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Financial Deregulation: The Securities Industry Perspective

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FINANCIAL DEREGULATION: THE SECURITIES INDUSTRY PERSPECTIVE*

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At the outset I must confess that I am extremely impressed by the title of today's program: "Financial Deregulation under the Glass-Steagall Act—Debate and Resolution." I am impressed because New York Law School, by the very choice of this title, is making a courageous attempt to provide a resolution of the Glass-Steagall debate.

Throughout the course of this symposium, you will hear a great deal about the state of the financial services industry. You will hear from a distinguished panel of commentators. There are few experts in this rapidly changing field, and little in the way of a clear and precise set of principles against which to judge the future course of events. However, I suggest that there is at least one set of principles from which we can seek direction: the existing law. Even on this point, however, there is widespread disagreement as to what the legislators meant when they enacted the Glass-Steagall Act ("Act") in 1933.[1]

There is also a sense expressed by some that what was said in 1933 has little or no applicability in 1986. The reason given for disparaging this legislation is that conditions have since changed.[2] It seems to me that this latter point raises questions of legal construction and legal policy which should be of interest to law students and legal scholars: To what degree is a law efficacious when it has become a so-called "old chestnut," that is, when conditions have changed dramatically since the law's enactment, and when an influential segment of society, in-

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1. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

2. *See, e.g.*, Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L.J. 631, 635 (1980).

Critics of Glass-Steagall dispute the assertion that securities trading by commercial banks would lead to undesirable speculation and inevitable bank failures. They argue that the additional regulatory measures enacted by Congress since the passage of Glass-Steagall provide sufficient protection. Additionally, critics contend that traditional securities are functionally equivalent to the government securities that commercial banks currently trade. *See* J.P. MORGAN & CO., INC., RETHINKING GLASS-STEAGALL (1984).

cluding large commercial banks, has chosen not to adhere to that law?

As citizens and as lawyers, we have to ask ourselves whether the Glass-Steagall Act is still efficacious. If it is not, then we have to decide how to go about changing the national policy reflected by this legislation. Do we change national policy by congressional action, after careful study and debate? Or do we permit non-elected regulators and bureaucrats to change national policy without input from the elected representatives of the people? Do we allow public opinion generated by interested parties to change national policy without resort to the legislative process? Should brokers and bankers, insurers, retailers, and others express their views and try to change national policy? My position is that each faction should be part of the process of change. Despite the current fashion to criticize special interest groups, what could be more democratic than for interested parties to express their views as advocates for their own cause? Such involvement in the process is not special interest lobbying in the negative sense. Rather, it is part of the democratic and civilized process of government.

Change in the financial services industry in the last ten years alone, to say nothing of the last fifty-three years, has been dramatic. As deregulation was introduced into the securities industry in 1975 with the unfixing of commission rates,[3] a course of events was unleashed which has continued unabated for almost eleven years. The original contraction in the industry, caused by a substantial reduction in revenues, has in some instances continued to the point where the top ten firms now account for about sixty percent of overall industry revenues.[4] What used to be a stock and bond business is now a cornucopia of products and services to meet almost every conceivable need of individual and institutional clients. These clients are more sophisticated and demanding than ever, and new techniques have been developed to meet their very sophisticated financial needs. The techniques of securitization, programmed trading, and complex debt swaps are now part of the day-to-day activities of the securities industry. Technology has made much of this possible. High interest rates, too, have played an important part in the deregulation process. Additionally, new entrants have come into the business, causing a blurring of the lines in the financial services industry. Today there are roughly a dozen mega-enti-

3. *See* SEC Release No. 11,203, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,067, at 84,951 (Jan. 23, 1975). The deregulation of commission rates became effective on May 1, 1975 ("Mayday"). *Id. See generally* Castruccio & Tischler, *Developments in Federal Securities Laws—1975,* 31 BUS. LAW 1855, 1884 (1976).

4. *See* SECURITIES INDUSTRY ASSOCIATION, 10 SEC. INDUS. TRENDS No. 4, at 10 (1984) (in 1982, the ten largest securities firms accounted for 58% of all securities underwriting revenues); *see also* ARTHUR ANDERSEN & CO. AND SECURITIES INDUSTRY ASSOCIATION, KEYS TO A CHANGING SECURITIES WORLD 30 (1985) (percentage of underwriting revenues held by ten largest securities firms expected to reach 61% by 1988).

ties in the financial services industry, coming from bases in brokerage, investment banking, thrift, commercial banking, insurance, retailing, credit unions, finance companies, and others.[5]

Deregulation has been good in many ways. It has provided more alternatives for investors. Additionally, greater competition has resulted in lower prices, although much of the savings has accrued to institutions rather than individuals. The deregulatory trend, however, has created a schism in Congress concerning the future development of the financial services industry.

The era of deregulation has been marked by congressional hearings and numerous bills. In fact, a bill granting broad new powers to banking institutions passed the Senate in 1984 by a vote of 89-to-5.[6] There is a philosophical difference, however, in the points of view of the House and the Senate with respect to financial deregulation and broadened powers for the banking industry. Even the chairmen of the respective banking committees take dramatically different approaches to the subject of deregulation. Consequently, the power to develop national policy in the securities industry has shifted from the Congress to the regulators. An activist Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation and others have greatly supported the demands of their regulated constitutents for broader powers.

Litigation has also increasingly become a pronounced element of the policymaking process as the financial services industry lines have blurred. I suppose the Securities Industry Association ("SIA"), if nothing else, is famous for its role as a litigator against regulators and members of the banking industry.[7] Litigation has been essential and remains so when permissive regulators grant broadened powers without congressional action.

5. *See* ARTHUR ANDERSON & CO. AND SECURITIES INDUSTRY ASSOCIATION, *supra* note 4, at 20-23. Financial conglomerates offering a wide range of products to various financial markets have combined different and varied business segments into one, hence "blurring" traditionally distinct business unit lines. *Id.* at 21. These diversified financial services companies are seen as a threat to the traditional securities business because of their existing high capital and proven marketing ability. *Id.* at 21-22.

6. S. 2851, 98th Cong., 2d Sess. § 104 (1984) (proposed amendment to 12 U.S.C. § 1843(c)). The bill, sponsored by Senator Jake Garn, subsequently died in the House. *See* Blakely, *Overcoming a Fractious Start: Congress Gets Down to Work,* 43 CONG. Q. WEEKLY REP. 1585 (1985).

7. *See, e.g.,* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207 (1984); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. 695 (D.D.C. 1986); Securities Indus. Ass'n v. Federal Home Loan Bank Bd., 588 F. Supp. 749 (D.D.C. 1984); Securities Indus. Ass'n v. Comptroller of the Currency, 557 F. Supp. 252 (D.D.C. 1983), *aff'd,* 758 F.2d 739 (D.C. Cir. 1985).

Adding Focus to the Debate

There are three important points to keep in mind when debating, and hopefully resolving, the issues in this area. First, there is absolutely no evidence of public demand for broadened bank powers. It would be a rare day indeed for a regulator or a member of Congress to receive a letter from the public demanding that commercial banks be permitted to participate in the securities industry, or that securities dealers, brokers, and underwriters be permitted to enter the banking business. The reason for this, quite simply, is that the public already has just about everything it needs in many different locations at competitive prices, and has little or no desire for one-stop financial shopping.

Second, apart from the merits of the Glass-Steagall Act and the understandable desire of those regulated by the Act to broaden their powers, there is an undeniable and very serious national problem involving financial weakness in the savings and loan and related industries.[8] Banks, quite frankly, are in their weakest financial condition since the 1930's. The insurance funds, in certain cases, have become inadequate to protect the public interest in the event of a major collapse or a significant number of smaller collapses in the banking industry. Each of us is familiar with the problems of agricultural loans, energy loans, and non-paying loans to Third World countries.

Third, a policy issue is being debated in the halls of academe, the halls of regulatory agencies, in the media, and in the courtroom, but not in the Congress, where it should be debated and decided. Some will say that because of this legislative impasse, there is a breakdown in the economic system which impairs our country's ability to compete internationally. I would suggest to you that if there is any difficulty in our country's competing internationally, there is very little evidence to indicate that it is caused by conditions in the financial services industry. In fact, global securities markets have become a reality, and vast sums are being raised internationally most days of the week.

What is the position of the securities industry on this subject? First, there is by no means a single view. There are some securities firms, a very small number, that might have an interest in entering the

8. *See* SECURITIES INDUSTRY ASSOCIATION, QUESTIONING EXPANDED BANK POWERS 6, 7-8 (1985). It is estimated that 10% of the nation's thrift institutions are in severe financial trouble; between 250 and 300 others are on the Federal Home Loan Bank Board's trouble list. *Id.* at 6. Recent crises at savings and loan institutions in Ohio and Maryland have questioned the ability of depositor insurance funds to respond to a wide-spread "bank run." *Id.* at 7-8. *See also* Calmes, *Bailing Out Banks: How Much Is Too Much?*, 42 CONG. Q. WEEKLY REP. 2243 (1984). In September 1984, federal regulators pumped $2 billion into the nation's largest thrift, Financial Corporation of America, to prevent a run on its deposits. *Id.*

banking business, but they are few and far between. Some large investment banking firms have little or no interest in the retail securities business and are content to carry on an international investment banking business where their capital is adequate to the risk. In some instances, smaller regional firms are concerned about the potential intrusions of banks into their geographical areas. However, even among the smaller securities firms, there is a basic feeling of confidence in the industry's ability to compete effectively in the changing financial services industry. What do I mean by that? I simply mean that the securities industry is increasingly becoming, not a transaction oriented business, but a financial management business in which clients are willing to pay for value added. Then there are new entrants into the business, Travelers Insurance, Prudential, Sears, Kemper, and American Express, for example, that intend to provide a broad range of financial services for many customer needs.

Last year the SIA published a "White Paper" on Glass-Steagall, entitled "Questioning Expanded Bank Powers."[9] We subtitled that paper "A case for maintaining the fundamental separation between the banking and securities industries."[10] Although the industry is not a monolith, it is nonetheless fair to say that this paper represents the attitude of the securities industry on the question of financial deregulation. The industry believes that there is today, as in 1933, complete efficacy in retaining the Glass-Steagall separation. We believe that separation has served its purpose in a satisfactory manner, despite the usual economic expansion and contraction, war and other difficulties which have taken place during the past fifty-three years.

The Continuing Need for Prudent Regulation

In our opinion, there are four major reasons for maintaining the Glass-Steagall separation. First, the commercial banking system is perfectly capable of maintaining and enhancing its profitability without added powers to trade and sell securities. This is evidenced by the fact that there are numerous banks in the United States doing so at the present time.[11] However, as outlined earlier, there are a number of weaknesses in the banking system. At the very least, this is hardly the time to set banks on a course of increased risk rather than improved stability. The prudent course for legislators and regulators is to insist that the banking industry strengthen its insurance coverage, capital base, regulatory oversight, and profitability before considering expan-

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9. SECURITIES INDUSTRY ASSOCIATION, *supra* note 8.

10. *Id.*

11. *See* Schmitt, *Split Picture*, Wall St. J., June 19, 1986, at 1, col. 1 (contrasting the recent profit recovery experienced by the larger commercial banks with the continuing struggle of smaller commercial banks).

sion into other areas of activity. This is especially true when there is no public demand for expansion of bank powers.

Second, banks, as a matter of long-standing national policy, have been considered special institutions because they are trustees of depositors' funds. To carry out this role, banks have quite appropriately been given special advantages involving credit and federal deposit insurance.[12] In light of the special needs and characteristics of banks, the prudent course, in our opinion, is to maintain the separation required by sound public policy.

Third, it has been said that the abuses that led to the problems of the 1930's and the enactment of Glass-Steagall could not happen again. There is no question in my mind that banks are better managed, better supervised, their capital is stronger, and national sensitivity is at a higher level today than was the case in the 1920's. The likelihood of a repetition of those problems is therefore much lower today than it was when banks were permitted to underwrite securities. However, the abuses that occurred in the 1920's—the conflicts of interest, the tie-ins, the self-dealing and all the rest—despite the improvements in the level of supervision and oversight, could very well occur again in the 1980's if the banks were to be permitted to engage in underwriting. In fact, today's sophisticated technology makes it easier than ever to abuse the power that comes from mixing the credit allocation function of banks with the capital raising function of securities firms.

Finally, there is simply no truth to the claim that the securities industry is uncompetitive. In fact, the securities industry is probably the most intensely competitive industry functioning at the moment. We have been competing on price for over a decade.[13] The commercial banks, by way of contrast, just entered the price free-for-all on April 1, 1986.[14] Moreover, the securities industry is marked by extreme ease of entry. It is open to newcomers from all areas of commerce. Many financial giants, Sears, Prudential, and Equitable, for example, have made major acquisitions in the industry. As an industry, we are opposed to banks entering non-bank related fields because banks have special responsibilities and possess unique advantages.

The securities industry is not blind to the blurring of lines among financial intermediaries. We recognize and share the concerns of the Congress and the Administration for a safe, sound and economically

12. *See generally* SECURITIES INDUSTRY ASSOCIATION, *supra* note 8, at 11 (discussing the various advantages enjoyed by banks).

13. *See supra* note 3 and accompanying text.

14. Effective April 1, 1986, Regulation Q governing "Interest on Deposits," 12 C.F.R. pt. 217, was amended to reflect the expiration of statutory authority under the Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 3501(b) (1982), to set interest rate ceilings on time and savings deposits. 51 Fed. Reg. 9636 (1986).

viable financial services sector. We agree that this sector must protect savers, facilitate investment and insure the greatest possible access to capital. It is our belief that the current system of separation enables the economic system to achieve these objectives. The elimination of Glass-Steagall, as proposed by many money center banks, would not inhere to the public benefit. Instead, a relative handful of major banks, Morgan Guaranty, Citicorp, Bankers Trust, and a few others, would be drawn into the intensely competitive institutional markets where programmed trading and arbitrage in the futures and exchange markets are the order of the day. Banks would compete in these markets not only as fiduciaries for pension funds, but also for their own account.

Would the entry of banks into this business create more competition, and therefore improve services and lower prices to the public? Obviously there would be more players. However, in a trading environment, which incidentally is increasingly a hallmark of the securities business, and at a time when agency commissions from an institutional standpoint are virtually nonexistent, the banks would have to step up to the trading desk with their own capital and capital supplied by depositors. I do not think it is sound public policy to allow banks to trade in the futures market with savings deposits.

Bankers claim that such activities could be carried out by fully independent subsidiaries.[15] A number of years ago, even the SIA endorsed the concept of the separate subsidiary for securities transactions.[16] If a subsidiary, engaged in the high-risk securities business, suffered a monumental loss, thereby impairing its capital, however, is it not reasonable to assume that the subsidiary would seek help from the parent bank,[17] and would that not involve the use of depositors' money? Is it not also reasonable to assume that a bank would come to the rescue of a troubled subsidiary, if only to assure the bank's own reputation? The real estate investment trust problems of the 1970's are clear examples of parent bank involvement in the problems of its so-called separate subsidiary.[18]

In our discussions with members of the Congress, we have found that few senators and representatives wish to eliminate the Glass-Steagall Act. There is no public demand for elimination, no demonstrable

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15. *See, e.g.*, J.P. MORGAN & CO. INC., *supra* note 2, at 18-22.

16. SECURITIES INDUSTRY ASSOCIATION, *supra* note 8, at 33, app. C(1) (identifying fully separated operations as one of ten conditions necessary for the equitable entry of banks into the securities industry).

17. *See* Investment Co. Inst. v. Camp, 401 U.S. 617 (1971). Justice Stewart, writing for the majority, recognized that such a bail-out scheme was one of the hazards Congress sought to address with the Glass-Steagall Act. *Id.* at 637-38.

18. *See generally* INVESTMENT COMPANY INSTITUTE, MISADVENTURES IN BANKING: BANK PROMOTION OF POOLED INVESTMENT FUNDS 10-19 (1979).

public benefit, and legitimate concern as to whether the public interest would continue to be protected if Glass-Steagall were eliminated.[19] We have long advocated and expressed our willingness to participate in a comprehensive review of all financial industry legislation. This would include a review of securities activities that might be appropriate for banks, as well as a review of banking powers that might be appropriate for securities firms. Such a comprehensive review is the only intelligent way to go about such an examination because of the broad domestic and international implications.

A piecemeal dismantling of the Glass-Steagall Act—a little commercial paper here, a little mutual funds there—only serves to weaken a securities industry that has succeeded mightily in raising capital. Although the current debate focuses only on powers which banks seek to attain, I think that a two-way discussion is the only equitable way of approaching a bank powers discussion.

Pending Resolution

While the debate continues, the SIA intends to remain vigilant in its efforts to see that the Glass-Steagall Act is enforced. SIA's reputation as a litigious group doesn't bother us at all. We view ourselves as helping to preserve a highly desirable national policy in the face of inappropriate actions by regulatory agencies. In our commercial paper case, for example, we sued the Federal Reserve Board for permitting Bankers Trust to underwrite commercial paper. We won a victory in the Supreme Court[20] and again in the lower court.[21] Judge Green clearly affirmed the SIA's position and issued an injunction barring Bankers Trust from dealing in commercial paper.[22] In fact, our attorneys are presenting our case again before the Court of Appeals for the District of Columbia.[23] We expect the court to decide that question within a very short time frame.

Some members of the banking community believe that the SIA has a distorted view of the meaning of the Glass-Steagall Act. On the other hand, the courts have come closer to our interpretation than that of the banks and their friendly regulators. It was not long ago that the

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19. *See* Schumer, *Drafting a New Regulatory Scheme: A Congressional Perspective*, 31 N.Y.L. SCH. L. REV. 295 (1986). Congressman Schumer's article appears in this issue.

20. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984) (holding that commercial paper is a security under the Glass-Steagall Act).

21. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. 695 (D.D.C. 1986) (holding that commercial paper placement by a commercial bank constituted selling, underwriting, or distributing a security under the Glass-Steagall Act), *appeal docketed*, No. 86-5089 (D.C. Cir. Feb. 28, 1986).

22. *Id.*

23. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. 695 (D.D.C. 1986), *appeal docketed*, No. 86-5089 (D.C. Cir. Feb. 28, 1986).

exception in section 16 of the Act was described as one for isolated unsolicited transactions.[24] In our own litigation we have asserted that the exception is a narrow one for unsolicited discount brokerage.[25] We do not believe that the court of appeals will conclude that this exception includes all agency transactions regardless of the nature of the market, primary or secondary, or regardless of the customer and how the transaction is marketed, as Bankers Trust Company is now arguing.

Private placements of securities are also in question.[26] We find nothing in section 21 of the Act creating an exemption from the broad underwriting, distributing and selling prohibition.[27] This issue was also argued today, and we believe that our position will be sustained. Needless to say, other pending applications before the Federal Reserve Board present the same question, and we will continue to vigorously defend our position.

May discount brokerage be combined with investment advice? We think not, despite the Comptroller's rulings.[28] A briefing schedule has been established in our suit against the Comptroller to test these rulings. Yet to be decided is the question of whether these activities can be conducted at non-chartered locations.

Finally, it must be noted that clever bank holding companies are trying to create a loophole in section 20 of the Glass-Steagall Act.[29] We

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24. Section 16 of the Glass-Steagall Act provides in pertinent part that:

> The business of dealing in securities and stock by [national banks] 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 [their] own account, and [national banks] shall not underwrite any issue of securities or stock . . . .

12 U.S.C. § 24, para. 7 (1982).

25. Securities Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), *aff'd on other grounds*, 758 F.2d 739 (D.C. Cir. 1985) (per curiam). The SIA argued that the exception created by § 16 was a narrow one enacted to accommodate existing bank customers. *Id.* at 254-55.

26. *See* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. at 708-09 (rejecting the Board's argument that, since the term underwriting typically referred to public offerings, a bank's private underwriting activities were not prohibited by the Glass-Steagall Act).

27. In Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. at 699, the SIA argued that the term "selling" in § 21 encompassed all sales activities and that no exception was created by the permissive language in § 16. Judge Green, however, rejected this broad based argument. *Id.*

28. *See, e.g.*, Decision of the Comptroller of the Currency on American National Bank, [1983-1984 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 99,732, at 87,179 (Sept. 2, 1983).

29. Section 20 provides in pertinent part that: "[N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, de-

believe that anyone who is regularly and continuously in the business of underwriting securities is "principally engaged" therein. To decide otherwise is to strip Glass-Steagall of any significance.

Several other cases are pending, all of which involve aspects of Glass-Steagall. We believe that our industry is on firm ground legally and that the national policy supports the principle of separation reflected in the Glass-Steagall Act, and we believe that the Congress shares this point of view.

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bentures, notes, or other securities. . . . " 12 U.S.C. § 377 (1982).