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STAFF MEMORANDA

SECURITIES ACTIVITIES OF COMMERCIAL BANKS: THE CURRENT ECONOMIC AND LEGAL ENVIRONMENT

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FEDERAL RESERVE BANK OF CHICAGO

Securities Activities of Commercial Banks: The Current Economic and Legal Environment

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One of the more striking developments in financial markets in recent years has been the increased involvement of commercial banks in a progressively wider variety of securities activities. These now include securities brokerage, investment advising, mutual fund management, issuance of mutual fund-like deposits, and underwriting and trading of an increasing number of non-federal government securities. Overseas, larger U.S. banking organizations are involved in full-service investment banking. In addition, Senator Proxmire, Chairman of the Senate Banking Committee, and other Congressmen have introduced legislation to repeal some of the prohibitions against further commercial bank activities in securities dealing and underwriting. Those favoring such liberalization argue that the restrictions unduly limit the ability of commercial banks to compete, thereby increasing the costs of these services to the public, and prevent banks from diversifying to reduce their risk exposure. Those opposed to liberalization believe that these activities would circumvent the congressional purpose embodied in the Banking Act of 1933, which introduced severe restrictions on commercial banks' securities activities, and that they pose a serious danger to the safety and competitiveness of the financial system. This paper examines the history of commercial banks' involvement in the securities markets and the role of securities activities in the banking collapse of the 1930s, reviews the rationale for and substance of the Banking Act of 1933, and surveys the evolution of bank securities activities since 1933, with emphasis on the last decade. It concludes with a reevaluation of the economic issues raised by commercial banks' involvement in securities activities.

Origins of the Glass-Steagall Act

The Banking Act of 1933, often referred to as the Glass-Steagall Act after the chairmen of the Senate and House banking committees, was a sweeping and complex piece of legislation. Congress enacted it in June as a quick, ad hoc fix in reaction to the Great Depression and in particular to the financial holocaust that saw the failure of more than 40 percent of all commercial banks in the United States between 1929 and 1933. There was a

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pervasive public attitude of fear and uncertainty about the future of the financial system, if not of the entire economic system. President Franklin D. Roosevelt's first official act was to close all banks for at least one week during the national banking holiday declared on March 6, 1933. The Glass-Steagall Act was one of the bills hurriedly enacted in the now fabled "first one hundred days" of the Roosevelt administration. It was intended to demonstrate that Congress and the administration were alert to the crisis and were willing to take strong action to correct any problems in the financial system.

The public and Congress alike sought easily identifiable causes and quick solutions for the calamity. They blamed the crisis on a number of perceived weaknesses that had disturbed some individual members of Congress for many years. Among these were: a poorly organized Federal Reserve System, excessive competition among commercial banks, undue risk-taking by commercial banks, an excessive number of small banks that were unable to diversify through geographical expansion, the channeling of bank credit into "speculative, nonproductive" uses, excessive economic concentration in banking, and serious conflict-of-interest abuses. Many bills had been introduced to correct these alleged problems during the late 1920s and early 1930s. For example, proposals to restrict bank deposit rates, to permit wider branching authority for national banks, and to adopt federal deposit insurance had been introduced in Congress on several occasions during the decade just prior to the Great Depression. Separation of commercial and investment banking had been a pet proposal of Senator Carter Glass for many years. Glass, who had been the main author of the Federal Reserve Act in 1913, firmly believed in the real bills doctrine, one tenet of which was that bank safety could be achieved only if banks restricted their lending to short-term financing of goods in the production process. While none of these proposals had gained sufficient support in Congress on their own merits to be enacted, they were well-developed and ready at hand when the crisis struck in 1933. As legislators scurried about to put together a comprehensive legislative package to correct the perceived causes of the crisis, it was only natural that they would turn to these proposals. Many of the individual proposals found some support on their own merits and gained additional support as a result of horse-trading among their various supporters in putting together a comprehensive package. The overriding consideration in their adoption was the safety of the banking system.[1]

The Banking Act of 1933 contained many provisions and affected nearly every aspect of banking. Among other things, it:

1. reorganized the Federal Reserve System,
2. prohibited the payment of interest on demand deposits,
3. imposed ceilings on interest rates payable on time deposits,

4. restricted entry of new national banks,
5. imposed margin requirements on bank-financed securities purchases,
6. introduced federal deposit insurance,
7. gave national banks the same intrastate branching powers as state banks in the same state, and
8. separated full-service commercial and investment banking.

Earlier Involvement of Banks in Securities Activities

Commercial banks have been involved in investment banking to some degree through the greater part of U.S. history. The distinguishing characteristic of commercial banks in Britain in the 18th century was that they were chartered by the government and granted exclusive rights to issue notes of circulation. Both to assure their safety and liquidity and to limit their activities for competitive reasons, commercial banks were prohibited from underwriting and investing in longer-term private securities. Different types of financial institutions which generally went by the name of merchant, investment, or private banks were organized to assist private firms in raising longer-term capital. Because they did not issue notes, these firms were not required to obtain commercial bank charters and were not subject to the same restrictive provisions. To service their customers, these entities began to offer deposit accounts, which were not an important service of commercial banks at the time.

However, unlike British banks, many U.S. commercial banks were active in underwriting early in the 19th century. In a review of the history of commercial bank involvement in investment banking in the United States, Carter Golembe concluded that "commercial banking and investment banking have been closely intertwined from the time banks first appeared on this continent."[2] In part, this appears to have been due to the absence of other highly developed, specialized financial institutions designed to provide long-term credit to business. According to Golembe, between 1800 and 1840, ". . . commercial banks were also the leading investment banking institutions, and may even have dwarfed all other institutions and individuals combined in the volume of securities underwritten and distributed."[3]

Other writers paint a similar picture. For example, H. Parker Willis and Jules S. Bogen wrote in 1929: "For many years banking or financial institutions have existed which have carried on both kinds of banking (commercial banking and investment banking) concurrently; the practice has continued up to the present time, and is still a prevailing one."[4] Similarly, Vincent Carosso noted that "[t]he investment banking function was also performed by incorporated commercial banks. . . . By the mid 1830s chartered banks in several states were successfully bidding for new issues and reselling them in smaller lots either to subcontractors or directly to investors."[5]

State banks were generally free to engage in a full range of investment banking activities throughout this period. National banks were initially restricted in their underwriting to securities that they were permitted to own. Their authority to engage in investment banking at all was derived from the Comptroller of the Currency's interpretation of the "incidental powers" clause of the National Banking Act. Through time, this authority was extended to corporate bonds and then to corporate equities in order to keep national banks on an equal competitive footing with state banks. Securities activities were conducted in the banks' bond departments. Precisely what type of securities national banks were permitted to underwrite and trade at what time between the end of the Civil War and the enactment of Glass-Steagall is unclear from readily available primary sources. Some secondary sources refer to an unreferenced ruling by the Comptroller of the Currency in 1902 that prohibited national banks from dealing in equities within the bank itself.[6] Shortly thereafter some of the banks shifted their securities activities to state-chartered affiliates that they had recently organized primarily to expand their trust, savings deposit, and mortgage lending activities. Use of these affiliates also permitted the banks to operate more easily across state boundaries.

To clarify the securities powers of national banks and reduce their reliance on affiliates, which were supervised and examined by state banking agencies and whose operations had been called in question by the Pujo Committee "money trust" investigation in 1912[7] , the Comptroller recommended legislation that would codify existing practice.[8] Congress responded by enacting the McFadden Act of 1927 (which is better known for granting national banks limited branching powers), which made explicit the authority of national banks to underwrite and deal in "investment securities" and authorized the Comptroller to define such securities within the limitations of the National Banking Act. Both the Senate and House reports accompanying the act note that "this is a business that is regularly carried on by state banks and trust companies and has been engaged in by national banks for a number of years. The effect of this provision, therefore, is primarily regulative."[9]

Relying on the language of the incidental powers clause in the National Banking Act, the Comptroller initially limited the definition of investment securities "to marketable debt securities."[10] But by the onset of the Great Depression, both national and state banks or their affiliates were permitted to engage in almost all available securities activities, and many of the larger institutions had taken advantage of these powers.

Securities Activities and the Banking Collapse of the 1930s

It is often argued that the involvement of commercial banks in securities activities contributed importantly to the banking collapse of the 1930s. In 1933, a subcommittee of the Senate Banking Committee conducted well-publicized hearings on stock exchange practices. Named after the subcommittee's chief counsel, Ferdinand Pecora, these hearings are often cited as demonstrating the key role of banks' securities affiliates in precipitating and amplifying the banking crisis. A careful reading, however, reveals that this is an overstatement.[11] What the hearings did demonstrate was that individual bankers, like other people, are capable of venality and a disregard for the public interest.

Among the practices whose propriety was questioned during the hearings were the purchase of securities by the bank from its securities affiliate, the promotion and sale by the bank to its correspondents of securities underwritten by the bank's affiliate, lending by banks to their affiliates to finance underwriting activity, the tying of corporate loans to use of the bank's affiliate for underwriting new issues of securities, compensation of bank officials by securities affiliates that greatly exceeded their compensation from the bank, and speculation by officers and directors in the stock of their bank.[12] It should be noted that some of these activities appear to have been perfectly legitimate and that none of them was illegal at the time, though some of them were subsequently prohibited by the securities legislation of 1933 and 1934. More importantly, however egregious a few of the practices uncovered by the Pecora hearings might have been, the hearings provided no support either for concluding that such practices were widespread or for blaming the bank failures of the early 1930s on securities activities.[13] Indeed, a number of recent studies reexamining national banks' investment banking activities prior to 1933 concluded that bank affiliates did not adversely affect commercial banking operations, that bank managers did not favor the affiliates at the expense of the banks, and that the activities of security affiliates did not lead to the failure of a single bank.[14]

The Divorce of Commercial and Investment Banking

Nevertheless, the alleged abuses uncovered by the Pecora hearings aroused great public indignation at the time and proved instrumental in gaining passage of the provisions separating commercial and investment banking. This was true despite the fact that Senator Glass, a longtime foe of bank involvement in securities activities, had already indicated his willingness to compromise on the issue by settling for something less restrictive than separation, such as increased supervision.[15]

It is important to recognize that the separation of commercial and investment banking decreed by the Banking Act of 1933 was neither complete nor ironclad. Sections 16 and 5(c) limit national banks and state member banks, respectively, to dealing in and underwriting U.S. Treasury and municipal general obligation securities.[16] Section 20 proscribes affiliations between member banks and organizations "principally engaged in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities."[17] Section 21 prohibits securities firms from engaging in "the business of receiving deposits."[18] Finally, Section 32 prohibits officer, director, or employee interlocks between organizations "primarily engaged" in securities activities and member banks.[19] (The texts of these sections are included in the appendix). Subsequent experience has shown that the language of the act—in particular, the terms "principally engaged" and "primarily engaged" —lends itself to a variety of interpretations.

Reentry into Securities Activities—1933-1980

Commercial banks showed little inclination to reenter investment banking during the decades immediately following passage of the Glass-Steagall Act. The industry was not particularly attractive for entry. A number of investment banking firms had themselves failed during the early 1930s.[20] Activity was at a low ebb as firms had little cause to resort to the capital markets to raise new funds. Between 1930 and 1939, U.S. nonfinancial corporations used internal funds to retire a large portion of their outstanding debt.[21] Partly as a consequence, assets of security dealers and brokers actually declined by 60 percent between 1929 and 1952. This was the largest decline of any of the 24 types of financial intermediaries analyzed by Raymond Goldsmith in his study of U.S. financial intermediaries in the 20th century.[22] In contrast, assets of commercial banks nearly tripled over this period. Nor did security firms do much better over the longer 1900-1952 period; their assets increased by a factor of six over this period, only one-third that for commercial banks. Together with the newfound conservatism that pervaded commercial bank management for several decades after 1933, the depressed state of the industry deterred any widespread efforts by banks to reenter the securities business until more than 20 years later.

One of the first major post-Depression moves toward restoring commercial banks' position in the securities markets came in the late 1950s in the form of proposals for a limited extension of banks' powers in an area of securities activities that they were still authorized to engage in—municipal bonds. The Glass-Steagall Act limited member banks to underwriting and trading "general obligations of any state or any political subdivision thereof..."

However, during the years following passage of the act, revenue bonds, which were not widely used in the 1930s, had come to make up a progressively larger proportion of total municipal bonds issued. Arguing that such bonds were not markedly more risky than general obligation bonds and that commercial bank entry would greatly reduce borrowing costs to municipalities, the banking industry proposed a number of legislative bills to allow commercial banks to underwrite revenue bonds.[23]

Making little headway via the federal legislative route, the banks came close to achieving their goal through regulatory decisions during the tenure of Comptroller of the Currency James J. Saxon in the early 1960s. A lawyer who was impatient with extant banking law, Saxon liberalized entry and merger by national banks and authorized by regulation certain activities, such as travel agency services, leasing of personal property, purchase of common stock in local development corporations, and the offering of corporate savings accounts, that were widely believed to be prohibited by statute.[24] He also authorized national banks to underwrite some municipal issues that were arguably revenue bonds rather than general obligation bonds. In this, as well as in most of the other cases, his initiative was eventually rejected by the courts. In contrast, the Federal Reserve Board took a much more conservative view of the language of the Glass-Steagall Act and limited itself to calling on Congress to revise the law to permit banks to underwrite revenue bonds. In 1968, Congress liberalized the law to permit banks to underwrite certain classes of municipal revenue bonds, namely those used to finance housing, university, and dormitory construction. This change enabled banks to underwrite roughly half the dollar volume of all revenue bonds in some years.[25]

Commingled Trust Accounts (ICI-1)

In 1965, Saxon's successor as Comptroller, William Camp, approved an application by First National City Bank of New York to offer its customers commingled managing agency accounts.[26] These differed from ordinary trust accounts in that the bank actively promoted the commingled investment funds publicly and accepted customers' funds in the capacity of a managing agent rather than as a trustee. Camp's decision was challenged by the Investment Company Institute (ICI), a trade association for mutual funds, and struck down by the district court for the District of Columbia, which held that such accounts were indistinguishable from mutual funds and constituted selling of securities in violation of Sections 16 and 21 of the Glass-Steagall Act. This decision set in motion one of the first and most important series of court tests regarding bank securities activities under Glass-Steagall. The court of appeals reversed the district court and upheld the Comptroller's decision. Upon further challenge, the appeals court's ruling was, in turn, overturned by the Supreme Court in 1971.[27]

The Supreme Court decision in this case, frequently referred to as *Investment Company Institute* or "ICI 1," is notable for its description of the "subtle hazards" of commercial bank involvement in investment banking activities that led Congress to enact the Glass-Steagall Act. These were, according to the Court:

1. Public confidence in the bank might be impaired if a bank's customers lost money through dealing with a bank's securities affiliate.
2. A bank might make imprudent loans to companies in whose securities the bank's affiliate had invested.
3. A bank might lose customer good will if its depositors suffered losses through the purchase of securities recommended by the bank's securities affiliate.
4. If lent to the promotion of particular securities, a banks' reputation for prudence and restraint would be damaged as a result of the perceived normal risks of the investment banking business.
5. Banks might lend to customers in the expectation that the loans would be used to purchase securities from the bank's affiliate.
6. There might be a conflict of interest between a bank's desire to promote sales of securities and its obligation to give its customers disinterested investment advice.
7. A bank might unload excessive inventories of securities on trust accounts managed by the bank for its customers.

The Court concluded that "Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system."[28] The Court argued that although a national bank might legally commingle customers' trust funds for efficiency of management and might also manage individual customers' accounts on an agency basis, "the union of these powers gives birth to an investment fund whose activities are of a different character. . . it is undisputed that this bank investment fund finds itself in direct competition with the mutual fund industry."[29]

Commercial banks also attempted to extend their securities brokerage activities. In 1936, the Comptroller ruled that brokerage services, if they were not to violate Glass-Steagall, could be offered by banks only as an accommodation for customers and not for profit.[30] In 1957, the Comptroller eliminated the requirement that brokerage services could not be provided for profit, but continued to require that they be offered only as an accommodation for existing customers.[31] In the late 1970s, Chemical Bank of New York offered its customers retail brokerage services.[32] However, before its legality could be challenged, the service was abandoned because of its failure to achieve profitability. The plan's failure in the marketplace may have been partly attributable to the fixed rate commission system then in force on the New York Stock Exchange, which prohibited brokers from offering discounts and made it difficult for new entrants to compete.

Another securities activity that banks have engaged in for many years is advising companies placing their securities with investors privately.[33] The Securities Industry Association (SIA), a trade association for investment banks, publicly questioned the legality of commercial bank private placement activities, arguing that they constitute underwriting of corporate securities. However, it did not take its case to court until 1978, when Bankers Trust Company began placing third-party commercial paper. Together with the securities firm A.G. Becker, Inc., the SIA brought suit to challenge the activity as underwriting of securities in violation of Sections 16 and 21 of the Glass-Steagall Act. Because the case was not finally decided until 1987, the discussion of it is postponed to the next section on developments in the 1980s.

Efforts by commercial banks to expand their securities activities have followed a now-familiar sequence of events. First, either with or without prior regulatory approval, banks have attempted to offer the service in such a way as not to violate existing restrictions. The securities and investment company industries have responded with law suits to prevent or delay such evasions. Finally, both sides have engaged in vigorous lobbying designed to enlarge or restrict commercial bank activities in the securities markets.

Developments since 1980

Through the 1970s, conservatism on the part of regulatory agencies and the courts, as well as that of the banks themselves, restricted the expansion of bank securities activities. Since 1980, however, growth in the range and volume of domestic securities activities conducted by commercial banks, in particular the larger banks, has greatly accelerated. This acceleration appears to reflect at least five new forces:

1. Improvements in technology that have reduced sharply the costs of information processing and communications. The new technology holds out the promise of economies of scope in conducting expanded securities activities alongside the banks' currently permissible securities, lending, and deposit activities. In many cases, these expanded activities can be offered using in-place personnel and equipment.

2. A search for new activities as profits from traditional commercial banking activities have declined. This is particularly true of lending to large corporations, many of which are finding it cheaper to sell their own commercial paper than to borrow from banks. Technology has contributed to this development by increasing the availability and reducing the cost of credit information and analysis to the public, thereby eroding commercial banks' comparative advantage in this area.

3. The perceived rapid growth and large profits in full-service securities activities, at least up to the time of the stock market break in October 1987, as the volume and complexity of securities have both increased sharply.

4. More liberal interpretations of the language of existing legislation by both the bank regulatory agencies and the courts.

5. The growing internationalization of financial markets, which has provided U.S. banks with experience in securities activities in many foreign countries and has intensified competition with foreign banks and foreign markets.

In previous articles, we chronicled the progress of banks in expanding their securities activities through the watershed acquisition of Schwab Discount Brokers by BankAmerica in 1984. At that time, one of the authors concluded that

> it would appear that the limitations on commercial banks' activities in providing securities and ancillary services are to a large extent the fault of the banks themselves. They were inhibited, for good or for bad reasons, as much by internal, self-imposed constraints (including lack of imagination) as by external constraints. . . . While enactment of sweeping new banking legislation is improbable, a continued nibbling away of the elements of separateness between commercial banking and investment banking does seem likely. . . . Indeed, it is not too farfetched to predict that Glass-Steagall will be no more effective in maintaining a separation between commercial and investment banking in a few years than the McFadden Act and the Douglas Amendment...have been in preventing interstate banking.[34]

We see no reason to change these conclusions. Since 1984 the barriers to bank securities activities have continued to erode. But this has not been the result of new federal legislation. Rather it reflects 1) increases in the volume of activities that were either specifically permitted in 1984 or not obviously prohibited and whose entry by banks was subsequently sustained by the courts, 2) new activities that were neither provided by the banks nor prohibited to the banks in 1984, and 3) activities permitted by regulation or order since 1984. This section focuses on some of the more important developments.

Legal Developments

Federal regulatory rulings. In 1984, the FDIC issued a ruling authorizing insured banks that are not members of the Federal Reserve to offer a broad range of securities activities.[35] As the ruling noted, most of the prohibitions of the Glass-Steagall Act do not apply to nonmember banks (although the Banking Act of 1987 temporarily extended these provisions to nonmember banks). There are, however, few banks that are neither Fed members nor subsidiaries of bank holding companies, and thus subject to Fed jurisdiction, that are interested in and able to engage in securities activities importantly.[36] Favorable regulatory rulings since 1984, primarily by the Board of Governors of the Federal Reserve System, have reinforced the ability of member banks, through holding company subsidiaries, to place commercial paper privately and, with some restrictions on volume, to underwrite and deal in commercial paper, most types of municipal revenue bonds, and mortgage-backed securities.[37] In 1986, the Board clarified banks' authority to provide integrated brokerage services and investment advice first to institutional investors and later to individual investors as well.[38] In May 1986, the Comptroller of the Currency authorized subsidiaries of national banks to underwrite collateralized mortgage obligations (CMOs), expanding an earlier decision allowing banks to underwrite money market funds investing only in securities eligible for bank underwriting.[39]

In April and May of 1987, the Board of Governors of the Federal Reserve System approved the applications first of three large New York bank holding companies[40] and then of four other large bank holding companies to underwrite and trade restricted amounts of commercial paper, municipal revenue bonds, and securitized mortgage debt.[41] The Board postponed for further consideration their request for permission to trade securities backed by consumer receivables. In July, the Board decided to approve this activity as well.[42]

The applicant banks generally proposed to engage in the underwriting of the new securities through a holding company subsidiary to which the bank's current underwriting of government securities already eligible under Glass-Steagall would be transferred as well. Among other reasons, this was to make the underwriting of the new securities a small part of the business of the subsidiary, thereby precluding a finding that the subsidiary was "principally engaged" in underwriting securities and therefore not eligible for affiliation with a bank under Section 20 of the Glass-Steagall Act. For this approach to work, it was essential that "bank-eligible" government securities for purposes of Section 16 not be considered securities for the purposes of Section 20. Such a construction would preclude a holding company from carrying out activities in a nonbank subsidiary that the bank itself was free to engage in. The applicants asserted that it was unreasonable to believe that Congress had intended such a result.

However, the language of Section 20 makes no distinction between securities that banks are permitted to underwrite and other securities. Based on this interpretation, two of the five voting Governors, including then Chairman Volcker, registered an interesting dissent to the Board's April and May decisions. While the dissenters agreed with the economic result of the ruling—Volcker has since called upon Congress to consider giving banks the authority to underwrite corporate securities[43] —they argued that Section 20 of the Glass-Steagall Act precluded approval of the applications. Although the new securities were subjected to dollar volume and market share limits, they would be underwritten by legal entities almost exclusively engaged in underwriting securities—albeit government securities that banks themselves were free to underwrite—and therefore, according to the dissenters, in violation of Section 20.

The Board majority sided with the applicants, finding it implausible that the restriction on member bank affiliation with firms "engaged principally" in securities underwriting was meant to apply to securities that the bank itself may underwrite without limit. This was no surprise, based on the Board's previous interpretations of Section 20, particularly in the Bankers Trust commercial paper decision.[44] Moreover, in approving a 1978 application by United Bancorp to transfer its government security underwriting and dealing to a holding company subsidiary and in a later ruling permitting eligible securities to be traded and underwritten in any bank holding company affiliate, the Board had already decided that the definition of securities under Section 20 did not include government securities.[45] The minority argued that this interpretation was correct only if the affiliate were restricted to dealing exclusively in bank-eligible securities.

Neither the applicants nor the opponents of bank entry into the securities business were happy with the decision. The banks objected to the limitation of the new activities to 5 percent of the gross revenues of their securities subsidiaries and also to the 5 percent market share limitation that the Board subjected them to in each of the permitted securities.[46] These numbers were far below the 25-50 percent advocated by the Comptroller of the Currency in a letter dated January 29, 1987.[47] Indeed, the successful applicants petitioned the Court of Appeals to review these ceilings.[48]

On June 16, 1987, the Comptroller of the Currency sent a letter to Security Pacific National Bank approving its proposal to sell mortgage-backed pass-through certificates. The letter went on to argue that national banks may sell any lawfully acquired assets. It explicitly rejected the contention that a bank's participation in the initial placement of its own securities constituted illegal underwriting or dealing as asserted by the Securities Industry Association.[49]

State regulatory rulings. At yearend 1986, the New York State Banking Superintendent issued a ruling that the state's "little Glass-Steagall Act" permits a state-chartered bank to operate a securities affiliate provided that no more than 25 percent of its underwriting involves securities that the bank itself is not permitted to underwrite.[50] Because these regulations presently affect few if any commercial banks that are in a position to provide these services seriously, they represent more smoke than fire.[51] Almost all larger banks are either national banks subject to the authority of the Comptroller of the Currency or subsidiaries of a bank holding company subject to regulation by the Board of Governors of the Federal Reserve System. However, these rulings may be useful in sending signals to other regulatory and legislative bodies.

Court decisions. Favorable court rulings have left standing the following activities and regulatory arrangements: 1) the provision by subsidiaries of national banks of brokerage services at out-of-state offices,[52] 2) the supervision of all commercial bank-affiliated brokerage personnel and units by the bank regulatory agencies rather than by the Securities and Exchange Commission,[53] 3) the private placement of commercial paper by either state or national banks acting in an agency capacity,[54] 4) commercial bank commingling of IRA funds for both investment and advertising purposes,[55] 5) provision of both investment advice and securities brokerage services to institutional brokers through a single subsidiary,[56] 6) the FDIC's 1984 ruling that insured nonmember banks are not subject to the Glass-Steagall Act's restrictions on underwriting,[57] and 7) the Board's 1987 decisions allowing limited underwriting and dealing by bank affiliates in some securities ineligible to be underwritten or traded by the banks themselves.[58]

The decision in the commercial paper case, *SIA versus Board of Governors,* is important for a number of reasons. First of all, it culminated a long (since 1978) and especially hard-fought court battle, with A.G. Becker and the SIA winning at the district court level, losing in the District of Columbia Court of Appeals, winning on the definition of commercial paper as a security in the Supreme Court, again winning in the district court on the merits of the case, and ultimately losing in the Supreme Court on appeal by the Board of Governors. It is also important because it partially resolved the issue of defining a security for the purposes of the Glass-Steagall Act and because it opened the doors for a major expansion of banks into an area previously considered of questionable legality for banks. In 1980, the Board of Governors had ruled that, subject to restrictions, member banks could privately place third-party commercial paper.[59] The Board relied on a functional analysis to show that commercial paper is more like an ordinary bank loan than a security. It decided that the placing of third-party commercial paper did not constitute underwriting and that it did not pose the "subtle hazards" that the Congress intended to avoid in enacting the Glass-Steagall Act. Only on its finding that commercial paper is not a security for purposes of the Glass-Steagall Act was the Board ultimately overruled.

More recently, the decisions by the Board of Governors in the underwriting cases decided in the spring of 1987 activated the automatic reflex court challenge by the SIA. In a rare courtroom victory for the SIA, the U.S. Court of Appeals for the Second Circuit granted a stay of the Board's April decision.[60] However, in the summer of 1987 the federal district court in New York City upheld the Board's decision. The Securities Industry Association then appealed to the federal appeals court. On February 8, 1988, the U.S. Court of Appeals for the Second Circuit upheld the Board's decision in all respects except for the 5 percent limitation on market share of the new activities, which it felt was too restrictive.[61] When the moratorium imposed by Congress until March 1, 1988 was not extended, bank holding companies had hoped to be free to commence the new underwriting activities in March. However, on February 29, the day before the expiration of the moratorium, the Court of Appeals agreed to postpone lifting its stay until March 15 to give the SIA time to appeal to the Supreme Court. When made, the appeal would automatically extend the stay a minimum of 90 more days.[62]

Federal legislation. Both the administration and the regulatory agencies have generally supported proposals to broaden banks' securities powers. Proposals by the Reagan Administration, in particular, would have allowed bank holding companies to engage in an expanded range of securities activities, while requiring that they be conducted through a nonbank subsidiary. Under pressure to respond one way or the other to the Board of Governors' regulatory rulings earlier in the year, Congress enacted the Competitive Equality Banking Act of 1987, which imposed a moratorium until March 1, 1988 on activities approved by federal regulatory agencies after March 5, 1987. However, even the moratorium appears to be subject to erosion, as evidenced by the move of First Interstate Bank of Denver to underwrite collateralized mortgage obligations backed by its own mortgage loans based on a June 1987 interpretation by the Comptroller of the Currency.[63] As noted earlier, Senator Proxmire has introduced a bill to repeal many of the prohibitions of Glass-Steagall. In addition, a number of other members of Congress have introduced their own bills to expand commercial banks' securities powers. Although none of these had been enacted when the moratorium expired, a modified version of the Proxmire bill was approved by the Senate Banking Committee a few days later and passed by the full Senate on March 30, 1988.[64]

State legislation. Several states have passed legislation liberalizing restrictions on the securities activities of state-chartered banks. For example, in 1987 Arizona allowed bank holding companies owning state-chartered banks to broker and underwrite mutual funds, municipal revenue bonds, commercial paper, and asset-backed securities through a nonbank subsidiary.[65] Similar to state and FDIC regulatory rulings, these measures are of little consequence because of overriding federal restrictions on the activities of bank holding companies, which own most of the larger state banks. But they send a reinforcing message to federal legislators that the state favors modification or repeal of Glass-Steagall.

New Activities

Despite the importance of regulatory rulings and court decisions in enabling banks to enter activities previously considered off-limits, it would be a mistake to assume that the regulators exogenously took the initiative in expanding bank securities activities. Most if not all of these rulings have been in response to the continued search by banks for new ways to enter the securities area that do not confront the Glass-Steagall prohibitions head on. The keys to success remain imagination and willingness to expend the financial and managerial resources necessary to fight the particular activity through regulatory and legislative barriers.

Brokerage. Most of the increased securities action in dollar terms appears to be in the expansion of recently entered or newly discovered permissible activities. Perhaps the most important is the expansion of brokerage activities. As already noted, regulation has permitted banks to act as brokers for institutions as well as individuals. Because they are unable to hold large inventories of all securities or to purchase any and all securities from customers immediately, commercial banks had viewed themselves as at a disadvantage relative to security dealers in this area. But some larger banks have found ways around this obstacle. Pension and other large funds managed by bank trust departments have continuing orders for securities that they wish to purchase and for securities that they wish to sell out of their portfolios. These transactions can be channeled through the bank's brokerage facility, providing it with an effective inventory and a partial equivalent to the ready market capability of a full-service dealer. However, the broker still would not be able to participate in any gains (or losses) from positioning securities in inventory.

Overseas expansion. A number of the largest banks have established brokerage and dealer facilities in major foreign countries, where commercial banks are permitted to engage more fully in securities activities. The most recent major country to permit such activities was Japan, which extended them to foreign but not domestic banks.[66] Domestic Japanese banks are restricted by Article 65 of the Banking Law, a clone of the Glass-Steagall Act imposed on Japan by the United States during the post-World War II occupation. In mid-1987, the Japanese Ministry of Finance invited 10 foreign institutions, including U.S. banks, to apply to establish securities firms, and most did so.[67] Similarly, in June 1987 Canada adopted legislation permitting both domestic and foreign banks to own securities firms.[68] The first major U.S. money center organization to take advantage of this power was First Chicago Corporation, which moved to acquire an interest in Wood Gundy, Inc. of Toronto.[69] However, First Chicago called off these plans in December 1987 following the stock market crash and after Wood Gundy suffered heavy losses in underwriting a stock offering by British Petroleum Co.[70] In the process of expanding their overseas securities activities to Japan and elsewhere, U.S. banks have developed execution and research capabilities in foreign securities that they can offer their clients in the United States. Citicorp affiliates overseas are reported to be members of 17 major stock exchanges in foreign countries and to regularly research some 800 foreign stocks that account for 70 percent of the aggregate capitalization of the stocks traded on these exchanges.[71] In addition, Citicorp engages in investment banking in over 35 foreign countries and has some banking presence in over 90 foreign countries. In January 1988, Citicorp arranged for its London-based securities company, Citicorp Scrimgeour Vickers Securities Ltd., to cooperate with Dominick & Dominick, a New York securities firm, in making markets in securities in the United States.[72]

Such worldwide brokerage is a service that few if any domestic nonbank security dealers can offer domestic customers. In a recent full two-page advertisement in the *The Economist,* the Chase Manhattan Bank compared its international presence, particularly in merger and acquisition activities, with that of ten major investment banks. (Exhibit 1) The ad stated:

> With offices in 60 countries around the world, Chase has greater international presence than any U.S. investment bank. In fact, Chase has offices in almost twice as many countries as the above ten investment banks combined.[73]

The Federal Reserve has identified more than 30 major investment banking subsidiaries of U.S. banking organizations operating in foreign countries, 12 in the United Kingdom alone. In 1985, overseas affiliates of five U.S. commercial banks were among the top 30 leading managers of Eurobond underwriters and 11 were among the top 50 leading managers of Euronote underwriters.[74] With the rapid growth in interest by U.S. institutions in overseas securities and markets, these banks are uniquely positioned to capture a large share of the business.

Ironically, foreign banks have long been empowered to engage in a full range of securities activities in the United States. Not considered banks under the definition in the National Banking Act or the Bank Holding Company Act, they were not subject to Glass-Steagall. Instead, they were subject to the broker/dealer provisions of the Securities Exchange Act. The exemption from Glass-Steagall of the existing securities activities of foreign banks that established investment banking operations in the United States before July 1978 was grandfathered when the International Banking Act was passed in 1978.[75] However, other nongrandfathered foreign banks have the same interest in the repeal of Glass-Steagall as domestic U.S. banks.[76]

Mutual funds. Commercial banks have also exploited the ability to circumvent many Glass-Steagall restrictions on their powers by entering into joint venture-like arrangements in which the other party undertakes the activity specifically prohibited to commercial banks. For example, Glass-Steagall has been interpreted by the courts to prohibit commercial banks from distributing mutual funds other than those associated with servicing IRAs. This activity is viewed as engaging in the public sale of securities. But the act does not prohibit banks from managing such funds and this activity has been specifically authorized by regulation. And managing funds is where the money is! As a result, an increasing number of banks have entered into agreements with investment companies to create new private label mutual funds that will be managed by the bank, advertised to its customers and others by the bank, but sold and bought by the investment company. Advertisements for such mutual funds are now relatively common. (Exhibit 2) Other banks broker outside-managed mutual funds for a sales commission. A recent survey of larger banks reported that nearly 70 percent of the banks offered mutual funds in one way or another in 1986.[77] This represented a 50 percent increase over 1985. In addition, another 15 percent planned to offer mutual funds in the near future. Some banks offered funds only to IRA customers. Most funds were offered through the banks' discount brokers.

Market index CDs. In 1987, Chase Manhattan Bank introduced a unique and highly sophisticated securities product, the market index deposit account (MID). The account is a fixed-term deposit whose return is partially tied to the performance of the S&P 500 stock index. (Exhibit 3) In its initial form, it came with a choice of three maturities—three months, six months, and one year—and three combinations of minimum guaranteed return and percentage participation in increases in the stock market index. For example, on the one-year account, the depositor could choose a zero guaranteed minimum return and 70 percent of the increase in the S&P index over the year, a 2 percent guaranteed minimum return and 60 percent of the index increase, or a 4 percent guaranteed minimum return and 40 percent of the index increase.[78] These numbers are changed by the bank as market conditions change. The total return on MIDs is not known until maturity. As a deposit, its principal amount is fixed and it plus the guaranteed interest is insured up to $100,000 by the FDIC. MIDs have since been introduced by a number of other banks.[79] Some of the banks have tied the returns to gains in other market indices (bull MIDs) and a few have tied increases in returns to decreases in the indices (bear MIDs).

Economically, an MID differs in only two significant ways from an indexed mutual fund. One, it has a fixed maturity or redemption date (although early redemptions are permitted with penalty of loss of all interest and part of the principal). Two, it has a guaranteed floor if the market index declines or increases by less than the floor percentage. The cost of this downside protection to the investor is reduced upside participation in increases in the index return above the guaranteed minimum. In this way, the account resembles a mutual fund account with an embedded European put option that can be exercised by the investor at maturity at the guaranteed floor value.

To reduce its portfolio risk from this account, the Chase invests in S&P 500 index futures contracts.[80] Banks and bank affiliates are permitted to invest in these futures contracts for their own accounts because the contracts are settled only in cash, not in stocks. Thus, they are not considered equity securities by the regulatory agencies for purposes of Glass-Steagall. Except for the use of futures contracts instead of the underlying equities, Chase's operations in both distributing and managing this account are not greatly different from those of any mutual fund. Not surprisingly, the Investment Company Institute has filed a suit charging violation of the Glass-Steagall Act. Unless rejected by the courts, deposit accounts of this type can provide commercial banks with a product that is highly competitive to mutual funds. Indeed, such accounts differ from a mutual fund product in name only and demonstrate clearly how a combination of imagination and nerve can effectively circumvent the constraints of Glass-Steagall.

Distribution of new issues. Bank brokers can also participate in the sale of newly underwritten "bank-ineligible" securities with the broker's name even appearing on the issue tombstone alongside those of the actual underwriters (although in a lower bracket to conform with the traditional pecking order in investment banking and clearly identified as a broker). The bank broker provides the underwriters with a list of potential buyers from among its own customers and processes orders from these and possibly other buyers for a commission per transaction. The first such cooperative venture appears to have been formed in 1986 between Charles Schwab, at the time a brokerage affiliate of BankAmerica, and Lazard Freres.[81]

Profitability of Securities Activities

Commercial banks have succeeded in entering securities activities to an extent that would have been hard to imagine a decade earlier. However, obtaining the legal ability to offer new services is no guarantee of profitability in providing them. Of course, not all banks have pursued expanded securities powers equally vigorously.[82] The leaders in the battle are primarily the large banks, which may be expected to make the greatest absolute and relative use of any new powers granted. But is far from certain that even all larger banks will find the new activities profitable.[83] For a number of reasons, many will find the returns realized to be below those expected. As the president of Security Pacific National Bank's brokerage subsidiary noted in early 1987, "we probably misgauged the extent of the fierce competition. An area that looked like a very open field became cluttered very quickly."[84] For example, many banks with offices in London have found this to be true in the short time since the "Big Bang" of October 27, 1986, when most restrictions on banks' securities activities were removed.[85] Noting many parallels with "May Day" in 1975 when fixed brokerage commissions were ended in the United States, one knowledgeable observer has predicted the demise of "some of the most venerable names in capitalism."[86] A recent article in the *American Banker* speculated that perhaps only Morgan Guaranty, Bankers Trust, and possibly Citicorp would be profitable in their current broad investment banking activities.[87] Indeed, since the stock market break of October 1987, prospects for investment banking have been revised downward almost across the board and many investment banks and investment banking departments of commercial banks have laid off personnel and cut back on their expansion programs.

Many more commercial banks are likely to be successful in more limited securities areas by selecting their niches carefully. Ironically, it may well be some of the regional and smaller banks that have generally not been active in agitating for additional securities powers that are among the more successful.[88] Investment banking activity is concentrated in the larger cities and services primarily large clients. Smaller firms and smaller government units, particularly in smaller cities, may be less well served. Investment banks have few offices in smaller cities and those that are there are mostly retail offices. Nonretail securities services in these areas are generally conducted from distant, nonlocal offices. In contrast, commercial banks tend to have more decision-making personnel at their local offices, even if they are only branch offices. Banks in these areas that have good ongoing relationships with a broad base of customers may make significant inroads into the business of competing investment bankers.

One of the factors limiting profitability is the high cost of obtaining skilled personnel. A large number of securities activities are highly entrepreneurial in nature and attract players who can command remuneration that is extraordinarily high relative to that in other, more traditional bank activities. This puts many banks in a quandary. If they do not pay competitive salaries, the more successful personnel may leave for investment banking houses; if they do, jealousies may arise in other parts of the bank that could adversely affect efficiency and morale. Both patterns have occurred in recent years. Investment banking appears to have a substantially different corporate culture than commercial banking, and the two may not mix easily or peacefully.

The Remaining Issues

Already, many bankers and others are speaking of Glass-Steagall in the past tense. For example, the president of the American Bankers Association observed recently, "There's a growing sense of the inevitability of the breakdown of Glass-Steagall."[89] This view is also exemplified by a recent two-page advertisement by Chase Manhattan Bank, N.A. in the *Wall Street Journal,* which reads: "JVC didn't have to choose between commercial and investment banking. Choosing Chase gave them precision in both."[90] (Exhibit 4) The extent to which commercial banks have already succeeded in breaching the restrictions is dramatized by a recent Citicorp estimate that, of about $5.7 trillion of securities issued in 1985, including federal government securities, U.S. commercial banks were excluded from underwriting only $265 billion, or 4 percent of the total.[91] Nonetheless, virtually no one expects regulation of bank securities activities to disappear completely. More importantly, the precise form such regulation should take depends on several key questions regarding the effects of combining commercial and investment banking that have not been satisfactorily answered yet.

As the authors have argued elsewhere, the public policy issues involved in any further expansion of banks' securities activities include the impacts of such expansion on efficiency, investor protection, competition, aggregate concentration, the likelihood of abuses resulting from conflicts of interest, and—most important of all—the safety and soundness of the financial system.[92] Some of these can be dealt with rather summarily. For example, the effects on efficiency of combining commercial banking with securities activities are an issue only to the extent that increased efficiency is weighed against any adverse effects of allowing banks to engage in these activities. The absence of demonstrable efficiencies per se is no grounds for preventing banks from entering the activities.

Similarly, differential investor protection would disappear as an issue if all institutions engaged in securities brokerage or underwriting were subject to

SEC supervision in the performance of this activity. As noted earlier, that is not now the case. Sections 3(a), 4, and 5 of the Securities Exchange Act of 1934, which define the terms "broker" and "dealer," explicitly exclude banks from their definitions.[93] The Securities and Exchange Commission (SEC) has long argued that traditional banking supervision is not adequate to protect investors. Finally, in 1985, it acted on its own by adopting Rule 3b-9, which redefines the term "bank" to exclude those banks engaged in the brokerage business for profit. The effect of the rule would have been to make such banks subject to SEC supervision. To be sure, banks' brokerage activities are subject to essentially the same statutory provisions as other brokers, but the SEC has long contended that the banking agencies do not enforce them as vigorously as the SEC does.[94] Challenged by the American Bankers Association, the rule was upheld at the district court level. However, in 1986, the U.S. Court of Appeals for the D.C. Circuit overturned the district court's decision.[95] While the issue of existing law appears to be settled, there is growing support for adopting a functional approach to supervision in place of the current structure based on the type of institution.[96]

Competition. It is frequently asserted that entry by banks into a broader range of securities activities will have anticompetitive effects. These assertions are usually based on the belief that banks enjoy important competitive advantages that will enable them to drive existing investment bankers out of the market, increasing concentration through time and leading to increased prices and poorer service. Although it is true that some banks enjoy a subsidy in the form of access to below-market rates on borrowings from the Federal Reserve discount window and underpriced federal deposit insurance, there is no reason to suppose that the benefits of this subsidy have not already been fully utilized to enhance banks' competitive position in their existing markets. The subsidy may be viewed as a lump sum payment that is related to a bank's size, but is independent of the nature of the activities in which a bank engages. There is no reason to believe that a bank would share this subsidy with its customers in the form of more advantageous prices.

To the extent that capital is more expensive than debt because dividends are not tax deductible while interest payments are, the federal deposit insurance safety net may generate an advantage to banks by permitting them to operate on lower capital ratios than otherwise. The evidence suggests both that capital ratios at commercial bank were significantly higher before the establishment of the FDIC than afterwards (even without adjusting for double liability for many depositors) and that bank capital ratios are currently lower than those of their competitors, such as finance companies and insurance firms. In addition, unlike the capital ratios for investment banks and some other competitors, bank capital ratios are computed on the basis of book values, which frequently overstate market values.

Some have also argued that banks have an additional competitive advantage resulting from their large size. However, commercial banks have competed with investment bankers for years in the underwriting of general obligation municipal bonds without dominating the market. Indeed, a study of the general obligation municipal bond market between 1960 and 1977 showed that commercial banks lost market share to investment banks.[97] Another study that considered the available evidence on economies of scale and scope in banking concluded that it is very unlikely that bank entry into securities activities would result in commercial bank domination.[98]

On the other hand, removing Glass-Steagall may not have the major pro-competitive effects that some economists expect. This result is suggested by a characteristic of the law that differentiates it from most other statutory restrictions on entry; it restricts entry only by one type of institution—commercial banks. In the absence of demonstrable economies of scope in providing commercial banking and securities activities together and with no legal barriers to entry into investment banking by firms other than commercial banks, one might reasonably expect commercial bank entry to have little or no competitive effect.[99] So long as profitable opportunities exist in the industry, entry by other types of financial institutions should occur until these are competed away.

However, there is some evidence that the investment banking industry is not as competitive as the absence of legal barriers to entry would suggest. One type of evidence is derived from market structure. Although the markets for some securities activities, such as retail brokerage, are characterized by large numbers of competing firms and low concentration, this is not true of corporate underwriting. Both debt and equity underwriting are characterized by high levels of concentration relative to most other types of financial services.[100] Between 1975 and 1982 the share of total corporate debt and equity underwriting accounted for by the eight largest firms increased from 79 percent to 83 percent.[101] In 1986 the share of the eight largest firms was 88.8 percent in debt underwriting and 79.8 in stock underwriting.[102]

Additional evidence on the competitiveness of the industry is based on performance data. The level and persistence of profits in investment banking in recent years, at least through September 1987 before the stock market drop, suggest the possibility that competition is less than intense. Over the past five years, returns on equity of commercial banks averaged about 12 percent. For five of the largest investment banking firms—First Boston, Salomon Brothers, Paine Webber, E. F. Hutton, and Merrill Lynch—the average was about 20 percent. These figures do not include some of the houses believed to be most profitable, e.g. Morgan Stanley.[103]

The increased tendency of corporate clients to develop in-house expertise and reduce their reliance on investment bankers to underwrite their new issues would also be unlikely if specialized underwriters were pricing their services competitively. SEC Rule 415, which allows issuers to file a registration statement up to two years before the actual issue, has encouraged issuers to design their own issues.[104] Several studies have shown that this has lowered costs to issuers, although the benefits have been confined to larger companies.[105] The opposition of many underwriters to Rule 415 is at least circumstantial evidence of its effectiveness in increasing the intensity of competition.[106] Conversely, the fact that many security issuers, such as the firms represented by the National Association of Manufacturers, have endorsed legislation to liberalize Glass-Steagall suggests that they believe that they would benefit from bank entry into underwriting.[107] Other possible symptoms of the lack of competition in investment banking are the exceptionally high levels of compensation of personnel in the industry and the eagerness of commercial banks to enter it.

To such casual empiricism, it may be objected that returns in the industry are justified by the risks, that prior to the past five years returns in investment banking were much closer to the average for all industries, and that the high returns before October 1987 reflected a temporary disequilibrium resulting from the unusual strength of the equity market, the enormous amount of merger and acquisition activity that has fueled the growth of junk bonds, and the spurt of innovation in the futures, options, and fixed income markets. Similarly, it may be argued that the high levels of compensation in investment banking reflect the scarcity of the exceptional talent the industry requires.

On the other hand, it may be argued that the great importance of established working relationships in allocating new corporate underwritings makes it difficult for new entrants to penetrate the market. Thus, it is not surprising that only large, well-established nonsecurity firms with extensive expertise in financial markets find large-scale entry attractive or feasible. But it is precisely the commercial banks that are most likely to have these characteristics. To the extent that this is true, Glass-Steagall, rather than simply being an annoyance to the banks and the source of a modest loss in efficiency due to the inability to realize economies of scope, constitutes a serious impediment to entry and its removal would almost certainly be a boon, rather than a threat, to competition.

Aggregate concentration. Aggregate concentration, defined as large size of firms relative to the overall economy, has been widely feared in the United States throughout its history. This fear has been especially strong with respect to banking, whose services pervade every industry in the economy, and has played a major role in maintaining public policy support for limiting banking powers and separating banking and commerce.[108] However, concern over aggregate concentration provides little justification for restricting bank entry into securities activities. In the first place, the shares of total bank assets controlled by the 5 largest and 10 largest banking organizations have trended downward over the past two decades, while the share of the 25 largest has remained essentially unchanged.[109] This hardly provides support for the widespread impression that nationwide concentration in the banking system is on the increase. Even the fact that the asset shares of the 50 largest and 100 largest banking organizations have increased since the advent of regional interstate banking is little cause for alarm. Relative to most other industries, banking remains extremely unconcentrated; the 100 largest commercial banking organizations accounted for only 57.7 percent of banking assets in 1985, up from 50.4 percent in 1970.[110] In comparison, it is not unusual in manufacturing industries for the four largest firms to account for 80 or 90 percent of total domestic output.[111]

More importantly, it is concentration in local banking markets, not aggregate national concentration that is crucial for competition. Even though firms become larger and national concentration increases, local concentration need not increase.[112] Finally, the adverse effects generally attributed to high aggregate concentration—undue influence on political decisions, the ability to cross-subsidize activities, the market power derived from "deep pockets" —remain somewhat vague and amorphous, which makes them different, although no less important or real. To a large degree, they are political rather than economic, In any case, the appropriate way to deal with problems related to excessive size of firms is to attack size itself, not product diversification. Thus, the issue of aggregate concentration is logically separable from that of what activities banks should be permitted to engage in and is amenable to remedy under enforcement of the existing antitrust statutes, possibly reinforced by the Bank Merger Act and the Bank Holding Company Act or by new legislation limiting mergers among the very largest institutions.

Conflicts of interest. Another widespread concern related to bank entry into securities activities, particularly corporate underwriting, is the potential for conflicts of interest. It is frequently alleged that banks engaged in securities activities are faced with serious conflicts of interest that may lead to abusive practices. In justifying the separation of commercial and investment banking, Senator Carter Glass said of the underwriting activities of banks in 1932, "there was a conflict between the business of marketing securities and the business of protecting depositors' money. . . ."[113] The combination of these activities puts banks in the position of serving two groups of customers and of executing transactions that benefit one group at the expense of the other. The sale to some customers of securities underwritten by the bank for other customers may have the effect of lowering the costs of raising capital to the latter by increasing the investment risks borne by the former or vice-versa. More recently, Martin Mayer called for a go-slow policy toward liberalizing the Glass-Steagall Act to give banks time "to think through what they mean by relationships and the extent to which established banking relationships impede the exercise of coldhearted judgement in securities trading."[114]

Economists and lawyers frequently differ in their assessments of the importance of conflicts of interest.[115] While not denying the existence of conflicts, most economists view them as being unavoidable in any multiproduct industry serving a variety of customers and largely self-correcting. The seller of a good or service always has an interest in giving up as little, and charging as much, as is consistent with profit maximization in the long run. However, if the seller tried to increase the price or reduce the quality of the product, customers would eventually learn that they were being ill-served and would attempt to take their business elsewhere. In a competitive environment, this constrains the seller to maintain some minimum standard of quality or service and to limit prices.

A bank in a competitive market would be induced to meet these standards of service and price in marketing securities, even if the bank had other customers who would benefit from a deliberate misrepresentation of those securities. Only if the market were noncompetitive so that customers had no alternative suppliers would a profit-maximizing bank be able to take continued advantage of its customers. Thus, the best antidote to conflicts of interest is a healthy competitive environment. But the existence of conflicts of interest is irrelevant to how the customer is treated. In the absence of a second group of customers whose interests conflict with those of the exploited group and which the bank has some reason to promote or subsidize, the resulting higher net revenues from charging higher prices than otherwise to the first group would simply end up in the banker's pocket.[116]

Even if conflicts of interest are viewed as a serious problem, most of them can be dealt with by devising effective internal control mechanisms.[117] If these were inadequate, there are at least four external control mechanisms that operate to minimize conflict-of-interest abuses. These include competition in the market for commercial and investment banking services, the existence of a market for corporate control and management, monitoring by investors and bond rating agencies, and bank examination and supervision. It is generally believed—based in part on experience with bank trust departments, which involve virtually all of the conflicts of interest attributed to bank underwriting and dealing activities—that these mechanisms in combination are adequate to prevent the great majority of problems potentially resulting from conflicts of interest.[118]

Overzealousness in devising safeguards against conflicts of interest may actually be undesirable to the extent that it causes bank organizations to forego some potential intra-firm synergies that are more valuable societally than the protection gained. For example, in approving the application by Bankers Trust New York Corporation to act as an agent and adviser to issuers of commercial paper, the Federal Reserve Board imposed a number of restrictions that, in principle, could reduce the benefits from the company's performance of the activity. One of these conditions was that "Applicant's subsidiary banks will not purchase commercial paper placed by Company for accounts managed or advised by their trust departments and neither the banks nor any of their affiliates will purchase commercial paper placed by Company for any other accounts they advise or for which they have investment discretion."[119] While eliminating a potential conflict of interest, this provision also deprives some of the customers of the applicant's banks of a potentially remunerative outlet for their funds.

Another condition imposed by the Board was that "no lending affiliate of Company may disclose to Company any non-public customer information concerning an evaluation of the financial condition of an issuer whose paper is placed by Company. . . ."[120] This measure was adopted "to remove even the possibility that some unwarranted competitive advantage might occur. . . ."[121] Whatever its purpose, it precludes the type of information-sharing economies that have been touted as a major benefit of diversification by financial services firms. The same observation may be made of the long-established "Chinese Wall" between bank trust departments and commercial lending departments. By minimizing the danger of conflict-of-interest abuses, it also minimizes the potential information efficiencies obtainable by combining commercial banking and trust activities. Moreover, because the same types of conflicts face investment banks, life insurance companies, and many other types of financial institutions, limiting the activities of commercial banks reduces competition without affecting the incidence of conflicts of interest in the economy as a whole.

Safety and soundness (Risk). The final issue—and the one almost unanimously held to be most crucial—is the likely effect of expansion of banks into securities activities on the safety and soundness of the banking system. Several of the witnesses testifying before the Senate Banking Committee during its hearings on possible revision of the Glass-Steagall Act in July 1987 raised anew the question of whether increased involvement in securities activities would threaten bank safety.[122] The issue is not disposed of by the evidence provided earlier indicating that securities activities were not a major cause of the 1930s banking collapse; much has changed since 1933. What is needed is convincing evidence regarding the risks associated with various combinations of commercial banking and each of the securities activities banks engage in or wish to enter. A great deal of empirical research has been undertaken in recent years to attempt to answer these questions.

Before summarizing the results of this research, it is useful to note several conceptual problems encountered in the evaluation of the risks associated with securities activities. Perhaps the primary one is that securities activities, or even the particular activities included under the category of underwriting, are highly heterogeneous. Some of them are extremely risky, others are not. Moreover, the riskiness of a combination of commercial and investment bank activities is a function not only of their individual risks, but also of how those risks are related to one another. This is determined by the covariances between the risks. Thus, the variance of returns of an underwriting activity might be higher than that of permissible bank activities, but the combination of the two could have a lower overall variance than either of the component activities. This is the primary benefit of diversification. However, if traditional commercial banking were much less risky than a particular new activity, combining banking with this activity might increase the overall risk to the bank. To see whether entry into additional securities activities will enable banks to reduce their overall risk, it is necessary to examine the marginal contribution of each activity to the bank's existing risk.

A number of studies have examined the risks of individual securities activities currently prohibited to commercial banks. Ian Giddy has looked at the risks involved in corporate stock and bond underwriting.[123] He found that the distributions of returns in underwriting were very similar to those in bank lending, with the upper bound on returns in lending set by the contract loan rate and in underwriting by the agreed net offering price. On average, the risk from the greater potential volatility of the price of a newly issued security is limited by the very short period of time that the underwriter holds the stock in inventory. In any case, the ultimate risk in underwriting depends on how accurately the underwriter sets the gross spread, which has to cover costs and compensation for the risks incurred. On balance, the evidence suggests that the risks of corporate underwriting do not appear to be inherently greater than those of bank lending.

The risks in two of the activities banks currently engage in—general obligation municipal bond underwriting and foreign exchange dealing and trading—have been examined by Anthony Saunders for the late 1970s and early 1980s.[124] He found the risks in municipal bond underwriting to be similar to those in corporate bond underwriting. In the case of foreign exchange trading and dealing, he found only one case of an annual loss by a major bank despite the extremely volatile exchange rates in recent years. Hence, the available studies of the risks of individual activities do not suggest that securities activities need be unduly risky.

The evidence on the benefits of diversification is not totally satisfactory. Many of the extant studies looked only at activities that were currently permissible for banks or bank holding companies, and so cannot be used as evidence on activities currently prohibited. The results of studies that attempted to measure the effects on bank risk of diversifying into currently prohibited securities activities are rather mixed. On the one hand, a study by Peter Eisemann found that limited expansion into investment banking, such that it accounted for between 11 percent and 19 percent of a bank holding company's total assets, could significantly reduce its overall risks.[125] Similarly, a study by Larry Wall and Robert Eisenbeis found negative correlations (and, hence, covariances) between the earnings of both banks and bank holding companies, on the one hand, and those of security broker/dealers on the other, over the period 1970-1980.[126]

The results of all of these studies are somewhat suspect because they relied on data aggregated to the industry level and are therefore strictly applicable only to a merger of all firms in both the banking and the securities industries (although some of the "industry" data consisted of data for as few as two firms). Variance of return data for the industry as a whole tend to understate variability for the individual firms because some benefits of diversification can be realized simply by combining firms within the industry. Similar effects result from using annual rather than quarterly or monthly observations. These two problems are both forms of what is known as aggregation bias. It can be shown that conclusions regarding the measurable benefits of diversification are highly sensitive to these forms of statistical bias.

The first study of the effects of bank diversification into securities activities to discuss and attempt to avoid such bias was a 1982 article by Roger Stover.[127] Using industry aggregate data he found a large positive correlation between the earnings of commercial banks and investment banks and, thus, no benefits of diversification. However, when he used individual firm data, he found that commercial bank earnings variability was reduced by a modest diversification into investment banking and that such activities should therefore be included in an efficient portfolio of banking activities.

Using quarterly data for 1976 through 1984 for nearly 7500 commercial banks with and without eligible securities trading accounts, Myron Kwast calculated the effects of engaging in eligible securities trading on banks' mean and median percentage returns and on the standard deviation of returns.[128] These results were then used to calculate risk-return frontiers for various subsamples of banks. Kwast found that both the mean and median returns to securities activities and their standard deviation exceed those for other banking activities. However, he finds that the level of assets devoted to securities activities resulting in the greatest reduction in the standard deviation of return varies so greatly from one time period to another that he is unable to derive general conclusions. Like the other studies cited above, Kwast's implicitly assumes that the combination of banking and securities activities producing the lowest standard deviation of returns is the one contributing the most to bank safety—i.e., minimization of the probability of failure—without regard to the effect on mean return. However, it is well established in the literature that the probability of failure is a function of both the expected value and the variance of return in combination with the degree of leverage. Nonetheless, given the small slopes of the risk-return frontiers that he calculated, which indicate that there was little additional expected return to be obtained by accepting greater variance, this consideration is probably of little practical importance.

Much work remains to be done before we can be confident of the consequences for bank risk of combining commercial and investment banking activities. Nevertheless, it appears that, with adequate internal safeguards to limit exposures and encourage the appropriate use of hedging, well-managed banking organizations should be able to engage in underwriting and dealing activities without increasing their overall risk. Poor or risk-prone managers do not need additional securities powers to increase their risk exposure. They can continue to fail the old way through misuse of the powers currently available to them. Most of the recent failures of commercial banks and thrift institutions provide strong support for this.[129]

Conclusions

The separation of commercial and investment banking introduced by the Glass-Steagall Act was neither as complete in practice nor as well-grounded in theory or evidence as many people have supposed. It was primarily a hasty, ad hoc response to the most severe financial crisis in U.S. history.

The first attempts by commercial banks to reenter securities activities other than underwriting and dealing in U.S. government and municipal general obligation bonds came in the 1950s when they sought unsuccessfully to get Congress to authorize then to underwrite municipal revenue bonds. In the early 1960s the Comptroller of the Currency authorized national banks to underwrite some municipal revenue bonds and to offer mutual funds, but these actions were struck down by the courts. Not until 1968 did Congress authorize banks to underwrite certain housing and university-related municipal revenue bonds. Since then, relying on existing law, banks have successfully entered discount brokerage, private placement of commercial paper, financial advising, managing (but not selling) mutual funds and closed end investment companies,[130] and, most recently, issuing deposit accounts that resemble mutual funds. Absent a successful legal challenge by the SIA to the Supreme Court, they may soon be trading commercial paper, municipal revenue bonds, and securitized mortgage and consumer debt. The status, as of early 1988, of what commercial banks that are members of the Federal Reserve may or may not do in the securities arena is shown in Tables 1 and 2, respectively. Commercial banks appear to be able to participate in activities that currently account for more than 50 percent of the gross revenues of all securities firms and to underwrite securities accounting for close to 80 percent of the dollar amount of all new issues.

In searching out additional potentially profitable securities activities and designing means to engage in them without challenging the core of Glass-Steagall head-on, the banks have been assisted by the bank regulatory agencies, at first the Comptroller of the Currency and more recently the Board of Governors of the Federal Reserve System. The regulators are less conservative then a decade ago and are responding to the changes in the marketplace by providing more liberal interpretations of the language of the act. At least recently, the courts appear to have placed substantial weight on the rulings of the agencies when they are argued carefully so as to appear consistent with the purpose of the act and do not flaunt the novelty of the permitted powers. (This approach by the courts may assist the SIA in its appeal to the Supreme Court of recent Board rulings on new securities powers in which there were strong minority dissents, including that of former Chairman Volcker.) Commercial banks are now openly advertising their progressively expanded investment banking services and challenging the investment banks and mutual funds head-on. And so it probably will continue, with both the banks and the regulatory agencies becoming more aggressive.

Neither major de jure dismantling nor a reinforcement of Glass-Steagall by Congress is likely in the next few years. Although the Proxmire-Garn bill, which would repeal many of the Glass-Steagall Act's restrictions on banks' securities activities, passed the Senate by a vote of 94-2, it faces strong opposition in the House of Representatives[131] This remains true despite the fact that such prestigious public figures as former Federal Reserve Board Chairman Paul A. Volcker, current Federal Reserve Chairman Alan Greenspan, FDIC Chairman L. William Seidman, and Finance Undersecretary of the Treasury George D. Gould have urged Congress to liberalize the act's restrictions.[132] Such changes generally occur only at times of major financial crisis or loud public outcry. Neither event is likely soon, at least for commercial banks. Indeed, the stock market break of October 19, 1987 may have added to the hesitancy of Congress to enact any dramatic liberalization of Glass-Steagall. The fact that the Continental Illinois National Bank judged it necessary to come to the assistance of its options clearing subsidiary not only incurred the wrath of the Office of the Comptroller of the Currency, but reinforced the suspicion of some members of Congress that securities activities were too risky for banks.[133] After the crash, several articles appeared arguing that postponing liberalization of Glass-Steagall on these grounds would be irrational.[134] However, such arguments are unlikely to persuade all members of Congress.[135] In order to reduce the consequences of a perceived increase in risk, the bill enacted by the Senate would require that the new securities activities be conducted by bank affiliates rather than by the bank itself. The bill would enforce this separation by establishing thick firewalls, breaches of which would be severely penalized. This approach would limit the ability of banks to take advantage of any synergies that may exist between the new and existing activities and would reduce the benefits to consumers of permitting bank holding companies to offer additional securities services without affecting the actual, as opposed to the perceived risk of these activities to the bank or the FDIC. To the extent that the public views the securities issue as primarily a turf battle between two powerful industries, members of Congress cannot expect to garner much public support for voting one way or the other. They will only aggravate some lobbyists.

Because the market place and the regulatory agencies have been slowly eroding the act's prohibitions, neither outright repeal nor major modifications of Glass-Steagall are as necessary as they once were. Nevertheless, our assessment of the history of U.S. banks' involvement in investment banking, recent studies showing that the role of securities activities in the banking collapse of the 1930s had been greatly exaggerated, and existing evidence concerning the likely costs and benefits of permitting banks to enter a broader range of underwriting and dealer/broker activities convince us that a major liberalization of existing legislation would contribute, on net, to the achievement of a banking system that is both safer and more efficient.

Footnotes

[1] Edwin J. Perkins, "The Divorce of Commercial and Investment Banking: A History," *Banking Law Journal,* vol. 88 (June 1971), pp. 483-528 and Helen M. Burns, *The American Banking Community and New Deal Banking Reforms* (Westport, CT: Greenwood Press, 1974).

[2] Golembe Associates, "Commercial Banks and Investment Banking," a paper prepared for the Economic and Financial Research Division of the American Bankers Association,
November 29, 1976, p. 31.

[3] *Ibid.,* p. 32.

[4] H. Parker Willis and Jules I. Bogen, *Investment Banking* (New York: Harper & Brothers, 1929), p. 6.

[5] Vincent P. Carosso, *Investment Banking in America: A History* (Cambridge, MA: Harvard University Press, 1970), p. 2.

[6] See, e.g., Fritz Redlich, *The Molding of American Banking: Men and Ideas,* Part II (New York: Hafner Publishing Company, Inc., 1951), p. 393.

[7] U.S. Congress, House, Committee on Banking and Currency, *Investigation of Financial and Monetary Conditions in the United States,* Washington, 1913.

[8] *Annual Report of the Comptroller of the Currency,* 1924, p. 12 and *Annual Report of the Comptroller of the Currency,* 1926, pp. 2-3.

[9] U.S. Congress, Senate Committee on Banking and Currency, Report No. 473, 69th Cong., 1st Sess., March 25, 1926, pp. 6-7, and U.S. Congress, House, Committee on Banking and Currency, Report No. 83, 69th Cong., 1st Sess., 1926, p. 2.

[10] "Regulations Further Defining the Term 'Investment Securities' as Used in the Act Approved February 25, 1927," June 30, 1927. Reprinted in *Annual Report of the Comptroller of the Currency,* 1927, p. 11.

[11] According to William F. Upshaw, ". . .only the Bank of United States was singled out as an example of failure caused by the relationship of the bank and its securities affiliate." "Bank Affiliates and Their Regulation, Part I," *Monthly Review,* Federal Reserve Bank of Richmond (March 1973), p. 17. However, it has been argued that even this weak assertion is not supported by the facts. See Eugene Nelson White, "Before the Glass Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History,* vol. 23 (January 1986), pp. 33-55.

[12] One of the things that angered the public the most was that, because of accumulated securities losses, none of the senior partners of J.P. Morgan paid any income taxes in 1933. See Walker F. Todd, Remarks to the New York County Lawyers' Association, January 15, 1987, p. 18.

[13] Mark J. Flannery, "An Economic Evaluation of Bank Securities Activities Before 1933" in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market,* edited by Ingo Walter (New York: John Wiley & Sons, 1985), pp. 67-87.

[14] White, "Before the Glass-Steagall Act," pp. 33-55.

[15] Perkins, "The Divorce of Commercial and Investment Banking," p. 515.

[16] 12 U.S. Code 24 and 12 U.S. Code 335. The Competitive Equality Banking Act of 1987 expanded the prohibition to insured nonmember banks for one year ending March 1, 1988. The 1933 act did not apply to to other depository institutions, such as savings and loan associations, and some of these institutions are affiliated with securities firms. The Federal Home Loan Bank Board lifted a five-year moratorium on such affiliations in March 1988.

[17] 12 U.S. Code 377.

[18] 12 U.S. Code 378(a).

[19] 12 U.S. Code 78.

[20] Carosso, pp. 307-309.

[21] Robert Taggart, "Recent Trends in Corporate Finance," presentation at De Paul University, Chicago, Illinois, April 6, 1987.

[22] Raymond W. Goldsmith, *Financial Intermediaries in the American Economy since 1900* (Princeton, N.J.: Princeton University Press, 1958), p. 59.

[23] One of these, Senate Bill 1306, was passed by the Senate in 1967, but failed in the House. See *Bank Underwriting of Revenue Bonds,* Hearings, U.S. Congress, Senate, Committee on Banking and Currency, Subcommittee on Financial Institutions, 90th Cong., 1st Sess., August 28-30 and September 12, 1967.

[24] For a discussion of some of these actions, see Howard H. Hackley, "Our Baffling Banking System," *Virginia Law Review,* vol. 52 (May 1966), pp. 605-620.

[25] George G. Kaufman, "The Securities Activities of Commercial Banks," in *Handbook for Banking Strategy,* edited by Richard Aspinwall and Robert Eisenbeis (New York: John Wiley & Sons, 1985), pp. 661-702.

[26] The plan was approved under regulations promulgated by the Comptroller in 1963: 12 Code of Federal Regulations, Section 9.18(a)(3).

[27] *Investment Company Institute v. William B. Camp,* 401 U.S. 617, 28 L Ed. 367, April 5, 1971.

[28] *Ibid.,* p. 380.

[29] *Ibid.,* p. 375.

[30] *Bulletin of the Comptroller of the Currency,* October 26, 1936, pp. 2-3.

[31] Comptroller of the Currency, *Digest of Opinions* (August 1957), paragraph 220A.

[32] Matthew Clark and Anthony Saunders, "Glass-Steagall Revised: The Impact on Banks, Capital Markets, and Small Investors," *Banking Law Journal,* vol. 97 (October 1980), pp. 829-831.

[33] See "Commercial Bank Private Placement Activities," *Staff Study,* Board of Governors of the Federal Reserve System, June 1977, pp. 26-47.

[34] George G. Kaufman, "The Securities Activities of Commercial Banks," in *Handbook for Banking Strategy,* edited by Richard Aspinwall and Robert Eisenbeis (New York: John Wiley & Sons, 1984), pp. 696, 698.

[35] "Statement of Policy on the Applicability of the Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Non-Member Banks," FDIC News Release PR-72-82, September 1, 1982.

[36] Michael S. Helfer and Russell J. Bruemmer, "FDIC Securities Rule May Not Have Major Effect," *Legal Times,* December 24/31, 1984, pp. 13, 16, 18-19.

[37] The key decision was in "Citicorp, J. P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation," *Federal Reserve Bulletin,* vol. 73 (June 1987), pp. 473-508.

[38] "National Westminster Bank PLC," *Federal Reserve Bulletin,* vol. 72 (August 1986), pp. 584-596.

[39] David Zigas, "Comptroller Gives Nod to Bank to Underwrite CMOs", *American Banker,* May 29, 1986, pp. 1, 20.

[40] "Citicorp, J.P. Morgan & Co., Incorporated, and Bankers Trust New York Corporation," *Federal Reserve Bulletin,* vol. 73 (June 1987), pp. 473-505. See also Jed Horowitz, "Fed's Ruling Not Clear-cut Bank Victory," *American Banker,* May 4, 1987, pp. 1, 31.

[41] "The Chase Manhattan Corporation," "Chemcial New York Corporation," "Manufacturers Hanover Corporation," and "Security Pacific Corporation," *Federal Reserve Bulletin,* vol. 73 (July 1987), pp. 607-608, 616-618, 620-621, and 622-623. see also Barbara A Rehm, "Fed Approves 4 More Banks' Securities Bids," *American Banker,* May 20, 1987, pp. 1, 23.

[42] "Chemical New York Corporation, The Chase Manhattan Corporation, Bankers Trust New York Corporation, Citicorp, Manufacturers Hanover Corporation, and Security Pacific Corporation," *Federal Reserve Bulletin,* vol. 73 (September 1987), pp. 731-735.

[43] Robert M. Garsson and Jay Rosenstein, "Give Banks New Powers, Volcker Asks Congress," *American Banker,* January 22, 1987, pp. 1, 14.

[44] "Bankers Trust New York Corporation," *Federal Reserve Bulletin,* vol. 73 (February 1987), pp. 138-154. On June 22, 1957, the Supreme Court refused to hear a Securities Industry Association challenge to the Board's decision. Robert M. Garsson, "High Court: Banks Can Deal in Commercial Paper," *American Banker,* June 23, 1987, pp. 1, 14.

[45] "United Bancorp," *Federal Reserve Bulletin,* vol. 64 (March 1978), pp. 222-223.

[46] These two types of limits had very different purposes, the former being designed to assure that banks were not principally engaged in the new activities and the latter to prevent them from dominating a market.

[47] Barbara A. Rehm, "Comptroller Would Relax Curbs on Bank Securities Operations," *American Banker,* June 26, 1987, pp. 1, 16.

[48] In particular, the applicants argued that the Board had no authority under Glass-Steagall to impose a market share limitation.

[49] Jed Horowitz, "Comptroller Approves Asset-Backed Securities," *American Banker,* June 19, 1987, pp. 1, 14.

[50] Letter from Jill M. Considine, New York State Banking Superintendent, to Morgan Guaranty Trust Company and Bankers Trust Company, December 23, 1986. See "New York Adds to Pressure on Glass-Steagall," *Banking Expansion Reporter,* vol. 6 (January 19, 1987), p. 14.

[51] However, several New York State bank holding companies are considering converting their national banks to state-chartered banks. Citicorp has applied to convert Citibank (NY State) NA of Rochester to a state bank. "Citicorp Seeks State Charter for Subsidiary," *American Banker,* April 21, 1987.

[52] In Clarke v. Securities Industry Association, Nos. 85-971 and 85-972, January 14, 1987, the Supreme Court upheld the Comptroller's approval of Security Pacific's operation of brokerage subsidiaries of the bank across state lines, holding that it does not violate the McFadden Act prohibition of interstate branching. See "Court Decision Signals Wider Bank Activities," *American Banker,* February 26, 1987, pp. 4-6.

[53] In *American Bankers Association v. SEC,* No. 85-6055, slip op. (D.C. Cir., Nov. 4, 1986), the U.S. Court of Appeals for the D.C. Circuit determined that SEC Rule 3b-9 improperly expanded the definition of a broker-dealer to include banks.

[54] "Bankers Trust New York Corporation," *Federal Reserve Bulletin,* vol. 73 (February 1987), pp. 138-153.

[55] "Combining IRAs," *Wall Street Journal,* November 4, 1986, p. 4.

[56] On July 7, 1987 a federal appeals court upheld the Board's approval of an application by National Westminster Bank PLC, London, to offer such services through its County Securities Corporation USA subsidiary. Jed Horowitz, "Court Upholds Move by Banks Into Brokerage", *American Banker,* July 8, 1987, pp. 1, 22.

[57] Jed Horowitz, "High Court Upholds Securities Powers for Units of Nonmember State Banks," *American Banker,* October 6, 1987, pp. 1, 14, 23.

[58] The decisions were upheld by the U.S. Court of Appeals for the Second Circuit on February 8, 1988. Robert Guenther, "Banks Win Round in Appeals Court Over Underwriting," *Wall Street Journal,* February 9, 1988, p. 48 and Jed Horowitz, "Court Upholds Fed's Approval of New Powers," *American Banker,* February 9, 1988, pp. 1, 23.

[59] In a document entitled "Commercial Paper Activities of Commercial Banks: A Legal Analysis," the Board's General Counsel had argued in June 1979 that state member banks could sell third-party commercial paper. On September 26, 1980 the Board issued a "Statement Regarding Petitions to Initiate Enforcement Actions" in which it said commercial paper was not a security under the Glass-Steagall Act and therefore could be sold by Bankers Trust.

[60] The stay was granted on May 19, 1987. Barbara A. Rehm, "Fed Approves 4 More Banks' Securities Bids," p. 1.

[61] "Second Circuit Decision in SIA v. Fed," *BNA's Banking Report,* February 15, 1988, pp. 276-288.

[62] Jed Horowitz, "Court Stalls New Powers for Banks," *American Banker*, March 1, 1988, pp. 1, 14.

[63] Jed Horowitz, "Denver Bank Move Challenges Bank On Underwriting," *American Banker*, August 21, 1987, pp. 1, 9, 15.

[64] Robert M. Garsson, "Senate Panel Backs New Powers for Banks," *American Banker*, March 4, 1988, pp. 1, 15 and "Senate Injects Community Issues into Banking Bill," *American Banker*, April 1, 1988, pp. 1, 12.

[65] "Arizona Law Broadens Securities Powers," *American Banker*, May 4, 1987, p. 31.

[66] Jed Horowitz, "Japan Opens Door to Securities Units of U.S. Commercial Banks, Source Says," *American Banker*, March 10, 1987, pp. 1, 15.

[67] Jed Horowitz, "Banks Win Japan Securities Nod," *American Banker*, June 4, 1987, p. 1.

[68] David Lake, "Change Ahead for Canada's Financial Services Industry," *American Banker*, June 30, 1987, p. 2.

[69] Richard Ringer, "First Chicago to Buy 35% Stake in Toronto Firm," *American Banker*, June 30, 1987, p. 2.

[70] Andrea Bennett, "First Chicago Halts Deal with Wood Gundy," *American Banker*, December 29, 1987, pp. 2, 8.

[71] E. S. Ely, "Dawn of a New Age," *Institutional Investor*, (March 1987), pp. 245-255.

[72] Jed Horowitz, "Citicorp Allies with US Broker In Bid to Trade Global Equities," *American Banker*, January 18, 1988, pp. 1, 11.

[73] Chase Manhattan Bank, "If You're Doing A Merger or Acquisition on Foreign Soil, Make Sure Your Bank Knows the Turf," advertisement, *The Economist*, July 11-17, 1987, pp. 22-23.

[74] Appendices to Statement by Paul A. Volcker in *Structure and Regulation of Financial Firms and Holding Companies*, Hearings, Part I, Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations, U.S. Congress, House, 99th Cong., 2d Sess., April 22, June 11, and July 23, 1986, pp. 452-454.

[75] 12 U.S. Code 3106.

[76] John J. Duffy, "Foreign Banks Have a Vested Interest in the Demise of the Glass-Steagall Act," *American Banker*, March 19, 1987, pp. 1, 15.

[77] "More Banks Offer Mutual Funds to Customers," *American Banker*, November 3, 1986, p. 14.

[78] Chase Manhattan Bank, *Market Index Investment Information Booklet*, n.d.

[79] Lynn Brenner, "Banks, Brokerages Lining Up to Sell Indexed CDs," *American Banker*, October 9, 1987, p. 2.

[80] Stephen R. King and Eli M. Remolona, "The Pricing and Hedging of Market Index Deposits," *Quarterly Review*, Federal Reserve Bank of New York (Summer 1987), pp. 9-20.

[81] "Glass-Steagall Defenders Made Uneasy by Schwab Arrangement," *Bank Expansion Reporter*, vol. 5, October 20, 1986, p. 13. A June 5, 1986 letter from Federal Reserve Board General Counsel Michael Bradfield to the law firm of Sidley & Austin said that the arrangement did not violate Glass-Steagall. See "The Schwab-Lazard Arrangement," *Bank Expansion Reporter*, vol. 5, October 20, 1986, p. 14.

[82] According to testimony by Roberto G. Mendoza, executive vice President of Morgan Guaranty Trust Company, before the Senate Banking Committee, a few, very large banks might be willing to give up federal deposit insurance to gain expanded securities powers. However, he said that the majority of U.S. banks have no interest in new powers to underwrite securities. This view was reiterated by Steven Verdier, lobbyist for the Independent Bankers Association of America. Robert M. Garsson, "Division Remains Deep Between Big and Small Banks," *American Banker*, October 14, 1987, p. 2. However, in later testimony before the Senate Banking Committee, Edward E. Crutchfield, chairman of First Union Corporation of Charlotte, North Carolina, said that his institution would trade federal deposit insurance for broader securities powers. Robert M. Garsson, "Compromise Suggested on New Powers," *American Banker*, December 9, 1987, pp. 1, 15.

[83] Some of the problems faced by new entrants were recently described by a leading savings bank official. See Paul A. Willax, "When Debate over Powers Ends, Performance Issue Will Remain," *American Banker*, April 1, 1987 pp. 4, 16.

[84] Jed Horowitz, "Security Pacific's Discount Brokerage: Too Busy to Savor High Court Victory," *American Banker*, January 27, 1987, pp. 1-2, 14.

[85] Peter Field, "US Banks Abroad Undergo Changes Tied to Big Bang," *American Banker*, December 16, 1986, pp. 18-19.

[86] Gordon Matthews, "Lessons from the Street on Surviving the Shock," *American Banker*, Feature Section, "The Big Bang," July 30, 1986, pp. 23-27.

[87] Andrew Albert, "Few Win at Investment Banking, But Biggest Institutions are Making Inroads," *American Banker*, July 21, 1986, p. 9.

[88] See for example, Peter Mantius, "Supperregionals Eye Potential For Investment Banking Plans," *American Banker*, November 12, 1987, pp. 1, 6, 11, which discusses the investment banking plans of the six superregional banks in the Southeast.

[89] "Bankers Hope Glass-Steagall Will Tumble Down This Year," *American Banker*, February 20, 1987, p. 16. However, former FDIC Chairman William M. Isaac recently argued that past failures to liberalize Glass-Steagall resulted primarily from a concerted lobbying effort by the securities industry to keep competitors out, thereby preserving their exceptionally high profits. "The Real Reason Glass-Steagall Still Survives," *American Banker*, April 23, 1987, pp. 4-5.

[90] Chase Manhattan Bank, N.A., advertisement, *Wall Street Journal*, April 8, 1987, pp. 44-45.

[91] Andrew Albert, "A Letter to Legislators," *American Banker*, December 2, 1986, Feature Section, "Securities Industry Review," pp. 15-16.

[92] Thomas G. Fischer, William H. Gram, George G. Kaufman, and Larry R. Mote, "The Securities Activities of Commercial Banks: A Legal and Economic Analysis," *Tennessee Law Review*, vol. 51 (Spring 1984), pp. 503-515.

[93] Section (4): "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Section (5): "The term 'dealer' means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank. . ."

[94] See "Shad Replies to House Panel Questions on Industry Regulation," *American Banker*, September 26, 1986, p. 4.

[95] In *American Bankers Association v. SEC*, No. 85-6055, slip op. (D.C. Cir., Nov. 4, 1986), the U.S. Court of Appeals for the D.C. Circuit determined that SEC Rule 3b-9 improperly expanded the definition of a broker-dealer to include banks.

[96] "At a minimum, investor protection demands that when banks enter into any phase of the securities business, they should abide by the same standards and enforcement mechanisms that apply to securities firms under the securities laws." Charles L. Marinaccio, "Glass-Steagall Erosion Raises Key Policy Choices," *Legal Times*, November 19, 1984, pp. 13-14. Hans H. Angermueller, vice chairman of Citicorp, has also supported functional regulation, citing American Express, whose banking, insurance, and securities activities are regulated by different state and federal agencies, as a possible role model. Robert M. Garsson, "Citicorp Seeks New Kind of Regulation," *American Banker*, December 18, 1986, pp. 1, 18.

[97] George G. Kaufman, "Municipal Bond Underwriting: Market Structure," *Journal of Bank Research*, vol. 12 (Spring 1981), pp. 24-31.

[98] Sherrill Shaffer, "Competitive Effects of Glass-Steagall Reforms," unpublished paper, Banking Studies Department, Federal Reserve Bank of New York, October 6, 1982.

[99] This is clearly the view of the Securities Industry Association. During a panel discussion on the topic "Should Banks and Thrifts be Allowed to Engage in Securities Activities?" held in Washington, D.C. in December 1987, Donald Crawford, senior vice president for government relations of the SIA, said of entry by commercial banks, "I don't think this is going to do anything except replace competitors." *Financial Services Report*, December 16, 1987, p. 2.

[100] Samuel L. Hayes III, A. Michael Spence, and David Van Praag Mark, *Competition in the Investment Banking Industry* (Cambridge: Harvard University Press, 1983), pp. 29-44.

[101] Richard M. Levich, "A View From the International Capital Markets," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 274.

[102] *Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework for Safe and Sound Banking*, Report 100-324, U.S. House of Representatives, Committee on Government Operations, 100th Cong., 1st Sess. (USGPO, 1987), Appendix, "Supplementary Data on Underwriting Concentration," Exhibits C-1 and G-1, pp. 85, 88.

[103] "Who's Where in Profitability," *Forbes*, vol. 39 (January 12, 1987), pp. 252-257.

[104] Thomas A. Pugel and Lawrence J. White, "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 209.

[105] *Ibid.*, p. 230.

[106] Samuel L. Hayes III et al., pp. 57-58.

[107] Jed Horowitz, "Manufacturers Group to Back New Bank Powers," *American Banker*, January 21, 1988, p. 2.

[108] Bernard Shull asserts that the legal separation of banking and commerce arose in England in the 17th century to protect private business from the special privileges accorded the Bank of England. "The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust," *Antitrust Bulletin*, vol. 28 (Spring 1983), pp. 255-279. More recently, Thomas F. Huertas has argued that "Banking and commerce have been mixed in the United States since the birth of the Republic, and banking and commerce remain mixed today." "Can Banking and Commerce Mix?" paper prepared for the Cato Institute's Fifth Annual Monetary Conference, Washington, D.C., February 26-27, 1987. Legislation to separate banking from other lines of commerce did not come until the passage of the Bank Holding Company Act of 1956. See Donald T. Savage, "History of the Bank Holding Company Movement, 1900-1978," *The Bank Holding Company Movement to 1978: A Compendium* (Washington, D.C.: Board of Governors of the Federal Reserve System, 1978), p. 46.

[109] Donald T. Savage, "Interstate Banking Developments," *Federal Reserve Bulletin*, vol. 73 (February 1987), p. 90.

[110] *Ibid.*

[111] In 1972 over 20 percent of domestic factory output was in industries with four-firm concentration ratios over 60 percent. *Concentration Ratios in Manufacturing*, U.S. Department of Commerce, October 1975, Table 5.

[112] See, e.g., Bernard Shull, "Multiple-Office Banking and the Structure of Banking Markets: The New York and Virginia Experience," in *Proceedings of a Conference on Bank Structure and Competition* (Chicago: Federal Reserve Bank of Chicago, 1972), pp. 30-40.

[113] 75 *Congressional Record* 9904 (1953).

[114] Martin Mayer, "Conflicts of Interest," *American Banker*, April 17, 1987, pp. 1, 4.

[115] See Roy A. Schotland, "Conflicts of Interest Within the Financial Firm: Regulatory Implications" and Sam Peltzman, "Commentary," both in *Issues in Financial Regulation*, edited by Franklin R. Edwards (New York: McGraw Hill, 1979), pp. 123-161.

[116] See Fischer, Gram, Kaufman, and Mote, pp. 506-510.

[117] Anthony Saunders, "Conflicts of Interest: An Economic View," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market,* edited by Ingo Walter (New York: John Wiley & Sons, 1985), pp. 207-230.

[118] This was the basic conclusion of a study of conflicts of interest in bank trust departments written for the Twentieth Century Fund by Edward Herman. See "Commercial Bank Trust Departments" in *Conflicts of Interest in the Securities Markets* (New York: Twentieth Century Fund, 1975). However, the study did point out a number of clear-cut abuses that had occurred despite existing deterrents.

[119] "Bankers Trust New York Corporation," *Federal Reserve Bulletin,* vol. 73 (February 1987), p. 153.

[120] *Ibid.*

[121] *Ibid.,* p. 152.

[122] In part, this concern is based on the possibility that Glass-Steagall would be repealed without any fundamental reform of the existing flat-rate federal deposit insurance system. As business author and journalist Martin Mayer testified:

> Flat repeal of Glass-Steagall would compound the imbecility of Garn-St Germain. The one thing that can be said for sure is that those who liked what happened to FSLIC under Garn-St Germain would love what would happen to Federal Deposit Insurance Corporation, not long after the repeal of Glass-Steagall.

Modernization of the Glass-Steagall Act, Hearing, U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess., July 30, 1987, p. 126.

[123] Ian Giddy, "Is Equity Underwriting Risky for Commercial Banks?" in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market,* edited by Ingo Walter (New York: John Wiley & Sons, 1985), pp. 145-169.

[124] Anthony Saunders, "Bank Safety and Soundness and the Risks of Corporate Securities Activities," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market,* edited by Ingo Walter (New York: John Wiley & Sons, 1985), pp. 171-206.

[125] Peter Eisemann, "Diversification and the Congeneric Bank Holding Company," *Journal of Bank Research,* vol. 7 (Spring 1976), pp. 68-77.

[126] Larry Wall and Robert Eisenbeis, "Risk Considerations in Deregulating Bank Activities," *Economic Review,* vol. 69, Federal Reserve Bank of Atlanta (May 1984), pp. 15-16.

[127] Roger Stover, "A Reexamination of Bank Holding Company Acquisitions," *Journal of Bank Research,* vol. 13 (Summer 1982), pp. 101-108.

[128] Myron L. Kwast, "The Impact of Underwriting and Dealing on Bank Returns and Risk," forthcoming, *Journal of Banking and Finance.*

[129] Susan F. Krause, Fred C. Graham, and James E. Horner, "An Evaluation of Factors Contributing to the Failure of National Banks," paper to be presented

at the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 13, 1988.

[130] However, in an interpretive letter to First Union National Bank of North Carolina dated December 9, 1987, the Comptroller of the Currency said that a national bank may recommend to its customers a mutual fund for which the bank acts as investment adviser. Lynn Brenner, "Comptroller's Letter Says Bank Can Be Broker of Fund It Advises," *American Banker,* January 29, 1988, pp. 1, 19.

[131] Jay Rosenstein, "Senate Banking Bill Tougher Sell to Some States Than to the ABA," *American Banker,* April 4, 1988, pp. 3, 8.

[132] See Barbara A. Rehm, "Volcker Urges Congress to Modify Glass-Steagall Act," *American Banker,* July 31, 1987, p. 2; Robert M. Garsson, "Greenspan Urges Repeal of Glass-Steagall," *American Banker,* November 19, 1987, pp. 1, 15; L. William Seidman, "Glass-Steagall Restricts Banking More Than It Helps," *American Banker,* August 26, 1987, pp. 4-6, 13, 16-17, 21-22; and Geoffrey A. Campbell, "Treasury Gives Conditional Nod to Repeal of Glass-Steagall Act," *American Banker,* September 29, 1987, pp. 2, 19.

[133] According to Donald Crawford, senior vice president for government relations of the Securities Industry Association, "We had one helluva disaster on our hands. . . . maybe there was wisdom behind Glass-Steagall," *Financial Services Report,* vol. 4, no. 38, December 16, 1987, p. 2. See also Martin Mayer, "Scandals from the Crash," *American Banker,* February 5, 1988, pp. 1, 4. Mayer also criticizes the potential for abuses inherent in the conflict of interest arising from the effects of Bankers Trust's program selling for trust accounts on the value of the collateral behind its loans to brokers.

[134] See Barbara A. Rehm, "Heller: Crash Shouldn't Block Expanded Powers," *American Banker,* October 26, 1987, pp. 2, 23 and William H. Isaac, "Loss at Options Unit Should Not Block Powers," *American Banker,* November 17, 1987, p. 4.

[135] Robert Trigaux, "Revival of Continental's Woes Raises Doubts on New Powers," *American Banker,* October 28, 1987, pp. 1, 15.

APPENDIX

Excerpts From Banking Act of 1933 Relating to Securities Activities

Section 16

The business of dealing in securities and stock by the (national) 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 issues of securities or stock: Provided (specifies securities qualified for the association's own investment account). . .The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to (specifies securities exempted).

(Section 5 extends these restrictions to Federal Reserve member banks.)

Section 20

No member bank shall be affiliated in any manner. . .with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

Section 21

It shall be 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 or receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor. . . .

Section 32

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 securities shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations 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.

EXHIBIT 1

If you're doing a merger or acquisition on foreign soil, make sure your bank knows the turf.

	United States	Argentina	Australia	Austria	Bahamas	Bahrain	Belgium	Brazil	British Virgin Islands	Cameroon	Canada	Cayman Islands	Channel Islands	Chile	China	Colombia	Denmark	Dominican Republic	Ecuador	Egypt	France	W Germany	Greece	Guam	Hong Kong	India	Indonesia	Ireland
CHASE	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Salomon Brothers	●		●																			●						
First Boston	●		●								●											●						
Merrill Lynch	●	●	●	●		●	●	●			●		●	●							●	●	●	●	●			
Goldman Sachs	●										●														●			
Drexel Burnham	●						●	●													●				●			
Morgan Stanley	●		●								●											●						
Shearson Lehman	●	●	●				●							●							●	●			●			
Kidder Peabody	●		●																		●				●			
Paine Webber	●										●										●		●		●			
Smith Barney	●					●															●							

	Italy	Ivory Coast	Japan	Korea	Kuwait	Lebanon	Luxembourg	Malaysia	Mexico	Monaco	Netherlands	Neth. Antilles	Nigeria	Norway	Pakistan	Panama	Paraguay	Peru	Philippines	Portugal	Puerto Rico	Saudi Arabia	Singapore	Spain	Sweden	Switzerland	Taiwan	Thailand	Turkey	USSR	United Kingdom	U.S. Virgin Islands	Uruguay	Venezuela
CHASE	●	●	●	●			●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Salomon Brothers			●																		●					●					●			
First Boston			●																		●		●			●					●			
Merrill Lynch	●		●	●	●	●	●	●		●	●	●				●			●		●		●	●		●	●				●		●	●
Goldman Sachs			●																							●					●			
Drexel Burnham			●								●	●									●		●	●		●					●			
Morgan Stanley			●																							●					●			
Shearson Lehman	●		●							●	●												●	●		●					●			
Kidder Peabody			●																		●					●					●			
Paine Webber			●																		●					●					●			
Smith Barney	●		●						●																	●					●			

Traveling to an unfamiliar land can be an adventure. Doing a merger or acquisition in one can be a nightmare.

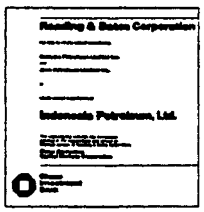
Differences in basic ground rules, in laws and regulations, in accounting practices, in language and culture—these and other factors make it difficult to accurately assess the inherent value of a company operating outside the U.S.

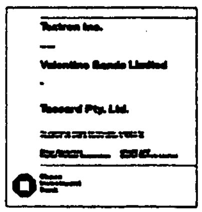
What you need is a financial institution not only with M&A expertise, but with in-country presence to understand the intricacies of doing business in foreign countries.

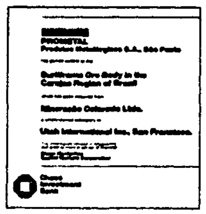
An institution, in short, like Chase.

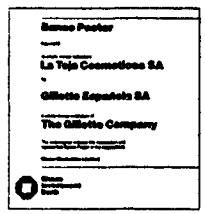
With offices in 60 countries around the world, Chase has greater international presence than any U.S. investment bank. In fact, Chase has offices in almost twice as many countries as the above ten investment banks combined.

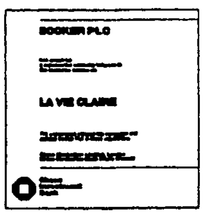
Moreover, Chase has been operating in many of these countries for decades, giving us an unsurpassed customer base and in-depth geopolitical knowledge. All in all, a combination of experience and presence that has played a major part in successful cross-border mergers and acquisitions.

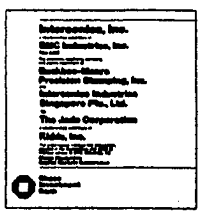


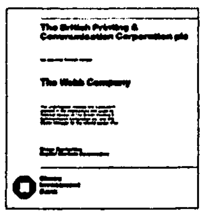


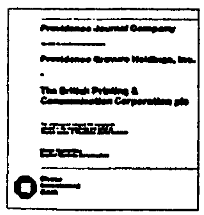












Such as our role when Banco Pastor, an industrial holding company in Madrid, put up for sale its Toja Cosmeticos subsidiary. Chase prepared a list of 32 companies from around the world that might have an interest in the Spanish toiletries market. U.S. based Gillette was the taker.

And when BPCC, a British printing company, chose to internationalize, Chase successfully targeted acquisition candidates in the U.S. We also acted as dealer-manager for the related tender offer.

There is, then, a world of reasons for choosing Chase as your investment bank for a merger or acquisition in a foreign country.

After all, that's one time you really don't want to lose anything in the translation.

CHASE

The Economist, July 11-17, 1987, pp. 22-23.

EXHIBIT 2

GOOD FO
YOUR IRA

Two High Yield Opportunities from Dreyfus and First Lakeshore

Take advantage of these professionally managed mutual funds seeking high current income with an initial investment of just $1,000 ($250 for IRAs)–and *no sales load!*

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This Fund seeks high current income, and, secondarily, capital growth. It has the flexibility to shift its portfolio mix between investment grade bonds and dividend-paying preferred and common stocks in response to changing market conditions. Investment management by The First National Bank of Chicago.

FIRST CHICAGO
The First National Bank of Chicago

Dreyfus GNMA Fund

This Fund invests primarily in high current yielding GNMA certificates. Portfolio securities are 100% guaranteed by the U.S. Government for the timely payment of interest and principal. Investment management by The Dreyfus Corporation.

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Attention IRA Investors–the 1986 IRA Deadline is April 15!

These Funds are available for your IRA at any First Chicago location. Stop in today for help in obtaining a Prospectus, or call the Funds directly at the toll-free number below. Remember, all IRA contributions for 1986 remain 100% deductible.

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For more complete information including management fee charges and expenses, obtain a Prospectus by calling Dreyfus/First Lakeshore or sending this coupon. Please read it carefully before you invest or send money. Share price and yield fluctuate.

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____

☐ Please send me an IRA Kit.

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For more information call toll free
1-800-821-1185
8am–7pm Weekdays
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Both Funds are distributed by Dreyfus Service Corporation

Chicago Tribune, Thursday, April 9, 1987.

EXHIBIT 3

THE WALL STREET JOURNAL TUESDAY, MAY 26, 1987 31

Only one bank investment links your return to stock market growth with no risk to your principal.

Introducing The Chase Market Index Investment: For business and individual investors.

This revolutionary new investment gives you the opportunity to link your earnings to today's dynamic market.

—The Chase Market Index Investment is a bank time deposit (FDIC insured up to $100,000) which features the safety of a fixed-term CD, but is keyed to stock market performance for potential high returns. Interest rates for The Chase Market Index Investment are based on one of the most reliable indicators of the stock market—the S&P 500 Index. While market advances can accelerate the growth of your investment, you may also select a guaranteed return—so your investment can only go up, never down. And there is never a fee or commission to pay.

How the Chase Market Index Investment Works

1. Select a term... three, six or twelve months. Let's say you select 1 year and Chase is guaranteeing a rate equal to 70% of the percentage rise in the S&P 500 Index.	Term One year
2. Assume an opening balance of $10,000. Suppose the S&P 500 Index was 280.0 on your commencement date.	S&P 500 Index on commencement date 280.0
3. Suppose the S&P 500 Index was 350.0 on your maturity date.	S&P 500 Index at maturity 350.0
4. The increase over the period of your investment was 70 points... a gain of 25%.	Percent rise in Index 25%
5. 70% of the increase would be 17.5%... a rate of interest well above recent one year CD rates.	Rate of Interest 17.5%

For more information about the Chase Market Index Investment, stop by your local Chase or Chase Lincoln First branch or call toll-free 1-800-854-1200, Ext. 378.
Or return this coupon.

Send to THE CHASE MANHATTAN BANK (U.S.A.) N.A.

CHASE

EXHIBIT 4

JVC didn't have to choose between commercial and investment banking. Choosing Chase gave them precision in both.

When this Japanese electronics giant chose Chase back in 1978, they did so for very good commercial reasons.

In those days, they simply wanted expert commercial banking services. And as a US bank with a vast global network, we were uniquely placed to handle their cash flows in the United States – their biggest center of operations outside Japan.

They could also use our international reach for their overseas trading activities and for the financing of overseas subsidiaries in Europe, Scandinavia, the USA and Asia.

But, when they decided to tap the international capital markets, happily they could also turn to Chase. Because at Chase we were able to provide a truly effective integration of commercial and investment banking expertise to deliver more comprehensive financial solutions.

Most recently we helped them arrange a Eurocommercial paper program to the tune of US$50 million. It went like clockwork because of our strength and experience in the Eurosecurities market.

For instance, we are a market maker in over 600 Eurosecurities issues trading in excess of US$8 billion a month. So naturally we have our finger constantly on the pulse of investor demand. And when the time is right, a powerful distribution capability to tap that demand – in every major financial center in the world.

This total global banking capability integrates size, international network and highly specialized industry knowledge with the broadest range of investment and commercial banking products. It is what sets us apart from other banking institutions in the world.

So, no matter how complex your financial deals may be, one thing is simple.

Which bank to choose.

CHASE

<u>Wall Street Journal</u>, Wednesday, April 8, 1987, pp. 44-45.

Table 1
Permissible domestic commercial bank securities activities[1]
(March 1988)

	Year Started[2]
Underwriting, distributing and dealing	
U.S. Treasury securities	Always
U.S. federal agency securities	Various years[3]
Commercial paper (third party)	1987[3]
Mortgage and consumer paper-backed securities	1987[3]
Municipal securities	
General obligation	Nearly always
Some revenue bonds	1968
All revenue bonds	1987[3]
Financial and precious metal futures brokerage and dealing	1983[4]
Private placement (agency capacity)	Always
Sponsor closed-end funds	1974
Underwrite deposits with returns tied partially to stock market performance	1987
Offshore dealing in Eurodollar securities	Always
Mergers and acquisitions	Always
Trust investments	
Individual accounts	Nearly always
IRA commingled accounts	1982
Automatic investment service	1974
Dividend investment service	Always
Financial advising and managing	
Closed-end funds	1974
Mutual funds	1974
Restricted	Always
Brokerage	
Limited customer	Always
Public retail (discount)	1982
Securities swapping	Always
Research advice to investors	
Separate from brokerage	1983
Combined with brokerage	
Institutional	1986
Retail	1987

Table 2
Nonpermissible domestic commercial bank securities activities[1]
(March 1988)

Underwriting, distributing, and dealing
- Corporate bonds
- Corporate equities

Mutual funds underwriting and distributing

---

1 Federal Reserve member banks or bank holding company affiliates.

2 After the Civil War. Different dates may apply to national and state banks and among state banks. With some exceptions, the earliest date is shown. Regulatory rulings frequently concluded that a specific activity was permissible before the date of ruling. If the activity was halted by enactment of the Glass-Steagall Act, the date of renewed activity is given.

3 Generally subject to stay pending outcome of court challenge to U.S. Supreme Court. The Comptroller has ruled that national banks are permitted to underwrite securities backed by their own assets.

4 Restricted to futures contracts for which banks may hold the underlying security or that are settled only in cash.