institutions with multipurpose branches throughout the country and abroad [6].

The German model has been criticized in the United States on several grounds. One ground has been that the vast power exercised by a small number of very large multipurpose banks gives rise to fears of monopoly and concentration of economic power. Another ground has been that an all-powerful east coast financial establish-
ment would arise and disadvantage western and southern economic interests. Still another ground has been that the banks would abuse their enormous economic power to the detriment of individuals and the nation. These concerns have led some states to prohibit any form of branch banking power. However, despite these concerns, there have been repeated attempts to move closer to the German model, usually for reasons of efficiency [7]. Such attempts have been initiated by both commercial banks and regulatory agencies and reflect a growing awareness that the finance industry has itself gradually been moving closer to the German system. The following describes how this has happened.

2.1. The emergence of trust companies

During the post-Civil War period, the American financial system began to move toward the German system by means of the increased importance of trust companies. These trust companies were state chartered institutions with broad incorporation documents that permitted them to engage in virtually any type of financial business activity. At first, the companies restricted their activities to management of the estates and wills of wealthy individual customers. Service to the dead, however, soon led to service to the living and, before long, trust companies were soliciting deposits in competition with strictly commercial banks. In addition, the companies made financial counselling and assistance available to businesses as well as to individuals. They dealt in securities in several ways. In some cases they acted merely as selling agents for new-money issues of corporations. In other cases they gave their approval to particular issues of securities and even promoted these securities among potential investors. In still other cases they purchased securities with funds held in trust, or with the companies' own funds [8].

By the beginning of the twentieth century, trust companies were widely recognized as department stores of finance. They succeeded in expanding into commercial/investment banking institutions because of broadly drafted incorporation laws and also because of the absence of federal regulation of trust companies or state chartered banks.

State banks experienced similar expansion of power when they demanded and received broadened powers from the state legislatures. Thus, by the turn of the century, state banks offered services similar to those offered by the trust companies, although the precise legal distinction between the two sets of services was not the same in any two states [9].

National banks were unable to prevent the gains made by the state banks and sought means to regain competitive parity. Many chose to enter into the field of investment banking directly.

2.2. Competitive retaliation: national banks and investment banking

During the early decades of the twentieth century, financial firms that had originally functioned as investment banking institutions began to broaden their
range of activities. Private investment bankers that were involved in the development of railroads and huge industrial concentrations in the late nineteenth century entered into the deposit banking business. They used deposit-type funds to meet their need for the huge financial resources required to underwrite the securities of growing industries. In order to market the securities they developed, they used subsidiary state chartered banks and trust companies.

By the beginning of the First World War there were no “effective market barriers in law or custom” [10] to prohibit any financial institution from participation in any form of commercial or investment banking activity. Expansion of state banks induced the courts to interpret the implied powers of national banks so as to allow them to invest in state, municipal, and corporate bonds. The United States Comptroller of the Currency responded to these broad interpretations by altering the portfolio regulations for the national banks accordingly. As investment in such outstanding securities was increasingly permitted, it became impossible to prohibit the underwriting of such securities, and so such underwriting became popular. When the Comptroller of the Currency ruled that national banks could not underwrite stocks, the national banks began to create state chartered security affiliates. As a result, national banks began to engage in underwriting activity free from the constraints of federal laws and regulations. In 1913, largely on account of this trend toward regulatory laxity, the Federal Reserve Act specifically conferred power upon national banks to operate trust divisions.

Financial requirements of the federal government during the First World War lent further impetus to the trend of regulatory laxity. The government’s demand for funds was huge and led to the utilization of state chartered commercial banks for the underwriting of United States Treasury Department securities. This practice, unrestrained by the federal government, caused national banks to believe that the government had conferred implicit approval upon their efforts to increase and expand their investment banking activities.

Following the First World War, banks that had been involved in the sale and distribution of U.S. Treasury bonds retained their securities personnel and redirected their new-issue efforts towards the private sector: This, in turn, influenced customers’ investment behavior. They became less afraid to invest in the private sector when the same bond salesman told them that the postwar, nongovernment securities were safe and yielded greater returns than had the wartime bonds. In addition, changes occurred at the other end of the finance market as corporations, discovering public acceptance of their new security issues, switched from repeated short-term credit into permanent financing. Consequently, commercial banks earned less and less from their short-term loan portfolios and were compelled to look elsewhere for income. The securities market was where the action seemed to be, and so they sought to enter more deeply into the investment banking business.

Passage of the National Banking Act of 1927, popularly called the McFadden Act, served to endorse commercial banks’ activities in the securities business.
Although the main purpose of the Act was to liberalize the branching powers of national banks, it also formally affirmed the authority of commercial banks to underwrite securities through their securities affiliates. Regulatory control over such activities was conferred by the Act upon the Comptroller of the Currency [11]. At first, the Comptroller permitted the underwriting of debt securities only; later he permitted the underwriting of stocks as well.

Thus, both state and nationally chartered commercial banks became the "dominant force in investment banking". Owing to the loosening of regulatory constraints and the booming securities markets of the late 1920s, these banks increased their share of securities underwritings dramatically. Between 1927 and 1930, for example, they nearly doubled their participation in bond underwriting activity, from 37 to 61 percent [12].

2.3. The Great Depression and passage of the National Banking Act of 1933

The commercial bank practice of engaging in securities activities by means of security affiliates came under sharp attack during the years of the Great Depression. The failure of the Bank of the United States in December 1930 was attributed to speculative excesses of management operating through a security affiliate. The final majority report of the Pecora Committee, released in 1934, revealed that deceptive, fraudulent, and manipulative practices were widespread in the securities activities of commercial banks. Disclosure by banks to investors concerning the securities being sold was minimal at best, and was often misleading or deceptive. The committee also raised questions about the propriety of interlocking personnel relationships, an issue argued some twenty years earlier by the Pujo Committee [13].

As a result of thousands of bank failures and hundreds of security broker/dealer bankruptcies, the incoming Roosevelt Administration encouraged a burst of legislative action that remains basically intact to this day. In 1933 Congress enacted two bills, the National Banking Act, or Glass–Steagall Act, and the Securities Act. The former protected commercial bank depositors by (a) organizing the Federal Deposit Insurance Corporation, (b) divorcing commercial banking institutions from investment banking institutions, (c) restricting bank credit extensions for speculation, (d) restricting branch banking and group banking, and (e) regulating the interest paid on savings deposits. The latter act protected investors and commercial bank depositors by (a) establishing the principles of full and public disclosure to the investors and potential investors of information concerning the companies whose securities they may purchase, (b) including an antifraud provision aimed at curbing speculative excesses in new issues, and (c) conferring power upon the Federal Reserve Board to regulate the extension of bank credit on margin to securities purchasers. Together, the two Acts aimed at curbing speculative trends in the securities markets.
3. The National Banking Act of 1933

The National Banking Act of 1933, most widely known as the Glass–Steagall Act, is currently the most far-reaching federal statute on the subject of commercial bank securities activities. In none of its pertinent sections however does it use the term “commercial bank”. Rather, it distinguishes between financial institutions that engage in either of two types of activity: receipt of deposits “subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor” or issuance, underwriting, sale or distribution “at wholesale or retail; or through syndicate participation [of] stocks, bonds, debentures, notes or other securities” [14]. Since these types of activity are commonly held to constitute the commercial banking business and the investment banking business, respectively, the Glass–Steagall Act has come to be known for its insistence that the two types of banking business be engaged in by completely separate and independently operated banking entities. The following two subsections illustrate exactly how the Act achieves this separation.

3.1. Commercial bank restrictions

The two pertinent sections of the Act are sections 16 and 20. Section 16 [15] limits the extent to which a national bank — a bank subject to the requirements of the Federal Reserve Act — can deal in and underwrite securities or stock. Dealing is limited to the purchase and sale of securities and stock “without recourse, solely upon the order, and for the account of, customers, and in no case for its own account”. Exception is made for so-called “investment securities” under statutory limitations and “under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe”. Underwriting is prohibited, except vis-à-vis certain types of securities, such as “obligations of the United States, or general obligations of any State or of any political subdivision thereof”.

Section 20 [16] limits the extent to which a member bank, i.e. one which is a member of the Federal Reserve system, can be affiliated with an organization that deals in securities. It prohibits any such affiliation if it occurs in any of the four forms described in the statute [17].

3.2. Investment bank restrictions

The two pertinent sections of the Act are sections 21 and 32. Section 21 [18] makes it unlawful for any individual or organization engaged in the securities business “to engage at the same time to any extent whatever in the business of” commercial banking. Section 32 [19] limits the extent to which there can be interlocking personnel between commercial and investment banks. No officer, director, partner, or employee of an investment banking organization, and no individual “primarily engaged” in the securities business can “serve at the same time as an
officer, director, or employee of any member bank”. However, exception is made “in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service when in [its] judgment it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments”.

3.3. Twilight zone of commercial bank securities activities

As is evident from the foregoing description of the Glass—Steagall Act, commercial banks are not prohibited from engaging in all investment banking, or securities activities. An illustration of this is found in section 16, which expressly permits purchase and sale of securities and stock on customer order and also allows underwriting of general obligation government securities. In conjunction with these activities, commercial banks are also permitted to render financial advice. However, there is a whole range of securities activities that is neither prohibited by nor expressly permitted by the Act. These activities, described and analyzed later in this paper, comprise the twilight zone of commercial bank securities activities.

4. Historical background of the current attempts by commercial banks to expand and increase their securities activities

During the approximately twenty-five years that followed passage of the Glass—Steagall Act, commercial banks were content to be the conservative, slow growth giants of the American financial markets. Opportunities in traditional commercial banking activities were plentiful, the consumer credit business was expanding, and banks were busy updating their internal modes of operation. However, changes began to occur in the late 1950s and 1960s and commercial banks no longer were content to be sleeping giants.

4.1. New management style in banking

During the 1950s a significant change occurred in the style of management of large national commercial banks. The traditional old-boy style was replaced by the new MBA style. Bank executives who traditionally focused upon custom, friendships, and college ties when granting loans were replaced by bank executives whose primary criterion was whether the loan would be profitable for the bank. To some extent this change was not entirely voluntary, since it often was forced upon the banks by their corporate clients who themselves were undergoing dramatic internal changes. Commercial bank customers began to view their relationship with the bank differently too. They began to ask whether better service in certain areas could be gotten from other types of financial institutions.
4.2. Competition from foreign banks and other types of financial institutions

As traditional business activity, i.e. demand deposits and business loans slackened, competition from both within and without the banking industry increased. Foreign banks increased their activities in the United States. Other types of financial institutions, such as investment banks, investment companies, and broker/dealers organizations, expanded their range of operations and provided highly desirable services that commercial banks were unprepared, or not permitted, to provide.

4.3. Regulatory climate conducive to the formation of bank holding companies

Commercial banks first used bank holding companies in order to form multibank corporations. This structure enabled them to expand the scale of their traditional banking operations and to circumvent some of the state laws restricting multibank banking. Later, positions taken by the Comptroller of the Currency and the Federal Reserve Board enabled the commercial banks to create bank holding companies for purposes of expanding their range of operations. That is to say, relaxed restrictions began to permit these banks to use the holding companies as umbrellas for expansion into nonbanking activities, including securities activities. Thus, such services as leasing, data processing, investment management, and foreign investment banking had become, and continue to be, permitted to the commercial banks [20].

4.4. New computer and telecommunications capacity

Commercial banks have been highly successful in their efforts to take advantage of the availability of sophisticated computer and telecommunications technologies. For example, they have proven themselves adept at handling large numbers of accounts, switching funds electronically from one account to another, and providing rapid access data bank retrieval services and low cost hard copy. This increased capacity to handle efficiently large numbers of customers and accounts provided much impetus for the commercial banks' movement into the securities business. In addition, corporate clients encouraged this expansion since they often felt dissatisfied with the services they were receiving from their investment banks.

Investment banks, brokerage firms, and other securities industry businesses eased the commercial banks' encroachment into their business by failing to keep pace with the new opportunities afforded by the new electronic technologies. This failure occurred for several reasons. First, few brokerage firms underwent the management revolution that commercial banks underwent. Most of them remained partnerships and were run by partners in the style of the 1930s. Secondly, computer systems were expensive to develop and to operate; few brokerage firms were large enough to have the capital base necessary to support such development and operation. Thirdly, the development process requires that brokerage firms, invest-
ment banks, and other securities industry businesses—including trading markets—coordinate their electronic systems with each other and with government regulatory agencies and industry associations; the large brokerage firms, the S.E.C., and the brokerage industry associations have been slow in the movement to form a coordinated system. Large banks, the Federal Reserve Board, and the American Bankers Association have worked at developing such a system. Finally, brokerage firms felt little need to mass merchandise; fixed commission rates made the securities industry profitable for the small individual brokerage firms and the industry generally did little to develop the capacity to handle large numbers of customers or orders [21].

5. Current attempts by commercial banks to expand and increase their securities activities

As commercial banks awakened to the age of sophisticated electronic technologies, they began to seek new ways to increase their profits and compensate for their slackening deposit and short-term loan businesses. Naturally, they looked to securities. Commercial banks were accustomed to the problems and the modes of operation of the securities industry because traditionally they had close ties with it.

From their earliest history in the United States, commercial banks have extended credit to brokerage firms for purposes of purchasing private and government debt securities. Later, in the 1860s, they extended the service to cover corporate equity securities. Commercial banks have also been the largest and steadiest customers of brokerage firms. Through their trust departments, especially in their role as trustee of pension funds, they have traded heavily in the secondary markets. They have also been large-scale purchasers of securities research services, since their activity as trustee requires them to be well informed about the securities markets. Finally, the commercial banks have had contacts with the securities business through the securities-related services they have provided to their corporate clients. They have acted as transfer agent or registrar for their clients’ securities, trustee and agent for their clients’ debentures, and paying agent for their clients’ dividends.

The banks have attempted, or are currently continuing to attempt, various means to expand and increase their securities and securities-related activities. Some of these means have included dealing in negotiable deposit certificates, rapidly expanding underwriting business abroad, writing term loan agreements that include escalator interest rate clauses, and forming multipurpose one-bank holding companies. Commercial banks have also used means that would enable them to participate more directly in the securities markets. These means, recently or currently attempted, are discussed below.

5.1. Revenue bond underwriting

Section 16 of the Glass-Steagall Act expressly allows national banks to underwrite general obligations of any state or political subdivision thereof. It also allows
the banks to underwrite certain other kinds of municipal obligations. These are specified in the statute and include obligations issued for such purposes as transportation development, housing, and education. However, the statute does not make any mention of the underwriting of state and municipal revenue bonds. At the time of the passage of the Glass–Steagall Act, revenue bonds constituted less than 3 percent of total state and municipal bonds; the vast majority consisted of general obligation bonds [22]. Today, however, revenue bonds comprise approximately one-half of all the state and municipal bonds issued [23]. Consequently, commercial banks no longer are content to underwrite only general obligation state and municipal bonds; they are currently seeking amendment of the Act to permit them to underwrite all forms of revenue bonds [24].

The central issue in the debate over whether to permit commercial banks to underwrite revenue bonds is whether the net potential benefits to issuers would outweigh the potential harm to the securities industry and thence to investors.

(i) Benefits to issuers. In the early 1960s the Comptroller of the Currency and the Federal Reserve Board studied comparative costs for the flotation of revenue bonds and general obligation bonds, respectively. It was found that general obligation bonds were less costly to float than revenue bonds. Subsequent studies have been conducted in order to determine whether the difference in cost is due to the competition from commercial banks for the business of floating general obligation bonds. Most of these studies seemed to indicate that a savings of 1–2 percent of total value of revenue issues would result if commercial banks were allowed to enter into the revenue bond business [25]. Serious criticism of these findings developed, however, as problems with statistics and difficulties in making the two instruments equivalent were revealed.

Cost savings to the issuing government result from increased competition among the underwriters for the issues — lower spreads or costs of flotation — and, from competition among the newly found buyers for the issues — lower coupons or reoffering yields. For banks' entry to lead to reduced costs in these ways there must currently be less than perfect competition among underwriters (a less than optimal number of bidders) and imperfect markets for municipals (less than fully informed and integrated market pricing). It would be easy to demonstrate such savings for small revenue bonds that are negotiated with a sole bidder as contrasted with large competitively bid general obligations, provided the basic qualities of the instruments were alike. The real empirical issue is how to design samples of revenue bonds that are comparable in every respect except that some have become eligible for banks' underwriting and others have not. In short, the problem is to hold constant all factors affecting costs of floating new revenue bonds except bank entry into the business.

More recent research seems to have resolved many of the methodological problems, but resolution of these problems has led to a decrease in the consensus estimate of cost savings to issuers. The revised estimate is 1 percent of the total proceeds of new issues.
Studies have shown that the marginal impact, \textit{i.e.} the impact of adding an additional bidder, falls rapidly as the number of bidders increases. For instance, an increase from one bidder to two, or from two bidders to three, would have a substantial impact on the bidding; an increase from four to five would have little impact. Although differences between revenue and general obligation bonds may result in the number of bids being relatively fewer for the former than for the latter, studies predict that the number of bids for revenue bonds would increase if banks were to become eligible to underwrite them. Even though revenue bonds are usually negotiated rather than put up for bidding, and so are not exactly comparable to general obligation bonds, bank participation in the underwriting of revenue bonds would likely improve local distribution and reduce borrowing costs.

The impact of commercial bank eligibility on reoffering yields was first demonstrated directly by the work of Phillip Cagan [26]. He determined that bank eligibility would result in a decrease of twenty basis points in net interest costs to the issuer. Thus, savings during the period 1968–1977 would have averaged 1.5 percent of the total value of revenue bonds offered, or \$150 million per year. Savings during 1977 would have averaged over \$400 million on new revenue bond issues of \$27 billion.

A study conducted by Michael Mussa [27] reworked Cagan’s data and determined that there would be a savings of only one basis point in net interest costs to the issuer for the year 1977. Mussa criticized Cagan’s statistical methodology (especially his sampling procedure) and found that eligible and noneligible revenue bonds are not comparable. Also, he made several assumptions that Cagan did not make. He assumed (a) savings to issuers must stem primarily from cuts in reoffering yields, rather than from cuts in underwriter spreads; (b) competition in the industry is so intense that profits are already at a minimum; (c) all buyers for revenue bonds and already known or have been uncovered, and (d) all revenue bond issuers are fully informed.

Taken backwards, Mussa’s argument is that (1) there are no savings possible from bank entry into the revenue bond business; (2) if the price to investors is increased (underwriter spread cannot be cut) this will only have the effect of lowering the price of general obligation bonds; and (3) the only revenue bonds significantly affected by cuts in reoffering yields or by price increases would be small, risky bonds that are driven by issuers to competitive bidding. Mussa notes that the driving of the bonds to competitive bidding is unlikely since it would already have been insisted on by borrower-issuers in this fully competitive market if in fact it could achieve a cost savings for them.

In good part, Mussa discounts the problem by assuming that there already exists a highly competitive and perfectly informed revenue bond market. If this were in fact the case, one would wonder why commercial banks are so eager to enter into the market, and others are equally eager to keep them out. Moreover, increased competition by banks for small, negotiated issues is likely to cut issuance costs as the result of both cuts in underwriter spreads and the development and uncovering of new revenue bond investors.
A review of all the empirical work on issuer savings from bank entry into the revenue bond market suggests that there would be an average savings in cost to issuers of fourteen basis points per bond, the equivalent of 1 percent of total revenue bond proceeds; that is, for example, a savings in 1977 of $270 million out of the annual aggregate revenue bonds value of $27 billion. Putting aside Cagan's estimate of $411 million and Mussa's estimate of $0, estimates in the literature of the savings to be derived from the lowering of reoffering yields range between $9 and $14 per $1000 bond; savings from cuts in underwriter spreads average between $1 and $4 per $1000 bond; and savings from driving the bonds to bidding range between $0 and $5 per $1000 bond [28]. Thus, for the year 1977, estimated savings on a total of $27 billion in revenue bond issues, range between $150 million and $350 million [29].

(ii) Harm to the securities industry. The securities industry argues that commercial banks, if permitted to underwrite revenue bonds, would take over the revenue bond business. This is inconsistent with the industry view that there is already such intense competition that no cost savings to issuers would result from bank entry into the market. Moreover, commercial bank underwriting of general obligation bonds has not led to bank pre-emption in that business; the business is in fact quite evenly divided between commercial bank and noncommercial bank underwriters. General obligation bond underwriting statistics for 1976–77 show that commercial banks accounted for 18 percent of total dollar value, or 29 percent of the number of bonds issued, while investment banks accounted for 22 percent of total dollar value, or 45 percent of the number of bonds issued; syndicates consisting of both commercial and investment banking institutions accounted for 60 percent of total dollar value, or 26 percent of the number of bonds issued [30].

There does not appear to be much difference in the concentration ratios of commercial and investment banks with respect to the number of general obligation bonds underwritten by the respective top ten institutions. The top ten commercial banks handle 75 percent of the total commercial bank underwriting of the bonds; the top ten investment bankers handle 60 percent of the total noncommercial bank underwriting of the bonds. General obligation bonds worth $1 million or less appear to be well distributed between commercial and noncommercial banks, and between large and small underwriters [31].

The two leading underwriters in 1977 were the Chase Manhattan Bank and Merrill Lynch — each handled 5 percent of the total annual underwriting. The top twenty underwriters who underwrote half of the annual total of $17 billion in bonds, included nine commercial banks. However, commercial banks are less significant in the figures for bond issues worth $5 million or less.

If commercial banks were permitted to underwrite revenue bonds, there is little if any danger that they would neglect or monopolize the market for smaller issues. Commercial bank offices are spread throughout the country and it is likely that regional banks would become more important, especially for local revenue issues. Similarly, there are currently three or four regional investment banks among the
The securities firms claim that commercial banks have an unfair competitive advantage over them in that the banks have privileged capital-raising sources. However, today it is difficult to speak of interest-free or even low-interest deposit sources of capital [32]. Funds may indeed be more available to the banks, but the marginal cost of the capital used for underwriting is probably the same for commercial bankers as it is for investment bankers. In any case, the capital required for underwriting of revenue bonds is small to begin with, and therefore not a legitimate cause for concern.

In one tax aspect, commercial banks do have an apparent advantage over their potential securities industry competitors. Securities firms that generally borrow mainly from banks in order to carry inventories of revenue bonds are not permitted to deduct the interest cost as an expense; this cost is not so singled out in commercial bank operations. The banks can hold tax exempt bonds both as investments and as trading inventory. The burden of the tax is not so great, however, with regard to new issues: these are largely pre-sold and unsold bonds are inventoried for only a few weeks. With regard to secondary trades, the burden is indeed great and so the securities firms would be entitled to tax equalization in the event that commercial banks were permitted to underwrite revenue bonds.

Finally, the securities industry maintains that conflicts of interest would result if commercial banks were permitted to underwrite revenue bonds. This is inconsistent with the fact that the banks have never been charged with conflicts of interest in connection with their long-term underwriting of general obligation bonds. If revenue bonds increasingly develop along industrial development lines, the comparison to corporate bond underwriting and its episodes of abusive practice would not be far-fetched. However, these developments are unlikely since commercial, as well as investment banks’ municipal bond activities are subject to self-regulation (M.S.R. Board), and to bank examination and S.E.C. procedures, respectively.

Conflicts of interest might well arise under crisis conditions, such as those that existed in the 1930s. Conditions could arise under which banks would be tempted for a short time to sell unwanted revenue bonds to trust funds or customer accounts. Conditions also could possibly arise under which banks might treat revenue bonds as loss leaders and thereby create possible concentration problems. Strict regulation however could prevent such actions by the banks.

There is one aspect of commercial bank underwriting of revenue bonds that does cause some difficulty. Unlike general obligation bonds that are 95 percent competitively bid, approximately 50 percent of revenue bonds are negotiated. Moreover, the dollar value of new issue revenue bonds tends to be larger than the value of general obligation issues [33]. Insofar as revenue issues are both negotiated and large in value, they are comparable to large negotiated public corporate bond issues. Competitively bid issues place the underwriter at arm’s length distance from the issuer; the underwriter in effect takes the issues as they come, or leaves them. The negotiated issues, however, do not place the two parties at arm’s length distance
from one another; rather they place the underwriter in the position of financial adviser since he is of necessity included as part of the design of the terms and conditions of the bond offering. The restrictions of the Glass-Steagall Act were aimed, in part, precisely at those combination roles of bond designer/underwriter and bond buyer/lender [34]. There is another side to this difficulty.

The financial adviser role that could develop between issuers and underwriters could also possibly lead to institutional trading relationships between the underwriter and state or local government pension funds. From the point of view of the securities industry it would be safer to allow banks to enter the competitively bid revenue bond business than the negotiated revenue bond business; but in fact, it is the latter business that is currently in need of additional participants.

5.2. Brokerage activities

Commercial banks have been trying for years to engage in increasing numbers of clearly brokerage activities. As to some of these activities, the banks have been successful; as to others, especially mutual fund sales — their principal brokerage target — they have been unsuccessful. This subsection describes the most important of the brokerage activities that interest the commercial banks. It pays special attention to mutual fund sales because these were the type of activity at issue in the most recent relevant Supreme Court decision, Investment Company Institute (I.C.I.) v. Camp.

(i) Dividend reinvestment plans. The first dividend reinvestment plan was offered in 1968. At present, nearly all banks that are dividend disbursing agents offer such plans. There are almost 1000 such plans administered by approximately eighty banks on behalf of more than a million individuals and institutions. No service provided by securities firms has ever attracted such a widespread following or grown so quickly [35].

As originally offered, dividend reinvestment plans entitled individual beneficial owners of stock to have the bank automatically reinvest their dividends into additional shares of stock of the same company. The bank would pool the dividends to be reinvested and purchase the shares through a brokerage firm at the institutional rate (this rate has dropped 80 percent since the first dividend reinvestment plan was offered). Then the bank would allocate the shares and its costs to the individual accounts. Fractional sales were also allocated. The bank retained the stock certificates and sent out quarterly statements to their customers.

These plans have been broadened steadily. Banks permit investors to put in additional cash which is aggregated and invested along with the rest of the investment pool. In order to forestall participation by larger institutions, a yearly dollar limit is placed upon the additional cash investment; the typical limit has grown from $1000 to over $10,000. Some banks permit institutional participation in the dividend reinvestment part of the plan but prohibit participation in the additional cash part of the plan. Only individuals or institutions that are direct holders of the
stock can participate at all. At the time of writing there is no provision made in these plans for stock held in street names, because it is felt there is no way possible to recover the costs of providing such a service. Fees to accounts usually consist of allocated brokerage fees plus a bank service charge which ranges from 50 cents to 4 dollars. Generally, the bank service charge is not enough to cover all bank expenses, so company clients often supplement their payments with additional cash or business to the bank. Many brokers discourage very small transactions, i.e. those involving less than $100, and so banks prefer larger transactions. In 1978, the customer's bill was often one-half to three-quarters less than the total fee would have been if the transaction had been made directly by the stockholder with his broker.

Some features of current dividend reinvestment plans resemble some features of mutual funds. However, banks have not been required to register under the Investment Company Act. Thus, under existing banking regulations banks (1) have relative freedom to promote such plans, (2) can use the cash flows for these plans until the purchase price of the securities acquired is due, (3) need not indicate to customers the specific amount of brokerage charges incurred, and (4) need not acquire the securities by bringing the order to the stock exchange for company's stock traded on the exchange.

(ii) Employee investment plans. Employee investment plans are really joint service plans offered by banks and their corporate clients to employees of the corporate client. The method of operation is similar to that for dividend reinvestment plans. Each month participating employees designate a particular part of their salary to be deducted by the company. The amount can range from $10 to 10 percent of their salary. The company forwards the funds to the bank which then pools the funds and purchases the company's stock on the secondary market. Often the company pays the bank service charge and brokerage fees as a fringe benefit for participating employees. Thus, the employees receive the shares at low net cost. The bank sends periodic statements to the employees indicating current transactions and position in the pool of stock.

In addition to the secondary market purchase plans, there are also in operation a few original issue plans. Some of these were established by banks themselves for their own employees. There would seem to be some conflict of interest here, but since banks have some difficulty raising equity capital through regular investment banking channels, the practice may grow. Sometimes the new-issue shares are offered at a discount (generally larger than the 5 percent discount typical of original issue dividend reinvestment plans), but even on a current market price basis the low transactions costs may make the purchase plans attractive to employees.

The first employee investment plans were offered in the early 1950s. Today, there are fewer banks offering such plans and the number of employee participants is less than 15 percent of the number of participants in the dividend reinvestment plans. A few brokerage firms compete with the banks' employee stock purchase plans. In fact, one firm, Merrill Lynch, seems to have more accounts in this
area than all the banks put together [39]. Since participating corporations support
the cost of this service, it would seem marginally attractive for institutions who
already offer dividend reinvestment plans to also offer employee investment plans.
This does not seem to be happening. Part of the explanation may be that the
depressed stock market of the early 1970s made purchase of one’s own company
stock (or any other stock) unattractive to small investors. As the tone of the market
improves, demand for such plans may increase.

(iii) Automatic investment service. This bank brokerage service is designed for
individual checking account customers. The banks deduct an authorized amount
from a participating customer’s checking account (usually $25 to $500) once a
month for investment in securities chosen by the customer. Securities are selected
from a bank-supplied listing of what are essentially the twenty largest corporations
in Standard and Poor’s 425 Industrial Index. Deductions for stock purchases are
pooled and turned over to the bank’s trust department trading desk for execution.
Each customer receives share credits based on average price, allocated brokerage
expense, and a bank service charge. The service charge averages about $2 per share
bought.

This service was introduced in about 1973 but has not been very successful. At
present, approximately twenty banks offer such plans [40]; fewer than 10,000
individuals have participated in the plans, investing less than $100 per month. The
few brokerage firms that have quietly offered competitive plans have also noted a
lack of success. Since costs are clearly lower than for direct stock purchase, it is not
clear why these plans are unpopular. Perhaps it is because of the restricted choice of
securities. Although the existence of these plans has been an extreme irritant to the
mutual fund industry (the Investment Company Institute has filed suit, arguing that
such bank plans are prohibited by the Glass—Steagall Act), the current competitive
threat is very small.

(iv) Individual portfolio management service. In performing this service, the
bank acts as agent for the customer. The customer instructs the bank and the bank
in turn transmits the order to a brokerage firm for transaction. The customer
chooses the broker. It has been estimated that about 4300 ‘banks provide such
customer transaction service for individuals who do not want to deal directly with
brokerage firms. Hundreds of thousands of orders are placed this way every year,
more than 15 percent of them by bank employees who know about the service. The
typical order is for less than $5000. For nonbank employees the typical fee is $25
plus perhaps 15 ¢ per share commission. Thus, the cost of transacting a $5000
order through the bank which has access to institutional-sized discounts is smaller
than the current standard brokerage rate.

As a separate service, these transactions are probably unprofitable for a bank,
but the relatively small volume per bank makes losses insignificant. Chemical Bank
did experiment with offering a more regular customer transaction service; it
advertised a phone-in order desk and standard brokerage firm service. The fees
charged were quite high, however, and the experiment failed. In any case Chemical
Bank's service would probably have been ruled illegal under the Glass–Steagall Act because it involved the active solicitation characteristic of the brokerage business rather than the clearly permissible sales made "solely upon the order" of the customer.

Bank customer transaction services generally are attractive from a cost viewpoint. But such services are seldom advertised or even noted in bank literature. They are special, occasional services provided for regular bank customers on demand. Traditionally, the securities industry has not regarded such passive services as any type of threat, and in any case they are exempt from Glass–Steagall proscriptions provided they fit within the category of "customer accommodation" brokerage.

(v) Individual pension plans. Individual pension plans offered by the banks are tax benefited retirement plans for employed individuals not covered for pensions by their employers. These plans usually require the investor to invest in bank savings accounts or in a bank designated mutual fund. Such plans are exempt from the requirements of the Securities Act of 1933 and the Investment Company Act; however, investments in such plans are not exempt from the registration requirements of the Securities Act.

Banks have not promoted these plans as aggressively as have insurance companies or thrift institutions. The potential market is large however and the securities industry is opposed to allowing the banks to offer such plans. It is not likely that the plans are violative of the Glass–Steagall Act. In offering these plans, the banks act as fiduciaries and banks have long been permitted to operate collective investment funds when the designated funds are of either of the following types: (a) pension, profit-sharing, stock bonus, or other trusts exempted from tax by the Internal Revenue Code, or (b) funds held as executor, administrator, guardian, or trustee under a will or deed [41].

(vi) Mutual funds. Mutual funds are commingled managing agency accounts created by an agreement authorizing the managing agent, i.e. the bank, to exercise investment discretion in managing the assets of the principal, i.e. the customer. The account is registered as an investment company and the customer receives undiscounted interests in the fund, or units of participation. The units of participation are registered as securities and can be marketed only through the fund.

In 1963 the Comptroller of the Currency issued Regulation 9 which allowed national banks to maintain customers' agency accounts collectively invested in a common fund managed by the trust departments of the banks. Shortly thereafter, the First National City Bank (Citibank) designed a plan that strongly resembled a mutual fund. Under the plan it offered to accept deposits of at least $10,000 for investment in common stock. All such funds were to be commingled so as to achieve economies of scale and the depositor was to receive units of participation in this commingled fund. The Investment Company Institute brought suit against Citibank to prevent it and other banks from offering any such plans. The legal challenge reached the Supreme Court which decided in favor of the Investment Company Institute.
In that case, *ICI v. Camp* [42], the plaintiffs argued that the creation and operation of an investment fund by a bank which offers to its customers the opportunity to purchase an interest in the fund's assets constitutes the issuing, underwriting, selling or distributing of securities or stocks. The purchase of stock by a bank's investment fund was a purchase of stock by a bank for its own account and, as such, was a clear violation of section 16 of the Glass–Steagall Act. Furthermore, plaintiffs argued, if the bank's investment fund was considered an entity distinct from the bank, then the bank's affiliation with the fund was a violation of section 21 of the Act.

The Court framed the dispute in terms of whether the plan involved the bank in the underwriting of noneligible securities. In holding against Comptroller of the Currency Camp the Court declared that while it is not improper under the Glass–Steagall Act for a bank to pool trust assets, act as a managing agent for individual customers, or purchase stock for the account of its customers, "the union of these powers gives birth to an investment fund whose activities are of a different character". Such a union necessarily involves the bank in purchasing stock for its own account and in issuing stock; there is no distinction between sale of an interest in the business of buying, holding, and selling stocks for investment and sale of an interest in a commercial or industrial enterprise. There is, however, a distinction between "the sale of fiduciary services and the sale of investments". In the case at hand, the Court determined that the plan involved the bank in the prohibited sale of investments. Thus, the Court held the plan to be in violation of sections 16 and 21 of the Glass–Steagall Act.

The *Camp* decision dealt a great blow to early bank attempts to enter the mutual funds business; banks and the Comptroller view it not as a definitive barrier but merely as an obstacle to be avoided. Banks are presently permitted to engage in a number of related activities and thus far seem to have had some success in their efforts to expand their securities activities. For instance, banks are permitted to act as management agents for individual portfolios so long as the customers get individualized service, banks do not have investment discretion, and customers can choose among a number of brokers. Furthermore, banks are allowed to act as advisers to mutual funds and can themselves set up closed-end mutual funds.

The Investment Company Institute continues to seek to enjoin these activities and has met with some success in the federal district courts. Existing mutual funds have been suffering for several years from investor withdrawals and so are conducting near open warfare with the banks for whom mutual funds could mean big business. The outcome of this battle is as yet unclear. Litigation might ultimately favor the securities industry, but legislation could well favor the banks, provided that the banks were willing to submit to S.E.C., rather than to traditional banking authority regulation.

5.3. Private placements

Commercial banks are not expressly prohibited from engaging in private placement activity. In fact, they have been engaging in such activity for quite some time,
mainly in response to the growing institutional investor market for corporate securities. This increased demand for securities has made it difficult for the commercial banks to maintain and acquire customers for their long-term loans business; corporations increasingly prefer securities financing and often look to institutional investors for just such financing.

Only recently has the right of commercial banks to engage in private placement activity been challenged by the securities industry. Private placements presently account for a large part of all corporate new debt and equity issues. In the period since 1966, they have accounted for one-third of total new issues; the annual range varies between 15 and 50 percent. Banks currently accomplish approximately 7—8 percent of all private placements. Thus, the banks now privately place approximately 2 percent of all new corporate issues. Since private placements are the predominant method for nongiant industrial corporate financing, it is likely that banks privately place at least 10 percent of all new issues of small/medium sized industrial corporation securities. In absolute terms, since 1976 bank-advised private placements have exceeded $1 billion per year. Thus, they appear to be big business for the banks, and the investment industry is concerned. Consequently it has begun to challenge the right of commercial banks to engage in such activity.

The challenge centers around the question of whether the Glass—Steagall Act implicitly prohibits private placement activity by commercial banks. Sections 16 and 21, taken together, prohibit the issuance, underwriting, distribution, or sale of securities. Clearly, private placement does not involve the issuance of securities, and so it differs significantly from underwriting and distribution. Private placements involve the sale of corporate securities to particular purchasers, usually institutional investors, who are highly sophisticated or who have advisers who are highly sophisticated in investment matters; underwritings and distributions involve the sale and distribution of corporate securities to the general public, many of which are persons unsophisticated in investment matters. Furthermore, private placements involve the commercial bank as an adviser to the corporation seeking to have its securities placed; transfer of the securities is accomplished directly by the issuer. Underwritings and distributions involve the investment banker or broker/dealer as intermediary between the issuer and the purchaser; the intermediary acts either as principal or agent.

It is unclear whether private placements constitute sales of securities within the context of the Glass—Steagall Act. The question turns on the meaning of the word "sale" in the context of the usual underwriting and distribution situation, i.e. where a broker/dealer sells securities to the public as either agent or principal. Clearly the private placement commercial bank engages in some activities that could well be deemed a part of the selling process of a security, i.e. the bank searches the market for potential investors, negotiates with them, and assists the corporate client in drawing up the terms and the timing of the offer. However, it is not clear to what extent these activities make the private placement a "sale" of securities.

If the private placement were deemed a sale then the issue would become
whether section 16 permits such a type of sale. Since the section permits sales of securities "upon the order, and for the account of, customers", it could be argued that the corporate client is, in the context of a private placement, merely a customer of the bank, and that the private placement is a sale for the account of a customer of the bank, i.e. the corporate client. However, the section also requires that such sales must be transacted "without recourse", that is, without any guarantee against loss. In some cases commercial banks receive from their clients, the issuing corporations, fees contingent upon the successful placement of the securities.

The purpose of private placements is, of course, to raise money for the corporation issuing the privately placed securities. Insofar as this is also the main reason for the existence of investment banks, all securities activities designed to raise money for the corporation could be considered investment banking activities. If this is deemed to be the case, then such activities might possibly be prohibited to the commercial banks under Camp, for there the Court declared that one of the objectives of the Glass–Steagall Act was to prevent commercial banks from going into the investment banking business. It is noteworthy that the Act does in fact expressly permit commercial banks to engage in some types of investment banking activity, i.e. the underwriting and distribution of general obligation government bonds. Therefore, it is not entirely clear that the Act necessarily prohibits private placements. Moreover, the Camp decision was rendered in the context of commercial banks' activities in selling securities (units of participation in commingled managing agency accounts) to the general public and the holding could be confined to the facts of that case.

Investment banks maintain that commercial banks have competitive advantages that could result in conflict of interest and concentration of economic power difficulties. First, they claim that commercial banks have access to and some control over necessitous customers, dependent upon bank lines of credit for more or less permanent financing. The banks may restrict, or tie, access to bank loans to private placement customers. Secondly, banks can combine lines of credit and term loans with a private placement to comprise an overall financing package. If this package were an all-or-nothing plan, rather than one based upon cost economies or greater service, it would be unfairly competitive. Thirdly, banks as depositories are said to have special advantages in raising capital over investment banks. The Securities Industry Association refers to these "special advantages and privileges — deposit insurance, access to the discount window, tax breaks" — as subsidies [45]. Finally, banks are subject only to the bank regulatory agencies' authority, which is deemed not as stringent as the S.E.C. It is feared by the investment banks that these competitive advantages combined with the presently weakened condition of securities firms will lead to a concentration of the private placement business in the hands of commercial banks.

Statistics do not seem to support the concentration of power argument. A data survey for the years 1976–77 reveals that commercial banks had 7 percent, or $1.5 billion worth, of the private placement market. During that period the total
value of privately placed corporate securities was $20 billion; total securities offerings were $60 billion. The $1.5 billion worth of private placements was handled by thirty-two banks, with almost half of it handled by five large banks. None of these banks, however, ranked among the top ten private placement organizations; those slots were occupied by the large investment banking houses. The top ten did two-thirds of all the private placement business during that period. Generally speaking, private placement is a business conducted by large financial institutions, whether commercial bank or not; 85 percent of the business is conducted by the twenty largest institutions.

Commercial bank private placements were largely confined (75 percent) to loan and deposit customers. Proceeds from the placements were usually used to expand the business, not to pay off loans. Bank loans were part of the package of bank financing, capped by a private placement of securities. The banks did tend to assist customers who had bank loans outstanding and who added to term debt as part of the total financing package. In other respects (size, industry, etc.) issuers working through commercial banks were similar to those working through investment banks.

The potential for concentrated power in commercial banks is slim. A study conducted by the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation indicated that "[if] the business of all commercial banks were to triple, while that of investment banks remained unchanged, no new commercial bank would break into the top twenty advisors. The three commercial banks previously among the second ten advisors would move into the top ten. The highest ranking commercial bank would edge into fifth place . . ." [44]. The top four's share of all investment banks' share would fall then from 39 to 36 percent.

Stanford Research Institute, in its 1977 forecast of the future of the securities industry, estimated that the commercial banks' share of private placements "might reach" 15–20 percent by 1981 [45]. This would be a tripling of the current 6–7 percent share. Both studies assumed no major shift in regulation of private placement activity.

Concentration is feared for its long-term effect of driving investment bankers out of business. It would be unusual in theory and in practice for increased numbers of competitors to cause decreased competitiveness in an industry, although it may well be that the size of the competitors may become larger and the composition of the competitors more diverse. In any case, the Glass–Steagall Act was not enacted in order to affect competition for private placement business, nor to preserve the business exclusively for the investment banks; its primary aim was to disengage commercial banking from those aspects of the securities business that created an unacceptable degree of risk for banks and their depositors and customers. Thus, it addressed potential hazards to the economy as a whole. Banks' funds are not placed at risk when commercial banks engage in private placement activity. Rather, it is only the bank's ability to act as adviser in private placement matters that is placed
on the line. The private placement business forms only a small portion of total bank assets of business loans. For 1976, private placements were the source of 0.1 percent of bank assets and 10 percent of business loans. Even for the leading five banks, private placements were the source of only 1 percent of total assets and 5 percent of business loans [46]. Tripling these activities to 3 percent would hardly affect bank stability.

The competitive advantages that are enjoyed by the commercial banks are not so obvious as the securities industry claims they are. First, commercial banks are absolutely prohibited from underwriting and distributing public issues of corporate securities; only the securities industry can do that. Two-thirds of all business corporation debt/equity issues are offered publicly, therefore the securities industry is assured of this business. Many issuers, such as utility companies, are required by law to offer their securities publicly. The private placement mode of financing is unlikely to overtake this business. In any case, 25 percent of all private placements are conducted entirely by the issuer, with no assistance from commercial or investment banks.

Secondly, surveys have shown that commercial bank private placements are priced in accordance with securities industry practice. Investment banks are able to offer financing packages to their customers, as well. Most large issuers sell their issues both publicly and privately and can be offered packages of long-term financing to woo them away from commercial bank financing packages. The efficiency of the investment banker as a finance specialist can also offset any convenience offered by commercial bank one-stop financing.

Thirdly, if it is true that "most of the private placement clients of commercial banks [are] previous or current loan or deposit customers", it is also true that most of the private placement clients of investment banks are previous or current public issue customers [47]. The investment banks also maintain long-term relationships with their customers. Finally, investment bank private placement activity is not subject to S.E.C. regulation. Investment banks are not registered as broker/dealers for private placement purposes. Both investment and commercial banks are subject to the antifraud provisions of the federal securities laws; but only banks are subject to multiexamination procedures.

Securities firms also argue that commercial banks would become involved in conflict of interest situations if they engaged in private placement activities. It is alleged that banks might be tempted to direct private placements so as to bail the bank out of problem loans, dump inferior loans into bank-managed trust funds, or replace outstanding loans, thereby drumming up trade. Such voluntary reciprocity or tie-in effects, the very essence of conflict of interests, would be implicit in the structure of the joint market situation or explicit by arrangement between the two parties.

The first allegation is not supported by available evidence. Evidence thus far indicates that only a small proportion, one-fifth, of privately placed funds is used to repay sound or unsound bank loans [48]. Institutional purchasers of private place-
ments, such as life insurance companies and pension funds, who in 1976 took 60 percent and 35 percent, respectively, of investment banks' private placements, are unlikely to take up issues made to pay off outstanding unsound bank loans. A slightly more realistic possibility is that unsound loans might be made in the future to bolster a faltering privately placing issuer that a bank had advised. However, this mode of reputation saving is uneconomic and unbusinesslike, and would likely be noticed and criticized by regulatory authorities in the process of their bank examinations. Thus, if such an event were to occur, it is unlikely that the bank would make such loans again.

The second allegation concerning dumping also is unlikely to occur. Bank examination procedures would uncover intrabank dumping of poor placements. In any case, bank policy, common law, and bank regulations specifically prohibit it [49]. This prohibition could be formalized by placing it into amendments to the Glass-Steagall Act. Amendments allowing commercial banks to engage in private placement activities could detail the necessary bank trust department examinations.

The third and final allegation, concerning drumming-up trade, is not very convincing. Commercial banks already advise their clients with respect to such items as loan terms, capital structure, pension plans, taxes, etc. There is no reason why advice regarding private placements should be deemed to create any conflicts of interest that are greater than those present in the other areas in which banks act as advisers.

Generally speaking, no single aspect of potential conflict of interest situations is powerful and convincing; nor is the fear realistic that bank size and power will result in less rather than more competition, at least for the next decade. Nonetheless, a combination of minor conflicts of interest in the banking industry, plus further contraction and structural change in the securities industry — an industry still adjusting to the shocks of automation and competitive commissions of the 1970s — may well, when summed up, cause both Congress and the courts to restrain further bank entry into this area of the securities business.

5.4. Some additional securities activities in which banks seek further engagement

The largest, most rapidly growing involvement of banks in securities industry activities has been in the investment services provided to corporations. Banks' trust departments currently manage about $400 billion in financial assets. Of this total, approximately $150 billion is managed as personal trust, perhaps another $80 billion as personal agency, and the largest component, more than $170 billion, as corporate employee benefit plans [50]. The growth of these plans and bank involvement in their administration is one of the primary factors causing a change in the traditional institutional structure of the securities industry in the 1970s. It is due, in part, to fiduciary constraints in the pension laws which inhibit corporate management of the plans, and in part to the securities industry's inability adequately to service this rapidly growing area.
Banks have been permitted to operate such pooled plans since 1955. They are operated as mutual funds, except that the clients are corporate pension funds and withdrawal by a client from participation takes a little longer than it would for an individual to sell his mutual fund shares. More than $25 billion has already been invested in these pooled fund pension plans and banks are aggressively seeking new business in this area. Banks seeking this business are not constrained by the prescriptions against advertising, management fee rules, professional standards tests, or trading restrictions which the S.E.C. imposes on those businesses that operate within the securities industry. Since banks are going after parts of the funds of large corporations, and all of the pension funds of small corporations (many with fewer than 100 employees), the securities industry views this activity as a serious direct threat. The Investment Company Institute has argued that banks are in fact merchandising interests in these funds in violation of the Glass—Steagall Act and has filed suit to halt the practice.

In a closely related development, the Federal Reserve Board, even after the Camp decision, adopted regulations permitting a subsidiary of a bank holding company to act as an investment adviser, to sponsor and advise a closed-end mutual fund, and to advise but not sponsor or control an open-end mutual fund. There are more than fifty such investment advisory affiliates; most are registered as advisers under the Investment Advisers Act, but a few are organized as bank trust companies and have not registered. Already, banks are advising open-end mutual funds with assets of more than $1.5 billion and have organized closed-end funds with assets approaching $1 billion. In addition, some of those affiliates are selling investment research and advice directly to customers—largely other institutional investors and correspondent banks.

The permitted investment advisory activities have not worked out entirely in the banks’ favor. Shortly after such activities were permitted, a number of banks, through their subsidiaries, became the advisory companies for mortgage or real estate investment trusts. Between 1970 and 1975, bank-sponsored real estate investment trusts (REITs) became the largest segment of this new industry. More than forty REITs were advised by subsidiaries of bank holding companies. The banks provided more than $10 billion in loans to these firms. Although banks did not directly market the shares of their REITs, they provided the illusion of bank-sponsorship and responsibility—more a fact than illusion, as it turned out [51].

With the collapse of the real estate market in 1974–75, most REITs found themselves on the verge of bankruptcy. They looked to their sponsoring financial institutions (usually banks) to bail them out, and the banks did. There were severe conflicts of interest created in this whole process. Banks transferred high risk loans to their REITs, extended loans on favorable terms, had officers who took finders fees, and when the REITs faced bankruptcy, repurchased loans or extended credit on terms unfavorable to the bank’s own stockholders. The securities industry and Investment Company Institute have been quick to point out that these were exactly the conditions the Glass—Steagall Act was intended to prevent, and it was possible
for banks to become advisers to REITs in the 1970s only because the Federal Reserve Board encouraged banks to by-pass the Camp decision. Of course, the banks have argued that the reason there were so many opportunities for them to participate as investment advisers in this area is because this is yet another area where the securities industry has not been providing adequate service for the American capital markets. They are also seeking legislation that would allow them to undertake investment advisory/management activities without S.E.C. regulation. It is unlikely that they will be successful in their attempt to avoid S.E.C. regulation.

6. Regulation of commercial bank securities activities

Regulation is a major issue in the debate over whether to allow commercial banks to engage in any of the aforementioned securities activities. In other words, if banks will be deemed eligible to participate in these activities, the question will become which governmental agencies ought to be given regulatory authority over them — the banking authorities or the S.E.C.? The banks prefer to remain under banking authority regulation. The securities industry, on the other hand, believes that the banking regulation is less demanding than the S.E.C. regulation, and that, as a result, the banks would obtain a competitive advantage. To assess the validity of this argument, it is necessary to describe the structure of bank regulation and then to compare the goals and methods of the bank regulatory agencies with those of the S.E.C.

6.1. Commercial banking industry regulation

Unlike most businesses, commercial banks have a choice of the agency which regulates them. Banks can obtain either a national charter or a state charter. Those that obtain national charters must become members of the Federal Reserve System and have as their primary regulator the Comptroller of the Currency. Banks choosing state charters do not have to become Federal Reserve System members. The Federal Reserve System serves as primary regulator for state member banks, while the Federal Deposit Insurance Corporation (F.D.I.C.) serves as primary regulator for state nonmember banks that elect to obtain F.D.I.C. insurance. All members of the Federal Reserve System must join the F.D.I.C. Those few state nonmember banks without F.D.I.C. insurance are exempt from federal regulation and are primarily regulated by the respective states. Federal Reserve System services are valuable, therefore most large banks become members. On the other hand, the cost of membership is high, so many smaller banks opt for state nonmember status. The result of this multiple regulatory structure is that the banks can shop for the regulator that will best serve their needs. Additionally, in an effort to obtain banks to regulate, the various agencies allegedly compete for the least restrictive regulation.
The bank regulation scheme is further complicated by the development of the bank holding company. The Bank Holding Company Act of 1956 placed all multi-bank holding companies under the regulatory control of the Federal Reserve System. In the late 1960s many of the largest banks used one-bank holding companies to expand into nonbanking activities. These activities were exempt from Federal Reserve regulation. Amendments to the Bank Holding Company Act were enacted in 1970 to close this loophole and to establish a framework for deciding what were the appropriate nonbanking activities for bank holding companies. Currently, all bank holding companies are regulated by the Federal Reserve System, which also decides which activities are permissible. The criterion used is whether the activity is "closely related to banking". This is a nebulous standard and the Federal Reserve System has been most concerned about its effect on the safety of the banking system. Through mid-1974 the number of permissible activities increased rapidly and banks expanded their nonbanking activities. However, with the collapse of several large banks, most notably Franklin National Bank, the Federal Reserve System adopted a more stringent attitude and considerably slowed the regulatory expansion of permissible activities. The Federal Reserve has generally been a conservative regulator in expansion of bank holding company activity through both acquisition and *de novo* entry.

6.2. Commercial bank regulation and securities industry regulation

When analyzing the securities activities of banks, the difference in regulatory attitudes between the S.E.C. and the bank regulatory agencies must be considered. The primary concern of the S.E.C. is that investors and prospective investors be provided with adequate information to make informed investment decisions; to this end it issues rules for disclosing and reporting information. When the agency finds that an institution does not follow the required standards, it orders public disclosure of the required information or it takes other forms of publicized enforcement action.

The primary concerns of the bank regulatory agencies are the safety of the banking system and bank solvency. When a particular regulatory problem arises with respect to a bank, it is solved privately between the bank and the regulator. Efforts are made to keep the public uninformed about the problem, since protecting the bank from adverse publicity serves to protect the solvency of the bank and thus the bank's depositors. At all costs, regulators seek to avoid depositor loss of confidence in the bank and withdrawal of funds. They recall the experience of the 1930s, when a run on an individual bank adversely affected the whole banking system.

The first important areas of difference in regulatory treatment concerns the issue of disclosure. Since the S.E.C. is principally concerned with the provision of accurate information, it is not surprising to discover that the S.E.C. has more stringent disclosure requirements than the bank regulatory agencies. Bank holding com-
panies are not exempt from S.E.C. regulation, and so have been subjected to regulation that the banks themselves are unaccustomed to. An example of this occurred several years ago when a bank holding company, Chemical New York Corporation, filed a registration statement for a new stock issue.

The staff of the Commission requested Chemical to amend its prospectus to disclose information relating to the quality of Chemical's loan portfolio. Specifically, the staff wanted more information on Chemical's nonincome producing loans for the prior 3 years and more narrative information on problem loans. After a number of meetings, which produced amendments to the filing, the revised registration statement was declared effective by the Commission. However, Chemical decided not to go through with the offering and withdrew its registration statement. The Commission has been criticized for having imposed unnecessarily elaborate disclosure on Chemical and for having caused Chemical to determine that it could no longer successfully sell its securities [52].

Another example concerns annual statements. Although commercial banks are exempt from S.E.C. regulation, the bank regulatory agencies are given the responsibility of administering and enforcing certain sections of the securities laws with respect to the new issues of bank securities. Amendments to the Securities Exchange Act of 1934, passed in 1974, require the bank regulatory agencies to "issue substantially similar regulations to regulations and rules issued by the Commission" unless "not necessary or appropriate in the public interest or for protection of investors". Deviations from the rules must be explained by the bank regulatory agencies in the Federal Register [53]. The bank regulatory agencies do not require public certification of annual statements because they feel that the regular bank examination process is sufficient. The Comptroller of the Currency and the Federal Reserve Board consider banks to have only one line of business and therefore do not follow S.E.C. regulations, which require line of business reporting.

The second important area of difference in regulatory treatment concerns the issue of insider information. Both banks and brokerage firms obtain confidential information about companies in one department and must advise customers about these companies in other departments. The S.E.C. would like investors to be fully informed and so prefer that investor-customers be provided with all available information. The bank regulatory agencies, however, require a separation of departments (i.e. so-called "Chinese walls"), for example between those that deal with new issues and those engaged in trading, and so prefer that information not be shared among the departments. Resolution of this issue in favor of either agency would conflict with the basic policies of the other agency.

A third area of regulatory disagreement is enforcement and can be illustrated by two cases. First, when fraud was uncovered in dealings between Westgate California Corporation and the United States National Bank of San Diego, the S.E.C. informed the Comptroller that it wanted to make the bank a defendant. The Comptroller of the Currency objected to this because he feared that the adverse publicity could cause depositors to withdraw funds from the bank and impair the
condition of the bank, *i.e.* cause a "run" on the bank. Secondly, when rumors about the condition of Franklin National Bank caused a substantial drop in the price of its stock in 1974, the S.E.C. wanted to suspend trading in the stock. Again, the Comptroller of the Currency felt that this would not only adversely affect Franklin but also all banks. Lengthy negotiations between the regulatory agencies was necessary to determine a course of action [54].

The fourth area of difference concerns proper record-keeping. One S.E.C. sponsored study has concluded that records actually maintained by banks are neither uniform in content nor, in many cases, adequate for examination purposes. To take one example, without adequate time records of the receipt and entry of orders, banks cannot be effectively examined for promptness of execution or for the existence of fraudulent "kick-back" types of schemes. . . . [55]

This same study has also criticized the bank examination procedure, asserting that bank examiners are not knowledgeable about the securities laws. This is of special concern to the S.E.C. since some of the problems it has had in dealing with banks are caused by a lack of awareness of the securities laws on the part of bank personnel. Recently, however, with the aid of S.E.C. personnel, bank examiners have been given some training in securities law.

Still another important area of regulatory difference concerns the issues of industrial concentration and competition. The bank regulatory agencies have long been concerned with these issues, and are entrusted with the preservation of competition. The S.E.C., on the other hand, has not been seriously concerned with structural questions affecting competitive levels and until recently presided over an industry with administratively fixed prices. If banks are permitted to expand their activities, especially through the bank holding company, these issues will become very important. There appears to be great potential for regulatory disagreement.

If Congress decides that banks should be permitted full-scale entry into investment banking, it is likely that expansion will occur through acquisitions of existing investment banking firms by bank holding companies and through establishment of investment banking subsidiaries by bank holding companies. Primary regulatory authority for the holding company would reside with the Federal Reserve System while the S.E.C. would be the prime regulator of the subsidiary. In addition to the regulatory problems between the Federal Reserve Board and other bank regulators under existing arrangements where regulatory authority is divided, joint responsibility with the S.E.C., an agency with a vastly different philosophy for regulatory responsibility, would present even more serious conflicts.

Since 1974, the Federal Reserve Board has become more concerned about the effect of nonbanking subsidiaries upon a bank and has been much more reluctant to approve new nonbanking ventures. Questions would arise about the investment banking subsidiary which have been raised about other nonbanking subsidiaries. What capital standards would be applied to the investment banking subsidiary? To what extent would the bank be permitted to support an affiliate in financial diffi-
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The S.E.C. would still maintain some regulatory responsibility over the bank holding company, but the Commission has had little experience with issues of this type. In any event, commercial bank entry into investment banking would strain relations between regulatory agencies and likely would necessitate a restructuring of regulatory responsibilities.

If banks do expand into investment banking, competitive analysis of the consequences of such entry could become one of the most important areas for the regulatory agencies. People in the securities industry generally feel that banks would have an unfair competitive advantage over nonbank firms. The Securities Industry Association asserts that banks have "special advantages and privileges" the effect of which is to lower the cost of intermediation of funds and thus to lower the cost of funds to borrowers. "... It would be patently unfair if nonbanking entities were forced to compete with banks without the benefit of such privileges" [56]. To illustrate this point, the industry cites the case of bank entry into mortgage banking in the early 1970s.

That industry is similar to the investment banking industry in that mortgage bankers "underwrite" or inventory mortgages while looking for institutional purchasers. In performing this function, independent mortgage bankers suffer a distinct disadvantage in competing with mortgage banking firms affiliated with banks. A large expense is the interest cost of holding mortgages in inventory, but bank-affiliated firms can finance their inventories with loans from their affiliated banks. Securities firms are placed at a similar disadvantage in competing with banks in underwriting general obligation bonds [57].

Although evidence does not support this viewpoint [58], constant surveillance to reveal potential unfair competition, and measures to stop it should it arise, will require joint regulatory activity.

Increasing bank involvement in securities-related activities and the prospects for future involvement are bound to raise issues of regulatory mix and procedures; it has already led to suggestions to alter the regulatory framework.

Each regulatory agency has sought to maintain or extend its jurisdiction. The bank regulatory agencies want to maintain their full regulatory powers over the banks. The S.E.C. has argued for expanded S.E.C. responsibility. For example, Commissioner Evans of the S.E.C., addressing the Ninth Annual Banking Law Institute, has stated that "... you should expect banks either to be prohibited from engaging in securities activities or for bank securities activities to come under S.E.C. jurisdiction. I believe it will be the latter. If this occurs, it will not be based on any Commission desire to expand its jurisdiction, but because it is fair and logical" [59]. The S.E.C. itself has taken a more moderate view, i.e. that bank regulatory agencies be compelled to act as the S.E.C. would, and for these agencies to consult with the S.E.C. [60]. The banking authorities in effect would prefer to educate their examiners to become "security-wise"; i.e. to internalize securities regulation.

Since the best choice of regulatory mode is dependent upon the uncertain future course of bank involvement in the securities industry, we do not advocate here a
particular regulatory reform. However, any regulatory arrangement should have as its basic aim *equality* of regulation for all market participants. Efficient operation of the market requires that some firms not be given a regulatory advantage over others.

7. Conclusion

The overall impression is that in this past decade commercial banks have steadily encroached on brokerage activities formerly provided only by securities industry firms. However, the banks have also created new services for which there is no counterpart in the securities industry. Many of these services would not seem to conflict with the Glass–Steagall Act; a few of them do appear to violate the intent, if not the letter, of the Act [61]. This is particularly true in the case of pooled investment funds and promotion of the sale of shares in those funds to individuals. Real estate investment trusts have actually led to the very conflict of interest problems that the Glass–Steagall Act sought to prevent.

The argument from the viewpoint of the public welfare that underwriting revenue bonds ought to be permitted to commercial banks is stronger than the argument that commercial banks be granted explicit permission to handle corporate private placements. That is to say, to the two financial industries and their customers and to the economy as a whole the risks and hazards are probably greater from private placements than from underwriting revenue bonds or the expected rewards smaller from bank entry into private placements than from entry into underwriting revenue bonds. Despite this, commercial banks are doing private placements and are not doing revenue bond underwritings.

If our general findings with respect to potential risk are supported, it is both logical and likely that the Glass–Steagall Act be amended to provide:

1. specific allowance of revenue bond underwriting, subject to equal regulation and taxation, and

2. specific disallowance of private placement activity unless certain conditions are met: (a) absence of specific conflict of interest conditions; (b) presence of equal competitive conditions and equal regulatory constraints (*i.e.* equivalent to the securities industry); and (c) revision of deposit insurance plans to ensure that the increased risks are imposed on depositors by scaling the premium according to line of activity, rather than according to deposit size, as is presently done.

The revision of deposit insurance plans will certainly require that, in addition to supervision of existing specialized regulatory agencies, there be supervision by the S.E.C. and the Department of Justice of all the banks’ securities activities, just as investment bankers and brokerage firms would be required to subject themselves to banking authority if they entered the deposit banking business (and insurance regulators if they entered the annuity business). Depositors are entitled to insulation from risk, or to increased return if increased risks are approved.
(3) Reaffirmation and clarification of the banks' power to provide brokerage services upon order of their customers, subject, of course, to equal regulation, i.e. subject to regulation under the Securities Act in their capacity as brokers.

If these precautionary measures cannot be taken, banks (whether directly or through affiliates) should continue to be excluded from revenue bond underwriting and excluded from further corporate securities placement, or from mass brokerage activity. Banks do seem willing however to accept S.E.C. and other securities industry regulations with respect to these activities.

It is most likely and desirable that the outcome of the debate be the maintenance of separate but overlapping and competing financial institutions. However, if the separate but overlapping structure is to be fairly and effectively competitive in supplying funds to the economy, regulation will have to be equalized. Equalizing regulation of the competitive and complementary intersection of two industries will not be an easy task, since the regulatory structures, goals, and methods are very different. Commercial banks are regulated at various state/federal levels by authorities whose principal purpose is to ensure the solvency and stability of each bank in its community. The banking authorities maintain close ties with the institutions they regulate and protect the bank customers by means of periodic and confidential examination of each bank under their supervision. Securities firms are largely self-regulating; but the S.E.C. superimposes its own regulations so as to ensure adequate disclosure and to prevent fraudulent practices in the securities markets. The S.E.C.'s supervision is not company-oriented, but market-oriented; as a result, its relationships with securities firms is not close. The S.E.C. specifies rules of behavior and checks up on the securities industry by means of analysis of market behavior and self-regulatory organizations.

The need to expand regulation of banks' securities activities should not be underestimated. It pervades every argument made in defense of banks' rights to compete fairly. For example, to keep bank conflicts of interest from damaging the unsophisticated, S.E.C. disclosure-type rules and enforcement are required. Another example is that in order to offset the increased riskiness of banks doing securities business, the depositors and the community will require variable or indexed deposit insurance, and perhaps some direct relationship to S.I.P.C. [62]. Or deposit insurance will have to be keyed to a set of rules and regulations that in turn are specified in accordance with the various risks of various lines of securities business activity. A final example: to require banking affiliates to be used to insulate risky securities activities from the banks proper may reduce bank risk, but it stimulates conflict of interest; to require the securities activities to be consolidated within the bank will require that bank regulations be supplemented by disclosure-oriented security regulators, and parallel changes in deposit insurance mechanisms [63].

In the absence of equal regulation of joint securities activities, competition is necessarily unfair, concentration more likely, and conflicts of interest more prevalent.

The likelihood of legislative reform must be viewed in the context of the fact
that it is very difficult to set clear-cut limits or to separate powers, purposes, and functions meticulously and for all time. Continuous and rapid changes in the financial markets and in technology tend to modify existing financial market structures and set their own competitive frontiers. This is so for two reasons. First, financial institutions respond more quickly and effectively to market changes than does the legislature. Legislative response requires a political consensus among competitors that is difficult to obtain. Generally speaking, consensus tends to emerge only at those times when general anxiety and uncertainty overwhelm the more parochial concern of relative competitive advantage. Secondly, the character of market pressures or innovation is not easy to predict. For instance, it was difficult at the beginning of the last decade to foresee the increasing importance of overseas operations of American commercial banks and the increasing competition from foreign banks' operations in the United States.

There is pressure for legislative reform, especially because of the spread of American banks abroad and vice versa. Until recently foreign banks operating within the U.S. were subject only to state, not to federal, banking laws. Although the International Banking Act of 1978 deals with these matters, there remains a need to equalize competition for the purely domestic state banks. In addition, American banks abroad, subject to federal jurisdiction, have opportunities to serve an important role in syndicating Euro-currency loans, a true investment banking activity, often for corporate customers, involving both best efforts and firm commitment underwritings. The securities industry itself may also press for legislative reform because of increasing inroads which the banks are making into its business. At the present time the securities industry is having difficulty resisting the banks. It is in a weakened condition because there are competitive brokerage fees, regional banking firms are aggressively entering into the profitable negotiated revenue bond business, and the S.E.C. is pressing for flexible underwriting terms. The securities industry may well come to prefer risking a full Congressional review of Glass—Steagall to piecemeal expansion by the banking industry into securities activities.

On the other hand it may be that if full-scale commercial bank entry into the securities industry requires additional capital, insurance, or tax increases, and regulatory supervision, and further, if securities firms feel compelled in response to enter the commercial banking industry, the commercial banks as a whole (if not the giants) may well beat a hasty retreat.

Table 1 contains projections concerning twenty-four types of securities activity that commercial banks are concerned with. The securities industry has usually reacted to these competitive threats by challenging the right of the banks to conduct the given activity. With respect to those services which the industry has not previously supplied, we believe that this strategy is unwise. This is especially so in those cases where the industry has not as yet offered comparable services. Furthermore, the securities industry reputedly does not have sufficient political clout or lobbying resources to get its way in Congress. The banks, on the other hand, despite a great deal of clout and lobbying resources, have not succeeded in getting permissive bills out of committee.
Table 1

<table>
<thead>
<tr>
<th>Type of activity</th>
<th>Dominant supplier</th>
<th>Profitability</th>
<th>Glass–Steagall status</th>
<th>Projected status</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Registrar and transfer agent</td>
<td>B</td>
<td>P</td>
<td>L</td>
<td>B</td>
</tr>
<tr>
<td>2. Extension of credit on securities</td>
<td>B</td>
<td>P</td>
<td>L</td>
<td>B</td>
</tr>
<tr>
<td>3. Dividend-paying agent</td>
<td>B</td>
<td>M</td>
<td>L</td>
<td>B</td>
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<tr>
<td>4. Bond trustee and agent</td>
<td>B</td>
<td>P</td>
<td>L</td>
<td>B</td>
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<tr>
<td>5. Government bond dealers</td>
<td>E</td>
<td>P</td>
<td>L</td>
<td>B</td>
</tr>
<tr>
<td>6. Dividend reinvestment plans</td>
<td>B</td>
<td>P</td>
<td>C</td>
<td>B</td>
</tr>
<tr>
<td>7. Automatic customer purchase plans</td>
<td>B</td>
<td>U</td>
<td>C</td>
<td>B</td>
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<td>8. Agency portfolio management for individuals</td>
<td>E</td>
<td>P</td>
<td>C</td>
<td>B</td>
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<td>9. Keogh and IRA individual plans</td>
<td>E</td>
<td>P</td>
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<td>B</td>
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<tr>
<td>10. Keogh and IRA pooled investments plans</td>
<td>E</td>
<td>P</td>
<td>C</td>
<td>B</td>
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<tr>
<td>11. Personal trust activity</td>
<td>B</td>
<td>P</td>
<td>L</td>
<td>B</td>
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<tr>
<td>12. Commingled agency accounts</td>
<td>S</td>
<td>P</td>
<td>I</td>
<td>BS</td>
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<tr>
<td>13. Investment company advisers</td>
<td>S</td>
<td>P</td>
<td>C</td>
<td>BS</td>
</tr>
<tr>
<td>14. Closed-end fund sponsor</td>
<td>S</td>
<td>P</td>
<td>C</td>
<td>BS</td>
</tr>
<tr>
<td>15. Open-end fund sponsor</td>
<td>S</td>
<td>P</td>
<td>I</td>
<td>X</td>
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<tr>
<td>16. REIT adviser</td>
<td>B</td>
<td>P</td>
<td>C</td>
<td>B</td>
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<tr>
<td>17. Employee stock purchase plans</td>
<td>E</td>
<td>M</td>
<td>L</td>
<td>B</td>
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<td>18. Employee pension funds: separate</td>
<td>B</td>
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<td>L</td>
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<td>19. Employee pension funds: commingled</td>
<td>B</td>
<td>P</td>
<td>C</td>
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<tr>
<td>20. Private placement advice</td>
<td>S</td>
<td>P</td>
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<td>21. Lease financing pools</td>
<td>E</td>
<td>P</td>
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<td>22. Mergers and acquisitions service</td>
<td>S</td>
<td>P</td>
<td>L</td>
<td>B</td>
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<tr>
<td>23. Long-term financing</td>
<td>B</td>
<td>P</td>
<td>L</td>
<td>B</td>
</tr>
<tr>
<td>24. Overseas investment banking</td>
<td>E</td>
<td>P</td>
<td>C</td>
<td>B</td>
</tr>
</tbody>
</table>

Note: Banks currently engage in all of the above activities except 12 and 15.

a) Dominant supplier:
   - B = banks; S = securities industry; E = both in significant amounts.

b) Profitability of activity:
   - P = profitable; U = unprofitable; M = marginal.

c) Status under Glass–Steagall Act:
   - L = apparently legal and unchallenged;
   - C = currently legal but challenged by securities industry;
   - I = currently illegal for banks.

d) Projected status of activity:
   - B = banks will gain right to offer this service without direct S.E.C. supervision (or already have the right);
   - BS = banks will offer this service with some S.E.C. supervision;
   - X = banks will be excluded from providing this service.
Given the extent of structural shifts in the securities business since 1933, it is likely that Congress will alter the banking laws. Between 1933 and 1979, municipal bonds (largely by means of revenue bond variants) have become as important as corporate bonds in the underwriting business; institutional purchasers, along with their preferences for private placements have come to dominate the industry; and the rise of pension funds, mutual funds, and other portfolio purchases by individuals at the cost of sharply diminished purchases (picking) of individual security issues is the new heart of the brokerage wing of the securities industry. At the very least, the Glass–Steagall Act will be reviewed to determine whether and how the separation of commercial banking and investment banks should be maintained given these sizable structural changes in the securities industry (and in its rules and regulations as well) that have occurred since the Act was enacted into law.

Legislative inertia, a crowded calendar, the influence of the contending lobbies, and the very real difficulties inherent in devising equal legislation may cause Congress to postpone (1) formal hearings and (2) actual passage even if some hearings are held until after interested parties have themselves tried to resolve their differences. The real unknown is how much time the Congress will allow for the industries and their regulators to resolve the issues between them. In the meantime, the issues themselves could change since the recent rapid pace of structural change in the finance industries is unlikely to slow down.

Notes

[1] The "commercial loan" theory of banking maintained that short-term, self-liquidating loans were best adapted to meet the requirements of commercial banks because of their fiduciary relationship to depositors. See Peach, The Security Affiliates of National Banks, Johns Hopkins University Studies in Historical and Political Science, Vol. LVIII, No. 3 (Baltimore, 1941) at 9.

[2] The 1929 stock market crash — bank "holiday" — Great Depression sequence is only the most severe of such historical citations. The panics of 1873 and 1907 (which led to enactment of the Federal Reserve Act) are others.


[7] One of the earliest criticisms of these attempts was made in 1913 by the Pujo Committee of the U.S. House of Representatives, as a result of its investigation into the concentration of control of money and credit. In its report, entitled "Money Trust Investigation", the Committee stated: "The national banks in the great cities are exceeding their charter power in the character of the business they are conducting and from which their principal revenues are derived. They are acting as promoters, underwriters, and houses of issue for the securities of railroad and industrial corporations." Report of the Committee Appointed to Investigate the
Concentration of Control of Money and Credit, H.R. Rep. no. 1593, 62d Cong., 3rd Sess. 1 (1913) at 151.


[10] Id. at 490.


[12] Id. table IV, at 110.


[20] For some background comments by Federal Reserve authorities on the drift of commercial banks into securities industry activity, see Bucher, Statement to the Senate Banking Subcommittee on Securities, Federal Reserve Bulletin (Dec. 1975) and Volcker, Reform of Financial Institutions, Progress and Frustration, Remarks before the New York State Savings Association League (Sept. 1978).


[22] 2.5 percent of total state/local bonded debt, largely for local waterworks and electricity projects.

[23] Over 40 percent of state/local bonds are in revenue bond form, i.e. about $115 billion of the outstanding $290 billion are revenue bonds. Net new issues comprise $12.5 billion or half of the total $25 billion average annual increase of recent years in outstanding state/local debt. In 1977 gross long-term revenue bonds at $27 billion (a new high) were 60 percent of total state/local bond issues for that year.

[24] Revenue bonds differ from general obligation bonds in three essential ways. First, revenue bonds are secured by earnings derived from the operation of such things as toll highways and bridges, power projects and school dormitories; general obligation bonds are secured by the general taxing power of the issuer. Secondly, revenue bonds are usually negotiated; general obligation bonds are usually bid for competitively. Finally, revenue bonds are usually larger in size, or value, than are general obligation bonds.


[26] Cagan, The Interest Savings to States and Municipalities from Bank Eligibility to Underwrite All Non-Industrial Bonds, Gov’t Finance (May 1978) at 40.


[28] Bank entry would not only increase the number of bidders, but would also affect costs indirectly by improving the liquidity of secondary markets and increasing the intensity as well as the scope of the search for customers. See Benston, The Search for Information by Underwriters and Its Impact on Municipal Interest Cost, J. Finance (Sept. 1979) at 871.

[31] Id. at 4–5.
[32] It cannot simultaneously be charged that the banks are exposing their capital resources to undue risk. New York City's experience teaches that there is greater risk of default with respect to general obligation bonds than with revenue bonds, at least insofar as these are issued by municipalities.
[34] Letter from Howard T. Sprow, Vice President and General Counsel of Merrill Lynch, to Sen. Harrison Williams (Feb. 17, 1976).
[36] For the terms of a typical bank dividend reinvestment plan see Citibank Dividend Reinvestment Services (Citibank, N.Y.) (1978).
[37] In the early 1970s the American Telephone and Telegraph Company began offering an original issue dividend reinvestment plan. Instead of using the funds to purchase already outstanding stock for participants, the funds were retained by AT & T and new shares issued. Several months of negotiation with the S.E.C. were required before the plan was allowed. The negotiations mostly related to how often and how elaborate a prospectus must be sent to a participant. The rules worked out were similar to the rules for the mutual fund industry. Now more than forty firms have developed original issue plans and hundreds of millions of dollars annually are being raised this way.
[39] Id. at 51–52.
[40] At present about twenty banks are offering such plans. One group uses Investment Data Corporation as a service sub-contractor for preparing individual statements (but each bank handles its own securities transactions) and another group uses The First National Bank of Chicago (which handles transactions and some of the statement preparation). Thus, there are really only two banking agents offering the service. Id. at 54–101.
[41] Id. at 421–540.
[47] Id. at 41.
[49] See id., at 65, 79.

[57] Id. at 780.

[58] Banks entering mortgage banking and consumer finance have not been more profitable or faster growing than the independent firms. See Talley, Bank Holding Company Performance in Consumer Finance and Mortgage Banking, Bank Ad. (July 1, 1976) at 44; and Rhoades, The Effect of Bank-Holding-Company Acquisitions of Mortgage Bankers on Mortgage Lending Activity, 48 J. Bus. 344 (Univ. Chicago Press, 1975) at 347.


[62] Securities Investor Protection Corporation (a Government corporation) covers individual customers by $100,000 at this writing (late 1979) of which $40,000 can be in cash. See U.S.C. § 78 ccc (1976).


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