Facing the Future – Life Without Glass-Steagall

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The Glass-Steagall Act (Glass-Steagall or the Act)\(^1\) is among the last of a dying breed of bank regulatory statutes enacted when bank regulation was in its infancy and Congress' response to banking problems was to erect rigid walls confining financial institutions to narrow bounds. Interstate banking barriers\(^2\) and interest rate ceilings\(^3\) are other prominent members of that class of statutes which, like Glass-Steagall, for so many years insulated the banking system from competitive pressures and perceived threats to banking safety and soundness but left it ill-equipped to adapt to the changes wrought by inflation, new competitors, and technological innovations. These forces have redefined the financial services marketplace on a global scale, making the old boundaries within which banks are allowed to compete largely irrele-

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\(^2\) The McFadden Act, 12 U.S.C. § 36 (1982), generally prohibits a national bank from establishing branch offices outside of the state where it is headquartered. The Douglas amendment to the Bank Holding Company Act (BHCA) of 1956, § 3(d), 12 U.S.C. § 1842(d) (1982), prohibits a bank holding company from acquiring banks outside of the state where the operations of its banking subsidiaries are principally conducted. An exception to this prohibition is provided when laws of the state in which the bank to be acquired is located specifically authorize the acquisition of a state bank by an out-of-state bank holding company. 12 U.S.C. § 1842(d) (1982).

\(^3\) Congress first granted the Federal Reserve Board the authority to impose limits on the maximum interest rates payable on time deposits by banks in the Banking Act of 1933, ch. 89, § 11(b), 48 Stat. 162 (current version at 12 U.S.C. § 371b (1982)). Later, similar authority over rates paid by nonmember insured banks was vested in the Board of Directors of the Federal Deposit Insurance Corporation (FDIC). Act of September 21, 1950, ch. 967, § 218g, 64 Stat. 873, 891 (codified as amended at 12 U.S.C. § 1828q (1982)).
vant to economic realities.\footnote{For a general discussion of the changing dynamics of the financial services industry, see \textit{Structure and Regulation of Financial Firms and Holding Companies: Hearings Before the Subcomm. of the House Comm. on Government Operations}. 99th Cong., 2d Sess. (1986) [hereinafter \textit{Structure and Regulation Hearings}].}

While interstate and interest restrictions have yielded to this market evolution,\footnote{As of September 9, 1987, all but six states had enacted statutes permitting out-of-state bank holding companies some form of entry. \textit{Bank Trigger Dates}. \textit{Am. Banker}, Sept. 9, 1987, at 15, col. 1. Ceilings on the amount of interest that a bank may pay on deposits were phased out as a result of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C. (1982)). Congress found that interest ceilings “discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds, and have not achieved their purpose of providing an even flow of funds for home mortgage lending.” 12 U.S.C. § 3501 (1982).}

Glass-Steagall still stands as an artificial barrier preventing commercial banks from entering natural markets for bank securities products. As a result, the profitability and asset quality of commercial banks have seriously declined and their viability as the bulwarks of the nation's financial and monetary system is in question.\footnote{See generally \textit{FEDERAL RESERVE BANK OF NEW YORK, RECENT TRENDS IN COMMERCIAL BANK PROFITABILITY: A STAFF STUDY} (1986) [hereinafter \textit{COMMERCIAL BANK PROFITABILITY STUDY}]. The study attributes the decline in bank profitability, deterioration in the quality of bank assets, and lagging stock price performance to a series of economic, competitive, and technological changes occurring in the past decade. The Comptroller of the Currency has attributed this trend in large part to outdated regulatory restraints: There is a disturbing longer term trend . . . which indicates that profitability and asset quality may continue to deteriorate. In addition to the sectoral economic problems, commercial banks face increasingly intense competition. Current laws and regulations limit the ability of commercial banks to respond to this competition. I am concerned that unless something is done to give banks additional flexibility to respond to competitive pressures, there exists the potential for an erosion of the safety and soundness of the banking system. \textit{Financial Condition of Federally Insured Depository Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs}, 100th Cong., 1st Sess. 11 (1987) [hereinafter \textit{Financial Condition Hearings}] (statement of Robert L. Clarke, Comptroller of the Currency). Similarly, the Chairman of the FDIC has warned that “[t]he archaic system of laws under which the banking industry operates has created inefficiencies in the system that are contributing to some disturbing trends in the banking industry . . . .” \textit{Id.} at 22 (statement of L. William Seidman, Chairman, FDIC).}

The fateful consequences posed to the future of the banking system by a prolongation of Glass-Steagall have led banks and their federal regulators to appeal to Congress for repeal of the Act.\footnote{The Federal Reserve Board, the FDIC, and the Comptroller of the Currency each have issued studies or public statements questioning Glass-Steagall’s relevance in today’s financial marketplace. \textit{See generally The Financial Modernization Act of 1987 and the Financial Services Oversight Act: Hearings on S. 1886 and S. 1891 Before the Senate Comm. on Banking, Housing, and Urban Affairs}, 100th Cong., 1st Sess. 2-11 (1987) [hereinafter Greenspan Testimony of Dec. 1, 1987] (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).} Although Congress has turned a
deaf ear to similar pleas in the past, key members of Congress are now focusing congressional attention on the need for comprehensive review of the Glass-Steagall framework. Extensive hearings have been held and numerous bills to dismantle Glass-Steagall have been introduced in Congress, including the Proxmire Financial Modernization Act of 1988 (S. 1886), which was passed by the United States Senate on March 30, 1988 by an overwhelming vote of ninety-four to two. Notwithstanding enactment of a temporary congressional moratorium on expanded securities activities and the


setback to reform efforts as a result of "Black Monday," the legislative groundwork is being laid for the inevitable demise of Glass-Steagall, if not in the 100th Congress, then in the 101st.

Of course, Glass-Steagall's repeal does not mean that banks will be given carte blanche to expand their securities activities without any limitations. Only the most unreconstructed free marketeer would advocate allowing banks to place depositors' funds at risk by underwriting corporate equities, at least not without fundamental changes in the federal deposit insurance system. Rather, what seems more likely is that the separate affiliate concept will be adopted, under which banking organizations could engage in expanded securities activities only through separately incorporated and operated affiliates, and with restrictions imposed to insulate the banks from such affiliate activities. This approach, embraced by S. 1886, also would allow securities firms to own banks, thereby softening political opposition to

moratorium on new securities activities until March 1, 1988. The moratorium's stated purpose was to give Congress time "to conduct a comprehensive review of our banking and financial laws and to make decisions on the need for financial restructuring legislation in the light of today's changing financial environment both domestic and international before the expiration of such moratorium." Id. § 203(a). Congress also stated in the CEBA that "[i]t is the intent of Congress not to renew or extend the moratorium . . . ." Id. § 203(b). The moratorium was allowed to expire on March 1, 1988.


12. While the Senate has approved Glass-Steagall reform legislation in the 100th Congress, the climate in the House for such legislation in the 100th Congress appears more speculative. See Aide, Dingell Stands Firm Against Underwriting, Am. Banker, Mar. 8, 1988, at 9, col. 2. However, even the securities industry has recognized that Glass-Steagall repeal is inevitable. See Horowitz, Glass-Steagall's Demise is Predicted, Am. Banker, Dec. 5, 1986, at 3 (prominent securities industry executives predict the downfall of Glass-Steagall).

13. For example, S. 1886 would repeal only theGlass-Steagall prohibitions on bank affiliations and interlocks with securities firms, 12 U.S.C. §§ 377, 378 (1982), leaving generally intact Glass-Steagall's limitations on securities activities conducted directly in banks.

Glass-Steagall reform generated by the securities industry.15

This Article argues for repeal of Glass-Steagall and examines the separate affiliate concept as embodied in S. 1886 as a likely model for expanded bank securities powers in a world without Glass-Steagall. The authors conclude that the separate affiliate concept, if not rigidly applied, offers a practical alternative to Glass-Steagall requiring minimal restructuring of the existing bank and securities regulatory frameworks. At the same time, the concept addresses the Glass-Steagall concerns of safety, soundness, and conflicts of interest.

The appendix of this Article surveys the wide range of permissible securities activities already engaged in by banking organizations. These activities demonstrate that the traditional Glass-Steagall concerns can be adequately addressed by regulation, and that within an appropriate framework, banks and securities firms can operate under the same corporate umbrella consistent with sound banking principles.

I. DISPPELLING THE GLASS-STEAGALL MYTHOLOGY

The notion that bank securities activities caused the 1929 stock market crash and the collapse of the banking system shortly thereafter is a myth propagated by the securities industry to assure Glass-Steagall a perpetual life.16 If Glass-Steagall is abolished, the myth threatens, the banking system is destined to repeat those events.17 These claims ring hollow in light of securities firms' aggressive efforts to enter banking through the back door by acquiring "nonbank banks," offering the equivalent of deposits in the form of cash management accounts, and engaging in other bank-like activities.18

15. The securities industry has vehemently opposed Glass-Steagall reform short of "complete, two-way" repeal that would grant securities firms the unencumbered ability to own banks. See The Structure of the Financial Services Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 100th Cong., 1st Sess. 3-4 (1987) [hereinafter Statement of Matthew P. Fink] (written statement of Matthew P. Fink, Senior Vice President and General Counsel, Investment Company Institute).


17. See supra note 16; see also The Structure of the Financial Services Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 100th Cong., 1st Sess. 6 (1987) (statement of Robert A. Gerard, Managing Director, Morgan Stanley & Co.).

18. Merrill Lynch, Shearson Lehman, Dreyfus, Prudential Bache, and First Boston Company are among the numerous securities firms that acquired so-called "nonbank banks" (i.e., banks that either accept demand deposits or make commercial loans, but not both). The ownership of such banks is grandfathered under the CEBA. 12 U.S.C.A. § 1846 (West Supp. 1988). For a description of money market mutual funds, see discussion at infra note 68.
Moreover, the unprecedented October 1987 stock market plunge demonstrated that stock market stability does not depend on the exclusion of banking organizations from securities activities.\textsuperscript{19}

Contrary to the claims of the securities industry, no evidence exists that the 1929 crash caused the collapse of the banking system or that bank securities activities caused the failure of a single bank. Indeed, the banking system collapsed not in 1929 but four years later in 1933. The banking collapse ultimately was due to general economic conditions exacerbated by tax increases, protectionist trade measures, and a restrictive monetary policy.\textsuperscript{20}

The Presidential Task Force on Market Mechanisms appointed to study the October 1987 stock market events compared the 1987 plunge with that of 1929.\textsuperscript{21} The Task Force Report did not even hint that bank securities activities caused the 1929 stock market crash or the banking decline in the 1930's; furthermore, the report did not mention the Glass-Steagall Act as a significant structural distinction between market conditions in 1929 and 1987.\textsuperscript{22}

In fact, the Glass-Steagall prohibitions on commercial bank securities activities resulted largely from excessive political efforts to restore public confidence in the banking system following the financial crisis of the early 1930's and disclosures of abuses in the securities industry generally. Although no evidence of widespread securities abuses in the banking industry or of a link

\textsuperscript{19} The stock market decline on October 19, 1987, was more than double the plunge that caused the 1929 stock market crash. \textit{See, e.g.}, \textit{Stock Market Suffers Largest Loss in History As Dow Industrial Average Drops 508 Points}, Wash. Post, Oct. 20, 1987, at A1, col. 5; \textsuperscript{11} supra note 11. In view of banks' limited involvement in securities activities on October 19 due to Glass-Steagall prohibitions, the securities industry cannot attribute Black Monday to such activities. Indeed, Federal Reserve Chairman Greenspan has noted that the limited effects of the October stock market volatility on securities firms reinforces the view that the risks of securities activities can be managed prudently. Greenspan Testimony of Dec. 1, 1987, \textsuperscript{supra} note 7, at 12.


\textsuperscript{22} The Report states, "arguing that the [1929] Crash played a leading role in the collapse of the banking system appears unwarranted . . . . Indeed, the condition of the banking system seems to have followed rather than led the decline in the level of real economic activity." \textit{Id.} at VIII-3.

\textit{[T]he Great Depression appears to have been caused not by the stock market Crash but by the interaction of a number of diverse circumstances (such as the declines in agriculture and housing) and misguided policies (such as the Smoot-Hawley Tariff, the tight monetary policy in late 1931 and the tax increase in the summer of 1932). Thus, as long as a similar set of circumstances and policy initiatives are avoided, a comparable economic contraction should remain only a remote possibility.}

\textit{Id.} at VIII-10.
between these abuses and the collapse of banking was ever produced,\textsuperscript{23} sensational congressional hearings focusing on speculative and manipulative stock market practices prompted a public outcry for reform measures.\textsuperscript{24} The failure of over 4,000 banks and numerous indictments of bank officials for fraud during the course of legislative deliberations inflamed public opinion and made banks an easy target for legislative attack.\textsuperscript{25}

In this climate of public hostility toward banks, Senator Carter Glass’ banking philosophy appealed to Congress.\textsuperscript{26} Glass espoused the so-called commercial loan or “real bills” theory that banks should be confined to making short-term loans to finance the production of goods.\textsuperscript{27} Glass distrusted the ordinary investor’s wisdom and believed that securities financing diminished desirable bank control over the allocation of capital.\textsuperscript{28} In Glass’ view, securities activities were inconsistent with a bank’s proper role.

Pressed by the urgency of restoring public confidence in the banking system and imbued with Senator Glass’ banking theories, Congress’ response to alleged abuses resulting from bank involvement in the securities business was not an attempt to eliminate such abuses by regulation, but rather to separate “as completely as possible” commercial banking from investment banking.\textsuperscript{29} Congress did this through the four regulatory provisions that comprise the

\textsuperscript{23} Federal Reserve Chairman Greenspan has stated that “research over the past 50 years concludes, contrary to Congress’ view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally.” Greenspan Testimony of Dec. 1, 1987, \textit{supra} note 7, at 13; see also \textit{Modernization of the Glass-Steagall Act: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs}, 100th Cong., 1st Sess. 56-57 (1987) (statement of Edward J. Kelly III). Kelly stated that “[t]here is no evidence in the legislative history that the failure of any large bank was attributable to the underwriting or dealing activities of its securities affiliates.” \textit{Id.} at 57. Indeed, as Kelly points out, most banks that had securities affiliates survived the storm of bank failures from 1930 through 1933. \textit{Id.}

\textsuperscript{24} \textit{See generally} S. REP. No. 455, 73d Cong., 2d Sess. 1 (1934). Although the hearings exposed some well-publicized misdealings by certain large banks, most of the stock market abuses involved securities firms not affiliated with banks.


\textsuperscript{26} \textit{WEBSTER’S AMERICAN BIOGRAPHIES} 403-04 (C. Van Doren ed. 1974). Architect of the 1913 Federal Reserve Act and other banking legislation for over a quarter of a century, Senator Glass was chairman of the subcommittee that drafted the Glass-Steagall Act. As a former Secretary of the Treasury and Chairman of the Senate Appropriations Committee, he wielded considerable power and influence in the Congress. \textit{Id.}

\textsuperscript{27} \textit{U.S. DEPARTMENT OF TREASURY, PUBLIC POLICY ASPECTS OF BANK SECURITIES ACTIVITIES} 12-15 app. (1975).

\textsuperscript{28} \textit{Id.} at 13-14 app.

Glass-Steagall Act. These provisions prohibit banks from underwriting and dealing in securities or purchasing securities for their own account, with certain exceptions, and prohibit securities firms from accepting deposits. Furthermore, Federal Reserve System member banks are not permitted to be affiliated with any firm that is engaged “principally” in securities underwriting activities or to have management interlocks with firms engaged “primarily” in such activities.

However, the restoration of banking safety and soundness was brought about not by enactment of Glass-Steagall, but by the creation of the federal deposit insurance system and the regulatory reforms introduced in the omnibus Banking Act of 1933, of which Glass-Steagall was a small part.

In addition to inflicting losses on millions of depositors and inflaming public opinion against bankers, the wave of bank failures exposed fundamental flaws in the banking system which had contributed to its collapse. Virtually all of the banks that failed were small, undercapitalized, lacking in diversification, and poorly managed. Most of the failed banks were not

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The business of dealing in securities and stock by [a national bank] shall be 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.

Id. § 24(Seventh). A national bank is permitted to purchase for its own account investment securities up to 10% of its capital and to underwrite and deal in certain government securities and money market instruments. Id.

31. Id. § 378(a)(1). Section 21 of Glass-Steagall makes it unlawful “For any person ... or ... organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits ....” Id.

32. Id. § 377. Section 20 of Glass-Steagall provides that “no member bank shall be affiliated ... with any ... 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 ....” Id.

33. Id. § 78. Section 32 of Glass-Steagall provides that:

No officer, director, or employee of any [organization] and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank.

Id.


35. See generally Operation of the National and Federal Reserve Banking Systems: Hearings on S. Res. No. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 2d Sess. (1931) [hereinafter 1931 Hearings] (survey of the National and Federal Reserve Bank systems in order to provide recommendations for legislation to improve the systems' operation).
Federal Reserve System members and thus were ineligible for Federal Reserve emergency advances. The power of the Federal Reserve Board and the Comptroller of the Currency to discipline unsafe banking practices proved insufficient.

The Banking Act of 1933 repaired fundamental defects in the banking system. In addition to establishing the Federal Deposit Insurance Corporation (FDIC), the Banking Act of 1933 provided for more rigid control over capital requirements of federally supervised banks, gave bank regulators authority to examine affiliates of banks and to remove bank directors who engaged in unsafe or unsound banking practices, imposed restrictions on transactions between member banks and their affiliates, and introduced other much needed reforms.

At the same time Congress introduced these fundamental structural changes in the bank regulatory system, it created a securities regulation system under the Securities and Exchange Commission (SEC) to restore public confidence in the stock markets. The Securities Act of 1933 prohibits false or misleading information in connection with the offer and sale of securities. The Securities Exchange Act of 1934 (Exchange Act) condemns manipulative practices in the securities markets and imposes strict regulation on extensions of credit for the purchase of securities. The Investment Company Act of 1940, enacted shortly thereafter, similarly eliminates abuses in the mutual fund business. The enactment of this securities regulation system, not Glass-Steagall, was the single most important factor in curtailing abuses in the securities business.

36. Id. at 46. Many failures occurred in outlying rural areas that, with the advent of automobile travel and new roads, were being served by more competitive in-town banks. Id. at 7, 252, 375. Because of the ban on branch banking in most states, banks that faltered were forced to terminate in bankruptcy rather than through acquisition by a healthy bank. Id. at 34.

37. See id. at 7, 20, 39. The Comptroller, for example, lacked power to remove bank officers and had no authority to examine bank security affiliates. Id. at 39.

38. The Federal Deposit Insurance Corporation originally was established by the Banking Act of 1933 as part of the Federal Reserve Act, ch. 6, 38 Stat. 103 (1913) (codified as amended at 12 U.S.C. §§ 1811-32 (1982 & Supp. IV 1986)).

40. Id. § 481.
41. Id. § 248(f).
42. Id. § 371c.
45. Id. § 7, 15 U.S.C. § 78g.
The regulatory frameworks established by these statutory enactments have proved durable and effective in providing the basis for sound commercial banking institutions and securities firms and guarding against conflicts of interest, self-dealing, and other abuses. In light of the fact that banks and securities firms face extensive regulation within this framework, the Glass-Steagall Act is largely superfluous. Indeed, Senator Glass himself appeared to recognize as much. Only two years after the act bearing his name was enacted, he unsuccessfully sought to amend the Glass-Steagall Act to permit commercial banks to underwrite corporate securities to a moderate extent.

II. DISMANTLING GLASS-STEAGALL

For over fifty years, Glass-Steagall has been a source of conflict between the commercial banking and investment banking industries. In an attempt to compete in each other's territory, the industries have assaulted the Act from both sides. The Glass-Steagall war has been waged intensively for the past two decades before the banking agencies, the courts, and Con-

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47. The well-publicized indictments of Ivan Boesky and other securities dealers for illegal insider-trading activities demonstrate that while individuals who disregard the law will always exist, the securities industry is well policed. See generally Insider Trading: Hearings Before the Subcomm. on Telecommunications, Consumer Protections, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. (1986).

48. 79 CONG. REC. 11,824-27 (1935) (statement of Sen. Glass). Glass justified his proposed amendment as necessary to create additional underwriting facilities to aid in financing the faltering heavy goods industries. Although Glass' amendment was approved by the Senate, it failed to pass the House.

49. The Federal Reserve Board, the Comptroller of the Currency, and the FDIC each has been faced with controversies under the Glass-Steagall Act in recent years. These controversies, which often result in litigation, arise from the securities activities of banking institutions that the agencies regulate. See infra note 50. See generally Confusion in the Legal Framework of the American Financial System and Services Industry, Report of the House Subcomm. on Commerce, Consumer, and Monetary Affairs, 98th Cong., 2d Sess. (1984).

None of which has dealt it a fatal blow. Unlike the Douglas amendment, whose death knell was rung by a single United States Supreme Court decision, it will take an act of Congress to finally put Glass-Steagall to rest.

Congress has been able to avoid tampering with Glass-Steagall until now because there is no grass roots constituency supporting its repeal. Unlike Regulation Q interest rate ceilings which fell under the weight of consumer opposition, Glass-Steagall has not attracted voter appeal as a political issue because consumers do not yet perceive it as directly affecting their pocketbooks. On the other hand, the securities industry has staged an intensive lobbying campaign aimed at preserving its Glass-Steagall monopoly. Yet even the securities industry, while continuing to publicly condemn expanded bank securities, has recognized that it fights a losing battle.

The consequences of continued congressional inaction to lift the Glass-Steagall yoke from the banking system should be painfully obvious. The disastrous results in the thrift industry, caused by artificial regulatory barriers that confined those institutions to a narrow range of financial activities,

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53. The Supreme Court's decision in Northeast Bancorp Inc. v. Board of Governors of the Fed. Reserve Sys., 472 U.S. 159 (1985), opened the door to interstate banking by interpreting the interstate restrictions in the Douglas amendment to the BHCA, 12 U.S.C. § 1842(d), in a manner that allowed states to form regional compacts for interstate banking. Within barely three years, all but a handful of the states have enacted laws permitting interstate banking to some extent and many have adopted nationwide banking laws. A contrary interpretation by the Court would have meant that only Congress could make the decision to allow regional interstate banking. If that had occurred, a healthy evolution of the banking system might have been delayed or curtailed to a larger extent.


56. See Glass-Steagall's Demise is Predicted, Am. Banker, Dec. 5, 1986, at 3, col. 1 (securities industry executives acknowledge that Glass-Steagall is a "dinosaur," "Swiss cheese," and a product of "nostalgia.").
were a costly lesson.\textsuperscript{57} That lesson will be repeated if Congress continues
to ignore the technological, economic, and competitive forces shifting the financial
markets away from traditional banking channels toward increased use of
the securities markets for financial intermediation.

The technology revolution has opened up twenty-four hour worldwide fi-
nancial markets linked by instantaneously communicated financial informa-
tion on a global scale.\textsuperscript{58} This development has made it possible for financial
customers to bypass banks and meet their credit and investment needs di-
rectly and less expensively in the securities markets. By enhancing investor
ability to assess credits and diversify risk without the need for banking ex-
pertise or FDIC protection,\textsuperscript{59} computer technology has dramatically altered

\textsuperscript{57} Prior to 1982, thrifts were limited to offering primarily fixed rate long-term home
mortgages funded by deposits subject to a 5.25\% interest ceiling. Inflation driven interest rates
in the late 1970's and early 1980's caused massive outflows of funds from thrifts, resulting in a
severe mismatch of assets and liabilities and loss of earnings in the industry. Congress pro-
vided additional asset flexibility and earnings opportunities to thrift institutions in the Thrift
sections of 12 U.S.C.). The Senate Report on the bill recognized that "defective structuring is
a primary cause of the current economic vulnerability of thrifts," S. REP. No. 536, 97th Cong.,
2d Sess. 13 (1982), and that "the current statutory asset constraints facing thrift institutions
are simply inconsistent with the ability of those institutions to compete in a marketplace char-
acterized by payment of market rates of interest . . . it is imperative that thrifts receive asset-
side empowerments capable of generating the earnings needed to support competitive rates.”
Id. at 14 (quoting former Federal Home Loan Bank Board (FHLBB) Chairman Richard
Pratt). The new powers enacted by the Garn-St Germain Depository Institutions Act of 1982,
came too late for many thrift institutions. The General Accounting Office's examination of the
Federal Savings & Loan Insurance Corp. (FSLIC) revealed that troubled thrift institutions
caused a net loss of almost $11 billion in the FSLIC fund for 1986 and a deficit of more than $6
billion at the end of 1986. The General Accounting Office concluded that more than $20
billion was needed to assist troubled institutions. Letter from the Comptroller General to the
Chairman of the FHLBB (May 1, 1987), reprinted in Financial Condition of Federally Insured
Depository Institutions: Hearings on S. 198 Before the Senate Comm. on Banking, Housing,
and Urban Affairs, 100th Cong., 1st Sess. 90-91 (1987). The FSLIC's insolvent condition ne-
cessitated congressional enactment of legislation to recapitalize the FSLIC fund with $11 bil-

\textsuperscript{58} See generally Federal Reserve Bank of New York, Recent Innovations in International
Banking (1986): Hearing on Globalization of Capital Markets By the Senate Comm. on Bank-

\textsuperscript{59} On-line data bases, massive computation capacity, and telecommunication facilities
enable investor/lenders to analyze securities issuers' creditworthiness based on instantaneous
credit information. Greenspan Testimony of Nov. 18, 1987, supra note 7, at 4; Greenspan
Testimony of Dec. 1, 1987, supra note 7, at 9. Computerized trading and hedging through the
use of options and futures, including stock index futures introduced in 1982, help managers of
large pension and other investment funds manage investment risks. See generally Implications
of New Technology for Banking Regulation: Hearings Before the Senate Comm. on Banking,
Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Gruson, The Global Securities Mar-
the credit evaluation and diversification role of banks that once made them essential intermediaries. Moreover, increased institutionalization of savings in the form of pension and retirement plans and the management of these funds by professional nonbank money managers has diverted vast pools of funds away from banks to the securities markets.60

Glass-Steagall's constraining effects have dramatically inhibited the ability of banks to respond to the evolving financial needs of large corporate customers, traditionally the strongest source of profitable banking activity. Prime corporate customers increasingly are sidestepping banks and satisfying their short-term and intermediate credit needs by issuing commercial paper and securitizing their assets.61 Fifteen years ago, commercial banks controlled some 90% of the short-term loan market. Today, roughly half of this market is satisfied through the use of commercial paper.62 The securitization of assets has reduced the need for bank loans even further.63 By packaging automobile loans, leases, consumer loan receivables, and portfolios of other assets into pools, a company can fund its operating costs by selling interests in the pool directly to investors.64

Bank loans are being used increasingly as a source of back-up liquidity

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60. See generally Gruson, supra note 59, at 303.

61. The Securities Industry Association boasts that securities firms' distribution of commercial paper enabled corporate borrowers to raise funds at costs well below the 250 to 300 basis point spread over costs of funds typically demanded in bank loans. Testimony of Edward I. O'Brien, President, Securities Industry Association, Before the House Subcomm. on Financial Institutions Supervision, Regulation, and Finance (Feb. 2, 1988).


63. For example, mortgage pass-through securities accounted for approximately one-third of all residential mortgage credit in 1987. The President of the Federal Reserve Bank of New York has stated that, "if securitization were to continue to spread rapidly to other types of credit, the historic role of the deposit-based credit intermediation process could be seriously jeopardized." COMMERCIAL BANK PROFITABILITY STUDY, supra note 6, at xvi (foreword by E. Corrigan).

64. The securitization of assets allows a company to eliminate intermediary expenses in obtaining funding, transfer credit and interest rate risks, enhance balance sheet liquidity, improve asset management, and diversify credit risk. The asset-backed securities market is expected to grow to $100 billion in the next five years. Standard & Poor's, Dramatic Growth Expected, ASSET BACKED SECURITIZATION CREDIT REV., Mar. 16, 1987, at 1. See generally Pavel, Securitization, Economic Perspectives, 10 Fed. Reserve Bank of Chicago 16 (1986); AMERICAN BANKER ASSET SALES REP., Jan. 11, 1988, at 5.
rather than a primary funding source for many commercial customers.65
These customers need underwriting and distribution services to facilitate the
sale of their own securities directly in the market. Glass-Steagall precludes
banks from providing these services. While banks have gained limited au-
thority to assist corporate customers in privately placing commercial paper
after a decade-long battle,66 their ability to underwrite commercial paper
and securitized assets has been narrowly circumscribed and is entangled in
ongoing litigation initiated by the securities industry.67

65. See sources cited supra note 64. Although the October 1987 stock market plunge
temporarily boosted the demand for commercial loans as major borrowers fled from the volatile
securities markets, the long-term downturn in the commercial loan sector has not changed.
137 (1984); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 807 F.2d
1052 (D.C. Cir. 1986), cert. denied, 104 S. Ct. 2979 (1987); Bankers Trust New York Corp., 73
Paper Private Placement Activities (1977). Although banks may participate in the
commercial paper market as issuers of standby letters of credit providing back-up liquidity to
issuers whose commercial paper fails to sell in the market, they may not do so with respect to
commercial paper they place under restrictions imposed by the Federal Reserve Board. Moreover,
this activity is not a substitute for commercial loans. Id.
67. In 1987, under the BHCA, the Federal Reserve Board approved for the first time major
bank holding companies' applications to engage, through subsidiaries, in underwriting,
and dealing in commercial paper, mortgage backed securities, municipal revenue bonds, and
Corp., 74 Fed. Res. Bull. 133 (1988). The Board limited such activities to no more than 5% of
each underwriting subsidiary's total gross revenues and limited each to no more than a 5%
share of the market in each type of security. The Board also imposed numerous operating
restrictions on such underwriting subsidiaries, including a prohibition on management inter-
locks with affiliated banks, restrictions on extensions of credit to issuers and purchasers of
securities underwritten by the holding company's subsidiary, and capital adequacy require-
ments. The Board's orders approving the applications have been challenged in court by both
the Securities Industry Association as well as the bank holding company applicants and are
the subject of a judicial stay. See The Chase Manhattan Corp. v. Board of Governors of the Fed.
Reserve Sys., No. 87-1333 (D.C. Cir. filed July 20, 1987); Securities Indus. Ass'n v. Board of
Governors of the Fed. Reserve Sys., Nos. 87-4091, 87-4093, 87-4095 (2d Cir. filed July 1 and
July 15, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-
4041 (2d Cir. filed May 1, 1987); Securities Indus. Ass'n v. Board of Governors of the Fed.
Reserve Sys., No. 87-1169 (D.C. Cir. filed April 17, 1987); Bankers Trust N.Y. Corp. v. Board
of Governors of the Fed. Reserve Sys., No. 87-1035 (D.C. Cir. filed Jan. 23, 1987); Securities
20, 1987). On Feb. 8, 1988, the Board's Order of April 30, 1987, was upheld by the United

Commercial banks not only are constrained by Glass-Steagall in responding to technological and market changes but are facing increased competition from nonbank financial institutions in the provision of traditional banking services. Securities firms and other providers directly supply credit to traditional banking clients and offer financial instruments that are functionally equivalent to interest-bearing deposits. Volatile interest rates have created a demand for market sensitive financial instruments and cash management techniques that nonbank competitors have pioneered in the form of money market funds, mutual funds, sweep plans, and other nonbanking investment vehicles that substitute for deposits. Although the Competitive Equality Banking Act of 1987 prohibits nonbanking companies from acquiring so-called "nonbank banks," securities firms that acquired such banks prior to the Competitive Equality Banking Act are permitted to continue operating them.

Glass-Steagall has significantly hindered the ability of banks to keep pace with these changes and has diminished their role in the financial system. A recent poll conducted by the American Banker demonstrates the extent to which banks are losing ground to nonbank financial service providers. Consumers were asked to select which of nine major financial service providers best meets the typical consumer's financial service need. Thirty-one percent of the respondents selected Sears Roebuck & Co. while only 7% selected Citicorp and Citibank.

States Court of Appeals for the Second Circuit, with the exception of the 5% market limit which the court struck down. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., No. 87-4041 (2d Cir. Feb. 8, 1988). The Securities Industry Association has filed a petition for certiorari seeking Supreme Court review of the court's opinion.

68. Money market mutual funds (MMMF's) are functionally equivalent to bank checking accounts but differ from checking accounts in that they represent an equity interest rather than credit interest. Unlike bank deposits, MMMF's are not federally insured and are not subject to insurance premiums or reserve requirements. MMMF's also were not subject to interest rate ceilings when such limits were in effect for banks and consequently were able to attract substantial deposits away from banks. See Restructuring Financial Markets: The Major Policy Issues, supra note 51, at 161, 314-15. The short-term volatility of prices of financial instruments has been described as "explosive." The President of the Federal Reserve Bank of New York has stated, "we now see intraday or even intrahour movements in financial asset prices that not long ago would have been unthinkable." E. Corrigan, supra note 7, at 9.


70. See supra note 10. Although the Competitive Equality Banking Act imposes limits on asset growth and expansion of services by grandfathered nonbank banks and restricts cross-marketing of their products and services with those of affiliates, grandfathered nonbank banks have substantial latitude to conduct banking operations. CEBA, 12 U.S.C.A. § 1843 (West Supp. 1988).

71. Rosenstein, Consumers Say Sears Best Meets Financial Services Needs, Am. Banker, Sept. 28, 1987, at 1, col. 2. Other nonbank financial providers were ranked in the poll as follows: American Express (8%), Merrill Lynch (7%), Prudential Insurance (6%), Beneficial
United States commercial banks also face increasing competition from foreign banks and securities firms as a result of the globalization of financial markets. These foreign competitors operate in the international markets unencumbered by Glass-Steagall-type restraints on their activities. While United States banking organizations operate with fewer restraints abroad than in the United States, their inability to offer a full range of financial services domestically has impaired their international competitiveness, and, with the exception of Citicorp, they no longer rank among the largest banking organizations worldwide.

As a matter of sound regulatory philosophy, Congress should allow the banking industry to respond to the natural competitive forces that are shaping the markets unencumbered by regulatory constraints, unless there is evidence that bank securities activities pose insurmountable conflicts of interest, undermine the stability of the banking system, or threaten other effects inimical to the public interest. Such evidence simply does not exist. To the contrary, by confining banks to a narrow range of products and services of declining profitability, Glass-Steagall threatens the long-term health and survival of banks as the fulcrum of our financial system.

As a result of losing their most creditworthy commercial loan customers, banks are making riskier loans at the expense of the overall soundness of the banking system. The dramatic decline in bank earnings and the lagging performance of bank stocks in recent years is symptomatic of the systemic weakness to which Glass-Steagall has contributed. If Congress fails to broaden the range of profitable business areas for banking organizations, this trend will have growing destabilizing economic consequences. Moreover,
the Federal Reserve Board has warned that declining bank profitability will have serious implications for the effectiveness of general monetary policy and economic stability.\textsuperscript{75}

\section*{III. Life Without Glass-Steagall}

In a world without Glass-Steagall, banking organizations would be free to expand securities activities according to customer needs and marketplace demands rather than remain in artificial statutory limits. Securities firms similarly would be free to operate deposit-taking organizations and offer banking services.\textsuperscript{76} Substantial public benefits could be gained from such a deregulated system. Expanded bank securities activities would enhance competition, increase the availability of services for securities issuers and investors alike, and reduce the cost of financial transactions generally. Moreover, these benefits would be felt by both large and small customers.

The corporate securities underwriting market currently is highly concentrated with five firms underwriting the vast majority of issues.\textsuperscript{77} Bank hold-

\begin{footnotesize}
\begin{itemize}
\item sify their assets and sources of income make it cumbersome, if not impossible, to restructure the products and services they offer in line with changing market conditions and consumer demands. Furthermore, only if banks have the authority to deliver the products customers demand will they be able to earn returns that can attract capital. \\
\textit{Financial Conditions Hearings, supra} note 6, at 9 (statement of Robert L. Clarke, Comptroller of the Currency).
\end{itemize}
\end{footnotesize}
ing company entry into this market can be expected to increase competition, lower concentration levels, and reduce funding costs for business.\textsuperscript{78} Similarly, expanded bank authority to underwrite municipal securities would result in savings for state and local governments and thereby for local taxpayers who ultimately bear the cost of municipal borrowing.\textsuperscript{79} The introduction of banking competitors also can be expected to benefit smaller and infrequent issuers that currently have a limited choice of underwriters.\textsuperscript{80} Bank underwriting of mortgage-backed securities also would enhance competition in that market and increase the available funding sources used to support the housing market.\textsuperscript{81}

Expanded bank securities brokerage services would provide substantial benefits to retail investors. Until recently, banks and bank holding companies could offer combined securities brokerage and investment advice only to institutional and wealthy individual customers.\textsuperscript{82} Legislation repealing Glass-Steagall and establishing clear authority for banking organizations to offer full-service brokerage services would preclude the need for litigation and ensure the availability to retail brokerage customers of bank investment advisory services currently available only to wealthy customers. Further-


\textsuperscript{79} Expanded bank municipal securities underwriting activities have long been supported by associations of state and municipal governments, including the National Governors Association and the National League of Cities. See Board Order of April 30, 1987, supra note 67; New Securities Powers for Bank Holding Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 53 (1987) [hereinafter New Securities Powers Hearings] (statement of Richard B. Geltman, Staff Director, National Association of Governors); id. at 66 (statement of Richard Guthman, National League of Cities).

\textsuperscript{80} See Board Order of April 30, 1987, supra note 67.

\textsuperscript{81} National trade associations of home builders and realtors have supported bank holding company entry into the mortgage-backed securities underwriting business as a means of developing a strong private secondary market for mortgage securities. See, e.g., New Securities Powers Hearings, supra note 79, at 38-39 (statement of Stan H. Sabin, Chair, Real Estate Finance Committee, National Association of Realtors); id. at 44-45 (statement of Kent Colton, National Association of Home Builders).

more, the ability of banks to securitize loans on their books and sell them to investors will result in new sources of liquidity, greater flexibility in responding to loan demand and interest rate fluctuations, and increased return on equity.\textsuperscript{83}

As the appendix to this Article indicates, banking organizations already offer their customers a wide range of securities products and services within existing Glass-Steagall parameters. These services include discount brokerage, commingled individual retirement accounts, private placements, investment advice, and underwriting of government securities. These bank securities activities have enhanced competition in the securities industry and given both wholesale and retail customers increased access to financial services at greater convenience and reduced costs. Furthermore, these public benefits have been achieved without giving rise to unfair competition, conflicts of interest, or unsafe and unsound practices. Bank regulators have utilized the existing bank supervisory structure to fashion appropriate regulatory restrictions, establish guidelines for expanded securities activities, and monitor compliance with these regulations. Moreover, United States banking organizations actively engage in foreign securities underwriting and dealing activities that are not authorized domestically. The foreign investment banking experience of these organizations has been viewed favorably by United States banking regulators.\textsuperscript{84}

It is clear that banking is inherently more risky than it was in 1933, while the securities business is safer.\textsuperscript{85} The relative risks, for example, of making a thirty year fixed-rate loan should be obvious when compared to holding short-term commercial paper for thirty minutes in an underwriting. Con-

\textsuperscript{83} Aber, Securitization: Promise and Opportunity for Lenders, 2 COM. LENDING REV. 21 (Fall 1987); Annable, Will All Banks Be Securitized Someday?, 2 COM. LENDING REV. 3 (Fall 1987); Bank Attracts Cheap Funds With Offering, Am. Banker, Mar. 8, 1988, at 2, col. 4. The Comptroller of the Currency has authorized national banks to sell their own securitized assets but such activities are the subject of a legal challenge by the Securities Industry Association under the Glass-Steagall Act. OCC Interpretive Letter No. 388, [Current] Fed. Banking L. Rep. (CCH) \$ 85,612, at 77,938 (June 16, 1987) [hereinafter OCC Interpretive Letter No. 388] (letter of Robert L. Clarke, Comptroller of Currency).


\textsuperscript{85} The Comptroller of the Currency, referring to underwriting revenue bonds, managing mutual funds, purchasing security interests in loan pools, and other new activities, has noted that many of the new activities involve less risk than activities that are part of commercial banking's established practices. Financial Condition Hearings, supra note 6, at 6 (statement of Robert L. Clarke, Comptroller of the Currency); see also Structure and Regulation Hearings, supra note 4, pt. 3, at 30 (statement of James J. Baechle, Executive Vice President and General Counsel, Bankers Trust Company). Baechle stated that underwriting corporate securities is inherently far less risky than lending because underwriting risk is brief, more easily hedged, and simpler to liquidate than loans. Id.
gress should worry more about the risks to the banking system of failing to repeal Glass-Steagall than the risks of repeal.

The ability of banking organizations to offer diverse financial products and services in step with changing market demands is critical to their ability to remain profitable and attract capital. The average return on securities activities in recent years has exceeded the average return on commercial banking activities.\textsuperscript{66} Increased flexibility for banking organizations to participate in more profitable securities product markets can be expected to increase significantly banking organizations’ earnings. Moreover, economies of scale and product synergies resulting from combined commercial and investment banking activities would achieve cost savings.\textsuperscript{67} The increased diversification of assets resulting from repeal of Glass-Steagall also would reduce the tendency to take on riskier loans and reduce bank vulnerability to failure, thereby enhancing overall banking stability.\textsuperscript{68}

\textbf{A. The Separate Affiliate Concept}

While several alternatives for Glass-Steagall’s repeal are conceivable, not all are practical or politically feasible.\textsuperscript{69} The separate affiliate concept offers the most realistic approach to Glass-Steagall’s repeal and could, with a minimum of restructuring, be accomplished within the existing regulatory framework. Such an approach would mandate that all bank securities activities, other than those deemed acceptable for banks, be conducted in non-FDIC-

\begin{enumerate}
\item The average after-tax return on equity for investment banks during 1980-84 was 26\% compared to 12.2\% for commercial banking institutions. \textit{Commercial Bank Profitability Study}, supra note 6, at 372.
\item Greenspan Testimony of Dec. 1, 1987, supra note 7, at 5-6.
\item The Federal Reserve Bank of New York has recognized that profitable new activities “could support the overall profitability of bank holding companies during periods of weakness in the profitability of traditional banking. Moreover, by improving credit ratings, they could lower the cost of funding bank intermediation, thus enhancing its profitability.” \textit{Commercial Bank Profitability Study}, supra note 6, at 6.
\item For example, under one approach, the price for freedom from Glass-Steagall could be allocated according to the riskiness of an individual bank organization’s activities by proportionate increases in deposit insurance premiums paid by banks. However, such an alternative would require fundamental changes in the deposit insurance system, and would raise thorny questions as to how risk should be measured and by whom. See \textit{Structure and Regulations Hearings}, supra note 4, pt. 3 app. E, at 390 (\textit{An Analysis of Alternative Proposals for Deposit Insurance Reform} appendix prepared by Thomas F. Huertas and Rachel Strauber). The Financial Services Oversight Act, S. 1891, 100th Cong., 1st Sess. (1987), and the Financial Services Holding Company Act of 1988, H.R. 3360, 100th Cong., 1st Sess. (1987), suffer from the same disability of requiring major structural changes in banking regulation. Such proposals are likely to ignite turf battles among the existing banking agencies, which could be fatal to legislative repeal of Glass-Steagall.
\end{enumerate}
insured affiliates separated from the deposit-taking function and the federal safety net by appropriate safeguards.

The theory is based on several premises stemming from the belief that banks need special regulatory supervision and protection in view of their role as the custodians of the bulk of society's liquid assets, the operators of the payments system, the back-up source of liquidity to the financial system, and a primary means of transmitting monetary policy to the economy.90 Because banks are the beneficiaries of the federal safety net, particularly federal deposit insurance and the Federal Reserve discount window serving as a lender of last resort, it is believed that banks should not directly engage in risky activities that cannot be regulated effectively and that would place an undue supervisory and insurance burden on the federal government.91 Similarly, the unique status of banks is said to give them a competitive advantage over nonbank financial institutions lacking access to FDIC-insured deposits to fund their operations.92 Furthermore, because of their custody of the enormous pool of public deposits, banks are perceived to be susceptible to potential conflicts of interest.

The separate affiliate concept addresses these concerns by creating a legally separate organization to engage in activities deemed inappropriate for banks. Through a separate organization, it is possible to minimize exposure of the bank's insured deposits to risks deemed unacceptable, avoid the use of insured deposits in competition with nonbanking institutions, and guard against potential conflicts of interest.93 Moreover, the separate affiliate concept provides a politically palatable alternative to Glass-Steagall that can be enacted without major structural changes in the existing bank regulatory system.94

The concept has already been utilized in several regulatory contexts authorizing banking institutions to engage in permissible securities activities,

notably in the FDIC's "bona fide subsidiary" rule and the Federal Reserve Board's orders approving bank holding company applications to engage in limited securities underwriting activities through separate affiliates. In addition, several of the pending legislative proposals to repeal Glass-Steagall substantially, including the Proxmire Financial Modernization Act of 1988, embrace this concept.

B. The Proxmire Financial Modernization Act of 1988

The Proxmire Financial Modernization Act (S. 1886), as approved by the Senate on March 30, 1988, creates a framework for expanded securities activities of banking organizations utilizing the separate affiliate concept. The bill would repeal the section 20 and section 32 Glass-Steagall restrictions on affiliations and interlocks between member banks and securities firms and amend the Bank Holding Company Act (BHCA) to authorize specifically bank holding companies to establish securities affiliates.

A securities affiliate would be authorized to engage in underwriting, distributing, or dealing in securities of any type, including corporate debt and equity securities and mutual funds. A securities affiliate also could engage in securities brokerage, private placement, investment advisory, and other securities activities permissible for SEC-registered broker-dealers. Activities of banks affiliated with securities affiliates would be limited and strict "firewalls" imposed to insulate the banks from the affiliate's activities.

96. See, e.g., Board Order of April 30, 1987, supra note 67, at 473.
99. S. 1886, supra note 9, § 101.
100. The bill would add a new § 4(c)(15) to the BHCA incorporating the new powers for securities affiliates. S. 1886, supra note 9, § 102.
101. S. 1886 provides that activities with respect to corporate equities may not be commenced prior to congressional approval, on or before April 1, 1991, of a joint resolution specifically authorizing such activities. Id. In addition, activities with respect to mutual funds and unsecured corporate debt securities with a maturity of one year or more at time of issuance are not authorized until six months following the date of enactment of the bill. Id.
102. Id. A securities affiliate also could engage in nonsecurities activities that are otherwise permissible under § 4 of the BHCA. S. 1886, supra note 9, § 102. In addition, a bank holding company could engage, pursuant to § 4(c)(8) of the BHCA, in securities activities other than underwriting, distribution, and dealing in bank ineligible securities. Such § 4(c)(8) activities would not be subject to the firewall provisions applicable to securities affiliates approved under § 4(c)(13).
103. The bill prohibits a bank or FSLIC-insured institution affiliated with a securities affiliate from engaging directly or indirectly in underwriting, distributing, or dealing in securities except to the extent specifically authorized by statute for a national bank or by regulation promulgated by the Comptroller of the Currency before November 18, 1987. S. 1886, supra
The firewalls imposed by S. 1886 include the following restrictions on capital adequacy, extensions of credit, and other relationships between securities affiliates and affiliated banks:

1. Capital Adequacy

S. 1886 would prohibit a bank holding company from acquiring control of a section 4(c)(15) affiliate if the acquisition would reduce the bank holding company's capital below the minimum level required for bank holding companies. S. 1886 requires a bank holding company that invests in a securities affiliate to maintain a capital cushion above the minimum capital requirements for bank holding companies and prevents a bank holding company from "double leveraging" its investment without maintaining additional capital. In order to promote functional regulation and competitive equity, the securities affiliate itself would be subject to the same SEC capital standards that apply to securities firms unaffiliated with banks.

2. Extensions of Credit

Under S. 1886, no bank or insured institution affiliated with a securities affiliate may, directly or indirectly:

a. "extend credit in any manner to the securities affiliate or a subsidiary thereof," except for intraday extensions of credit incidental to the clearing of transactions in United States government securities;

b. "purchase for its own account financial assets of the securities affiliate or a subsidiary thereof";

c. Underwriting and distributing of securitized assets originated or purchased by the bank or its affiliates is specifically prohibited. Id. However, the capital requirements imposed by S. 1886 would not apply to the extent that the Federal Reserve Board determined by order that an item relates to activities other than underwriting and the other activities enumerated in proposed § 4(c)(15) as permissible securities activities.

In calculating capital for regulatory purposes, a bank holding company would be required to subtract from its total capital and total assets an amount equal to the sum of (1) its equity investment in a securities affiliate, and (2) its extensions of credit that are considered capital of the securities affiliate for securities law purposes. Id. § 102. As a result, each dollar a bank holding company contributed to a securities affiliate's capital would result in a one-dollar reduction in the holding company's capital.

S. 1886 does this by providing that the assets and liabilities of a § 4(c)(15) shall not be consolidated with those of the parent bank holding company and that the bank holding company's total assets and total liabilities shall each be reduced by an amount equal to the amount of the bank holding company's extensions of credit to any § 4(c)(15) affiliate, excluding extensions of credit treated as capital for SEC purposes. See 15 U.S.C. 78o(c)(3) (Supp. IV 1986); 17 C.F.R. 240.15c3-1 (1987). Thus, a securities affiliate would be required to raise capital to support funds loaned by its parent or raised from sources other than the parent holding company, but such funding would not result in an increase in the parent's capital requirements.
c. "issue a guarantee, acceptance, or letter of credit, including an endorsement or a standby letter of credit, for the benefit of the securities affiliate or a subsidiary thereof";

d. "extend credit in any manner to any investment company advised by or the shares of which are distributed by the securities affiliate";

e. "extend credit or other instruments for the purpose of enhancing the marketability of a securities issue underwritten or distributed by the securities affiliate";

f. "extend credit to an issuer of securities underwritten by the securities affiliate for the purpose of paying the principal of those securities or interest or dividends on those securities";

g. "extend or arrange for the extension of credit, directly or indirectly, secured by or for the purpose of purchasing any security while, or for 30 days after, a distribution in which a securities affiliate . . . participates as an underwriter or a member of a selling group." This restriction applies to the parent bank holding company and any of its subsidiaries in addition to bank subsidiaries.107

3. Interlock Restrictions

Furthermore, S. 1886 would prohibit an officer or director of a securities affiliate from serving at the same time as an officer or director of any affiliated bank or FSLIC-insured institution.108 This prohibition would not apply to bank holding companies with total banking assets of not more than $500 million (adjusted annually). In addition, the Federal Reserve Board would be authorized to grant exemptions based on factors including size, burden, safety and soundness, unfair competition, and improper exchange of nonpublic customer information.109

4. Disclosure

a. Separateness

A securities affiliate would be required to disclose prominently in writing to each of its customers that the affiliate is not a bank or FSLIC-insured institution and is separate from any affiliated bank or insured institution.110

b. Non-FDIC Insured Status

A similar disclosure would be required detailing that securities sold, of-

107. S. 1886, supra note 9, § 102.
108. Id.
109. Id.
110. Id.
fered, or recommended are not deposits insured by the FDIC or FSLIC, are not guaranteed by an affiliated bank or insured institution, and are not otherwise an obligation of such a bank or insured institution.\footnote{111}

c. \textit{Securities Dealt in by Affiliates}

A bank or FSLIC-insured institution would be required to disclose to customers that a securities affiliate is underwriting, distributing, or dealing in any securities on which the bank or insured institution expresses an opinion as to value or advisability of purchasing or selling.\footnote{112}

d. \textit{Nonpublic Customer Information}

A bank or insured institution would be prohibited from disclosing to a securities affiliate any nonpublic customer information without the customer's consent, and vice versa.\footnote{113}

5. \textit{Securitized Assets of Affiliates}

S. 1886 also prohibits a securities affiliate from underwriting or distributing securitized assets originated by an affiliated bank, FSLIC insured institution, or subsidiary thereof unless those securities are rated by an unaffiliated, nationally recognized statistical rating organization.\footnote{114} This restriction would not apply to dealing in such securitized assets.

C. \textit{Avoiding a Rigid Structure}

The firewall and other provisions of S. 1886 demonstrate that appropriate safeguards can be constructed to insulate banks from the securities activities of affiliates and thereby address concerns regarding safety and soundness, conflicts of interest, unfair competition, and concentration of resources. Indeed, virtually all of the firewall provisions in S. 1886 are borrowed from the Federal Reserve Board's orders approving limited securities underwriting activities by bank holding companies.\footnote{115}

While these extensive restrictions may be appropriate in a regulatory framework crafted by bank regulators as the initial step toward phasing in expanded securities powers, however, it would be a mistake for Congress to carve them into stone without affording a regulatory mechanism to modify the restrictions as time and experience prove appropriate. Moreover, unless

\footnote{111. \textit{Id.}}
\footnote{112. \textit{Id.}}
\footnote{113. \textit{Id.}}
\footnote{114. \textit{Id.}}
\footnote{115. \textit{See} Board Order of April 30, 1987 and cases cited \textit{supra} note 67.}
Congress makes clear that these restrictions are maximum strictures, the regulators may be subjected to pressure by competitors of bank holding companies to impose stricter conditions than those deemed necessary by Congress.\textsuperscript{116}

If the separate affiliate approach is applied too rigidly, it will defeat the benefits of expanded securities powers. Joint accounting, data processing, and other administrative services between a securities affiliate and affiliated banks, for example, do not give rise to any conflicts of interest or other concerns and could result in synergistic benefits that would benefit a banking organization as a whole. S. 1886 does not prohibit such joint services and would allow such benefits to be realized.

Moreover, cross-marketing arrangements between banks and their affiliates could be structured in such a way as to maintain effective insulation of the bank without sacrificing the benefits of synergy between the two. The sale by a securities affiliate of securitized assets of affiliated banks, for example, should raise no greater concerns than when the bank directly sells such assets, an activity that the Comptroller of the Currency has found to be permissible for national banks.\textsuperscript{117} S. 1886 does not prohibit bank securities affiliates from cross-marketing services and underwriting securitized assets of affiliated banks if those assets are rated by an unaffiliated nationally recognized rating agency.\textsuperscript{118} Congress should make clear that the Federal Reserve Board may not prohibit such activities using its regulatory authority under the Bank Holding Company Act, as it did in approving limited underwriting activities for bank holding companies.\textsuperscript{119}

\begin{footnotes}
\item[116.] The Federal Reserve Board, for example, in considering bank holding company applications or notices to engage in securities activities, would be required to apply the same balancing test currently applicable under § 4(c)(8) of the BHCA. S. 1886, supra note 9, § 203. The test considers whether the proposed activity “can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.” 12 U.S.C. § 1843(c)(8) (1982). The Board may attempt to utilize this authority to impose conditions stricter than those deemed necessary by Congress. Nonbank competitors protesting bank holding company applications in the past have successfully urged the Board to apply this test in a restrictive manner. S. 1886 limits the ability of protesters to influence the Board’s consideration of bank holding company applications in the future by substituting a notice procedure for the current application procedure. S. 1886, supra note 9, § 203. The notice procedure would become effective for § 4(c)(15) activities, however, only after four years from the date of enactment of S. 1886.
\item[117.] OCC Interpretive Letter No. 388, supra note 83, at 77,938-46.
\item[118.] S. 1886, supra note 9, § 102.
\item[119.] See Board Order of April 30, 1987, supra note 67, at 504. The Board prohibited underwriting subsidiaries of bank holding companies from underwriting securitized assets of affiliated banks. Id.
\end{footnotes}
Excessive regulatory separation requirements would impose prohibitive legal, administrative, personnel, and other costs that would deter banking organizations, particularly small and regional organizations, from diversifying into new securities markets. For example, a prohibition that prevents holding company officers and directors from serving as officers and directors of both a securities affiliate and a subsidiary bank would impose duplicative personnel costs and could impair the ability of a bank holding company to effectively manage its subsidiaries. Although a large banking organization may have no difficulty in finding replacement personnel for the bank, a smaller firm may not have the resources to hire duplicative personnel. Furthermore, a rigid insulation policy could deny securities affiliates the benefits of experience and expertise acquired by affiliated banks that would be beneficial, particularly in the start-up phase, to the securities affiliate. On the other hand, bank management may suffer if bank officers engaged in securities activities are transferred to a securities affiliate. It would not be unreasonable for a bank officer who manages a bank’s government securities activities to act in a similar capacity with respect to a securities affiliate. Such an interlock is permissible under current law, and should not be prohibited by new law.

S. 1886 recognizes potential burdens on small and regional organizations by exempting from the interlock prohibitions bank holding companies with banking assets of $500 million or less and authorizing the Federal Reserve Board to grant further exemptions. The Committee report states that the Board is expected to grant exemptions for small and regional bank holding companies when the services of key personnel are crucial to both the securities affiliate and the bank.

The Board should be given similar authority to grant limited exemptions from the other restrictions in S. 1886 under appropriate circumstances. Congress should leave to bank regulators some discretion to determine, consistent with safe and sound principles, the degree of separation necessary for maximum efficiency and profitability of the banking system. The feasibility of various restrictions may be affected by competition, new product developments, or other economic or technological changes affecting the market. Experience with new activities may demonstrate over time that lesser degrees of separation are appropriate. For example, the FDIC, has determined that certain regulatory restrictions it imposed to force a separation between state nonmember banks and their securities affiliates are overbroad and has re-

120. The Board is required to consider the size of the institution involved, any burdens that may be imposed by a prohibition on interlocks, the safety and soundness of the institutions, and other appropriate factors. S. 1886, supra note 9, § 102.

laxed them. Similarly, some of the Federal Reserve Board's restrictions on limited securities underwriting activities for bank holding companies reflect an overcautious attitude that the Board has stated it will relax as it gains experience with the new activities.

Regulatory caution is understandable as Congress and the agencies take their initial steps in authorizing new securities activities, particularly in the face of vigorous opposition from the securities industry. However, the agencies' flexibility to modify the restrictions as banking organizations develop a record of experience with the new powers should not be eliminated by incorporating overly rigid statutory restrictions.

D. Flexibility for Bank Activities

The separate affiliate concept does not necessarily require expanded securities activities to be lodged in a separate affiliate of the parent bank holding company, as opposed to a bank subsidiary. The FDIC's "bona fide subsidiary" rule demonstrates that it is feasible to insulate effectively a bank from the activities of a subsidiary as well as from a holding company affiliate. Strengthening the banking system by increasing the profitability of banking organizations is one of the fundamental purposes of Glass-Steagall reform afterall. Therefore, banks should be allowed to profit directly from their subsidiaries' expanded securities activities rather than allocating such profits only to the parent holding company. Moreover, approximately one-third of all banks chartered in the United States are not affiliated with holding companies. These banks should not be forced to incur the organizational and regulatory costs of forming holding companies in order to take advantage of expanded securities powers.

S. 1886 does not adopt this view and generally would prohibit FDIC-insured banks from affiliating with any company engaged in securities activities other than a securities affiliate under the BHCA. Although S. 1886

122. Under the FDIC's initial rule, state nonmember banks' securities subsidiaries that are regulated by the FDIC were required to maintain separate entrances, locations, names, and logos from their banking affiliates. 12 C.F.R. § 337 (1987). These requirements were significantly curtailed by the revised rule, provided that the securities affiliates make certain disclosures to customers regarding their separate, non-FDIC-insured status. Unsafe and Unsound Banking Practices, 52 Fed. Reg. 47,379 (1987) (to be codified at 12 C.F.R. § 337).

123. For instance, the Board has announced that it will consider raising the volume limit on securities underwriting activities from 5% of gross revenues to 10%. Board Order of April 30, 1987, supra note 67, at 485.


125. See, e.g., Seidman Testimony of Oct. 28, 1987, supra note 7, at 7-9 (testifying in favor of expanded securities activities conducted in a bank subsidiary).

126. S. 1886, supra note 9, § 107. This restriction would not apply to an affiliate engaged in underwriting and dealing in solely government securities, municipal revenue bonds, and other
establishes expedited simplified procedures for the establishment of shell one-bank holding companies, these procedures are not available if the company will engage in nonbanking activities after the company is formed.127

Not all securities activities pose increased risks or potential conflicts of interest for banks. For example, underwriting of municipal revenue bonds, mortgage-backed and consumer receivable-backed securities, and other securitized bank assets are similar to activities currently permissible for banks under Glass-Steagall and would be appropriate for banks to engage in directly. Other appropriate activities for banks would include the underwriting of unit investment trusts that invest only in securities in which a national bank is authorized to underwrite and the distribution of mutual funds that are not organized, sponsored, or managed by the bank or any of its affiliates.128

Congress should not use the separate affiliate concept as an excuse to preclude bank participation in all securities activities. As the appendix to this Article demonstrates, banks currently engage in a wide range of permissible securities activities without giving rise to conflicts of interest or safety and soundness concerns. Thus, banks should not be denied the benefits of new securities activities that they can conduct safely.

S. 1886 would provide a limited expansion of national bank securities powers by specifically authorizing such banks to underwrite and deal in municipal revenue bonds.129 In addition, S. 1886 authorizes two new securities activities for national banks that are not affiliated with securities affiliates. Such banks may underwrite securities of a unit investment trust130 that holds only securities that national banks are specifically authorized by statute to underwrite and may distribute shares of an investment company that is not organized, sponsored, managed, or controlled by the bank or any affiliate thereof.131

S. 1886 narrows the securities powers of national banks that are affiliated with securities affiliates by requiring the transfer to a securities affiliate of certain activities recognized as permissible by the Comptroller of the Currency, but not recognized specifically by statute.132 Thus, such an affiliated

127. Id. § 201.
129. S. 1886, supra note 9, § 108.
131. Id. State member banks would gain identical powers by virtue of 12 U.S.C. § 335 (1982), which subjects them to the same restrictions on securities activities that apply to national banks under 12 U.S.C. § 24(Seventh) (Supp. IV 1986).
132. S. 1886, supra note 9, § 102.
national bank would lose its current authority to underwrite mortgage-backed securities and other securitized assets. A national bank not so affiliated could continue to engage in such activities.  

E. Existing Regulatory Safeguards

In addition to the protections established by S. 1886, existing laws and regulations safeguard banks from possible adverse effects arising from securities activities directly conducted by banks or their affiliates. Furthermore, these laws provide ample regulatory authority for banking supervisors to impose protective measures as needed.

Section 23A of the Federal Reserve Act limits extensions of credit, purchases of assets, and other transactions between an FDIC-insured bank and its nonbank affiliates. Covered transactions with a single affiliate may not exceed 10% of the bank's capital and surplus. Furthermore, such transactions with all affiliates may not exceed 20% of the bank's capital and surplus. A bank may not purchase any low-quality asset from an affiliate, other than a bank affiliate, and all transactions must be on terms and conditions consistent with safe and sound banking practices.

Similarly, section 23B of the Federal Reserve Act requires that transactions between a bank and its affiliates be on terms and conditions, including credit standards, that are substantially the same as or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies. These "arm's length" requirements apply to transactions involving the sale of assets to an affiliate as well as the purchase of assets from an affiliate for the affiliates' benefit.

133. Nonmember FDIC-insured banks would be similarly affected. Id. Affiliates of such banks would be subject to limitations similar to those under the proposed § 4(c)(15) of the BHCA.


136. Id. § 371c(a).

137. Id. Although § 23A does not apply to transactions between a bank and its direct subsidiaries, the Federal Reserve Board has authority to apply § 23A limits to such transactions if the Board determines that the action is necessary to avoid detriment to the bank or its subsidiary. 12 U.S.C. § 371c(b)(E) (1982).


139. Id. § 371c-1(a)(2), (3). Transactions covered by § 23B include any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person and any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party, or if an affiliate is a participant in the transaction. Id.
National banks are subject to restrictions on the amount of loans that may be extended to a single borrower. Such loans may not exceed 15% of a bank's unimpaired capital and surplus, plus an additional ten percent if the additional amount is secured by readily marketable collateral. 140 Although the statutory limits do not apply to direct subsidiaries of national banks, the Comptroller of the Currency has applied the limits to such subsidiaries on a case-by-case basis. 141

Federal law restricts extensions of credit by an insured bank to insiders of the bank or its affiliates, 142 and prohibits a bank from purchasing securities or other property from any of its directors unless the purchase is on an arm's length basis in the regular course of business or a majority of the board of directors approves the purchase. 143 Similar restrictions apply to the sale of securities by a bank to its directors. 144 These limitations have proven effective in minimizing fraud and insider abuse in the banking industry. 145

The extensive bank supervision and surveillance system enables banking regulators to monitor closely the securities activities of banking organizations through periodic examinations and reporting requirements. 146 Each of

Section 23B also prohibits a bank or its affiliates from advertising or suggesting in any way that the bank is responsible for its affiliates' obligations. Id. § 371c-1(c). Moreover, § 23B prohibits a bank from purchasing as a fiduciary any securities or other assets from any affiliate. This prohibition includes an investment company advised by an affiliate, unless specifically authorized by the fiduciary instrument, court order, or appropriate law. Id. § 371c-1(b). Section 23B similarly prohibits a bank acting as fiduciary from purchasing or acquiring securities underwritten by an affiliate during the underwriting period, unless it is approved by a majority of the bank's outside directors prior to the public offering. Id. §§ 371c-1(b)(1)(B), 371c-1(b)(2). National and state member banks are required to file periodic reports under oath with federal banking regulators that disclose relations between each bank and its affiliates. National banks are required to file the reports quarterly. Id. § 161. State member banks are required to file the reports three times a year. Id. § 334. Failure to file subjects the bank to a $100 per day penalty. Id. §§ 161(c), 334.

141. See Comptroller of the Currency, News Release, No. 85-75 (1987) (enforcing such limits with regard to Continental Bank's extensions of credit to its subsidiary first options).
142. Bank loans to executive officers, directors, principal shareholders, or related interests of banks or their affiliates must not be on preferential terms or pose abnormal risk of repayment, must be approved by a disinterested majority of the bank's board of directors, and generally must not exceed the bank's limit on loans to a single borrower. 12 U.S.C. §§ 375a, 375b (1982).
143. Id. § 375.
144. Id.
the agencies also has general rulemaking authority\textsuperscript{147} which enables them to adopt appropriate regulations as needed to govern bank securities activities. Moreover, the Federal Reserve Board has authority to order a bank holding company to terminate or divest any activity whenever it has reasonable cause to believe that the activity "constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank."\textsuperscript{148}

Federal banking regulators have various enforcement remedies available to ensure compliance with laws applicable to bank securities activities.\textsuperscript{149} For example, violations of sections 23A, 23B, and other restrictions are punishable by civil money penalties, not exceeding $1,000 per day, which may be assessed against the violating bank or any bank officer, employee, or agent responsible for the violation.\textsuperscript{150} In addition, federal banking regulators have cease-and-desist powers to prevent banking organizations from engaging in unsafe and unsound practices or violations of law.\textsuperscript{151} Title V of S. 1886, the Enforcement Powers Improvement Act of 1988, would strengthen these enforcement powers.\textsuperscript{152}

Under existing laws, banking organizations are required to notify federal banking regulators or seek regulatory approval prior to engaging in nonbanking activities, including securities activities.\textsuperscript{153} These procedures provide regulators with an additional mechanism to monitor such activities for compliance with applicable laws and regulations as well as safety and sound-
As noted above, the banking regulators have utilized this authority to impose extensive conditions on bank securities activities. Section 4(c)(8) of the Bank Holding Company Act requires the Federal Reserve Board, in reviewing bank holding company proposals to engage in non-banking activities, to consider whether the proposed activities "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." S. 1886 would require that the activities of securities affiliates meet this test. In addition, S. 1886 specifically provides that the Board must be satisfied that the bank holding company possesses the managerial resources to conduct proposed activities through a securities affiliate safely and soundly.

Banking organizations also are subject to the antitrust laws which prohibit combinations that substantially lessen competition, result in monopoly power, or restrain trade. In addition, as noted, the BHCA specifically requires that the Federal Reserve Board consider the potential for decreased or unfair competition and undue concentration of resources in approving bank holding company acquisitions of nonbank companies. S. 1886 would add specific concentration limits under which the Board may not approve any acquisition that would result in the affiliation of a bank holding company or a bank with total assets of more than $30 billion with an investment bank with total assets of more than $15 billion. Banking organizations are also subject to existing statutory prohibitions on tying arrangements that may result in unfair competition.

154. For example, section 4(c)(8) of the BHCA, requires the Federal Reserve Board to determine whether a specific bank holding company's performance of a particular activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increase competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." 12 U.S.C. § 1843(c)(8) (1982).
155. See supra notes 106-21 and accompanying text.
157. S. 1886, supra note 9, § 102.
161. The Bank Merger Act and the BHCA specifically apply antitrust standards comparable to those in the Sherman and Clayton Acts, but allow violations of the antitrust laws to be mitigated by factors relating to the "convenience and needs of the community." 12 U.S.C. §§ 1828(c)(5), 1842(c) (1982).
162. Id. § 1843(c)(8).
163. S. 1886, supra note 9, § 102.
164. Banks and bank holding companies are prohibited from providing services or ex-
F. Deference to Securities Regulation

The securities laws provide an additional layer of regulation that addresses many of the concerns regarding the conduct of expanded securities activities by banking organizations. Depending on its activities, a securities affiliate would be regulated by one or all of the SEC, the Commodities Futures Trading Commission, the Municipal Securities Rulemaking Board, the National Association of Securities Dealers, and individual stock and commodities exchanges, as well as by state securities regulatory authorities. The statutes and regulations enforced by these regulatory bodies provide effective safeguards against conflicts of interest and abusive practices in the securities business. For example, the federal securities laws require registration of securities broker-dealers and investment advisers,\(^{165}\) compliance with net capital and disclosure requirements,\(^{166}\) registration of publicly offered securities,\(^{167}\) and periodic reporting by issuers of such securities.\(^{168}\)

The extent to which banking organizations should be subject to the securities laws and SEC jurisdiction with respect to their securities activities is a nettlesome question on which the banking agencies and the SEC have disagreed for years.\(^{169}\) Banks currently are exempt\(^{170}\) from enforcement of securities regulations by the SEC, but are subject to similar regulation by the banking agencies.\(^{171}\) Bank holding companies and their nonbank affiliates are not exempt from SEC enforcement, and frequently must comply with dual regulations of the SEC and the banking agencies addressing the same regulatory concerns. The antifraud provisions of the securities laws are ap-

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166. See generally id. § 77g.
167. See generally id. §§ 77d, 77e, 77f, 77j.
168. See generally id. §§ 78m, 78o(d).
169. The SEC attempted to assert jurisdiction over bank securities brokerage activities in 1985 when it promulgated rule 3b-9 requiring banks engaged in such activities to register as broker-dealers under the Exchange Act. 50 Fed. Reg. 28,385 (July 12, 1985). The banking agencies objected and the American Bankers Association successfully argued in court that the SEC has no jurisdiction to regulate banks as broker-dealers. American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986) (overturning SEC rule 3b-9).
171. See, e.g., id. 78f(i); 12 C.F.R. §§ 11, 206 (1987). The Federal Reserve Board recently amended its regulations to provide that state member banks required by the Exchange Act, 15 U.S.C. § 78f(b), (g) (1982), to file certain information with the Board must do so on the forms prescribed by the SEC for other entities subject to the reporting requirements of the Exchange Act. Amendment of Regulation F, 52 Fed. Reg. 49,374, 49,376 (1987) (to be codified at 12 C.F.R. § 208.16).
The expansion of securities powers of banking organizations will require careful coordination of the securities and banking laws in order to avoid regulatory duplication and conflict. Congress should defer as much as possible to the existing securities regulation system to govern expanded securities activities of bank holding companies rather than establishing yet another layer of regulation to govern such activities. The public benefits of expanded bank securities activities will not be realized if banking organizations are burdened by layers of unnecessary and overlapping regulations. The securities laws should govern bank securities affiliates in matters relating to investor protection, potential conflicts, advertising and disclosure issues, and abusive practices that are within the realm of the securities laws. To the extent that new statutory or regulatory conditions imposed on expanded bank securities activities address the same issues that are addressed by the securities laws, banking organizations will be needlessly burdened by compliance with overlapping and potentially inconsistent regulations.

Deference to the securities regulatory framework would further the interests of market efficiency by allowing bank holding companies to compete on the same terms and conditions as their securities industry competitors. Thus, for example, bank holding companies should be permitted to underwrite securitized assets of their affiliates to the same extent as their securities industry counterparts without additional regulatory requirements.

To the extent that banks may be authorized to engage directly in securities activities, however, Congress should avoid subjecting those activities that are closely related to traditional banking functions to securities law regulation. For example, brokerage for trust accounts, self-directed IRA accounts, securities safekeeping, trading for the bank's own account, and similar activities are traditional bank activities that alone should not subject a bank to securities regulation. Such activities are subject to extensive bank regulation and the imposition of securities regulation on such activities would be unduly burdensome and unnecessary.
S. 1886 adopts a position of deference to the securities laws by requiring that most of the expanded bank securities activities be conducted in a securities affiliate subject to the SEC's jurisdiction. With respect to securities activities authorized directly for banks, S. 1886 embodies a compromise with respect to the appropriate division of jurisdiction worked out by the SEC and the banking agencies.

S. 1886 would amend the definition of "broker" in the Securities Exchange Act of 1934 to include banks actively engaged in soliciting customers to buy and sell securities and bank brokerage activities for which a bank receives incentive compensation. In addition, S. 1886 would require banks to transfer their public brokerage business into separate, SEC-regulated affiliates.

However, banks could continue performing certain securities services that are incidental to traditional banking functions without the necessity of registration under the Exchange Act. For example, brokerage services for trust accounts would not require registration under S. 1886 unless the bank receives incentive compensation and publicly solicits brokerage business. Similarly, securities safekeeping, IRA, and managed agency accounts would require registration only if the bank publicly solicits such business separately and receives incentive compensation or offers execution services in connection with securities safekeeping. Additionally, safe deposit box services, escrow arrangements, and holding securities as collateral for loans similarly would be permitted without registration. Furthermore, exemptions would be provided for "networking" arrangements under which a bank may contract with an affiliated or unaffiliated broker-dealer to provide brokerage services to bank customers on bank premises, for "sweep" arrangements under which customer bank deposits are swept into money market mutual funds, and for private placement activities. Banks that do not have a securities affiliate pursuant to section 4(c)(15) of the BHCA could effect transactions in municipal securities without registering as a broker; banks with such an affiliate would be required to transfer municipal activities to the affiliate.

175. S. 1886, supra note 9, § 301.
176. S. 1886 would amend the Exchange Act to prohibit a bank from becoming a broker except on an exclusively intrastate basis, id. § 304, thereby requiring banks to create separate affiliates or subsidiaries to conduct broker-dealer activities.
177. Id. § 301.
178. Id.
179. Id.
180. Id.
181. Id.
S. 1886 would continue to exclude banks from the definition of "dealer" in the Exchange Act with respect to transactions for the bank's account in commercial paper and bankers acceptances and, in addition, municipal securities if the bank does not have a securities affiliate. Similarly, a bank could deal in its own securitized assets without registering as a dealer.

Banking organizations would be subjected by S. 1886 to SEC regulation under the Investment Company Act with respect to mutual fund activities. S. 1886 would amend the Investment Company Act to address issues arising when an investment company becomes affiliated with a bank. For instance, a bank would be permitted to serve as trustee for an affiliated unit investment trust only in accordance with rules adopted by the SEC after written consultation with the banking agencies. Similarly, a registered investment company would be prohibited from knowingly acquiring, during an underwriting, any third party security the proceeds of which will be used to retire indebtedness owed to a bank that sponsors, organizes, or underwrites the company. In order to promote coordinated regulation of bank investment adviser activities, S. 1886 would require the SEC to notify a bank's primary federal banking regulator prior to initiating any examination or enforcement action against any bank, bank division, or bank holding company registered as an investment adviser. The SEC and federal banking regulators would be required to share reports of examinations of bank investment advisory activities.

The need for coordinated bank and securities regulation will be ongoing and will become even more acute if securities firms are permitted to acquire banks. S. 1886 recognizes this need by directing the Federal Reserve

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183. S. 1886, supra note 9, § 302.
184. Id.
186. S. 1886, supra note 9, § 401. S. 1886 would eliminate the current exclusion from the definition of "investment adviser" in the Investment Company Act, 15 U.S.C. § 80b-2(a)(11) (1982), for banks and bank holding companies serving as investment advisers to registered investment companies unless, in the case of a bank, the bank conducts such activity through a separate department or division in which case only that department or division must register as an investment adviser. S. 1886, supra note 9, § 408.
187. S. 1886, supra note 9, § 401.
188. Id. § 402.
189. Id. § 411.
190. Id.; see also id. § 412 (authorizing the SEC to share information with federal banking regulators and other federal and state agencies for law enforcement purposes).
191. S. 1886 would amend the BHCA to allow the acquisition of banks by "diversified financial holding companies," defined as companies that devote 80% of their total assets to activities permissible under sections §§ 4(c)(8), 4(c)(13), 4(c)(14), and proposed § 4(c)(15) of the BHCA, 12 U.S.C. 1843(c)(8), (13)-(15) (1982), and devote no more than 20% of their total activities...
Board and the SEC to prepare, within one year, a joint study for Congress addressing issues relating to harmonizing regulation. Such issues are to include the advisability of consolidated regulation of companies controlling banks or securities firms, appropriate techniques for supervision of affiliate transactions within such firms, international financial harmonization, and the nature and techniques used in supervising banking and securities organizations. The Board and the SEC also are directed to develop proposed revisions to harmonize capital adequacy standards of banking and securities organizations and to report annually to Congress regarding their progress toward and recommendations for achieving regulatory harmony.

IV. CONCLUSION

Reports of Glass-Steagall's death may be premature. In the past, Congress has retreated when faced with opportunities to liberalize bank securities activities. The stock market volatility in October of 1987 has provided a new focal point for securities industry opposition to expanded bank securities powers. Other industries facing competition from banking organizations, notably the insurance and real estate industries, may seek to hold hostage any new securities powers to demands that Congress ban bank competition in those industries. Faced with a clash of competing interest groups, Congress may find it impossible to fashion a politically acceptable compromise in an election year with early adjournment scheduled. Congressional failure to enact Glass-Steagall reform legislation, however, will assets to the ownership of FDIC-insured banks or FSLIC-insured institutions. S. 1886, supra note 9, § 110.

192. S. 1886, supra note 9, § 111.
193. Id.
194. Id.
195. Id.
196. For example, in 1984 a bill to expand bank securities powers was passed by an overwhelming majority in the Senate but failed to win House approval. S. 2181, 98th Cong., 2d Sess. (1984) (approved by the Senate on Sept. 13, 1984).
197. The insurance industry succeeded in adding strict limitations on insurance activities of banking organizations in title VIII of S. 1886. The National Association of Realtors succeeded in adding a provision limiting bank real estate activities to the proposed St Germain-Wylie Depository Institutions Act of 1988, DEPOSITORY INSTITUTIONS ACT COMMITTEE PRINT, supra note 9, § 144. Consumer groups have also demanded that their interests be addressed in any Glass-Steagall reform. Banking trade groups have announced that they will oppose any federal banking reform legislation that places new restrictions on nonbanking activities currently authorized under state laws. The trade groups include the American Bankers Association, Association of Bank Holding Companies, Association of Reserve City Bankers, Bank Capital Markets Association, Consumer Bankers Association, and the Independent Bankers Association. Six Banking Trade Groups Would Oppose Bill to Restrict State-Authorized Powers, 50 Banking Rep. (BNA), Feb. 8, 1988, at 193, col. 2.
198. Proceedings in the House of Representatives on Glass-Steagall reform legislation are
ensure a further weakening of the banking system as banking organizations see their traditional business erode and their profits shrink in the face of competition for financial services which they cannot provide under current law.

The separate affiliate concept offers a viable alternative for expanded bank securities powers. The Senate-passed Proxmire Financial Modernization Act of 1988, embracing this concept, offers Congress the opportunity to usher in a new era of banking better aligned with market realities and customer financial needs consistent with the traditional role of banking and safety and soundness principles. But Congress should not lock into place a set of rigid restrictions that will deny banking organizations the flexibility to respond to further evolution of the financial markets. Deference to existing securities regulations and a willingness to allow the regulatory agencies to structure appropriate regulations to accommodate future market changes according to a broad congressional mandate will avoid further years of protracted legal struggle and congressional paralysis over the appropriate scope of bank securities activities.

complicated by the joint jurisdiction over such legislation by the Committee on Banking, Finance, and Urban Affairs and the Committee on Energy and Commerce.
APPENDIX*

SECURITIES ACTIVITIES OF BANKING ORGANIZATIONS
PERMISSIBLE UNDER FEDERAL LAW

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