Beyond "The Wall": The American Financial System and Glass-Steagall Reform

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THE AMERICAN FINANCIAL SYSTEM
AND GLASS-STEAGALL REFORM

The character of the United States banking system was fundamentally altered by the passage of the Glass-Steagall Act¹ ("Glass-Steagall" or the "Act"), which effected the divorce of commercial

¹ Ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). Although the Glass-Steagall Act ("Glass-Steagall" or the "Act") is the popular name for the Banking Act of 1933, the term "Glass-Steagall" is most often used to refer to four key sections of the Act—sections 16, 20, 21 and 32. Congress enacted these four provisions "to separate commercial banking from investment banking because affiliations between these institutions were perceived as a main factor contributing to the stock market crash of 1929 and the Great Depression." See Norton, Up Against "The Wall": Glass-Steagall and the Dilemma of a Deregulated ("Regulated") Banking Environment, 42 Bus. Law. 327, 327 (1987). "Congress became concerned that banks had placed customer deposits at unacceptable risks by buying, selling, and underwriting questionably sound securities." Id. at 329. By separating the two types of banking, "Congress sought to restore public confidence in the commercial banking system." Id. at 327.

Section 16 of the Act provides in pertinent part:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock.

12 U.S.C. § 24 (Seventh) (Supp. II 1984) (section 16 of the Act, as amended). Although the broad prohibitions of this provision expressly govern only the activities of national banks, the Federal Reserve Act extends these same prohibitions to state-chartered banks which are members of the Federal Reserve system ("state member banks"). See 12 U.S.C. § 335 (1982).

A number of exceptions are contained in section 16 pursuant to which banks may engage in limited securities activities. Underwriting of specified federal, state and local securities is open to banks. See 12 U.S.C. § 24 (Seventh) (Supp. II 1984). Also, banks may purchase these and other qualified securities for their own accounts. See id.

Section 20 of the Act prohibits member bank affiliation with any firm "engaged principally in the issue, flotation, underwriting, public sale, o. distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." 12 U.S.C. § 377 (1982) (section 20 of the Act, as amended).


Section 32 excludes officers, directors, and employees of securities firms from concurrently holding similar positions in member banks unless the Board of Governors of the Federal Reserve finds that "it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments." 12 U.S.C. § 78 (1982) (section 32 of the Act, as amended).
banking from certain activities associated with investment banking. Glass-Steagall was enacted in the aftermath of the Great Depression and it was commonly believed that a principal reason for the collapse of the financial system was excessive bank involvement in investment banking. Commentators perceived the existence of inherent conflicts of interest and excessive risks associated with the securities industry. The last quarter century has been marked by a gradual retreat from the absolute separation implemented by the Act’s Depression-era drafters. Currently, a well-documented debate rages in the courts and the legislature concerning the efficacy of the Glass-Steagall “wall” and its continued viability in the modern American financial system. This Note will undertake a review of the Act’s evolution in response to the impetus provided by the changing economic and financial environment.

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2 Commercial banking is generally understood to encompass acceptance of demand deposits, savings deposits and time deposits, as well as the extension of long- and short-term credit to businesses and consumers. See J. White, Banking Law 34-36 (1976). Commercial bank trust departments also engage in a wide range of fiduciary services. Id. For a thorough discussion of commercial banking, see generally E. Reed, R. Cotter, E. Gill, & R. Smith, Commercial Banking (1976).


4 See Securities Indus. Ass’ns v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137, 144-45 (1984) [hereinafter Bankers Trust I]. The Court noted that the failure of the Bank of the United States was primarily caused by its investment banking activities. Id. at 145, n.4. Due to a perceived inherent conflict between investment and commercial banking, Congress rejected legislation which would merely regulate bank securities activities in favor of the Glass-Steagall “wall.” Id. at 147.

5 See Perkins, The Divorce of Commercial and Investment Banking: A History, 88 Banking L.J. 483 (1971) (reviewing legislative history). For example, the 1932 Democratic campaign platform had called for a complete separation of the two industries. See id. at 518.

6 This changing financial and economic environment can be demonstrated by an analysis of leading economic indicators. When measured by return on assets, bank profitability has generally fallen since 1970, when the indicator was first measured at .89 percent. See Federal Reserve Bank of New York, Recent Trends in Commercial Bank Profitability: A Staff Study 9 (1986) [hereinafter Bank Profitability]. By 1984, the figure had fallen to .64 percent. Id. This decline in profitability has been attributed to the general economic climate of the 1980's, “permanent” structural factors, the recent need to increase bank reserves to support low quality loans and the changing composition of the package of products offered by commercial banks. Id. at 16.

Banks have also suffered a decline in market share in fields which they have traditionally dominated. For instance, the years from 1966 through 1986 witnessed an eighteen percent decline in the bank's share with regard to the supplying of the short- and medium-term credit needs of domestic non-financial corporations. See Federal Deposit Insurance Corporation, Mandate for Change: Restructuring the Banking Industry 8 (preliminary draft, Aug. 18, 1987) [hereinafter Mandate for Change]. Much of this loss may be attributed to corporate issuance of commercial paper as a substitute for seeking credit in the form
the challenges presented by the securities industry and the regulatory, judicial and legislative climates, which have become increasingly receptive to change. Part I contains a review of regulatory and judicial decisions which have vastly expanded the scope of permissible securities activities of bank affiliates. Part II examines

of commercial loans from banks. Id. at 9.

Commercial paper consists of "unsecured note[s] payable to the bearer on a stated maturity date between one and ninety days after issuance." Norton, supra note 1, at 343. This growth in the commercial paper markets is reflected in statistics which show a rise in the dollar value of such issues, increasing from $8.8 billion in 1973 to $71.3 billion in 1984. See Bank Profitability, supra, at 167. During the same period, the value of commercial and industrial loans held by domestic commercial banks showed a markedly smaller increase, rising from $147.5 billion to $373.2 billion. Id.

Other developments in financial markets have also contributed to the banking industry's demands for increased power to permit their full participation in financial markets. Advances in technology, such as the electronic communications network, have made investment with nonbank institutions an attractive alternative for the customer. See Langevoort, Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation, 85 Mich. L. Rev. 672, 678-79 (1987).


See infra notes 16-73 and accompanying text. Regulation of banks and their affiliates is accomplished at the federal level by utilization of the concept of the "primary regulator." See Public Information Department, Federal Reserve Bank of New York Depository Institutions and Their Regulators (1987). The agency which is to regulate a particular bank is predicated on two considerations: the type of bank, such as, national, state member, etc.; and the area of regulation, such as, chartering, reserve requirements, deposit insurance, etc. See id.


It shall be unlawful, except with the prior approval of the [Federal Reserve] Board, (1) for any action to be taken that causes any company to become a bank holding company; (2) for any action to be taken that causes a bank to become a subsidiary of a bank holding company; (3) for any bank holding company to acquire direct or indirect ownership or control of any voting shares of any bank if, after such acquisition, such company will directly or indirectly own or control more than 5 per centum of the voting shares of such bank; (4) for any bank holding company or subsidiary thereof, other than a bank, to acquire all or substan-
the impact of the moratorium, contained in the Competitive Equality Banking Act of 1987, on the expansion of bank securities activities. In addition, an analysis of various proposals for reform which have been advanced by the legislative branch, commentators and industry spokespersons is considered. Finally, this Note will advocate change while stressing the need for a restructuring of the regulatory system in light of the differing objectives of the banking and securities statutory schemes.

The scope of this Note primarily encompasses the securities

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tially all of the assets of a bank; or (5) for any bank holding company to merge or consolidate with any other bank holding company.

*Id.* An entity, except as provided in section 1841(a)(5), is a bank holding company within the meaning of the statute if it has "control over any bank or over any company that is or becomes a bank holding company." *Id.* § 1841(a)(1).

The Federal Reserve also exercises supervision over bank holding company affiliation with nonbanking entities. *See id.* § 1843. Section 1843 provides in pertinent part:

Except as otherwise provided in this chapter, no bank holding company shall——

... retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company or engage in any activities other than (A) those of banking or of managing or controlling banks and other subsidiaries authorized under this chapter or of furnishing services to or performing services for its subsidiaries, and (B) those permitted under paragraph (8) of subsection (c) of this section.

*Id.* § 1843(a). The activities permitted under 12 U.S.C. § 1843(c)(8) are those "which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." *Id.* § 1843(c)(8). The analysis required by this section has been frequently used to permit banking organizations to engage in nonbanking activities by locating such activities in their nonbanking subsidiaries. *See, e.g.*, Schwab, 468 U.S. 207, 207 (1984) (Federal Reserve Board can authorize bank holding company acquisition of nonbank affiliate engaged principally in retail securities brokerage). However, to authorize such conduct, the Federal Reserve must make a separate finding that such conduct does not violate section 20 of the Glass-Steagall Act. *See id.* at 213.

* Our system of bank regulation is intended primarily to preserve the integrity of the banking system by guarding against bank failures. *See Langevoort, supra* note 6, at 680-81. In contrast, United States securities legislation aims to protect the interests of the individual investor and the securities markets. *See Norton, supra* note 1, at 341. This distinction serves as a principal rationale underlying the contention that the expansion of bank powers requires a new regulatory structure designed along functional lines. *Cf.* COMMITTEE ON GOVERNMENT OPERATIONS, U.S. HOUSE OF REPRESENTATIVES, 100TH CONG., 1ST SESS., MODERNIZATION OF THE FINANCIAL SERVICES INDUSTRY: A PLAN FOR CAPITAL MOBILITY WITHIN A FRAMEWORK OF SAFE AND SOUND BANKING 81-82 (1987) [hereinafter COMMITTEE REPORT]. The Committee Report recommended that responsibility for enforcement of securities laws governing financial holding companies and their subsidiaries be given to the Securities Exchange Commission. *See id.* at 81. With respect to banks and thrift institutions, it advocates that the SEC be allowed to delegate its enforcement power to other regulators. *See id.* at 81-82.

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activities of bank holding company affiliates, and includes only a cursory examination of those engaged in by thrift institutions, "nonbank banks," national and state member banks and state nonmember banks.

JUDICIAL AND ADMINISTRATIVE EXPANSION OF BANK SECURITIES POWERS

The Supreme Court's first interpretation of a Glass-Steagall provision occurred thirteen years after the statute's enactment in Board of Governors of the Federal Reserve System v. Agnew. In Agnew, the Court interpreted the "primarily engaged" standard of section 32. The Board of Governors of the Federal Reserve (the

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11 See supra note 8.
12 Thrift institutions include savings banks and savings and loan associations. See 12 U.S.C. § 1464(a) (1982). Federally chartered thrift institutions are permitted to engage in non-banking activities, such as investing in "service corporation" subsidiaries, subject to the rules and regulations of the Federal Home Loan Bank Board ("FHLBB"). See id. § 1464(c)(4)(B). Generally, service corporations may engage in businesses which the FHLBB finds "reasonably related to the activities of Federal associations." See 12 C.F.R. § 545.74(c) (1987).
13 The concept of "nonbank banks" was developed as a result of a loophole in the Bank Holding Company Act, which defined a bank as an institution which both "accepts deposits that the depositor has a legal right to withdraw on demand, and . . . engages in the business of making commercial loans." 12 U.S.C. § 1841(c) (1982). By owning an affiliate which technically engaged in only one of these activities, an organization could escape classification as a bank holding company and permissibly engage in nonbanking activities. See Committee Report, supra note 10, at 27. Section 101 of the Comparative Equality Banking Act of 1987 closes the nonbank bank loophole by redefining a bank, with certain exceptions, as any of the following: "(A) [a]n insured bank as defined in section 3(h) of the Federal Deposit Insurance Act . . . or [a]n institution . . . which both . . . accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and . . . is engaged in the business of making commercial loans." Pub. L. No. 100-86, 101 Stat. 552, 554 (1987).
14 Although banking entities have engaged in expanded securities activities pursuant to determinations by the Comptroller of the Currency that such activities are consistent with Glass-Steagall, most commentators advocate placing such businesses in bank affiliates. See infra notes 101-04 and accompanying text. For a general discussion regarding the effect of Glass-Steagall on national and state member banks, see supra note 1.
16 329 U.S. 441 (1947).
17 Section 32 provides in relevant part:
No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securi-
“Board”) decided to remove certain directors of a national bank from office based on their status as employees of a firm “primarily engaged” in underwriting securities.18 Upholding the Board’s construction of the statute, the Court refused to limit the section 32 prohibition to only those firms which derived more than fifty percent of their gross income from underwriting activities. Rather, the Court interpreted the statute as requiring only that such activity be “substantial.”19

Twenty-four years later, in Investment Company Institute v. Camp,20 the Supreme Court invoked Glass-Steagall to invalidate portions of a regulation promulgated by the Office of the Comptroller of the Currency (“OCC”). Camp involved Regulation 9,21 which purported to authorize banks to operate open-end investment funds.22 Petitioners, an association of open-end investment companies23 and various individual companies, challenged, as violative of sections 16 and 21 of the Act, the provisions of Regulation 9 and the OCC’s approval of an application made by First National

18 See Board of Governors of the Fed. Reserve Sys. v. Agnew, 329 U.S. 441, 444 (1947). The respondents had been employed by the firm since 1941, and had remained in its employ after their election to the bank’s board of directors. Id. at 445. While serving as directors, however, none of the respondents did business with the bank “other than [on] a strictly commission business with its customers,” nor did the firm itself do business with the bank. Id. at 445-46.

19 See id. at 446-47. Refusing to use a strictly quantitative test to measure substantiality, the Court referred to the “legislative purpose” of the Act:

Section 32 is directed to the probability or likelihood . . . that a bank director interested in the underwriting business may use his influence in the bank to involve it or its customers in securities which his underwriting house has in its portfolio . . . . That likelihood or probability does not depend on whether the firm’s underwriting business exceeds 50 per cent of its total business. It might, of course, exist whatever the proportion of the underwriting business.

Id. at 447.


22 Camp, 401 U.S. at 618-19. The regulation permitted “managing agency accounts” which involved the “collective investment of monies delivered to the bank for investment management.” See id. at 622.

23 See id. at 612. Open-end investment companies are commonly referred to as mutual funds and typically permit investors to redeem their shares from the issuer. Id. at 625 n.11. See also ICI, 450 U.S. 46, 51 (1981) (distinguishing open-end and closed-end investment companies).
City Bank of New York to operate such a fund. After finding that petitioners had standing to bring the action, the Court held that the fund approved by the OCC involved the bank in underwriting, issuing, selling and distribution of securities, activities proscribed by sections 16 and 21. The Court referred to Congress' intent to eliminate both the "obvious danger[s]" and "subtle hazards" created by commercial bank involvement in the securities business. Prior to Camp, banks had been permitted to engage in commingling of trust assets, as well as providing services as managing agent and purchasing securities for the account of customers. However, the Court chose to broadly apply the prohibitions of sec-

24 Camp, 401 U.S. at 618-19. Pursuant to the First National City Bank managing agency accounts plan, customers would purchase freely redeemable "units of participation" in amounts ranging from $10,000 to $500,000. See id. at 622. The customers' investments would be pooled in a fund and the bank would act as managing agent. Id. In addition, the fund would register as an investment company under the Investment Company Act of 1940 and file a registration statement with the SEC. See id. at 622-23. The bank would serve as the underwriter of the fund's "units of participation." See id.

25 Id. at 620-21. The Court based its finding upon its holding in Association of Data Processing Service v. Camp, 397 U.S. 150 (1970) (data processing companies had standing to challenge Comptroller's ruling allowing banks to provide data processing services), concluding that Glass-Steagall arguably prohibited the type of competition between banks and the mutual fund industry, from which petitioners suffered injury. Camp, 401 U.S. at 620-21.

26 Camp, 401 U.S. at 639. OCC had argued that the prohibitions of sections 16 and 21 were inapplicable because the "units of participation" held by individual customers were not securities within the meaning of Glass-Steagall. See id. at 634. The Court rejected such a narrow construction of the term "securities" as it found "direct evidence that Congress specifically contemplated that the word 'security' includes an interest in an investment fund." See id. at 635.

27 Id. at 630. In an often quoted passage, the Court stated:

The hazards that Congress had in mind were not limited to the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments. . . . The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments.

Id. The Court listed the following "subtle hazards" which Congress envisioned if the commercial banking business extended beyond the Glass-Steagall limits: (1) problems of public confidence resulting from poor performance by an affiliate; (2) expenditure of bank assets to aid an ailing affiliate; (3) extension of unsound or preferential credit to companies involved with the securities affiliate; (4) loss of good will of customers suffering losses in transactions entered into with the affiliate after relying on the bank-affiliate relationship; (5) damage to commercial banks' reputation for prudence and restraint; (6) excessive loans to customers for the purpose of purchasing securities; (7) purchases by the bank's trust department of excessive affiliate holdings; and (8) the bank's impaired ability to render disinterested investment advice. Id. at 630-33.

28 Id. at 624-25.
tions 16 and 21 by preventing banks from concurrently conducting these activities within the framework of an open-end investment fund. 29

Following Camp, the Board amended Regulation Y, 30 and issued an interpretive ruling thereunder permitting bank affiliates to act as investment advisors to closed-end investment companies. The amendment and ruling were challenged by the mutual fund industry and upheld in Board of Governors of the Federal Reserve System v. Investment Company Institute 32 ("ICI"). Unlike Camp, ICI involved bank affiliate activity, implicating section 20 of Glass-Steagall and section 4(c)(8) of the Bank Holding Company Act. 33

The Investment Company Institute contended that the proposed activity failed to satisfy the "proper incident to banking" analysis required by the Bank Holding Company Act because, if conducted by the bank itself, the activity in question would contravene sec-

29 See id. at 625. The Court held that although the differences between a bank's trust powers and the operation of an open-end mutual fund are subtle, the different character of the two activities warrant distinction. Id.


31 See id. § 225.125(c). The amendment made the following addition to its list of permissible bank activities: "(ii) serving as investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act." Id. § 225.4(b)(5)(ii).


The analysis employed by the Federal Reserve in determining whether an affiliate's nonbanking activity is permissible involves two questions. The first question is whether the activity is violative of the prohibitions contained in sections 20 and 32 of the Glass-Steagall Act. Here, the Federal Reserve must determine if the affiliate would be "engaged principally" in underwriting, issuance, flotation, public sale or distribution of securities. 12 U.S.C. § 377 (1982).

In addition, the Federal Reserve must analyze the bank affiliate activity in view of Bank Holding Company Act considerations. It must determine whether the activity is "closely related to banking." 12 U.S.C. § 1843(c)(8) (Supp. 1987). In making this determination, the Federal Reserve generally employs the criteria set forth in National Courier Association v. Board of Governors of the Federal Reserve System, 516 F.2d 1229 (D.C. Cir. 1975), and examines: whether banks have generally provided the services in question; whether banks generally provide functionally or operationally similar services which render them particularly well-equipped to provide the proposed services; and whether banks provide services integrally related to those in question, requiring that they be provided in a specialized form. See id. at 1237.

The Board will also consider "any . . . factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking." See 49 Fed. Reg. 806 (1984). Finally, in order to approve an activity, the Board must further determine whether the activity may "reasonably . . . be expected to produce public benefits that outweigh any potential adverse effects." See Schwab, 468 U.S. 207, 211 (1984).
tions 16 and 21 of Glass-Steagall. In rejecting this argument, the Court concluded that such a violation had not occurred, distinguishing the closed-end investment activity at issue here from the open-end investment activity challenged in Camp. The Court determined that the "subtle hazards" which accompany open-end investment activity were not a risk in connection with closed-end activity. Further, an interpretive ruling by the Board, prohibiting affiliate involvement in the underwriting or selling of securities, limited closed-end investment activity so that, even if engaged in by a bank, it would arguably not violate the Act. Based on the Bank Holding Company analysis, the Court concluded that bank affiliates may properly participate in certain activities denied to banks in addition to those activities deemed permissible for bank involvement within the Glass-Steagall framework.

By adopting the Board's analysis, the ICI Court established a practice of according the "greatest deference" to Board determi-

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25 Id. at 64-67.
26 See supra note 27.
27 ICI, 450 U.S. at 65-67.
28 Id. at 62. The ruling placed certain restrictions on the activity of closed-end investment companies to which bank holding companies served as investment advisors. See 12 C.F.R. § 225.125(f), (g), (h) (1987). The name of such investment company could not be similar to that of the holding company or its subsidiaries. The holding company and its affiliates were prohibited from: purchasing securities of such investment company for their own account, in a fiduciary capacity, or as managing agent; extending credit to the investment company; accepting such securities as collateral for credit extended for the purpose of purchasing other such securities of the investment company; directly or indirectly participating in the sale or distribution of such securities; distributing sales literature or prospectuses at its offices; expressing opinions recommending the purchase of such securities; providing lists of customer names to the investment company; and acting as investment advisor to a fund having offices in a building perceived by the public as being associated with the holding company or its subsidiaries. Id.
29 ICI, 450 U.S. at 62.
30 Id. at 60 & n.26.
31 See id. at 56, 68. As the Federal Reserve Board is the regulatory agency responsible for application of the statutory scheme, the standard of review to be applied by the courts is to show "greatest deference" to the Board's findings. See Schwab, 468 U.S. 207, 215-16 (1984); accord Bankers Trust I, 468 U.S. 137, 142 (1984) ("substantial deference"); NatWest, 821 F.2d 810, 813 (D.C. Cir. 1987) (same), cert. denied, 108 S. Ct. 697 (1988).

The decisions of the Board must be upheld if it is a reasonable construction of the statute. Id. See also Chevron U.S.A. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) (reviewing decision of Environmental Protection Agency). In Chevron, the Court noted that if the agency's "choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned." Id. at 845 (quoting United States v. Shimer, 367 U.S.
nations. *ICI* was the first in a line of cases which upheld regulatory actions sanctioning bank affiliate involvement in an increasingly broad spectrum of securities activities. In 1984, the Supreme Court, in *Securities Industry Association v. Board of Governors of the Federal Reserve System* ("Schwab"), affirmed a Second Circuit determination that a bank holding company may, within the meaning of the Glass-Steagall and Bank Holding Company Acts, acquire a discount brokerage subsidiary. The Court deferred to the Board's findings that discount brokerage services did not constitute a "public sale" of securities within the meaning of section 20, and that such activity was "closely related to banking" within the meaning of section 4(c)(8) of the Bank Holding Company Act.

The same year in which *Schwab* was decided, the Supreme Court reviewed another challenge to Glass-Steagall in *Securities...* 374, 382-83 (1961)).

However, courts are obligated to reject administrative constructions of a statute which are "inconsistent with the statutory mandate or that frustrate the policy that Congress sought to implement." *Bankers Trust I*, 468 U.S. 137, 143 (1984) (quoting Federal Election Comm'n v. Democratic Senatorial Campaign Comm., 454 U.S. 27, 32 (1981)); see Note, An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall, 52 BROOKLYN L. REV. 281, 311 n.172 (1986).

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45 See *Schwab*, 468 U.S. at 209, 214-16. Charles Schwab & Co., the subsidiary in question, provided retail brokerage services at a discounted price. *Id.* at 209. In addition, it offered margin lending services, custodial accounts, and account maintenance services to customers, but did not provide investment advice. See *id.* at 209, 215 n.14.

46 *Id.* at 221. The Court held that the "public sale" of securities is only prohibited under section 20 when performed in conjunction with the "issue," "flotation," "underwriting" or "distribution" of securities. See *id.* at 217; 12 U.S.C. § 377 (1982). The Court expressed no opinion as to whether a "best-efforts" underwriting, in which the underwriter acts merely as an agent for the issuer, is a prohibited activity under Glass-Steagall. See *Schwab*, 468 U.S. at 217-18; 12 U.S.C. § 377 (1982). This issue has not yet been decided by the courts. See *NatWest*, 821 F.2d 810, 814 n.7 (D.C. Cir. 1987) (declining to decide issue), *cert. denied*, 108 S. Ct. 697 (1988); compare *Bankers Trust II*, 807 F.2d 1052, 1062 n.3 (D.C. Cir. 1986) (suggesting that best efforts underwriting performed solely on agency basis may constitute underwriting within meaning of Act), *cert. denied*, 107 S. Ct. 3228 (1987) with L. Loss, supra note 3, at 172 (best efforts underwriting not technically "under-writing").


Industry Association v. Board of Governors of the Federal Reserve System49 ("Bankers Trust I"). Bankers Trust, a state member bank, had served as agent for issuers of commercial paper by placing these issues with institutional investors.50 In response to a challenge by a securities industry trade association, the Court reversed the District of Columbia Circuit's decision51 which had upheld a Board determination52 that commercial paper was not a "note ... or other security" within the meaning of sections 16 and 21.53 Rejecting a narrow interpretation of the statutory language, the Court held that commercial paper is a security for purposes of Glass-Steagall,54 but expressed no opinion as to whether Bankers Trust's placement activity violated the Act's prohibition against "issuing, underwriting, selling or distributing" securities.55

On remand,56 the district court rejected the contention that Bankers Trust's selling of securities upon the order and for the account of customers was an activity permitted under section 16, and warned of "subtle hazards" created by such practices.57 The court also stated that Bankers Trust had engaged in underwriting and distribution of securities in violation of sections 16 and 21 of the Act.58 The Circuit Court of Appeals for the District of Columbia reversed the lower court and adopted the Board's reasoning in


52 See A.G. Becker, 693 F.2d at 143, 151-52.
55 Id. at 160 n.12.
57 Id. at 704-06.
58 Id. at 696. See supra note 34 and accompanying text.
Securities Industry Association v. Board of Governors of the Federal Reserve System69 ("Bankers Trust II"). In his opinion, Judge Bork accorded the administrative decision "the greatest deference,"60 and accepted the Board's determination that the activity was within the permissive language of section 16.61 The opinion further supported the Board's view that Bankers Trust's private placement of commercial paper did not constitute "underwriting" of securities.62 The court reasoned that only a public offering would overcome the section 16 exemption.63

Banker's Trust II, while clearly dispositive of the issue at bar, failed to address such issues as the legal consequences of the agency relationship involved in a "best efforts" underwriting.64 Notwithstanding the issues left unanswered by the decision, several commercial banks have announced their intention to expand

69 Bankers Trust II, 807 F.2d 1052, 1069-70 (D.C. Cir. 1986).
60 Id. at 1056. See also supra note 41 and accompanying text.
61 Bankers Trust II, 807 F.2d at 1058.
62 Id. at 1062.
63 Id. The court found the distinction between public offerings and private placements to be reasonable because it is supported by congressional intent in coexisting securities legislation, and relates to matters that Glass-Steagall sought to address. Id. The transactions sanctioned under section 16 include dealing in securities and stock for customers, but not for the bank's own account. See 12 U.S.C. § 24 (Seventh) (Supp. II 1984). The section further provides that "the association shall not underwrite any issue of securities or stock." Id. See supra note 1. The language of section 16 is arguably inconsistent with that of section 21, which provides in pertinent part that it is unlawful:

For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits . . . .

12 U.S.C. § 378(a)(1) (1982). In Bankers Trust II, the appellee had contended that while the activity in question may have been permissible under section 16, it was nonetheless prohibited by section 21. See Bankers Trust II, 807 F.2d at 1058. The court agreed that both sections prohibited underwriting, but noted that section 16 allows a commercial bank to sell securities on account of its customers, yet, section 21 denies it the power of "selling" securities. Id. The court then relied on the Supreme Court's statement in Bankers Trust I that "[sections] 16 and 21 seek to draw the same line" between commercial and investment banking, Bankers Trust I, 468 U.S. 137, 149 (1984), and concluded that the terms "issuing," "selling," and "distributing" in section 21 cannot be read to defeat section 16's permissive effect. See Bankers Trust II, 807 F.2d at 1057-58. The court's interpretation of "underwriting" has been criticized as being overly restrictive. See Langevoort, supra note 6, at 716. It has been suggested that such a term should be defined generically, in light of possible hazards feared by Congress without reference to specific features in the market. Id.

64 See Bankers Trust II, 807 F.2d at 1062. The court found it unnecessary to resolve the agency relationship issue because it agreed with the Board's conclusion that an "underwriting" defeats the section 16 exemption only if it includes a public offering." Id.; see supra notes 46 & 63 and accompanying text.
their commercial paper placement activities, and, through their affiliates, have gained Board approval to engage in underwriting of these securities to a limited extent.

In the most recent judicial expansion of the securities activities of bank affiliates, Securities Industry Association v. Board of Governors of the Federal Reserve System ("NatWest"), the court denied a petition seeking review of a Board determination.

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It is widely recognized that Glass-Steagall does not bar bank participation in all investment banking activity. Specifically, banks may underwrite and deal in debt securities outside the United States, see 12 C.F.R. § 211.5(d)(13) (1987); in certain U.S. government securities and state and municipal general obligation securities, see 12 U.S.C. § 24 (Seventh) (Supp. II 1984); and in certificates of deposit, see Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (certificate of deposit not a security). These are merely examples of the securities activities permissible under Glass-Steagall. The Act's attempt to separate investment banking from commercial banking seems futile considering that approximately forty-two percent of domestic underwriting markets were open to banks. See Bank Profitability, supra note 6, at 274.


The Board had concluded that a combined offering of securities brokerage services and investment advice by a bank affiliate did not constitute a “public sale” of securities within the meaning of sections 20 and 32 of Glass-Steagall. This activity was considered a “proper incident to banking” within the meaning of section 4(c)(8) of the Bank Holding Company Act. By upholding the Board’s determination, the court increased the list of permitted bank affiliate activities by effectively combining the holdings of ICI and Schwab. Furthermore, the court suggested that a “subtle hazards” analysis is not necessary when it is determined that the challenged activities fall squarely within specific terms of the Act. The court found no “subtle hazard” which would require a rejection of NatWest’s application. This line of judicial and regulatory decisions has enabled bank holding companies to offer diversified products and services heretofore foreclosed. However, some commentators have pointed out the dangers of such an ad hoc approach to expansion of bank participation in the securities industry. In recent years, widespread demands for reform of the regulatory structure and significant changes in the financial services industry have prompted increasing legislative attention.

The Congressional Response:

The Competitive Equality Banking Act of 1987

The Competitive Equality Banking Act of 1987 ("CEBA") was signed into law on August 10, 1987. This statute was primarily...
ily enacted to recapitalize the Federal Savings and Loan Insurance Corporation. The CEBA also contained provisions which imposed restrictions on the activities of “nonbank banks”; broadened authority permitting emergency acquisitions of failing financial institutions; set forth temporary expedited funds availability schedules; and imposed a moratorium on certain nonbanking activities.

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78 See Jones, FDIC Emergency Authority Under the Competitive Equality Banking Act of 1987 in The Competitive Equality Banking Act of 1987 35 (1987); see generally Competitive Equality Banking Act §§ 501-09, 1987 U.S. Code Cong. & Admin. News (101 Stat.) 552, 623-35. Title V of the Competitive Equality Banking Act, the “Financial Institutions Emergency Acquisitions Amendments of 1987,” was enacted to permit FDIC-assisted interstate acquisitions of failing banks. See Jones, supra. Section 502 permits out of state banks or holding companies to acquire institutions which are in danger of failing. See Competitive Equality Banking Act § 502, 1987 U.S. Code Cong. & Admin. News (101 Stat.) 552, 623-29. Further, holding companies or insured banks in danger of closing may be acquired by out of state holding companies if the former entity owns a bank subsidiary or subsidiaries with aggregate banking assets of $500 million or more; such subsidiaries comprise thirty-three percent or more of the holding company’s banking assets. See id. at 624. See also Explanatory Statement, supra note 76, at H6904.

79 See Competitive Equality Banking Act § 603, 1987 U.S. Code Cong. & Admin. News (101 Stat.) 552, 637. The “Expedited Funds Availability Act” aims to improve the nation’s check processing system. See generally id. (Act limits time period between check deposits and availability of cash for withdrawals). Schedules which take effect on September 1, 1988 provide limits on the time period which elapses before deposited funds are made available for the bank customer. The provisions contain modifications of the schedules which allow limited cash withdrawals. See Explanatory Statement, supra note 76, at H6906.
Section 201(b), which contains the moratorium provision, applies to foreign banks which are subject to the Bank Holding Company Act; bank holding companies, their subsidiaries and affiliates; and insured banks and their subsidiaries and affiliates. This section precludes federal banking agencies from authorizing or allowing, by “action, inaction or otherwise,” these institutions to engage in securities activities during a one year period. Any activity which involves the “flotation, underwriting, public sale, dealing in or distribution of securities,” agency approval of which would require a determination that the applicant not be “engaged princi-

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80 See Competitive Equality Banking Act §§ 201-05, 1987 U.S. CODE CONG. & ADMIN. News (101 Stat.) 552, 581-85. Section 201 provides in pertinent part: (a). . . The provisions of this section shall apply during the period beginning on March 6, 1987, and ending on March 1, 1988. (b). . . (1) A foreign bank or other company covered by subsection (c) of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106(c)) shall not, under any provision of law which is not applicable to domestic bank holding companies, expand any activity in which it is engaged pursuant to that subsection by acquiring an interest in, or the assets of, a going concern. . . . (2) A Federal banking agency may not authorize or allow by action, inaction, or otherwise any bank holding company or subsidiary or affiliate thereof, any foreign bank or other company subject to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) under section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)), or any insured bank or subsidiary or affiliate thereof to engage in the United States to any extent whatever — (A) in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities, (B) in any securities activity not legally authorized in writing prior to March 5, 1987, or (C) in the operation of a nondealer marketplace in options. Subparagraph (B) shall not affect (i) activities in which any bank holding company or subsidiary or affiliate thereof, any foreign bank or other company subject to the Bank Holding Company Act of 1956 under section 8(a) of the International Banking Act of 1978, or any insured bank or subsidiary or affiliate thereof acts only as an agent; (ii) activities which had been lawfully engaged in prior to March 5, 1987; or (iii) sales or transactions closed on or before June 30, 1987.

81 See id. § 201(b)(2), 1987 U.S. CODE CONG. & ADMIN. News (101 Stat.) 552, 582.

82 Id. This phrase was added during the deliberations of the Conference Committee by way of the so-called “missing page” amendment offered by Rep. Charles Schumer (D-N.Y.). See Corwin, supra note 75, at 4-5.

pally” in such activities, is prohibited during the moratorium. The moratorium’s scope also extends to “any securities activity not legally authorized in writing prior to March 5, 1987” and to the “operation of a nondealer marketplace in options.” The CEBA qualifies the requirement of written legal authorization by providing that it shall not affect activities in which the entity “acts only as an agent,” those “lawfully engaged in prior to March 5, 1987” and “sales or transactions closed on or before June 30, 1987.”

Congress’ intent in enacting CEBA is clarified by sections 202 and 203. The former provision expressly permits continued

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84 Id. at 582. This provision was apparently included to impose the moratorium on extensions of permissible subsidiary activity such as that approved by the Board in the Section 20 Applications. See supra note 66.


86 See id. § 201(b)(2)(C), 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 552, 582. This provision is aimed at placing a moratorium on activity previously approved by the board in applications similar to the one made by Security Pacific Corporation in 1987. See Security Pac. Corp., 73 Fed. Res. Bull. 622 (1987). In this order, the applicant gained approval to operate a system for trading put and call options on U.S. Treasury Securities through a subsidiary, Security Pacific Options Trading Corp. (“SPOT”). Id. at 623. SPOT would act only as an agent for participants it selected to become members of the system. Also, these such participants would not deal directly with each other, but would execute transactions through a third party unaffiliated with Security Pacific Corp. Id.


88 Competitive Equality Banking Act § 201(b)(2)(C)(ii), 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 552, 582. Commentators have questioned whether this exemption is “industry-generic or institution-specific.” See Corwin, supra note 75, at 8. In other words, in order to take advantage of the exemption, an entity is arguably required to have engaged in the given activity itself prior to March 5, 1987.


90 Id. § 202, 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 552, 584. Section 202 provides:

Nothing in section 201 may be construed to prevent a Federal banking agency from issuing any rule, regulation, or order pursuant to its legal authority in existence on the day preceding the date of enactment of this Act to expand the securities, insurance, or real estate powers of banks or bank holding companies that are subject to the moratorium established under section 201 if the effective date of such rule, regulation, or order is delayed until the expiration of such moratorium.

Id.

91 See id. § 203, 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 552, 584. Section 203 provides:

(a) . . . It is the intent of the Congress, through the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives, to conduct a comprehensive review of our banking and financial laws and to make decisions on the need for financial restructuring legislation in the light of today’s changing finan-
regulatory action authorizing activities affected by the moratorium, subject only to the requirement that the effectiveness of such decisions be stayed until the expiration of the moratorium. In section 203, Congress revealed its determination "to conduct a comprehensive review of our banking and financial laws" before the expiration of the moratorium.

Title I of the CEBA expands the scope of restrictions imposed upon transactions between banks insured by the Federal Deposit Insurance Corporation ("FDIC") and their affiliates through the adoption of section 23B of the Federal Reserve Act. The section was intended to supplement the restrictions found in section 23A, which govern extensions of credit by such banks to their affiliates. In addition to enumerating certain prohibited transactions, section 23B requires that some transactions be entered into

(b). . . It is the intent of the Congress not to renew or extend the moratorium established under section 201 whether or not subsequent banking legislation is passed by the Congress.

Id. The Board has included language in its orders to this effect. For example, in the Section 20 Application submitted by Citicorp, J.P. Morgan & Co. and Bankers Trust, the following statement appeared:

In its consideration of this case, the Board has noted that on March 27, 1987, the United States Senate passed legislation that, if enacted, would prohibit Board approval between March 6, 1987 and March 1, 1988, of any application, such as the present proposals, that would permit a bank holding company to engage in the underwriting or public sale of securities on the basis that it was not "engaged principally" in such activity within the meaning of section 20 of the Glass-Steagall Act. This prohibition would not apply to applications pending prior to the date of enactment of the legislation if the Board delays the effective date of the decision until the expiration of the moratorium. . . .

. . . [T]he Board calls to Applicants' attention that they may be required by subsequent Congressional action to cease their ineligible underwriting and dealing activities approved in this Order.


See Competitive Equality Banking Act § 102(b), 1987 U.S. Code Cong. & Admin. News (101 Stat.) 552, 565. Member banks or their subsidiaries are prohibited from:

(A) . . . purchas[ing] as [a] fiduciary any securities or other assets from any affiliate unless such purchase is permitted— (i) under the instrument creating the fiduciary relationship, (ii) by court order, or (iii) by law of the jurisdiction governing the fiduciary relationship; and (B) whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any
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on terms "substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies." A good faith standard is applied where no comparable transactions are present. Section 23B further provides that transactions with third parties which benefit an affiliate are transactions with affiliates. Additionally, an anti-fraud provision, which prohibits member banks, their subsidiaries or their affiliates from representing in advertisements or agreements that the bank is "responsible for the obligations of its affiliates," is contained in this section.

Enactment of the CEBA has resulted in increased attention to the Glass-Steagall dilemma, and has prompted numerous calls for reform. It is submitted that the continued restraints imposed by the moratorium will create uncertainty in the financial services industry and frustrate decisions concerning allocation of resources. For these reasons and others, prompt congressional action on this matter is necessary.

underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank.

(2) . . . Subparagraph (B) . . . shall not apply if the purchase or acquisition of such securities has been approved, before such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.

Id.

See Competitive Equality Banking Act § 102(a), 1987 U.S. CODE CONG. & ADMIN. News (101 Stat.) 552, 564. Transactions subject to this restriction include "covered transactions" with affiliates; sales of assets or securities to an affiliate, including those subject to a repurchase agreement; payment or the rendering of services to an affiliate; transactions in which an affiliate acts as an agent or broker, or is paid for rendering services to a bank; and transactions with a third party in which an affiliate participates or has a financial interest. Id. "Covered transactions" of an affiliate of a member bank, are defined as:

(A) a loan or extension of credit to the affiliate; (B) a purchase of or an investment in securities issued by the affiliate; (C) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation; (D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or (E) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.


Id. § 102(c), 1987 U.S. CODE CONG. & ADMIN. News (101 Stat.) 552, 564.
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PROPOSALS FOR RESTRUCTURING THE LEGISLATIVE AND REGULATORY FRAMEWORK

Although reform of the financial services industry appears to have gained widespread support, no single proposal has gained general acceptance. This Note examines several propositions, focusing primarily on those advanced by E. Gerald Corrigan, President of the Federal Reserve Bank of New York,101 the FDIC,102 and Thomas F. Huertas, Vice-President of Citicorp103 and the Committee on Government Operations, U.S. House of Representatives.104

The Corrigan Proposal

This proposal embraces the view that the separation of banking and commerce should remain intact regardless of the type of reform adopted.105 The author provided support for this concept by emphasizing that insulation of the bank from the commercial entity would require total segregation.106 Not surprisingly,

102 MANDATE FOR CHANGE, supra note 6.
104 COMMITTEE REPORT, supra note 10.
105 E.G. CORRIGAN, supra note 101, at 24. Mr. Corrigan characterizes his position as a "widely held view." Id. The Committee, however, explicitly rejected his analysis, stating:

Mr. Corrigan ... takes the position that we must preserve and strengthen the separation between banking, on the one hand, and nonfinancial business and commerce, on the other, and that this requires a strict prohibition against commercial firms owning and controlling insured depository institutions. He presents no analysis to explain why such a prohibition is needed, however, nor does he indicate that there have been any harmful effects or risks arising from the existing instances of such ownership.

... His position is only that commercial firms should not control banks or thrifts; he takes no position on banks or thrifts controlling commercial firms.

The committee finds this aspect of Mr. Corrigan's policy blueprint inconsistent with his supportive position on financial services integration.

... [His] position on commercial firms also has serious anticompetitive implications.

COMMITTEE REPORT, supra note 10, at 65 (footnote omitted).
106 E.G. CORRIGAN, supra note 101, at 25. The commentators embrace differing views on the insulation issue. Some argue that it is possible to insulate banks from their affiliates. Therefore, consolidated supervision of the entity owning the bank and restrictions on the activities which may be engaged in by such affiliates are unnecessary. See Huertas, supra note 103, at 19. This position is exemplified by the FDIC proposal, the Committee report
Mr. Corrigan concluded that this type of insulation would be impractical and would likely remove any incentive for such affiliation.\textsuperscript{107}

The Corrigan proposal offers a framework for regulatory reform based on functional supervision.\textsuperscript{108} It further recommended regulatory supervision of financial holding company activity.\textsuperscript{109} Mr. Corrigan outlines permissible organizational structures comprehended by the proposal, which include the financial holding company,\textsuperscript{110} the commercial-financial conglomerate,\textsuperscript{111} the bank hold-
ing company and the single-entity structure.

Under this approach, financial holding companies would be permitted to participate in the securities and insurance industries, but their banking activity would be limited to offering "transaction accounts." Such entities could not obtain access to the large dollar payments system or the discount window if they were controlled by commercial firms. Another type of institution, the commercial-financial conglomerate, would be permitted to be part of a commercial entity, but would be prohibited from owning deposit-taking institutions. Mr. Corrigan's scheme provides for the expansion of bank holding company activities to include a full range of financial services. However, these companies may not

window. Id; see infra note 116 and accompanying text.

See E.G. CORRIGAN, supra note 101, at 41. Mr. Corrigan's proposal requires that entities controlling a bank or thrift be unaffiliated with commercial enterprises. Id. at 41. However, they would be permitted to offer a full range of financial services and could own insured banks having access to the payments system and the discount window. Id. In addition, they may be subject to liquidity reserves. Id.

Id. at 34. This category would include the thousands of broker/dealers, insurance companies and finance companies. Id.; see infra note 121 and accompanying text.

See E.G. CORRIGAN, supra note 101, at 36. Transaction accounts are defined as non-insured balances with strict, low limits on the number of deposits and/or withdrawals permissible during a stated period. In addition, the principal balance may be subject to capital losses or gains. Id.

Id. at 15. The large-dollar electronic payments system is operated by the Federal Reserve Banks' FedWire system and the CHIPS system of the New York Clearing House Association. Id. Banks make substantial daylight overdrafts on these systems. The Federal Reserve provides "implicit insurance coverage" to the payees of these transfers, and risks significant liability if one of these institutions fails before covering its overdrafts. See COMMITTEE REPORT, supra note 10, at 57. Mr. Corrigan has expressed concern that allowing nonfinancial firms to control banks would create further risks to this system. See E.G. CORRIGAN, supra note 101, at 37. Such nonfinancial firms may not be subject to Board supervision and could be tempted to gain improper access to the system through their bank affiliates. See id; see also COMMITTEE REPORT, supra note 10, at 57-58 (concern regarding abuses by nonfinancial parent companies not subject to same degree of regulation as holding companies); MANDATE FOR CHANGE, supra note 6, at 91-94 (discussion of risks in payment system).

See E.G. CORRIGAN, supra note 101, at 34. The "discount window" is a process by which member banks may receive credit in the form of liquidity assistance from the central bank at below-market rates. See id. at 38.

Id. at 34.

Id. at 39. "Deposit-taking institutions" are entities which accept transaction deposits, as opposed to transaction accounts. See supra note 114 and accompanying text. Mr. Corrigan defines transaction deposits as "any liability which can be drawn down by the depositor at par within 24 hours without prior notice and the proceeds of which can be paid to third parties by the instruction of the depositor." See E.G. CORRIGAN, supra note 101, at 35-36.

See E.G. CORRIGAN, supra note 101, at 41.
be controlled by commercial firms. Finally, the single-entity structure which exists today would remain a permissible option. It is submitted that Mr. Corrigan’s rejection of the efficacy of insulation is unduly restrictive, as it is premised on the theory that banking and commerce must remain separated. The validity of this assumption is put into doubt by the many excellent insulation frameworks proposed by other commentators.

The FDIC Proposal

This proposal presents a striking contrast to that advanced by Mr. Corrigan. This staff study suggests that there is no policy basis supporting the continued separation of banking and commerce. It concludes that both Glass-Steagall and the Bank Holding Company Act are unnecessary to preserve the integrity of the banking system and argues that both acts should be gradually repealed. Rejecting the need for regulation of nonbanking affli-

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120 Id.
121 Id. at 34. Such institutions would be largely unaffected by the Corrigan proposal. Id. However, a degree of consolidation and product diversification among these institutions would be a likely result. See id.
In addition, the proposal advocated: the establishment of a “Financial Services Oversight Board,” id. at 43, consolidated Board supervision of banks, thrifts, and financial holding companies having access to the discount window, id., and functional supervision of individual activities conducted by bank, thrift, financial and commercial-financial holding companies. Id. at 44.
122 See MANDATE FOR CHANGE, supra note 6, at 139-66.
123 Id. at 159. This study defined commerce as all activities, including those of a nonfinancial nature, that are not engaged in directly by banks. Id. at 28. The FDIC proposal asserted that the elimination of unnecessary regulations promotes economic efficiency. Id. Since a separation between banking and commerce is unnecessary, see infra text accompanying note 131, the study suggests that there is no public policy to support the separation.
124 MANDATE FOR CHANGE, supra note 6, at 159. The study notes that “[n]either the Glass-Steagall separation of commercial and investment banking nor the Bank Holding Company Act appear to be necessary to the safety and soundness of the banking system.” Id.
125 See id. at 161. In connection with the phasing out of Glass-Steagall, the study proposed that banks first be granted the authority to underwrite municipal revenue bonds, mortgage-backed and other securitized securities and commercial paper. Id. The eradication of the Bank Holding Company Act presents a greater risk. Id. Therefore, it demands a more gradual phase-out, which should begin with the Board’s relinquishment of its authority over mergers and other antitrust matters. Id. The regulatory structure governing nonbank affiliates and the holding company would then be dismantled. Id. at 162. Once this is accomplished, bank tie-in regulatory authority could be transferred to the Federal Trade Commission, which governs other unfair and deceptive trade practices. Id. “Tie-ins exist when a business entity attempts to condition the sale of a particular product or service upon the purchase of another of the entity’s products or services.” Id. at 79. Finally, restrictions on
ates of banks, the proposal asserts that abuses could be effectively avoided by increasing the regulation of interaffiliate transactions.\textsuperscript{126} Such increased regulation would include limited administrative power to require audits and disclosure.\textsuperscript{127}

The FDIC study also advocates enactment of new legislation extending the scope of sections 23A and 23B of the Federal Reserve Act\textsuperscript{128} to include direct subsidiaries of banks.\textsuperscript{129} In addition, the FDIC proposal contains a provision for making the limits on dividend payments and general loan limits uniform for all banks.\textsuperscript{130} It concludes that since the continued separation of banking and commerce is unnecessary, the regulatory structure developed pursuant to Glass-Steagall and the Bank Holding Company Act could be largely dismantled.\textsuperscript{131} While this proposition loosely advocates change and voices general approval of an insulation framework, it is submitted that this proposal fails to outline precisely which measures should be taken to effectuate the change.

\textit{The Huertas Proposal}

Somewhere between the Corrigan proposal, which would preserve much of the existing regulatory framework,\textsuperscript{132} and that of the permissible affiliate activity would be liberalized, beginning with the addition of financial, then nonfinancial functions. \textit{Id.} at 162.

\textsuperscript{126} \textit{Id.} at 140-43. The restrictions on affiliate transactions contained in section 23A and 23B of the Federal Reserve Act apply to all banks insured by the FDIC. 12 U.S.C. \textsection{} 1828j(1) (1982). Various state and federal statutes, contain other restrictions which govern activities such as dividend payments and general loan limits. \textit{See Mandate for Change, supra} note 6, at 143. These limitations may not be applicable to all banks.

The FDIC proposal advocates passage of new legislation aimed at creating uniformity in these areas. \textit{Id.} The proposal suggested that either a new section, 23C, articulating consistent regulations, be added to the Federal Reserve Act, or that sections 23A, 23B and 23C be transferred to the Federal Deposit Insurance Act. \textit{Id.} The study concluded that this reform "would be sufficient to insulate banks if activity restrictions are removed from nonbank affiliated organizations and if the banking agencies no longer have the direct regulatory control and supervisory authority of the Bank Holding Company Act over these entities." \textit{Id.} at 140.

\textsuperscript{127} \textit{Mandate for Change, supra} note 6, at 159. This power would be the sole form of control which banking authorities could exercise over nonbanking affiliates. \textit{Id.} at 160.

\textsuperscript{128} 12 U.S.C. \textsection{} 371c (1982).

\textsuperscript{129} \textit{See Mandate for Change, supra} note 6, at 144. The term "affiliate" within the meaning of sections 23A and 23B of the Federal Reserve Act does not include nonbank subsidiaries. See 12 U.S.C. \textsection{} 371c (1982).

\textsuperscript{130} \textit{See Mandate for Change, supra} note 6, at 160.

\textsuperscript{131} \textit{See supra} notes 122-30 and accompanying text.

\textsuperscript{132} \textit{See supra} notes 105-21 and accompanying text.
FDIC, which would eschew much of its structure,\textsuperscript{133} lies a solution proposed by Thomas F. Huertas, Vice-President of Citicorp.\textsuperscript{134} Advocating broad expansion of permissible activities for bank affiliates,\textsuperscript{135} the Huertas proposal suggests that financial services holding companies be required to provide additional capital to their bank subsidiaries and rejects propositions which would impose separate capital requirements on the holding company.\textsuperscript{136} Further, the insulation problem is handled by allowing the financial services holding company to take advantage of synergies which may be achieved by reason of its structure,\textsuperscript{137} while curbing its potential for abuse through imposition of regulatory requirements.\textsuperscript{138} These requirements would include the preservation of existing insulation devices and the addition of several new provisions.\textsuperscript{139}

\textsuperscript{133} See MANDATE FOR CHANGE, supra note 6, at 159. It also advocated that the modernized system not feature comprehensive consolidated supervision of nonbank affiliates. Id. at 158-160.

\textsuperscript{134} See supra note 103.

\textsuperscript{135} Huertas, supra note 103, at 43-44. Presently, optimal competition does not exist in the finance industry because the number of participants in the investment banking/securities industry is limited by Glass-Steagall. See id. at 42-43. Mr. Huertas believed that a concentration of resources will be reduced when the Act, a barrier to entry into the industry, is eliminated. Id. at 43-44. By permitting bank affiliates to engage in activities which are presently restricted by Glass-Steagall, an increase in the number of participants in the industry would occur. Therefore, the economic and political concentration within the industry would be reduced, leading to a more perfectly competitive market. Id. at 42. The author based this conclusion on the following economic analysis:

In economic markets, concentration means the power of a firm to raise the price of a product or service above its competitive level. This power depends on barriers to entry by other firms into that market. If anyone can legally enter an industry, no firm in the industry can exercise market power, unless there are natural barriers to entry. And, in finance, there do not appear to be any significant natural barriers to entry. Hence, removing the artificial barriers to affiliation between banks and non-bank firms is a sure way to reduce whatever economic power may currently exist in banking and finance.

Id. at 42 (footnote omitted). In addition, concentration creates political power in the entities, who are then protected by Glass-Steagall's barriers to affiliation. See id. at 43. Mr. Huertas seeks to reduce political concentration by the adoption of his proposal. Id.

\textsuperscript{136} Id. at 26. Mr. Huertas reasoned that this requirement would further the aim of ensuring bank soundness, while avoiding the implementation of a consolidated regulatory structure. Id. In contrast, Mr. Corrigan proposed that all transaction accounts, including those issued by non-banks, be subject to reserve requirements. See E.G. CORRIGAN, supra note 101, at 36, 48.

\textsuperscript{137} Huertas, supra note 103, at 26-27.

\textsuperscript{138} Id. at 27.

\textsuperscript{139} Id. The existing insulation provisions include dividend restrictions, section 23A of the Federal Reserve Act, and the anti-fraud and disclosure provisions of the securities laws. Id. The new insulation devices include the bear-down, anti-fraud, extra layer, plenipotentiary and enforcement provisions. Id. at 27-28. For a discussion of these provisions, see infra
One of these, the “bear-down” provision,\textsuperscript{140} encompasses stringent bank capitalization requirements coupled with regulatory authority to impel divestiture in the event of continued violation.\textsuperscript{141} Further, banks which became members of financial services holding companies would be subject to supplemental capitalization requirements.\textsuperscript{142} Additionally, Mr. Huertas advocates a “plenipotentiary” provision,\textsuperscript{143} granting rule-making authority to bank regulators, and imposing civil and criminal sanctions for violations.\textsuperscript{144} Regulators would also be empowered, pursuant to an enforcement provision, to enjoin unsafe and unsound practices by the bank and to obtain orders requiring divestiture of the bank.\textsuperscript{145} In short, the Huertas proposal rejects the consolidated official regulation of financial services holding companies and supports the placing of responsibility for maintaining insulation on the bank’s primary federal regulator.\textsuperscript{146} It is submitted that the Huertas proposal sets forth a comprehensive scheme based on insulation, which could effectively control any risks associated with the reform of

\textsuperscript{140} Huertas, supra note 103, at 27. The bear-down provision imposes severe penalties for maintenance of insufficient capital, and would serve to protect the deposit insurance system from risk, as regulators are empowered to step in before a bank is forced to close. \textit{Id.} at 25-26.

\textsuperscript{141} \textit{Id.} at 25.

\textsuperscript{142} See supra note 136 and accompanying text.

\textsuperscript{143} Huertas, supra note 103, at 27-28. The plenipotentiary provision would provide further regulation of interaffiliate transactions by granting the bank’s primary federal regulator rule-making authority in this area, thus protecting the safety and soundness of the bank. \textit{Id.} at 27.

\textsuperscript{144} \textit{Id.}

\textsuperscript{145} \textit{Id.} at 28. Rather than seeking cease-and-desist orders, the primary federal regulator of the bank could utilize the injunction procedure to expedite this action. \textit{Id.} In response to such action, the enforcement provision would give the courts the power to order divestiture of the bank, thereby preventing continued unsafe or unsound banking practices. \textit{Id.}

\textsuperscript{146} \textit{Id.} at 29. Mr. Huertas comments that:

This comprehensive approach concentrates responsibility for insulating the bank in the hands of the federal regulator responsible for examining and supervising the bank (e.g. the Comptroller of the Currency for national banks). Rather than ossify all insulation provisions in a statute, this approach gives the bank’s primary federal regulator the flexibility to adapt regulations to changing conditions and the power to stop any practice that he considers to be unsafe and unsound. Thus, this approach protects what needs to be protected (the bank), and assigns the job of protection where it belongs—to the bank’s primary federal regulator. This is a much more direct and, I would argue, much more effective method of preserving the safety and soundness of the bank than consolidated official supervision of the entity owning the bank.

\textit{Id.}
Glass-Steagall. Moreover, concentrating supervisory authority on the bank, rather than the holding company, will further the aim of functional regulation, leading to a more efficient allocation of resources.

**Proposals for Reform: A Critical Analysis**

The Corrigan, FDIC and Huertas proposals were presented to the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations ("Committee") in a series of hearings conducted throughout 1986. The Committee subsequently issued a comprehensive report which included its own proposal for reform of the current system of regulation.

The Committee found that the prohibitions contained in Glass-Steagall and the Bank Holding Company Act lead to an inefficient allocation of capital because of restricted mobility. This finding was based in part upon a distinction between financial capital, which is freely transferable, and organizational capital, which is found abundantly in the banking industry and is largely immobile. Consequently, the banking industry has experienced declining business opportunities, intense competition and falling profits. From the viewpoint of the Committee, increasing the scope of activities in which bank affiliates may engage would increase in-

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148 See COMMITTEE REPORT, supra note 10.
149 See id. at 25. The Committee found that banks utilize organizational capital, as opposed to financial capital, intensively. Id. at 24. Intangible organizational capital is defined as the "collective expertise, accumulated institutional wisdom, team capabilities, and organizational 'momentum' or 'going-concern value' of each individual firm." Id. at 23. The organizational capital of a firm is greater than the sum of the talents of the individual employees. Id. This is due to "the synergy of cooperative teamwork among many individuals of diverse talents" which is only fully realized through organization into systems. Id. at 24. This form of capital is not as freely transferable as purely financial capital. Id. at 24. Thus, the restrictions imposed by Glass-Steagall and the Bank Holding Company Act on the mobility of organizational capital to other expanding business activities result in an inefficient allocation of resources. Id. at 25.
150 Id. at 23-24.
151 See id. at 24. During the period 1975-1984, commercial banking was one of the least profitable selectors in the financial industry. See BANK PROFITABILITY, supra note 6, at 269. When compared to the securities industry, which maintained an average after-tax return on equity of 16.4 percent, commercial banking exhibited a much lower figure, measured at 12.3 percent, for the same nine year period. Id. at 270.
dustry profitability and restore financial soundness to the banking industry.152

Analyzing the anticompetitive effects of Glass-Steagall and the Bank Holding Company Act, the Committee reasoned that banks are one of a limited number of organizations which could successfully enter the business of investment banking.153 The Committee specifically advocated underwriting of corporate securities by bank affiliates.154 Further, the Committee went on to praise the function which “nonbank banks” serve in decreasing concentration, and disclosed its intention to incorporate these entities into the regulatory framework.155

A starting point for the Committee’s analysis lies in its fundamental belief that regulation should focus on preserving the integrity of the banking system as a whole, rather than ensuring the continued viability of individual banks.156 This principle led the

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152 See COMMITTEE REPORT, supra note 10, at 24-25. The Committee reasoned that “impediments to the mobility of capital among industries or lines of business reduce the investment appeal and increase the risks of loss from investing in any industry subject to these impediments.” Id. at 24.

153 Id. at 27. The Committee noted that economies of scale and high fixed costs of entry are common to the commercial and investment banking industries, thus making banks a potential competitive force against investment banks. Id. Indeed, in areas where competition is permissible, banks have fared well. For instance, banks controlled forty-two percent of the underwriting markets open to them in 1984. BANK PROFITABILITY, supra note 6, at 274.

154 See COMMITTEE REPORT, supra note 10, at 28. The Committee noted:

The corporate securities underwriting business in the United States is highly concentrated in a small number of major investment banking firms. . . .

Given this high degree of concentration in the management of corporate securities underwritings, the committee believes that there must be a presumption that the entry of new competitors would be beneficial to both issuers and investors. Moreover, the fundamental shift now occurring toward greater and greater use of the securities markets for financial intermediation both domestically and in the international financial markets . . . increases the importance of assuring the maximum competitive efficiency and integrity in the securities markets. . . . [T]he committee finds that removal of the Glass-Steagall barrier that now prohibits corporate securities underwriting by domestic affiliates or subsidiaries of commercial banks would contribute importantly to strengthening the fundamental process of financial intermediation in the U.S. economy.

Id.

The Committee rejected the argument that limited underwriting activities, if conducted by banks, would increase the likelihood of bank failures. Id. at 33. The increased risk through portfolio investment would be eliminated by diversification. Id.

155 Id. at 27-28.

156 Id. at 30-31. This principle, that the safety of the entire system, rather than any individual bank is of paramount importance, guided the Committee’s analysis of the risk factor. The Committee asserted that “no individual bank or thrift institution is, by itself,
Committee to conclude that limited underwriting activity engaged in by bank affiliates would not necessarily increase the risk encountered by the institution, and that any perceived increase in risk could be controlled by raising minimum capital requirements.

The report discussed various issues pertaining to the insulation of banks from their nonbank financial and commercial affiliates, and recommended the adoption of a comprehensive insulation program rather than a system of direct regulation at the holding company level. The Committee rejected consolidated regulation of nonbank affiliates as violative of the concept of functional regulation and as potentially disruptive to the operation essential to the safety of the banking and payments systems." Id. at 30. Discussing the importance of the Federal insurance system, which provides insurance for bank deposits, the Committee report also stressed that this system cannot be compromised by any legislative changes. Id.

Id. at 33. The report found, in fact, that if such activities were limited to a stated percentage of the bank's activity, the effects of diversification of investment would ensure that riskiness would not increase. Id.

Id. In consideration for protecting the integrity of the system, the report concluded that increased minimum capital requirements would eliminate the risk of insolvency. Id. at 33-34.

See id. at 38-45. The insulation system recommended by the Committee, sought to obviate the need for consolidated regulatory supervision of the holding company and nonbank affiliates and included a complete prohibition of interaffiliate bank loans. Id. at 78. In addition, all financial services holding companies would have to be "substantially publicly owned." Id. at 80. The report contended that financial service holding companies and their nonbank affiliates would be able to easily obtain credit from uninsured sources. Id. at 78. Also, bank affiliates would be precluded from purchasing debt or equity securities or investment assets from a nonbank affiliate. Id.

The report urges that legislation be enacted which specifically prohibits deposit insurance funds from aiding the shareholders or business interests of the holding company. Id. at 79. This legislation, in the Committee's opinion, would allow a Federal insurance agency to place insured institutions in protective custody upon a finding of repeated violations. Id. Under the insulation scheme, a financial services holding company would be required to reimburse the deposit insurance fund for all payments made as a result of the closing and liquidation of an insured institution. Id. at 80. Finally, the insulation system would include regulation of cross-marketing programs among affiliates to protect the public from unfair competition. Id. at 81. See also supra notes 135-43 and accompanying text.

Id. at 78.

Id. at 38-39. Such a system would lead to serious inequities. The report stated that: [The banking industry] would object strongly to the imposition by any holding company oversight agency of similar risk-related regulations or controls over these separate subsidiaries if [its] competitors—presumably securities firms without banking affiliates—were not subject to the same limits. Risk-related controls imposed on a holding company securities subsidiary to which independent securities firms were not subject would clearly create a competitive disparity that could put the holding company subsidiaries at a fundamental disadvantage.
of the securities markets. Significantly, this proposal explicitly concluded that insulation may be accomplished without destroying the advantages implicit in the structure of the organization.

The Committee Report incorporated these findings into a proposal which would be implemented through comprehensive structural change, rather than ad hoc expansion of permissible activity. Principal to the suggested structure is the establishment of financial service holding companies, which would be permitted to engage in financial service activities. The holding company may be controlled by any publicly owned firm, even if such firm engages in nonfinancial activities. Only the depository institution would be subject to comprehensive regulation. The integrity and soundness of the banking system would be maintained through insulation, rather than extensive regulation of the holding company and its nonbanking affiliates. The Committee speculated that oversight of the holding company might properly be delegated to the Board. Regardless of the agency chosen, its powers would include definition of activities constituting "financial services," oversight of the insulation system and maintenance of capitalization requirements applicable to financial services holding companies.

The proposal advanced by the Committee is a comprehensive analysis which draws on many of the desirable aspects suggested by other commentators. Significantly, the Committee adopted the concept of functional regulation, which has been advanced by each of the commentators, but limits its scope. Further, the Commit-

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Id. at 39.
Id. at 41-42.
See id. at 73. The Committee recommended that "Congress should not adopt the piecemeal approach of granting just selected new securities powers to banking firms or making individual extensions to the list of permissible holding company activities." Id. (emphasis in original).
Id. at 74.
Id. For a non-financial entity to own a holding company, it must be registered as a separately incorporated entity. Id.
Id. at 75.
Id.; see also supra note 107.
See Committee Report, supra note 10, at 76.
Id. at 76-77.
Id. at 58. The Committee found that in some cases the principle of insulation requires that securities affiliates of banks bear a greater regulatory burden than unaffiliated firms. Id. at 59. The Committee did however, indicate general support of the concept of equal regulatory treatment and regulation independent of ownership or affiliation. Id. at 61.
tee concluded that enforcement authority over securities affiliates should be vested in the Securities and Exchange Commission, rather than in bank regulatory agencies.\footnote{172 See id. at 81.} It is submitted that this action is reasonable in the interest of efficiency and uniformity of application. Moreover, the Committee's advocacy of limited official supervision at the holding company level should be incorporated into any legislative reform undertaken;\footnote{173 See id. at 76-78.} to do otherwise would damage the profitability of nonbank subsidiaries whose competitors would not be subject to such regulation.

Finally, the Committee adopted and approved the concept of insulation.\footnote{174 See id. at 78-81.} It is submitted that insulation between banks and their securities affiliates should be the centerpiece of Glass-Steagall reform. The report adopted several of the ideas advanced by Huertas, including the "bear-down" provision, which sets minimum capital guidelines, and the enforcement provision. These safeguards will provide a powerful deterrent against excessive risk taking and unsound banking practices. Most significantly, the issuance of the Committee Report evinces Congressional resolve to undertake comprehensive reform.

\section*{Conclusion}

The last decade has been marked by an increasingly strong and widespread conviction that the regulatory system imposed by Glass-Steagall and the Bank Holding Company Act has become inefficient and unworkable. Expansion of permissible bank activity by regulatory and judicial action on an ad hoc basis has been applauded by the banking industry. This approach, however, leaves the existing regulatory system intact, forcing institutions to face administrative burdens and benefits not encountered by participants in other industries.\footnote{175 See supra note 108.}

To remedy this inequity, commentators have generally embraced a system of functional regulation.\footnote{176 See id. at 39.} Other aspects of their proposals for reform have unfortunately not commanded such a broad consensus. While the task faced by Congress in this area is formidable, the efforts undertaken by the Committee on Govern-

\begin{footnotesize}
\begin{enumerate}
\item See id. at 81.
\item See id. at 76-78.
\item See id. at 78-81.
\item See id. at 39.
\item See supra note 108.
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mental Operations exhibit an ability and willingness to forge a new legislative structure governing the financial services industry. The task is too important to be subsumed by partisan politics and special interest lobbying.

It is submitted that legislative reform should reject overly restrictive consolidated official supervision of the holding company structure. The separation of banking and commerce should be largely abandoned in the interest of economic efficiency and free competition. Most importantly, a comprehensive system of insulation, such as that proposed by Mr. Huertas, should be adopted to ensure the continued soundness of the American financial system after Glass-Steagall reform.

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