Bank Securities Activities: Memorandum for Study and Discussion*

SECURITIES INDUSTRY ASSOCIATION**

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* The *San Diego Law Review* is pleased to provide a forum for the publication of the Securities Industry Association's (SIA) *White Paper* on bank securities activities. The *Review* joins with the SIA in its hope that this article will "stimulate further discussion." Therefore, the *Review* plans to publish a symposium on the issues raised by this article. Interested authors should submit their manuscripts for possible publication before 1 November 1977. The *Review* encourages writers to submit even brief commentary, if the comment deals with a specific issue raised by the SIA's *White Paper*. However, the *Review* would be pleased to receive full-length papers dealing with the broader questions of the regulation of financial institutions. The Editorial Board would like to express its gratitude to Mr. Steven R. Hunsicker of Baker & Botts, Washington, D.C., for his invaluable assistance in facilitating the publication of the *White Paper*. Of course, Mr. Hunsicker neither is responsible for nor necessarily endorses the views expressed by the SIA.

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INTRODUCTION ***

A strong and vital United States Banking system is essential to the economic well being of this nation and, indeed, the economic

*** [Editor's Note] For earlier discussions of the issues raised by the *White Paper*, see *Securities Activities of Commercial Banks: Hearings on the Expansion of Commercial Banks' Securities Business Operations and the Elimination of Barriers Between the Banking and Securities Industries Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. (1975); E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS (1975); R. JENNINGS & H. MARSH, JR., SECURITIES REGULATION, CASES AND MATERIALS 19-21 (4th ed. 1977); I L. LOSS, SECURITIES REGULATION 121, 174, (2d ed. 1961); II *id.* 1189-91, 1295-96; V *id.* 3189-202, 3355-56 (Supp. 1969); PRACTICING LAW INSTITUTE, BANKS AND THE SECURITIES LAWS 1975 (1975); PRACTICING LAW INSTITUTE, BANKS AND THE SECURITIES LAWS IN 1974 (1974); PRACTICING LAW stability of the world. Banks play a central role in international trade and finance and domestically provide the credit essential to the smooth flow of commerce. The importance of the role of banks in this country is underscored by the unique legal and regulatory

INSTITUTE, BANKS AND THE SECURITIES LAWS (1973); D. RATNER, SECURITIES REGULATION: MATERIALS FOR A BASIC COURSE 5 (1975); J. WHITE, TEACHING MATERIALS ON BANKING LAW 319-47, 375-82 (1976); Lipton, *Commercial Banks' and Other Lenders' Responsibilities Under the Federal Securities Law*, in EXPANDING RESPONSIBILITIES UNDER THE SECURITIES LAW 257-82 (S. Goldberg ed. 1973); Beatty, *What are the Legal Limits to the Expansion of National Bank Services?* 86 BANKING L.J. 3 (1969); Beatty, *The Incidental Powers of National Banks*, 4 NAT'L BANKING REV. 263 (1967); Carter, *Bank Loans and Bank Credit Agreements: Federal Securities Laws Status*, 93 BANKING L.J. 1020 (1976); Casey, *The SEC and the Bankers*, 3 J. COM. BANK LENDING 3 (1972); Chase, *The Emerging Financial Conglomerate: Liberalization of the Bank Holding Company Act*, 60 GEO. L.J. 1225 (1972); Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1 (1976); Evans, *Regulation of Bank Securities Activities*, 91 BANKING L.J. 611 (1974); Garrett, *The SEC and its Concern with Bank Trust Activities*, 113 TR. & EST. 280 (1974); Golembe, *Our Remarkable Banking System*, 53 VA. L. REV. 1091 (1967); Greenberg, *Banks and the Federal Securities Laws: Some Recent Developments*, 49 S. CALIF. L. REV. 665 (1976); Hackley, *Our Baffling Banking System*, 52 VA. L. REV. (pts. 1 & 2) 565, 771 (1966); Hackley, *Our Discriminatory Banking Structure*, 55 VA. L. REV. 1421 (1969); Harfield, *Sermon on* Genesis 17:20; Exodus 1:10 (*A proposal for testing the propriety of expanding bank services*), 85 BANKING L.J. 565 (1968); Herman & Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 B.C. INDUS. & COM. L. REV. 21 (1972); Huck, *What is the Banking Business?*, 21 BUS. LAW. 537 (1966); Israels, *Banks and Federal Securities Regulation*, 85 BANKING L.J. 1 (1968); Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps, Eight Remedies*, 90 BANKING L.J. (pt. 1) 912 (1973); Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps; Eight Remedies*, 2 SEC. REG. L.J. (pt. 1) 122 (1974); Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 YALE L.J. 977 (1973); Mehle, *Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition*, 26 SYRACUSE L. REV. 1117 (1975); Miller, *Banks and Securities Act of 1933*, 84 BANKING L.J. 95 (1967); Murane, *SEC, FTC, and the Federal Bank Regulators: Emerging Problems of Administrative Jurisdictional Overlap*, 61 GEO. L.J. 37 (1972); Peltzman, *Entry in Commercial Banking*, 8 J.L. & ECON. 11 (1965); Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971); Robertson, *Federal Regulation of Banking: A Plea for Unification*, 31 LAW & CONTEMP. PROB. 673 (1966); Ryder, *The Legal Meaning of "Bank,"* 1965 J. BUS. L. 34; Saxon & Miller, *Common Trust Funds*, 53 GEO. L.J. 994 (1965); Schotland, *Bank Trust Departments and Public Policy Today*, 4 SEC. REG. L.J. 389 (1977); Schweitzer, *Banks and Banking—A Review of a Definition*, 94 BANKING L.J. 6 (1977); Solomon, *Institutional Investors: Stock Market Impact and Corporate Control*, 42 GEO. WASH. L. REV. 761 (1974); Willis, *The Banking Act of 1933 in Operation*, 35 COLUM. L. REV. 697 (1935); Note, *Glass-Steagall Act—A History of its Legislative Origins and Regulatory Construction*, 92 BANKING L.J. 38 (1975) (adapted framework in which they function. Because of this unique position, it is no small wonder that "the American people have repeatedly demonstrated their determination to have a sound system of banking."[1]

Background

The banking system currently is undergoing its most extensive governmental review in over forty years. For example, the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Banking, Currency and Housing Committee recently has completed a broad study of the nation's depository institutions[2] and has proposed legislation to reform the regulatory structure of the banking industry.[3]

The Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs also is conducting an extensive study of bank securities services, including brokerage-related services and investment advisory services.[4] The Subcommittee's study

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from a press release of the Honorable James E. Smith, Comptroller of the Currency); Note, *The Glass-Steagall Banking Act of 1933*, 47 HARV. L. REV. 325 (1933); Note, *Commingled Investment Accounts: Banks v. Securities Industry*, 45 NOTRE DAME LAW. 746 (1970); Note, *Bank-Sponsored Investment Services: Statutory Proscriptions, Jurisdictional Conflicts, and a Legislative Proposal*, 27 U. FLA. L. REV. 776 (1975); Note, *The Legality of Bank-Sponsored Investment Services*, 84 YALE L.J. 1477 (1975); Comment, *Implementation of the Bank Holding Company Act Amendments of 1970: The Scope of Banking Activities*, 71 MICH. L. REV. 1170 (1973); Comment, *Banks, Trusts and Investment Companies: The Commingled Investment Fund*, 115 U. PA. L. REV. 1276 (1967); Comment, *Banks and the Securities Act of 1933*, 52 VA. L. REV. 117 (1966); Golembe Associates, Commercial Banks and Investment Banking 2, 37-49, 56, 59-64, 67-73 (revised, Nov. 29, 1976) (unpublished paper prepared for the Economic & Financial Research Div. of the Am. Bankers Assoc. on file with the *San Diego Law Review*) ("in no sense should this paper be viewed as an analysis of, or response to, the SIA [*Bank Securities Activities*] document").

1. Address by Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, Maintaining the Soundness of Our Banking System 1, given at 1974 American Bankers Association Convention in Honolulu, Hawaii (Oct. 21, 1974) (on file with the *San Diego Law Review*).

2. *Hearings on Financial Institutions and the Nation's Economy (FINE) Study Discussion Principles Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 1st & 2d Sess. (1975-1976).

3. Federal Reserve Reform Act, H.R. 12934; Financial Reform Act of 1976, H.R. 13077, & International Banking Act of 1976, H.R. 13211, 94th Cong., 2d Sess. (1976). (The House has passed H.R. 13876 in place of H.R. 13211; further action on the other two bills is not expected).

4. SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 1ST SESS., THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS, STUDY OUTLINE (Comm. Print 1975).

will attempt to determine, among other things, whether allowing banks to provide securities services may cause an undue concentration of economic power and whether it may endanger the safety and solvency of banks or investor confidence in capital markets.[5]

In addition to legislative review, the Capital Markets Task Force, an interagency working group which the Department of the Treasury chairs, is conducting a far-ranging study of bank securities services, including brokerage-related, investment advisory and investment banking services, to determine if the availability of securities services from banks might have an adverse effect on the nation's capital markets.[6] In 1974, the Securities and Exchange Commission (SEC) conducted an extensive inquiry into bank securities services to determine if adequate protection is being afforded investors patronizing those services.[7] The SEC is now undertaking a congressionally mandated study to determine whether it is appropriate to continue to exempt banks from many of the provisions of the securities laws.[8] In addition to the adequacy of investor protection, the SEC has also expressed concern about the disparity of regulatory burdens among participants in the securities industry as a matter of competitive fairness.[9]

This extensive governmental consideration of the appropriateness of bank-sponsored securities services has initiated a widespread public debate. We believe it is essential that those who will play a role in resolving this issue be aware of the securities industry's point of view. This paper is intended to present the industry's perspective in a manner that will contribute to intelligent and informed debate.

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5. Unfortunately, the study does not intend to examine the serious problems raised by investment banking services provided by banks.

6. DEP'T OF THE TREASURY, PUBLIC POLICY ASPECTS OF BANK SECURITIES ACTIVITIES—AN ISSUES PAPER (Nov. 1975) [hereinafter cited as TREASURY ISSUES PAPER].

7. SEC, COMMISSION INQUIRY CONCERNING BANK-SPONSORED INVESTMENT SERVICES, Securities Act of 1933, Release No. 5491, Securities Exchange Act of 1934, Release No. 10761, Investment Company Act of 1940, Release No. 8336 & Investment Advisers Act of 1940, Release No. 409 (Apr. 30, 1974).

8. SEC, Study of Persons Excluded from Definition of "Broker" and "Dealer" Pursuant to the Directive of section 11A(e) of Securities Exchange Act of 1934, *as amended.*

9. *E.g., Securities Activities of Commercial Banks: Hearings Before the Securities Subcomm. of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 140-41 (1975) (Testimony of SEC Chairman Roderick M. Hills).

Summary

It has long been the public policy of the United States to separate the business of commercial banking from other areas of commerce.[10] This theme has predominated bank reform legislation from the Banking Act of 1933 (the Glass-Steagall Act) through the 1970 amendments to the Bank Holding Company Act and is visible in legislation currently pending in Congress.

Their dominant position as the principal suppliers of credit to the private sector of the economy makes bankers a force to be reckoned with, with substantial influence not only on the economic and financial community but on our social and political institutions as well. Indeed, concern over excessive concentrations of power in the banking industry is manifest in many features of the present structure of our banking system, which includes a dual system of state and federal regulation, restrictions on interstate banking and a separate industry—apart from commercial banking—comprised of savings and loan and other thrift institutions.

In addition to their efforts to limit concentration, our legislators consistently have attempted to circumscribe the tendency of banks to become entrepreneurs rather than intermediaries—that is, investing depositors' funds on their own rather than providing credit to others. During the 1920's and early 1930's, bank participation in the securities industry threatened to bring the underwriting of equity securities and medium- to long-term debt instruments under the domination of the major commercial banks.[11] Congress enacted legislation explicitly separating banking from most aspects of the securities business. More recently in 1970, Congress, in amending the Bank Holding Company Act, codified the principle that banking organizations should confine their activities to fields closely related to banking.[12]

In recent years, commercial banks again have begun to expand their operations into numerous nonbanking businesses. Some busi-

10. As early as 1864, the National Bank Act limited the power of banks chartered by the federal government to engage in activities other than traditional banking functions. National Bank Act, Act of June 3, 1864, ch. 106, 13 Stat. 99 (incorporated into 1878 Rev. Stat.).

11. "By the end of the decade [the 1920's] commercial banks and their affiliates had become the dominant force in the investment banking field." Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 495 (1971). In 1930, commercial banks and their affiliates underwrote 61% of all new bond issues. *Id.*

12. Some pertinent excerpts from the legislative history of both the Glass-Steagall Act and the Bank Holding Company Act, including the 1970 amendments, are set forth in App. I p. 800 *infra*.

nesses in which they have engaged, or attempted to engage, include operating an insurance agency, providing financial and management consulting services, operating travel agencies, providing armored car service, leasing automobiles, and providing data processing services.[13]

It has been widely assumed that existing banking law prohibits bank expansion into securities activities, other than those specifically permitted by the Glass-Steagall Act. In the area of underwriting and dealer activity, this assumption generally has not been questioned, although there remains some uncertainty about the kinds of government obligations which qualify for the exemption afforded by the Glass-Steagall Act. The legal status of other investment banking activities, however, is less clear. The Office of the Deputy Comptroller of the Currency has ruled that banks may offer private placement services, subject to a number of conditions —for example, a bank may not participate in negotiations between the issuer and the purchasers or charge a fee for its services contingent upon the success of the placement. The status of financial advisory services offered by banks to corporate clients, such as advice on mergers and long-term financing, also is in doubt. The practice of syndicating long-term bank loans is another area where the legal implications of Glass-Steagall have yet to be definitively resolved.

More recently, banks have sought to offer certain types of brokerage services, such as monthly automatic investment plans and dividend reinvestment plans. The legality of the former has been judicially challenged and upheld by a United States district court, a decision which currently is being appealed. At least one major commercial bank has reported plans to offer a standard brokerage service to the general public, and so far no regulatory authority has moved to challenge this undertaking. It seems fair to conclude that the status of brokerage-related activities under present law is highly uncertain.

The courts and, to some extent, the bank regulatory agencies have sought to place certain restrictions on bank expansionism. But the issues raised by bank participation in these activities are too important to be resolved in this manner, especially since the process

13. *See* note 139 *infra*.

would involve application of legislative proscriptions over forty years old to facts clearly not then contemplated by Congress. It is a phenomenon which raises critical public policy issues deserving of careful reevaluation by Congress. Such a reevaluation requires examination of the principles and policies underlying the Glass-Steagall Act and other major banking legislation to determine the need for updating their provisions in light of contemporary activities of banks and bank holding companies.

There are a number of important policy considerations which should be weighed in the course of any congressional review. A good starting point would be a definition of what Congress now believes are realistic and necessary goals to be attained by national policy respecting the banking and securities industries. We believe that an appropriate list of such goals would be: (a) to promote maximum efficiency in the capital markets, (b) to create an environment in which financial institutions have both the incentive and the ability to meet the rapidly changing demands of our economy, (c) to create a climate in which public trust in intermediating institutions is high, (d) to encourage widespread direct public ownership of United States industry, (e) to promote fair competition not only within markets but also between markets for substitute products, (f) to limit the economic and political power of any one sector, and (g) to protect investors and depositors against improper practices. These objectives may conflict at times, and careful reconciliation often is necessary to strike a reasonable balance. The activities of banks must be regulated with a view toward promoting these goals.

Because of their importance as financial intermediaries, banks have been accorded a variety of privileges designed to reduce their costs of intermediation. The intended effect of reducing these costs is to make credit available to the economy at low cost. Included among such privileges are favorable tax treatment, restrictions on entry into the banking business, and the ability to obtain funds readily at low cost from depositors, from other banks in the federal funds market, and from the Federal Reserve's discount window. Because of these and other advantages, banks possess an enormous edge when they compete with other types of enterprises in nonbanking businesses.

The critical point is that each of these advantages or privileges is paid for by taxpayers and bank depositors and is provided to banks for the benefit of those in need of credit. They are not for the purpose of enhancing the ability of banks to engage in nonbanking activities; in fact, it would constitute a clear departure from their purpose if banks were permitted to employ them in such activities. Equally as important, it would be highly unfair to expect nonbanking entities to compete with banks in businesses other than banking without the benefit of such privileges.

Another concern which cannot be overlooked in any reevaluation of permissible bank activities is an appraisal of the economic power which the major commercial banks presently possess and continue to gather. Commercial banks already are such a significant force in the economy, and so far overshadow all other intermediary institutions, that any serious study of the nation's present and prospective financial structure cannot ignore their growing influence. Commercial banks control in the aggregate over $1,300 billion in assets and provide well over half of all external corporate financing through bank loans.

In this regard, a good deal of public and congressional concern stems from the fear that banks may become so dominant that, for practical purposes, no alternative means of financing will remain available to provide business capital—a situation not unlike that which currently prevails in Europe, where commercial banks control virtually every source of credit. Failure to take account of this possibility could have serious consequences not only for our economy but for our political system as well.

There are several other factors which should receive consideration in the review of banking law here recommended. They include scrutiny of the conflicts of interest with which bankers are faced when they provide securities or other nonbanking services, the potential impact on the stability of the banking system of bank expansion into nonbanking activities, and the adequacy of investor protection when banks offer brokerage and other securities services.

It is our belief such a review will prompt Congress to conclude that reform of the banking laws is required to restrict banks from continuing on their present course. Such reform should effect a tightening of the existing provisions of the Glass-Steagall and Bank Holding Company Acts, which seek to restrict banks to banking-related activities. It also should ensure that banks are not permitted to underwrite revenue bonds. Moreover, any amendments should effect whatever changes are necessary to ensure that bank regulators will not be tempted to erode such statutory limitations.

Legislative reform of this kind should be accompanied by changes in the laws applicable to activities carried on in the United States by banking organizations affiliated with foreign banks. The policy objective should be to regulate such organizations in a manner comparable to regulation of domestic banks, particularly with respect to limitations on nonbanking activities.

In the material which follows, we shall undertake to explore in detail the nature and implications of increasing bank involvement in other areas and particularly in the securities business. This task has been rendered considerably more complex by the absence of reporting requirements and the unavailability, for obvious competitive reasons, of much data relating the specific activities engaged in by individual banks. We also have experienced some difficulty in learning the precise nature of the positions with respect to such activities taken by certain bank regulatory agencies which do not make public in the normal course replies to requests for interpretive advice or rulings.

SECURITIES ACTIVITIES OF BANKS

The role played by commercial banks in various aspects of the securities business has become extensive in recent years, undoubtedly beyond anything dreamed of by Congress when the Glass-Steagall Act was adopted. Although lack of comprehensive information makes cataloguing a difficult task, the following subsections contain a brief description of their principal activities in this area.

Investment Advisory Services

Apart from their own assets, banks are responsible for the management of more funds than is any other type of financial institution.[14] In their capacity as fiduciaries, banks manage the assets of pension and other employee benefit plans and of trusts and estates of individuals. In their capacity as agent, they manage the portfolios of a variety of individual and corporate customers. In addition, banks serve as investment advisers to both open-end and closed-end investment companies and also act as investment advisers to Real Estate Investment Trusts (REIT) (which, in many cases, they sponsor).

Brokerage Related Services

In recent years, many banks have begun to offer their customers several brokerage related services. One of the more common of

14. The Treasury Department has estimated that commercial banks manage approximately $400 billion in trust assets alone. TREASURY ISSUES PAPER, *supra* note 6, at 7.

these is the automatic investment service (AIS). Through AIS plans, banks offer customers the opportunity to have a specified amount automatically deducted each month from their checking accounts and invested by the banks in the common stock of one or more issuers included on a list supplied by the bank. The list typically includes the twenty-five largest corporations in the Standard and Poor's 425 Industrial Index, based on the market value of the corporation's outstanding common stock. The bank pools the monthly deductions from the accounts of the participating customers and orders a broker to execute transactions for the pooled accounts. Each AIS customer receives a monthly statement indicating, among other things, the number of shares purchased and the purchase price.

Some banks also offer dividend reinvestment plans under which investors may have the dividends they receive from a participating corporation automatically reinvested in the securities of that corporation. Through these plans, shareholders of a participating corporation may request that their dividends be paid directly to a bank which pools the dividends received and purchases additional shares of the corporation's stock in the open market.

Besides pooling funds and acting as a conduit between brokers and customers, some banks perform a more traditional type of brokerage by executing agency transactions for their trust and other managed accounts, as well as for banking customers, either through a registered broker-dealer in the case of exchange transactions or directly in the over-the-counter market.

More recently, Chemical Bank of New York has announced that it plans to offer brokerage services to customers on an agency basis, regardless of whether a banking relationship with the customer exists.[15] The bank will charge a fee to participate in the service and a flat fee per transaction. A major clearing firm reportedly will execute these transactions for Chemical. A spokesman for the bank indicated that its marketing plans were still being developed but would not deny that the service might be promoted through bank mailings to checking and savings account customers.[16] The possibil-

15. The Chemical Bank announced that it would offer brokerage services and place the orders through registered broker-dealers. SEC. WEEK, Mar. 15, 1976, at 1.
16. *Id.* Mar. 29, 1976, at 7.

ity that a bank affiliate might apply for stock exchange membership remains open.

In the over-the-counter market, particularly the "third market" where listed securities are traded, banks have a long history of dealing directly with market makers as agents for their customers. To the extent they do so, they appear to be performing a traditional broker-dealer function.

Investment Banking Services

Banks are permitted to underwrite and distribute publicly debt instruments which constitute general obligations of United States government units, although they reputedly purchase more of their syndicate participation for their own accounts than they distribute.[17] In recent years, the definition of a general obligation bond has been broadened by the Comptroller of the Currency so as to include a number of instruments more traditionally thought of as revenue bonds. Apart from underwriting, the investment banking activities of commercial banks generally take two forms—the rendering of financial advice to corporations and the finding or furnishing (or both) of funds for the long-term capital needs of corporations.

Financial counseling may be provided for a fee either on a long-term basis or for specific projects—for example, the financing of a new plant—and generally comprehends the customer's total need for financing, ranging from short-term borrowings to permanent capital.[18] When funds are to be obtained other than through the bank itself, the bank frequently will assist its customer in preparing the necessary documents for a private placement[19] or in selecting and negotiating with an underwriter in the case of a public offering. Banks also furnish financial advice in connection with corporate reorganizations, including mergers and acquisitions, and sometimes perform appraisal services in connection with such transactions.

Banks also serve directly as a source of long-term funds, either through their own lending facilities or by arranging private placements of securities with other lenders. At the time the Glass-Steagall Act was enacted, bank lending typically was short term

17. E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 12 (1975).

18. In two private interpretative letters, the Comptroller authorized the provision of financial counseling services by national banks. Apps. IIA & IIB p. 809 *infra*.

19. In those same letters the Comptroller also authorized limited bank involvement in private placement activities. *See* text accompanying notes 31-66 *infra*.

in character, ranging from demand to ninety-day loans. Since then, banks have gradually increased the maturity of their loans so that long-term loans (those exceeding one year in maturity) now constitute more than forty percent of industrial and commercial loans of major commercial banks,[20] and borrowings with much longer maturities (exceeding five years) constitute a significant portion of such loans.[21] Frequently, these loans are made through syndicates of banks which contain from a handful to a substantial number of domestic, and sometimes foreign, banks. Syndicated bank loans are effected for domestic and foreign borrowers and are extended both by United States banks and their overseas affiliates.

In addition to providing long-term funds themselves, banks have become quite active in arranging, for a fee, private placements of securities of all types, from long-term bonds to equities, with a variety of institutional lenders. Although some of the commercial banks most active in the private placement of securities—for example, Morgan Guaranty, Crocker National and Manufacturers Hanover—do not report the extent of those activities, during 1975, those which did not report were involved in over $500 million of private placements.[22] In some instances, banks participate in private place-

20. 62 FED. RES. BULL., Feb. 1976, at app. 23.

21. According to the *Treasury Issues Paper*, on Apr. 30, 1975, 140 national banks having deposits in excess of $250 million reported that 10.75% of their industrial and commercial loans had maturities of greater than five years. TREASURY ISSUES PAPER, *supra* note 6, at 10.

22. As reported by *Investment Dealers' Digest*, the following banks were engaged in private placement activities during 1975:

Advisor	Number of Issues	Amount (000)
Citibank N.A.	4	$231,590
First National Bank of Chicago	19	138,947
Northern Trust Company	6	81,000
Chase Manhattan Bank	3	38,476
Manufacturers National Bank of Detroit	1	5,000
Hibernia National Bank - New Orleans	2	4,700
Marquette National Bank - Minneapolis	1	2,045
Total	36	$501,758

As compiled from the *Investment Dealer's Digest* (1975 & 1976 issues). *Business Week* reports that although they do not reveal their dealings, Morgan Guaranty Trust Company, Crocker National Bank, and Manufacturers Hanover Trust Company are active in the private placement field. Morgan is characterized as "[p]robably the leader in bank practice placements." *Merchant Banking, Is the U.S. Ready For It?*, BUS. WEEK, Apr. 19, 1976, at 54, 64.

ments they have arranged by purchasing for portfolios under their management a portion of the securities to be sold,[23] and on occasion a bank will assemble for a customer a financing package consisting of a medium-term loan from the bank itself, together with a private placement to provide the ultimate long-term financing.

Because the legal restrictions of the Glass-Steagall Act do not apply to the foreign securities activities of United States banks,[24] those banks have been engaging in an ever-increasing range of investment banking activities overseas.[25] Through foreign branches, Edge Act [41 Stat. 378 (1919)] corporations, and investments in foreign banks, United States banks participate in large syndicated bank loans to foreign borrowers[26] and Eurobond underwriting syndicates,[27] in addition to offering financial counseling services.

For over thirty years, U.S. commercial banks had been largely content with confining themselves to accepting deposits and lending money, but beginning in the 1960's commercial banking underwent a radical change.[28] The large money-center banks aggressively sought funds through new deposit instruments, such as certificates of deposit, and began to extend the term of their loans. Then, with the advent of the one-bank-holding-company concept as a catalyst, these banks expanded into new fields, such as consumer finance, foreign merchant banking, and mortgage origination, in search of outlets for those funds.

If recent patterns of activity and development by the major commercial banks continue, it appears likely that these banks will attempt to extend their activities in the securities industry during the next decade. Brokerage and advisory services in particular—which require principally personnel and office space—are especially attractive to many of the large banks because they can afford the opportunity to offer a "full-line" of financial services to gain an

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23. E. HERMAN, *supra* note 17, at 47-48.

24. These restrictions are discussed more fully in text accompanying notes 31-48 *infra*.

25. *See* C. WELLES, THE LAST DAYS OF THE CLUB 423 (1975); *The Lessons Banks Learned from Overseas Misadventures*, BUS. WEEK, Apr. 19, 1976, at 104.

26. *See* advertisements App. III p. 813 *infra*.

27. Eurobonds are securities publicly offered by an international underwriting syndicate in more than one country. Of the 173 Eurobond offerings in 1975, it was reported that Manufacturers Hanover Ltd., an affiliate of Manufacturers Hanover Trust Company, participated in 159, Citibank's foreign affiliate in 128, Bank of America's in 99, Bankers Trust's in 48, and First Chicago's in 36. *The Lessons Banks Learned from Overseas Misadventures*, BUS. WEEK, Apr. 19, 1976, at 104.

28. *See generally Merchant Banking, Is the U.S. Ready For It?*, *id.* at 54.

edge in the intense competition for both depositors and commercial customers.

The combination of the competitive advantages enjoyed by banks[29] with their natural interest in the securities industry suggests that participation in the industry by the major banks is likely to increase in the absence of legislative or regulatory restrictions. These banks can surely be expected to employ their advantages with the same degree of imagination they exhibited in utilizing the one-bank-holding-company mechanism to diversify despite the restrictions on that concept imposed by the 1970 amendments to the Bank Holding Company Act.[30]

LEGAL STATUS OF BANK SECURITIES ACTIVITIES

General

The Glass-Steagall Act (Act) was enacted in 1933 in reaction to congressional findings that there were many abuses by banks in the securities industry. During the decade following World War I, banks expanded into the securities industry through the formation of securities affiliates. Not only did these affiliates fuel the speculation of the late 1920's, but they also diverted valuable financial and managerial resources from the parent banks.[31] Furthermore, securities underwritten by bank affiliates frequently were purchased by the affiliated banks themselves, often for their trust

29. These advantages are discussed in text accompanying notes 78-94 *infra*.

30. Instead of serving as a deadly barrier between banking and other businesses, the 1970 "one-bank holding company" law is coming to look more like the gateway to a promising new land of profits and power. By setting up holding companies, many banks now find it possible to move into lucrative new ventures ranging from the operation of insurance agencies to computerized payroll processing.

Janssen & Foldessy, *Holding-Firm Law Designed to Limit Banks Instead Opens New Finance-Service Vistas*, WALL ST. J., Jan. 7, 1972, at 24, col. 1. "Thanks to the 1970 amendments to the Bank Holding Company Act of 1956, commercial lending institutions gained both incentives and authorization to widen their corporate horizons." Anreder, *Beautiful Balloon? Bank Holding Companies Embark on Frantic Expansion*, 3 BARRON'S, Apr. 29, 1974, at 3.

31. The possibility of spectacular profits from securities affiliates caused the principal officers of many banks to establish such affiliates. H. BURNS, THE AMERICAN BANKING COMMUNITY AND NEW DEAL BANKING REFORMS: 1933-1935, at 64 (1974).

accounts, and sometimes were "unloaded" on correspondent banks.[32] These purchases weakened the financial stability of the banks themselves.

Because the public associated the bank securities affiliates with their parent banks, their financial plight in the wake of the stock market crash of 1929 seriously undermined public confidence in banks and the banking system. The failure of the Bank of the United States in 1930 was widely attributed to that bank's activities with respect to its numerous securities affiliates.[33]

The powers of national banks[34] are enumerated in section 16 of the Glass-Steagall Act. Such banks also may exercise all incidental powers necessary to carry on the business of banking;[35] however, dealing in securities by national banks is expressly limited to "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock . . . ."[36] Moreover, anyone "engaged in the business of issuing, underwriting, selling, or distributing" securities is prohibited by section 21 of the Act from engaging in "the business of receiving 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 . . . ."[37] In addition, by virtue of the Act, all member banks[38] are prohibited from being affiliated with securities firms,[39] and no individual who is an officer, director, employee, or partner of a securities firm may be an officer, director, or employee of a national bank.[40] To complete the statutory pattern, bank holding companies are limited to engaging

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32. *See Landmark Law that Boxes In the Banks*, BUS. WEEK, Apr. 19, 1976, at 56.
33. Investment Co. Inst. v. Camp, 401 U.S. 617, 629 (1971).
34. Banks may be subject to regulation by a variety of regulators, both federal and state. Because most of the banks active in offering securities services are either national banks or subsidiaries of bank holding companies, this section will focus on federal banking regulation.
35. 12 U.S.C. § 24 (Supp. V 1975).
36. *Id.*
37. *Id.* § 378(a)(1) (1970).
38. Every national bank is required to be a member of the Federal Reserve System. *Id.* § 222.
39. *Id.* § 377. "[N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . ."
40. *Id.* § 78.

in banking and activities closely related to banking as defined in section 4(c) (8) of the Bank Holding Company Act. The Federal Reserve Board (FRB) has read into the Bank Holding Act the provisions of the Act prohibiting banks from providing securities services.[41]

It is clear that one of the Act's purposes was to prohibit commercial banks from entering the investment banking business.[42] Congress was familiar with the practice of many banks in establishing securities affiliates that had engaged in the business of floating bond issues and, on occasion, underwriting stock issues, and determined that bank involvement with the speculative securities prevalent at the time damaged not only the financial stability of the banks, but also of the nation. It was feared that the responsibility of banks to make disinterested credit decisions might be impaired by pressures resulting from bank affiliation with securities firms. In addition, Congress was clearly concerned about the conflicts of interest stemming from such affiliation. Finally, it is apparent Congress feared that loss of depositors' confidence in the banking institutions, which could be heightened as a result of their securities involvement, would have a serious detrimental effect on the national economy.

In *Investment Co. Institute v. Camp*,[43] an association of open-end investment companies and several individual companies challenged both a regulation of the Comptroller of the Currency which authorized banks to operate collective investment funds and the Comptroller's approval of a First National City Bank collective investment fund. Under First National's plan, the bank customer tendered between $10,000 and $500,000 to the bank, together with an authorization naming the bank the customer's managing agent. The customer was then issued written evidence of his participation which was freely redeemable and transferable to anyone who had executed the bank's managing agency agreement. The fund, which was registered as an investment company under the Investment Company Act of 1940, was managed by the bank as investment advisor.[44]

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41. *See* 12 C.F.R. § 225.125(b) (1977).
42. *See* App. I p. 800 *infra*.
43. 401 U.S. 617 (1971).
44. *Id.* at 622-23.

The Supreme Court found that the bank's activities were substantially equivalent to operation of a mutual fund and that, on their face, sections 16 and 21 of the Act prohibited this activity by national banks.[45] Nevertheless, it proceeded to explore thoroughly the legislative intent of the Act. The Court found that Congress wanted to keep commercial banks out of the investment banking business "largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system."[46] In passing the Act, Congress was motivated by more than the obvious danger that banks would invest their assets in imprudent investments.[47] Congress believed it was imperative to eliminate the temptations banks would face upon entering into investment banking which could impair their ability to function as an impartial source of credit. A bank, for example, might well fear that it would be discredited in the public's view if its securities affiliate did poorly. Accordingly, it might be tempted to shore up its affiliate's finances in several ways: by making unsound loans or providing other aid to the affiliate, by lending money or extending credit to those companies in which the affiliate had invested, or by lending money to a third person to finance its purchase of the affiliate's investments. Furthermore, the Court perceived a strong concern on the part of Congress over the "plain conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice."[48] And, perhaps most importantly, the loss of goodwill resulting from customers' suffering losses on investments purchased in reliance on the bank's name would result in a loss of the bank's reputation which would impair national confidence in the entire banking industry and, ultimately, the national economy.

Thus, the Court recognized the serious public policy issues which arise not only when banks enter the business of investment banking but also whenever banks determine to enter fields outside the business of commercial banking. The principles enunciated by the Court in *Camp* are a prerequisite to proper analysis of the legality of various bank securities services.

45. *Id.* at 625.
46. *Id.* at 634.
47. In fact, the securities affiliates had often operated without direct access to the bank's assets.
48. 401 U.S. at 633.

Investment Banking

Although it is clear that the Act at least forbids bank participation in the underwriting of non-exempt securities,[49] the legality of bank involvement in other investment banking services is uncertain. Indeed, certain investment banking services have been found by the Comptroller of the Currency to be incidental to banking and therefore permitted to a national bank.

For example, the Office of the Deputy Comptroller of the Currency has issued two letters which take the view that banks may, with certain limitations, engage in private placement activities. In the view of the Deputy Comptroller, a bank may properly provide assistance to a customer in determining long-term financial objectives. Incidental to this function, therefore, a bank may convey to this customer names of potential participants in a private placement and even may make preliminary inquiries of investors to ascertain interest in the issue. The bank may not, however, participate in the actual negotiations between the customer and the purchasers, for acting as a middleman is the "heart of the investment banking business." Moreover, because the Office of the Deputy Comptroller recognizes that a bank clearly cannot participate in a "best efforts" underwriting, it may not charge a fee for its services contingent upon a successful private placement, for "the levying of such a fee is a strong incentive for the bank to locate a purchaser with whom a deal can be made."

A persuasive argument can be made, however, that banks may not provide their customers with private placement services. As discussed above,[50] both sections 16 and 21 of the Act prohibit banks from underwriting any issue of non-exempt securities or stock. Because arranging private placements of securities appears substantially similar to "best efforts" underwriting, and in a sense results in a "distribution" of those securities, it would seem that a bank would transgress the prohibitions of those two sections by providing private placement services.

Moreover, the preceding analysis of the Act strongly suggests that Congress intended to prohibit bank participation in private place-

49. The decision in Investment Co. Inst. v. Camp, 401 U.S. 617 (1971), rested on the Supreme Court's finding that the offering of commingled agency account services by a bank constituted an illegal underwriting.
50. *See* text accompanying notes 35-37 *supra*.

ment activities. One of the primary functions of investment banking, after all, is the distribution of securities, whether by public offering or by private placement; and the dangers Congress intended to prevent by divorcing investment banking and commercial banking—including imprudent extensions of credit, diversion of bank personnel from commercial banking, conflicts of interest and undermining of public confidence in banks—are the same dangers that arise when banks engage in private placement activities. For example, a bank may find itself pressured by those who participated in a private placement arranged by the bank to make imprudent loans to the issuer to assuage the participants' dissatisfaction with their investment. Serious conflicts of interest also may arise when a bank attempts to place privately securities with accounts managed by its trust department.[51]

The limitations on bank involvement contained in the Deputy Comptroller's letters—no direct negotiation, no contingent fee—apparently stem from his recognition that such direct participation involves the bank in the promotional aspects of securities marketing which the Act expressly banned. The promotional problems, however, may arise even within the limits of permissible activities. Since a bank has a clear interest in the success of a placement, it is difficult to understand how realistically it may make even "preliminary inquiries" of potential investors or participate to an "insubstantial" extent in negotiations without at the same time marketing the securities. The factors which underlie the Deputy Comptroller's objection to a contingent fee exist whenever a bank participates in a private placement, since the size of the bank's future placement fees—from that client and other prospective clients—relates directly to its reputation for successful placements. Thus, the concerns expressed in the Deputy Comptroller's letters provide grounds for concluding that banks should not, to any extent, engage in private placement activities.

Other types of financial consulting by banks, apart from private placement activities, similarly raise questions of legality. Although providing financial advisory services in connection with extending short-term loans would appear properly to be incidental to the business of banking, it is by no means clear that other financial advisory services customarily provided by commercial banks, such as advice on mergers and long-term financings, are properly within a bank's incidental powers. For example, the FRB has ruled that bank holding companies may not provide management consulting services—

51. *See* E. HERMAN, *supra* note 17, at 47-48.

including advice or analysis as to a firm's planning operations, such as corporate acquisitions and mergers, and determination of long-term and short-term goals—because it does not regard such services as being "closely related to banking" under section 4(c)(8) of the Bank Holding Company Act.[52] Although the FRB's enumeration of non-permissible management consulting services[53] does not expressly encompass all financial advisory services, the rationale of its ruling supports the proposition that national banks may not properly engage in such services (except those incident to the extension of short-term credit).

Finally, although extending long term loans in itself does not seem to exceed the banking powers of national banks, under certain circumstances this practice could be subject to question. As noted above, section 21 of the Act prohibits a bank from "underwriting, selling or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities . . . ."[54] Presumably, an ordinary bank loan would not constitute a "security" within the meaning of this section; however, the distinction between a loan and a security depends on the characteristics of the instrument creating the obligation and, more importantly, on the circumstances surrounding its sale.

A recent Ninth Circuit case has explored this distinction in the context of when a bank loan may be a security for purposes of the Securities Exchange Act of 1934.[55] Under the rationale of the case, this question turns on whether repayment of the loan depends on the entrepreneurial or managerial efforts of another person; if it does, a security is likely to be involved. Among the factors considered relevant to this determination are the length of the loan, whether the obligation is issued to a single investor or a group of investors, the size of the debt relative to the business, and the extent of the obligation's collateralization.

It would appear that some syndicated long-term bank loans might constitute securities under such a test. Accordingly, the syndication process itself could be deemed an illegal distribution of securities under section 21.

52. 12 C.F.R. § 225.125(f) (1977).
53. *Id.* § 225.4(a)(5) n.3. This enumeration is not deemed exclusive.
54. 12 U.S.C. § 378(a)(1) (1970).
55. Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

Furthermore, although generally the provisions in long-term bank loan agreements are appropriate for protecting the bank's investment, in some cases those provisions may give banks such a degree of influence over the borrower that the loan and the agreement have attributes similar to a prohibited equity investment.[56]

Brokerage Related Services

The legal status of one form of brokerage service offered by banks is currently the subject of litigation: the New York Stock Exchange (NYSE) and the Investment Company Institute (ICI) have appealed the district court's decision granting the Comptroller's motion for summary judgment in their case challenging the Comptroller's interpretative letter permitting banks to offer AIS's.[57] That interpretation[58] reviewed the provision of section 24 of title 12 which states that "[t]he business of dealing in securities and stock by the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers,"[59] and concluded that the plain meaning of the words permits banks to purchase and sell stock as agent for customers, precisely the activity involved in AIS's. It further determined that the creation and management of an AIS by a bank did not involve the business of underwriting, selling, or distributing securities in contravention of section 378 of title 12.

The NYSE and ICI, however, maintained that the statutory language permits agency transactions, but only when done as an accommodation for the customer and at or below the bank's costs.[60] Moreover, they argued, the Act did not intend for banks to promote, advertise and solicit participation in such services nor to use such services to attract new banking customers.

The district court's decision was based largely on the doctrine that courts should give great weight to an agency's interpretation of a statute for which the agency has administrative responsibil-

56. National banks are prohibited from purchasing for their own account equity securities. 12 U.S.C. § 24 (Supp. V 1975). Similarly, bank holding companies may not purchase stock of a company which is not a bank or engaged in a business closely related to banking. *Id.* § 1843(a) (1970).

57. New York Stock Exch., Inc. v. Smith, 404 F. Supp. 1091 (D.D.C. 1975), *following opinion of* James E. Smith, Comptroller of the Currency, *expressed in a letter to* G. Duane Vieth (June 10, 1974), *reprinted in* [1974] FED. BANKING L. REP. (CCH) ¶ 96,272 at 81,359.

58. Letter from James E. Smith, Comptroller of the Currency, to G. Duane Vieth (June 10, 1974), *reprinted in* [1974] FED. BANKING L. REP. (CCH) ¶ 96,272 at 81,353.

59. 12 U.S.C. § 24 (Supp. V 1975).

60. NYSE's & ICI's Memorandum in Support of Plaintiff's Cross Motion

ity.[61] This doctrine has not rescued other interpretations promulgated by the Comptroller.[62] Furthermore, the fact that the challenged interpretation marks a reversal of the Comptroller's earlier view[63] casts further doubt on the current interpretation. While the legislative history is ambiguous on this point, the intent of the Act, as articulated by the Supreme Court in *Investment Co. Institute v. Camp*,[64] suggests that the very risks the Act sought to eliminate—loss of public confidence in the banks, conflicts of interest, and biased credit judgments—arise when the bank has a salesperson's stake in its investment services through offering an AIS plan.[65]

Regardless of the outcome of the case, however, the critical question is not the legality of AIS or dividend reinvestment plans; it is the legality of the full-scale brokerage services that at least one major commercial bank has disclosed plans to offer.[66] Through these services, banks would seek to reach more customers than they do with AIS plans and such services would receive a full-scale pro-

for Summary Judgment at 27, New York Stock Exch., Inc. v. Smith, 404 F. Supp. 1091 (D.D.C. 1975).

61. New York Stock Exch., Inc. v. Smith, 404 F. Supp. 1091, 1096-97 (D.D.C. 1975), *citing* Investment Co. Inst. v. Camp, 401 U.S. 617, 626-27 (1971); Udall v. Tallman, 380 U.S. 1, 16 (1965); Zemel v. Rusk, 381 U.S. 1, 16 (1965).

62. During the past decade numerous interpretative rulings promulgated by the Comptroller have been overturned by the courts: Investment Co. Inst. v. Camp, 401 U.S. 617 (1971) (mutual fund); First Nat'l Bank v. Dickinson, 396 U.S. 122 (1969) (armored car services); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) (travel agency); Nat'l Retailers Corp. of Arizona v. Valley Nat'l Bank, 411 F. Supp. 308 (D. Ariz. 1976) (data processing); Georgia Ass'n of Ind. Ins. Agents, Inc. v. Saxon, 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd sub nom.* Saxon v. Georgia Ass'n of Ind. Ins. Agents, Inc., 399 F.2d 1010 (5th Cir. 1968) (insurance agency); Baker, Watts & Co. v. Saxon, 261 F. Supp. 247 (D.D.C. 1966), *aff'd sub nom.* Port of New York Auth. v. Baker, Watts & Co., 392 F.2d 497 (D.C. Cir. 1968) (underwriting municipal revenue bonds).

63. Originally, the Comptroller interpreted this provision to prohibit banks from purchasing or selling securities for a customer's account except as an accommodation to the customer. COMPTROLLER OF THE CURRENCY, BULL. No. 2, at 2-3 (Oct. 26, 1935).

64. This legislative intent argument is more fully set out in the NYSE & ICI Memo, *supra* note 60, at 12-25.

65. The same considerations would appear to apply with equal force to dividend reinvestment plans and the limited direct brokerage in which banks are currently engaged.

66. *See* note 15 *supra*.

motional and advertising campaign. Such services clearly would involve many of the problems the Act sought to remove.

Investment Advisory Services

Investment advisory services seem to be properly incidental to the trust activities of a bank, and no legal basis for challenging such activities appears to exist so long as they are performed by the bank's trust department independent of its commercial department.

POLICY REASONS FOR RESTRICTING BANK SECURITIES ACTIVITIES

This section will explore some of the fundamental policy issues raised by bank participation in securities activities. To develop these issues in the proper context, we shall begin with a discussion of some of the objectives for national policy respecting the banking and securities industries.

Public Policy Objectives

As articulated in the *Introduction* to this paper, we believe an appropriate list of major policy objectives would include the following: (a) to promote maximum efficiency in the capital markets,[67] (b) to create an environment in which financial institutions have both the incentive and the ability to meet the rapidly changing demands of our economy, (c) to create a climate in which public trust in intermediating institutions is high,[68] (d) to encourage widespread direct public ownership of United States industry,[69] (e) to promote fair competition not only within markets but also between markets for substitute products,[70] (f) to limit the economic and political power of any one sector,[71] and (g) to protect investors and depositors against improper practices.[72] The first four goals relate to the

67. This objective is discussed more fully in text accompanying notes 74-77 *infra*.

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

69. *Id.*

70. The preamble to the Bank Holding Company Act of 1956, states as its purpose to "control their future expansion, and require divestment of their nonbanking interests." 70 Stat. 133 *reprinted in* [1956] U.S. CODE CONG. & AD. NEWS 169. *See* S. REP. No. 1095, 84th Cong., 2nd sess., *reprinted in* [1956] U.S. CODE CONG. & AD. NEWS 2482.

71. *Id.*

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

> For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-

need to maximize our capital-raising ability in order to satisfy the nation's immense capital needs:[73] Goals (a) and (b) are concerned with institutional efficiency and flexibility; goal (c) relates to the highly developed sense of public confidence in our financial intermediaries which is a necessary precondition to use of such intermediaries for savings and investment; and goal (d) refers to the direct equity ownership which gives the public a stake in the free enterprise system. Achievement of these goals, it is urged, would produce the conditions necessary for sustained economic growth and a high level of employment. Goals (e), (f), and (g) also are vital because of our national commitment to commercial fair play and our democratic tendency to avoid massive aggregations of power in any individual, corporation, institution, or industry.

These goals frequently may be in conflict, and reconciliation often is necessary. Nevertheless, a workable compromise among them should be attainable. For example, a reasonable balance between promoting economic efficiency and limiting concentration can be struck by limiting the areas of direct competition between different types of institutions while encouraging these institutions to offer close substitutes for one another's products, subject to certain constraints, and providing for easier entry by other types of competitors into each of the restricted markets. Similarly, investor protection through full and fair disclosure need not be inconsistent with public confidence in intermediaries. Some would argue, in fact, that disclosure eventually improves corporate behavior and thus enhances public confidence.

The remaining subsections discuss the desirability of separating the banking and securities industries to maximize attainment of the above policy objectives.

Role of Banks and Securities Firms in Capital Markets

Much of the banking legislation of this century has been a response to the perceived need to foster and maintain the stability

> counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . to insure the maintenance of fair and honest markets in such transactions.

15 U.S.C. § 78(b) (1970).

73. *Business Week* estimates that during the decade 1975-1984, $4.5 trillion in capital investment will be needed by the economy, nearly three times the $1.6 trillion consumed in the 1965-1974 decade, *Capital Crisis: The $4.5 Trillion America Needs To Grow*, BUS. WEEK, Sept. 22, 1975, at 42, 43.

and soundness of the banking system. The Federal Reserve Act of 1913 was enacted in response to the banking panic of 1907, and the Glass-Steagall Act was enacted to deal with the role of banks in the credit excesses of the 1920's that contributed to the collapse of the nation's economy and numerous bank failures in the 1930's.[74] The Bank Holding Company Act of 1956, as amended in 1970, reflected congressional concern that banks through bank holding companies would diversify into businesses which could jeopardize their financial stability.[75]

The role of the securities industry in our capital markets is equally vital to the economy.[76] The underwriting network makes new capital available to government and industry, and the secondary markets operate to provide a highly efficient mechanism for valuing and transferring ownership of securities. Indeed, one of the principal purposes of the Securities Acts Amendments of 1975 was to promote the efficiency of the securities markets.[77]

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74. The Senate committee which reported the bill that became the Federal Reserve Act of 1913 stated that:

> The chief purposes of the banking and currency bill is to give stability to the commerce and industry of the United States, prevent financial panics or financial stringencies; make available effective commercial credit for individuals engaged in manufacturing, in commerce, in finance, and in business to the extent of their just deserts; put an end to the pyramiding of the bank reserves of the country and the use of such reserves for gambling purposes on the stock exchange.

S. REP. No. 131, 63d Cong., 1st Sess. pt. 2, at 7 (1913). The preamble to the conference report which accompanied the bill that was enacted as the Banking Act of 1933 (the Glass-Steagall Act), 48 Stat. 162 (1933), stated that the bill's purpose was "to provide for the safer and more effective use of the assets of banks." H.R. REP. No. 254, 73d Cong., 1st Sess. 1 (1933).

75. The report of the Conference Committee that reported the Bank Holding Company Act Amendments of 1970 noted the "mixing [of] banking and nonbanking in complete contravention of the purpose of both Federal banking laws going back to the 1930's and the Bank Holding Company Act of 1956" and quoted with approval the following statement of the President:

> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.

H.R. REP. No. 1747, 91st Cong., 2d Sess. 11 (1970).

76. Public Policy for American Capital Markets, *supra* note 68, at 1.

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

> The securities markets of the United States are indispensable to the growth and health of this country's and the world's economy. In order to raise the enormous sums of investment capital that will be needed in the years ahead and to assure that that capital is properly allocated among competing uses, these markets must continue to operate fairly and efficiently. The increasing tempo and magnitude of the changes that are occurring in our domestic and interna-

Economic Advantages Possessed by Banks

Financial intermediation by banks involves the accumulation of savings as deposits and the lending of those funds to those with capital needs. This transfer process is a primary economic function of financial intermediaries. There are essentially two cost elements in the intermediation of funds: (1) the rate of return required to induce holders of idle funds to deposit them, and (2) the costs of the intermediation process. The privileges that banks enjoy are intended to lower those costs so that those who need funds may obtain them relatively inexpensively.

For example, federal deposit insurance serves to lower the rates of return required to attract depositors by making bank deposits up to prescribed levels virtually "risk free."[78] Such rates of return also may be kept artificially low through governmental action when legal interest ceilings or prohibitions on deposits are set at levels below the rate that market forces would otherwise dictate.

Moreover, the direct costs of intermediation are reduced through the favorable tax treatment accorded banks for interest expenses[79] and loss reserves,[80] which increases their after tax income.[81] In

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> tional economy make it clear that the securities markets are due to be tested as never before. Unless these markets adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the Nation will suffer.

H.R. REP. No. 229, 94th Cong., 1st Sess. 91 (1975).

78. The Federal Deposit Insurance Corporation (FDIC) insures up to $40,000 of each account. 12 U.S.C. § 1813(m) (Supp. V 1975).

79. Banks are permitted to deduct interest expenses incurred to hold tax-exempt municipal bonds. Rev. Rul. 61-222, 1961-2 C.B. 58.

80. Although this provision is being gradually phased out, banks are permitted to reserve against future loan losses and to deduct such reserve from gross income. I.R.C. § 585.

81. The following is a comparison of tax rates applicable to banks and brokers:

1975, five of the ten largest bank holding companies had a negative federal income tax liability on their worldwide income,[82] and no one of the ten had a tax liability to all governments in excess of thirty-five percent of its worldwide income,[83] although the statutory corporate income tax rate in the United States is forty-eight percent.

In addition, banks have ready access to short-term capital at low cost through access to the federal funds market and the FRB's discount window.[84] The cost to banks of long-term capital also is

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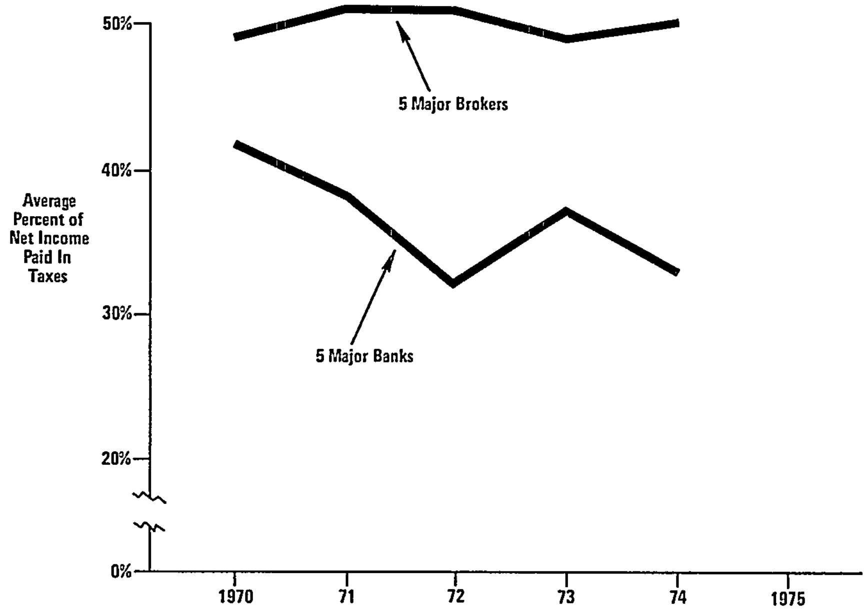
TABLE 1
Effective Tax Rate Is Lower for Banks than Brokers



Source: Speech by Alan F. Blanchard, former Executive Director of the SEC, before the Carter Golembe Associates Executive Seminar (Oct. 16, 1975) (The SEC, Banks and the Capital Markets 22A, on file with the *San Diego Law Review*) [hereinafter cited as Blanchard Speech].

82. Chase Manhattan Corp.'s negative federal income tax liability constituted 31.7% of its worldwide income; Bankers Trust's was 4.5%; Chemical New York Inc.'s 10.5%; Citicorp's 3.3%; and Manufacturers Hanover Inc.'s 7.1%. 4 TAX NOTES, Apr. 26, 1976, at 31.

83. The worldwide tax liability of each of the ten as a percentage of worldwide income was: Bank of America, 31.3%; Bankers Trust, 15.1%; Chase, 10.3%; Chemical, 2.6%; Citicorp, 29.8%; Continental Illinois, 28.7%; Manufacturers, 9.9%; J.P. Morgan, 31.7%; Security Pacific, 9.6%; and Wells Fargo, 15.0%. *Id.*

84. At a time when the prime rate, the rate charged a bank's best com-

lower because of reduced risks associated with investment in the banking business. Such reductions in risk result in part from federal and state restrictions on entry into banking and the readiness of the FRB to provide low cost credit through the discount window to meet banks' temporary liquidity problems.

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

For example, limited entry into the banking business reduces the competition for deposits, thereby decreasing the rates earned by depositors, as against those that would prevail were there free entry. Similarly, interest rate ceilings in respect of time deposits and interest prohibitions in respect of demand deposits eliminate price competition for deposits when they operate to prevent commercial banks from having to pay what would be the market rate of interest on such deposits. These differences in interest rates constitute income transfers in favor of such banks.

Other advantages are paid for by taxpayers indirectly when banks are permitted to reduce their tax liabilities by deducting interest paid on funds borrowed to hold tax-exempt securities, a privilege not generally available to nonbank financial institutions.

These privileges are provided to banks in the expectation they will be passed on to borrowers of funds, thus reducing borrowing costs, making credit more freely available in the economy, and stimulating economic growth. It would constitute a clear departure from the purpose of the privileges for banks to employ them in nonbanking activities.

Moreover, it would be patently unfair if nonbanking entities were forced to compete with banks without the benefit of such privileges. To illustrate this point, one need only compare the cost of borrowed funds to banks with the cost to broker-dealers. Broker-dealers de-

mercial risks, was at 6-¾%, the federal funds rate was approximately 4-⅝% and the discount rate was 5-½%. WALL ST. J., Apr. 20, 1976, at 37, col. 1; 62 FED. RES. BULL., Apr. 1976, at app. 6.

pend on bank loans to provide a "margin" for their customers and to carry securities during an underwriting; as of June 30, 1975, they owed the large banks of New York City alone nearly $4 billion.[85] Under these circumstances, it is difficult to understand how broker-dealers could successfully compete with banks, for their effective interest cost on borrowed funds is one to two percentage points higher than the cost to banks (which translates into an effective cost of funds of as much as twenty-five percent greater than the cost to banks).[86] It would be "like a dress shop that buys its goods wholesale competing against another dress shop that must buy stock retail."[87]

An even more telling example is provided by the experience of the mortgage banking industry, in which many bank holding companies made acquisitions in the early 1970's. 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. One of the anti-competitive impacts cited as having prompted the FRB to disapprove Citicorp's retention of Advance Mortgage Corporation was the 1100% increase over two years in its extension of credit to Advance.[88] Securities firms are placed at a similar disadvantage in competing with banks in underwriting general obligation bonds.

Many other nonbanking enterprises owned by bank holding companies are financed by interest free funds from the holding company. Often in such cases the nonbanking activity would produce little or no profit if it were charged for its funds at market rates.[89] For example, had Citicorp charged its nonbanking subsidiaries at least the cost to it of the funds it made available to those subsidiaries, they would have shown a net loss for 1975 instead of a $17 million profit.[90]

85. 62 FED. RES. BULL., Feb. 1976, at app. 16.

86. For example, broker call money carried an interest rate of approximately 6% at a time when banks were paying only 4.8% on one month certificates of deposit. WALL ST. J., Apr. 20, 1976, at 37, col. 1.

87. WELLES, *supra* note 25, at 391.

88. "This financial support following the subject acquisition permitted Advance, in no small part, to improve its position significantly within the mortgage banking industry." 60 FED. RES. BULL., Jan., 1974, at 50, 53.

89. WALL ST. J., Apr. 20, 1976, at 1, col. 1.

90. Citicorp made available to its nonbanking subsidiaries over $600 mil-

Common sense suggests, and economic theory confirms, that "competition" of this sort does not produce the social benefits normally expected to flow from competitive forces.[91]

In the securities industry, banks have additional cost advantages over securities firms which make direct competition particularly unfair. Banks, for example, are not subject to the strict regulation of their securities activities which add significantly to operating costs for members of the securities industry.[92]

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lion interest free. Form 10-K filed by Citicorp with the SEC on March 30, 1976, at 13.

91. The major benefit of competition in an industry is the efficient allocation of scarce resources in that industry. However, such beneficial competition only occurs in the absence of structural defects in the organization of an industry. Among the defects commonly recognized by economists is the enjoyment of absolute cost advantages by certain members of an industry. The interest cost advantage enjoyed by banks suggests that efficient competition would not occur were banks to participate in the securities industry. *See* J. BAIN, INDUSTRIAL ORGANIZATION, 260-63, 464-66 (2d ed. 1968).

92. *See* Table 2, *infra*.

TABLE 2
REGULATORY BURDENS TO WHICH
MEMBERS OF THE SECURITIES INDUSTRY
ARE SUBJECT

BROKERAGE RELATED AND INVESTMENT BANKING SERVICES

1. Registration and licensing.
   A. Registration with SEC as broker-dealer under section 15 of the Securities Exchange Act of 1934.
      1. Filing of application.
      2. Periodic financial statement filings.
      3. Periodic fees.
   B. Membership in National Association of Securities Dealers, Inc. (NASD).
      1. Requirements for maintaining books and records.
      2. Minimum capital requirements.
      3. Membership fees and charges.
      4. Compliance with "suitability" rules and other extensive Rules of Fair Practices.
   C. Membership on national securities exchanges.
      1. Requirements for maintaining books and records.
      2. Periodic financial reporting.
      3. Minimum capital requirements.
      4. Membership fees and charges.
   D. Licensing of securities salespersons with NASD and exchanges.
      1. Training.
      2. Examination.
      3. Bonding of employees.
2. Continuing regulatory obligations under Securities Exchange Act and rules of self-regulatory bodies.
   A. Minimum capital requirements (usually must be calculated daily).

Furthermore, banks have a ready and willing market of customers for their securities services: Every day millions of customers stream across the threshold of the nation's banks to patronize banking services and regularly receive bank mailings in the form of statements and bills. Because of their banking relationship with these customers, which includes intimate knowledge of their financial position, banks are uniquely able to cull their customer lists for likely prospects. In addition, the ability of banks to extend personal loans to corporate officers enables them to provide another strong inducement to patronage of their services.

Without a suggestion that banks would engage in illegal tie-ins, it also seems apparent that potential borrowers may patronize various securities services offered by their bank in the belief that their patronage of those services enhances their creditworthiness with the bank. Particularly when short-term credit becomes a relatively scarce and valuable commodity, customers may feel obliged to be "good customers" of their bank in all respects. The Conference Committee that reported the Bank Holding Company Act Amendments of 1970 specifically noted the possibility of this occurring:

> Such tie-ins may result from actual coercion by a seller or from a customer's realization that he stands a better chance of securing a scarce and important commodity (such as credit) by "volunteering" to accept other products or services rather than seeking them in the competitive market place. In either case, competition is ad-

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B. Rules regarding suitability of securities for an investor.
C. Rules governing the appropriateness of advertising materials and requiring pre-clearance.
D. Requirement of furnishing detailed conformation of purchases and sales and periodic statements of accounts.
E. Contribution to Securities Investor Protection Corporation.
F. Rules requiring full disclosure of information regarding securities sold to customers.
G. General rules regarding the duty owed by brokers to their customers under the so-called "shingle" theory, which seeks to hold brokers to high professional standards.
H. Duty of broker-dealer principals to supervise employees.

INVESTMENT ADVISORY SERVICES

1. Registration and licensing.
   A. Registration with SEC as investment adviser under section 203 of Investment Advisers Act of 1940.
      1. Application.
      2. Filing fee.
      3. Books and records requirements.
2. Continuing regulatory obligations under Investment Advisers Act.
   A. Rules governing the appropriateness of advertisements and requiring pre-clearance.
   B. Rules governing advisory contracts with customers.
   C. Rules governing methods of calculating fees.
   D. Rules requiring disclosure of capacity and prior consent when acting as principal with investor.

> versely affected, as customers no longer purchase a product or service on its own economic merit.[93]

This potential for voluntary tie-ins has aroused concern among those responsible for protecting healthy competition in the economy because its anticompetitive impact cannot be cured by regulation or resort to the antitrust laws.[94]

Because of the unique advantages granted to banks to facilitate their intermediation services and because of their other cost advan-

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93. H.R. REP. No. 1747, 91st Cong., 2d Sess. 18 (1970).

94. As suggested by Richard W. McLaren, then Assistant Attorney General in charge of the Antitrust Division, in his testimony before the Senate Committee considering one-bank holding company legislation in 1970, the only solution to this structural defect in the marketplace is a separation of banking from nonbanking enterprises:

> Bank expansion in other areas permits the carry over of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature—adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere.
>
> I refer to a voluntary form of reciprocity or tie-in effect, where a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.
>
> This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insuror in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and as a pattern of such bank-insurance affiliations developed, market foreclosure in the tied field would become more and more serious.
>
> Such voluntary tying or tying effect, as we called it in a recent case, is the product of market structure—not misconduct.
>
> This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, we must concentrate on avoiding a structure which gives rise to such effects.

One Bank Holding Company Legislation of 1970, Hearings Before the Senate Comm. on Banking and Currency, 91st Cong. 2d Sess. 239-40 (1970). *See also* Mr. McLaren's remarks before the House Committee: *The Bank Holding Company Act Amendments: Hearings Before the House Comm. on Banking and Currency*, 91st Cong., 1st Sess. 91-92 (1969).

tages vis-à-vis members of the securities industry, fair competition in providing securities services between major commercial banks and members of the securities industry may not be possible. Nonetheless, commercial bankers and investment bankers can continue to compete indirectly on an equitable basis by offering users of capital two alternative types of financing. For most types of loans offered by commercial banks, investment bankers will strive to remain competitive by devising a comparable security that can be sold in the private or public capital markets. Thus, investment bankers provide the alternative of commercial paper to the banks' short-term loans. They also place medium-term public debt (five to seven years) to compete with bank loans of comparable maturity. Competition of this type produces innovation and efficiency while providing businesspeople with a meaningful choice of capital sources.

Concentration of Economic Power in the Major Commercial Banks

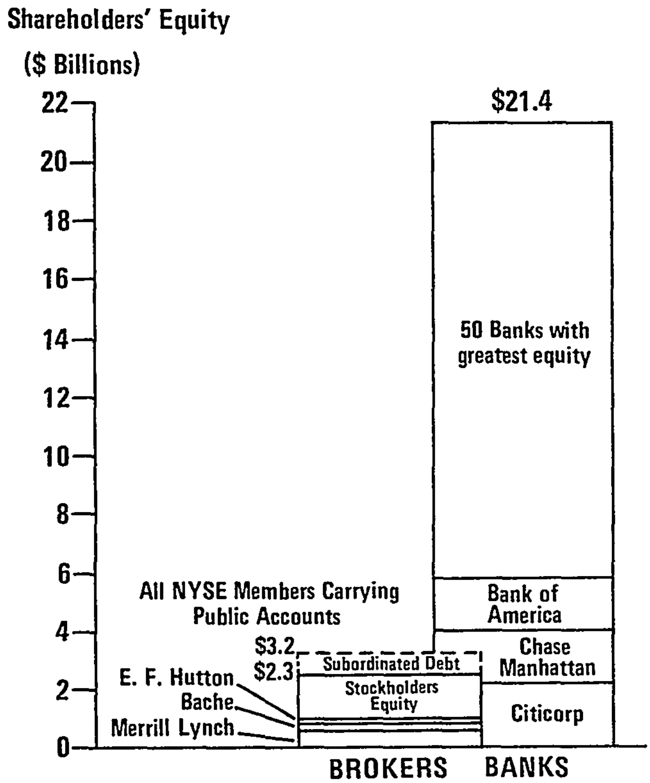
If the incursion of the major commercial banks into the securities industry goes unchecked, it is likely that they will come to dominate several aspects of that industry. In addition to the economic advantages cited in the preceding section, the sheer size of these banks in relation to the securities industry suggests that the securities industry would be unable to compete successfully against the wealth of resources available to the money-center bankers. The magnitude of the major banks in relation to the securities industry is illustrated by the fact that the shareholders' equity of Citicorp, Inc., the parent holding company of Citibank, N.A., was $2.074 billion at the end of 1974, almost as large as the $2.346 billion which was the aggregate shareholders' equity and proprietors' capital at that time of all members of the New York Stock Exchange.[95]

The possibility of bank dominance of the securities industry is particularly worrisome because these banks already represent the major intermediary institutions in the United States economy through their commercial and trust departments. There are six principal kinds of institutions in the economy that act as financial intermediaries: (1) insurance companies, (2) thrift institutions, (3) commercial banks, (4) trust companies (or trust departments of commercial banks), (5) mutual funds, and (6) broker-dealers. Various other kinds of intermediaries exist in the economy, such as finance companies, commercial factors and mortgage banks, but generally these are not major sources of intermediated funds for business.

95. *See* Table 3 *infra.*

Major banks dominate the nation's trust business. The trust departments of commercial banks manage over $400 billion in assets, composed of personal trusts and estates and employee benefit and pension plans.[96] In addition to these enormous trust assets, commercial banks have available for lending or other investment approximately $900 billion of their own funds.[97] Thus, commercial banks control over $1,300 billion of assets.[98] This concentration of

TABLE 3
Comparison of Size of Members
of Securities Industry and Banks



Source: Blanchard speech, *supra* note 81, at 18A.

96. TREASURY ISSUES PAPER, *supra* note 6, at 7.
97. FDIC, SUMMARY OF DEPOSITS IN ALL COMMERCIAL AND MUTUAL SAVINGS BANKS (1974). Insurance companies, the second largest type of asset management institution, manage only an estimated $300 billion in assets.
98. If legislation similar to the Financial Institutions Act of 1975 [S. 1267,

control over financial assets is the more noteworthy because nearly two-thirds of banks' trust assets are controlled by sixty banks, constituting only 1.5% of the number of insured commercial banks with trust departments.[99] These same large banks constituted less than .5% of all insured commercial banks but controlled over fifty-five percent of commercial bank deposits.[100] These figures suggest that an overwhelming amount of economic power is concentrated among the very few largest banks.

Banks also have become major competitors in the finance company business, commercial factoring and mortgage banking. For example, as of December 31, 1968, only two of the top ten mortgage servicing firms were affiliated with a bank;[101] as of December 31, 1975, seven were so affiliated.[102] Only eight of the top fifty mortgage services were associated with banks in 1968,[103] but in 1975, twenty-six were.[104] If banks were to use their competitive advantages to dominate the securities industry as well, virtually every major source of business capital—except insurance companies and mutual funds—would be controlled by a relatively limited number of large commercial banks, a situation which currently prevails in Europe.

It is widely recognized that the inflexibility of the European credit markets—for example, their limited ability to offer long-term credits with fixed maturities—is a product of the lack of sufficient public market alternatives to the credit facilities of the commercial banks. The public markets in the United States, which are supported by the confidence that comes from independent credit rating agencies and detailed financial disclosure, impose a discipline on borrowers.[105] The system quickly reveals financial weakness, and

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94 Cong., 1st Sess. (1975)]—repealing both interest rate ceilings on time deposits and restrictions on paying interest on demand deposits—were to become law, commercial banks might be able to absorb some of the deposits held by thrift institutions.

99. As of December, 1974. FDIC, TRUST ASSETS OF INSURED COMMERCIAL BANKS—1974, at 14 (1975).

100. As of June 30, 1974. Compiled from *Annual Survey of Bank Performance*, BUS. WEEK, Sept. 21, 1974, at 60-63, & 61; FED. RES. BULL., June 1975, at app. 14.

101. In order of dollar volume of permanent real estate mortgages. AM. BANKER, May 7, 1969, at 22.

102. *Id.* Apr. 26, 1976, at 10 (on file with the *San Diego Law Review*).

103. *Id.* May 7, 1969, at 22.

104. *Id.* Apr. 26, 1976, at 10 (on file with the *San Diego Law Review*).

105. Address by Henry Kaufman, Partner and Member of the Executive Committee of Salomon Brothers, before the Lombard Association (March 9, 1976) in London, England (The American Credit Markets Viewed from an International Perspective, on file with the *San Diego Law Review*).

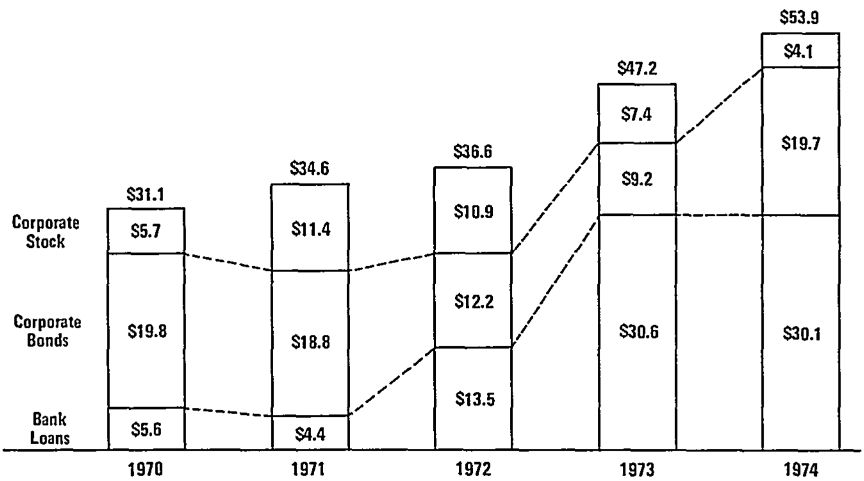
the markets thus act as a system of checks and balances, as well as an important safety valve which reinforces the strength of the private negotiated markets.[106]

The reason for concern over an undue concentration of financial power in the major commercial banks is that such concentration would involve control of the allocation of business capital in our economy.[107] Under the scenario of such concentration, the large commercial banks would be able to determine which enterprises are to grow and which are not, and investment decisions might tend to concentrate on a particular group of industries at the expense of all others.[108] The market can allocate capital efficiently only

106. "In the long run, this dual market structure contributes to the efficiency of American financial institutions." *Id.*

107. The commercial departments of banks are already providing well over half of all external corporate financing through bank loans. (*See* Table 4 *infra*). This is partly the result of the increased number of long-term loans extended by banks.

TABLE 4
Sources of External Corporate Financing



Source: Blanchard speech, *supra* note 81, at 16A.

108. Otto Eckstein, former Chairman of the Council of Economic Advisers, in the fall of 1974, stated the problem as follows:

> More fundamentally, a healthy capital market promotes the competitiveness of the American economy. If the current stock market situation were to persist, there would be increased concentration

when there is a broad base of investment decision-making; overconcentration of decision-making can result in an insufficient allocation of capital to many deserving industries. Furthermore, there is the increased danger that one area of enterprise may receive a substantial concentration of bank investment and then become unprofitable (like the REIT industry); banks might have to face large write-offs or substantially increase their reserves—a fact which could make it more difficult for them to attract capital. For these reasons as well, business must have a capital market alternative to the banking system.

Conflicts of Interest

A bank's performance of various securities services may create conflicts of interest adverse to its trust customers and other managed accounts, to its commercial customers, and to users of its securities services. Although most trust departments undoubtedly strive to conduct their businesses in full compliance with the high standards imposed by fiduciary law, serious conflicts can lead to unconsciously distorted judgments. In the securities industry conflicts are dealt with by measures ranging from disclosure to outright prohibition;[109] in the banking business, controls are less clearly defined and more readily waived.[110]

A bank's trust department, for example, might be inclined to purchase for its accounts securities which are the subject of a private placement arranged by the bank for a corporate customer or, in the case of municipal bonds, distributed by the bank as underwriter. Furthermore, if a private placement proves a bad investment for the participants, the bank's trust department might seek to obtain for the issuer additional investments or loans from other managed accounts in an attempt to assuage the dissatisfaction of the initial investors.

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of the economy. The largest companies tend to be the most creditworthy and have the ability to stand at the head of the line at the lending windows of the large commercial banks. The banks would become powerful as they are in Europe and Japan.

Quoted in address by Alan F. Blanchard, *supra* note 81, at 17.

109. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 78h(c) (1970) (written consent required before lending customers' securities); 15 U.S.C. § 78k(a)(1) (Supp. V 1975) (prohibition of executing exchange transactions for managed accounts); 15 U.S.C. § 78k(d) (1970) (disclosure of capacity in executing transactions); Rules 15c1-4 (disclosure of capacity and commission in executing over-the-counter transactions), 15c1-5 (disclosure of relationship with issuer); 15c1-6 (disclosure of interest in distribution).

110. *See* 12 C.F.R. § 9.12(a) (1977).

The allegations in the *Microdot v. Irving Trust Co.*[111] episode last year point out one of the more dramatic examples of potential conflict stemming from a bank's securities services to its commercial customers.[112] There Irving Trust allegedly revealed confidential knowledge of the financial condition of its credit customer, Microdot, in the course of providing advisory services to General Cable (another credit customer) in the latter's attempt to take over Microdot. Although determination of the facts must await adjudication, the incident illustrates that there are many opportunities for a bank, in the course of providing financial advisory services, to make improper use of confidential information obtained from its credit customers.

A bank also may have a conflict between its obligation to give its financial advisory customers objective advice and its own interest as a banker in making loans. For example, when a corporation seeks advice from a bank on raising capital, the bank may be tempted to advise the corporation to take on increased bank borrowings, even though such terms may not be so favorable as those available in the public market.

There are also potential conflicts with respect to bank brokerage customers. A bank, in providing AIS or dividend reinvestment plan to customers, is in a position to enjoy the use of the pooled funds without interest simply by a delay in placing orders. In some instances, such a delay could result in less favorable execution for such accounts. Similarly, the trust department can take advantage of its knowledge of when an order for a pooled account will be executed in placing orders for its managed accounts.

Investor Protection

Section 3(a)(4) of the Securities Exchange Act of 1934 provides that the term "broker" means "any person engaged in the business

111. Index No. 01123/76 (Sup. Ct. N.Y. filed Jan. 21, 1976) (on file with the *San Diego Law Review*).

112. Both the House and the Senate have conducted hearings on this attempted takeover. The House Financial Institutions Supervision, Regulation and Insurance Subcommittee of the Committee on Banking, Currency and Housing held hearings on March 26, 1976. The Senate Banking, Housing and Urban Affairs Committee held hearings on this matter on February 16, 1976.

of effecting transactions in securities for the account of others, *but does not include a bank*."[113] This statutory exclusion was based on the congressional understanding that banks were prohibited from engaging in the business of dealing in securities under the Glass-Steagall Act.[114]

Those who are classified as "brokers" under the Securities Exchange Act of 1934 are required to conform to a comprehensive system of governmental and private regulation developed over the years for the protection of investors. Among the standards and safeguards provided under this system, but inapplicable to banks and thus unavailable to their brokerage customers, are those relating to suitability, prompt execution, disclosure of adverse information, and insurance under the Securities Investor Protection Act.

Although it often is argued that banks, too, are subject to an elaborate regulatory scheme, the principal objective of bank regulation is protection of depositors and trust customers, not investors, whether they be holders of bank securities or customers of the bank's securities department. Moreover, understandable reluctance of regulators to unsettle the often delicate public confidence upon which the banking system depends can result in a different standard of enforcement in respect of bank conduct of securities business. Thus, permitting banks to furnish securities services is inconsistent with the policy objective of safeguarding the interests of investors—a goal upon which investor confidence in the securities markets is built.

Stability of the Banking System

The banking system plays an essential role in the capital raising process, and maintenance of its stability is essential to the economy. The history of the 1930's serves as a vivid reminder of our economy's dependence on that confidence and its need for a strong banking system. The stability of the banking system depends on three elements: Banks must (1) make prudent and disinterested loans and investments, (2) maintain a relatively stable flow of revenue, and (3) continue to enjoy the confidence of depositors.

The first of these elements is essential to bank solvency; sound loans and other investments result from credit decisions which are the product of an independent banking judgment. Second, bank revenues must be maintained at relatively steady and predictable

113. 15 U.S.C. § 78c(a)(4) (1970) (emphasis added).
114. *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 86 (1934).

levels[115] if banks are to be able to meet their operating expenses, including the interest they pay for some of the funds they utilize, and to attract long-term capital. Stable bank income typically has been provided by the revenues generated from the extension of short-term credit to commercial enterprises; to the extent banks engage in nonbanking activities which may produce volatile or unpredictable levels of revenue, their ability to maintain a stable flow of revenues may be jeopardized. Finally, the banking system depends on public confidence—the willingness of individual and corporate depositors to entrust their savings or idle funds to banks. Public confidence stems, in part, from the public's perception of the first two elements; however, it is also affected by nonquantifiable psychological influences. The performance by banks of nonbanking activities must therefore by analyzed against these three critical elements of a sound banking system.

To the extent banks acquire an entrepreneur's stake in a commercial enterprise, conflicts of interest may impair their ability to make prudent and disinterested credit decisions with regard to that enterprise. In addition, if a bank becomes associated with investment vehicles like mutual funds or REIT's, it may be tempted to extend favorable credit terms to those businesses which the fund or REIT has invested in.[116] Former FRB Chairman William McChesney Martin, in his 1969 testimony supporting legislation to remove the one bank holding company exemption, observed that: "If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated."[117] This statement is true because bankers may find that their ability to grant scarce credit to users of their other financial services is an important inducement to potential customers to use those services. Even bank-sponsored

115. "Banks have found that earnings stability, one hoped-for benefit of the holding company, has been particularly elusive." Foldessy, *Holding Firm Concept Turns Sour for Banks as Profits Fall Short*, WALL ST. J. Apr. 20, 1976, at 1, col. 6.

116. For example, Chase Manhattan Bank bought $160.6 million of loans from the Chase Manhattan Mortgage and Realty Trust, for which it serves as an investment adviser, in order to ease the financial burdens of the Trust. BUS. WEEK, May 31, 1976, at 30.

117. S. REP. No. 1084, 91st Cong., 2d Sess. 3 (1970).

plans for small investors, which customarily invest solely in blue-chip equities, may influence a bank to make loans it might not otherwise have made to prevent itself from being associated in the minds of its customers with any decline in such securities.[118]

The common bank practice of extending loans to REIT's for which the bank or its affiliate provides investment advisory services and sponsorship offers an illustration of the temptations to which banks may succumb. For example, Manufacturers Hanover was one of thirteen banks which were parties to a $106.2 million extension of credit to Citizens Mortgage Investment Trust, which is advised by Citizens Mortgage Corporation, a subsidiary of Manufacturer's holding company parent.[119] Similarly, BT Mortgage Investors, which is managed by BT Advisors, Inc., a subsidiary of Bankers Trust New York Corporation, owed Bankers Trust $55.7 million at June 30, 1975;[120] and Chase Manhattan Mortgage and Realty Trust, which is advised by Chase Manhattan Bank, had a line of credit with that bank in August 1974.[121] The Hamilton National Bank of Chattanooga was declared insolvent by the Comptroller of the Currency on February 16, 1976. Defaults in many of the nearly $100 million in loans originated by a mortgage banking affiliate of the bank reportedly were responsible for Hamilton's demise.[122]

In addition, a bank's ability to purchase for its own account a substantial portion of an offering of government securities it is underwriting may prejudice its judgment in bidding for such offer-

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118. The SEC's Institutional Investor Study Report observed a correlation between bank business relationships (including creditor relationships) with corporations and their portfolio holdings:

> Some institutions, particularly banks, have personnel and business relationships with portfolio companies. These relationships may tend to reinforce any power conferred as a result of stock holdings. They also create potential conflicts of interest and the possibility of misuse of inside information. Although the Study can draw no general conclusions as to whether these adverse consequences actually occur or to what extent they may occur, it appears that there is a strong statistical correlation between bank stock holdings and personnel and business relationships.

SEC, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, 127 (summary vol. March 10, 1971). *See* SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 2 (1971).

119. Prospectus of Manufacturers Hanover Corporation, June 19, 1975, on file with the SEC May 21, 1975 (on file with the *San Diego Law Review*).

120. Prospectus of Bankers Trust New York Corporation, Sept. 17, 1975 (on file with the *San Diego Law Review*).

121. Prospectus of Chase Manhattan Corporation, Aug. 2, 1974 (on file with the *San Diego Law Review*).

122. WALL ST. J., Feb. 17, 1976, at 6, cols. 1-3. The bank had also made over $30 million in loans to other affiliates.

ings. By the same token a bank may find a home in its own portfolio for securities it has underwritten which it might have declined to buy from an independent source. As a result, a bank may find itself burdened with securities in which it ordinarily would not or should not have invested. Many banks currently are experiencing the adverse effects of their extensive investments in general obligation bonds.[123]

The term of a loan also must be considered a factor in analyzing the prudence of the loan. As banks find themselves increasingly in competition with investment bankers, their long-term loans to corporate borrowers have been expanding, and in some cases their own capital positions have become tight. Although banks have, to a limited extent, utilized the capital markets for long-term funds, their principal source of funds continues to be demand and other short-term deposits. As the average maturity of their loans increases, prudent bank financial practice would dictate that such loans be matched against equally long-term sources of funds. Failure to do so could lead to disastrous results. The Senate Banking and Currency Committee observed, in 1932, that "[a] very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of various institutions have been so extensively 'tied' up in long-term investments."[124]

The second key element of bank stability is a steady source of revenues. The dangers of banks becoming dependent on revenues subject to volatile fluctuations in operating results led Congress to adopt the 1970 amendments to the Bank Holding Company Act which limit the scope of bank holding company operations to activities closely related to the banking business.[125] This same concern motivated Congress in 1933 to restrict the ability of banks to assume the risks inherent in underwriting and investing in corporate securities.[126] Although banks were permitted to underwrite general obligation bonds because there were thought to be few risks involved in such underwriting, even this area of the securities industry has risks for banks: Shortly before its demise the Franklin Na-

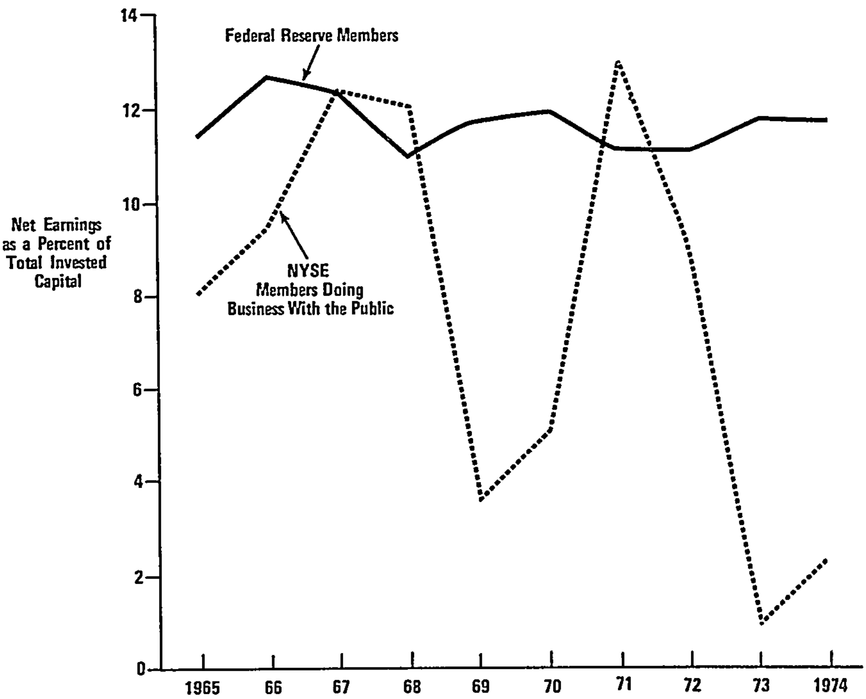
123. Citicorp has lost over $400 million in market value of the state and municipal securities it was carrying for its own investment at December 31, 1975. CITICORP [1976] ANN. REP., 24.
124. S. REP. No. 584, 72d Cong., 1st Sess. 8 (1932).
125. *See* text accompanying note 41 *supra*.
126. *See* text accompanying notes 42-48 *supra*.

tional Bank lost $5.6 million in the value of securities " 'which had been carried in the bank's securities trading account,' or bond dealer operations."[127] Similar risks exist in the case of municipal revenue bonds, which are backed only by the revenues of a particular enterprise. Accordingly, it would not appear desirable to permit banks to increase their activities in an industry whose revenues are subject to extreme fluctuations as well as unpredictable risks. The relative stability of income of the two industries is illustrated graphically.[128]

The third element of bank stability is depositor confidence, which may be affected adversely if banks become active in promoting a variety of investment vehicles. For example, if banks sponsor mutual funds, REIT's or AIS's which fail to live up to investor expectation—not an unlikely possibility since such investments hardly

127. Foldessy, *Franklin New York Puts Deficit at $60 million in First Five Months*, WALL ST. J., June 21, 1974, at 3, col. 1.
128. *See* Table 5 *infra*.

TABLE 5
Relative Stability of Income



Source: Blanchard speech, *supra* note 81, at 20A.

can be expected to be risk-free—the image of banks as riskless deposit-accepting institutions may be tarnished in the minds of the public. Moreover, the confidence of corporate borrowers often is as sensitive as that of individuals: The recent spate of bank failures reportedly has prompted many corporate treasurers to narrow their list of acceptable depository banks.

Any serious loss of public confidence conceivably could lead to withdrawal of bank deposits, consequent diminution of the funds available for credit, and the possibility of bank failures.[129] Our economy surely cannot afford the devastating effect of such a shortage of bank credit.

Competitive Considerations

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

Even if additional competition in the securities industry were desirable, it should not be provided by banks in view of the above considerations; in fact, however, the brokerage industry already is highly competitive.

The structural characteristics of a competitive industry commonly accepted by economists include: (1) low seller concentration, (2) lack of significant barriers to entry, and (3) low product differentiation.[130] The brokerage industry scores high on all three counts.

First, the brokerage industry's membership is diffuse and relatively non-concentrated. Second, there do not appear to be sub-

129. Although federal deposit insurance has greatly increased public confidence in the banking system, banks can ill afford to have their images tarnished. For example, the inability of a California bank holding company to refinance $11 million in commercial paper so seriously undermined depositor confidence that heavy withdrawals forced the otherwise healthy subsidiary bank to declare bankruptcy. Foldessy, *Holding Firm Concept Turns Sour for Banks As Profits Fall Short*, WALL ST. J., Apr. 20, 1976, at 33, cols. 1-2. Similarly, the FRB had to lend nearly $1.8 billion to cover depositor withdrawals when the Franklin National Bank's substantial foreign exchange losses became publicly known. Welles, *supra* note 25, at 393-94.

130. BAIN, *supra* note 91, at 464-66.

stantial barriers to entry.[131] Generally, such barriers include the absolute cost advantages discussed above,[132] significant economies of scale, and high product differentiation.[133] Although banks enjoy absolute cost advantages over members of the securities industry, there are no apparent cost advantages enjoyed by members of the securities industry over potential entrants. Furthermore, empirical studies suggest that there are no significant economies of scale in the securities industry.[134] Finally, there is relatively little product differentiation in the securities industry; what little product differentiation existed in the industry as a result of the service competition in which brokers engaged during the period of fixed commission rates will undoubtedly wane as price competition continues to flow from the May 1, 1975 unfixing of commissions.[135] Moreover, the sharp decline in commission charges since May 1, 1975, and the failure of a number of securities firms in the wake of that decline attest to the intensity of the competition in the brokerage business.

Similarly, bank entry into revenue bond underwriting would add little to the already strong competition among broker-dealers in this area. Not only do revenue bond offerings receive on the average over five bids per issue, but revenue bonds also generally receive more bids per offering than do comparable bonds in the bank-dominated general obligation market.[136] The revenue bond underwriting industry also exhibits the structural features necessary for competition discussed above with respect to the brokerage industry.[137]

Indeed, the employment by the major commercial banks of their unique advantages in the securities industry is likely to produce non-productive, and even detrimental, competition in that industry. The risk of increased economic concentration and the possibility of significant damage to the capital raising mechanism argue strongly for separating the two industries legislatively, as Congress attempted to do more than forty years ago.

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131. During the years 1971 through 1974, an average of 210 securities firms became members of the National Association of Securities Dealers, Inc. each year.

132. *See* note 91 *supra.*

133. BAIN, *supra* note 91, at 255.

134. *See* R. WEST & S. TINIC, THE ECONOMICS OF THE STOCK MARKET 134 (1971).

135. *See* Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign,* in PROMOTING COMPETITION IN REGULATED MARKETS 301, 311 (A. Phillips ed., The Brookings Institution 1975).

136. *See* note 81 *supra.* Testimony of Alvin V. Shoemaker, *Hearings on S. 1933 Before the Subcomm. on Securities, Senate Comm. on Banking. Housing and Urban Affairs,* 93d Cong., 2d Sess. 347 (1974).

137. *See* Testimony of Professor Simon Whitney, *Hearings, supra* note 136, at 352-98.

LEGISLATIVE PROPOSALS FOR CONSIDERATION

The legal analysis contained in this paper demonstrates the uncertainty under present law of the status of many bank activities in the securities area, and it seems equally clear that the various regulators with responsibility for administering the banking laws have done little to clarify the uncertainty. Set forth below for consideration are several legislative proposals which we believe should be evaluated in light of the above discussion.

Broker-Dealer Activities

In every major piece of banking legislation passed in this century, Congress has indicated its desire that commerce and banking be conducted separately.[138] However, many banks and bank holding companies have continued to expand their commercial activities.[139] In many cases, these activities were authorized by banking regulators, only to be later found by the courts to be impermissible.[140] Because of the tendency of bank regulators to permit banks to extend their competitive advantages into fields outside of banking, it is proposed that Congress declare unambiguously its intent to keep the business of banking separate from other commercial activities.

In particular, it is proposed that banks be prohibited from engaging in broker-dealer activities. We have discussed earlier how the offering by banks of private placement services and AIS and other brokerage-related services may have a deleterious effect on the economy.[141] Under the proposed legislation, in order to remove this

138. Federal Reserve Act of 1913, Dec. 23, 1913, ch. 6, 38 Stat. 251; Banking Act of 1933, June 16, 1933, ch. 89, 48 Stat. 162; Bank Holding Company Act of 1956, Pub. L. 89-485, 80 Stat. 236; Bank Holding Company Act Amendments of 1970, Pub. L. 91-607, 84 Stat. 1760.

139. According to Senator Proxmire's statement introducing the *Competition in Banking Act of 1975 (S. 2721)*, CONG. REC. S20790 (daily ed. Dec. 1, 1975), and based on court cases and private rulings by the Comptroller of the Currency, it appears that banks have engaged, or attempted to engage, in the following nonbanking activities: (1) operating an insurance agency, (2) underwriting securities other than those exempt under section 24 of Title 12, (3) privately placing non-exempt securities, (4) providing financial counseling services, (5) providing investment advisory services to closed-end investment companies, (6) operating mutual funds, (7) providing securities brokerage services, (8) operating travel agencies, (9) providing armored car services, (10) providing data processing services, and (11) leasing automobiles.

140. *See* note 62 *supra*.

141. *See generally* text accompanying notes 67-137 *supra*.

possibility, banks would be prohibited from soliciting orders to purchase or sell securities other than those securities now explicitly exempt from the restrictions of the Glass-Steagall Act.

Bank brokerage services would thus be limited to those for which the bank provides the service solely at an existing customer's request as an accommodation—the result intended by the Act. Banks would also be prohibited, for all intents and purposes, from engaging in private placement, as well as merger and acquisition activities.

Clarification of Glass-Steagall Prohibition on Bank Underwriting Municipal Revenue Bonds

Under the Act, banks are permitted to underwrite only general obligation bonds—those backed by the general taxing power of the issuing or guaranteeing jurisdiction—but not revenue bonds. In recent years there have been proposals that the Act be amended to exempt revenue bonds from its strictures. Those opposing such an amendment have observed that the same risks perceived by the Act's drafters in bank underwriting of corporate securities (and the temptation for banks to place such securities in portfolios under their management) exist in the case of revenue bonds, whose principal and interest are not backed by the general taxing power of the issuer or guarantor and thus must depend on the fortunes of a particular enterprise.

Recent events bear out the danger of expanding the Act's exemptions to permit banks to underwrite revenue bonds. The decline in the municipal securities market not only has resulted in a paper decline in the assets of many banks but also has affected the public's confidence in numerous banks with sizeable investments in municipal securities. The FRB, which had espoused the underwriting of revenue bonds by banks, recently changed its mind and, recognizing the potentially deleterious effects, expressed reservations about permitting banks to underwrite revenue bonds.[142] Moreover, as discussed above,[143] the entry of banks into the revenue bond underwriting business would not provide any beneficial increase in competition in that industry.

In addition, the Comptroller has interpreted the Act's exemption

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142. Testimony of Jeffrey M. Bucher, member, Board of Governors of the Federal Reserve System, *Securities Activities of Commercial Banks, Hearings Before the Securities Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 94th Cong., 1st Sess. 8 (1975).

143. *See* text accompanying notes 136-37 *supra*.

for general obligation bonds to include certain types of debt instruments having the characteristics of revenue bonds.[144]

It is proposed that the Act be amended to preserve and clarify the distinction Congress intended to draw between revenue bonds and general obligation bonds.

Implementation of a Clear and Definitive National Policy About What Is and Is Not Permissible Bank Activity

Experience has shown that when banks are able to choose among several regulators, each of which interprets and enforces the standard of permissible bank activities in a different manner, the possibility will exist that banks can gain more flexibility to expand their activities by switching characters;[145] in fact, they may find themselves at a competitive disadvantage if they do not. Non-uniformity of standards on a question of such importance contains the potential to frustrate the attainment of national policy objectives in the banking industry.[146] Although it is not our intention to offer suggestions on the subject of bank regulation, one can make the general observation that to preclude this problem, standards of permissible activity must be formulated and applied in a uniform manner, perhaps by delegating interpretive and enforcement authority to a single bank regulator or to a joint body comprised of representatives from each bank regulator.

CONCLUSION

The Securities Industry Association hopes that the issues addressed above will continue to be the subject of widespread discussion in Congress, elsewhere in government, and among members of the public. We believe these issues must be faced squarely and debated openly; in our view it would be a serious error to permit them to be resolved by default or through the momentum of events. We hope this response to the questions that current governmental inquiries have raised will serve to stimulate further discussion.

144. *See* Baker, Watts & Co. v. Saxon, 261 F. Supp. 247 (D.D.C. 1966), *aff'd* 392 F.2d 497 (1968).

145. See Bray, *Did the Bank Switch Rather Than Fight the Fed Examiners?*, WALL ST. J., Apr. 26, 1975, at 1, col. 1, for a discussion of First Pennsylvania Bank's change from a state to a federal charter, allegedly to take advantage of the Comptroller's more relaxed regulation. See Hackley, *Our Baffling Banking System*, 52 VA. L. REV. 565 (1966), for a discussion of 21 instances of disputes in the early 1960's between the Comptroller of the Currency, the FRB and the FDIC.

146. *See* note 1 *supra.*

Appendix I

Legislative History of the Glass-Steagall and Bank Holding Company Acts

A review of the legislative history of the Banking Act of 1933 (the Glass-Steagall Act), the Bank Holding Company Act of 1956, and the Bank Holding Company Act Amendments of 1970, evidences both congressional recognition that the combination of banking and nonbanking enterprises is inherently dangerous and a consistent congressional intent to separate banking from other areas of commerce.

The Glass-Steagall Act

The Glass-Steagall Act (the Act) was a product of congressional indignation over the role of national banks in fostering the prepanic speculation leading to the national financial crises of the 1920's and 1930's. Congress felt that the Federal Reserve System had been used to facilitate speculative securities operations and excessive amounts of securities loans, in total disregard of the system's purpose.[1]

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1. The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds. The effects of this situation in changing the whole character of the banking problem can hardly be overemphasized. National banks were never intended to undertake investment banking business on a large scale, and the whole tenor of legislation and administrative rulings concerning them has been away from recognition of such a growth in the direction of investment banking as legitimate. Nevertheless it has continued; and a very fruitful cause of bank failures, especially within the past three years, has been the fact that the funds of various institutions have been so extensively "tied up" in long-term investments.

S. Rep. No. 77, 73d Cong., 1st Sess. 8 (1933).

In this regard, Senator Glass, the Senate sponsor of the Act, speaking on the Senate floor, stated that:

> Not only has the Federal reserve banking system been used in an inordinate measure in stock-market transactions but there appears to have been an extraordinary misconception by the administrators of the act of its real purpose. In large degree the system has been transformed into an investment banking system, whereas the fixed purpose of Congress was to set up a commercial banking system and to preclude speculative operations . . . .
>
> Let me tell [the] Senators the meaning, and, in the last analysis, the result of that sort of administration of the law. It means that a member bank may engage in any sort of speculative business it may please, and then, when its reserve in the Federal reserve bank is impaired, it may take its eligible paper for rediscount and use the credit and the currency thus afforded to reestablish its reserve, and not to relend for "commercial, industrial, or agricultural purposes."
>
> That is an evasion of the intent, the spirit, and text of the Fed-

The "gambling fever" of the prepanic years was attributed to the rapid growth in the securities business of banks.[2]

The establishment of securities affiliates, which, Senator Glass said, made one of the "greatest contributions to the unprecedented disaster which has caused this almost incurable depression,"[3] had become prevalent as banks became aware of the profits to be derived from the distribution of securities,[4] despite the fact that the legality of the enterprise was at best questionable.[5] The report of the Senate Committee chronicles the abuses that crept into the affiliate system. "The greatest of such dangers is seen in the growth of 'bank affiliates' which devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank."[6]

> eral reserve banking act. It never was intended that its facilities should be used for investment purposes, or for speculative purposes, in that roundabout way.

75 CONG. REC. 9884 (1932).

2. Senator Walcott, a member of the Senate Banking and Currency Committee who addressed the Senate on the provisions of the Act relating to bank affiliates, described this process to his colleagues:

> It reached such a volume, there were so many willing purchasers, so much credit for investment purposes was available that there resulted a complete change in our banking system. . . . The commercial banking business in consequence of this extraordinary volume of security business declined. . . . The net result of it all was that we were in the flood tide of speculation. . . . How was all this expansion possible? . . . It took money, currency; it took a very expansive credit, which, of course, brought in the banks. As far back as 1911 the banks were investing heavily in securities, buying and selling securities. Most of the banks had been engaged in underwriting, and still are. The security business became such an important part of the operations of some of the banks, particularly of two or three of our larger banks, that some fear was occasioned that they would get away from the strictly commercial business for which they were organized and put out securities of doubtful value. . . . [T]here was a conflict between the business of marketing securities and the business of protecting depositors' money . . . . [T]he national banks engaged in the security business were compelled to divorce their security business from their banking operations, and the term "affiliates" came into being as the result of that divorce.

Id. at 9904.

3. *Id.* at 9887.
4. *Id.* at 9910 (remarks of Senator Bulkley).
5. *Id.* at 9911.
6. S. REP. No. 77, 73d Cong., 1st Sess. 10 (1933).

As Senator Glass described it:

> They sent out their high-pressure salesmen and literally filled the

The practice of the Bank of the United States in creating affiliates was cited as a "typical case of the excessive abuse of affiliates." Numerous undercapitalized affiliates were created, financed by shoe-string operations, and as suggested by Senator Walcott "of course it was inevitable that this great structure of innumerable affiliates should collapse."[7]

Senator Bulkley, another member of the Senate Committee on Banking and Currency who addressed Congress on the legislation, posed the following question: "When the national banks, through their affiliates, followed into the investment-banking business . . . the idea of increased profits more and more obsessed our bankers . . . . Did not professional pride become diverted from the pride of safe and honest banking service to that of profits, greed, expansion, power and domination?"[8] Much of the problem, it was believed, stemmed from the fact that permissive state bank regulation put pressure on the federal regulators to allow national banks to step beyond the boundaries of sound banking. In the words of Senator Walcott, the net result was "the disregard of a great many of the fundamentals of the banking business, taking chances with depositors' money, and the incorporation and rapid growth of the affiliate business, giving an outlet to that speculative type of business quite contrary to legitimate commercial banking."[9]

The banks, having set up sales departments to engage in the distribution of securities, now needed to cultivate sales markets in which to sell the securities and required securities to sell. Banks also made loans to facilitate stock purchases.[10] It became necessary

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> bank portfolios of this country with these investment securities. They actually dealt in the stocks of the parent bank; and one of them notably offended by running the stock of a parent bank above 500, and a few days ago it was down to 42. They were organized to evade the law. That is the very purpose of their existence—to evade the national bank act and to do a business outlawed by the national bank act—and yet they are so interlocked that it is difficult to tell which is which.

75 Cong. Rec. 9887 (1932).

7. *Id.* at 9905.

8. *Id.* at 9911.

9. *Id.* at 9906.

10. This practice, which fed the securities speculation, was condemned by Senator Walcott:

> It is evident from what has been said that the underlying factor in the whole prepanic situation was excessive use of bank credit . . . . The excessive use of bank credit in making loans for the purpose of stock speculation, or, more generally stated, for the excessive carrying of securities with borrowed money, was generally admitted before the panic of 1929, and almost universally since that time, to have been one of the sources of major difficulty, far exceeding in its scope any total that could be reasonably asked for as a basis for the financing of legitimate investment business.

Id.

to seek out issuers even though in some instances, it was thought, corporations had little or no need for long-term capital.[11] It was easy, Senator Bulkley stated, to see why on the one hand the security business was over-developed and why it overloaded the country with unfortunate investments.[12] On the other hand, he said, if "the business of originating and underwriting investment securities is confined to houses not engaged in deposit banking, then the extent and the desirability of new issues will be subjected to an independent and impartial check."[13] Moreover, the business of investment banking necessarily involved taking risks. If a securities affiliate suffered a loss, rumors might spread that the bank's financial condition would be impaired because of its loans to the affiliates. Rumors of stock price manipulation and other abuses of the distribution system, and the possibility of litigation against the banks, also posed a threat to depositors' confidence.[14] Senator Bulkley's conclusion was unequivocal: "If we want banking service to be strictly banking service, without the expectation of additional profits in selling something to customers, we must keep the banks out of the investment security business."[15]

The Bank Holding Company Act of 1956

The Bank Holding Company Act of 1956 (the 1956 Act), among other things, was intended to separate banking from other areas

11. Can any banker, imbued with the consciousness that his bond-sales department is, because of lack of securities for sale, losing money and at the same time losing its morale, be a fair and impartial judge as to the necessity and soundness for a new security issue which he knows he can readily distribute through channels which have been expensive to develop but which presently stand ready to absorb the proposed security issue and yield a handsome profit on the transaction?

Id. at 9911 (remarks of Senator Bulkley).

12. *Id.*

13. *Id.* at 9912.

14. Senator Bulkley considered the special role of the banker:

The banker ought to be regarded as the financial confidant and mentor of his depositors. . . . Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or any underwriting profit or a distribution profit or a trading profit or any combination of such profits.

Id.

15. *Id.*

of commerce. As stated in the Report of the Senate Committee on Banking and Currency (Senate Committee), "bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking."[16] As the following illustrates, such a separation was felt necessary to prevent banks from employing in nonbanking enterprises funds entrusted in them by depositors and to guard against banks taking unfair advantage in competing with nonbanking enterprises.

Concern over the safety of depositors' funds was expressed in several different ways. The then Chairman of the Board of Governors of the Federal Reserve System, William McChesney Martin, Jr., expressed concern over the use of depositors' funds in nonbanking businesses:

> Moreover, the ordinary nonbanking business requires a managerial attitude and involves business risks of a kind entirely different from those involved in the banking business. Banks operate largely on their depositors' funds. These funds should be used by banks to finance business enterprises within the limitations imposed by the banking laws and should not be used directly or indirectly for the purpose of engaging in other businesses which are not subject to the safeguards imposed by the banking laws.[17]

Chairman Martin also stated that the combination of banking and nonbanking enterprises "involves the lending of depositors' money, whereas other types of business enterprise, not connected with banking, do not involve this element of trusteeship."[18] The report of the House Banking and Currency Committee put it somewhat differently: "[B]anks are prohibited from engaging in any other type of enterprise than banking itself . . . [b]ecause of the danger to the depositors which might result where the bank finds itself in effect both the borrower and the lender."[19]

Aside from concern that biased and imprudent extensions of credit to nonbanking affiliates of a bank may seriously jeopardize the funds of its depositors, the report of the Senate Committee also warned that such "a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it controls."[20]

16. S. REP. No. 1095, 84th Cong., 1st Sess. 1 (1955).
17. *Hearings on S. 2577 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 84th Cong., 1st Sess. 75 (1955).
18. S. REP. No. 1095, 84th Cong., 1st Sess. 2 (1955).
19. H.R. REP. No. 609 ON H.R. 6227, 84th Cong., 1st Sess., *reprinted* in 101 CONG. REC. 8038, 8042 (1955).
20. S. REP. No. 1095, 84th Cong., 1st Sess. 14 (1955).

The report of the House Committee provides further illustration of this concern:

> If banks were permitted to own nonbanking businesses they would be compelled in many instances to extend credit to such businesses

The Bank Holding Company Act Amendments of 1970

The Bank Holding Company Act Amendments of 1970 (the Amendments) reflect not only the same congressional concerns that are revealed in the 1956 Act—that is, the safety of depositors' funds and unfair competition—but also concern over the concentration of economic power in bank holding companies. The primary purpose of the Amendments was to close the 1956 Act's one-bank holding company loophole in order to preserve the basic separation of bank and bank-related activities from other business activities.[21] The testimony at hearings, the floor debates, and the congressional reports consistently cite the problems of bank insolvency, unfair competition, and undue concentration in support of such a separation.[22]

> to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking viewpoint. A bank should always be at arms' length with its borrowers and such a position could not be maintained were banks permitted to own nonbanking businesses and make credit available to them.
>
> * * *
>
> Whenever a holding company thus controls both banks and nonbanking businesses, it is apparent that the holding company's nonbanking businesses may thereby occupy a preferred position over that of their competitors in obtaining bank credit. It is also apparent that in critical times the holding company which operates nonbanking businesses may be subjected to strong temptation to cause the banks which it controls to make loans to its nonbanking affiliates even though such loans may not at that time be entirely justified in the light of current banking standards. In either situation the public interest becomes directly involved.

H.R. REP. No. 609 ON H.R. 6227, 84th Cong., 1st Sess., *reprinted in* 101 CONG. REC. 8039, 8042 (1955).

21. H.R. REP. No. 1747, 91st Cong., 2d Sess. 11-12 (1970); *see* 115 CONG. REC. 32890 (1969) (remarks of Mr. Smith, member of the House Rules Commitee, in support of a resolution regarding House debate of one bank holding company legislation).

22. Chairman Martin discussed the potential threats to bank solvency in his testimony before the House Committee considering one bank holding company legislation:

> Considerations of safety and soundness reinforce the policy of separating banking and other businesses. A bank should be insulated from pressures that might lead it to favor customers of affiliated businesses in its credit decisions. Otherwise, the bank might build an unbalanced loan portfolio by discounting an excessive amount of obligations of such customers, or a low-quality portfolio by accepting substandard risks to foster sales to such customers. An essential part of the traditions of bank management has been a scrupulous observance of the need for prudence in handling funds entrusted to the bank by its customers; if management were to be-

The debates also raised the specter of unfair competition. Representative Patman, Chairman of the House Banking Committee, stated as one of the factors requiring closing of the one bank holding company loophole that threat of "[l]oan discrimination of banks in favor of enterprises owned by the holding company and against companies which compete with subsidiaries of the holding company."[23]

In his testimony at the Senate hearings, Federal Deposit Insurance Corporation Chairman Frank Wille cited both unfair competition and concentration of economic resources as reasons for one bank holding company legislation.[24] The possibility of economic concentration received wide attention in the deliberations leading

> come oriented toward the different objectives of other businesses, this tradition could be seriously weakened.

Hearings on H.R. 6778 Before the House Comm. on Banking and Currency, 91st Cong., 1st Sess. 197 (1969).

This concern was also mentioned by several participants in the House's floor debates.

> Depositors' funds in a bank doing business with a subsidiary business can be threatened because of the extension of unwise credit to the nonbanking subsidiary. Some of our largest banks in the 1920's were guilty of this type of activity, which caused detriment to depositors, stockholders, and the public at large.

115 CONG. REC. 32891 (1969) (remarks of Rep. Bennett, member of the House Rules Committee). *See also id.* at 32903 (remarks of Rep. Moorhead, member of the House Banking Committee).

23. *Id.* at 32893 (remarks of Rep. Patman). *See also id.* at 32891 (remarks of Rep. Bennett); *id.* at 32903 (remarks of Rep. Moorhead).

Richard W. McLaren, then Assistant Attorney General in charge of the Antitrust Division, testified before the Senate Committee considering one bank holding company legislation on this subject:

> The economic power enjoyed by banks is substantially enhanced by the fact that commercial banking markets are local markets for most customers. Competitive alternatives in local markets are few, and entry of new competitors is frequently restricted by legislative provisions or regulatory action. For substantial classes of financial customers in such markets, unable to journey conveniently and economically to distant metropolitan areas, local banks can be the sole suppliers of the services needed.

One Bank Holding Company Legislation of 1970, Hearings Before the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 239-40 (1970). *See also* Mr. McLaren's remarks before the House Committee in *The Bank Holding Company Act Amendments, Hearings Before the House Comm. on Banking and Currency*, 91st Cong., 1st Sess. 91-92; textual note 94 *supra*.

24. The [FDIC] believes that the activities of one-bank holding companies should be brought promptly under effective regulatory control at the Federal level in order to prevent an unhealthy concentration of the nation's economic resources and to control possible anticompetitive practices in the allocation of credit and financial services within the nation's economy.

One Bank Holding Company Legislation of 1970, Hearings Before the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 172 (1970).

up to the enactment of the Amendments.[25] Aside from general discussion on the floor of the House of the dangers of concentration at which the Amendments were aimed,[26] much concern was expressed over the potential threat to the economy of the rumored merger of four of the largest banks in New York and four of the nation's largest insurance companies.[27]

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25. In a statement accompanying the administration's version of a bill to regulate one bank holding companies, the President said:

> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.
>
> The strength of our economic system is rooted in diversity and free competition; the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it.

H.R. REP. NO. 1747, *to accompany* H.R. 6778 (Conference Report), 91st Cong., 2d Sess. 11-12 (1970).

The Conference report accompanying the bill which was enacted into the 1970 Amendments also discussed the dangers of undue concentration:

> The danger of undue concentration of economic resources and power is one of the factors which led to the enactment of this legislation, and constitutes a significant threat to the continued healthy evolution of our free economy. American trade has always operated on the principle that relationships between businessmen, large and small, should be founded on economic merit rather than monopoly power. Our national policies of limited governmental regulation and interference in trade and commerce, however, do make it possible for undue concentrations of resources and economic power to override fundamental fairness and economic merit when responding to the profit motive. This possibility is enhanced when concentrations of power are centered about money, credit and other financial areas, the common denominators of the economy. The dangers may be more pronounced where resources are more easily capable of being marshalled, or where the course of business is likely to lead to the constant realization of the existence of power by buyers and sellers in the marketplace.

Id. at 17.

26. 115 CONG. REC. pt. 24, at 32894, 91st Cong., 1st Sess. (Nov. 4, 1969) (remarks of Rep. Patman). *See also id.* at 32891 (remarks of Rep. Bennett); *id.* at 32903 (remarks of Rep. Moorhead).

27. This concern included this statement by Chairman Patman during the House debate:

> In addition, serious questions were raised by several witnesses during our hearings on H.R. 6778, including leading economists, concerning the tremendous economic power that would be created by the concentration of giant insurance companies and large banks under a single holding company umbrella. The assets of commercial banks and insurance companies comprise most of the assets available for use by all the institutional investors in the United States. Insurance companies and banks combined control roughly $865 billion, or 77.2 percent of the $1.1 trillion of institutional in-

Conclusion

To summarize, one of the primary goals of banking legislation since 1933 has been the separation of banking from other areas of commerce. The Glass-Steagall Act was enacted in reaction to the abuses of banks and their securities affiliates in participating in the speculative fervor of the 1920's which led to the stock market crash in 1929. The Act effectively ended bank participation in the securities industry for many years.

By 1956, the phenomenon of bank holding companies engaged in businesses other than banking was in part responsible for the enactment of the Bank Holding Company Act of 1956. Behind its provisions separating commerce and banking were concerns that a combination of the two would unnecessarily jeopardize the funds of depositors and lead to unfair competition with nonbanking enterprises.

In addition to dealing with the two concerns discussed above, the 1970 Amendments were passed to prevent the undue concentration of resources which was feared might result from the discovery by the nation's largest banks of the one-bank holding company loophole in the 1960's.

> vestors in the American economy. Commercial banks alone control \$646 billion, or 57.7 percent of this total. Various news media have indicated possible mergers, through the holding company device, of several of the largest commercial banks and largest insurance companies in the country. One such merger was dropped last winter after the Justice Department brought suit. However, we cannot rely in the long run on such administrative action. We should legislatively prohibit such massive concentrations of economic power. There is no justification for them. By permitting a combination of banks and insurance companies, a tremendous concentration of financial resources would be attained to the detriment of the public interest.

Id. at 32897.

APPENDIX IIA

[Letterhead of the Administrator of National Banks]
November 11, 1974

[Addressee deleted]

Dear

This is in response to your letter of August 14, 1974, and to earlier correspondence dated March 18, 1974 from [name deleted] of [name deleted] to which we replied on April 19.

[Name deleted], a subsidiary of [name deleted], Inc., requests permission to form an operating subsidiary pursuant to Interpretive Ruling 7.7376. The activities of the proposed subsidiary are described as follows:

> 1—The subsidiary will manage the business affairs of First [name deleted], a small business investment company licensed by the Small Business Administration and wholly owned by the bank. Personnel now employed by [name deleted] will be transferred to the proposed subsidiary, but [name deleted] will continue to have its own board of directors.
>
> 2—The subsidiary will provide financial counselling services, including advice and counselling regarding appropriate forms of financing, and will collect fees for such services, except that no fee will be collected from a customer for counselling related to that part of a financing provided by any direct or indirect subsidiary of the holding company.
>
> 3—The subsidiary will provide financial analysis and advice to customers in connection with acquisitions, mergers and reorganizations.
>
> 4—The subsidiary will not perform legal, accounting, insurance or real estate brokerage services.

Financial counselling has long been an integral part of the business of banking. Not only do individual customers frequently seek bank advice regarding their financial affairs, but business enterprises also need counsel on a wide range of matters relating to the capitalization and financial structure of their operations. Since loan officers, who have traditionally been the source of financial counselling to individuals, may not possess the necessary sophistication to advise corporations on their financial requirements, it is logical that a bank would want to assemble a group of specialists in corporate finance to fill this need. Indeed, many large banks have organized corporate finance departments.

Financial counselling may take a variety of forms. For the moment, [name deleted] intends to provide customers with financial counselling services on a long-term basis pursuant to contracts calling for a specified number of hours of counselling per month at a fixed rate. Customers not under financial counselling contracts will be able to purchase similar advice for specific projects. In both cases, the advice rendered will cover the whole range of financial problems that businesses must deal with from time to time.

The subsidiary's services will also include advising customers regarding appropriate types of financing. These services will include an in-depth review of the customer's current financial condition and future needs, following which the subsidiary will prepare a detailed plan of financing suitable for the customer (which may consist of debt securities, equity securities or a combination thereof) based upon conditions in the financial market and the types of lenders most likely to be interested in providing the suggested financing (*e.g.*, insurance companies, pension plans, SBIC's, trust funds, etc.).

With respect to the preparation of detailed plans of financing for business customers, the bank should understand that its activities in this area could bring the subsidiary close to the borderline between the permissible activity of financial counselling and the business of investment banking. This could occur if the subsidiary undertook to locate a purchaser of a client's securities, or assisted materially in the negotiations between the client and the purchaser, or charged its client a fee contingent upon successful placement of the securities by the bank. Under section 21 of the Glass-Steagall Act, 12 U.S.C. 378, banks may not, with certain exceptions, engage in the business of issuing, underwriting, selling or distributing securities. The possibility of a violation of this statute by the bank's new subsidiary is increased by the fact that at least one officer of the subsidiary was formerly employed by a venture capital firm in New York City. We must caution therefore that the operations of the subsidiary be confined strictly to those set forth above, namely, the rendering of financial advice only. Thus, the bank will not be permitted to participate in any significant way in negotiations between its client and prospective purchasers of equity or debt issues, and may not charge a fee contingent upon the successful placement of securities. The extent to which the bank contacts prospective purchasers is a matter we will leave to bank counsel, but as a general matter we do not believe it would be inconsistent with the Glass-Steagall Act if the bank, after making preliminary inquiries of potential purchasers, furnished its customer with the names of possible investors with whom the customer could then undertake negotiations on its own.

Very truly yours,
/s/ J.D. Gwin
John D. Gwin
Deputy Comptroller of the Currency

APPENDIX IIB

[Letterhead of the Administrator of National Banks]

January 15, 1975

[Addressee deleted]

This is in response to your letter of September 24, 1974, with reference to a proposal from [name deleted].

The Proposal

The bank proposes to organize a new division, [name deleted] Finance Company, to provide financial consulting advice to its corporate customers. This service will initially assist a client in determining his long term financial objectives. Alternative plans of attaining these objectives will then be devised and after a selection is made, the bank, through its new division, will assist in the implementation.

In the event that a client decides to issue debt or equity securities, the bank will, in the case of a public offering, help the client in choosing and dealing with an investment banker. In the case of a private placement, the bank will advise the client of possible sources of capital and assist in preparing a presentation to such sources, including the drafting of an offering memorandum and providing the necessary financial information.

If the client decides on a merger, the new division will advise and assist the client in negotiations with the other party.

Agreements between the new division and its client will provide for:

(a) Payment of fees for services rendered, based upon the time spent or the results accomplished, or both; and

(b) Permit a complete interchange of information betweeen the division and the bank's loan and credit departments with regard to any division client who is or may become a borrower of the bank.

Discussion

Financial counselling has long been an integral part of the business of banking. Not only do individual customers frequently seek bank advice regarding their personal finances, but business enterprises also need counsel on a wide range of matters relating to the capitalization and financial structure of their operations. Since loan officers, who have traditionally been the source of financial counselling to individuals, may not possess the necessary sophistication to advise corporations on their financial requirements, it is logical that a bank would want to assemble a group of specialists in corporate finance to fill this need. Indeed, many large banks have organized corporate finance departments.

Because financial counselling is a general concept, further inquiry is necessary to determine the specific activities that come under this heading. The purpose of this inquiry is to establish which activities are proper for commercial bankers and which are reserved to investment bankers under section 21 of the Glass-Steagall Act. *Cf.*, Investment Company Institute v. Camp, 401 U.S. 617, 629 (1971).

First, we think that Glass-Steagall cannot be read as prohibiting commercial bankers from performing all the activities that investment bankers perform. Since both commercial and investment bankers are in the business of furnishing financial advice, there will inevitably be some overlap. In addition, section 21 of Glass-Steagall bars commercial banks from only four specific areas: issuing, underwriting, selling or distributing securities. Activities which fall short of these four areas and which are also incidental to a commercial bank's function are therefore open to commercial banks.

For example, we feel that assisting a client in determining his long term financial objectives is not only well within what bankers have done in the past and are expected to do by their corporate customers, but also far short of anything Glass-Steagall intended to prohibit. Preparing alternative routes for achieving these objectives and furnishing advice on the execution of a memorandum describing the alternative selected, are natural adjuncts to this kind of financial counselling. None of these activities constitutes issuing, underwriting, selling or distributing securities within the Glass-Steagall Act.

On the other hand, underwriting an issue of securities is clearly off-limits to commercial banks. This means that a bank may not extend a firm commitment to purchase an issue with a view to selling the same, nor may a bank promise only its "best efforts" to market an issue. These activities rest at the heart of the business known as investment banking and undoubtedly constitute a proscribed underwriting, selling or distribution of securities.

In the twilight zone lies the degree to which a bank may solicit purchasers for a client's private placement, the extent to which the bank may participate in the negotiations between buyer and seller, and the fee that the bank may charge its client.

With regard to the bank's role in seeking investors to purchase a new issue, we think the bank is free to pass on to its client the names of prospective purchasers who in the bank's judgment may be interested in making an investment. This kind of information comes to a bank every day in the course of its normal business operations. We also would not object if the bank made preliminary inquiries of several investors to determine their interest in the new issue.

This does not mean, however, that the bank can participate in the actual negotiations between its client and the prospective purchaser. Inevitably, a banker who engages in negotiations of this sort ends us acting as middleman trying to bring buyer and seller together. It is precisely this role that lies at the heart of the investment banking business. CARESSO, INVESTMENT BANKING IN AMERICA, ix, xi, 1, 9, 13 (1970). A banker who participates to any substantial degree in the direct negotiations between client and purchaser may well be engaged in underwriting, selling or distributing securities in violation of the Glass-Steagall Act.

With respect to fees, we think the bank cannot, consistent with the above mentioned ban on "best efforts" underwriting, charge a fee contingent upon the successful placement of a private offering, since the levying of such a fee is a strong incentive for the bank to locate a purchaser with whom a deal can be made. Therefore, fees will have to be based on time expended or some criterion other than the success of the placement.

Raising capital by issuing securities can be accomplished in myriad ways. *See*, for example, the various methods listed in United States v. Morgan, 118 F. Supp. 621, 651 (S.D.N.Y. 1953). Beyond the guidelines set forth above, it is impossible for us to define what the role of the bank should be in each case. The degree to which a bank should become involved in direct negotiations leading to a merger between its client and another party, where new stock will be issued, is another question to which this letter is not addressed. In such situations, bank counsel must guide the bank past the shoals of the Glass-Steagall Act. In the meantime, we ask that the bank follow the guidelines set out in this letter when judging the propriety of its activities. We will be happy to discuss with bank counsel any aspect of this letter.

Very truly yours,
/s/ J. T. Watson
Justin T. Watson
Deputy Comptroller of the Currency

APPENDIX III

Bank Term Loan Syndications

This announcement appears as a matter of record only.

OXIRANE

$232,800,000
Project Financing

Agent and Manager
CHEMICAL BANK

Funds Provided By
CHEMICAL BANK
Bank of America N.T. & S.A. • The Bank of New York
The Bank of Nova Scotia • Security Pacific National Bank
Texas Commerce Bank National Association • Irving Trust Company
Bank of Montreal (California) • European-American Bank and Trust Company
Marine Midland Bank • National Bank of Detroit
Republic National Bank of Dallas • Toronto Dominion Bank of California
Bank of the Southwest • First City National Bank of Houston • California First Bank
The Bank of Tokyo Trust Company • Dresdner Bank AG (Los Angeles Branch)
Wells Fargo Bank N.A. • Houston National Bank

Source: WALL ST. J., Jan. 15, 1976, at 20, cols. 4-6.

This announcement appears as a matter of record.

$67,000,000

Production Payment Financing for

The Pittsburg & Midway Coal Mining Company

a wholly-owned subsidiary of

Gulf Oil Corporation

From coal production.

Arranged by

CONTINENTAL BANK

Funds provided by

Continental Bank
Continental Illinois National
Bank and Trust Company of Chicago

Bank of America NT & SA

Morgan Guaranty Trust Company of New York

Philadelphia National Bank

Pittsburgh National Bank

First National Bank of Denver

Source: WALL ST. J., Jan. 7, 1976, at 21, cols. 4-6.

$350,000,000

Mobil Oil Corporation

5-year production payment

FINANCING MANAGED BY:

MORGAN GUARANTY TRUST COMPANY OF NEW YORK

FUNDS PROVIDED BY:

MORGAN GUARANTY TRUST COMPANY OF NEW YORK
FIRST NATIONAL CITY BANK

THE CHASE MANHATTAN BANK, N.A.

BANK OF AMERICA NT & SA
CHEMICAL BANK
MANUFACTURERS HANOVER TRUST COMPANY

BANKERS TRUST COMPANY

THE BANK OF NEW YORK
THE BANK OF NOVA SCOTIA - NEW YORK AGENCY
CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO
FIRST CITY NATIONAL BANK OF HOUSTON
FIRST NATIONAL BANK IN DALLAS
THE FIRST NATIONAL BANK OF BOSTON
FIRST PENNSYLVANIA BANK, N.A.
IRVING TRUST COMPANY
MARINE MIDLAND BANK
MELLON BANK, N.A.
NATIONAL BANK OF DETROIT
REPUBLIC NATIONAL BANK OF DALLAS
THE ROYAL BANK OF CANADA
SECURITY PACIFIC NATIONAL BANK
TEXAS COMMERCE BANK NATIONAL ASSOCIATION
TORONTO DOMINION BANK - NEW YORK AGENCY
UNITED CALIFORNIA BANK
UNITED STATES TRUST COMPANY OF NEW YORK

Source: WALL ST. J., Feb. 26, 1976, at 27, cols. 1-3.

This announcement appears as a matter of record only.

The Kingdom of Thailand

U.S. $100,000,000

Five Year Term Loan

Provided by

Manufacturers Hanover Trust Company
Bank of America National Trust & Savings Association   Bank of Montreal *Singapore Branch*
Crocker National Bank   Union Bank of Switzerland *London Branch*
The Hongkong and Shanghai Banking Corporation
Standard Chartered Bank Limited
Bangkok Bank Limited   Thai Farmers Bank Limited *London Branch*
Bankers Trust Company   The Bank of Tokyo Trust Company
Chase Asia Ltd.   Chemical Bank   Citibank, N.A.
Commerzbank Aktiengesellschaft   Compagnie Financière de la Deutsche Bank AG
Dresdner (South East Asia) Limited—*Dresdner Bank Group*   The Mitsui Bank of California
Banque Française du Commerce Extérieur

Arranged by

Manufacturers Hanover Limited

March, 1976

Source: WALL ST. J., Mar. 26, 1976, at 18, cols. 4-6.

This announcement appears as a matter of record only

Bank Sanaye Iran
US $40,000,000

Five-Year Term Loan

Arranged by

Iran Overseas Investment Bank Limited (Iranvest)

Managed and Provided by

Compagnie Financière de la Deutsche Bank AG
Société Générale
The Chase Manhattan Bank, N.A.
Iran Overseas Investment Bank Limited
Wells Fargo Bank N.A.
Crocker National Bank
Rabomerica International Bank NV
International Mexican Bank Limited -Intermex-
Marine Midland Bank
Bayerische Vereinsbank International SA
Commerzbank AktienGesellschaft
Manufacturers Hanover Trust Company
Bankers Trust Company
Manufacturers Hanover Banque Nordique
Banque Commerciale pour l'Europe du Nord (Eurobank)

Agent Bank

Iran Overseas Investment Bank Limited (Iranvest)

Source: WALL ST. J., Mar. 12, 1976, at 18, cols. 1-2.

APPENDIX IV

Excerpt from Loan Agreement Between Downe Communication, Inc. and Bank of New York and First National City Bank

13. *Negative Covenants.* So long as the Company may borrow hereunder and until payment in full of the Notes and the Term Loan Notes and performance of all other obligations of the Company hereunder, without the written consent of the Banks, the Company will not:

(a) *Borrowing.* Create, incur, assume or suffer to exist any liability for borrowed money, or permit any Subsidiary so to do, except (i) indebtedness to the Banks, (ii)indebtedness of the Company or any Subsidiary secured by mortgages, encumbrances or liens permitted by subparagraph 13(b) hereof, (iii) indebtedness for borrowed money existing on December 31, 1971 as set forth on Schedule 9 hereto, and (iv) letters of credit and discounted notes as set forth on Schedule 10 hereto.

(b) *Mortgages and Pledges.* Create, incur, assume or suffer to exist any mortgage, pledge, lien or other encumbrance of any kind (including a charge upon property purchased under conditional sales or other title retention agreements) upon, or any security interest in, any of its property or assets, whether now owned or hereafter acquired, or permit any Subsidiary so to do, except (i) liens for taxes not delinquent or being contested in good faith and by appropriate proceedings, (ii) liens in connection with workmen's compensation, unemployment insurance or other social security obligations, (iii) deposits or pledges to secure bids, tenders, contracts (other than contracts for the payment of money), leases, statutory obligations, surety and appeal bonds and other obligations of like nature arising in the ordinary course of business, (iv) mechanics', workmen's, materialmen's or other like liens arising in the ordinary course of business with respect to obligations which are not due or which are being contested in good faith, (v) the pledge being made pursuant to the Pledge Agreement, and (vi) those mortgages, pledges, liens and encumbrances set forth on Schedule 7 hereto or any refinancings (up to the same amount) thereof.

(c) *Merger, Acquisition or Sale of Assets.* Enter into any merger or consolidation or acquire all or substantially all the assets of any person, firm, joint venture or corporation, or sell, lease, or otherwise dispose of any of its assets except in the ordinary course of its business, or permit any Subsidiary so to do.

(d) *Loans and Investments.* Make loans or advances to or investments in any person, firm, joint venture or corporation, or permit any Subsidiary so to do, except (i) loans existing on December 31, 1971 as set forth on Schedule 11 hereto, (ii) purchases of direct obligations of the United States of America or any agency thereof, certificates of deposit or acceptances of banks or trust companies having total assets in excess of $1,000,000,000, or commercial paper rated prime by a nationally recognized rating service provided that none of the foregoing shall have maturities in excess of one year at the date of the purchase thereof; (iii) loans or advances to or investments in a presently existing Subsidiary and, to the extent consented to by the Banks, any new Subsidiary; and (iv) investments represented by the securities of other companies being pledged in accordance with the Pledge Agreement.

(e) *Contingent Liabilities.* Assume, guarantee, endorse, contingently agree to purchase or otherwise become liable upon the obligation of any person, firm, joint venture or corporation, or permit any Subsidiary so to do, except (i) by the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of business and (ii) those contingent liabilities set forth on Schedule 12 hereto.

(f) *Capital Expenditures.* Make any capital expenditures, or permit any Subsidiary so to do, in any one fiscal year exceeding in the aggregate for the Company and the Subsidiaries $600,000.

(g) *Dividends and Purchase of Stock.* Declare any dividends (other than dividends payable in capital stock of the Company) on any shares of any class of its capital stock, or apply any of its property or assets to the purchase, redemption or other retirement of, or set apart any sum for the payment of any dividends on, or for the purchase, redemption or other retirement of, or make any other distribution by reduction of capital or otherwise in respect of, any shares of any class of capital stock of the Company, or permit any Subsidiary (all of whose outstanding shares are not owned by the Company or another Subsidiary) so to do, or permit any Subsidiary to purchase or acquire, any shares of any class of capital stock of the Company.

(h) *Sale and Leaseback.* Directly or indirectly enter into any arrangement whereby the Company or any Subsidiary shall sell or transfer all or any substantial part of its fixed assets then owned by it and shall thereupon or within one year thereafter rent or lease the assets so sold or transferred.

(i) *Obligations as Lessee.* Enter into any agreements as lessee of any tangible or intangible property, whether real property, machinery, equipment, personal property or fixtures or permit any Subsidiary so to do, if the aggregate of all rental payments by the Company and the Subsidiaries shall exceed an annual rate of $2,100,000.

(j) *Stock of Subsidiaries.* Sell or otherwise dispose of any shares of capital stock of any Subsidiary (except in connection with a merger or consolidation, to the extent permitted under this Agreement, of any Subsidiary into the Company or into another Subsidiary or the dissolution of any Subsidiary) or permit any Subsidiary to issue any additional shares of its capital stock except pro rata to its stockholders.

(k) *Dissolution, etc.* Dissolve or liquidate or permit any Subsidiary so to do.

(l) *New Business.* Engage in any business, or permit any Subsidiary to engage in any business, not of the same general types now conducted by it. The sale of additional products by mail order, including the sale of additional types of insurance, shall not, for the purposes of this Agreement, be deemed a new business.

(m) *Advertising.* Accept or permit any Subsidiary to accept securities of others in payment for advertising.

(n) *Liabilities of Subsidiaries.* Permit any Subsidiary to have any liabilities except (i) liabilities in the ordinary course of business to the Company or any other Subsidiary, (ii) liabilities for the payment of borrowed money to the Company, (iii) current liabilities to others incurred or accrued in the ordinary course of business and (iv) liabilities otherwise permitted under this Agreement.

Source: Form 8-K filed by Downe Communications, Inc. with the SEC, May 12, 1972.

APPENDIX V

Foreign Banks with Securities Affiliate in United States as of December 31, 1974

FOREIGN BANK	SECURITIES AFFILIATE	DOMESTIC BANKING OPERATIONS (IF ANY)
Algemene Bank Nederland NV	25% interest in ABD Securities Corp.	New York rep. & branch; Chicago branch; San Francisco Rep.
Amsterdam-Rotterdam Bank NV	Interest in SoGen-Swiss International.	One of six shareholders in European-American Bank & Trust (N.Y.), European-American Corp. (Cal.) one of 7 in European Banking Co. Ltd., branch in Chig., agency in L.A.
Banca Commerciale Italiana	Minority interest in Model, Roland & Co.	One of seven in European Banking Co., Ltd., branch in Chig.
Banco Ambrosiano	75% of Ultrafin International Corp.	(None)
Banca Di Roma	33% of Europartners Securities Corp.	Banco di Roma (Chicago); San Francisco Agency, New York Agency Rep.
Bank Leumi Le-Israel B.M.	Leumi Securities Corp. (Israel Secs.)	Branches in N.Y., Miami Rep.
Bank of Tokyo, Ltd.	5% of Nomura Securities Int., Inc.	Rep. in Chicago, majority of Bank of Tokyo of California, 4.95% of Chicago Tokyo Bank. Majority of Bank of Tokyo Trust Co. (N.Y.) agency in N.Y.; Portland branch, Seattle branch, Houston Rep.
Banque de Bruxelles	25% of ABD Securities Corp.	Representatives in New York.
Banque de L'Indochine	50% of Suez American Corp.	Branch in New York.
Banque Lambert	Interest in New Court Securities Corp.	(None)
Banque Rothschild	Interest in New Court Securities Corp.	(None)
Bank Julius Baer & Co., Ltd.	Baer Securities Corp.	Baer American Credit Corp., Ltd. (international finance corp.) (N.Y.)
Bayerische Hypotheken-und-Wechsel-Bank	25% of ABD Securities Corp.	(None)

Foreign Bank	Securities Affiliate	Domestic Banking Operations (if any)
Commerzbank AG	33% of Europartners Securities Corp.	Branch in Chicago and New York
Compagnie Financiere de Paris et des Pays-Bas	20% interest in Becker and Warburg-Paribas Group, Inc., holding co. for: (a) Warburg Paribas Becker, Inc.; (b) A.G. Becker & Co., Inc.; (c) Becker Securities Corp.	(None)
Compagnie Financiere de Suez	50% of Suez American Corp.	New York representative
Credit Lyonnais	33% of Europartners Securities Corp.	New York Branch and representative
Daiwa Bank Ltd.	6.9% of New Japan Securities Int., Inc.; 2.2% of Nomura Securities International Inc.	New York and Los Angeles agencies
Deutsche Bank AG	50% of UBS-DB Corp.	One of six in European-American Bank & Trust and one of seven in European-American Bank Co., Ltd.
Dresdner Bank AG	25% of ABD Securities Corp.	Chicago and New York branch; L.A. agency.
Robert Fleming & Co., Ltd.	Robert Fleming, Inc.	(None)
Fuji Bank Ltd.	2.3% of Nikko Securities International Inc.; 8.5% of Yamaichi International	L.A. and New York agency; Chicago Representative, Fuji Bank and Trust Company (N.Y.).
Hill Samuel & Co., Ltd.	Hill Samuel Securities Corp.	(None)
Industrial Bank of Japan	3.4% of Daiwa Securities Co., Ltd.; 9.4% of New Japan Securities International Inc.; 2.3% of Nikko Securities International, Inc.; 2.1% of Nomura Securities International, Inc.; 8.5% of Yamaichi International Inc.	New York and Los Angeles agency; Industrial Bank of Japan Trust Co. (N.Y.).

Kleinwort Benson Ltd.	Kleinwort Benson, Inc.	(None)
Kredietbank NV	Partial interest in Ultrafin International, Inc.	New York representative.
Long-Term Credit Bank of Japan Ltd.	3.4% of Daiwa Securities Inc.	New York branch.
Mitsubishi Bank Ltd.	2.5% of Nikko Securities International, Inc.; 8.5% of Yamaichi International, Inc.	Los Angeles agency; Chicago representative; Mitsubishi Bank of California