Chapter 14 | The Legal Barrier Between U.S. Investment and Commercial Banking: Its Origins, Application, and Prospects

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I. Introduction

The purpose of this discussion is to provide an overview of the Glass-Steagall Act—that is, of those provisions of U.S. national banking law which create a legal barrier between commercial and investment banking activities conducted in the United States. The focus of this presentation will be on how the legal distinctions between commercial and investment banking in the United States currently are interpreted and applied. This paper will, however, also discuss the origins and development of the Glass-Steagall Act and the prospects for its modification or repeal in the future.

A discussion of the Glass-Steagall Act and how it has influenced the development of the U.S. financial markets is particularly relevant today for several reasons. First, over the past twenty years, there have been major changes in the "business of banking" and how financial-service intermediaries have conducted their activities in the United States and abroad. In many respects, banking services have become integrated with other types of financial-market functions, and there has been a proliferation of banking services and products which bear many of the attributes of securities, insurance, or other financial services and products. In many cases commercial banks now are offering hybrid products and services which are functionally indistinguishable from products and services offered by securities firms, insurance companies, and other providers of financial services.

Second, there has been an increasing tendency for borrowers and investors to seek new funding sources or investment opportunities in other segments of the financial-service market and to rely less on traditional banking services. For example, corporate issuers have turned to the commercial-paper markets as a substitute for bank financing, and traditional deposit customers have sought alternative investments in products offered by the securities and insurance industries. Hence, banks have

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increasingly faced competition from other financial-service providers, with the result that several significant sources of banks' business have become less reliable.

The changes in the financial-service markets have been accelerated by the impact of technology: nowadays, large financial transactions are conducted electronically and can be consummated around the world almost instantaneously, forever changing the means by which traditional banking services are provided. Similarly, the internationalization of the world's capital markets has had a profound competitive and operational impact on both U.S. and foreign providers of financial services. As the capital markets and the products used to raise capital for public and private borrowers have multiplied and expanded around the world (as evidenced by such developments as the growth of the Eurosecurities markets and the continuous proliferation of new capital-market products, such as interest rate swaps), it has become clear that capital raising can no longer be regarded as a purely domestic function.

These changes in the domestic and international financial markets, and their impact on the competitive position of U.S. banking organizations, recently have received a great deal of public attention. In many segments of the U.S. financial-service industry, there has been a call for wholesale reform of the legal and regulatory structure of U.S. financial markets. At the present time, significant legislative initiatives have been proposed at the national level which may result in such reforms. One of the principal initiatives under discussion is a significant modification or removal of the Glass-Steagall Act's constraints on commercial bank involvement in securities underwriting and dealing activities.

Therefore, an understanding of the legal barriers between commercial and investment activities is particularly germane to the ongoing debate over whether these barriers ought to be left in place or changed. The balance of this paper will begin with a brief summary of the origins of commercial bank involvement in investment banking in the United States, in order to develop the context in which the Glass-Steagall Act was considered and enacted over 55 years ago. Following this summary, this paper will review the structure of the Glass-Steagall Act, including a discussion of its major statutory provisions and their interrelationships. Thereafter, the presentation will turn to a discussion of the judicial and regulatory applications of the Glass-Steagall Act to commercial banking activities, and the legal problems resulting from attempts to apply the Glass-Steagall Act to today's commercial banking environment. Finally, the paper will conclude with a brief discussion of the prospects for making modifications or changes in the Glass-Steagall Act.

II. Origins of the Separation of Commercial and Investment Banking in the United States

The Glass-Steagall Act is the popular name customarily given to the Banking Act of 1933,[1] one of the major pieces of legislation enacted during the first 100 days of the Roosevelt administration in response to the continuing deterioration of the U.S. economy which began with the October 1929 stock-market crash. The term "Glass-Steagall Act," however, is used by most legal commentators specifically with reference to the legal barrier the Act has erected between commercial and investment banking in the United States.

In order to understand the significance of the Glass-Steagall Act, one needs to appreciate its historical context, because the Glass-Steagall Act represented not only a congressional response to the economic crisis precipitated by the Great Depression but also the culmination of a long debate over commercial bank involvement in these kinds of activities. Hence, the Act's historical context includes the immediate events which precipitated its enactment in 1933, as well as the development in the United States of commercial bank involvement in investment banking activities.

What follows is not intended to be an original or extensive discussion of the development of commercial and investment banking in the United States; this is a subject which has been extensively explored in the scholarly literature.[2] Instead, the following discussion is intended primarily to provide a general framework for understanding the relationship of the Glass-Steagall Act to the U.S. banking system.

U.S. Development of Commercial Bank Securities Activities

Historically, the "business of banking," as it initially developed in colonial and early nineteenth-century America, bore a greater resemblance to the English system of banking than to banking practices as they had developed on the Continent. In contrast to the unified banking organizations (i.e., banks providing a wide range of deposit, investment, and merchant banking services) which developed in several European countries, the first banking organizations which emerged in colonial America more closely resembled the English model, in that they were relatively limited in the types of services they provided: the issuance of bank notes, the taking of deposits, and the providing of short-term credit.[3] With regard to the lattermost function, early American banks played an important role in facilitating the conduct of trade and commerce in a colonial society. Thus, during the first few decades of the United States' existence, commercial banks were more involved in the providing of short-term "mercantile"

credit (or operating funds) than in making direct investments in commercial ventures or providing long-term capital credits.[4]

Eighteenth-century and early nineteenth-century commercial banks, however, increasingly became involved in longer-term lending. For example, historians cite the early banks' acceptance of "accommodation paper," representing loans unconnected with specific business transactions.[5] As the country's agrarian and commercial bases grew, banks became increasingly involved in the supply of longer-term credit (to farmers, landholders, manufacturing concerns, and other commercial borrowers) and also provided credit to governmental interests, often through the device of acquiring the debt obligations (securities) of public and private issuers. Therefore, whatever the abstract appeal of the "traditional" English model of banking, by the early nineteenth century, the emerging U.S. banking system was, in practice, moving well beyond a purely short-term credit function.[6]

Indeed, almost from the start of the nineteenth century, commercial banks began to play an increasingly important role in the supplying of longer-term credit through purchases and sales of securities. For instance, the borrowing needs of the federal and state governments were satisfied in large part by commercial banks, which bought their obligations for investment and resale purposes.[7] Further, as the FDIC [Federal Deposit Insurance Corporation] Staff Study demonstrates, during this period the mixing of banking and commerce was not unusual.[8] Many states chartered banks expressly for the purpose of providing capital to, or even managing the stock of, public-improvement enterprises (railroads, canals, waterworks, light systems, etc.).[9] Moreover, some bank charters granted by the various states directed banks to provide short- and long-term credit to government and business alike.[10]

This is not to say, however, that commercial banks uniformly were given free rein to become participants in investment banking enterprises. As a general rule, each commercial bank was chartered by act of separate state (or federal) legislation,[11] which specified the powers the charter recipient was allowed to exercise.[12] In many cases, the charter powers were relatively limited, thus restricting their recipient institutions to deposit-taking, discounting, and note-issuing functions. Although securities dealing and underwriting activities were allowed for certain institutions, the willingness of states to allow chartered banks to become involved in commercial enterprises—and the trading and distribution of securities—progressively decreased toward the middle of the nineteenth century.[13] Further, during this same period, other sorts of financial institutions, including unincorporated private banking concerns, began to appear and (often with the assistance of European banking capital) became increasingly involved in the underwriting and distribution of securities issued by public and private

borrowers alike.[14] Therefore, commercial banks gradually ceded their primary position in the financing of commercial enterprises through direct investment or the negotiation of their securities.[15]

Commercial banks' involvement in investment banking activities, however, continued during the second part of the nineteenth century, especially as the borrowing needs of the federal government increased significantly because the U.S. Government issued large amounts of government obligations to finance the conduct of the Civil War.[16] In fact, it was during this period that the national banking system was created, in part to establish a market for U.S. Government obligations to be held by newly created "national banks" as collateral for the issuance of uniform national bank notes under the auspices of the newly created Comptroller of the Currency.[17] Thereafter, during the latter part of the nineteenth century, the financing needs of public, private, and semi-private borrowers increased dramatically as railroads, public utilities, and private manufacturing concerns raised short- and long-term funds in the capital markets, with the assistance of investment banking intermediaries selling to larger numbers of investors.[18] While private investment banks played a primary role in these financing activities, commercial bank involvement in these types of functions was considerable, and in many cases was permitted by law. At the same time, however, there was a widely held view that the proper function of commercial banks was to provide credit and liquidity to commerce, but not to become participants in commerce.[19]

Also during the middle portion of the nineteenth century, the "free banking" system emerged, as the states progressively passed legislation authorizing any group of individuals with a requisite amount of capital to apply for a commercial banking charter subject to such terms, conditions, and limitations as might be required by the enabling state statutes.[20] The free banking system was, in essence, embraced by enactment in 1863 of the National Currency Act,[21] and in 1864 of the National Bank Act,[22] which likewise permitted groups of individuals to apply for a national bank charter to exercise the powers granted pursuant to the enabling federal statutes. Thereafter, U.S. banks could be chartered under either federal or state law and would be permitted to exercise those powers granted by their respective enabling statutes; the U.S. system of concurrent state and federal chartering often is referred to as the "dual banking" system.[23] This system, which encouraged state chartering authorities to compete with national chartering authorities by providing more lenient charter provisions,[24] had a significant impact on the development of the legal barriers between commercial and investment banking in the next century.

The Early Twentieth Century

The enormous financing needs of the federal government occasioned by the First World War, coupled with the general era of prosperity following the conclusion of that war, set the stage for rapid expansion of the U.S. securities markets, as well as of the extent of bank participation therein.[25] Although commercial banks previously had been involved in the financing of public-borrower activities through their investments in, and their underwriting of, federal and state obligations, their involvement in this activity increased dramatically during the First World War, as the U.S. Government actively encouraged commercial banks to participate in the effort to raise funds to conduct the war. Moreover, the large amount of financing needed by the federal government during this period, as well as the increased borrowing needs of foreign governments, whetted the public appetite for stocks and bonds in general, an appetite which grew dramatically during the ensuing decade of prosperity after 1919.[26]

Hence, public and private borrowings of all sorts proliferated during the 1920s. At the same time, the needs of corporations and public borrowers alike for short-term financing, which had traditionally been provided in the form of bank loans, diminished, causing a decline in commercial banks' traditional lending bases.[27] As a result, commercial banks had a clear incentive to expand their securities operations as a means of retaining their customers and augmenting their income to make up for declining commercial lending business.[28]

During this time, national and state banking statutes imposed significant limitations on the ability of federally and state-chartered institutions to participate in securities dealing and underwriting. Under the laws of many states, however, chartered trust companies and general-purpose corporations were not as limited in the types of activities they could conduct. Therefore, in order to avoid the substantive limitations imposed by federal and state law on the activities of commercial banks, federal and state institutions alike began to organize "security affiliates," which were generally owned by a bank's shareholders in the same pro rata proportion as their holdings of bank shares, to conduct securities dealing and underwriting activities.[29]

While the existence of these "security affiliates" dates from the first decade of the twentieth century, the number of these affiliates did not grow dramatically until the late 1920s. Moreover, it is important to understand that most commercial banking institutions chose not to participate in the investment banking business; as a general rule, only the larger money-center banks, which had the economic incentives and the distribution channels to participate in the securities markets, created security affiliates.[30] Nevertheless, the use of the "security affiliate" device as a means of avoiding substantive powers restrictions imposed by federal and state

banking laws had a profound influence in the formulation of the Glass-Steagall Act as it was ultimately enacted, because it was through this device that twentieth-century commercial banks became significantly involved in the investment banking business.

As is commonly known, the 1920s saw an unprecedented growth in the size of, as well as in the universe of participants in, the U.S. securities markets, as large numbers of individuals, as well as institutions, bought and sold securities. The securities markets of that time, however, were dramatically different from their contemporary descendants. These markets were unregulated, and the speculative climate of that time encouraged a proliferation of abusive selling practices and manipulative activities by bank and nonbank participants alike. Further, institutional and individual participation in securities markets was highly leveraged, in that a large percentage of the buying and selling of securities was done on credit, or margin, with much of the financing provided by commercial banks. The problems which emerged during this period were the subject of a series of congressional investigations of concentrations of economic power in the banking industry and abusive securities-market practices.[31] These investigations, however, did not immediately produce any substantive legislation.

The increasing bank involvement in these types of activities did not go unnoticed. Although the laws of many states, as well as federal law, generally limited direct commercial bank participation in commercial enterprises, the growth of banks' "security affiliates" generated an active concern about bank participation in securities-market activities among regulators and legislators alike.[32] Again, however, these concerns were not acted upon, and by 1929, commercial bank involvement, through securities affiliates, in securities dealing and underwriting of all types had grown to such a level that commercial banks had become the dominant force in the investment banking industry.[33]

Economic Collapse of 1929 and Early 1930s

The events of October 1929—namely, the stock-market crash, which generally is identified with the onset of the Great Depression—brought an end to the era of prosperity which had been so instrumental in fueling the expansion of the securities activities of banks and investors alike. As the value of securities held by investors generally decreased in the aftermath of these events, investors who had purchased securities on credit and whose securities loans were collateralized by their purchases found they had to liquidate their holdings in order to satisfy margin calls made by creditors, which forced the prices of those securities down further in the public market and reduced their value to investors continuing to hold them. Commercial banks which were large holders of investment securities were

affected in the same fashion as other classes of investors, suffering losses resulting from the general price deflation in their securities portfolios.

As previously noted, Congress had conducted various inquiries into the operation of the U.S. securities markets during the second and third decades of the twentieth century. Further, congressional recommendations to separate commercial banks from the securities underwriting and dealing business had been made as early as 1913, but had never been acted on.[34] The events of 1929 and their aftermath, however, gave renewed vigor to the critical scrutiny of bank securities activities by the Congress. These debates continued during the early part of the 1930s, as Congress undertook special investigations of the securities practices of commercial banks and their affiliates, and of the abuses in the domestic securities markets generally.[35] Moreover, certain notable failures of banks with large securities affiliates, primarily the Bank of the United States (which, according to historical sources, had established as many as 59 separate affiliates to conduct various types of businesses not permitted to the bank itself),[36] and instances of other banks abusing their relationships with their securities affiliates sharply increased the public criticism of commercial bank involvement in the securities business.[37]

The historical record of the period suggests that the collapse of the U.S. banking system was less the result of bank overinvolvement in the securities business than it was the product of existing trade and monetary policy, the collapse of the agricultural and industrial sectors, and the resulting loss of bank depositor confidence.[38] Although the continuing economic decline in the early part of the 1930s might, in fact, have been only incidentally the result of bank securities activities, however, this possibility seems to have been given little weight by Congress, whose criticism of these activities continued unabated. Commercial banks were failing by the thousands by 1932 and 1933, and it was these bank failures and the obvious need for a serious legislative response to restore confidence in the U.S. banking system that directly led to the enactment of the Banking Act of 1933, which includes the provisions known as the Glass-Steagall Act. Indeed, the overriding purpose of the Banking Act of 1933 was precisely to stabilize the U.S. banking system and restore public confidence. It did so by, among other things, creating a system of federal deposit insurance to protect bank depositors (a move that was viewed as radical by many congressional and executive sources); imposing restrictions on transactions between banks and their insiders and affiliates; limiting the use of bank credit (in the form of "brokers' loans" and the like) for securities activities; and, of course, creating the limitations on securities dealing and underwriting by commercial banks now found in the various provisions of the Glass-Steagall Act.

The legislative history accompanying the Banking Act and contemporaneous debates reveal some interesting information concerning Congress's view on the need to separate commercial banking from investment banking. Among other things, the legislative history reflects a high level of discomfort with the extensive commercial bank involvement in securities dealing and underwriting activities through "security affiliates."[39] In a related vein, the reports criticized the extent of bank involvement in "brokers' loans" and other extensions of credit designed to facilitate the purchase and sale of securities, a practice the legislative reports condemned as fueling the speculation in securities that had occurred during the previous decade.[40]

Also suggested by the legislative history, however, was the notion that commercial banks, by engaging in these securities activities, had been "diverted" from their true purposes in the financial system: the providing of short-term credit to facilitate trade and commerce, as opposed to participation in long-term investment ventures.[41] Among others, Senator Carter Glass, a chief proponent of the Act which now bears his name, was a firm believer in the "real-bills" doctrine of banking—that is, the notion that the proper role of banking was limited to the providing of short-term, self-liquidating credit in trade and commerce.[42] In reflecting this belief, the legislative history in effect suggested that commercial banks were never intended to engage in longer-term investment banking activities and that the legislation in question was needed to return banks to their original and proper purposes.[43]

Whether the Glass-Steagall Act was, in fact, necessary is a question which never will be satisfactorily answered. There is no doubt that the Glass-Steagall Act, like other provisions of the 1933 Banking Act, was more the product of a true economic emergency than a reasoned consideration of the proper role of banks and banking in the U.S. economy at the time. Indeed, the relevant legislative reports recognized the need to undertake a longer-term study of the U.S. financial system, but acknowledged that a short-term solution was necessary in light of the then-current economic emergency.[44] In retrospect, several of the assumptions underlying the enactment of the law which ***prohibited***, as opposed to ***regulated***, bank involvement in securities distribution and trading activities were only partially valid.

First, while it is understandable why the activities of bank securities affiliates were of great concern to the Congress at the time,[45] many of the abusive practices which the investigations of these affiliates uncovered were not the peculiar result of the relationship between banks and their affiliates but rather involved manipulative and deceptive practices which occurred in the investment banking industry as a whole.[46] These practices spawned major pieces of legislation which created, for the first time, a

federal regulatory structure for offers, sales, and trading in the U.S. securities markets. Thus, the Securities Act of 1933[47] established disclosure requirements for the offer and sale to the public of securities which were designed to ensure that purchasers of securities would receive full disclosure concerning the securities sold and the business of the issuer selling them. One year later, the Securities Exchange Act of 1934[48] created the Securities and Exchange Commission (SEC), laid the foundation for an extensive regulatory scheme affecting securities professionals (including brokers, dealers, and securities exchanges), broadly prohibited manipulative and deceptive acts and practices, and limited the amount of credit that could be extended to finance purchases of securities. These two pieces of legislation alone went a long way toward alleviating some of the abuses found by the Congress in the investment banking industry and very possibly made some of the prohibitory provisions of the Glass-Steagall Act redundant upon their enactment. This became all the more true when, in 1940, Congress enacted the Investment Company Act of 1940[49] and the Investment Advisers Act of 1940,[50] which imposed significant regulatory requirements on the activities of investment companies and investment advisers, respectively.

Second, notwithstanding the great concern expressed over bank failures occasioned by securities dealing and underwriting activities, only a relatively small percentage of national banks were engaged in these types of activities. Moreover, the vast majority of bank failures that occurred in the 1930s had little to do with "risky" securities dealing and underwriting, in that most of the failures occurred in smaller cities and rural communities as a result of local economic conditions and not of "investment banking" activities. In this sense, one legitimately may question whether the concerns addressed by the Act were, in fact, a primary cause of the economic dislocations of the times.[51] Insofar as the Glass-Steagall Act is credited with restoring confidence in the U.S. banking system, it can also be argued convincingly that the creation of federal deposit insurance was at least equally, if not more, responsible for restoring depositor confidence in commercial banks.

Third, and in some respects most significant, the Glass-Steagall Act sought to create a barrier between lines of business ("banking" and "investment banking") which in many respects served functionally interchangeable purposes and did so without a clear sense of the precise activities that ought to be prohibited. Thus, while a bank loan, on the one hand, and a flotation of debt securities, on the other hand, were simply different manifestations of the same basic function—that is, the extension of credit—one activity was legal after Glass-Steagall and the other was not. The various legislative reports, however, did not define the precise lines of demarcation between prohibited and permitted activities. Similarly, the

assumption that commercial banks were not intended to venture into investment banking was largely belied by the fact that commercial banks had been involved in precisely these activities during the previous century; and even after the Glass-Steagall Act, they were permitted to continue engaging in highly significant securities underwriting businesses (e.g., dealing in and underwriting government obligations) and to provide services such as securities brokerage for customers. Therefore, in many respects, the Act's distinctions between "commercial" and "investment" banking were seriously blurred from the start.

The distinctions between commercial and investment banking created by the Glass-Steagall Act were destined to be difficult to apply even if those distinctions were necessitated by the events of the day. The application of the Glass-Steagall Act, however, has been complicated by the rapid changes in the financial markets since 1933—changes which now raise serious questions about the continued validity of the Act's original goals. These interpretations and the resultant difficulties are discussed at greater length in the following sections.

III. Overview of the Glass-Steagall Act

The provisions of the Glass-Steagall Act separating investment from commercial banking are found in four principal statutory provisions. Two of these provisions deal with the authority of commercial banking organizations to engage directly in investment banking activities; the other two govern the authority of commercial banking organizations to become affiliated with securities firms, or to have officers, directors, or employees in common with securities firms.

Sections 16 and 21

Section 16 of the Glass-Steagall Act[52] is the portion which generally limits the securities purchasing, dealing, and underwriting activities of national banks. It states that a national bank's business of dealing in "securities and stock" is limited to the purchase and sale of securities "without recourse, solely upon the order, and for the account of, customers, and in no case for its own account." In the same clause, Section 16 prohibits national banks from "underwriting" any issue of securities. Section 16 is made applicable to banks which are members of the Federal Reserve System, commonly referred to as "member banks," in accordance with Section 5 of the Federal Reserve Act.[53]

Section 16, however, contains a number of exceptions. First, national banks are permitted to purchase, subject to regulations adopted by the Comptroller of the Currency, "investment securities," which are defined

to mean marketable obligations evidencing indebtedness of any person or entity "in the form of bonds, notes and/or debentures commonly known as investment securities"[54] as further defined by Comptroller of the Currency regulations. Moreover, Section 16 contains provisions authorizing national banks to purchase, deal in, and underwrite without limitation general obligations of the United States and its instrumentalities and general obligations of states and political subdivisions thereof.

In contrast to Section 16, Section 21 of the Glass-Steagall Act[55] is designed to prohibit entities engaged in certain securities activities from engaging in the banking deposit business. To this end, Section 21 generally prohibits any firm "engaged in the business of" "issuing, underwriting, selling, or distributing" securities from accepting deposits. It does not, however, prohibit national or state member banks or other financial institutions from engaging in such securities activities to the extent permitted to national banks under 12 U.S.C. § 24 (of which Section 16 is a part). In addition, since 1935, Section 21 has provided that it does not affect in any way "such right as any bank ... may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate."[56]

Sections 20 and 32

The other main provisions of the Glass-Steagall Act, Sections 20 and 32, generally limit affiliates and management interlocks between banks which are members of the Federal Reserve System, on the one hand, and securities firms, on the other hand. Section 20 of the Act[57] generally prohibits any member bank from being affiliated with any organization "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution" of securities. The term "affiliated," as used in Section 20, generally is defined in another section of the federal banking laws as including any organization (1) owned or controlled by a member bank, (2) owned or controlled by the shareholders of a member bank, (3) a majority of whose directors are directors of any one member bank, or (4) which owns or controls either a majority of the shares of capital stock of a member bank or controls "in any manner" the election of a majority of directors of a member bank.[58] In a similar vein, Section 32 of the Act[59] generally prohibits any officer, director, employer, any firm, or any individual, "primarily engaged" in the "issue, flotation, underwriting, public sale, or distribution" of "stocks, bonds, or other similar securities" from serving at the same time as an officer, director, or employer of any member bank. The Federal Reserve Board, however, is given regulatory authority to allow officer, director, or employee interlocks when in "the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments."

The Federal Reserve Board, in turn, has adopted its Regulation R,[60] which generally implements this grant of regulatory authority.

Coverage of the Act

Under the terms of the relevant statutory provisions, the scope and coverage of the Glass-Steagall Act's prohibitions on commercial bank securities activities are not absolute. A close examination of the statutory terms and their interaction reveals that, contrary to the general understanding that the Glass-Steagall Act was designed to separate "as completely as possible" commercial from investment banking,[61] the Act in fact accomplishes at best an incomplete separation.

Notably, the Act provides an absolute exemption for banks' dealing in, and underwriting of, U.S. obligations, as well as state and local general obligations. Thus, commercial banks are not prohibited from engaging in dealing and underwriting activities involving U.S. Treasury obligations, as well as the general obligations of the various states or political subdivisions thereof, and, in fact, have continued since 1933 to be major participants in these markets. Similarly, Section 16 of the Glass-Steagall Act provides a partial exemption for bank dealing and underwriting in obligations of certain international lending organizations (for example, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the Inter-American Investment Corporation) but limits such dealing and underwriting activities to 10 percent or less of a bank's capital stock and unimpaired surplus. Further, since 1933, Section 16 has been amended on numerous occasions to provide express authority for national banks to purchase various types of securities issued by public instrumentalities of the United States.[62]

The second notable feature of the Glass-Steagall Act's coverage is that, by their terms, three of the four sections involved (Sections 16, 20, and 32) do not apply to state-chartered commercial banks which are not members of the Federal Reserve System (often referred to as state nonmember banks). At the time the Act was passed, there was a significant disagreement about whether Congress had the authority to regulate activities of banks which were not members either of the national banking system or the Federal Reserve System, and these three sections of the Glass-Steagall Act, which do not apply to state nonmember banks, reflected this general uncertainty.[63] The only section of the Glass-Steagall Act which applies to the activities of state nonmember banks is Section 21, which, as noted above, imposes a flat prohibition on the deposit-taking activities of any firm engaged "in the business" of conducting certain securities activities.[64]

Third, Section 16 of the Act provides an express exception for purchases and sales of securities "without recourse, solely upon the order and for the

account of, customers," an exception which is generally read to apply to the brokerage and related activities of commercial banking organizations.[65] In fact, the authority of banks to engage in these types of activities has been an important force in commercial bank expansion into various types of securities activities, including public (or "discount") brokerage, investment advisory activities, private placement services, and other activities involving the purchase and sale of securities for the accounts of others.

Fourth, the structure of the Glass-Steagall Act and the distinctions it draws between activities conducted directly by commercial banking organizations, on the one hand (Sections 16 and 21), and securities activities conducted by affiliates of commercial banking organizations (Sections 20 and 32), on the other hand, create only a partial prohibition on affiliates' securities activities. Section 20 prohibits only affiliations between member banks and entities *principally* engaged in certain prohibited securities activities; similarly, Section 32 of the Act prohibits only director and employee interlocks between member banks and entities *primarily* engaged in prohibited securities activities. Therefore, while the nature and coverage of the terms "principally" and "primarily" are not specifically defined, the Act does not prohibit affiliations or interlocks between member banks and firms engaged in securities activities to an extent which does not satisfy the "principally engaged" or "primarily engaged" standards in Sections 20 and 32.

It is worth noting that the restrictions of the Glass-Steagall Act applicable to national and state member banks do not apply with equal force to the foreign operations of U.S. banking organizations. Although the scheme of statutes and regulations which apply to foreign banking operations of U.S. banking organizations is quite complex, as a general rule, foreign banking affiliates (but not foreign bank branches) have, in effect, been permitted to conduct an unlimited underwriting and dealing business in debt securities abroad, although their authority to conduct such a business with respect to equity securities is significantly more limited.[66] The Glass-Steagall Act restrictions, however, generally apply to foreign banking organizations conducting securities activities in the United States.[67] A limited class of foreign banking institutions which had U.S. securities affiliates as of mid-1978 have been permitted, under the International Banking Act of 1978, to retain interests in domestic securities firms.[68] Under recent amendments to that Act, however, a "grandfathered" foreign banking organization must now divest itself of such an affiliate within two years (subject to limited extensions of time by the Board) of the date on which the former organization becomes a bank holding company by acquiring control of a U.S. bank.[69]

How are we to understand the reason behind the structure of the Glass-Steagall Act as it was written? It is important to recall the context in which the Act was passed: the high level of congressional concern about bank overinvestment in "speculative" securities ventures; the growth of the much-criticized "security affiliate" system as a device to avoid substantive federal and state banking law restrictions; the historic participation of commercial banking organizations in satisfying the borrowing needs of public issuers (both federal and state); and a desire to channel bank efforts into "traditional" commercial banking activities which did not pose any of the special risks which the Act reportedly was designed to prevent. Viewed in this context, the Act's general limitations on purchases and sales of non-investment-quality securities would appear to be a logical response to concerns about the use of bank assets for "speculative" purposes. By the same token, the application of limitations on affiliates and interlocks only to member banks, and the enactment of Section 21, with its particular emphasis on the deposit-taking activities of private organizations, appeared to be the result of the fact that, as originally enacted, the Banking Act of 1933 effectively obliged all commercial banks to join the Federal Reserve System if they wanted to obtain permanent federal deposit insurance for their deposits.[70] More generally, Section 21's particular orientation toward private deposit-taking entities also may have reflected an uncertainty about the authority of the Congress to regulate the activities of state banks—activities which were nevertheless a subject of significant congressional concern in the early 1930s.

In some instances, Congress simply decided not to apply the Act's restrictions owing to competing policy concerns extending, in some cases, beyond the national banking laws. With respect to the Act's general exemption for dealing and underwriting activities involving federal and state obligations, the federal and state governments historically have depended heavily on commercial banks to satisfy their borrowing needs, and this exception seemingly reflects a conscious congressional determination that these activities should not be subject to the general statutory prohibition. Likewise, the succession of congressional determinations to permit national and member banks to purchase, deal in, or underwrite various types of other quasi-public securities reflects a series of legislative judgments concerning the need to enhance the liquidity or marketability of certain instruments for independent public policy reasons.[71] Finally, the exception for brokerage-related activities (in Section 16) was inserted in recognition of banks' traditional role in providing brokerage services for their customers.[72]

Notwithstanding the patchwork of exceptions contained in the Act, it has been understood to be a prohibitory act generally barring commercial bank involvement in a variety of investment banking activities.[73] The Act's incomplete prohibitions, however, and the lack of definition of some of

the major statutory terms have posed significant problems in the interpretation and the application of the Act by the federal courts and the federal banking regulatory agencies alike. It is to these interpretations that this paper now turns in an attempt to understand how the Act has been applied and the kinds of difficulties which its various interpreters have encountered in attempting to fulfill its legislative purposes.

IV. Judicial and Regulatory Application of Glass-Steagall Act to Commercial Banking Activities

The applicability of the Glass-Steagall Act to bank securities activities depends, in the first instance, on the existence of two statutory prerequisites. First, by its terms the Act applies only to activities involving "securities." Second, assuming that a particular bank transaction or activity involves a Glass-Steagall "security," the Act nevertheless will not apply unless the activity in question is one of the prohibited securities activities enumerated in one or more sections of the Act. Thus, absent a prohibited "issuance," "underwriting," "distribution," "dealing," or "public sale" involving securities, the Act does not apply.

A principal difficulty in applying the Glass-Steagall Act is that virtually none of the major statutory terms in question are defined. For example, the Act does not provide a definition of "security," nor does it define the terms "issuing," "dealing," "underwriting," "distribution," or "public sale," though these terms are used in one or more sections of the Act. Moreover, the legislative history to the Act provides very little guidance as to the meaning of the relevant terms; in sharp contradistinction to contemporaneous pieces of legislation—that is, the federal securities laws, discussed previously in Subsection II.3—Congress saw fit neither to define any of the major relevant terms either in the Act nor to discuss the meaning of these terms in the relevant legislative histories.

Thus, courts and regulatory agencies which have attempted to apply the Glass-Steagall Act to bank securities activities have been obliged to apply the Act without an adequate frame of reference either in the statute or its legislative history as to precisely the types of instruments or activities covered by the Act. Nevertheless, a number of cases have arisen under the Glass-Steagall Act which are instructive in understanding how the Act has been applied over the years. In particular, a handful of U.S. Supreme Court decisions have demonstrated some of the analytical problems encountered in applying the Act to various types of bank securities-related activities.

Perhaps the single most significant case to emerge under the Glass-Steagall Act is the 1971 Supreme Court decision in *Investment Company Institute v. Camp*.[74] This case involved a challenge by a securities industry

trade association to a national bank's proposal to establish, with regulatory approval, a collective investment fund for managed agency accounts. In upholding the challenge by the plaintiff trade association, the Supreme Court articulated several important principles in the interpretation of the Glass-Steagall Act which have emerged in subsequent interpretations.

First, the Supreme Court concluded that a bank competitor is legally entitled to seek judicial enforcement of the Act's prohibitions; stated another way, the *Camp* case established that a securities competitor injured by bank or bank regulatory action involving activities potentially subject to the Glass-Steagall Act is entitled to bring a lawsuit challenging that action and have its case heard in the U.S. federal courts.[75] As a result, the *Camp* case established the right of the securities industry—the banking industry's primary competitor in the area of securities activities—to institute legal challenges, under the Glass-Steagall Act, against banks and bank regulatory agencies. That entitlement has played an extremely important role since that time in the development of Glass-Steagall precedent in the federal courts, because the judicial precedents under the Act have been developed through the legal challenges of the securities industry.

The *Camp* case, however, also applied to the Act a general principle of U.S. statutory construction that a statute is to be construed according to its "literal language." The Court stated that the distribution of "interests" in a collective investment fund for managed agency accounts appeared to involve the "distribution" or "underwriting" of "securities" within the meaning of the Glass-Steagall Act's literal language.[76] In reaching this conclusion, however, the Supreme Court also looked to what it understood were the statute's legislative purposes and sought to identify the hazards against which the Glass-Steagall Act was directed.[77] Notably, the Court concluded that the purposes behind the Glass-Steagall Act went beyond the prevention of bank overinvestment in speculative securities ventures. The Court noted that the Glass-Steagall Act also was designed to eliminate some of the more "subtle hazards" associated with bank involvement, either directly or through affiliates, in the securities distribution and underwriting business, including the following: the potential conflicts of interest between a bank's role as financial advisor and its promotional role as distributor of securities; possible abuses of a bank's lending function to support its securities activities; use of its depositor or fiduciary customers to "unload" securities of questionable value; and the loss of public confidence in a bank resulting from unsuccessful securities activities.[78]

Although the *Camp* case was decided twenty years ago, the "plain language" and the "subtle hazards" analyses that emerged from that case have been applied repeatedly in subsequent cases. Thus, for purposes of applying the Glass-Steagall Act, a so-called "hazards analysis" has been used uniformly by the courts and by the bank regulatory agencies (though

not without generating some criticism) in attempting to determine whether a particular activity is within or outside the scope of the Act, provided that the "plain language" of the Act has appeared to encompass the activity in question.

In *Securities Industry Association v. Board of Governors of the Federal Reserve System* (often referred to as the Commercial Paper case or as *SIA v. Board*),[79] the Supreme Court was requested to rule on the applicability of the Glass-Steagall Act to a commercial bank's proposed distribution of commercial paper issued by third-party corporate issuers. Previously, the plaintiff, the Securities Industry Association, a major securities trade group, had sought a ruling from the Federal Reserve Board that the activity in question was illegal under the Act. The Board, however, had concluded that the commercial paper in question was not a Glass-Steagall "security" and therefore was not subject to the Act. In reversing the Board's conclusion and determining that the commercial paper in question was a "note" that fell within the definition of "security" used in the Act, the Supreme Court reaffirmed the "plain language" analysis that was applied earlier in the *Camp* case.[80] In so doing, it considered the meaning of the relevant terms ("security" and "note") used in contemporaneous legislation—that is, the Securities Act of 1933 (the first major piece of federal securities legislation), concluding that the meaning of terms used in the Securities Act provided "considerable evidence" as to the meaning of those same terms in the Glass-Steagall Act.[81] The Court thus rejected the Board's attempt to distinguish between "notes" of an investment nature and "notes" of a commercial nature, asserting that this "functional analysis" converted the Act's prohibitions into an impermissible scheme of administrative regulation.[82]

In addition, the Supreme Court reconfirmed the viability of the "hazards analysis" in determining whether an activity apparently covered by the language of the Act was, in fact, intended to be included within its legislative purposes. The Court was unwilling to allow the bank regulator latitude to legalize, through regulation, activities which fell within the literal language of the Act's prohibitions.[83] In this regard, the Court considered at length the "subtle hazards" that might arise in a bank's distribution of third-party commercial paper, focusing particularly on the possible abuse of a bank's credit facilities to support the issuance of the commercial paper or its sale to investors.[84] The Court, however, expressly declined to rule on whether the banking activity in question was an illegal "distribution," "underwriting," or "public sale" of securities, because the Board had never ruled on this question; instead, the Court remanded this issue for consideration by the lower courts, which, in turn, directed the Federal Reserve Board to rule on the question. *See* discussion at pp. 297–301, *infra*.

The *Camp* and Commercial Paper cases have certain important elements in common. In both cases, the Supreme Court was confronted with activities which, at least arguably, involved the subject banks in promotional securities activities in a principal capacity.[85] Further, both cases involved what the Court viewed as "novel" bank activities, or ones which brought the banks in question squarely into competition with the securities industry.[86] In addition, in both cases, the Court was dissatisfied with the legal reasoning of the federal banking agencies which had passed on the legality of the activities in question, which, in effect, prompted the Court to substitute its judgment for that of the regulators.[87] Where one or more of these elements have been absent, however, both the Supreme Court and the lower federal courts have been less inclined to invalidate bank activities under the Act. A good example of this point can be found in *Board of Governors of the Federal Reserve System v. Investment Company Institute* (hereinafter referred to as *Board v. ICI*),[88] a 1981 case brought by the Investment Company Institute (ICI) challenging a regulation of the Federal Reserve Board allowing bank-holding-company affiliates to provide investment advice to certain classes of investment companies, subject to certain restrictions imposed by the Board. In rejecting the ICI's challenge to this regulatory action, the Court declined to conclude that investment advice was covered by the language of the Act.[89] The Court noted the "traditional" role banks had played in the providing of investment advice, and further concluded that the investment advisory activities at issue fell within neither the Act's literal language nor its general legislative purposes, inasmuch as the regulation did not authorize bank affiliates to buy and sell securities for their own accounts.[90] In this regard, however, while the Court did not find a complete absence of possible "subtle hazards" which might arise out of bank investment advisory activities, it was satisfied that the Board's restrictions would ensure the absence of these hazards, and it accepted the Board's "expert" administrative conclusions on this issue. Thus, the Court was reluctant to disrupt what it plainly perceived to be a traditional banking function on the basis of hazards which, in its view, would not arise if the activity in question were conducted in accordance with Federal Reserve Board regulations.[91]

The decision in *Securities Industry Association v. Board of Governors of the Federal Reserve System* (hereinafter referred to as the Discount Brokerage case)[92] demonstrates the importance under the Act of a banking organization's status as principal—or agent—in securities sales activities. That decision held that the Glass-Steagall Act's Section 20 prohibitions on affiliations between member banks and firms engaged in securities underwriting and dealing activities did not apply to so-called discount-brokerage activities (i.e., the purchase and sale with members of the public of securities in a brokerage capacity without the provision of investment advice). The Supreme Court was unwilling to conclude that the activities

in question constituted the "public sale" of securities of the sort prohibited by Section 20 of the Glass-Steagall Act.[93] Further, the Court concluded that the "subtle hazards" against which the Glass-Steagall Act was directed were not present to any significant extent when a bank-holding-company affiliate provided discount-brokerage services to the public, primarily because the bank affiliate was not buying and selling securities for its own account and had no promotional interest in any particular securities.[94] The Court also took comfort in the Board's "banking expertise," and the longstanding practice of banks effecting purchases and sales as an accommodation to existing customers.[95] Since that decision, the federal courts similarly have concluded that national and member banks may offer public discount-brokerage services directly (or through their subsidiaries) under Section 16 of the Act.[96]

The Supreme Court cases illustrate some methods the courts have used to overcome the difficulties which have arisen in applying the terms of the statute to a variety of bank securities-related activities. In view of the lack of definition of the major statutory terms, and the lack of legislative history as to what specifically was intended to be prohibited under the Act, the Supreme Court has used a "literal language" test to determine whether a given activity was within the scope of the Act's prohibitions. In order to buttress its conclusions as to the meaning of this "plain language," the Supreme Court also has created a "hazards analysis," drawing this analysis not exclusively from the major legislative reports accompanying the passage of the Glass-Steagall Act but also from the series of congressional debates preceding the legislation's enactment into law.[97]

As applied by the lower courts, however, these same cases have shown how a mechanical application of the language of the statute, or over-reliance on the "hazards analysis" in reaching any conclusions as to the Act's applicability, might interfere with "traditional" banking practices.[98] This problem has been most apparent in courts' efforts to apply the Glass-Steagall Act to *newer* manifestations of "traditional" banking activities. A significant series of cases which illustrates this difficulty arose out of efforts by national banks, with the Comptroller's regulatory approval, to establish collective funds for the investment of individual retirement account (IRA) (i.e., accounts which individuals have been permitted to establish for retirement purposes and which enjoy favorable, tax-deferred treatment under U.S. law) assets subject to the various provisions of the Internal Revenue Code and substantive federal pension laws; these cases commonly are referred to as the Collective IRA cases.[99] For reasons having to do with existing interpretations of the federal securities laws, these funds were registered with the SEC as investment companies, and interests in these funds were similarly registered under the Securities Act of 1933 (thus requiring a registration statement and prospectus to be used in connection with the sale of these interests). In each of these cases, plaintiff Investment

Company Institute sought to challenge the Comptroller's approval of these funds as allowing national banks to organize and sell to customers illegal mutual funds in contravention of the Glass-Steagall Act. The Comptroller defended his approval on the ground that the activities in question involved legitimate bank-fiduciary activities subject to state and federal provisions ensuring that the collective funds in question were established to facilitate the retirement purposes of their constituent trusts, and not solely for the purposes of investment.

Notwithstanding the fact that the funds in question were subject to various substantive provisions of the federal securities laws, because they involved transactions in "securities" under those laws, the federal courts have agreed that the offering of these "collective IRA" trusts is a bank-fiduciary service of the sort not covered under the Glass-Steagall Act, concluding that the funds and the interests therein did not involve bank activities in Glass-Steagall "securities."[100] In fact, the courts relied on language in *ICI v. Camp*, *supra*, to the effect that there was a difference between a bank's sale of "fiduciary" services, on the one hand, and "investments," on the other hand, for purposes of determining whether the Act applied.[101] Thus, these Collective IRA cases are very important in their demonstration of difficulties courts may face in attempting to apply the provisions of the Glass-Steagall Act to activities which, in important respects, are not only "securities" activities but also manifestations of traditional banking activities, albeit in a slightly new and altered form.

Another significant securities activity, the repackaging, or "securitization," of bank loan assets into participation form, raises these same issues. In *Securities Industry Association v. Clarke*,[102] the plaintiff challenged a June 1987 determination by the Comptroller of the Currency that the Glass-Steagall Act does not apply to bank sales of mortgage-loan assets in "securitized" form—that is, the issuance and sale to the public by a national bank of participation interests in a pool of real-estate mortgage loans originated by the bank.[103] Although lengthy and detailed in its analysis, the thrust of the Comptroller's decision was that bank sales of mortgage loans in "securitized" form are nothing more than the negotiating and discounting of debt, or the sale of lawfully acquired assets, of the sort expressly authorized under the national banking laws. (*See*, 12 U.S.C. §§24(Seventh), 371(a).) Thus, asserted the Comptroller, the activity in question does not involve any "prohibited" transactions in Glass-Steagall "securities,"[104] even though the certificates in question have been sold to the public by means of a registration statement filed with the SEC under the Securities Act of 1933.

The U.S. district court which ruled on this matter agreed with the SIA that the national bank's sale of mortgage participation interests was the "underwriting" and "distribution" of securities within the meaning of the

Glass-Steagall Act.[105] The U.S. Circuit Court of Appeals, however, disagreed with the lower court and upheld the Comptroller's ruling. The court accepted the Comptroller's determination that the sale of these participation interests was within the "business of banking" and therefore did not violate the Glass-Steagall Act. In so concluding, the Court of Appeals accepted the assertion that the bank's use of the pass-through certificate mechanism was, in substance, nothing more than a new means of engaging in the lawful sale of mortgage loans in a manner authorized under the national banking laws. The Court of Appeals also concluded that the regulation of mortgage-participation certificates as "securities" under the federal securities laws did not necessarily cause these instruments to be "securities" within the meaning of the Glass-Steagall Act, citing the reasoning of the Collective IRA cases previously discussed. In essence, what the Court of Appeals concluded was that because the activity in question was authorized under the national banking laws, it therefore was not prohibited under the Glass-Steagall Act. This conclusion has potentially far-reaching implications for banks' efforts to engage in "banking" activities through mechanisms which might be viewed, in other contexts, as securities activities subject to another regulatory scheme (such as the federal securities laws).

As noted above, there has been less judicial concern over bank securities activities conducted as agent rather than as principal, primarily because the former activities do not require the commitment of bank assets or capital to acquisitions and sales of securities. A further illustration of this attitude can be found in *Securities Industry Association v. Board of Governors of the Federal Reserve System*,[106] decided on remand by the Supreme Court in its 1984 Commercial Paper case for a ruling on whether the activity in question involved an illegal "distribution," "underwriting," or "public sale" of commercial paper.[107] Prior to this remand decision, the Federal Reserve Board had concluded that the placement activities involved did not constitute a prohibited securities distribution or underwriting, primarily owing to the fact that the activity involved a bank's placement of the paper, as agent, with a limited number of sophisticated institutional investors.[108] The plaintiff Securities Industry Association (SIA) challenged the Federal Reserve Board's conclusion, and the U.S. District Court which heard the case agreed with the plaintiff.[109] Significantly, the district court concluded that the "plain language" of the Act might not encompass the activities in question,[110] but concluded that the "hazards" against which the Act was directed demonstrated that its substantive prohibitions were intended to apply to these particular activities.[111]

The U.S. Court of Appeals for the District of Columbia Circuit, however, reversed the district court's conclusion. In reliance again on the "plain language" of the Act's permissive authority for commercial banks to engage in brokerage-type activities under Section 16 of the Glass-Steagall

Act, the court held that the placement activities at issue, even when accompanied by financial advice to commercial-paper users as to the terms and conditions of a transaction, still constituted transactions "on order" and "for the account of" issuer-customers.[112] Further, the court concluded that the non-public nature of the agency placement activities, involving primarily direct negotiations with sophisticated institutional buyers, did not constitute a "distribution" or "underwriting" of securities prohibited under the Act.[113] In so concluding, the Court of Appeals determined that the common understanding of the relevant statutory terms ("underwriting" and "distribution") did not encompass placement activities which were conducted on a private basis, again relying (as had the Supreme Court in the 1984 Commercial Paper case) on the general meaning of those terms as they were enacted in the contemporaneous federal securities laws.[114] Also of significance, however, was the Court of Appeals' evident dissatisfaction with the "hazards analysis" first enunciated in the 1971 *Camp* case: the Court of Appeals specifically questioned the validity of the "hazards analysis" in instances where a particular banking activity was permitted under the "plain language" of the Glass-Steagall Act, but felt obliged to develop such an analysis in view of Supreme Court precedent.[115] Even here, however, the Court, in essence, liberalized the analysis by concluding that each and every hazard against which the Act was directed did not need to be absent in order for a bank securities activity to pass Glass-Steagall muster.[116]

The extent to which the courts have been reluctant to apply the Glass-Steagall Act to bank brokerage and other agency activities also is demonstrated by a decision of the U.S. Court of Appeals in Washington, D.C. upholding a 1986 Federal Reserve Board ruling allowing a U.S. subsidiary of National Westminster Bank (commonly referred to as Natwest) to establish a nonbank subsidiary which would provide "full-service" brokerage—that is, brokerage combined with investment advice—to certain institutional customers. In *Securities Industry Association v. Board of Governors of the Federal Reserve System* (the Natwest case),[117] the Court, in reliance on the Supreme Court's Discount Brokerage case, concluded that Sections 20 and 32 of the Act did not preclude the affiliation of Natwest's U.S. bank subsidiary with the "full-service-brokerage" facility.[118] The Court reasoned that even with the provision of investment advice to the brokerage affiliate's customers, the combined activities did not constitute the "public sale" of securities of the sort prohibited under Section 20, and did not create the "hazards" against which the Act was directed (which the Court again criticized as unnecessary).[119]

The Act's incomplete coverage with respect to affiliate activities of commercial banks also has generated some significant decisions by the federal courts. Thus, the courts have upheld a series of FDIC regulations allowing insured nonmember banks to establish securities underwriting affiliates,

subject to regulatory conditions designed to ensure the corporate separateness of those affiliates and their operation in compliance with applicable prudential and regulatory standards.[120] These regulations flowed from the 1982 determination of the FDIC that Section 21 of the Glass-Steagall Act—the only statutory provision of the Act which applies by its terms to insured banks which are not members of the Federal Reserve System—did not by its terms prohibit affiliates and subsidiaries thereof from engaging in securities dealing and underwriting activities. In *Investment Company Institute v. Federal Deposit Insurance Corporation*,[121] the U.S. Court of Appeals in Washington upheld the legality of the FDIC regulations under the Glass-Steagall Act, and agreed with the FDIC's "plain language" analysis under Section 21, concluding that the securities activities of state nonmember bank affiliates and subsidiaries were not included within the coverage of that particular section.[122] In so concluding, the Court also accepted the FDIC's assertion that the "plain language" of the other sections of the Act—that is, of Sections 16, 20, and 32—did not by their terms apply at all to banking organizations or affiliates thereof which were not members of the Federal Reserve System.[123]

The federal courts also have been asked to consider the meaning of the term "engaged principally," as used in Section 20 of the Act, which generally prohibits affiliations between member banks and firms "engaged principally" in certain securities activities.[124] In a series of applications submitted to the Federal Reserve Board for regulatory approval under the Bank Holding Company Act of 1956, several major banking organizations requested authority to establish bank-holding-company affiliates to engage in certain types of securities underwriting and dealing activities (including underwriting and dealing in commercial paper, municipal revenue bonds, and mortgage-backed securities) which, if conducted directly by commercial banks, would be prohibited under the Glass-Steagall Act. All of these applications, however, had in common the fact that the proposed affiliates would conduct other types of business (including government securities underwriting and dealing), thus ensuring that these affiliates would not be "engaged principally" in activities prohibited to member bank affiliates under the Glass-Steagall Act.

In ruling favorably on these applications, the Federal Reserve Board agreed with the applicants' assertions. It determined, however, that the term "engaged principally" meant "any substantial bank-ineligible activity," and imposed severe percentage-revenue and market-share restraints on the securities activities of the securities affiliates (i.e., limiting the amounts which these affiliates could receive from "impermissible" activities to 5 percent of their gross revenues, and limiting their shares of the total relevant markets in each activity to 5 percent).[125] Because most of the affiliates in question proposed to engage in securities dealing and underwriting activities involving government obligations and other so-

called "bank permissible" securities, the Securities Industry Association asserted that the approval contravened the Glass-Steagall Act, in that Section 20 failed to distinguish between "bank permissible" securities activities and "bank impermissible" securities activities for purposes of the "principally engaged" criteria used in Section 20; in other words, the SIA asserted that the "principally engaged" test of Section 20 does not distinguish between permissible and impermissible bank securities activities, and that if a bank affiliate were "principally engaged" in any securities business (whether permissible for a bank or not), it would be violating Section 20 of the Act.

When asked to rule on this issue, the U.S. Court of Appeals for the Second Circuit disagreed, stating that it would be illogical to construe Section 20 to prohibit bank affiliates from engaging in certain activities which would be permissible to banks themselves. ***Securities Industry Association v. Board of Governors of the Federal Reserve System***, 839 F.2d. 47 (2d Cir. 1988), ***cert. denied***, 56 U.S.L.W. 3843 (June 14, 1988).[126] The case is noteworthy in that in order to reach the conclusion it did, the court arguably had to reject the "plain language" of the term "securities" in Section 20. In this regard, the SIA's assertion that the technical language of Section 20 did not distinguish between permissible and impermissible bank activities was technically accurate, but the result which the SIA reached was, as the court correctly understood, illogical.[127]

Many of the judicial interpretations of the Glass-Steagall Act have resulted from decisions made by the various federal banking regulatory agencies, because such regulatory actions have prompted challenges under the Act by the various securities industry trade associations. Quite apart from the regulatory interpretations of the Glass-Steagall Act which have been challenged in court, however, the banking agencies' interpretations generally have been important in defining the Act's applicability to securities-related activities of banks. Over the past decade or more, the Comptroller of the Currency and the Federal Reserve Board have indicated that a variety of bank and bank-affiliate activities—including brokerage, brokerage combined with investment advice, private placements, bank sales of mutual fund shares, and similar activities—fall within the scope of the permissive language found in the Act with respect to agency or brokerage transactions. The Comptroller's Office also has issued numerous interpretations with respect to the applicability of the Act to banks' loan-related activities, including asset "securitizations"; bank credit enhancements of issues of securities by letters of credit or other similar devices; and a variety of banks' collective investment activities, including the "collective IRA" applications referred to above.

As discussed above, the Federal Reserve Board has approved a variety of applications under the Bank Holding Company Act allowing nonbank

affiliates of bank holding companies to engage in securities underwriting and dealing activities (including the underwriting of mortgage-backed securities, commercial paper, and municipal revenue bonds), provided that those affiliates are not "principally engaged" in those activities within the meaning of the Glass-Steagall Act's Section 20. Finally, as previously noted, the Federal Deposit Insurance Corporation has permitted insured nonmember banks to establish securities-underwriting affiliates and subsidiaries in reliance on its position that only Section 21 of the Glass-Steagall Act applies by its terms to the activities of state banks which are not members of the Federal Reserve System and that the same section does not apply to the activities of affiliates and subsidiaries of those state-chartered institutions.

The case law and regulatory interpretations of the Act reflect a continuing effort by the regulators and the courts to understand and apply the Act to situations where neither the Act's language nor its legislative history provide meaningful guidance. In most cases, the federal courts have been inclined to apply the "literal language" of the Act to bank's securities-related activities. Other cases, however, including the collective IRA cases discussed above, illustrate the inherent limitations in this analysis, inasmuch as the courts found in those cases that banks were not engaged in illegal "securities" activities within the meaning of the Glass-Steagall Act even though the products involved were regulated as securities under the federal securities laws. Similarly, while most judicial and regulatory interpretations have at least recognized the "subtle hazards" analysis first articulated in the 1971 *Camp* case, there has been increasing dissatisfaction on the part of both the courts and the regulatory agencies with the applicability of that analysis, primarily because it is easy to find "hazards" of the sort complained of in *Camp* in almost every banking activity.[128]

What do these cases, in the aggregate, demonstrate about the application and interpretation of the Act? First, they illustrate the problems which both the courts and the government regulatory agencies have encountered in understanding the precise purposes of the Act. Although the legislative history, which was discussed above, reflects a culmination of long-standing concerns over bank involvement in securities underwriting and dealing functions, neither the legislative history nor the Act's statutory language provide much guidance as to the precise line of demarcation between "prohibited" and "permitted" activities. Adding to the general difficulty in understanding the purposes of the Act is the "dual nature" of many traditional banking activities—that is, the fact that many bank services and products can be characterized as both "banking" and "securities" activities. While the Act and its legislative history speak strongly in terms of prohibiting bank involvement in "securities activities," the Act provides little guidance as to whether a given activity should be treated as "banking" or "securities." Hence, the disputes over activities such as bank

collective investment activities (*e.g.*, the "collective IRA" funds offered by banks) illustrate the dilemma that the courts and regulators face in attempting to apply the Act to these types of "dual" activities. More recently, the growth of bank "securitization" activities reflects yet another variant of the ongoing dispute over how to treat bank activities involving transactions in what might otherwise be considered "securities."[129] The only clear trend which has emerged thus far is the courts' willingness to conclude that bank brokerage-related activities are not subject to the Act's prohibitions. Even here, however, important questions remain, such as the applicability of the Act to "best efforts" (agency) underwriting activities.

Second, the courts and the regulators have been asked to apply the Glass-Steagall Act during a time of enormous changes in the financial markets, particularly in the 1970s and the 1980s. In the several decades following the Act's 1933 enactment, commercial banking activities were subject to an extensive scheme of federal regulation which significantly limited the latitude commercial banks had in pricing their assets and liabilities; for instance, up until 1980, banks were severely limited by statute and regulation as to the interest they could pay on various types of deposit accounts. It was not until the 1970s that significant changes in the U.S. financial marketplace, coupled with the growing internationalization of the world's capital markets, began to exert significant pressure on bank operations.

Since that time, however, the effects of deregulation on financial market activities and commercial banking operations, and the development, for competitive reasons, of a variety of new bank products and services have complicated enormously the efforts of the government regulators and the courts to apply the Act. It is fair to conclude that the evolution of the financial-service marketplace in which commercial banks now operate was well beyond the ability of the Act's drafters to predict. Therefore, the particular conditions and concerns which prompted Glass-Steagall's passage seem, to many, to be of only passing relevance today. Yet it is this statute, the substance of which has not significantly changed since 1933, which the courts and regulators uniformly have been asked to apply.

V. The Prospects for Change

As the domestic and international financial-service environment continues to change at a dramatic rate, the debate over the continued viability of the Glass-Steagall Act in its current form has grown. This debate, in turn, has prompted serious efforts in Congress and the executive branch to study the applicability of Glass-Steagall in today's environment, and consider the need for significant changes in the Act or even outright removal of most or all of its current prohibitions.

Proponents of changes to the Glass-Steagall Act have cited a number of reasons in their favor. First, they have cited the fact that the Glass-Steagall Act, in its current form, may have adverse effects on bank stability, in that it may limit the ability of banks to liquefy their assets and diversify their sources of income. In this regard, it has been suggested that allowing banks to diversify into new areas of business may improve the ability of commercial banking organizations to weather losses in their lending operations and may assist banks in increasing the liquidity of their loan portfolios.

Second, proponents of change have criticized the Glass-Steagall Act for its anti-competitive effects. They state that the Glass-Steagall Act hinders bank competitiveness in the domestic and international capital markets, particularly as bank products and other capital-market products become increasingly interchangeable. Notwithstanding the proliferation of bank products and services over the past decade or more, it is asserted that the Act has discouraged innovation by banking organizations loath to be the subject of securities-industry legal challenges. Proponents further charge that the Act's anti-competitive thrust has been exacerbated by securities industry incursions into "traditional" banking activities through the offering of money-market accounts as deposit substitutes and securities products as loan substitutes. These anti-competitive effects, it has been said, increase the cost of products that presently exist.

Finally, proponents of change have cited the Act's ineffectiveness in preventing outright commercial bank entry into the securities business. Notwithstanding the Act's potential "chilling effects" on commercial bank innovation and diversification, the events of the past two decades have readily demonstrated that the Act has not served the purposes for which it reportedly was enacted—that is, to ensure a "complete" separation of commercial and investment banking activities. Related to this claim is the assertion by many that the congressional scheme of federal banking and securities regulation which exists today, but did not exist in 1933, renders the Act's prohibitory provisions unnecessary.

On the other side, arguments against Glass-Steagall reform have been raised by a number of parties—including, among others, the securities industry—against changes in the Act's current structure. Those who oppose radical changes have cited the fact that banks' securities activities may be inherently riskier than other types of commercial banking activities and have also cited the environment in which the Glass-Steagall Act was initially enacted and the deleterious effects bank overinvestment in the securities markets had during the 1920s and 1930s. They have argued that recent events, including the 1987 and 1989 stock-market crashes, show that the securities business is volatile and that the commercial banking system needs to be insulated from the risks of this business. They further

assert that there is no evidence that the Act has disadvantaged banking operations or has harmed consumers. More recently, opponents of Glass-Steagall reform have argued that the financial difficulties experienced by the savings and banking industries demonstrate that financial institutions should not be allowed—particularly at the present time—into new and "riskier" lines of business.

In a related vein, it has been suggested that the Act helps protect the federal "safety net" (the system of deposit insurance, the Federal Reserve Board's function as lender of last resort, and the large-dollar electronic payments system) from the effects of volatile securities activities. Inherent in this argument is the notion that it is bad public and economic policy (and competitively unfair) to use the federal safety net to protect commercial banks from possible losses in the securities business, and that the Glass-Steagall Act may play an important role in ensuring that the public is not asked to bear the costs of commercial bank involvement in these types of activities. In effect, opponents of change assert that the Act protects the federal "safety net," thus conferring on the Act a function—albeit one which raises serious public policy questions—quite removed from its original purposes.

The lack of consensus on the need for change in the Glass-Steagall Act, however, is, in part, a simple function of the U.S. political process and the role interest groups play in that process.[130] The banking and securities industries each have a significant competitive stake in the future of the Glass-Steagall Act, and both industries are bringing significant resources to bear in attempting to persuade the Congress about the merits of their respective views. The "interest-group" phenomenon is further complicated by the fact that even within the banking and securities industries, there is not universal consensus on the necessity for change in the Glass-Steagall Act. For example, representatives of the smaller community banks have questioned whether it would be in their interests to seek a liberalization of Glass-Steagall's prohibitions, particularly if the "price" of that liberalization might be to allow additional incursions by the securities industry into commercial banking activities.

The events of the past few years, however, gradually have increased the likelihood of change. There have been, for instance, a variety of proposals and studies addressing the need for reform in the current financial-service regulatory structure.[131] Further, committees of Congress have either prepared or directed the preparation of studies addressing the need for financial regulatory reform, including the need for changes in the Glass-Steagall Act.[132] While these studies are not uniform in their conclusions, they generally acknowledge the need to consider whether changes in the current regulatory structure affecting commercial and investment banking activities are necessary.

In August 1987, the Competitive Equality Banking Act (CEBA) of 1987 was enacted into law.[133] Among other things, this statute provided for a moratorium (now expired) on regulatory approvals by the federal banking agencies of new bank "securities activities."[134] The purpose behind this moratorium was to allow Congress the time to conduct a comprehensive review of current U.S. banking and financial laws, and to make a decision on the need for financial regulatory reform legislation.[135] The following year, a significant legislative proposal, in the form of the Financial Services Modernization Act of 1988, introduced by Senator William Proxmire, was passed by the U.S. Senate.[136] That bill would have provided, in essence, for an abolition of the affiliate restrictions contained in Sections 20 and 32 of the Glass-Steagall Act, and would have allowed commercial banking organizations to become affiliated, through common bank-holding-company ownership, with entities engaged in dealing in, and underwriting, securities of all types.

The Proxmire bill, however, also would have imposed a number of restrictions designed to insulate the activities of the securities affiliates from the insured deposit-taking functions of regulated banking organizations. With a few exceptions, banks no longer would be allowed to conduct many securities activities directly: all such activities (including public brokerage) generally would have to be "spun out" to securities affiliates (under common holding-company ownership). The new securities affiliates engaged in dealing and underwriting activities would have had to be separately capitalized and managed, and would have been subject to the full panoply of U.S. securities laws and regulations administered by the SEC. In addition, the new affiliates would have been subject to significant limitations in their transactions with affiliated banks; conversely, banks affiliated with these new securities organizations would have been severely limited in the financial support they would be able to provide for the securities activities of the affiliates.

Although this bank reform legislation easily passed the Senate, the House of Representatives was unable to reach a consensus on this legislation and therefore declined to follow the Senate's lead on Glass-Steagall reform. During the subsequent session of Congress, other attempts were made to re-introduce the question of Glass-Steagall Act reform, but these efforts also failed, primarily owing to Congress's preoccupation with the savings and loan crisis and its need to adopt thrift bailout legislation in 1989.

In 1991, largely at the behest of the administration, the banking committees of both the Senate and the House of Representatives considered and recommended broad-based banking reform legislation, which would have included modifications to the Glass-Steagall Act in a form substantially similar to those contained in the 1988 banking reform legislation

passed by the Senate. Neither the Senate nor the House of Representatives, however, ultimately agreed to legislation which included Glass-Steagall Act reform, owing in large part to the political distaste with which both houses of Congress viewed granting broad new powers to commercial banks when the commercial banking industry was experiencing significant financial difficulties. Moreover, the various interest groups which in the past had successfully blocked the passage of significant Glass-Steagall reform again were successful in persuading their congressional supporters to oppose such reform.

Hence, as of this writing, the prospects for Glass-Steagall Act reform legislation in the immediate future are, at best, uncertain. Given the current political climate and the continuing difficulties of the financial-services industry, coupled with a clear trend toward "reregulation" of banks and savings and loan associations, it is highly questionable whether the Congress will want to undertake further examination of bank reform legislation prior to the fall 1992 elections.[137]

Although there has been a significant impetus for the passage of financial-service reform legislation for some time, it is unclear whether there is currently enough of a consensus to ensure that any legislation will be enacted into law. To the extent that changes in the law occur at any time, it is almost certain that they will be premised squarely on the principle of insulation discussed above—that is, the legal and economic separation of the "new" securities activities from the depository functions of a commercial banking organization. The interested congressional committees and the federal banking regulators uniformly have endorsed the insulation principle as the basis for major Glass-Steagall Act reform. There is, however, a significant difference of opinion as to the extent of insulation that should be required, in that the banking industry and some of the banking regulators have asserted that the insulation requirements in any new legislation should not be so severe as to deprive commercial banking organizations of the economic benefits of affiliation with securities organizations. For its part, the securities industry, in its continued opposition to Glass-Steagall reform, asserts that insulation of bank securities activities from the other components of a banking organization will not work in times of economic dislocation.

At this time, the likelihood of changes in the Glass-Steagall Act in the immediate future also depends on factors somewhat removed from the substantive merits of Glass-Steagall reform (e.g., the jurisdictional interests of various congressional committees, and the possibility that Glass-Steagall reform may be "tied" to other changes in the banking laws limiting banks' insurance and real estate activities and expanding their consumer banking responsibilities). It is probably fair to conclude, however, that if there is no immediate change in the Act, continuing changes in the

financial-service industry here and abroad will continue to exert pressure on the Glass-Steagall Act. This pressure will grow as commercial and investment banking activities increasingly become functionally indistinguishable as a result of competitive pressures, technological change, and the continuing internationalization of the world's financial-service markets. Therefore, even if changes do not occur this year or next, it appears likely that in the medium-to-long term, significant modifications to, or perhaps an outright abolition of, the barriers between commercial and investment banking in the United States are probable, if not inevitable.

VI. Conclusion

The Glass-Steagall Act, enacted as part of the Banking Act of 1933 in response to the emergency economic conditions of that time, reflected a legislative judgment that commercial bank involvement in securities activities was at least partly responsible for the economic collapse in the 1930s and that this involvement represented an incursion by commercial banks into areas of business which they had not "traditionally" entered. By its terms, however, the Act accomplished only an incomplete separation of commercial and investment banking activities (two activities which, in many respects, were and are functionally interchangeable) and failed to define with specificity the types of activities which were to be prohibited to banks. As a result, since its enactment, the courts and the federal banking regulatory agencies have struggled to develop a consistent means of understanding and applying the Act to commercial banks' securities-related functions. This task has become increasingly difficult during the recent period of increased changes in the financial-service industry, both in the United States and internationally.

At this time, the legal barriers between commercial and investment banking are under significant pressure. While there is a growing sentiment for the view that significant changes in these barriers are necessary and appropriate, this view is not shared by all. Therefore, the prospects for a near-term change in the Glass-Steagall Act are highly uncertain. In the longer term, however, as further developments occur in the financial-service marketplace, significant changes to the Act are all but inevitable.

COMMENT

STEVEN ROBERTS

I guess I have an advantage over most of you in that I am not a lawyer, and therefore I am not going to go into the depths of the Glass-Steagall Act and its changes. I would like to start out by saying that I agree with Mr. Horn's conclusion that the die is cast. Glass-Steagall is going to be changed. The only questions are how—that is, with what safeguards and what prohibitions—and when. I do not think that will happen this year, although I think we will have some changes along the edges.

The debate on Glass-Steagall, now more than ever, is a big-bank matter. In our country we have 15,000 commercial banks.[1] Probably only a hundred of these banks could take full advantage of the repeal of Glass-Steagall; some probably would get some benefit but not a bit of profit. It is somewhat amusing that, on the one hand, these big banks are battling to tear down the Glass-Steagall fence. You might conclude from their actions that its proposed removal was a matter of profitability. On the other hand, you also have large securities firms on the other side of the fence that would like to get into banking.

If one were on Mars and observing financial activities on Earth, one might well ask where the profitability is in banking today. That is part of the Glass-Steagall issue. Margins are being squeezed by new products that are being developed on the securities side, and with the larger institutions the distinctions between bank products and securities products are very few and becoming fewer every day. In reality, though, it is not clear to me that the grass is greener on both sides of the fence—that is, that both the banks and the larger securities firms (not the smaller ones) will be better off if they are involved in each other's business, but that is a topic for another session.

I find it somewhat ironic that, as Mr. Horn noted, we are discussing the repeal of Glass-Steagall six months after the largest stock-market crash since 1929. However, it is constructive to note that we have come so far in our discussion of financial services and financial products that the October 1987 stock-market crash has had very little, if any, impact on the debate. I do not want to dwell on the history of Glass-Steagall. I think that the Horn paper is excellent and my comments really are, and ought to be, focused on some peculiarities in the U.S. banking system. These may or may not pertain to other countries, in that they may delay the reaction of

the U.S financial system to the globalization of finance and its securitization.

Mr. Horn did mention that the United States does have a complex regulatory system with three bank regulators. We have the Securities and Exchange Commission (SEC) regulating securities firms; we have a dual banking system; we have 40,000 depository institutions, banks, savings and loan associations (S & Ls), savings banks, and credit unions. We have the Bank Holding Company Act which, on top of Glass-Steagall, separates banking from commercial enterprises. We have an insurance industry that is not regulated at all at the federal level; it is regulated only by the states. And we have a safety net in this country supporting the banking and the financial system that is probably different from any other in the world. I am talking about federal deposit insurance, which, at this point, is almost unlimited in its scope. We have the discount window at the Federal Reserve, which has counterparts elsewhere in the world; we have a system of supervision and regulation which depends, in this country, much more on regulation than on supervision; and, as we deregulate, we will have to move away from regulation and toward supervision. My observation is that we do not supervise banks the way other central banks or other bank regulatory agencies around the world do. Part of the reason for that is that we have so many banks, whereas banking systems in other countries are much more concentrated. In general, I think our banking system will become much more concentrated as interstate banking gradually spreads across this very large country. At some point we might have about a hundred very large institutions and somewhere between 5,000 and 10,000 smaller institutions which, I think, will eventually be regulated differently from the large commercial banks. That is the pattern if you look across the world.

I want to preface the rest of my remarks with the thought that what may happen in the United States may or may not set the pattern for change elsewhere. Our banking structure has grown up over time, and is unlike that in any other country; certainly if we were to do it again, we would set up a structure quite different from the one we now have. I think the structure is part and parcel of the problem of the regulation.

The debate on Glass-Steagall really involves a debate on the goals of financial regulations and a recognition that the environment for banking has changed. We take for granted that we have banks and securities firms engaging in the same types of businesses; and no matter what our Congress does or our regulators do, we are not going to change that. In terms of the goals of financial regulation, I think that participants in the debate sometimes lose sight of the goals until actual decisions are ready to be made. Since I think that the important decisions are going to be postponed for some time, I would like to read you a list of goals of

financial regulation in the United States. It is really a compendium that was put together by one of the House of Representatives' subcommittees. I think it is instructive to hear it, because if you consider it together with the history recited in Mr. Horn's paper, you may be able to get some insights into the nature of, and the complications that arise in the course of, the debate on financial regulation.

The *goals* of financial regulation in the United States are the following:

First, to ensure access to credit and capital for all types of participants in financial markets. This has been a goal historically, and it remains important. It applies to large and small institutions, consumers, and commercial users.

Second, balancing the benefits of competition against safety-and-soundness concerns. This effort to achieve balance indicates a recognition of the fact that here, as elsewhere, all financial institutions have a quasi-public nature. You can find support for this approach in the work of Adam Smith, who, although he argued that the market should make economic decisions in most cases, recognized that financial institutions were different from other businesses.

Third, in regulating institutions, we ought to make sure that what we do improves efficiency wherever possible. While we are improving efficiency, we ought to make sure that conflicts of interest and concentration of resources are kept in mind, that credit decisions are made impartially, and that there are a large number of participants in financial markets.

Fourth, we ought to ensure that the financial system shoulders its fiduciary responsibilities (which include more than a pure business responsibility) to depositors and other customers. We need to protect customers by ensuring the integrity of institutions and markets and cushioning them against the impact of failures.

That list encompasses a great deal. It is not my list, but rather one set forth by a House subcommittee that has jurisdiction over the securities business. And I think that all of these elements are woven into the fabric of the various discussions that are taking place, though they are neither set forth clearly in one place nor clearly understood by most Congressmen. I think that eventually each and every one of those objectives will have to be addressed in some way before major changes can be made.

Let me now turn back to the question of structure. The Glass-Steagall debate is really a debate between large banks and small securities firms. I think that large securities firms, with perhaps one or two exceptions, are ready to tear down Glass-Steagall. I do not know exactly how that issue is going to be resolved, but my sense is that it will only be resolved when we decide to regulate large and small institutions differently. Second, the complex structure that regulates financial firms (including bank regulatory

agencies, the SEC regulating securities firms, the Commodity Futures Trading Commission (CFTC) regulating options and futures, and states regulating insurance firms) is a compartmentalized structure that mirrors the compartmentalized structure of the institutions themselves. In a perfect environment, we might choose to have a single regulator for all financial institutions. However, every attempt we have made to head toward a new regulatory structure has been thwarted by the system itself.

The third aspect of the regulatory structure, which I think is critically important, and also may be peculiar to the United States, concerns the safety net: how broad it should be and, in essence, who our federal government should underwrite. When deposit insurance was originally put in place in 1933 it was meant to insure the deposits of consumers. The level of coverage was $2,500 per account. It is now $100,000 in principle, but in practice it is unlimited. Until the deposit-insurance systems are reformed, the question of government support will always be with us. The second part of the safety net concerns the Federal Reserve's function as lender of last resort, which is carried out by means of its discount window. Having served as Chairman Paul A. Volcker's assistant, I can tell you firsthand that it would have posed a serious problem for the Federal Reserve if a large securities firm had collapsed last October. Such a serious problem would have been solved very quickly, and the Federal Reserve probably would have stepped in to avoid calamity, but there would have been a lengthy debate and a hard decision (which the administration would have had a serious problem with).

I have already mentioned that supervision and regulation are not the same thing. We have a broad system of regulation. However, we supervise with quarterly reports and maybe an annual examination. Whether that is sufficient in a world where banks engage in every type of financial activity and where there are a handful of large banks to worry about I am not sure. We also live in a global environment today. What happens in the United States affects what happens in Asia without much lag, and vice versa. This naturally raises questions about regulating institutions that are engrossed in investment banking and commercial banking. We have made great strides in bringing together regulators of commercial banks recently, but few attempts have been made to rationalize global regulations and securities firms, with the consequence that little progress has been made toward this goal.

If we consider Glass-Steagall, we may decide what steps need to be taken. First of all, I think that deposit insurance is the key. In my view, the system is broken and needs to be fixed. Instead of limiting the coverage of his account to a total of $100,000, any smart depositor today who has a million dollars will find 11 banks, put $90,000 in each of the 11 and thus have his million dollars fully insured by the U.S. Government. And if he is

not smart, he can find a broker that will be willing to do it for him, and, in fact, the broker can handle much more than a million dollars, spreading it around lots of small institutions, including S & Ls. I think that deposit insurance offers an opportunity for coverage extending far beyond $100,000 and that ought to be fixed.

More problematic is the reason why various types of securities firms, insurance firms, and commercial firms want to be in banking. I think part of it has to do with deposit insurance. It has to do with the leverage possibilities, which are probably greater for a depository institution holding company than a commercial firm holding company because the market perceives government support for the former. If that is true, as we debate Glass-Steagall, we ought to debate the issue of how big an institution ought to be to be able to compete effectively. Right now we have a number of institutions that, both reportedly and in practice, are too big to fail; as we go forward with the regulation, the number of these institutions grows, and I think that this issue has not been solved.

Second, if we allow Glass-Steagall to be repealed, we need to decide how to treat the commercial financial or now financial firms that already own securities firms. This is a two-way-street question. The Proxmire bill attempts to go in that direction. I am not sure that it is satisfactory to the Merrill Lynches and the American Expresses, as well as Aetna, the Travelers, and other major insurance firms. The mixing of commercial banking, investment banking, and commercial firms is an issue that probably limits the ability to make major strides in repealing Glass-Steagall this year. As a matter of fact, one of the issues holding up the House version of the Senate bill is a nonbank bank issue—that is, not a Glass-Steagall issue at all.

We have several options for moving forward. We can repeal Glass-Steagall in one step and erect "firewalls" or we can take the gradual approach of providing some new securities powers, adding some supervision as that goes forward to make sure that any affiliate transactions are clean, seeing that requirements are enforced to preclude dealing and that everybody is warm and cozy and comfortable as a result. I think that the latter approach is the one we are more likely to pursue.

There is also the possibility that Congress will do nothing this year. If that happens, I think the marketplace will work as it has in the past and that we will have gradual de facto repeal, perhaps accomplished by means of regulatory changes at the agency level.

I think the debate ought to go on. Having spent too many years at our central bank, I like marginal changes, not drastic changes. So I would like to see the House Banking Committee come out with a bill that makes real progress on Glass-Steagall and ensures that if those things that are supposed to insulate the bank from the holding company do not hold up,

major damage is not done. I think that is probably the way that we will go, regardless of the political fighting between the banks and by the securities firms. I think that this is the year—and the first year in 55 years—that major changes in the regulations covering the underwriting of non-governmental types of securities, including mortgage securities, will permit banks to participate in this activity on a wide scale. I guess the list includes commercial paper, mortgage-backed securities, consumer securities, and revenue bonds.

Overall, we are caught in a political debate. The political debate is taking place against a backdrop of an odd regulatory structure and encompasses deposit insurance, which has caused more harm than good in an allied industry—namely, the S & L industry.