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November 1975

Public Policy Aspects of Bank Securities Activities

An Issues Paper

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

Attached are issue papers prepared by the Capital Markets Working Group dealing with Glass-Steagall Act restrictions on commercial bank activities in the investment banking field. Comments from all interested parties are solicited. Please address all comments to the Office of Capital Markets Policy, Department of the Treasury, Washington, D. C. 20220.

Gerald L. Parsky

Attachment

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I. Introduction

Economic developments in recent years have spurred a reexamination of the role of financial institutions in the capital markets. One important issue that has excited increasing attention is the role of commercial banks in the securities markets. Since 1933, the Glass-Steagall Act has severely limited the activities of commercial banks within the securities markets.

Commercial banks have increasingly marketed securities-related services in competition with traditional investment banking and broker-dealer firms. Some of these activities have been challenged in the courts as violative of the Glass-Steagall Act restrictions on commercial banks. In one case, commercial banks have sought amendment of the Glass-Steagall Act to permit commercial banks to engage in securities activities presently proscribed by the Act.

These developments emphasize the need to review the policies and objectives of the Glass-Steagall Act restrictions on bank entry into the securities business to determine to what extent they remain valid in light of changes that have occurred in the economy, the banking industry, and government regulation of banking and securities transactions since 1933. This paper attempts to initiate such a review by examining the public policy arguments for and against permitting commercial banks to engage in various securities related activities. No attempt is made to reach definitive conclusions; rather, countervailing public policy arguments are presented as a means of stimulating discussion and soliciting comment on these issues.

Section II describes the relevant Glass-Steagall Act provisions that separate commercial and investment banking and discusses briefly the legislative policies and objectives underlying them. A more extensive review of the history, policies and objectives of these provisions is presented in an appendix to this paper.

Section III outlines current activities of banks in the securities area. These activities include agency or brokerage-oriented services, money management services, financial advisory work, medium- and long-term lending and arranging private placements.

Section IV describes various securities-related activities in which banks do not presently engage. These activities include retail brokerage, the sponsorship of mutual funds, underwriting and dealing in corporate securities and the underwriting of municipal revenue bonds. The Glass-Steagall Act clearly prohibits commercial banks from offering some of these services. With respect to others, it is less clear whether the Act's prohibition applies.

In Section V, each of these securities activities is examined in light of various public policy considerations. The central focus is upon the effect of each activity on the health of the securities markets and the capacity of the financial system to raise capital for American enterprise. In this respect, the probable impact of these activities upon competition between various segments of the financial community and upon competition within the commercial banking industry is examined. The broader ramifications of increasing economic concentration within the financial community are also explored. In addition, these bank activities are analyzed in terms of their compatibility with sound bank practices and their potential for creating conflicts of interest and other abuses within the commercial banking system.

II. Policies and Objectives of the Glass-Steagall Act Restrictions on Bank Securities Activities

The current restrictions on commercial bank securities activities were imposed by the Banking Act of 1933 (Glass-Steagall Act), enacted on June 16, 1933. A primary purpose of the Act was to separate commercial banking from investment banking. Security affiliates, a common adjunct of major commercial banks during the 1920's and early 1930's, are prohibited by Section 20 of the Glass-Steagall Act, which provides that no member bank shall be affiliated "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."1/

Section 16 of the Act places restrictions on the banks themselves, providing that the "business of dealing in securities and stock [by a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock."2/ This prohibition contains several important exceptions, most notably for obligations of the United States and "general obligations of any State or of any political subdivision thereof." The same limitations are extended to State chartered banks which are members of the Federal Reserve System.3/

1/ 12 U.S.C. Sec. 377. Section 2(b) of the Act, 12 U.S.C. Sec. 221(a), defines an affiliate of a member bank as an organization more than 50 percent owned or controlled by the member bank, under common ownership with the member bank or possessing a majority of interlocking directors with the member bank.

2/ 12 U.S.C. Sec. 24.

3/ 12 U.S.C. Sec. 335

Section 21 of the Act prohibits any person or organization engaged in underwriting securities from engaging at the same time to any extent whatever in the business of deposit banking.4/ This restriction extended the effective reach of the securities prohibitions to insured non-member banks.

Section 32 prohibits any officer, director or employee or partner of any organization engaged primarily in the underwriting of securities, or any individual so engaged, from serving at the same time as an officer, director, or employee of any member bank, subject to such limited exceptions as may be permitted by the Federal Reserve Board.

These provisions are generally viewed as separating commercial banking from investment banking. Investment banking has been traditionally defined as "that business which has as its function the flotation of new securities, both debt and equity, to the general public (including institutions) for the purpose of acquiring funds for clients that are private firms or public bodies."5/ If this definition of investment banking is accepted, it can be said that Congress, in enacting the Glass-Steagall Act, clearly prohibited commercial banks from engaging in investment banking. But the Glass-Steagall Act did more than prohibit commercial banks from underwriting securities. The Act also prohibited banks from investing their assets in equity securities or from acting as a dealer in securities. Strictly speaking, these functions are not considered to be investment banking; they can be viewed as securities activities.

The Glass-Steagall prohibitions resulted from the interaction of economic conditions and preconceptions about banking theory. The 1929 crash, the subsequent collapse of the banking system, and revelations concerning the abuses of the security affiliate system of the banking industry precipitated the Congressional investigation which eventually resulted in the enactment of the legislation. But, while the public outcry against the securities activities of the banking industry may have been a critical factor influencing Congress to opt for an absolute prohibition of, as distinct from regulation of, investment banking activities of commercial banks, the preconceived ideas of Senator Glass as well as his principal advisor, Professor H. Parker Willis, profoundly influenced Congress' decision.

Three objective reasons for enactment of the legislation can be identified from the legislative history. First, Congress concluded that the separation was necessary to protect and maintain the financial stability of commercial bank operations and insure public confidence in commercial banks

4/ 12 U.S.C. Sec. 378(a).

5/ Friend, Longstreet, Mendelson, Miller, and Hess, Investment Banking and the New Issues Market 80 (1967).

The Congress determined that commercial banks' efforts to promote or rescue security affiliates had, in the past, threatened their financial viability, and it sought to protect the banking system against this threat in the future. Second, Congress desired to eliminate the potential for conflicts of interest which could arise from performance of both the commercial banking and investment banking operations. Third, Congress concluded that bank securities operations tended to exaggerate financial and business fluctuation and undermine the economic stability of the country by diverting bank deposits into "speculative" securities investments.

Underlying these judgments, however, was the belief, held by Senator Glass and others, that investment banking was outside the traditional and proper sphere of activities of commercial banks. This school of thought held that banks should confine themselves mainly to making short-term, self-liquidating loans to finance goods in the process of production and commercial transactions.

Finally, an understanding of the reasons for the Glass-Steagall restrictions would not be complete without reference to the political environment in which they were enacted. Congressional hearings in 1931 and 1932 disclosed egregious abuses on the part of banks and bankers in the 1920's and early 30's. These revelations led to the indictment of numerous banking directors and officials. The failure of over 4,000 banks during the period in which the Act was under consideration, together with a widely held belief that the participation of banks in speculative securities activities had contributed to the '29 stock market crash, resulted in a sense of public outrage reflected in Congress' actions. This loss of public confidence in the banking system was an important impetus toward enactment of the legislation.

III. Description of the Current Activities of Commercial Banks in the Securities Area

Commercial banks presently offer several securities-related services in competition with investment banking, broker-dealer, or investment management firms. These include the handling of securities transactions for customers in an agency capacity, providing investment management services, providing financial advisory services to corporate customers, medium-term lending and arranging private placements. Each of these activities is briefly described below.

Agency or Brokerage-oriented Services

At the present time, commercial banks do not execute securities transactions directly for their customers as members of established stock exchanges or in the over-the-counter market.6/ Banks do, however, serve as conduits between their customers and the broker-dealer community. The banks deal directly with the customer in communicating the customer's desire to buy, sell or trade certain securities to a broker or dealer.

One of the oldest such services is the custodial account. Typically, a customer will deposit with the bank his current portfolio of securities. The bank provides safe-keeping of the securities and collects the dividends and interest which they generate. This income may be reinvested at the direction of the customer, remitted directly, or deposited in a checking account with the commercial department. The fee charged for this service is usually a percentage of income collected.

In addition to this safe-keeping service, the bank, for a fee, may also buy and sell securities at the direction of the customer or his outside investment adviser. The bank may execute the transactions through a broker, charging the commissions to the customer's account, or it may execute them directly with an over-the-counter dealer. Very often the broker-dealer used is selected by the customer or his investment adviser.

Another brokerage-oriented service offered by banks is the voluntary investment plan. Under this plan a participating broker-dealer compiles a list of generally 25 to 30 securities, selected on whatever basis the broker-dealer normally recommends particular securities to his customers. Small investor customers of the broker-dealer expressing an interest in the plan are referred to a bank which offers these customers a monthly purchase program for the securities selected by the customer from among those recommended by the broker-dealer. In the event a customer wishes to invest an amount in excess of a specified amount, for example, $1,000 on a monthly basis, the bank refers the customer back to the broker-dealer, for investment service.

6/ It is arguable that the Glass-Steagall Act permits banks to provide brokerage services directly to their customers. The Glass-Steagall Act states that 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 . . ." Whether this provision authorizes banks to perform brokerage for their customers remains unsettled and banks thus far have not attempted to test the issue by entering the retail brokerage business.

In a typical voluntary investment plan, the bank establishes a custodial account for each customer, handles all funds and securities and provides confirmation of purchases to each customer. Each participating customer is charged a fee equal to a percentage of the total amount invested to cover all commission charges and bank service charges. A portion of this fee is paid by the bank to the broker-dealer who referred the customer to the bank.

Recently, some banks throughout the country have begun offering a new type of plan called the automatic investment plan or AIS. Participation in these plans is initiated by the bank, not the broker-dealer. Through such a service, a bank offers existing, and perhaps potential, banking customers the opportunity to have a specified amount of money deducted monthly from their checking accounts and invested by the bank in the common stock of one or more issuers which are included on a list supplied by the bank. The issuers comprising the list may be, as in several plans, the 25 largest corporations in the Standard and Poor's 425 Industrial Index, based on the market value of their outstanding common stock.

The monthly deductions from each participating customer's account are pooled by the bank so that orders to purchase securities designated by customers can be pooled and executed through a broker at lower cost. The bank charges the customers a per transaction service fee. Each participating customer is provided a monthly statement by the bank that indicates the amount of a particular stock designated for purchase, the number of full and fractional shares purchased, the price per share, the date of acquisition and the total number of shares of that particular stock owned by the particular customer. If the bank makes more than one purchase of a particular stock in a monthly cycle, the price per share deemed paid by each customer will be the average price (including his pro rata share of brokerage commissions) paid by the bank for all purchases made during that cycle, not the price paid by the bank in any particular transaction.

The securities purchased for the account of a customer generally are held by the bank in the name of the bank's nominee, but whole shares will be delivered to any customer requesting such delivery. Each participating customer has the right to vote attributable to whole shares purchased by him through the service, and the bank will provide each participant proxy material with respect to his holding.

A customer may terminate participation in the service at any time upon notice to the bank. Upon termination, a customer may elect delivery of shares in his account, or may instruct the bank to sell his entire interest and remit the proceeds. The bank will make such sales in the open market to or through a broker-dealer.

A final form of brokerage-oriented services provided by banks is the dividend reinvestment plan. Through this plan, shareholders of a participating corporation may request that their dividends be paid by the corporation directly to a bank which aggregates all the dividends received and purchases shares of the issuer corporation's common stock, either directly from the issuer or in the secondary market. The shareholder may also contribute cash for such purchases. Recently, this service has been expanded to allow a participating shareholder to deposit with the bank the securities of a different class issued by the same corporation. The dividends or interest received with respect to these securities also are reinvested in the corporation's common stock.

Money Management Services

Banks have long handled money for individual and institutional customers by acting in a fiduciary capacity through trust departments. At the current time, the nation's commercial banks handle approximately $400 billion in trust assets. Approximately $150 billion (38 percent of the total) represents holdings of institutional customers, such as pension funds. The remainder is managed for private individuals.7/ In addition, banks handle sizable amounts of assets in estates of decedents, incompetents and minors in the capacity of executor, administrator or guardian. Over the last several years, many banks have shifted money management activities to investment advisory subsidiaries of the parent holding companies or to separately organized trust companies.

Traditionally, investment management accounts have only been available to customers with substantial funds since banks have found it uneconomic to provide individualized investment management services for small accounts. These large accounts are afforded individualized portfolio management in accordance with the objectives of the individual or institution for which the funds are being managed. The bank has custody of the securities and cash, makes investment decisions on a discretionary or nondiscretionary basis and collects and disburses dividends and interest. Banking regulations prohibit banks from pooling these accounts to provide economies.8/ These regulations are based upon the Supreme Court's decision in Investment Company Institute v. Camp, 401 U.S. 617 (1971), which held that commercial banks' commingling of agency accounts violated the Glass-Steagall Act prohibition against underwriting of securities.

7/ "Trust Departments," Forbes, July 1, 1975, p. 92.

8/ 12 CFR Sec. 9.18.

While banks cannot pool non-trust or agency accounts in which the individual retains title to the assets since this would be construed as underwriting securities in violation of the Glass-Steagall Act, they are permitted to pool trust accounts. Thus, while individualized investment advice is uneconomic for small agency accounts, the banks can now economically manage small trust accounts by using collective investment funds or pooled accounts.

Banks offer several types of collective investment funds. The best known of these is the commingled fund for employee benefit trusts. Pension funds fall into this category. The other major type of collective investment fund offered by banks is the common trust fund. Most of these funds are open-ended, have quarterly admission and redemption, and involve no charges for admission or redemption. Title to the assets lies with the bank as fiduciary.

Participation in common trust funds is limited to the trust accounts of the bank. However, new individual trust accounts may not be solicited on the basis that such accounts may participate in these funds.

A number of banks have also recently begun to act as investment advisers to both open-end and closed-end investment companies.9/ In some cases, the banks have acted directly as investment advisers. In accordance with the exemption for banks in the Investment Advisers Act of 1940, these banks have not registered as investment advisers with the Securities and Exchange Commission. In other cases, banks have operated as investment advisers through investment advisory subsidiaries of bank holding companies, in which case the subsidiaries must register under the Investment Advisers Act of 1940.

Current rulings of the Board of Governors of the Federal Reserve System restrict banks from engaging in the full range of activities permitted investment advisers that are not affiliated with banks. Principally, the Board has imposed various restrictions on a bank holding company's dealings with an investment company for which it acts as investment adviser in order to protect against potential conflicts of interest. For example, the bank is prohibited from granting credit to such an investment company.10/

9/ In February 1972, the Board of Governors of the Federal Reserve System amended Regulation Y to allow bank holding companies to serve as investment advisers to investment companies registered under the Investment Company Act of 1940. Sec. 225.4a of Regulation Y, 12 CFR Sec. 225.4(a).

10/ Section 225.125 of Regulation Y, 12 CFR Sec. 225.125.

In addition, bank holding companies are prohibited from sponsoring, organizing or controlling an open-end investment company, or mutual fund. However, they may sponsor a closed-end investment company as long as the company does not frequently issue or stand ready to redeem its share after the initial offering.11/

Financial Advisory Work

In line with their objective of offering corporate customers a more complete package of financial services, many banks now offer corporate customers a financial consulting service. This service is generally rendered through a separate non-bank subsidiary of the bank or holding company set up for this purpose. Financial counselling services are provided on a long-term basis pursuant to contracts calling for a specified number of hours of counselling per month at a fixed rate. Customers not party to a financial contract can usually purchase similar advice for specific projects. In both bases, the advice rendered may cover the whole range of financial problems that businesses may encounter.

In most cases, this service begins with a thorough analysis of the customer's long term financial objectives. Alternative financing plans are formulated to attain these objectives. If a private offering of securities is contemplated, the bank will advise the customer of possible sources of capital and assist him in preparing an offering memorandum and other necessary information. In the case of a public offering of securities, the bank may assist the customer in choosing and dealing with an investment banker. In the latter case, it is not clear to what extent the bank can participate in the negotiations for the actual distribution of the securities without violating the Glass-Steagall prohibition against bank underwriting. Banks also often provide financial advice in connection with mergers, acquisitions and reorganizations.

Medium- and Long-Term Lending and Private Placements of Bonds

Commercial banks have increasingly provided longer-term financing to corporate clients either by granting medium- or long-term loans or by arranging private placements of debt, or through some combination of the two. To the extent commercial banks offer longer-term financing services to corporations, they can be considered in direct competition with investment bankers which provide such financing through underwriting public offerings of securities, or by arranging private placements of securities.

11/ 12 CFR Sec. 225.125.

Commerical banks have gradually increased the maturity of commercial loans over the past 40 years. At the time that the Glass-Steagall Act was enacted, commercial banks generally limited their lending to 90-day loans or demand loans. By the end of 1974, 37 percent of all commercial and industrial loans of large commercial banks were term loans, having a maturity of 1 year or more.12/ Statistics released by the Comptroller of the Currency indicate that approximately 11 percent of the commercial and industrial loans of large national banks had maturities in excess of 5 years.13/ Both statistics exclude loans which mature in less than a year or 5 years, as the case may be, but which typically are rolled over, and thus, in effect, are long-term in nature.

In addition to supplying corporate customers directly with medium and long-term credit, commercial banks also may arrange on their behalf private placements of securities. Typically, the private placement will involve bonds with maturities in the range of 15 to 20 years.

In some instances, commercial banks may meet a customer's needs for long-term financing through a combination of a medium-term loan and a private placement of securities. This arrangement is often used in financing construction projects where the borrower's financial requirements accumulate over the period of the project. The bank meets the borrower's cash flow requirements while development of the project is in progress. After completion, another investor, or group of investors, brought to the transaction by the bank, assumes the loan and provides the long-term financing.

12/ Federal Reserve Bulletin, A-25, Dec. 1974."Term" loans are defined as all outstanding loans with an original maturity of more than 1 year and all outstanding loans granted under a formal agreement -- revolving credit or standby -- on which the original maturity of the commitment is in excess of 1 year. (Large commercial banks are here defined as the 160 banks reporting weekly to the Federal Reserve Board, which have approximately 70 percent of the commercial and industrial loans held by all commercial banks.)

13/ On April 30, 1975, 140 national banks, each of which possesses deposits in excess of $250 million, reported that 10.75 percent of the commercial and industrial loans held in their portfolios had maturities in excess of 5 years. Quarterly Report of Maturity Schedules of Assets and Liabilities filed with the Comptroller of the Currency by the 217 national banks with deposits in excess of $250 million.

IV. Description of Securities-Related Activities in Which Banks Do Not Currently Engage

Commercial banks do not currently participate in several areas of the securities business, in most instances because of the prohibitions of the Glass-Steagall Act. In one case, banks may have failed to enter a securities-related activity because of business, rather than legal, considerations.

The most important securities activity presently denied to commercial banks is the underwriting of corporate securities. Thus, commercial banks do not, and may not, engage in the issue, flotation, underwriting, public sale or distribution of corporate securities. Commercial banks are also prohibited from dealing for their own account in corporate securities.

With certain limited exceptions, 14/ commercial banks are also currently prohibited from underwriting municipal revenue bonds, *i.e.*, those bonds payable from specified sources of revenues such as tolls, user charges, rents, or designated taxes. While the Glass-Steagall Act prohibition against underwriting contains an exception for general obligations of States and their political subdivisions, the Comptroller of the Currency defined general obligations so as to exclude most municipal revenue bonds 15/ following an adverse court decision in *Port of New York Authority v Baker, Watts & Co*.16/

Another securities activity that is presently denied to banks is the sponsorship of open-end investment companies, or mutual funds. While the Federal Reserve System has permitted bank holding companies to sponsor closed-end investment companies, the legality of this bank activity has been challenged in court.17/

14/ The exceptions include public housing authority bonds and obligations issued by any State or political subdivision or any agency of a State or political subdivision for housing, university, or dormitory purposes, which are at the time eligible for purchase by a national bank for its own account.

15/ 12 CFR Sec. 1.3(g).

16/ 392 F. 2d 497 (D.C. Cir. 1968).

17/ The Investment Company Institute filed suit against the Board of Governors of the Federal Reserve System in the United States District Court for the District of Columbia, claiming that the Board's action in permitting bank holding companies to sponsor closed-end investment companies violated the Glass-Steagall Act. The District Court dismissed the suit for lack of jurisdiction on July 30, 1975. *Investment Company Institute v. The Board of Governors of the Federal Reserve System*, Civil Action No. 74-697 (D.D.C., July 30, 1975). The case is now on appeal.

Finally, another area of the securities business that banks have not entered is the retail brokerage business. While banks arrange for the purchase or sale of securities by their customers through a broker-dealer firm, they have not become direct participants in the broker-dealer community. Since it is not clear that the Glass-Steagall Act prohibits entry into the retail brokerage business, the failure of banks to enter the business may be the result of economic or business considerations, as well as legal considerations.

V. Analysis of the Advantages and Disadvantages of Bank Participation in Securities Activities

In assessing the desirability of bank participation in the above-described securities activities, the foremost consideration should be the effect of such bank activities upon the long-term health of the securities markets and their ability to meet the capital needs of American enterprise. A second, and perhaps equally important, consideration is the effect that such bank activities would have on the stability and integrity of the commercial banking system.

The impact of bank participation in the various securities activities on the capital markets may be analyzed in terms of the impact on the primary capital markets or the "new issues" markets, and on the secondary capital markets. For example, bank underwriting or corporate securities would bear more directly on the functioning of the primary markets while dealing -- *i.e.*, market making -- would involve the secondary markets.

As assessment of the desirability of such bank activity would require a consideration of the probable effect on the competitive posture of the investment banking industry and its ability to service the capital needs of corporations, especially smaller companies. Some argue that the lifting of the restriction on bank underwriting would result in a more competitive investment banking industry. Other contend that, because of the competitive advantages possessed by banks, bank entry into the investment banking business would eventually result in a single integrated industry and a greater concentration of economic power within the financial community. Thus, it is argued, lifting of the Glass-Steagall restrictions could result in less competition within the investment banking business through the consolidation of closely related financial activities in a single group of institutions.

The desirability of other bank securities activities must be assessed in terms of their immediate effect on the secondary markets. Some argue that bank participation in brokerage-oriented and investment activities could reinforce the trend toward centralization of investment decisions in a small number of large institutions. Centralization of investment decisions, it is feared, could distort the valuation function of the market and, therefore, the allocation of capital to American enterprise. For example,

it is alleged that institutional investors have in the past favored a few favorite stocks to the detriment of less favored companies, generally smaller or emerging companies. It further argued that the domination of secondary trading by large institutions may also decrease market liquidity and increase price volatility. On the other hand, proponents of such bank activities contend that they would increase investor participation in the secondary markets by providing investors with convenient and less costly access to those markets.

Some claim that bank sponsorship of the various investment services could also indirectly affect the primary markets. For example, bank automatic investment plans and the other investment services, it is argued, may cause a net reduction in commission revenues paid to brokerage firms in a competitive rate environment. A reduction in commission revenues could result in a shrinkage in the number of retail brokerage firms that could affect the viability of the distribution system for new issues.

The second important public policy consideration in assessing the desirability of bank entrance into the securities field is the effect that such an expansion of bank operations would have on the stability and integrity of the commercial bank system. The securities business, especially underwriting and dealing in securities, is inherently risky and subject to wide fluctuation in earnings. Concern has been expressed that bank participation in this business could seriously threaten the adequacy of bank capital, and could weaken public confidence in commercial banks since there is a risk that the fortunes and good will of the bank and its securities affiliates will rise and fall together. Moreover some people fear that the combination of investment banking and commercial banking would give rise to potential conflicts in that banks would be encouraged to make undesirable loans and investments to support their investment banking operations.

This latter consideration is less cogent in some areas of the securities business than in others. Thus, for example, the provision by banks of investment services to customers would not appear to threaten the capitalization of banks since such business generally requires very little capital investment. Similarly, it can be argued that the provision of financial advice to corporate clients or the arrangement of private placements on an agency basis for corporate clients would not appear to pose any direct risk to bank capital or to threaten public confidence in commercial banks, although potential conflicts between their financial advisory and commercial lending business do exist.

Investment Services

In analyzing the advantages and disadvantages of bank participation in brokerage-oriented and money management activities, the focus must be on the economic and financial impact of concentration of such services in a few financial institutions. Other issues such as conflicts of interest, institutionalization of markets, efficiency of markets and financial intermediaries and competition all seem to result from or relate to the issue of concentration.

Bank entry into various brokerage-oriented and money management activities could result in either of two forms of concentration. Conglomerate concentration would result where a single financial institution, such as a bank, provides a broad range of investment services. Horizontal concentration occurs when the number of financial entities providing investment services is reduced. Horizontal concentration could result from the entry by banks into new securities activities through merger with, or acquisition of, existing financial entities that perform these services, or through the attrition of competitors that provide services which banks offer. Conversely, bank entry into new securities activities de novo could result in horizontal deconcentration.

The concentration of investment services in one institution such as a bank has several advantages and disadvantages. Some observers argue that such conglomerate concentration can lower costs of providing investment services by spreading the overhead of investment advisory, account maintenance and processing functions over a broader customer base. To the extent that such cost savings are passed on to customers, the cost of securities transactions would be reduced, thereby enhancing the efficiency of securities markets and encouraging greater investor participation.

In addition, it is argued that the concentration of investment and other financial services in a single institution may provide customers with more convenient access to securities markets, and thereby further encourage participation by small individual investors in securities markets. On the other hand, it can be argued that providing individual investors more convenient and less costly access to investment services may not necessarily result in a net increase in savings and investment. Whether a net increase in investment resulted would depend on whether investors diverted funds from consumption of goods and services or diverted funds from other investments, such as time deposits.

A principal disadvantage of conglomerate concentration of investment and other financial services within banks rests in the increased potential for conflicts of interest. It is claimed, for example, that potential conflicts may arise between a bank's investment management activities and its commercial lending operations.

The principal advantages of horizontal concentration whereby the number of institutions providing investment services is reduced are the increased efficiencies resulting from economies of scale.

Horizontal concentration of investment services in a few multi-service banks, however, may produce several adverse effects on the capital markets. Many observers argue that increased concentration of investment services in banks could lead to an overconcentration in investment in a few favored stocks, usually well established issues, and in an allocation of investment funds away from smaller emerging companies to larger established ones. Thus, bank investment services, it is argued, reinforce tendencies toward a tiered market.

Stated another way, the argument is that such concentration harms market efficiency by reducing the diversity of investment opinions and the number of independent investment decision makers in the market place. Financial market efficiency, as opposed to efficiency in executing and clearing transactions, may well depend upon the maintenance of a broad range of diverse viewpoints and decision makers in the market place. Moreover, the concentrations of investment advice in a small number of large institutions could adversely affect the liquidity and stability of the securities markets.

Agency and Brokerage-oriented Services

As noted above, commercial banks presently offer several agency services which provide customers with access to securities markets. These include voluntary investment plans, automatic investment plans, dividend reinvestment plans and custodial accounts.

It is argued that these services benefit investors and our capital markets by providing bank customers with a convenient, low cost and more competitive means of purchasing securities. While it is clear that these plans do provide customers with a convenient means of access to securities markets, the extent to which such services provide cost savings to investors is uncertain. On the one hand, banks, through their strong competitive position and by virtue of the economies associated with large orders, may be able to negotiate lower brokerage fees for their customers than the latter would be able to obtain by themselves. On the other hand, it is argued that the banks' own service charges may, in many cases, offset to a great extent any commission savings.

To date, these investment services have had limited success in attracting new investors to the securities markets. However, they may have had some success in attracting new capital to the securities markets. Dividend reinvestment plans have experienced substantial growth in recent years and are now offered by almost 500 issuers.18/ Individuals participating in such plans often

18/ See William E. Chatlos, "Growth of Automatic Dividend Investment Plans" Financial Executive at 38. (Oct. 1974).

augment the amounts made available through dividends for investment. Therfore, it appears that these plans have had a positive effect in attracting additional capital to securities markets on the part of small investors. Because of the automatic nature of such plans and the allocation of fractional shares, they not only facilitate, but in many cases make possible, the reinvestment of typically small amounts of cash dividends. In so doing, they may reduce the tendency of shareholders to allocate dividend payments to consumption rather than savings.

While automatic investment plans also have a potential for attracting new investors to the markets, they have generally not realized this potential to date. Banks sponsoring automatic investment plans report that approximately 40 to 60 percent of participants in the plans are first-time stock market investors.19/ However, investor participation in these plans has fallen dramatically short of market projections by the industry itself and, thus, the volume of investment through these plans has not been significant.20/ Voluntary investment plans have apparently had even less success in attracting bank customers to participate in the securities markets. It can be argued that declining stock prices, rather than the nature of the investment service itself, has been the primary reason for low investor participation in these plans.

It is argued that bank sponsorship of investment plans creates opportunities for abuse. One alleged abuse arises from the banks' interest-free use of customers funds during the acquisition interval of the investment plans.

Banks offering automatic investment services are permitted to invest customers' funds pending the banks' execution of securities transactions for the investment plans. The banks' use of customers' funds during the acquisition interval of investment plans, it is argued, conflicts with the interest of customers in receiving prompt or best execution for their securities transactions. The

19/ The American Bankers Association, in its response to the SEC's inquiry concerning bank-sponsored investment services (Securities Act Release No. 5491 of April 30, 1974), reported that approximately 40 percent to 60 percent of automatic investment plan participants were first-time stock investors.

20/ The New York Clearing House Association, responding to the SEC's inquiry concerning bank-sponsored investment services, reported that, while there are approximately 18,000 automatic investor service accounts administered by banks, investor participation has fallen short of market projections. Similarly, the Security Pacific Naitonal Bank responded that after 1 year of operation, its service had only approximately 1,500 participants, or less than 2 percent of the projected market.

banks contend that the Comptroller of the Currency regulations, requiring that funds held in a fiduciary capacity by national banks awaiting investment shall not be held uninvested any longer than is reasonable for the proper management of the account, provide adequate protection.21/ In addition, banks are subject to an examination by Federal and State banking authorities to protect and prevent abuses with respect to funds held during the acquisition interval.

Some observers contend that potential conflicts also arise in connection with bank trust operations. The knowledge of impending purchases or sales of securities for automatic investment plans, it is argued, could influence the investment decisions of the trust department and other investment operations of banks.

The sponsorship by banks of various investment services may also give rise to potential conflicts with respect to their commercial loan business. It is argued that a bank may be in a position to favor a borrowing corporation through its automatic investment service or to use that service as a means of gaining new loan business. Spokesmen for the banking industry respond that banks have little incentive to invest in the securities of issuers solely because the issuers are borrowers. Such an investment in the secondary market for an issuer's security would only be of an indirect benefit to the issuer, and would be substantially outweighed by the potential loss of a bank's reputation as an investment adviser.

It is also alleged that banks may be encouraged to make loans to issuers whose stocks have been purchased by bank customers through a bank investment service in order to enhance the financial condition of the issuer so as to prevent a loss of public confidence in its investment services. Banking industry spokesmen respond that banks would not possess any incentive to make such loans because the bank's reputation is not at risk inasmuch as it is not acting as an investment adviser, but is merely providing a nondiscretionary investment service to customers. Nonetheless, it can be argued that there would be a strong association in the public mind between the bank and its investment services. As a result, the bank's public image could suffer if stocks offered through its investment services declined substantially in value. The existing bank examination procedures may, however, deter banks from making unsound loans for the purpose of assisting issuers whose stocks are held by bank customers of bank sponsored investment services.

Banks might attempt to engage in the retail brokerage businsss in direct competition with broker-dealer firms, assuming they are not prohibited from doing so by the Glass-Steagall Act.

21/ 12 CFR Sec. 9.10.

The principal advantage of this activity would be increased competition within the brokerage industry which could perhaps result in lower transaction costs for small investors. In addition, customers may find it more convenient to have their brokerage needs met at the same institution which handles other financial matters.

On the other hand, some fear that increased competition within the brokerage industry may cause an undesirable shrinkage in the number of broker-dealer firms, especially during the current difficult period. Substantial attrition among retail brokerage houses because of bank entry could threaten the viability of the existing capital raising system which depends on a strong network of broker-dealers to distribute new corporate issues. Some fear that, should this occur, pressures would be created to permit commercial banks to engage in the underwriting of corporate issues, as well as retail brokerage. Thus, it is argued, the question of bank participation in retail brokerage cannot be considered apart from the broader question of the role of banks in the investment banking field.

Moreover, the brokerage operations of banks could pose a threat to the integrity and financial stability of commercial banks. First, a large retail brokerage operation would require significant capital to support the necessary investment in plant and equipment, as well as the brokerage operation itself. Asset growth has outpaced growth in capital and the commercial banking industry presently faces a capital adequacy problem. Banks have generally been unable to raise equity capital in recent years due to low stock prices. Moreover, high loan losses are, in some cases, making inroads into existing capital resources. It may be questioned whether existing levels of bank capital could support entry by banks on a significant scale into a new area requiring substantial amounts of additional capital.

Secondly, banks would be associated in the public's mind with various securities investments by virtue of their brokerage activities. Public confidence in commercial banks could suffer if securities held by customers of bank investment services declined substantially in value.

In addition, the cyclical nature and low predictability of earnings from brokerage operations could hinder the ability of commercial banks to raise capital. One reason for the relatively low price/earnings ratios of most bank stocks today is the fact bank earnings recently experienced a decline after many years of steady growth. Investors generally bought bank stocks for steady, if moderate, growth in earnings. Banks are now in the process of attempting to make their earnings less susceptible to changes in interest rates and the health of the economy. The return to a steady earnings growth pattern, it is hoped, will allow the banks to regain investor confidence in their stocks and thereby bring about high price levels. Bank entrance into the retail brokerage

business, it can be argued, would not be in harmony with this objective.

Money Management Activities

Commercial banks have provided money management services to individual customers on a fiduciary as well as an agency basis. However, commercial banks may collectively manage in a commingled investment account only assets held on a true fiduciary (as opposed to investment) basis.22/ Thus, the principal question in the money management area is whether commercial banks should be permitted to sponsor and manage commingled investment accounts or mutual funds.

The primary advantage of allowing banks to sponsor mutual funds is that the small investor would have access to the sophisticated portfolio management services of commercial banks. Many bank trust departments, particularly in the larger banks, have large, highly trained staffs devoted to the management of funds entrusted to the bank. Through the sponsorship of mutual funds, the bank could make this expertise available to the general public. While the small investor currently has access to the money management expertise of bank trust departments through the common trust fund, this investment vehicle possesses certain disadvantages. Common trust funds of banks generally provide less frequent and complete disclosure of investment performance than do mutual funds. Moreover, participation in a common trust fund is limited to the bank's trust customers, while participation in a mutual fund is open to any investor.

Bank participation in the mutual fund field might also benefit the investing public by providing increased competition within the industry. Some observers believe that this competition could encourage better investment services and lower sales load charges and investment advisory fees.

On the other hand, bank expansion into the mutual fund field could pose the risk of economic concentration within that industry. As noted above, such concentration could have potential adverse consequences for our capital markets.

Furthermore, bank participation in the mutual fund field would appear to give rise to the same potential abuses and hazards which the Glass-Steagall Act was designed to eliminate. The promotional incentives and pressures incidental to a bank's sponsorship of a mutual fund, as well as the bank's pecuniary stake in the success of the fund, it can be argued, could be destructive

22/ The Supreme Court, in Investment Company Institute v. Camp, 401 U.S. 617 (1971), held that the Glass-Steagall Act prohibits commercial banks from operating commingled investment funds comprised of numerous individual agency investment accounts.

of prudent and disinterested commercial banking and of public confidence in the commercial banking system. A bank sponsoring a mutual fund obviously would have an incentive to promote the sale of participations in the fund in order to insure its profitable operation. Thus, the bank would have a strong interest in insuring the successful performance of its fund so as to attract investors. But, the bank's stake in the fund's success is more than this. The bank's reputation and goodwill stands squarely behind the fund so that imprudent or unsuccessful management of the fund could result in a loss of public confidence in the bank itself, as is evidenced by the experience of bank-managed real estate investment trusts.

These promotional incentives and pressures, it is argued, create the potential for abuses within the commercial bank's operation. Some fear that the bank's stake in the fund might distort its credit decisions. Thus, the bank could be tempted to make unsound loans to finance the purchase of shares in the fund, or for the purpose of assisting companies in which the fund had invested. In addition, the bank could be tempted to undertake, directly or indirectly, to make its credit resources available to the fund, or to exploit its access to confidential information in its commercial department for the benefit of the fund.

These potential abuses may be limited to some extent through appropriate regulation and supervision by banking authorities. The Federal Reserve System, for example, has carefully limited the dealings between a bank holding company and an investment company for which it acts as an investment adviser. The bank holding company is prohibited from (1) purchasing for its own account securities of such an investment company; (2) making discretionary purchases of such securities in an agency or fiduciary capacity; (3) extending credit to such an investment company and (4) accepting securities of such an investment company as collateral for loans for the purchase of such securities.23/

While potential abuses arising from bank sponsorship of mutual funds may be limited by similar restrictions enforced through examination procedures, it can be argued that it is impossible to prevent all such abuses from occurring by regulatory fiat. It can be further argued that no amount of regulation could protect against the risk that the fortunes and goodwill of the bank and the mutual fund will rise and fall together.

23/ 12 CFR Sec. 225.125(g).

Corporate Financing Services

Some commercial banks have aggressively expanded the types of financial services offered to corporate and governmental clients. They have offered corporations medium-term loans, financial consulting advice, and services in arranging private placements. In addition, commercial banks have sought legislation to permit them to underwrite municipal revenue bonds. This expansion is limited by the boundaries of the Glass-Steagall Act, which continues to prohibit banks from underwriting and dealing in corporate securities.

Perhaps the central policy issue raised by the expansion of bank financial services is whether such activities will result in greater concentration of economic power within the financial community, and, if so, would such concentration result in more or less efficient, competitive financial markets better able to serve the needs of American enterprise, both large and small.

Bank expansion into new markets offers the potential for additional competition, which may be especially desirable where the new market is highly concentrated. Such competition could provide consumers with more innovative and less costly services. It is generally recognized that the competitive benefits of bank expansion into new financial activities are maximized where such expansion occurs through *de novo* entry, rather than through the acquisition of existing concerns. *De novo* entry of new competitors not only increases the number of competitors, but also provides an incentive for the entering company to compete vigorously in order to build its share of the market.24/

24/ Scherer, *Industrial Market Structure and Economic Performance*, 366-78 (1970). The Bank Holding Company Act Amendments of 1970 recognize the greater competitive benefits of *de novo* entry vis-a-vis entry by acquisition of existing firms. Thus, in authorizing the Federal Reserve Board to authorize bank holding companies to engage in nonbanking activities, the Act permits the Board to differentiate between activities commenced *de novo* and activities commenced by the acquisition of a going concern. 12 U.S.C. 1843. The Board has done so by providing for an expedited procedure for *de novo* entry by banking holding companies into each of the nonbanking activities which the Board has thus far authorized under the 1970 Amendments. Section 225.4(b) of Regulation Y, 12 CFR Sec. 225.4(b).

On the other hand, some observers contend that banks possess such enormous leverage in so many key areas of finance that, if banks are permitted to engage in these financial activities, they would possess unfair competitive advantages over other financial institutions. Thus, it is argued that, if banks are permitted to continue to expand their financial activities in competition with investment bankers, a few large money center banks will eventually dominate the securities and investment banking business.

A danger may exist that bank activities in related financial fields could have an anticompetitive effect through the potential tying of one bank service to another. Such tying could occur through formal or informal agreements or tying arrangements between a bank and its customer whereby the bank agrees to sell one product over which it has substantial market power (such as credit) only on the condition that the customer agree to purchase another bank product.

Tying arrangements are possible where the seller possesses substantial market power or monopoly power over a particular product (tying product) so that it can use its power over that product to acquire market power over another product (tied product). Since banks possess substantial market power with respect to a variety of financial services, especially credit, banks may be encouraged to use that market power to increase their power with respect to other financial services which they are authorized to provide.

However, the ability of banks to engage in tying is sharply limited by the antitrust laws, particularly Section 1 of the Sherman Act. Moreover, a special statutory provision makes it illegal <u>per se</u> for banks to enter into tying arrangements.25/ However, the possibility of voluntary tying, or what is called tying effect, still exists. For example, a customer seeking credit from a bank might determine voluntarily to purchase other bank services, not on their economic merit, but only to enhance its chances of obtaining credit. Thus, the mere offering of related financial services by banks could have a potentially anticompetitive tying effect.

The offering of more than one service by a bank is not necessarily entirely anticompetitive. Credit customers of a bank may choose to purchase other services from the same financial institution to achieve economies, to reduce the risk of disclosure of confidential information, or simply for convenience. It is only where the customer purchases the tied product solely to curry favor with the bank and thereby enhance its access to other bank services that tying effect undesirably distorts the market place.

25/ Section 106(b) of the Bank Holding Company Act Amendments of 1970, Public Law 91-607, 84 Stat. 1766-67, 12 U.S.C. Sec. 1972.

Accordingly, it has been suggested that in assessing whether banks should be permitted to engage in the various proposed securities activities, each activity should be evaluated in terms of the potential undesirable tying effect that might result. If it is determined that bank entrance into a particular securities activity raises a strong likelihood of an undesirable tying effect, consideration should be given to whether such activity should be prohibited, or, short of that, whether restrictions or regulations should be implemented to alleviate the possibility of a tying effect. For example, it may be possible to require banks to notify their customers that their purchase of other bank services will have no effect upon their decision to provide a particular service to a customer.

But, some observers believe that the question of economic concentration is more than the possibility that banks may exercise their substantial market power in anticompetitive ways that distort market decisions. They argue that if banks are permitted to engage in various financial activities, they may eventually come to dominate these financial areas through their natural competitive advantages. Thus, in their view, the broader question that must be faced is whether such a concentration of economic power within commercial banks would be in the best interest of the capital markets.

<u>Financial Advisory Work</u>

Several policy arguments can be made in favor of commercial banks being permitted to offer corporation customers financial advisory services. To begin with, the provision of financial advice to corporations seems a logical supplement to existing bank services such as providing short and medium term credit. Financial counselling in individual and family financial affairs has traditionally been an integral part of the banking business. Business enterprises also require counselling on a wide range of matters relating to financial aspects of their operations. It seems quite natural that commercial banks should seek to meet the financial counselling needs of business enterprises as well as individuals.

Allowing commercial banks to offer corporations financial consulting services would provide an added convenience to corporate customers who could receive financial advice as well as other bank services from the same financial institution. Bank entrance into the financial counselling business would also increase competition in this business and thereby could result in more efficient, less costly and a wider variety of services than might otherwise be available.

Finally, the offering of financial advisory services by banks clearly falls outside the scope of those activities proscribed by the Glass-Steagall Act, nor does the offering of such services give rise to the potential abuses that the Glass-Steagall Act was designed to prevent. The provision of financial advice for a fee does not involve the promotion of securities activities such as underwriting, in which the bank has a pecuniary stake. Therefore, the offering of financial advice does not produce promotional pressures and incentives on the part of the bank which creates the potential for abuses within commercial banking operations.

On the other hand, it can be argued that permitting commercial banks to offer financial advisory services may tend to increase concentration of economic power in the commercial banking industry. It seems reasonable to conclude that commercial banks, by virtue of their natural competitive advantages, such as economies and providing customers the convenience of a multi-service financial institution, would capture a significant portion of financial advisory business from the investment banking industry. Investment banking firms may thus be stripped of one source of revenues that helps cushion the cyclicality of their earnings in their investment banking operations. The net result may be an enhancement of the economic power of commercial banks at the expense of the investment banking industry.

In addition, there is a danger that banks would possess an unfair competitive advantage in providing financial advisory services by virtue of their market power in providing traditional banking services such as credit. Thus, corporate clients, especially during periods of tight credit, may voluntarily choose to purchase financial advisory services from the bank so as to enhance their chances of obtaining credit from the bank. This undesirable tying effect could perhaps be alleviated by appropriate regulation.

Finally, some people feel that potential conflicts could arise between commercial bank lending and trust operations and the provision of disinterested financial advice in mergers and acquisitions. For example, a bank, in advising a corporate client to acquire a particular company, could be influenced by the fact that the bank has a substantial investment in the target corporation, either in the form of a commercial loan or a securities holding of the trust department. Furthermore, a bank might have an incentive to recommend a financing alternative in which it could participate.

The Comptroller of the Currency has authorized national banks to provide financial advisory services to corporate clients on the ground that such services are incidental to the business

of banking and are not prohibited by the Glass-Steagall Act. 26/ However, uncertainties concerning the extent to which the Glass-Steagall Act applies to bank financial advisory activities, coupled with the Act's harsh criminal penalties, 27/ have inhibited the evolution of bank financial advisory services. For example, in advising corporate clients in mergers and acquisitions, which may involve the issuance of securities, banks are uncertain to what extent they can become involved in the negotiations without risking a violation of the Glass-Steagall Act's prohibitions against underwriting corporate securities. Similar uncertainties arise in connection with banks arranging private placements for corporate clients.

In view of these considerations, the Comptroller of the Currency is of the view that the criminal penalties provided in Section 21 of the Glass-Steagall Act 28/ should be repealed. These harsh measures, it is argued, are inappropriate in a statute containing such gray areas between what is permissible and what is forbidden.

Medium- and Long-Term Lending and Private Placements

As noted above, commercial banks, particularly the large money center banks, offer a range of services that are designed to meet corporate needs for long-term financing. These include the granting of medium- and long-term loans and the arranging of private placements. Such services could be viewed as substitutes for securities underwritings.

The trend toward longer term lending, it is argued, is beneficial. Proponents argue that such lending provides corporations with an alternative source of long-term financing. This additional competition in financial markets could benefit corporations by lowering the costs of capital.

26/ In many cases, national banks seek to offer financial advisory services through a new operating subsidiary of the bank. The Comptroller of the Currency must approve the creation of a subsidiary for that purpose under 12 CFR Sec. 7.7376, which provides that a national bank may engage in any activity that is incidental to the business of banking by means of an operating subsidiary.

27/ The Glass-Steagall Act provides for up to 5 years imprisonment for violations. 12 U.S.C. 378(b).

28/ 12 U.S.C. 378(b)

Moreover, medium- and long-term lending represents a part of the traditional banking business and does not violate the underwriting prohibitions of the Glass-Steagall Act. Nor do such lending practices give rise to the potential abuses of the commercial banking system against which the Glass-Steagall Act was intended to protect. Because such lending does not involve the bank in buying and selling investments for its own account, such bank activity does not create the promotional pressures and incentives associated with investment banking that threaten prudent and disinterested commercial banking.

On the other hand, to the extent that commercial bank long-term lending displaces corporate securities underwriting as a means of corporate financing, the net effect could be a diminution of investment banking firms and a corresponding increase in the importance of commercial banks as suppliers of long-term capital. Thus, the evolution of commercial banking services in the area of long-term lending must be considered in the context of the possible long-range effects on inter-industry competition and economic concentration within the financial community.

The participation of commercial banks in arranging private placements of corporate debt securities would also appear to have several benefits. An obvious benefit is increased competition in providing private placement services to corporations, which could lower the costs to corporations of raising debt capital. In addition, increasing the number of financial institutions that are able to arrange private placements, particularly outside of the major financial centers, could make this type of financing more readily available to smaller corporations. Corporations often prefer to raise funds through private placements rather than public offerings in order to avoid the delay involved in registered public offerings, to save on costs of flotation, and to permit the tailoring of each loan indenture to each particular situation. Moreover, for those small corporations that do not have access to public markets, private placements provide an alternative means of access to the capital markets.

Bank participation in the private placement area produces other benefits. Commercial banks are able to serve more efficiently the financial needs and convenience of corporate clients by offering a complete package of services. By offering full financial services, banks permit corporate clients to satisfy all their financial needs at the same financial institution.

Moreover, the arrangement of private placements by commercial banks would not appear to create the same inherent conflicts of interest which arise when a commercial bank also engages in the underwriting and distribution of corporate securities. When arranging private placements, a bank acts as an agent for its corporate client, rather than as a principal in buying and selling securities for its own account. Thus, the bank would not be subject to the same promotional pressures or incentives associated with investment banking that could threaten prudent and disinterested commercial banking.

On the other hand, commercial bank expansion in the private placement business raises the same concerns over economic concentration that are raised by commercial bank expansion into other financial advisory services. Banks could reduce private placement and financial advisory business of investment banking firms. The lending function may be an important advantage in competing with the investment banking industry for this business. For example, if a commercial bank advises a corporate client, which has an outstanding line of credit with the bank, that it needs long-term financing in the form of a private placement, the client may feel obligated to use the bank's services in arranging the private placement.

Thus, it is argued, bank private placement and financial advisory activities may threaten the viability of some investment banking firms especially smaller firms specializing in mergers, acquisitions and private placements. In the long-term, this would lead to a further concentration of economic power within the commercial banking industry and a weakening of the investment banking industry.

Finally, while bank participation in arranging private placements would not appear to create the same potential for abuse that occurs when commercial banks underwrite corporate securities, it can be argued that this bank activity is not entirely free of potential conflicts. In arranging a private placement, a bank will necessarily have a stake in insuring that the offering is successfully placed, especially if the bank's fee is contingent upon the successful placement of the offerings, and even more so if the proceeds of the placement are used to retire an interim obligation to the bank. The promotional pressures thus created in arranging a private placement for a corporation could cause a bank to make imprudent loans to the corporation in order to complete or facilitate the successful placement of securities. For example, the bank could make a long-term loan to satisfy that portion of the offering that could not be placed with an institutional investor. Alternatively, the bank could make a loan to the corporate issuer in order to enhance its financial condition and thereby encourage an institution to invest in a private placement of the issuer's securities.

Underwriting and Dealing in Corporate Securities

The Glass-Steagall Act prohibits commercial banks from underwriting and dealing in corporate securities. In reviewing this restriction on commercial bank activity, it is logical to begin by examining the abuses which led to its enactment. The potential for recurrence of these abuses should be an important consideration in assessing the suitability of this activity for commercial banks.

The policies and objectives of the Glass-Steagall prohibition against commercial bank underwriting and dealing in corporate securities are discussed in detail in the appendix: "Review of the History, Policies and Objectives of the Glass-Steagall Separation of Commercial and Investment Banking." As noted above, three primary reasons for enactment of the prohibition can be identified from the legislative history. First, it is evident that the Congress concluded that the separation of commercial and investment banking was necessary to protect and maintain the financial stability of commercial bank operations and to ensure public confidence in commercial banking.

Secondly, Congress desired to eliminate the potential for conflicts of interest which could arise from performance of both commercial banking and investment banking operations. Congressional investigation 29/ into the breakdown of the banking system in the early 1930's revealed the following actual or potential conflicts arising from the operations of security affiliates of commercial banks:

(1) Banks made excessive and nonprudent loans to their security affiliates, which they would not normally have made if they were dealing with nonrelated entities.

(2) Securities were sold by the security affiliates to their parent banks or another of their affiliates under repurchase agreements.

(3) Bank funds were used to purchase excessive security holdings of security affiliates.

(4) Banks made excessive and nonprudent loans to their customers to purchase securities underwritten by their security affiliates, or in which their security affiliates otherwise had an interest.

(5) Security affiliates of banks conducted manipulative transactions in their parent banks' stock.

(6) Bank officers received compensation from security affiliates far in excess of that paid to them by their banks and otherwise personally profited from the operations of security affiliates.

(7) Security affiliates engaged in high leveraging and unwise risk-taking in reliance upon access to the resources of their parent banks.

29/ Hearings Before a Subcommittee of the Senate Committee on Banking and Currency pursuant to S. Res. 71, 71st Congress, 3rd Session, Part I 1064 (1931).

(8) Banks faced a significant loss of confidence by depositors and others as a result of losses by such persons in the operations of the banks' security affiliates and the resultant termination of depositor relationships.

A final concern that motivated Congress in enacting the Glass-Steagall prohibition was the feeling that bank securities operations tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities investments. Underlying these judgments, however, was the belief held by Senator Glass and others that investment banking was outside the traditional and proper sphere of commercial banks whose role was viewed as limited mainly to making short-term, self-liquidating loans to finance goods in the process of production and commerce.

Many of the concerns underlying Congress' decision to divorce commercial and investment banking appear to have been allayed in large part by subsequent economic and regulatory developments. By enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress subjected underwriting and dealing in corporate securities to a pervasive regulatory framework. The 1933 Act provided investors with protection against abuses related to false or misleading information in connection with securities underwritings. The 1934 Act also provided investors with protection against insider self-dealing and manipulation of securities markets, and prohibited the extension of credit by broker-dealers to customers for the purchase of new issues.30/

In addition, commercial banks have been subject to a far more extensive Federal regulatory system than existed prior to 1933. The Bank Holding Company Act of 1956 granted the Board of Governors of the Federal Reserve System authority to supervise the non-banking affiliates of banks. Section 7 of the Securities Exchange Act of 1934 authorized the Board to regulate the extension of bank credit for the purchase of securities.31/ This provision effectively achieved one of the underlying objectives of the Glass-Steagall legislation which was to control speculative uses of commercial banks' assets in the securities markets. Federal and State laws have provided increasingly stricter standards for commercial bank fiduciaries in exercising investment discretion on behalf of public investors. All these developments tend to reduce the potential for the abuses of commercial bank securities operations which occurred in the 1920-1930's.

30/ Securities Exchange Act of 1934, Sec. 11(d), 15 U.S.C. Sec. 78k(d).

31/ 15 U.S.C. Sec. 78g.

It is against this background that the question whether banks should be again permitted to engage in investment banking must be assessed. It appears, however, that some of the inherent conflicts and potential hazards that arise from the combination of commercial and investment banking remain valid concerns even in light of the development of securities and banking regulation since 1933. For example, the securities business is inherently risky and subject to wide fluctuations in earnings. Some people, both within and outside the banking industry have expressed concern that the severe cyclical nature of this business might lead to a weakening of public confidence in banks should they be permitted to engage in it once again. While Federal deposit insurance might mitigate any adverse effects on public confidence, they fear that the risk remains that the fortunes and goodwill of the bank and its securities affiliate will rise and fall together.

In addition, it is argued that the possibility always exists that banks will be encouraged to make imprudent loans and investments to promote or support their investment banking activities. While these potential abuses may be limited through examination and oversight by banking authorities, it is impossible to prevent all such abuses from occurring by legislative or regulatory fiat.

A review of the Glass-Steagall provisions separating commercial banking and investment banking should not be limited to a consideration of the policies and objectives that motivated Congress in 1933. Rather, the review should encompass broader policy considerations that reflect current financial and economic concerns. Two such policy considerations that may not have been contemplated by Congress in enacting the Glass-Steagall prohibitions concern the question of economic concentration within the financial community and the problem of capital adequacy. These policy considerations are explored below.

An assessment of the desirability of bank underwriting and dealing in corporate securities requires a consideration of the effect of such bank activity on the competitive structure of the investment banking industry and its ability to service the capital needs of corporations, particularly small and emerging companies. Some observers argue that the entry of commercial banks into the underwriting field would significantly enhance the competitive environment in the existing investment banking industry. They point to the present highly concentrated structure of the investment banking industry in which the top ten firms managed 85 per-cent of corporate underwritings in 1974.32/ Bank entry, it is argued, would increase the number of competitors and result in more efficient less costly services for corporate issuers.

32/ Investment Dealers Digest, Corporate Financing Directory at 18 (March 11, 1975).

On the other hand, some people fear, that while bank entry into the investment banking field might provide increased competition in the short-term, the integration of commercial and investment banking, in the long-term, could result in less competition and less liquidity in our capital markets. This would be especially true, it is argued, should the commercial banking system become more streamlined and dominated by a few large money center banks possessing extensive networks of correspondent banks.

This fear is grounded on the belief that, in the long-term, commercial banks would dominate the investment banking business. It is contemplated that commercial banks would seek to enter the underwriting business by acquiring existing investment banking firms, rather than taking the more difficult course of starting a de novo investment banking operation. The existence of firmly established client relationships within the current investment banking industry and the commercial banks' lack of skills and experience in this area would make it unlikely that commercial banks could establish new investment banking operations and promptly obtain a meaningful position in the industry through de novo activities. On the other hand, entry by acquisition of going concerns should be easy since many investment banking firms, particularly those with financial difficulties or capital ownership concentrated in a few individuals or families, would probably be eager to affiliate with a commercial bank.

Thus, it is argued that ultimately commercial banks would acquire a dominant position in the investment banking industry, although a substantial number of the large and well established investment banking firms would probably survive. However, these investment banking firms would eventually enter the commercial banking business in order to remain competitive with the commercial banks. Thus, the full integration of commercial and investment banking would be completed.

On the other hand, it can be argued that the foregoing analysis fails to take into account the probable regulatory system under which such bank entry into the investment banking field would occur. First, bank entry into a new nonbanking activity, such as investment banking, would be subject to the strictures of the antitrust law. While the ways in which the antitrust laws might affect such bank expansion are uncertain, there are several potential theories under which the antitrust laws could be applied to restrict or control bank expansion into the investment banking field.

Secondly, if banks were permitted to enter the investment banking business, the Congress could determine that such entry should take place under the existing provisions of the Bank Holding Company Act, which provide a vehicle for bank expansion into nonbanking activities under Federal Reserve Board supervision. If this were to occur, bank entry into the investment banking business would be carefully regulated by the Board to insure that the public benefits of such entry are not outweighed by the adverse effects of decreased competition or undue concentration of resources.33/ In considering the effect of bank entry on competition, the Board is concerned with the loss of potential competition and, thus, encourages de novo entry or entry by "foot-hold" acquisition of one of the smaller firms in the market, as opposed to entry by acquisition of a major existing concern.34/ Where the bank holding company has the capacity to enter de novo, the Board views entry through acquisition of an existing business as a loss of potential competition.

Thus, it can be argued that, if banks were permitted to enter the underwriting business under the present Bank Holding Company Act provisions, the Federal Reserve Board would regulate such entry so as to promote competition and to avoid undue concentration within the investment banking industry.

A second policy consideration that may not have been a primary basis for the Glass-Steagall prohibitions is the impact of investment banking operations on the adequacy of bank capital. It is clear that both regulators and investors are concerned over the adequacy of current levels of capital in both the commercial and investment banking industry. Not only are commercial bank capital-to-asset ratios very low by traditional standards, but a number of broker-dealers have declared bankruptcy or been forced to merge in recent years because of capital problems.

33/ The Bank Holding Company Act authorizes the Federal Reserve Board to permit bank holding companies to engage in non-banking activities which the Board determines "to be so closely related to banking or managing and controlling banks as to be a proper incident thereto." In determining whether a particular nonbanking activity is so related to banking as to be a proper incident thereto, the Board is directed to weigh the expected benefits of the requested bank activity against possible adverse effects, such as undue concentration of resources, and decreased or unfair competition. Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. Sec. 1843 (c)(8). This provision, which was added by 1970 Amendments to the Act, was designed to permit bank holding company expansion into related financial areas where the Federal Reserve Board finds such expansion to be in the public interest.

34/ For a description of the Federal Reserve Board's policy in this regard, see Note, Implementation of the Bank Holding Company Act Amendments of 1970: The Scope of Banking Activities 71 Mich. L. Rev. 1170, 1199-1200 (1973).

On the other hand, it has been suggested that banks could enter the corporate underwriting business by the use of security affiliates and thereby limit the direct risk to bank capital. In such cases, banks would be under strict limitations as to the aggregate amount of credit or investments that they could extend to or make in their security affiliates.35/ In addition, the amount of dividends they could pay to their holding companies would be limited.36/ While these and other restrictions would in some measure insulate the bank from any financial problems of a security affiliate, some observers believe that in reality it is extremely unlikely that a bank would fail to support a non-bank affiliate in financial difficulty to the extent permitted by law. If a bank did fail to honor this "moral obligation," public confidence in that bank, and perhaps in the banking system as a whole, could be severely shaken.

It can be furthered argued that bank entry into investment banking also poses a risk to the earnings stability of commercial banks. Although corporate underwriting can be a highly profitable enterprise,37/ it is a risky business subject to wide fluctuations in earnings. A good market can produce high profit levels whereas in a bad market there may be few, if any, corporations able to seek new capital in the long-term markets. Some fear that investment banking would introduce added cyclicality to bank earnings at a time when commercial banks are trying to regain the stable earnings growth trends of the 1960's. They maintain that it is unlikely the multiples on bank equities will improve materially until some earnings predictability and stability is regained. And until the market prices of bank stocks improve, it is unlikely banks will be able to significantly improve their capital positions.

35/ Section 23A of the Federal Reserve Act, 12 U.S.C. 371c, prohibits, with certain exceptions, a member bank from extending credit to or making investments in any affiliate in an amount in excess of 10 percent of the capital stock and surplus of the member bank. Where credit and investments are made in more than one affiliate, the aggregate amount of such credit and investments shall not exceed 20 percent of the capital stock and surplus of the member bank.

36/ A national bank must obtain the approval of the Comptroller of the Currency in order to pay dividends in excess of the total of its net profits for the year, combined with its retained net profits of the previous 2 years. 12 U.S.C. 60 (b). Member banks that are not national banks must seek such approval from the Board of Governors of the Federal Reserve System. 12 U.S.C. 324.

37/ Hayes, "Investment Banking: Power Structure in Flux," Harvard Bus. Rev. at 137-38 (March-April 1971).

Underwriting of Municipal Revenue Bonds

As described in an earlier section, commercial banks may now underwrite and deal in general obligation bonds issued by a political subdivision of a state, but not in revenue bonds offered by the same issuer. It has long been argued that banks should be allowed to underwrite both types of municipal obligations. Several government agencies have recently supported this change. The Senate passed legislation in the 93rd Congress that would have permitted commercial banks to underwrite municipal revenue bonds, but the House failed to act on it.38/

Proponents of the change argue that, insofar as issue characteristics and marketability are concerned, there are no significant differences between general obligation issues and revenue issues. However, the prohibition of bank underwriting of revenue bonds, they maintain, has a marked influence on the sale and distribution of such bonds to the detriment of the issuers involved. Extensive studies have demonstrated that issuers of revenue bonds receive fewer bids from underwriting syndicates than do issuers of general obligation bonds of comparable size, maturity and quality. As a result, those issuers of revenue bonds pay relatively higher interest costs.39/ It is estimated that the interest costs that could be saved by allowing bank underwriting of revenue bonds would amount to millions of dollars annually.40/ No systematic quantitative study that refutes these conclusions has been conducted.

Opponents of allowing banks to underwrite revenue bonds contend that such action would ultimately lead to an undesirable concentration of economic activity in commercial banks. Proponents argue, however, that the history of commercial bank activity in underwriting general obligation municipal bonds indicates that the banks would not dominate the underwriting of revenue bonds to the exclusion of existing investment banking firms. Throughout

38/ S. 3838, 93d Cong., 2d Sess. (1974).

39/ Peter Keir and James Kichline, "Interest Cost Effects of Commercial Bank Underwriting of Municipal Revenue Bonds," Federal Reserve Bulletin (August 1967); Reuben Kessel, "A Study of the Effects of Competition in the Tax-exempt Bond Market," The Journal of Political Economy, vol 79, no. 4 (July/August 1971); and Wm. Paul Smith, Commercial Bank Entry into Revenue Bond Underwriting; Competitive Impact & Public Benefits, Washington, D.C.: Office of the Comptroller of the Currency, 1968.

40/ See Report of the Senate Committee on Banking, Housing and Urban Affairs on S. 3838, S. Rep. No. 93-1120, 93rd Cong., 2d Sess. 12-13 (1974).

the past 40 years, commercial banks have been joined by investment bankers as participants and as managers of underwriting syndicates. There is a well established record of cooperation in the underwriting of general obligation issues, but little evidence of either intent or opportunity for commercial banks to engage in predatory practices or to exclude investment bankers. While commercial banks have been highly successful as underwriters of general obligation issues, investment banking houses have always played a major role as underwriters of such issues. There is also little evidence to support the theory that commercial bankers could, or indeed would wish to, exclude investment bankers from the underwriting of municipal revenue bonds. Thus, it is argued that commercial bank entry into revenue bond underwriting would not lead to an undesirable concentration of activity in commercial banks.

It is also alleged that permitting commercial banks to underwrite revenue bonds would create conflicts of interest between the banks' investment banking and fiduciary functions. Certainly a potential conflict exists between the interest of the underwriting section of a commercial bank in achieving the minimum yield for the agency offering the security issue and the goals of bank investment managers and trust account managers who seek to achieve some desirable combination of risk and return on investment. However, while the potential for conflicts exists, there is no record of actual conflicts arising from commercial bank underwriting of general obligation municipals during the past 40 years that they have engaged in such activity.41/ Since municipal revenue bonds are comparable to general obligation municipals in all essential characteristics, there is no reason to believe that actual conflicts of interest would arise in bank underwriting of revenue bonds.

Furthermore, under Federal and State law, member banks may not now sell their dealer inventory to fiduciary accounts except when lawfully authorized in the trust instrument, by local law or under specific direction of a court. However, member banks could sell their dealer inventory to their own portfolios. Moreover, most States prohibit banks from selling underwritten securities to fiduciary accounts except under specific direction of a court. In any event, it is argued that a safeguard of this nature can be easily incorporated into Federal law permitting commercial banks to underwrite municipal revenue bonds.

41/ This issue was probed extensively in 1967 hearings before the Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency on S. 1306 90 Cong., 1st Sess. (1967). Opponents of commercial bank underwriting of revenue bonds were unable to present a single instance where a bank had been guilty of a conflict of interest in underwriting and dealing in general obligation issues.

A P P E N D I X

REVIEW OF THE HISTORY, POLICIES AND OBJECTIVES OF

THE GLASS-STEAGALL

SEPARATION OF COMMERCIAL AND INVESTMENT BANKING

Table of Contents

Policies and Objectives of Glass-Steagall Act Restrictions on Bank Securities Activities

The Banking Act of 1933 (Glass-Steagall Act) enacted on June 16, 1933, was designed to deal with a variety of banking issues. The Act introduced major reforms in the areas of branch banking, deposit insurance, and securities activities of commercial banks. A primary purpose of the Act was to restrict commercial bank participation in the securities business.

This paper examines the policies and objectives of the restrictions on bank securities activities contained in the Glass-Steagall Act. The questions are why did the Congress enact such restrictions on bank securities activities, and particularly what were the abuses, actual or potential, that it was seeking to eliminate.

The Glass-Steagall prohibitions resulted from the interaction of economic conditions and preconceptions about banking theory. The 1929 crash, the subsequent collapse of the banking system and revelations concerning the abuses of the security affiliate system of the banking industry precipitated the Congressional investigation which eventually resulted in the enactment of the legislation. But, while the public outcry against the securities activities of the banking industry may have been a critical factor influencing Congress to opt for an absolute prohibition of, as distinct from regulation of, investment banking activities of commercial banks, the preconceived ideas of Senator Glass as well as his principal adviser, Professor H. Parker Willis, profoundly influenced Congress' decision.

Three objective reasons for enactment of the legislation can be identified from the legislative history. First, Congress concluded that the separation was necessary to protect and maintain the financial stability of commercial bank operations and insure public confidence in commercial banks. Second, Congress desired to eliminate the potential for conflicts of interest which could arise from performance of both commercial banking and investment banking operations. Third, Congress concluded that bank securities operations tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by diverting bank deposits into "speculative" securities investments. Underlying these judgments, however, was the belief, held by Senator Glass and others, that investment banking was outside the traditional and proper sphere of activity of commercial banks. This school of thought held that banks should confine themselves mainly to making short-term, self-liquidating loans to finance goods in the process of production and commercial transactions.

Finally, an understanding of the reasons for the Glass-Steagall restrictions would not be complete without reference to the political environment in which they were enacted.

Congressional hearingsin 1931 and 1932 disclosed egregious abuses on the part of banks and bankers in the 1920's and early 30's. These revelations led to the indictment of numerous banking directors and officials. The failure of over 4,000 banks during the period in which the Act was under consideration, together with a widely held belief that the participation of banks in speculative securities activities had contributed to the '29 stock market crash, resulted in a sense of public outrage which was reflected in Congress' actions. This loss of public confidence in the banking system was an important impetus toward enactment of the legislation.

Securities Activities of Commercial Banks Prior to Glass-Steagall Act

In its early history, the American banking system, at least in theory, held to the traditional English view -- i.e., banks which accepted deposits from the public should not engage in investment banking.1/ During the latter half of the 19th century, the national banking system generally followed, albeit imperfectly, the English practice of separating commercial and investment banking functions.

Efforts fully to conform United States practice to the English system were impeded by our dual banking structure: the state banking systems generally permitted state chartered commercial banks and trust companies to engage in investment banking. This development produced competitive forces which influenced national banking authorities to liberalize restrictions on the investment banking activities of national banks. By 1930 the institutional separation of banking functions was a thing of the past.

The National Banking Act of 1864 granted national banks:

"all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title."2/

Initially, the Act was narrowly interpreted to restrict the securities activities of national banks. National banks were

1/ Perkins, The Divorce of Commercial and Investment Banking: A History, 88 Banking L.J. 483, 485 (1971). (Hereinafter Perkins).

2/ 13 Stat. L., Ch. CVI, Sec. 8, (1864); Rev. Stat., Title LXII, Sec. 5136, par. 7.

prohibited from underwriting or dealing in the securities of entities other than the Government. Early judicial decisions prohibited bank investment in securities and stocks except when acquired to compromise a preexisting debt3/ or when taken as personal security incidental to the power to loan money.4/

Meanwhile, national banks, as a result of the limitations on their powers in the investment banking field, were placed at an increasing disadvantage in competing with state commercial banks and trust companies and private bankers in servicing large corporate clients. The trust companies, which first came to prominence after the Civil War, possessed broad powers under their state charters to engage in practically any financial activity. While they initially specialized in the administration of trusts and estate, they eventually began to solicit deposits from the public in competition with the traditional state banks.5/ Gradually, trust companies moved into the business of underwriting securities. By the end of the 19th century, the trust companies were firmly established in the commercial banking and investment banking fields.6/

The rise of the trust company caused state chartered commercial banks to demand competitive powers from their state legislatures. Their demands for broader powers were generally met so that by the turn of the century trust companies and state banks possessed generally equivalent powers and privileges in providing diversified customer services.7/

At the same time the private investment bankers which had helped develop the railroads and construct the giant corporate consolidations of the late 19th century added their expertise to the financial amalgam developing on the state level. Investment bankers needed larger and larger concentrations of liquid financial resources to provide underwriting capital and additional

3/ First National Bank of Charlotte v. National Exchange Bank of Baltimore, 92 U.S. 122, 128 (1875). The Court stated with respect to the prohibition on stock trading implied under the 1864 Banking Act that "a prohibition against trading and dealing (in stock) was nothing more than a prohibition against engaging in the ordinary course of buying and selling for profit and did not include purchases resulting from ordinary bank transactions." 92 U.S. 128.

4/ National Bank v. Case, 99 U.S. 628.

5/ Perkins at 487.

6/ For a description of the evolution of the trust companies, see Perkins at pp. 486-488.

7/ Barnett, State Banks and Trust Companies Since the Passage of the National Banking Act at 12 (Washington, 1911).

outlet for securities, and so they became dominant in state commercial banks and trust companies and organized new ones.8/

Debt

Gradually, however, the courts interpreted the clause "by discounting and negotiating promissory notes ... and other evidence of debt" to include the implied power of national banks to invest in state, municipal and corporate bonds.9/ The Comptroller of the Currency likewise interpreted this clause to give national banks the authority to invest in these types of bonds.10/ Once national banks were permitted to invest in municipal and corporate securities, it became difficult to distinguish underwriting -- i.e., the purchase of securities with the intent to resell them at a profit -- from investment in such securities. During the early 1900's the Comptroller of the Currency was content to permit national banks to underwrite and deal in municipal and corporate debt to the extent that they were entitled to invest in them.11/

8/ Friend and Miller, at 89.

9/ First National Bank v. Bennington, 16 Blatchford 53 (N.Y. 1879); Newport National Bank v. Board of Education of Newport, 70 S.W. 186 (Ky. 1902)

10/ Report of the Comptroller of the Currency, 1909, pp.8-9.

11/ Redlich, The Molding of American Banking -- Men and Ideas, Volume 2, at 389 (New York, 1951) (Hereinafter referred to as Redlich) Redlich states:

> "For many years the Comptroller of the Currency, going still further, allowed National Banks to participate in the distribution of new securities and generally to deal in securities to the extent that the banks were entitled to use them as an investment. Since National Banks almost without exception bought bonds of all types as secondary reserves occasionally, if not regularly, it was a natural step for the larger ones to participate in syndicates which enabled them to acquire at a favorable rate what they would have acquired any way. Bond departments, originally established for investing funds of the bank in question, began to act for customers and especially correspondents and finally wound up in investment banking activities. It is probably that more National Banks took syndicate participations than the few which had a special interest in investment banking ... This seems to be indicated by the fact that the holding of securities by National Banks increased continuously over the years from .59 percent of their total resources in 1863 to 9.45 percent in 1912."

Clearly, the Comptroller was motivated by the desire to keep national banks competitive with state chartered banks and state incorporated trust companies which by 1900 had evolved into integrated commercial banking and investment banking institutions.

Equity

In 1902 the Comptroller ruled that the National Banking Act did not permit national banks to participate in the underwriting and distribution of equities, "although the right of national banks to hold bonds (except mortgage bonds) and to participate in bond flotations was not contested."12/

In the face of the competition from state chartered commercial banks, trust companies and private investment bankers, the national banks soon found themselves excluded from large corporate clients because of the limitation on their services. Initially, some nationally chartered banks had tried to prevent their competitors from gaining such broad corporate privileges. However, when they found it impossible to obtain preventive legislation, many made plans to enter the investment banking field themselves.13/ The First National Bank of New York and other national banks had participated in underwriting government securities and stocks and bonds of railroads and other corporations.14/ In the face of the Comptroller of the Currency ruling that national banks cease their underwriting of stocks, the major national banks, commencing in 1908, created security affiliates chartered under state law. The affiliates were free of Federal regulation and thus able to engage in the wide range of securities activities permitted under state law, including the underwriting of corporate stocks.15/

12/ Redlich, Vol. 2 at 393.

13/ Perkins, at 489, citing H. Moulton, Financial Organization and the Economics System, 338 (New York 1938).

14/ The rise of the First National Bank of New York in the investment banking field in the period 1870-1910 is described in Redlich, Vol. 2, at pp. 389-91.

15/ Three common ways in which affiliates were formed were (1) the stockholders of the bank were given a pro rata interest in the stock of the affiliate, (2) the affiliate was carried as an investment of the bank, and (3) the security affiliate was owned by a holding company which controlled the parent bank. This last method is comparable with the modern one-bank holding company.

World War I encouraged increased participation by national banks in the securities business to finance the United States' military effort. During the first world war the government issued $17 billion in Liberty Bonds from May 1, 1917 to November 1, 1918 of which 50 percent was allotted to national banks and their clients.16/ The use of national banks for this distribution effort had a major effect on future bank operations in the securities area. As Peach notes:

> "Although national banks received no immediate pecuniary reward for their efforts, they benefited indirectly. For not only did they become familiar with the technique of distributing securities, but they gained many contacts with investors and won their confidence, partly because of their patriotic mission, partly because they offered bonds of unquestioned soundness. Individuals, formerly prejudiced against all types of securities, became security minded and potential customers for future issues of corporate securities. The banks, having once overcome the traditional skepticism of large masses of people who had saved money, found it easy to approach them a second time with other securities. The Salesmen could argue that the corporate securities which they had for sale were as safe as government bonds and the yield far in excess."17/

Thus, the Government's war bonds program allowed the banks to develop the distribution network and staff to operate in the securities business.

In addition to the use of national banks for distribution of war bonds, the Federal Reserve Board appeared to recognize the legality of the security affiliate system by officially accepting state banks and trust companies as members of the system without requiring them to relinquish their securities underwriting activities:

> "In an effort to strengthen the still experimental Federal Reserve System, state banks and trust companies were allowed to enter the new system without having to give up any of the corporate privileges granted to them by state law. The result of this decision by the Federal Reserve Board in Washington was to recognize formally the right of at least one class of member banks to engage in investment banking. Any national bank that had heretofore pondered the ultimate legality of the security affiliate system interpreted this move as a go-ahead signal to pursue profits in the investment banking field."18/

The rise of state security affiliates and the burgeoning American securities markets threatened the viability of the national banking system. The Comptroller of the Currency, as Professor Peach points out, felt this concern during the 1920's:

> "Because of competition with state banks and trust companies and the fear of driving banks out of the National Banking System, the Comptroller did not enforce the existing restrictions on the powers of national banks and suggested greater leniency in the national banking laws. From 1923 to 1927 the Office of the Comptroller was the driving force behind the legislation which conferred on national banks the power to engage in a modified securities business."19/

Moreover, developments in the financial markets during this period argued for permitting national banks to participate in the securities business. The traditional commercial loan business of banks was falling off as corporations turned to the securities markets to finance their post war expansion:

> "During the long period of prosperity before the depression many business enterprises were able to relieve themselves from dependence on commercial banks for financing their seasonal requirements. The major factor responsible for the decline in commercial loans was not that banks showed a dislike for this type of loan but that borrowing corporations were able to obtain funds by what seemed to them more desirable methods. The most usual method by which bank loans were reduced was through excess of earnings over dividends or through new stock issues. The effect was to reduce the indebtedness of the corporations . The opportunity to liquidate their commercial loans and their bonded indebtedness, presented by nearly a decade of prosperity accompanied by an active and rising stock market, was seized upon by the stronger and more successful companies."20/

16/ W.N. Peach, The Security Affiliates of National Banks at 31-32 (Baltimore 1941) (Hereinafter referred to as Peach.)

17/ Peach, at 32-33.

18/ Perkins at 419, citing Charles S. Tippetts, State Banks and the Federal Reserve System at 109-112 (New York, 1929).

19/ Peach at 150.

20/ Peach at 24-25.

With demand for loans falling and increased competition from state chartered institutions, the national banks found it necessary to compete with state banks in the area of securities underwriting and distribution to which they had been earlier introduced by the Federal Government.

The Comptroller responded to this situation by requesting in his 1924 annual report that legislation be enacted to allow national banks to buy and sell investment securities other than stocks. The Comptroller based his reasons for the proposed amendment on the ground that "the provision would make very little change in existing practice since a great number of national banks now buy and sell investment securities and the Office of the Comptroller has raised no objection because this has become a recognized service which a bank must render" (emphasis added).21/ It is clear from the Comptroller's 1926 annual report that the major fear behind the liberalization movement was the growing defections from the national bank system which were "clearly indicative of the difficulty which national banks find in operating under their present charter powers."22/

This concern was not so much over the number of member banks, but rather the comparison between assets held by state and national banks -- with state bank assets growing and national bank assets stagnating. The fundamental concern was that the Federal Government was "gradually losing its positive and immediate control over the instrumentalities of commercial credit and over the membership in the Federal Reserve System."23/ In response to this fear, the Comptroller strongly supported enactment of a bill to allow branch banking as well as the underwriting of investment securities by national banks. This bill, the McFadden Act, was enacted in February, 1927.

The McFadden Act reaffirmed the power of national banks to underwrite certain investment securities.24/ The Comptroller of the Currency was given the duty to determine what type of securities were eligible for national banks to underwrite. In effect, this legislation resolved the question of bank participation in the securities business by providing for regulation, not prohibition. Although the Comptroller initially restricted the approved list to debt securities, it was later expanded to include equities.

The passage of the McFadden Act, coupled with the rising stock market, stimulated greater participation by commercial banks in investment banking. Commercial banks increased their participation in underwritings of new bond issues from 37 percent in 1927 to 61 percent in 1930.25/ By the end of the 20's the commercial banks, both state and national, became the dominant force in the investment banking field.

Criticism of the Integration of Commercial Banking Prior to Glass-Steagall Act

The gradual integration of commercial banking and investment banking during the period 1860-1930 represented a natural institutional development in response to the changing needs of an increasingly industrialized economy. However, this process of integration developed in direct conflict with the predominant banking theory of the era, which advocated the separation of commercial banking from investment banking and opposed the use of bank funds for "speculative" purposes. This theory was manifested in the legal restrictions imposed on the securities activities of national banks, which were not formally lifted until the passage of the McFadden Act in 1927.

This theoretical opposition to the integration of commercial banking and investment banking was further expressed at one time or another by various segments of Congress, the leading banking scholars of the day and by the Comptroller of the Currency.

21/ Annual Report of the Comptroller of the Currency, 1924 at 12. In the report, the Comptroller suggested that the power to buy and sell stocks not be included "since these do not evidence indebtedness," a reference to Federal court interpretations of the National Banking Act and the continued distinction made between debt and equity investments.

22/ Annual Report of the Comptroller of the Currency, 1926, at 2.

23/ Id. at 3.

24/ The bill was purposely couched in terms of reaffirming the authority of national banks under preexisting law to engage in the underwriting of securities, rather than granting a new power. H.Rep, 83, 69th Cong., 1st Sess. 2 (Jan. 12, 1926).

25/ Perkins, Appendix 1, at 527

Pujo Hearings

As early as 1912, Congress critically examined the movement of the commercial banks into the investment banking field. During that year, the Pujo Committee 26/ conducted an investigation of the concentration of money and credit in the so-called "money trust" 27/ and questioned the legal authority of national banks to engage in the underwriting of bonds and stocks. 28/ As a result of its investigation, the Committee recommended legislation to prohibit national banks from participating in the underwriting of corporate securities. 29/

26/ The Pujo Committee was a subcommittee of the National Monetary Commission, which was established by Congress to study and recommend any necessary changes in the money and banking system to prevent a recurrence of banking panics such as that experienced in 1907. The Commission's recommendations eventually led to the establishment of the Federal Reserve System in 1913.

27/ The money trust, in the words of Committee constituted:

> "An established and well defined identity and community of interest between a few leaders of finance which has been created and is held together through stock holdings, interlocking directorates, and other forms of domination over banks, trust companies, railroads, public-service and industrial corporations, and which has resulted in a vast and growing concentration of control of money and credit in the hands of a comparatively few men."

Report of the Committee to Investigate the Concentration of Money and Credit, 62d Cong., 3rd Sess., at 130 (1913). (Hereinafter Pujo Report.)

28/ Pujo Report at 151-152. The Committee's case presented in these pages denied the legality of banks' purchase and sale of equities and expressed "grave doubt of the power of national banks to buy and sell bonds." But the Committee focussed on bank underwriting activities primarily because they generated "abnormal" profits for the banks and gave the money trust great leverage over industry capital raising activities. (Pujo Report at 152.)

29/ Id. at 170. The Committee was convinced that "however well... founded may be the assurances of good intentions by those now holding the places of power which have been thus created, the situation is fraught with too great peril to our institutions to be tolerated. (Pujo Report, p. 133).

The principal motivation for this proposal lay in the Committee's concern over the domination of the securities underwriting industry by a few private investment bankers who thereby possessed effective control over the development of American industry. 30/ The Committee feared that this private group, through its increasing affiliation with the large commercial banks and trust companies, was consolidating its control of the securities underwriting business, and believed it possible to check this alarming trend toward concentration of money and credit by prohibiting national banks from engaging in securities underwriting, thereby eliminating the incentive for the "money trust" to seek their control. It was hoped that the states would enact similar restrictions on the securities activities of state commercial banks and trust companies. 31/

The Pujo Committee's recommendation to restrict national banks from underwriting was based also on the belief that the flotation and distribution of new corporate issues was not the proper function of banks. The resources of banks should be devoted "to supplying the needs of the commercial community" and not to the financing of speculative securities issues. 32/ This reasoning reflected the orthodox "commercial loan" theory of banking which was strongly to affect the shaping of the Glass-Steagall legislation twenty years later. This theory is explained by Perkins as follows:

> "Banking experts believed that the financial system was subject to 'Scientific' analysis. This analysis, as proven in England, demonstrated that if banks limited their lending activities to loans for bona fide commercial purposes, the entire economic system would automatically adjust to the 'needs of trade.' Depressions, when unavoidable, could at least be prevented from causing chaos and panic in commercial banks. Beyond the establishment of a sound system of finance, nothing could be done to promote economic stability except to educate bankers to use good judgment and to increase bank examinations by outside auditors. In their outlook was an aura of fatalism. The logical source of funds for permanent capital investment in the economy was from 'real savings' of the populus, not bank deposits." 33/

30/ Pujo Report at 134-35

31/ Id. at 153.

32/ Id.

33/ Perkins at 501. This theory is further discussed at pages infra.

While the Pujo Committee's investigation influenced the shape of the Federal Reserve Act and the Clayton Antitrust Act of 1914, Congress failed to act on any of its recommendations, including the recommendation to limit the underwriting activities of national banks. Several factors accounted for this failure. President Wilson kept the Congress preoccupied with more pressing business, and many Senators and Congressmen felt that the investigation had not been conducted in an impartial and objective manner.34/

Criticism of the Comptroller of the Currency

The Comptroller of the Currency vacillated from one policy to another on the question of the proper role of national banks in the securities field and suggested appropriate legislation with each approach. At times, the Comptroller followed a policy of liberal interpretation of the powers of national banks in this area in order to enhance their competitive position vis-a-vis the State banks and trust companies. At other times, the Comptroller expressed concern that securities operations of national banks jeopardized the soundness of their normal commercial banking business and urged restraint. In its annual report of 1920, the Comptroller pointed out some of the dangers of the security affiliate operations of national banks.35/ The Comptroller noted that the promotion of securities underwritings and speculative ventures by banks could threaten the liquidity and soundness of bank assets. Fear was also expressed that unprofitable flotations by security affiliates had in the past damaged the reputation and credit of national banks.36/

As with the Pujo Committee findings, the Comptroller suggested that "Congress enact such protective legislation as the facts, obvious tendencies, and equally obvious peril of the future so clearly demand." But, just as with the Pujo Committee's legislative suggestions, no legislation was passed by Congress to reflect these views. However, by 1924, the Comptroller was pressing for legislation to "reaffirm" national bank underwriting powers and this time the Congress acted with passage of the McFadden Act.37/

Ideas of Senator Glass and Professor Willis

The gradual integration of commercial banking and investment banking ran counter to the orthodox "commercial loan" banking theory of the times. Both Senator Carter Glass and Professor H. Parker Willis had been leading proponents of this school of thought. Because these men were the principal movers of the

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34/ Carosso, Investment Banking in America 138, 176 (1970).

35/ Annual Report of the Comptroller, 1920, at 55-56.

36/ Id.

37/ See pages 8-9, supra.

Glass-Steagall legislation, it is important to understand their ideas concerning the role of the banking system.

Senator Glass and Professor Willis had been the principal draftsmen of the Federal Reserve Act of 1913. In their view, the Federal Reserve Act had been enacted for two purposes:

> "the first that of absolutely preventing the use of bank reserves in speculative lines; the other that of making sure that the loans of the reserve banks were always liquid and based on actual transactions in business. The two things are quite different in a way, but they are the obverse and the reverse sides of the same situation."38/

Senator Glass and Professor Willis explained their philosophy of banking during testimony in 1928 before the Senate Committee on Banking and Currency on a proposal to restrict loans by Federal Reserve banks for speculative purposes. Both Glass and Willis reiterated their convictions that the proper role of commercial banks was to allocate capital through commercial loans to productive uses and not for "speculative" purposes. They emphasized that this was the fundamental premise on which the Federal Reserve System was founded.39/

More importantly, Willis and Glass felt that corporate financing through the public securities markets acted against the public interest. This is revealed in the following Willis testimony which also explains the role he saw for commercial banks. Speaking about securities financing he states that:

> "It diminishes the desirable control by the banks, and their regulation of business expansion. My thought about a bank is that it is in a sense a public-service corporation. One of its functions is that of shifting capital into the various lines in which it ought to go . If a business house now gets its capital not from the bank but from thousands of investors who never look into the statements, who never attend a stockholders' meeting, and never do any thing except draw their dividends and spend them, the tendency in business is to separate itself from this kind of supervision and consequently to do things that are not, on the

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38/ Hearings before the Senate Committee on Banking and Currency on S. Res. 113, 70th Cong., 1st Sess. at 16 (1928). (Hereinafter referred to as Brokers' Loans Hearings).

39/ As Senator Glass noted with regard to speculative loans:

> ". . . the thought which the proponents of the Federal Reserve System had was that we should have a system that would meet the requirements of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as unproductive operation of stock and commodity gambling." Brokers' Loans Hearings at 53.

whole, in the interest of the community . . . it has been released from one of the types of control that under our capitalistic system has been established for the purpose of regulation.

The effect of that is that business tends to push ahead and expand largely, to adopt methods of selling its goods, etc. and to act in ways that it would not if it was subject to satisfactory banking control.

Perhaps the best illustration of that is the overcapitalized condition of much of our manufacturing industry in the United States today [1928]. We have a great deal of idle plant capacity, and that is due, of course, to the fact that businesses have been allowed to get more capital than they really needed."40/

This fear of corporate financing through the securities markets had evidenced itself during the Pujo hearings and was to resurface during the Glass-Steagall hearings of the early Depression. Willis and Glass believed that the banker should loan money only for the production of goods and only to the extent that the loan was covered by the market price of the goods or commodities. This view sees the banker as "essentially one who concerns himself with facilitating the movement of goods into actual consumption, the basis of his loans being found in the consuming power of the community."41/ The opposing school of thought, which had captured the banking community of the post war era, maintained, according to Willis, that "soundness of banking seems best tested by the ability of the bank to effect the sale of assets rather than the ability of bank customers to obtain the liquidation of their holding of goods . . . and that the ability to convert bank assets or deposits into money depended upon the maintenance of a satisfactory market for obligations which the bank was holding."42/

Willis believed that Congress had succeeded in blocking speculative operations by the new Federal Reserve Board in the 1913 legislation:

"The system, itself, bottomed as it was on British practice and developed upon the basis afforded by British-banking thought, was from the first organized with the idea of banking liquidity as its controlling motive. Its constituent act forbade the making of loans for the purpose of speculation or the carrying of investment securities, and directed that rediscounting by the Reserve banks be done solely for the purpose of effecting the exchange of goods. Indeed, every safeguard that was possible was applied in the framing of the act with a view to preventing it from surrendering the fundamental standard of liquidity to which it had been subjected in the first instance."43/

But he saw this theory undermined by the Board itself when during the war banks were asked to finance government securities -- something quite different from their normal and desirable commercial functions. As Willis notes:

"It was an easy transition, after the war was over, from a portfolio [of government securities] . . . to a situation in which the central-banking system was conceived of as dealing largely in such bonds and in advancing its funds for any purpose for which they might be desired or needed . . . Speculation was thus given an entree into the Federal Reserve System, and the underlying basis of its existence was altered.

During the decade 1920-1930, Reserve banking authorities seldom allowed themselves to fall back upon, or even to take seriously, the original principle upon which the system had been organized, and a very large portion of their portfolios came to consist either of securities primarily, or of loans protected by such securities as collateral. The outcome was to make the Reserve banks dependent quite as truly as any other banks upon the ability of the community to purchase, pay for, and hold or absorb issues of bonds, stocks and other securities. Accordingly, when the strength of the financial structure was put to a test, as it was in 1929, the result was to force it to fall back upon a dependence on general conditions in the stock market."44/

Thus, when the crash came Willis, Glass and the other "liquidity" theorists, who believed that the Federal Reserve System had been abused by allowing banks to engage in speculation, attacked those aspects of banking which ran contrary to their theories. Not too surprisingly, their first target was the use of bank loans for securities speculation, and the second was the use of banks as underwriters and dealers in securities. However, while the crash may have reaffirmed their own belief in the desirability of returning to "anti-speculative" banking practices, this rationale did not prevail. It was the revelation of scandalous self-dealing by bank directors via security affiliates which ignited a public clamor for Congressional reform of the banking structure.

40/ Brokers' Loans Hearings at 23-24.

41/ Willis and Chairman, Banking Situation, at 31 (1934).

42/ Id.

43/ Id. at 32.

44/ Id. at 33.

Glass-Steagall Legislation

The erosion of the nation's banking structure caused the Senate Banking and Currency Committee to conduct, under the leadership of Senator Glass, a broad investigation of the banking structure during 1931 and 1932. His ideas remained the same as those that had forged the 1913 legislation, but this time he was determined to rid the banking system of the speculative forces that had caused severe difficulties. Consequently, the Glass Committee focused on where and how the banks had diverted capital to speculative uses.

During the course of his investigation, Senator Glass became convinced that a separation of the commercial banking and investment banking functions was in the best interests of the banking system. But he believed that such a radical proposal had little chance of passage in the political environment of 1930. Accordingly, he proposed legislation calling for immediate Federal examination and regulation of security affiliates and, over a 5 year period, the absolute divorce of the commercial banking and investment banking functions.45/ The strategy was to use the most severe provision; namely the divorce of the commercial and investment banking functions, as an inducement to gain acceptance of the less severe remedy -- i.e., the examination and regulation of security affiliates -- favored by a majority of the Committee.46/

45/ Perkins at 505.

46/ The Committee focused on three alternative courses of policy: "(1) severe inspection and regulation of the affiliates under penalty of expulsion of the parent bank from the Federal Reserve System should the desired inspection be refused; (2) organization of the affiliates under Federal charters with penalties applied to member banks if they permitted themselves to operate in conjunction with any affiliate not federally chartered; (3) complete separation of the affiliates from the parent banks." Willis and Chapman, The Banking Situation, at 68.

The Committee rejected the second option, not for policy reasons since, in fact, this procedure had been followed with respect to the organization of railway affiliates, but rather because "the Committee recognized that to propose a comprehensive plan for such Federal incorporation would be a task of lengthy character, while it was hoped the proposed Glass bill might find a fairly prompt reception -- of course, if it were held to more simple terms. Id.

With respect to the two remaining options, the Committee at first favored the first option of subjecting the affiliates to stringent regulation. Senator Glass, during the 1932 Senate floor debate on the bill, explained the decision that had to be made between regulating or prohibiting security affiliates of member banks. Senator Glass indicated that some of the Committee felt that it would be better to subject security affiliates to Federal regulation and examination, rather to require their separation from member banks and leave them to State regulation. 75 Cong. Rec. 9888 (May 10, 1932).

Reasons for Adoption of Glass-Steagall Act

As noted above, the views of Senator Glass, Professor Willis and others concerning the proper role of the commercial banking system in controlling the supply of credit available to the economy 47/ significantly influenced the decision to divorce commercial banking from investment banking. It is clear that these preconceptions were widely shared within Congress, as well as among the public at large. Members of the Glass Committee and the general public believed at the time that the securities activities of banks contributed to and accentuated the economic collapse. They believed that the banking community, as the depository of individual savings and the institution which created credit, bore higher standards of responsibility as a result of its crucial position of influence over the state of the economy.

The legislative history demonstrates the intensity of Congress' feeling in this regard. Representative Fish, a member of the House Subcommittee, which considered the Glass-Steagall Act, blamed the bank security affiliates for the speculation of the 1920's which led to an over-expansion of productive capacity and the subsequent crash. His comments reflected, in more simplistic terms, the views of the Progressives including Glass and Willis. Fish noted:

> ". . . There is nothing new about this depression, as far as the principle involved. It is exactly the same as any other. There was an enormous inflation brought about because of the mass overproduction of stock, bonds, and other securities largely emanating from these [bank security] affiliates, which were sold to the American people often without much investigation, and as a result it meant a mass over production of factories, commodities, real estate, and everything else -- an enormous inflation that sooner or later had to crash and when it did crash and the pendulum swung back, it did not stop at normalcy but went right on down into the depths where we are now."48/

The Subcommittee report further emphasized the theme that bank securities activities had tended to exaggerate capital investment, speculation and economic growth:

> "During a period of widespread confidence and active business, the stimulation of the capital market resulting from rapidly increasing bank loans on securities and bank purchases of bonds tends to stimulate capital investment far more than would otherwise be the case. At the same time the overdevelopment that ordinarily occurs in various fields during such a period is correspondingly exagger-

47/ See pages 13-15, supra.

48/ 77 Cong. Rec. 4028 (1933) (remarks of Representative Fish).

ated, making the subsequent reaction and period of deflation and liquidation all the more severe. The experience of the past 10 years lends spectacular confirmation to the view that the more intensive participation by commercial banks in the capital market exaggerates financial and business fluctuations and undermines the stability of the economic organization of the country.

The further participation by the banks in the security markets through security affiliates has the same general effect, since these companies tend to rise to the forefront of activity in the capital market during active periods, because of their strong connections with the banks, while in deflation periods the possession of large portfolios of securities and lack of a large outside demand for issues they sell tend to make all of them relatively inactive."49/

While these arguments might seem extreme today, they were very forceful at the time and, as noted earlier, reflected the ideas of an influential school of banking thought.

Abuses of Security Affiliates Identified by Glass Subcommittee

In its investigation of the banking system, the Glass Subcommittee identified multiple abuses that arose primarily through attempts by commercial banks to promote the underwriting operations of affiliates.50/ Commercial

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49/ Hearings Pursuant to S. Res. No. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess., Part 1, at 1001 (1931).

50/ Senator Bulkey, a member of the Subcommittee described the temptations of commercial banks to use their powers and resources improperly to promote their securities activities:

> "While the banks competed with each other in the business of finding and distributing issues of investment securities, yet they had at all times one great common interest -- none of these profits could be made unless the condition of the securities market was such as to assure the absorption of securities . . . Can there be any doubt that under such pressure of competition there was an overproduction of capital securities? Can there be any doubt that in order to maintain the market conditions which would absorb the great production of capital securities and produce the big profits for the affiliates and bond departments commercial banks went astray by encouraging an overdevelopment of collateral security loans?" 75 Cong. Rec. 9911-12 (May 10, 1932).

banks promoted their security affiliates by loans and by purchase of securities from these affiliates, either for their own account or the account of trusts under bank management. The misuses of these commercial banking operations to promote security affiliates also represented serious conflicts of interest between the bank's responsibility to its depositors, shareholders, and customers and its promotion of the affiliate. The Committee found that this conflict promoted neither the interests of the bank nor the security affiliates, but rather those of bank directors and other insiders who stood to profit more from their role in the underwriting affiliate than as directors or bank shareholders.

The Subcommittee also concluded that the desire of large metropolitan banks to promote their securities business led them to abuse their relationships with regional correspondent banks which often relied on them for investment advice. The large banks used their correspondents for the distribution of securities underwritten by security affiliates. The Subcommittee pointed out the pervasive conflict of interest that infected this relationship.51/

The banks' lending authority was used to promote security affiliates in several ways. Banks made loans to their own affiliates to finance underwriting activities and financed for customers the purchase of securities underwritten by their affiliates. In addition, funds were loaned to corporations which agreed to use bank affiliates for underwriting their securities issues.

Congress focused on the possibility that these loans might be made on terms which did not reflect objective lending policies and thus jeopardize depositors' funds. The Glass Subcommittee noted that a bank may "lend much more freely to customers on issues sponsored by the security affiliate, in order to facilitate their distribution, than it would otherwise do. Also, it may prove more

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51/ Senator Bulkey described this conflict during the floor debate:

> "Can any banker imbued with the consciousness that his bond-sales department is, because of lack of securities for sale, losing money and at the same time losing its morale, be a fair and impartial judge as to the necessity and soundness for a new security issue which he knows he can readily distribute through channels which have been expensive to develop but which presently stand ready to absorb the proposed security issue and yield a handsome profit on the transaction?
>
> It is easy to see why the security business was overdeveloped and why the bankers' clients and country bank correspondents were overloaded with a mass of investments many of which have proved unfortunate." 75 Cong. Rec. 9911, (May 10, 1932).

difficult to insist upon the maintenance of adequate margins on these security loans than on other such advances, in view of the fact that customers are encouraged to make loans by the bank's own affiliate."52/

In the case of loans made by the bank to its underwriting affiliate, the concern was that the bank would fail to require adequate collateral, or would overvalue securities placed as collateral for loans. In those instances where loans to a single affiliate exceeded the existing legal limit of 10 percent of the bank's capital and surplus, this legal restriction was circumvented either by increasing the number of affiliated underwriters or by using repurchase agreements (i.e., the affiliate would agree to repurchase at an agreed price securities placed with a bank as collateral). These transactions were viewed by bank authorities as investments and not loans.

The Subcommittee concluded that these loan abuses resulted in commercial banks assuming undue risks. The Subcommittee also found that in declining markets, banks placed even more funds at risk in order to protect security affiliates whose collapse might threaten the bank's own viability, or diminish public confidence in the bank. In this regard, the failure of the Bank of the United States in 1930 was often cited by the Subcommittee as an example of the erosion of a commercial bank's soundness which could result from unsound loans made to security affiliates.

Apart from the possible abuses of the commercial bank's lending powers in promoting their underwriting affiliates, Congress was also concerned about other threats to the financial position of the parent bank. The bank might purchase securities from an affiliate to assure the success of an underwriting effort or to relieve the affiliate of excess holdings. These investments on the part of commercial banks, it was believed, could seriously affect the bank's financial solvency, especially in cases where the bank repeatedly utilized its purchasing power to support a floundering security affiliate.

In fact, the Senate Banking and Currency Committee found that a major cause of the failures of commercial banks during the early 1930's had been the extensive investment of bank assets in long-term securities, many of which were acquired from security affiliates:

> "A very fruitful cause of bank failures, especially within the past 3 years, has been the fact that the funds of various institutions have been so extensively tied up in long-term investments. The growth of the investment portfolio of the bank itself has been greatly emphasized in importance by the organization of allied or affiliated companies under State laws, through which even more extensive advances and investments in the security markets could be made."53/

52/ Hearings before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess., Part 1, at 1064 (1931).

53/ S. Rep. No. 584, 72d Cong., 1st Sess., at 8 (1932).

The Glass Subcommittee also pointed out that, in the case of a trust company or a commercial bank with a trust department, "the possession of a security affiliate may adversely affect the independence with which fiduciary activities are exercised."54 The fear was that such trust companies or banks would be encouraged to purchase for their trust accounts securities underwritten by their affiliates.

The Subcommittee also recognized that affiliates could be used to conceal the existence of bad bank investments. Its report states that, "The existence of the affiliates may induce the bank to make unwise commitments, in the knowledge that in case of need they can be shifted to the affiliates, and thus be removed from the bank's condition statement."55/

Another abuse perceived by the Subcommittee was the affiliate's manipulation of the bank's own stock. This could result in wide fluctuations of the stock's price which the Subcommittee believed could affect the bank's financial condition. The Subcommittee report states that, "Operations by the affiliate in the market for the bank's own stock may cause undesirably wide fluctuations in the latter. Also, efforts made in some cases to push the sale of the bank's stock through the affiliate to depositors of the institutions hurts the position of the bank when its shares suffer a major market decline subsequently."56/ The Subcommittee also pointed out that the underwriting activities of affiliates may adversely affect the goodwill of a bank with its depositors when the latter suffer substantial losses on security issues purchased from affiliates.57/

But what attracted the most public attention was the degree of self-dealing by bank officers and directors in the operation of security affiliates. Those who profited most from the misuse of commercial bank powers to promote security affiliates were those bank officers who, as partners in affiliated underwriting firms, stood to gain more than they were risking as bank shareholders. These directors took advantage of their positions in the bank to risk the bank's assets for the benefit of their own underwriting and distribution operations.

Impact of Public Opinion and Changing Economic and Political Events

During 1931 and 1932 Senator Glass' proposal to divorce commercial and investment banking met with stiff resistance from the banking industry, the Administration and the Federal Reserve Board. 58/ A broadly representative group of banking interests protested the proposal during hearings on the Glass bill in March, 1932. As a result,

54/ Hearings before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess., Part 1, at 1064 (1931).

55/ Id.

56/ Id.

57/ Id.

58/ Peach at 154.

the Senate failed to take up the bill in 1932 and it was carried over to the next session.

President Roosevelt's election in November, 1932 greatly enhanced the prospects for passage of the Glass bill, for the Democratic platform supported enactment of legislation to divorce commercial and investment banking. 59/ After the President-elect generally endorsed the Glass bill, the Republican controlled Senate passed the bill in the lame duck session, apparently fearing that any banking legislation enacted in the next Congress would be even harsher on the financial community.

There were other forces at work that weakened and finally overwhelmed opposition to the divorce provision of the Glass bill. First, the financial community was preoccupied in early 1933 with what it viewed as two far more radical and dangerous legislative movements that were to lead to the creation of Federal deposit insurance and the enactment of the Securities Act of 1933. These legislative proposals overshadowed the concern of the banking industry over the divorce issue.

Secondly, the depressed condition of the securities markets in 1933 made divorce of investment banking much less objectionable to commercial bankers. The Glass restrictions on investment banking would provide an excuse for phasing out the currently unprofitable securities underwriting operations of banks.

The events of the first six months of 1933 dealt a final blow to opponents of the divorce of investment and commercial banking. Public confidence in the banking system reached a low ebb during this period in the face of increasing bank failures and the declaration of various state bank holidays and a national bank holiday on March 5, 1933. Bank failures often were accompanied by the indictment of bank officials for fraud and forgery. 60/

The Senate Banking and Currency Committee investigation into the stock exchange practices at the request of President Hoover further incensed public opinion against bank security affiliates. During February and March, 1933, concurrent with Congress' consideration of the Glass bill, the Committee conducted hearings on the activities of the National City Bank and its security affiliate, the National City Company. Under the leadership

59/ Perkins at 518.

60/ Peach summarizes the developments of the first six months of 1933 that eventually lead to the passage of the Glass-Steagall Act. Peach at 155-59.

of the Committee's Counsel, Ferdinand Pecora, the Committee made headline news for months by exposing the abuses of the National City Bank affiliate.

The hearings revealed stories of people who had lost their life savings as a result of National City Company's investment of their funds (though not as depositors in the bank) in exotic foreign bonds and speculative securities. Much was made of the promotional aspects of the National City Company and the lack of information disseminated to the purchasers about the type of securities which they were acquiring. "Since truth-in-securities legislation still lay in the future, National City broke no law, but it did offend the public's sense of fair play and social responsibility."61/

The undesirable promotional and sales activities were confined mostly to the security affiliate, but:

> "Pecora apparently wanted the [Bank] officers to admit that the National City Company was a mere alter ego for its affiliate bank, [and] that the bank traded in bonds and stocks through the thin legalization of the company. Moreover, he attempted to show that the bank was trading in its own stock through the same affiliate... Both New York State and Federal laws forbade a bank to deal in its own stock or that of any other bank. Technically, the National City Company traded National City Bank issues; yet the affiliate existed to circumvent those State and Federal statutes. Two in law, one in practice -- the twins offered an annoying ambiguity in ethics."62/

In addition, the immense salaries, which bankers were paying themselves either directly or indirectly through their security affiliates, influenced public opinion. The Senate hearings revealed that a portion of annual profits of National City Company and the bank was distributed among the bank officers to compensate them for what they might have received as partners in private banking house.63/ This "management fund" totaled "twenty percent of the bank's net earnings after 8 percent of capital, surplus, and undivided profits had been deducted from the net operating expenses of the year."64/ With many banks around the country failing or on the brink of bankruptcy, the public was incensed to learn that a few bank

61/ Kennedy, The Banking Crisis of 1933 at 120 (1973).

62/ Id. at 121.

63/ Id. at 123.

64/ Id.

officials were paying themselves massive salaries to benefit from the securities speculation which, it was believed, had led other banks to ruin.

Public outrage was widespread. The pressure of Congress was intense and soon even the commercial bankers themselves were willing to do whatever was necessary to divert attention from their operations. As Kennedy notes:

> "The sections of the Glass bill dealing with commercial and investment banks, however, represented a curious and timely meeting of minds of the diverse sections of the country and of the banking community. Although this separation had been central to the Senator's concept of his bill, until the spring of 1933 it had met with vigorous attack, particularly from Wall Street. The Pecora hearings changed that attitude. The sensational manner of these hearings, as well as their timing on the eve of the national [bank] moratorium, inflamed public resentment. Outrage centered upon the security affiliates, since by 1930 they were sponsoring 54.4 percent of all new securities issues.
>
> Events as much as publicity acted against the affiliates. The banking crisis had already forced a separation of commercial and thrift accounts. Segregation of new deposits so that they would not be used to pay off liabilities of old deposits became a usual procedure on reorganized or reopened banks after the holiday. In the midst of the collapse Winthrop W. Aldrich, new chairman of the Chase National Bank, announced that his bank (controlled by the Rockefeller interests) would completely sever its investment affiliates so that the commercial banks would not be smeared with the spirit of speculation. Aldrich generously suggested a program whereby the rival house of J. P. Morgan and Company could follow his good example. Other bankers writing to the President at the same time frequently included an announcement that their bank had never been involved in the securities business or that it was now abolishing its affiliates.
>
> Glass welcomed added support for what he regarded as the paramount issue in his bill and he included in the final draft a provision for complete separation of investment banking from commercial activities of members of the Federal Reserve System." 65/

65/ Id., at 212-13.

Conclusion

Many of the concerns which underlay Congress's decision to divorce commercial and investment banking appear to have been resolved by subsequent regulatory measures. The Securities Act of 1933 provided investors with protection against abuses relating to providing false or misleading information in connection with securities underwritings. Such practices by affiliates and other underwriters contributed in large measure to the public condemnation of bank security affiliates after the 1929 crash. The Securities Exchange Act of 1934 and the 33 Act also provided investors with protection against insider self-dealing in securities.

In addition, the Bank Holding Company Act of 1956 provided for the supervison by the Federal Reserve Board of the non-banking affiliate operations of banks. 66/ Federal and state laws provide stringent standards for fiduciaries exercising investment discretion on behalf of public investors. All of these developments tend to reduce the potential for the abuses of security affiliates which occurred in the 1920's and 1930's.

Section 7 of the Securities Exchange Act of 1934 authorized the Federal Reserve to regulate the extension of bank credit to purchasers of securities. 67/ This provision satisfied a principal objective of Senator Glass: to control speculative uses of commercial bank assets in the securities markets. Professor Willis had early recognized that the mere separation of commercial and investment banking did not alone solve the problem of the excessive diversion of bank resources to the securities markets. 68/

Insofar as the separation of commercial and investment banking may be in part based on the banking theories of Willis and Glass, which viewed the banking system as the most efficient means of allocating capital to American business, and distrusted the ability of securities markets to perform this function, these theories should be thoroughly reviewed in light of current economic thought. 69/ Such a reevaluation is also

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66/ 12 U.S.C. Secs. 1841-48 (1970).

67/ 15 U.S.C. Sec. 78g (1970).

68/ Willis and Chapman, The Banking Situation at 70 (1934).

69/ Most economists today generally assume that securities markets efficiently allocate capital to corporate business. See, generally, Fama and Miller, Theory of Finance. (New York 1972).

warranted by the major regulatory developments which, in part, serve to protect investors, depositors and the banking system from potential abuses arising from the integration of the commercial and investment banking functions.

It appears, however, that some of the inherent conflicts that arise between commercial and investment banking remain valid concerns even in light of the development of securities and banking regulation since 1933. Further analysis is required to determine whether and the extent to which this may be true.

69/ Cont'd

West and Tinic, The Economics of the Stock Market, 2-4, (1971); Baumal, The Stock Market and Economic Efficiency, 1, (1965). Some commentators challenge this assumption questioning whether the market actually serves the function of accurately valuing corporate stocks and thereby efficiently allocating capital. See, Soloman, Institutional Investors: Stock Market Impact and Corporate Control, Geo. Wash. L. Rev. 761, 766, (1974) citing Smith, The Money Game, 12, 23, 44-47, (1968).

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THE WHITE HOUSE

WASHINGTON

July 9, 1975

SIGNING CEREMONY FOR ENROLLED BILL S.2003
THE INTERNATIONAL AND DOMESTIC TOURISM PROGRAMS

Wednesday, July 9, 1975
3:00 p.m. (10 minutes)
The Rose Garden

From: Jim Cannon

I. PURPOSE

- To sign enrolled bill S.2003, which reinstitutes a domestic tourism program and authorizes appropriations for the international and domestic tourism programs of the U.S. Travel Service (in the Department of Commerce).

- To eliminate any ill will which remains from your May 28 veto of similar tourism legislation.

II. BACKGROUND, PARTICIPANTS, AND PRESS PLAN

A. Background: You have agreed to sign enrolled bill S.2003, which reinstitutes a domestic tourism program to encourage Americans to travel within the United States and authorizes $90 million of appropriations through fiscal 1979 to expand the current program of foreign tourism promotion in the United States.

On May 28, 1975, you vetoed similar legislation because you opposed reinstatement of a domestic tourism program and because the program authorization level was about double your request.

The current compromise is basically identical to the vetoed bill, except that it only provides support for domestic tourism programs "which are in the public interest and which do not compete with activities of any State, city or private agency."

B. Participants:

Rogers C. B. Morton, Secretary of Commerce
David N. Parker, Acting Assistant Secretary for Tourism
James Sparling, Assistant to the Secretary of Commerce for Congressional Affairs
Jim Cannon
Jack Marsh
Max Friedersdorf
Bill Baroody
Paul Leach
Congressional and industry participants listed at Tab A.

C. Press Plan: Full press coverage

III. SIGNING STATEMENT

Attached at Tab B.

A

PARTICIPANTS

SENATORS

Warren G. Magnuson
John O. Pastore
Daniel K. Inouye
Vance Hartke
Howard W. Cannon
Wendell H. Ford
Frank E. Moss

James B. Pearson
Roman L. Hruska
James L. Buckley
Robert P. Griffin
Ted Stevens
J. Glenn Beall
Hugh Scott

CONGRESSMEN

Harley O. Staggers
Fred B. Rooney
Brock Adams
Ralph H. Metcalfe
W. G. Hefner
Jim Santini
James J. Florio
John M. Slack

John Rhodes
Samuel L. Devine
Joe Skubitz
James F. Hastings
Elford A. Cederberg

PRIVATE INDUSTRY

James A. Henderson
Executive Vice President
American Express Company

Kenneth E. Hickel
President
Best Western, Inc.

M. William Isbell
President and Chief
Executive Officer
Ramada Inns, Inc.

Howard P. James
Chairman and President
The Sheraton Corporation

Jerry N. Jordan
President
Thomas Cook, Inc.

Roger Manfred
President and Chief
Executive Officer
TraveLodge International, Inc.

J. Willard Marriott, Jr.
President
Marriott Corporation

Winston V. Morrow
Chairman and President
Avis Rent A Car System, Inc.

William B. Walton
Vice Chairman of the Board
Holiday Inns, Inc.

Barron Hilton
President
Hilton Hotels Corporation

James L. Kerrigan
President
The Greyhound Corporation

Tom Donnelly
Walton's Washington Representative

C. Langhorne Washburn
former Assistant Secretary
for Tourism

Harry Mullikin
President
American Hotel and
Motel Association

Robert McMullen
American Society of
Travel Agents

Bob Juliano
Washington Representative
Hotel and Bartenders
International Union

SECRETARY OF COMMERCE'S TRAVEL ADVISORY BOARD

Richard P. Ensign
Western Airlines, Inc.

Harold L. Graham
Amtrak

James Low
Executive Vice President
American Society of
Association Executives

Robert T. Murphy
Association of Local
Transport Airlines

Norman J. Philion
Air Transport Association

David M. Reid
South Carolina Department of
Parks, Recreation and Tourism

Robert Sullivan
San Francisco Convention
and Visitors Bureau

William D. Toohey
Discover America Travel
Organizations

William Patterson

ADMINISTRATION REPRESENTATIVES

Robert Jackson
Director of Office of Information
Services
U.S. Travel Service

Henry Riegner
Acting Executive Director
U. S. Travel Service

Peter Malatesta
Deputy Assistant Secretary for
Bi-Centennial Affairs
Department of Commerce

William Rhatigan
Special Assistant to the Secretary
for Public Affairs
Department of Commerce

CONGRESSIONAL STAFFERS

Bill Kovacs
Paul Malloy
Bill Williamson
Dennis Taylor
Art Pankopf
Fred Lordan
Betsy Harrison
John Hardy
Ralph Vinovich
Henry Jivgni

B

SIGNING OF TOURISM BILL --

U.S. TRAVEL SERVICE AUTHORIZATION

WEDNESDAY, JULY 9, 1975

I AM PLEASED TODAY TO SIGN INTO LAW S. 2003, WHICH AUTHORIZES THE DEPARTMENT OF COMMERCE TO CARRY OUT A VARIETY OF INTERNATIONAL AND DOMESTIC TOURISM PROGRAMS. THIS ACT PROVIDES AN ACCEPTABLE COMPROMISE CORRECTING THE MAJOR PROBLEM CONTAINED IN H.R. 5357 WHICH I VETOED IN MAY.

I COMMEND THE MEMBERS OF CONGRESS OF BOTH PARTIES FOR ENACTING THIS LEGISLATION. THIS IS A GOOD EXAMPLE OF THE WAY IN WHICH THE CONGRESS AND THE EXECUTIVE BRANCH CAN -- AND SHOULD -- WORK TOGETHER TO ASSIST AN INDUSTRY WHICH IS IMPORTANT TO AMERICA.

AS WE CELEBRATE OUR BICENTENNIAL YEAR, I BELIEVE THIS IS AN IDEAL TIME TO ENCOURAGE FOREIGN AND AMERICAN TOURISTS TO VISIT THE WONDERS OF OUR NATION. THE PROGRAMS AUTHORIZED BY THIS LEGISLATION WILL ENABLE A GREATER NUMBER OF PEOPLE TO ENJOY THE UNIQUE ATTRACTIONS OF AMERICA THAN MIGHT HAVE BEEN POSSIBLE OTHERWISE.

I HAD VETOED THE EARLIER TOURISM BILL BECAUSE SOME OF ITS PROVISIONS INFRINGED ON THE RESPONSIBILITIES AND PREROGATIVES OF THE STATES AND THE PRIVATE SECTOR.

THE CONGRESS HAS CORRECTED THIS DEFECT. THE LEGISLATION I AM ABOUT TO SIGN REPRESENTS A RESPONSIBLE AND EFFECTIVE APPROACH FOR FEDERAL GOVERNMENT ENCOURAGEMENT OF TOURISM IN AMERICA.

I AGAIN THANK THE CONGRESS FOR ITS CONSTRUCTIVE COMPROMISE AND HOPE THAT THE SPIRIT OF COOPERATION WILL CONTINUE IN OTHER BADLY-NEEDED MEASURES.

IN CLOSING, I URGE ALL AMERICANS AND OUR NEIGHBORS THROUGHOUT THE WORLD TO JOIN OUR BICENTENNIAL CELEBRATION AND TAKE THIS SPECIAL OPPORTUNITY TO EXPLORE OUR FASCINATING AND BEAUTIFUL COUNTRY.

END OF TEXT

Department of the Treasury

Under Secretary

to: Mr. Seidman

room: ________ date: 2/12/75

Bill:

Attached are some questions and answers on securities reform legislation for use by the President in New York tomorrow.

Also attached for your information is a copy of a memo from me to Bill Simon which he asked me to send to you. I have also sent a copy of the memo to Wally Scott.

As you will note, I am scheduled to testify on the securities reform legislation before Senator Williams' Subcommittee on February 19. The attached memo will provide the basis of my testimony which will, of course, be cleared in the usual way through OMB.

Edward C. Schmults

Attachments

cc: Roger Porter

cc to Jim Cannon Domestic Council

Edward C. Schmults
room 3430
ext. 5363

Date: February 11, 1975

MEMORANDUM FOR: SECRETARY SIMON

From: Edward C. Schmults

Subject: Proposed Treasury Position on Securities Legislation

Comprehensive securities legislation has been reintroduced in both the Senate and House. On the Senate side, Senator Williams, Chairman of the Subcommittee on Securities of the Senate Banking Committee, introduced S. 249, an "omnibus" securities bill which consolidates all five pieces of securities legislation which his subcommittee developed in the 93rd Congress.

S. 249 incorporates bills that would (1) provide for the development of a national market system and the strengthening of SEC oversight of the self-regulatory system; (2) address the issues of competitive commission rates and institutional membership; (3) establish a national system for clearing and settling securities transactions; (4) extend the coverage of the Securities Exchange Act of 1934 to securities firms and banks which underwrite and trade municipal securities; and (5) require institutional investors to report their securities holdings and transactions to the SEC.

On the House side, Congressman Moss, former Chairman of the Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee, has introduced in the 94th Congress H.R. 10, which is identical to the securities reform legislation (H.R. 5050) which expired in the House Rules Committee in the 93rd Congress.

I am scheduled to testify before Senator Williams' Subcommittee on S. 249 on February 19. I believe that Treasury should support the bill but propose amendments to certain key provisions. The attached memorandum describes the important provisions of S. 249 and sets forth a recommended Treasury position on each. Differences between the Senate and House legislation are noted where applicable.

If you approve, my testimony will reflect these positions.

Attachment

Approve: /i/ WES

Disapprove: _______

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	STOUGHTON	GERARD				
Initials / Date	JH / 2/11/75	/	/	/	/	/

Form OS-3129
Department of Treasury

Proposed Treasury Position on S. 249

1. Commission Rates

Senate. S. 249 would not require elimination of fixed commission rates. The Committee Print summarizing the provisions of S. 249 states that, "Because the SEC is proceeding in a deliberate and responsible manner to phase out fixed rates, further legislation in this area appears to be unnecessary. However, the bill would authorize the SEC to permit exchanges to impose fixed commission rates only if it finds that the rates are "reasonable in relation to the costs of providing the service for which such charge is made, (and publishes the standards employed in adjudging reasonableness) and necessary to accomplish the purposes of the [Securities Exchange Act."] Secs. 6(e), 19(b)(2) (pp. 25, 121).1/

House. H.R. 10 would require exchanges to eliminate fixed commission rates on May 1, 1975, except that until October 1, 1976, the SEC may permit exchanges to fix reasonable rates of commission for transactions involving amounts up to $300,000, provided that the SEC determines that the public interest requires the continuation, establishment or re-establishment of fixed rates. After October 1, 1976, the SEC may permit exchanges to impose a fixed commission rate schedule if it determines (1) that the rate of commission is reasonable and (2) that such action is necessary to assure the maintenance of fair and orderly securities markets, taking into consideration the competitive effects of permitting fixed rates against the competitive effects of other action which the Commission is authorized to take, and "taking into consideration the preservation of auction markets, the promotion of market liquidity, the encouragement of direct investment by individual investors, the availability of equity capital to business, and the prevention of undue concentration of the investment banking industry."

Recommended Position. That Treasury support the Senate provision on commission rates. The SEC promulgated Rule 19b-3 requiring exchanges to eliminate rules establishing fixed public commission rates on May 1, 1975. Neither the Senate nor the House legislation would

1/ Section references, unless otherwise specified, are to sections of the Securities Exchange Act, as amended by the bill. Page references are to pages of the bill.

compel the SEC to change this decision. The Senate bill would, however, provide the SEC with greater discretion in determining the method and timing of the elimination of fixed rates. Accordingly, I recommend that Treasury support the Senate provision on commission rates.

2. Institutional Membership

Senate. S. 249 would impose restrictions on self-dealing by exchange members on the date that fully competitive rates are established. On that date, the bill would prohibit an exchange member from effecting transactions on an exchange "for any account in which it or an associated person thereof has a financial interest or with respect to which it or an associated person thereof exercises investment discretion." Sec. 11(a)(1) (p. 26). The bill would exempt from this prohibition transactions for the member's own account as well as certain other transactions which contribute to the efficient functioning of exchange markets or which are not considered to have given rise to serious problems.

This membership restriction, which would require exchange members to conduct 100 percent of their business for public customers, would be phased in over a two-year period following the triggering date. In the first year, they would have to meet an 80-20 percent requirement; a 90-10 percent requirement during the second year; and, thereafter, a 100-0 percent requirement.

House. H.R. 10 would prohibit, on or after May 1, 1975, an exchange member from executing transactions on an exchange for its own account, any account in which any affiliated or associated person has a financial interest, or any managed account, with the exception of certain market making and other transactions which contribute to the efficient functioning of markets. The bill would give the SEC authority to prescribe similar rules for transactions effected by exchange members off exchanges and for transactions by non-member broker-dealers.

Recommended Position. That Treasury support the House bill. Treasury has supported the policy that broker-dealers should be required to do a public business on the ground that it will (1) promote public confidence in our securities markets by eliminating the potential for conflicts of interest and remove the ground for feeling that institutions which have direct access to markets possess special advantages as compared to the general public in buying and selling securities, and (2) serve to strengthen the broker-dealer network. There appears to be no reason to tie rigidly the implementation of this policy to the establishment of competitive commission rates.

3. Separation of Money Management and Brokerage Functions

Senate. The bill would prohibit exchange members from performing brokerage for managed accounts.

House. H.R. 10 would prohibit exchange members, on or after May 1, 1975, from executing brokerage for any managed account, except that the SEC could permit member firms to continue to execute brokerage for managed accounts where the member serves only as a money manager and is not affiliated or associated with the person for whose account it performs such money management services, provided that provision is made for an independent monitoring of trading for the managed account so as to guard against any conflict of interest that may occur from a combination of money management and brokerage functions. Thus, a member firm which performs any additional services or has any other business or corporate relationship with the managed account would be prohibited from executing brokerage for the account.

Recommended Position. That Treasury support the House bill. Permitting broker-dealers to provide money management services to unaffiliated customers should enhance the financial strength of the securities industry. As long as institutions have access to brokerage services at competitive rates, no important objective of public policy would be jeopardized by this restriction.

4. Soft Dollar Payments

There is considerable concern within the securities industry that under a system of competitive rates fiduciary money managers may not continue to pay for research with soft dollars because of legal uncertainties as to the authority of fiduciaries to pay a commission rate higher than the lowest possible "brokerage only" rate, irrespective of whether other services are provided. Both House and Senate bills propose amendments to the Investment Company Act of 1940 and the Investment Advisers Act of 1940, which are intended to remove the legal uncertainty.

Recommended Position. That we support the purpose of these provisions which is to remove the legal uncertainty concerning the fiduciary's authority to pay up for research with commission dollars in a competitive rate environment. However, we feel that both the Senate and House provisions, as presently drafted, do not adequately accomplish this objective. Therefore, we propose to submit an amendment to this provision clarifying that fiduciaries, after the institution of competitive rates, will be able to continue to pay up for research with commission dollars without violating their fiduciary obligations under state or Federal law. Our position is shared by the SEC, and we are working with them to develop an appropriate amendment to the "soft dollar" provisions of the Senate and House bills.

5. Municipal Securities Regulation

Senate. S. 249 would extend the basic coverage of the Securities Exchange Act of 1934 to securities firms and banks which underwrite and trade municipal securities. All such firms would be required to register as "municipal securities dealers" with the SEC and to comply with rules and regulations prescribed by a new self-regulatory body, called the Municipal Securities Rulemaking Board. Issuers of municipal securities would continue to be exempt from the regulatory requirements of Federal securities laws.

The Board would be delegated broad rulemaking power to regulate the activities of all municipal securities dealers. It would, however, have no inspection or enforcement responsibilities. Its membership would include representatives of broker-dealers, banks, and the public, including issuers and investors in municipal securities. The SEC's oversight powers over the Board would be identical to those which the SEC would have over other self-regulatory agencies, as proposed by S. 249.

Inspection and enforcement responsibilities would be assigned to the NASD with respect to dealers which are members of the NASD, and to appropriate Federal bank regulatory agencies with respect to those dealers which are banks. With respect to banks, enforcement and inspection powers are divided between the SEC and the bank regulatory agencies. The SEC would be authorized to bring an independent action against a bank provided that it first give notice to and consult with the appropriate bank regulatory agency. Similarly, the SEC would have the power to inspect any bank after notice and consultation with the appropriate bank regulatory agency.

Recommended Position. That Treasury not oppose this provision of S. 249. This provision was passed by the Senate last session after extensive consultations between the Senate Banking Committee, the Comptroller of the Currency, the SEC, the Dealer Bank Association and the Securities Industry Association. All interested parties agreed to the compromise bill that was passed. They continue to support the bill as it has been introduced as part of S. 249. While the Comptroller of the Currency is less than enthusiastic about extending SEC regulation over municipal securities dealers because of the lack of evidence of extensive abuse among the dealer banks, he believes that the provision represents a workable compromise which the Comptroller can live with.

6. Disclosure of Institutional Holdings and Transactions

Senate. S. 249 would require institutional investors, including bank trust departments, to report to the SEC on a regular basis their holdings and transactions in equity securities. Reports would be required from institutional investors managing equity securities having an aggregate fair market value on the last trading day in any of the preceding twelve months of at least $100 million, or such other amount not less than $10 million as the Commission may require. Section 13(f)(1) (p. 48). The bill would require the reporting of certain data with respect to any transaction having a market value of at least $500 thousand or such other amount as the Commission may determine. The bill specifies the information that is to be reported with respect to holdings and transactions in equity securities by institutional investors, and authorizes the Commission to require additional related information. All information filed with the Commission would be made publicly available promptly after filing in such form as the Commission prescribes, subject to confidential treatment in appropriate cases.

House. H.R. 10 contains no comparable provision for institutional disclosure. However, the House Interstate and Foreign Commerce Committee considered a separate bill of a similar nature in the 93rd Congress.

Recommended Position. That Treasury support this provision insofar as it requires the periodic reporting to the SEC and disclosure of institutional holdings in the manner that would not reveal the investment strategy or the holdings of any natural person, trust or estate, but oppose the provision requiring reporting and public disclosure of institutional transactions.

The bill's requirement to report institutional transactions does not appear to be justified by any legitimate regulatory objective.

The requirement is purported to be necessary to bolster public confidence in the fairness of our securities markets. However, rather than promoting fairness in our securities markets, it could introduce unfairness by placing at a disadvantage investors who use institutions to manage their funds. Such unfairness would arise if disclosure of transactions revealed an investment strategy or intentions to trade. Moreover, passage of the pending securities reform legislation should serve to bolster investor confidence in the fairness of our securities markets.

The second purpose of these reporting requirements appears to be to provide the SEC with authority to obtain empirical information and data concerning institutional trading so that the Commission can accurately gauge the impact of institutional activities on the market and determine whether statutory restrictions should be imposed upon the manner in which institutions trade. The collection of data on institutional transactions cannot be justified on this ground because regulation of institutional trading is unnecessary and is also contrary to the public interest. Restrictions on the size or frequency of institutional transactions would adversely affect the interests of those investors whose assets are managed by institutions and would interfere with the efficient functioning of securities markets to the detriment of the public interest.

Treasury Department
February 12, 1975

Questions and Answers on Securities Reform
for the President's NYSSA Speech

Q. The Securities and Exchange Commission promulgated last month a rule which will require the elimination of exchange rules fixing rates of commission on May 1, 1975. What is the Administration's position with regard to this decision by the Commission?

A. The Administration supports the move from fixed to competitive brokerage rates within the securities industry. We believe that competitive rates will benefit our capital markets and lead to a stronger securities industry and a more efficient securities market.

We recognize that the transition to competitive commission rates will require adjustments on the part of the securities industry and investors. We are also aware of the financial difficulties experienced by the securities industry during the recent past. The Administration will do what it can to insure that the adjustment to a competitive rate environment is made in a smooth and orderly manner. We will be working with the Congress and the Securities and Exchange Commission to achieve this objective. While we don't expect that any disasters will occur with the introduction of competitive rates, we will closely observe events and be prepared to recommend any necessary remedial steps.

Q. The Senate and the House have introduced legislation that would effect significant reform in our securities markets. What is the Administration's position on this legislation? Does the Administration prefer the House or Senate proposals?

A. We have supported and continue to support the basic reform measures which are included in both the House and the Senate legislative proposals. We will be working closely with the relevant committees in the Senate and the House to work out the differences in the legislation and some areas where we disagree.

[Background: Implementation of the national market system called for by both the Senate and House legislation will help insure that every investor--no matter how large or small--will have access to the best transaction price. This new system will allow the investing public to benefit from the great technological advances of recent years. Creating a national clearing and settlement system will result in substantial savings of both costs and time, not to mention an important reduction in risks.]

Q. [Intended to provide a general response to any "technical" questions.] One of the controversial issues raised by the proposal to implement a national market system concerns New York Stock Exchange Rule 394, which generally prohibits exchange members from executing transactions in listed securities off the exchange. What is the Administration's position on Rule 394?

A. I am not familiar with all the technical rule changes and adjustments that will occur in the evolution to a national market system. The national market system should be developed in a careful thoughtful way by you--the securities industry--working with the Securities and Exchange Commission under the guide lines specified in the proposed securities legislation. The Administration will be working closely with both the Congress and the Securities and Exchange Commission in addressing the important policy decisions that will have to be made in shaping the structure of the new national market system.

DEPARTMENT OF COMMERCE BRIEFING
FOR VICE PRESIDENT ROCKEFELLER AND DOMESTIC COUNCIL
MARCH 10, 1975

MAJOR NATIONAL CONCERNS

- EROSION OF INDIVIDUAL ECONOMIC FREEDOMS
- GROWTH IN GOVERNMENT AND PROLIFERATION OF REGULATION
- PERPETUATION OF FEDERAL BUDGET DEFICITS
- VIABILITY OF PROFITS
- GROWTH IN PRODUCTIVITY
- RATE OF CAPITAL INVESTMENT
- UNCERTAINTY BECAUSE OF GOVERNMENT INTRUSION
- TREND TOWARD BASIC CHANGES IN POLITICAL/ECONOMIC SYSTEM

(CHART 1)

<u>REVITALIZATION OF THE ECONOMY THROUGH INVESTMENT</u>

A. Specific Needs

- Reduce inflation
- Stimulate capital investment
- Achieve energy self-sufficiency
- Assure adequate materials supply
- Promote new technology and establish White House science advisor
- Maintain international competitiveness in trade and tourism
- Increase investment in human resources
- Expand minority business opportunities
- Develop better data for decision making
- Improve transportation systems

B. Department of Commerce Activities

- Maritime Administration activities provided 125,000 man years of employment for American workers in the shipbuilding and allied industries, representing the largest backlog of new ship construction in the Nation's peacetime history

(CHART 2)

- U.S. Travel Service contributed $100 million to our economy, a measured return of 9 to 1, and an invaluable link to international understanding

- Office of Minority Business Enterprise assisted 24,683 minority firms, packaging over $200 million in loans and $253 million in procurement

- Patent and Trademark Office processed over 116,000 patents, an all time record, and installed a system to forecast new technological developments

- National Oceanic and Atmospheric Administration conducted programs to promote development of ocean and coastal resources consistent with national energy needs and ecological goals

- National Technical Information Service sold 2.4 million copies of scientific and technical reports to the public

(CHART 2a)

- Social and Economic Statistics Administration published 2,400 economic and demographic reports

- Domestic and International Business Administration expanded services to local businessmen; responded to more than 60,000 requests for information and assistance; conducted an industrial energy conservation program designed to avoid loss of production or employment involving 43,000 businessmen, awarding 8,000 SavEnergy citations; and enlisted the participation of U.S. firms in 75 major exhibitions and over 1,000 smaller exhibitions

- National Weather Service provided weather predictions for agricultural purposes and disaster warnings for the entire Nation

(CHART 2b)

PROLIFERATION OF REGULATION AND INHIBITORS OF OUR FREE MARKET

A. Specific Needs

- Develop, in anticipation of the establishment of the Regulatory Reform Commission, analysis of regulatory agencies to determine their impact on inflation, retardation of productivity or unreasonable demands on the private sector
- Implement deregulation
- Develop better data on costs of regulation
- Reexamine justification for special interest statutes that affect the construction industry, transportation, shipping, etc.

B. Department of Commerce Activities

- Supported comprehensive review of regulation
- Developed data on costs, to include inflation and productivity impact, of regulatory proposals such as product safety, health insurance, occupational safety and health and environmental regulation
- Identified and sought modification of legislative and regulatory proposals that tended to encroach on the private sector
- Eliminated, in 1974, controls on U.S. direct investments abroad

(CHART 3)

BALANCE OF ENVIRONMENTAL BENEFITS AND COSTS

A. Specific Needs

- Achieve balance between environmental objectives and economic costs
- Resolve problems associated with development of energy, including coal, offshore oil and gas, nuclear and synthetic fuels
- Reexamine underlying environment/health assumptions
- Avoid reliance on "available technology" as sole criteria

B. Department of Commerce Activities

- Proposed amendments to the Clean Air Act
- Supported reduced environmental standards for utilities
- Reviewed and prepared recommendations on 800 environmental impact statements in FY-74
- Established an Environmental Economic Staff in January 1975, to focus attention on economics of environmental protection

(CHART 4)

ARREST GROWTH IN GOVERNMENT

A. Specific Needs

- Reassess the role of Government in providing goods and services which could be furnished more efficiently by the private sector
- Strengthen efforts of National Commission on Productivity and Work Quality to improve productivity in Government sector

B. Department of Commerce Activities

- Identified and amended legislative and regulatory proposals that place the Federal Government in competition with, or constrain, the private sector
- Compiled and published statistics relating to growth trends in public and private sectors as components of GNP
- Cosponsored productivity seminars at district and national levels to promote exchange of productivity techniques between private and public sectors

(CHART 5)

EXPANSION OF EMPLOYMENT OPPORTUNITIES

A. Specific Needs

- Reduce unemployment
- Create new jobs for growing population and new market opportunities
- Utilize human resources more effectively

B. Department of Commerce Activities

- In FY-74, the Economic Development Administration provided $174 million for public works, $17.9 million in technical assistance, $20 million for business development loans, and $7.7 million for local economic planning
- Maritime Administration provided 125,000 man years of employment for American workers in the shipbuilding and allied supply industries
- United States Travel Service, in support of $61 billion segment of the economy, established 355 travel planning centers and trained over 5,000 foreign travel agents, contributing to a 17 percent rise in receipts in 1974, over 1973
- Domestic and International Business Administration promoted exports contributing to $98 billion in exports in 1974, an increase of 38 percent over 1973, and, thereby, creating additional jobs for Americans
- Developed, in conjunction with Health, Education, and Welfare and the Department of Labor, a work-education program to improve skills and meet the needs of the work place

(CHART 6)

SUMMARY OF RECOMMENDATIONS FOR DOMESTIC COUNCIL ACTION

- REVITALIZE THE ECONOMY BY ENHANCING THE CLIMATE FOR PRIVATE INVESTMENT
- PROTECT AND STIMULATE THE FREE MARKET
- ACHIEVE BALANCE BETWEEN THE ENVIRONMENT AND THE ECONOMY
- ARREST GROWTH OF GOVERNMENT
- INITIATE OCEAN POLICY STUDY
- FORMULATE STATEMENT ON NATIONAL TOURISM POLICY
- REVIEW INSTITUTIONAL FRAMEWORK FOR SCIENCE POLICY FORMULATION AND COORDINATION WITHIN THE EXECUTIVE BRANCH
- IMPROVE CAPABILITY TO ANTICIPATE CLIMATE CHANGES AND THEIR IMPACT ON FOOD PRODUCTION
- PRODUCE STATISTICAL DATA WHICH WILL ILLUMINATE EMERGING DOMESTIC PROBLEMS IN MORE DETAIL FOR MORE SUBNATIONAL ISSUES

(CHART 7)

DENT

Dent 3/10/75

28,000 people

pet NO 1 - Basic concept of our economy

Individual Economic Republic

As we lose individual we upset lose other

urgent

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estimates 40% of GNP

accumulative deficit 13 of last 14 yrs

Govt - The price of inflation is another decision w/ Advertising Council on American Enterprise System

In-depth study — program develop and today s/1

NAR

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who

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D.C. Ocean policy
Marine enterprise CO?
Interim Ocean Policy Study

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on Domestic
situation
Trade Deficit
6

Allison - Assemble & collate

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w/ domestic ec - ~~[illegible]~~ [illegible]
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emphasized economic ~~[illegible]~~ policy

moving away from former

attention to Mid East

policy —

Commerce

THE WHITE HOUSE

WASHINGTON

April 30, 1976

MEMORANDUM FOR: BILL SEIDMAN

FROM: JIM CANNON Jim

SUBJECT: Upcoming Discussion of Assistance To the Maritime Industry

As it happens, I have a brother who is Controller of Waterman Steamship Company. Although he and I do not engage in substantive discussion of anything related to federal assistance to the maritime industry, I think it is appropriate that I avoid participation in EPB's discussion on this subject.

With your approval, I shall ask Paul Leach, Associate Director of the Domestic Council for Economic Affairs, to attend this EPB meeting as an observer, but to take no part in the discussion or recommendations for action.

cc: Paul Leach

THE SECRETARY OF COMMERCE
Washington, D.C. 20230

2 8 APR 1976

MEMORANDUM FOR: The Economic Policy Board

Subject: Options for Assistance to the Maritime Industry

The purpose of this memorandum is to set forth options for actions that might be undertaken by the Administration to provide immediate assistance to the U.S. maritime industry, which continues to be affected directly and indirectly by the worldwide tanker industry depression.

At present, ships representing over 50 million deadweight tons (dwt) of tanker capacity are in layup worldwide, and spot charter rates have declined to a fraction of actual costs. In the United States there are presently 17 tankers, with about 750,000 dwt, in layup without prospect for employment in the foreseeable future. Furthermore, as a reflection of the tanker depression, the world shipbuilding market is also deeply depressed, and the scramble for shipbuilding contracts has resulted in foreign price quotations so low as to impose strong upward pressures on U.S. construction subsidy rates for all types of ships.

The full impact of the worldwide tanker depression was first apparent in the United States early in 1975. It led directly to cancellations of orders for nine tankers in U.S. yards. Some relief was afforded by Soviet grain purchases in 1975 and the U.S./USSR transportation rate agreement for grain. As a result of these factors, the number of U.S. tankers in layup declined from 33 in September 1975 to the vicinity of 20, with minor variations around that total (such as the current 17).

In reaction to the developing tanker situation early in 1975, the Executive Committee of the Economic Policy Board established an interagency group under the chairmanship of the Secretary of Commerce to consider alternative approaches to providing relief to the industry. This group met several times and formulated a number of alternatives. By mid-spring, its functions had shifted to the Economic Policy Board itself, and in the summer an informal committee consisting of the Secretaries of Commerce, Treasury, and Labor plus the Director, OMB and the Assistant to the President for Economic Affairs was established to investigate the matter further. The activity of this informal committee continued until November.

Alternatives most actively considered included a number of forms of oil cargo reservation for U.S.-flag ships, plus the manning of some military cargo vessels by non-government seamen. A meeting on March 7, 1975, with the President was arranged for representatives of the industry, including maritime labor spokesmen. The industry representatives indicated that an oil cargo preference measure limited to existing and on-order ships would provide the relief they deemed necessary. One decision stemming from this extended deliberation has involved the trial substitution of non-government for government crews on four tankers under long-term charter to the Military Sealift Command.

At the Economic Policy Board meeting of April 14, 1976, the Secretary of Commerce was asked to look again into optional actions that might help to relieve the maritime industry situation. Five options have been developed and are set forth briefly in the attachments hereto. The options include:

- Limited Oil Cargo Preference (Attachment 1)
- Extension of Jones Act to Virgin Islands Oil Trade (Attachment 2)
- Increased Military Use of Commercial Tankers with Non-government Crews for Underway Replenishment (Attachment 3)
- Amendment of "Buy American" Provisions of the Merchant Marine Act (Attachment 4)
- A Shipping Agreement for the Movement of Soviet Oil (Attachment 5).

Joseph E. Kasputys
for Elliot L. Richardson

Attachments

LIMITED OIL CARGO PREFERENCE

An oil cargo preference bill involving reservation of 30 percent of U.S. oil imports for U.S.-flag ships by mid-1977 was passed by the Congress in 1974. It was vetoed by the President in December of that year on the basis that it would:

- Cause an inflationary increase in the cost of imported oil;
- Stimulate inflation in the ship construction industry;
- Cut into the industry's ability to meet Navy shipbuilding needs;
- Serve as an undesirable precedent for other countries; and
- Violate a large number of Treaties of Friendship, Commerce, and Navigation.

Since that veto, the President has indicated that although he does not like the approach, he would sign a cargo preference bill if it were properly drafted.

The proposal of limited cargo preference that is advanced herein would eliminate some of the major objections of the President's 1974 veto message. This measure would require oil importers, as a condition in granting an import license, to use U.S.-flag vessels, provided such vessels are available at fair and reasonable rates. These fair and reasonable rates would cover the cost, including cost of capital, of ships built in the United States and registered under the U.S.-flag. The degree of use of U.S.-flag tankers could either be established as a fixed percentage of each importer's import quantity in a given time period, or by simply requiring importers to charter U.S.-flag tankers when available prior to chartering foreign flag tankers.

These provisions would only apply to existing ships under 25 years of age, and those contracted for construction as of the effective date. This would avoid support of old, inefficient ships and would generate no new building, and hence no inflationary pressures on the shipyards or competition with Navy programs. This measure should be reviewed after two years and lifted whenever world rates return to compensatory levels.

PROS:

* Would insure that U.S.-flag tankers receive compensatory employment.

* Would maintain employment of some 2,220 merchant seamen, covering ships currently in layup and those temporarily inactive.

* Does not create inflationary pressures in shipyards and does not support inefficient ships.

* A temporary measure.

* Is the major recommendation presented by the tanker industry to the President.

CONS:

* Would result in inflationary added transport costs for oil imports of about $300 million in the first year, declining to the order to $200 million by 1980. The associated net incremental cost per gallon of gasoline consumed in the U.S. would be about 12 hundredths of a cent initially and somewhat less by 1980.

* May create an undesirable precedent, with the industry pressing to have cargo preference made permanent and perhaps extended to other commodities. Could be interpreted as violating FCN treaties and trade agreements, although exceptions are made for national security.

* Some degree of government control and regulation over tanker utilization and rates would be required.

* Could result in retaliation, but this would be less likely because of the temporary nature of this measure.

EXTENSION OF JONES ACT TO VIRGIN ISLANDS

The Virgin Islands have been exempted from the coastwise laws of the United States since their purchase in 1917 from Denmark. This exemption has been based historically on the lack of U.S. flag vessel capacity to serve the trade between the U.S. mainland and the Virgin Islands. Exemption on this basis is no longer valid since sufficient capacity to transport Virgin Islands/mainland oil movements is now available.

In recognition of this, the Senate Commerce Committee, Subcommittee on the Merchant Marine, has conducted hearings on S. 2422, which would amend the 1920 Merchant Marine Act to require that all shipments of crude oil, residual fuel oil, and refined petroleum products from the Virgin Islands to the U.S. mainland be on American flag ships. One of the principal motivations of this legislation is to provide more maritime jobs.

<u>PROS</u>:

* Reserving this trade to U.S. flag tankers would provide employment for some 25 tankers or about 750,000 Cargo Deadweight Tons.

* The provision would eliminate the current layup problem. During the first two months of 1976, idle status vessels that could be made available for employment in the Virgin Islands trade ranged from 275,000 to 520,000 Cargo Deadweight Tons. In addition, ships returning from employment in the Russian grain trade as well as some of those tankers now under construction will be added to the list of vessels requiring employment.

* Extension of the Jones Act to the Virgin Islands trade would mean about 2,000 jobs for U.S. seamen. Employment of tankers currently in layup would account for 1,400 of this total.

* Jones Act application to the Virgin Islands oil export trade would represent a logical extension of U.S. cabotage laws.

* Policy has already been established to assist the U.S.-flag tanker industry in Virgin Islands trade by preferential treatment under the oil import fee system.

* Considering the current import fee system, if U.S.-flag vessels are used there is a savings of one cent a gallon. The price differential between U.S. and foreign tankers is also approximately one cent a gallon. Therefore, for fee oil, there is essentially no differential. By 1980 all imports will be subject to fees unless the current court challenge to the fee system is successful.

* The Balance of Payments savings from using U.S.-flag tankers is some $61 million.

* The measure would eliminate the cost advantage over Gulf Coast and Puerto Rico refineries that now exists in the case of oil deliveries to the East Coast from the Virgin Islands.

CONS:

* The fee system has been challenged in the courts. The Supreme Court is expected to review the case this year. Without the fee, it costs one cent a gallon more to use U.S. flag vessels. This is expected to decline to six tenths of a cent after 1980. At current rates, the differential cost per year is some $70 million. The long term differential should be some $39 million.

* The Virgin Island Refinery Corporation may be encouraged to cancel expansion plans because of a requirement to use U.S. flag tankers and may be detrimental to the Virgin Islands' economy.

* It would entail marginally increased prices to consumers or to the U.S. Treasury depending on the outcome of the fee challenge.

* It is opposed by the Departments of Transportation, Treasury, Justice, and Interior and by OMB, the Council of Economic Advisors, and FEA as well as the Virgin Islands government. (OMB recommends that the Administration should retain the option of supporting such legislation later if circumstances change.)

Attachment 3

INCREASED MILITARY USE OF COMMERCIAL TANKERS

The feasibility of underway replenishment by merchant ships has been demonstrated, first several years ago by the ERNA ELIZABETH test, subsequently by opportune use of other commercial tankers for refueling Navy ships. The ERNA ELIZABETH, a standard 35,000 ton, 16-knot privately owned tanker, with a merchant crew, replenished 40 Navy ships in a 12,771 mile voyage. The initial purpose of that exercise was to test and evaluate the opportune refueling concept, but the ERNA ELIZABETH successfully performed dedicated replenishment and resupply missions as well.

Up to this time, the concept of using commercial ships for underway replenishment has not proceeded beyond the feasibility demonstration stage. Admiral Zumwalt observed, in his article in the April issue of the U.S. Naval Institute Proceedings, in effect, that it was never possible to overcome the institutional barriers to closer cooperation between the Navy and the Maritime Administration. From the Department of Commerce viewpoint, those barriers were on the Navy side and increased use of privately owned chartered tankers can be accomplished. The Navy has not been willing to give up its own ships up to now.

PROS:

* Operating costs are reduced by replacing Navy tankers with merchant tankers and peacetime costs of the ships in the UNREP role might be offset in part by part-time commercial employment. For example, the British Merchant Marine is regarded as a full auxiliary of the British Combat Navy and heavy reliance is placed on the use of merchant ships for Naval Fleet support.

* Opportune replenishment from commercial tankers has been particularly valuable in remote waters where the continuing U.S. Navy presence is limited; for example, in the Indian Ocean. Support by commercial vessels, in addition to reduced cost to the Navy, has maintained the combat effectiveness of deployed naval forces by allowing naval ships to remain on station instead of returning to distant ports for replenishment.

* The Navy could replace some of its old less productive tankers with newer, more efficient vessels.

* The Navy could charter the laid-up tonnage at a relatively low price.

* By chartering laid-up tonnage the Navy would reduce the possibility of mortgage defaults by private owners.

CONS:

* While merchant tankers could be used for practically all of the purposes served by the UNREP and MSC ships, the U.S. commercial fleet is not now fully prepared to perform some Navy tasks. For example, special UNREP deck fittings and some extra communications equipment would be necessary. Other commercial ship construction programs could be adjusted to accommodate Navy requirements, but such programs cannot be undertaken without a basic change in Navy policy. If the Navy were willing to rely on U.S. merchant tankers for UNREP and point to point deliveries, instead of maintaining a Navy-owned fleet, effective programs could be designed and executed to meet Navy needs in peace and war.

* Merchant crew size may be considered by the Navy to be inadequate to fully handle all of the demands and requirements of UNREP. Merchant crew augmentation is possible, but since the proposal in question involves primarily secondary support to the fleet, crew size should not be a constraint.

AMEND "BUY AMERICAN" PROVISIONS OF THE MERCHANT MARINE ACT

Even though Section 505 of the Merchant Marine Act, as amended, requires the use of materials and components manufactured in the United States, specialized parts are so frequently in short supply that numerous waivers have been granted. The small number of vessels built in the United States under subsidy has not provided the market that companies engaged in manufacture of specialized marine equipment have found profitable. Therefore, shortages have occurred in diesel engines, anchors, lube oil purifiers, cargo cranes, lifeboat engines, fans and even binoculars. In each case, an expensive and time consuming investigation must be made, prior to the granting of the requested waivers.

It is difficult for American firms to maintain competitive positions vis-a-vis foreign competitors who have a world wide market. The American market is reserved by law to U.S. manufacturers and is not of sufficient size to insure adequate sources of supply or to provide price restraint.

The existing legislation is difficult to enforce because many products of U.S. manufacture contain within them foreign made parts which are not clearly identifiable upon inspection. Many binoculars, for example, produced by American workers, utilize foreign-made lenses which render them unsuitable under the law for use aboard subsidized vessels.

One way of solving the problem and reducing the current cost of shipbuilding would be to permit foreign material to be used in subsidized ship construction. Precedence for such action already exists under the Economy Act of 1932, which exempts the U.S. Navy, Coast Guard and the National Oceanic and Atmospheric Administration from 100 percent "Buy American" provisions, even though the vast majority of equipment supplied to these vessels is still of U.S. manufacture. This program has not, to our knowledge, adversely affected U.S. marine suppliers. If such as exemption were extended to commercial subsidized vessels, American workers would benefit in two ways: First, products of U.S. manufacture, employing foreign-made parts would become eligible for use on American ships, thus expanding both company profit and supplier industry jobs. Second, more ships could be built for a given level of subsidy. More ship orders mean more jobs.

PROS:

* Creation of new markets for American companies which assemble components containing foreign parts.

* Reduced ship cost leading to potential new construction if market conditions are favorable.

* Increased Federal administrative efficiency due to lightened investigative caseload.

* Better price competition between American firms, resulting in lower component cost in the future, if vessels are supplied by domestic firms.

CONS:

* Some domestic manufacturing capacity may be eroded by the inroads of foreign material, thus reducing mobilization readiness.

* Components now produced domestically may be imported from lower cost foreign subsidiaries, reducing employment for Americans.

SHIPPING AGREEMENT FOR THE MOVEMENT OF SOVIET OIL

Negotiations are now under way which may lead to an agreement between the United States and the USSR for the U.S. purchase of ten million tons of Soviet oil a year by the United States. This would be a corollary to the U.S./USSR grain purchase agreement. Parallel to the oil purchase negotiations are discussions of shipping rates, terms and conditions of carriage by U.S. flag tankers of one third of the oil purchases pursuant to the existing maritime agreement.

If the noted negotiations are successful, they will provide oil backhauls for U.S. tankers that deliver grain to the USSR. In the current year, with grain purchases expected to reach 17.5 million tons, the backhauls for U.S. tankers carrying a third of the grain would probably not reach the level of outbound loads. There are indications that this may also be the case next year, since grain purchases next year are currently predicted to exceed 10 million tons. In this situation, while the oil backhauls would provide tanker operators with additional revenue, they would affect only marginally the number of tankers employed. Since Soviet oil ports are some distance from grain delivery ports, there would be additional steaming time before the start of laden return voyages. This addition to total voyage time would increase the number of tankers required to deliver given amounts of grain within fixed periods. In this light, it is anticipated that employment for as many as two or three additional tankers would be generated by the oil and associated shipping agreement in 1976, and, probably, in 1977.

Under the 1976 grain agreement the USSR is expected to import a minimum of 6 million tons in ensuing years of which U.S. ships will carry a third. If the oil agreement, at 10 million tons, and the associated oil shipping agreement, are consummated, the U.S. share of the oil movement will involve greater tonnage than the grain movement in years when grain movement is limited to 6 million tons (or any amount less than 10 million tons). In this situation, the oil shipping agreement would generate an incremental opportunity for employment of some U.S.-flag tankers potentially in excess of the marginal increment based on voyage length.

<u>PROS</u>:

* The oil and oil shipping arrangements would provide maximum additional employment for at least 2-3 U.S.-flag tankers in the immediate future and possibly for more (on the order of 6-8) in the long run.

* Would increase voyage revenues.

CON:

* Relief to the U.S. tanker industry in terms of numbers of tankers employed provided by this measure in the next year or so would be marginal.