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THE CONVERGENCE OF COMMERCIAL
AND INVESTMENT BANKING UNDER THE
GRAMM-LEACH-BLILEY ACT: REVISITING
OLD RISKS AND FACING NEW PROBLEMS

Matthew J. Restrepo*

I. INTRODUCTION

WITH the repeal of the Glass Steagall Act, commercial banks
can now freely affiliate with securities firms that underwrite
securities. This paper will demonstrate that these commercial
lending institutions are engaging in, or have the ability to engage in, the
types of high-risk activities associated with securities underwriting that
compelled the framers of the Glass Steagall Act to separate commercial
and investment banking in 1933. It analyzes and explains the severity of
these risks and will recommend the promulgation of three regulations
that could substantially mitigate or completely eliminate them. Part II of
this paper traces the evolution of the relationship between commercial
and investment banking from the National Banking Act to the Gramm-
Leach-Bliley (GLB) Act. Part III of this paper examines the risks associ-
ated with the underwriting of both stock and bond issues, which are the
two ways in which banks may face a two-tiered or double exposure to
these risks, and the tendency of banks to expose their depositors’ funds to
high-risk securities such as junk bonds and technology stocks. Part IV
discusses the manner in which commercial banks have used their compet-
itve advantage over unaffiliated securities firms to become leaders in the
underwriting industry, how banks may be engaging in anti-competitive
activities to exploit their competitive advantages over securities firms,
and the possible consequences of the oligopoly that may emerge as a re-
sult of these activities. Part V addresses the conflicts of interest that may
arise from commercial banks affiliating with underwriting firms, including
a bank’s ability to rescue its financially distressed securities affiliate, and
the possibility that banks may recommend speculative securities, under-
written by their securities affiliate, to their depositors. Finally, Part VI
points out that even though these risks could be very detrimental to the
safety and soundness of a commercial bank, the promulgation of three
new federal regulations, if they came to fruition, could substantially miti-

* Member New York Bar. Research Fellow, SMU Institute of International Bank-
ing and Finance, Dallas, Texas.
gate or completely eliminate these risks. The Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency would have the ability to promulgate these regulations under their power to regulate the “safety and soundness” of covered banking institutions.

II. THE EVOLUTION OF THE RELATIONSHIP BETWEEN COMMERCIAL AND INVESTMENT BANKING

The relationship between investment and commercial banking in the United States has come full circle over the past eighty years: commercial banks were allowed to affiliate with underwriting firms under the McFadden Act, prevented from doing so under Glass Steagall, and again allowed to do so under the GLB Act.

In the early part of the twentieth century, the banking industry witnessed the rise of trust companies, which were entities that not only offered traditional banking services, but securities-related services, such as underwriting, as well. In order to compete with these trust companies, many national banks utilized their incidental corporate powers, under the National Banking Act, to enter the securities underwriting business. Congress later officially recognized the ability of national banks to affiliate with securities firms under the McFadden Act of 1927. This Congressional stamp of approval, combined with the rise in stock market prices from 1927 to 1929, resulted in commercial banks becoming very active in the securities market. In 1929, the stock market crashed, and by 1933, 11,000 banks had failed or were forced to merge, thereby reducing the number of banks in the country by 40 percent.

In the years prior to the passage of the Glass Steagall Act, Senator Carter Glass sought to prevent commercial banks from dealing in and holding corporate securities because he believed that such activities were responsible for the rampant stock market speculation that eventually led to the Crash of 1929, bank failures, and the Great Depression that followed. His theory that banks’ securities activities led to many bank failures gained a great deal of acceptance in Congress after the Bank of the United States failed in 1930, presumably due to its activities with its securities affiliates. Many Congressmen suspected that the wave of bank failures that plagued the country were partly caused by the exposure of banks to the securities markets, both directly and indirectly through their securities affiliates. One Congressman elaborated on this concern

2. Id.
3. Id.
4. Id. at 164.
6. Id.
7. See Johnson, supra note 1, at 164.
8. Id.
The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and overinvestment in securities of all kinds. . . . [A] very fruitful cause of bank failures, especially within the past three years, has been the fact that the funds of various institutions have been so extensively “tied up” in long-term investments.9

Statements reflecting this same sentiment were made over and over again in the Congressional Sessions of 1932 and 1933. In response to these concerns, Congress passed the Banking Act of 1933 that included provisions separating commercial and investment banking. These provisions make up what is commonly referred to as the Glass Steagall Act.

Sections 16 and 20 of the Banking Act of 1933 specifically address the issue of commercial bank involvement in investment banking activities. Section 16 states that a national bank “shall not underwrite any issue of securities or stock.”10 Section 20 prevents commercial banks from affiliating with firms “engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities.”11 Together, these regulations acted to prevent commercial banks from underwriting most types of securities and from affiliating with investment banking firms. Section 21 of the Act, which states that any person “engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities” can not engage “to any extent whatever” in deposit banking,12 prohibits investment banking firms from entering the commercial banking business. Sections 16, 20, and 21 seemed to drive a permanent wedge between investment and commercial banking; however over time, federal regulators softened these restrictions, particularly those involving affiliation.

In 1987, the FRB approved securities activities in non-bank subsidiaries of Bank Holding Companies, subject to certain revenue limitations and firewalls.13 This regulation allowed commercial banks to affiliate with firms that engaged in underwriting as long as these firms were not principally engaged in bank-ineligible activities.14 The principally engaged test was based on the revenue of the securities firm.15 As long as no more than a certain percentage of the firm’s revenue was derived from bank-ineligible activities, such as securities underwriting, a commercial

15. Id.
In 1997, commercial banks acquired the ability to indirectly participate in securities underwriting through a different type of entity: an operating subsidiary. In this controversial ruling, the Office of the Comptroller of the Currency (OCC) determined that securities activities, including the underwriting and dealing in municipal revenue and corporate bonds, qualified as part of the business of banking under 12 U.S.C. § 24. The OCC further held that if the activities were conducted out of the subsidiary, rather than the bank itself, the limitations on securities activities under section 16 did not apply. Rather, the applicable provision was section 20, which permitted securities activities as long as the entity in question was not principally engaged in the defined conduct. Thus the revenue-based principally engaged test would also apply to these operating subsidiaries. In interpreting the Bank Holding Company Act of 1956, the FRB originally set the revenue limitation at 5 percent in 1987; however, by 1999, the revenue cap had risen to 25 percent. This trend of the softening of certain Glass-Steagall restrictions, by federal regulators, came to a dramatic climax in 1999 when Congress passed the GLB Act, eliminating section 20 of the Banking Act of 1933. This legislation effectively opened the door to the merger of commercial and investment banking, just as the McFadden Act had done seventy-two years before.

The GLB Act repeals section 20 of the Glass Steagall Act by amending the Bank Holding Company Act of 1956 (BHCA). Section 1843(c)(8) of the GLB Act allows a bank holding company to acquire only a firm whose acts were determined “to be so closely related to banking as to be a proper incident thereto.” The GLB Act adds section 1843(k)(1) to the BHCA, which allows a financial holding company to engage in any activity that is “financial in nature or incidental to such financial activity.” The Act then goes on to specifically list “underwriting, dealing in, or making a market in securities” as financial in nature. Any bank holding company that is well-capitalized and well-managed, and whose banks have a satisfactory Community Reinvestment Act rating, may become a financial holding company. Once a financial holding company has been established, the commercial bank, within the entity, is free to

16. Id.
17. Id.
18. Id.
19. Id.
20. Id.
22. Schooner & Taylor, supra note 13, at 324.
23. See Wallenborn, supra note 21, at 256.
24. Id.
26. § 1843(k)(1)(A).
27. § 1843(k)(4)(E).
28. § 1843(l)(1).
affiliate with an underwriting firm without revenue restrictions, as they were under the FRB’s interpretation of the BHCA. The GLB Act also allows a national bank that is well capitalized and well managed to control or hold an interest in a financial subsidiary if the subsidiary engages only in activities that are “financial in nature or incidental to financial activity.” Securities underwriting is included under this standard, but the financial subsidiary’s assets must not exceed the lesser of 45 percent of the assets of the parent bank or $50 billion.

Now that the GLB Act has effectively done away with the Glass Steagall Act’s restriction that made it difficult for commercial banks to indirectly participate in securities underwriting through affiliated securities firms, the question arises as to whether such activity could have a detrimental effect on the safety and soundness of the banks that decide to participate in the underwriting process. Congress passed the Glass Steagall Act to address concerns about multiple high-risk endeavors in which commercial banks could or were engaging. A bank’s exposure to underwriting risk through various activities was one of these concerns, but there were others, including the risks of banks taking part in anti-competitive activities and the conflicts of interest that a bank’s involvement in underwriting could create. All of these risky activities could potentially jeopardize the safety and soundness of a bank and the stability of the banking system as a whole. Unfortunately many banks now have the ability to engage in these activities or are currently engaging in them. If the risks associated with these endeavors were to come to fruition for a particular bank, that bank could definitely find itself in need of a large-scale government bailout. If undertaken by a majority of the country’s banks, it is debatable whether these risky activities could lead to another banking crisis, but there is no reason for federal regulators to take this chance. Three new federal regulations must be promulgated to restrict these high-risk activities.

III. UNDERWRITING RISKS

Now that commercial banks have the ability to affiliate with securities firms that engage in underwriting, they not only face the risks associated with underwriting stock and bond issues, but they may also face a two-tiered or double exposure to these risks.

A. UNDERWRITING RISKS IN GENERAL

The framers of the Glass Steagall Act recognized the inherent risks of underwriting as evidenced by this statement read aloud during the Glass Subcommittee Hearings:

the wholesale underwriting of securities does tend at times to leave the securities affiliate with big unsold commitments that, in times of

30. § 24a(a)(2)(D).
rapidly declining prices, may result in large losses of at least a temporary nature. . . . The portfolios of the security affiliates indicate that the profits of years of operation can be more than wiped out through two or three unprofitable commitments of this kind. . . .

These statements deal with the underwriting risks that face a securities affiliate.

If a securities affiliate has one or more offerings go sour, and as a result faces financial hardship, the commercial bank with which it is affiliated would not necessarily be faced with financial troubles as well. But if the commercial bank was in some way directly exposed to the offering or offerings that went sour, it and the securities affiliate could be in trouble. A commercial bank is directly exposed to underwriting risk when its funds are used to finance the underwriting process. This exposure to risk was one of the primary concerns of the framers of the Glass Steagall Act as Senator Glass said that the purpose of the Act was to provide against the "use of the Federal Reserve's facilities for stock speculation purposes."32

Today, a commercial bank by itself cannot underwrite a securities issue because the GLB Act did not repeal section 16 of the Glass Steagall Act, which prohibits commercial banks from purchasing securities for its own benefit.33 Thus the only way that a commercial bank can finance the underwriting of securities is through loans to its securities affiliate or to its financial subsidiary. Such loans were a focal point of the Glass Subcommittee Hearings as the hearings focused almost entirely on banks lending to their securities affiliates.34

B. THE RISKS OF STOCK ISSUES

There are two basic types of public stock offerings, the initial public offering (IPO), which is a private company's first sale of stock to the public,35 and the follow on offering, a company's offering of more shares after its IPO.36 In the case of either type of offering, the underwriting firm can purchase all of the shares to be sold from the issuing firm and then sell them to the investing public in what is known as a firm commitment.37 The risk associated with the firm commitment is that the price of the securities might deteriorate while they are in the under-

31. BENSTON, supra note 5, at 27 (quoting Hearings on S. Res. 71 Before the Subcomm. on Banking and Currency Comm., 71st Cong. 1057-58 (1931)).
32. Id. at 217 (quoting Hearings on S. Res. 71 Before the Subcomm. on Banking and Currency Comm., 71st Cong. 272 (1931) (statement of Sen. Carter Glass)).
33. § 24.
34. BENSTON, supra note 5, at 217.
writer's inventory, which would decrease profits or even result in losses if the underwriter is not able to sell all of the securities that it has purchased from the issuer. If this scenario occurs, the underwriter could face a large-scale financial loss, and if the money to finance the issue came from the securities firm's commercial banking affiliate, that bank could face a very large default. While the idea that a skilled, seasoned underwriter would not be able to sell the entirety of a stock issue at a price that would allow it to recoup its investment seems like a bit of a farce, it is possible given the inherent risks associated with a public stock offering.

The initial public offering is particularly risky for an underwriter for a variety of reasons. IPOs are generally carried out by smaller younger firms seeking capital to expand their business. Due to this fact and the fact that the firms' stock has never been publicly traded before, underwriters often have a very difficult time estimating the demand for the shares which dictates the price that investors would be willing to pay for them. Because of this uncertainty, underwriters always run the risk of overvaluing the issue when they purchase it. This occurred in the well publicized debacle of the British government's IPO of British Petroleum in which the underwriters lost over $1 billion dollars in one day and was very common during the IPO boom of the 1990's. Even if the underwriter is able to sell all of the shares that it purchased, if the price of the shares drops sharply afterwards due to a valuation error, it still faces the risk that the purchasers of the shares might sue it for over-hyping the issue, which was also a common occurrence during the IPO boom. There is so much uncertainty associated with the valuation of an IPO that IPO prospectuses include price spreads in which the underwriter sets out a broad price range at which the securities are expected to be offered in order to get a feel for what the market might be willing to pay, despite what the underwriter believes the issue to be worth. Underwriters with a significant number of institutional customers often wish to price an IPO between $13.00 and $20.00, regardless of the price that their valuation techniques yield because a bias exists among some sophisticated investors against lower-priced offerings. These actions on the part of underwriters demonstrate that the securities industry as a whole does not place a great deal of faith in underwriters' pre-offering valuations of IPOs. In an

40. See Investopedia.com, Initial Public Offering, supra note 35.
41. See BREALEY & MYERS, supra note 39, at 410.
42. Id.
43. Id.
45. Id. at 347.
environment plagued with uncertainty, it is easy to see how an underwriter could inadvertently overvalue an offering and suffer serious financial consequences.

The other basic type of public offering is the follow on offering, which comes after the initial public offering. One might assume that the risk of valuation errors that occur within the context of the IPO would not be as prevalent in a follow on offering because the firm's shares are already publicly traded, and thus the market has already established a price for the firm's existing shares. Despite this fact, there is still a risk of overvaluation with this type of offering. The reason for this is that potential investors may believe that the firm's management thinks that the firm's existing shares are currently overvalued and are offering another issue simply to raise as much capital as possible before the market corrects its valuation, which is not an uncommon scenario. Investor paranoia aside, there is also evidence that underwriters, in general are not anymore confident in their valuation of follow on offerings than their valuation of IPOs in that they use the exact same measures to reduce the risk of valuation errors in both types of offerings. Underwriting syndicates are common in both IPOs and follow on offerings, unless the issuer of the follow on offering is a seasoned firm. An underwriting syndicate is formed to allocate total underwriting risk across multiple underwriting firms, so that no single firm bears all of the risk of overvaluation for a particular offering. In follow on offerings and IPOs, underwriters often utilize Rule 430A of the 33 Securities Act, which allows a registration statement to become effective without a set price as long as the price is set within five days of the effective date. This rule allows the underwriter to have a better idea as to the price at which the issuer's securities will be trading before he purchases them, mitigating the risk of overpayment.

Another risk-reducing measure, common to both types of securities issues, is a stabilization agreement. Such an agreement entitles the managing underwriters in a syndicate, who will always have the largest stake in the issue, to purchase all of the securities issued from other underwriters at a set price. When the market price of the issued securities falls below the original issue price, the measure allows the managing underwriter to purchase the rest of the issue at the original price, thus fixing the price at that level and preventing other investors from purchasing it at a discount. Though a stabilization agreement does allow the managing underwriter to fix the market price, it puts the underwriter in the unenviable

46. See Investopedia.com, Follow On Offering, supra note 36.
47. See BREALEY AND MYERS, supra note 39, at 414.
48. See Allen, supra note 44, at 333.
49. Id.
50. Id. at 348.
51. Id.
52. Id. at 349.
53. Id.
position of having to purchase the securities at a price above what the market is willing to pay. This will lead to a short-term loss of profit to the underwriter, which will not be recovered until the stock rebounds, assuming of course that it ever does. Depending on the size of the decrease in the post-issue price, the underwriter's use of this risk-reducing measure could either wipe out its profits or cause it to incur a loss.

Another risk-reducing measure involves what is known as overallotment, which allows an underwriter in a syndicate to sell more than its allotted share in the market, thereby creating a short position in the securities. This method of risk mitigation demonstrates how little confidence an underwriter has in his valuation and how concerned he is with the possibility of having to sell the securities at a price below what he paid for them. When an underwriter shorts securities, he is betting that the price will fall after he has purchased them from the issuer. In fact, the only way in which one can profit from a short sale, due to the transaction costs associated with it, is if the security actually decreases in value. If the security increases in value, the underwriter will lose money covering the short, and if the increase is large enough, covering the short could cost the underwriter all of his profits and more, unless efforts are made to mitigate this risk.

The fact that these extreme risk-reducing tactics are used in both IPOs and follow-on offerings, demonstrates that risk of overvaluation is very real. In addition to the risk of overvaluation, there is also the risk that the firm, for which an underwriter conducted a public offering, could experience an earnings disappointment, missed milestone or volatile operating performance that could cause a drastic decrease in the firm's stock price, while the underwriter is still holding the securities in inventory. This too could lead to the underwriter not being able to sell all of the securities and not recouping its initial investment. This risk, like the risk of overvaluation, occurs in the context of both IPOs and follow-on offerings. Thus both types of offerings pose a significant amount of risk for an underwriting firm.

Those who work in the financial industry would inevitably counter this argument by pointing out that underwriters generally seek to undervalue issues in order to reduce the amount of risk they will face. While this is

54. Id.
56. Id.
58. Id. at 33.
59. Id.
60. See Allen, supra note 44, at 346.
true, an underwriter's ability to do this is limited by the demands of the issuer, particularly when the issuer needs a certain amount of capital to finance a particular project. In response to this, supporters of the GLB Act argue that some stock offerings are obviously more risky than others, and that large commercial banks, which make up the vast majority of banks in the country that currently engage in securities underwriting, would not allow their affiliates to deal with high-risk stock offerings out of fear of besmirching their reputations. This argument does seem to make a great deal of sense. There does not seem to be any logical reason for a large, well-to-do commercial bank to associate itself with a securities firm that has a reputation for engaging in highly speculative stock offerings, when such an association could potentially undermine the trust and confidence of its depositors. Unfortunately this argument has no basis in fact. By the end of 1999, several big banks had made substantial equity investments in high-tech firms. High-tech firms by nature are inherently risky. These risks did not stop banks from increasing their investment in tech stocks during the first half of 2000, and after the tech bubble burst, eight major banks reported combined losses of $4 billion from losses on these investments. These equity investments were venture capital deals, which are merchant banking activities rather than investment banking activities. However, the fact that large commercial banks were willing to invest in the equity of tech firms demonstrates that they are not opposed to dealing in high-risk equity.

C. THE RISKS OF BOND ISSUES

Bonds are another type of security underwritten by securities dealers. As is the case with stock offerings, an underwriter can purchase the entire issue of the bonds from the issuer and then attempt to market it to the investing public through a firm commitment.

The risks associated with a firm commitment of bonds are the same as those of a firm offer of stock in that the underwriter may not be able to sell all of the bonds to the investing public because of a decrease in their value while the underwriter is holding them, which could lead to lower than expected profits or a loss.

Even though bonds pose the same type of risk to the underwriter, they

61. Id.
64. Id. at 331.
65. Id. at 332.
66. Id.
67. Id. at 327.
68. See van Bergen, supra note 38.
are generally considered to be less risky investments than stocks.\textsuperscript{69} One big exception to this rule, however, is junk bonds. Junk bonds are high-yield bonds below investment grade.\textsuperscript{70} They are below investment grade because they carry a higher than average risk of default.\textsuperscript{71} Events since 1989 show that underwriters in the junk bond market face significant liquidity, volatility, and default risks.\textsuperscript{72} These risks became very evident to the investing public during the well publicized junk bond debacle of the early 1990s. During this time period, there was a sudden rise in junk bond defaults, due in part to the recession of 1990-91.\textsuperscript{73} Some of these defaults were quite large as ten of the twenty-five companies that issued $1 billion or more in junk bonds during the period between 1985 and 1989 defaulted on their bonds.\textsuperscript{74} These defaults triggered sharp declines in the market values of outstanding junk bonds, which in turn led or contributed to the near insolvency of several leading securities firms and banks, as well as the bankruptcy of the once-mighty Wall Street powerhouse Drexel, Burnham, and Lambert.\textsuperscript{75}

Since junk bond issues have proven to be extremely risky, one might assume that large commercial banks would seek to avoid them at all costs, especially after the massive junk bond devaluation of the early 1990s put many large banks in financial jeopardy. Unfortunately, this is not the case. Leading banks now underwrite a major portion of domestic junk bonds and are aggressively expanding into overseas markets.\textsuperscript{76} Even before the GLB Act was passed, commercial banks, through their section 20 subsidiaries, underwrote one-third of all domestic junk bond issues in 1999, up from one-fifth in 1996.\textsuperscript{77} Now that the Glass Steagall Act restrictions no longer exist, Citigroup, J.P. Morgan Chase, and Bank of America have become leading underwriters of junk bonds.\textsuperscript{78} Chase has even gone so far as to direct much of its underwriting business to its non-investment grade customers.\textsuperscript{79}

An argument could be made that junk bonds are not that risky, and that the massive junk bond devaluation of the early 1990s was an anomaly caused by the combination of a recession and the overheated leveraged buyout (LBO) market of the late 1980s.\textsuperscript{80} Because it is unlikely that the LBO market will ever reach the overheated level that it did in the late

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\textsuperscript{71} Investopedia.com Articles, Junk Bonds: Everything You Need to Know, http://www.investopedia.com/articles/02/052202.asp.
\textsuperscript{72} Wilmarth, Jr., supra note 63, at 330.
\textsuperscript{73} Id. at 328.
\textsuperscript{74} Id.
\textsuperscript{75} Id.
\textsuperscript{76} Id. at 329.
\textsuperscript{77} Id. at 326.
\textsuperscript{78} Id.
\textsuperscript{79} Johnson, supra note 1, at 179.
\textsuperscript{80} Wilmarth, Jr., supra note 63, at 328.
1980s and early 1990s and even more unlikely that a recession would hit right in the middle of it, one could argue that junk bonds are simply not as risky as they were during that time period, and might not ever be that risky again. This assumption is invalid, however, as evidenced by the massive number of junk bond defaults that occurred between the years of 1998 and 2001. The junk bond default rate tripled during this time period, reaching its highest level in almost a decade and as a result, yield rates on junk bonds reached their highest levels since 1991.81 There was no recession or LBO craze between 1998 and 2001. In fact, “[a]nalysts blamed this sharp rise in junk bond defaults on the willingness of banks and securities firms to underwrite a record number of highly speculative issues.”82 The sheer magnitude of damage that junk bond defaults could inflict upon a firm became very evident during this time period. American Express lost over $1 billion from investing in junk bonds, and the FRB organized rescues for Banker’s Trust and LTCM, two firms that reached the point of insolvency due to their investment in junk bonds.83 But despite the fact that junk bonds are still risky, commercial banks aggressively pursue the underwriting of junk bond issues. Banks did not pursue junk bond underwriting until the very early 1990s, but now that they underwrite a major portion of domestic junk bonds through their securities affiliates or financial subsidiaries, they openly expose themselves to adverse developments in the market.84

D. The “Double-Exposure Risks”

1. Banks Making Loans to Their Securities Affiliates to Underwrite a Firm’s Securities Issue and Then Making Loans to That Firm

Critics of the Glass Steagall Act may have claimed that all the Act really did was prevent commercial banks from making loans to securities affiliates by not allowing commercial banks to affiliate with securities firms. The Act fails to prevent commercial banks from lending money to unaffiliated securities firms. Although this is a valid point, what the framers of Glass Steagall worried about, or what they should have been worried about, was commercial banks engaging in transactions that would subject them to a two-tiered exposure to underwriting risks. This two-tiered or “double exposure” risk could come about in two different ways. The first involves a situation in which a commercial bank lends money to its securities affiliate to underwrite an issue of securities for a particular firm, and then lends money to that same firm. The framers of the Glass Steagall Act were concerned about commercial banks making loans to their securities affiliates to finance securities issues.85 They also worried

81. Id. at 329.
82. Id.
83. Id. at 329-30.
84. Id. at 330.
85. “The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans. . . .” Investment Company Institute v. Camp, 401 U.S. 617 n.29 (citing S. REP. NO. 73-77, at 8).
about banks making loans to firms that had contracted with the bank’s securities affiliate to underwrite its securities. In fact, the U.S Supreme Court, in interpreting the legislative history of the Glass Steagall Act, stated that one of the main problems with allowing banks to affiliate with securities firms was that the bank might be tempted to loan money to a firm to which its securities affiliate had already provided underwriting services. The Court was commenting here on the belief of the framers of the Glass Steagall Act that such loans might be made without regard to the creditworthiness of the firms of which the bank’s securities affiliate had underwritten securities for, which could put depositors’ funds at risk. It is unclear from the legislative history whether Congress worried about commercial banks being faced with double exposure to securities underwriting, or if they simply worried about commercial banks making unsound loans to firms whose securities their affiliates had underwritten. If Congress was concerned about the latter, it occurs today. Ever since the passage of the GLB Act, “[c]ommercial banks are offering customers inexpensive loans in order to land lucrative securities underwriting mandates.” Low interest or barely profitable loans could definitely be unsound because the interest rate in a low interest rate, or barely profitable, loan may inadequately compensate the lender for the default risk of the borrower.

While there is no indication in the legislative history of the Glass Steagall Act that Congress contemplated the “double exposure risk,” they were concerned with commercial banks financing underwriting endeavors, as well as with commercial banks making loans to firms that their securities affiliate had underwritten securities for. This “double exposure risk” is simply a combination of these two risks and may represent a greater danger to the safety and soundness of commercial banks than either of the aforementioned risks by themselves because the bank could face two defaults: its securities affiliate could default on the loan if it is not able to sell the entire issue, and the firm itself could default on its loan.

It does indeed seem very unlikely that a double default such as this would come to fruition. One would assume that such a scenario would only occur if the borrowing firm in question was one that the market viewed as extremely risky and that large prestigious financial institutions would never lend money to such an unstable firm and then turn around and finance the underwriting of its securities. Unfortunately this is not

86. Id at 631.
87. Thomas G. Fischer., The Securities Activities of Commercial Banks: A Legal and Economic Analysis, 51 Tenn. L. Rev. 467, 504 (1984)).
88. Johnson, supra note 1, at 161.
89. “*[T]he fixed purpose of Congress’ not to see the facilities of commercial banking diverted into speculative operations by the aggressive and promotional character of the investment banking business.” Camp, 401 U.S. at 632 (citing 75 Cong. Rec. 9884).
the case. In recent years, leading banks have aggressively offered packages of loans and junk bonds to finance mergers and acquisitions by firms specializing in LBOs. In these transactions, banks provide loans to the LBO sponsor, who eventually becomes the owner of the acquired firm and is responsible for servicing the bonds used to finance the acquisition as well as the loans made to the firm. As stated earlier junk bonds are inherently risky but more importantly, they are an indicator that the issuing firm carries a high default risk. In such a transaction, commercial banks are lending money to high risk firm and financing the underwriting of their high-risk securities.

2. Banks Making Loans to Their Securities Affiliate to Underwrite a Securities Issue and Then Making Rescue Loans to That Firm When it is in Financial Jeopardy

The other type of “double exposure risk” arises when a commercial bank lends money to its securities affiliate for underwriting purposes, and the securities affiliate later falls into financial trouble. If the commercial bank then lends money to the securities affiliate to rescue it, the bank faces a double exposure to underwriting risk. The initial loan for underwriting obviously opens it to underwriting risk, and the second loan to the securities firm indirectly exposes it to underwriting risk because the securities firm itself is exposed to underwriting risk. This “double exposure risk” was not mentioned in the legislative history of the Glass Steagall Act. However, Congress was concerned with banks making rescue loans to their affiliates as evidenced by a statement read before Congress, stating:

Activities of a bank’s securities affiliate as a holding or finance company or an investment trust are fraught with the danger of large losses during a deflation period. Bank affiliates of this kind show a much greater tendency to operate with borrowed funds than do organizations of this type which are independent of banks, the reason being that the identity of control and management which prevails between the bank and its affiliate tends to encourage reliance on the later.

As mentioned earlier, Congress was worried about bank funds being used for underwriting. Once again, this double exposure risk is a combination of two risks, contemplated by Congress, that is much more dangerous to the safety and soundness of a bank than either of the individual risks standing alone.

91. Wilmarth, Jr., supra note 63, at 326.
92. Id.
93. Id. at 71.
94. Camp, 401 U.S. at n.21 (citing Hearings Pursuant to S. Res. 71 before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong. 1058 (1931)).
95. Camp, 401 U.S. at 632.
3. Regulation W and Its Failure to Mitigate the “Double-Exposure Risks”

The concept of the “double exposure risk” is based on the premise that a securities affiliate can get into financial trouble by being unable to sell security issues at the price that allows it to recoup its investment in those securities. Once this occurs, the assumption made is that the affiliate will then default on its commercial loan. Whether or not a securities affiliate would default on its loans after a loss on a securities issue is debatable. While one bad securities offer might not be enough to put the firm in financial jeopardy, evidence presented at the Glass Subcommittee Hearings did demonstrate that two or three bad offerings could wipe out the profits of a securities firm. These profits would presumably be the source of the funds that the securities firm would use to service the debt. Regulation W, which was promulgated under Sections 23 and 24 of the Federal Reserve Act, places limitations on transactions between a commercial bank and its affiliate. One reason that this regulation was presumably put in place was to insulate commercial banks from the risk of their securities affiliates defaulting on loans made by the banks. Regulation W requires that loans made by banks to their affiliates be collateralized at 100-130 percent, depending on the type of the collateral. The Regulation also requires a commercial bank to set the interest rate on these loans at a market rate, which the regulation defines as a rate favorable to the member bank, as those prevailing at the time for comparable transactions with or involving non-affiliates. Presumably, this requirement is in place to insure that the bank is adequately compensated for the risk of the loan.

There are multiple problems with this Regulation, both on its face and in its application. The first problem deals with the market rate requirement. Commercial banks already make barely profitable loans to firms that use their securities affiliates for underwriting services. These firms are non-affiliates, so wouldn’t the rate on a loan to one of these firms be a market rate? There has been no litigation yet to determine this, but if the rate on these barely profitable loans is a market rate, the question raised is whether such a rate adequately compensates a bank for the inherently high default risk of an underwriting firm.

Another problem with Regulation W is the collateralization requirement. The primary assets of investment banks are securities, so they would more than likely pledge securities as collateral for large loans from their commercial affiliates, which Regulation W expressly allows them to do. Securities in general are subject to value fluctuations and liquidity

96. BENSTON, supra note 31.
97. 12 C.F.R. § 223.1
98. 12 C.F.R. § 223.14
99. 12 C.F.R. § 223.51
100. Johnson, supra note 1, at 161.
101. 12 C.F.R. § 223.14 (b)(D)(iii)-(iv)
risks, while cash is not. If the commercial bank is forced to seize these securities as collateral, it may have difficulty selling them due to the restriction in section 16 of the Glass Steagall Act.\textsuperscript{102} In addition to this problem, if the value of these securities depreciated, the bank may not be able to sell them at a price that would compensate it for the amount of its loan, or it might be unable to sell them at all.

The third and final problem with Regulation W is one of application. If the securities firm is in financial distress, there is a possibility that it may not be able to meet these collateralization requirements. If the securities firm is unable to find adequate rescue financing from another bank, its commercial banking affiliate may find itself in the position of having to idly stand by while the firm goes under. This is because Regulation W will not allow the commercial bank to make any loans to the firm that are not collateralized.\textsuperscript{103} This raises the question as to whether the FRB would actually prevent a commercial bank from rescuing its affiliate in such a situation. The FRB recently created a “Too Big to Fail” policy that was intended to assure the public that it would do everything in its power to prevent any large commercial bank from failing.\textsuperscript{104} This doctrine was enacted to prevent depositors from panicking and seeking immediate withdrawal of their funds from a large bank if that bank entered a state of financial distress.\textsuperscript{105} Large banks are generally the only banks that affiliate with securities firms.\textsuperscript{106} The framers of the Glass Steagall Act believed that if a securities affiliate was facing insolvency, depositors of the affiliated commercial bank might panic and try to withdraw all of their funds, just as they might if the bank itself was in trouble.\textsuperscript{107} This led many commentators to believe that, in the spirit of the “Too Big to Fail” doctrine, the FRB would not prevent a large commercial bank from rescuing a troubled securities affiliate in fear that the affiliate’s insolvency would undermine the public’s confidence in the bank.\textsuperscript{108} If the FRB did allow this rescue to happen, the commercial bank faces the double exposure risk, assuming that it had made loans to the securities affiliate to finance securities issues.\textsuperscript{109} Due to these three aforementioned problems with Regulation W, it is clear that the regulation fails to insulate the firm from the “double exposure risk.”

\textsuperscript{103} 12 C.F.R. § 223.14
\textsuperscript{104} Wilmarth, Jr., supra note 63, at 225.
\textsuperscript{105} Id.
\textsuperscript{107} Camp, 401 U.S. at 630-31 (1970) (stating that “pressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired”).
\textsuperscript{108} Wilmarth, Jr., supra note 63, at 225.
\textsuperscript{109} Id.
IV. ANTI-COMPETITIVE RISKS

The ability of banks to take on the double-exposure risk, in which they lend money to their securities affiliates to underwrite a firm's securities issue and then make loans to that same firm, has provided them with a competitive advantage over unaffiliated investment banking firms, the ability to exploit this advantage via anti-competitive activities, and the ability to become leaders in the underwriting industry. This trend, if allowed to continue, would result in a concentration of underwriting business within a small number of large banks that control the majority of deposits in this country, which could be detrimental to the safety and soundness of the banking industry.

A. THE COMPETITIVE ADVANTAGE OF BANKS

The Congress of 1933 was concerned "with the relationship between commercial banks and their subsidiaries that underwrote securities and the ability of the banks, through their subsidiaries, to dominate corporate underwriting."\(^\text{110}\) According to former Assistant Secretary of the Treasury for Domestic Finance, Roger Mehle, this ability stems from the fact that commercial banks retain a significant competitive advantage over non-bank underwriters, including a lower cost of capital and the tax deductibility of carrying costs.\(^\text{111}\) In regard to the lower cost of capital claim, Mehle points out that the majority of banks' liabilities are low-interest or interest-free deposits, as opposed to investment banks, which borrow money from commercial banks to finance their activities.\(^\text{112}\) Another commentator expounded that banks can also seek Federal Reserve discount window borrowing, while non-bank underwriters cannot.\(^\text{113}\) Because commercial banks have this ability to borrow at a lower interest rate than non-bank underwriters, underwriting is more profitable for them than for investment bankers.\(^\text{114}\) This profitability advantage creates a competitive advantage. Because banks are no longer able to directly underwrite most securities,\(^\text{115}\) an argument could be made that they are no longer in the position to exploit this competitive advantage. However, the bank might be able to pass along this advantage to its securities affiliate by loaning it money at an interest rate below what an unaffiliated investment bank would pay on a similar loan from an unaffiliated commercial bank. This conceivably gives the affiliated securities firm a profit advantage over an unaffiliated securities firm, which creates a competitive advantage. Regulation W might prevent this from happening be-


\(^{111}\) BENSTON, supra note 5, at 164; Roger W. Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 SYRACUSE L. REV. 1117, 1155 (1975).

\(^{112}\) Mehle, supra note 111, at 1139.

\(^{113}\) BENSTON, supra note 5, at 165.

\(^{114}\) Mehle, supra note 111, at 1140.

cause it requires a market rate of interest on loans between affiliates, but as discussed earlier, the question remains as to what a market rate is. Assuming that because of Regulation W restrictions commercial banks are not able to make low-interest loans to their affiliates, securities affiliates still have one very substantial competitive advantage over unaffiliated securities firms: the ability to secure low-interest, barely profitable loans from their affiliated commercial banks for the firms that they underwrite securities for. Banks have a clear competitive advantage over securities firms in making loans because securities firms have to pay a higher interest rate on money they borrow. Large banks affiliated with securities firms exploit this competitive advantage.

B. BANKS AS LEADERS IN THE UNDERWRITING INDUSTRY

As stated earlier, "[c]ommercial banks are offering customers inexpensive loans in order to land lucrative securities underwriting mandates" for their affiliates. A great deal of evidence exists showing that large banks gain substantial market share as a result of this competitive advantage. For instance, bank-affiliated investment banking firms topped the list of revenue producers in the industry in 2001. Salomon Smith Barney, JP Morgan Chase, Bank of America Securities, and First Union Securities were all among the top fifteen underwriters of U.S. Debt and Equity Offerings in the United States. In fact, Citicorp, the financial holding company of Citibank, became the industry leader in underwriting revenues, and many believe that it has risen to this position because it promises firms barely profitable loans from Citibank if the firm allows its securities affiliate, Salomon Smith Barney, to provide underwriting services. JP Morgan Chase also seeks to marry its lending and underwriting business together in efforts to further develop its investment banking activities. More and more large corporations have become aware of the fact that commercial banks can offer these low-interest loans in tandem with underwriting services, and they have taken advantage of this. Though they have not necessarily stopped dealing with unaffiliated investment banking firms, many have threatened to do so if their investment bank does not provide them with low-interest loans. This strategy, known as "pay to play," is becoming a normal part of doing business, as evidenced by the fact that large corporations such as Ford, AT&T, Lucent, and Primedia have all disclosed that they are requiring

117. See Mehle, supra note 111, at 1155.
118. See Schooner & Taylor, supra note 13, at 349.
119. Johnson, supra note 1, at 161.
120. Schooner & Taylor, supra note 13, at 348-49.
121. Johnson, supra note 1, at 171.
122. Schooner & Taylor, supra note 13, at 389.
123. Johnson, supra note 1, at 170.
124. Id. at 176.
underwriters to lend to them. Premier securities underwriters, such as Merrill Lynch and Goldman Sachs, found out the hard way that if they refuse such a request, many large firms remain more than willing to take their business to a securities affiliate of a commercial bank that will provide the low-interest lending. Many investment banks are not in the position to make the low-interest loans that commercial banks can offer.

C. Tying Arrangements: Potential Anti-Competitive Activities

Unaffiliated investment banks are understandably annoyed by the fact that banks are exploiting this competitive advantage and have the ability to do so in the first place. Many of these firms are crying foul because they, like many industry analysts, believe that banks engage in tying arrangements with some of their smaller, less influential customers. In this context, a tying arrangement results if a commercial bank demands that one of its commercial clients contract with its securities affiliate for underwriting services, or else the bank would cut off the firm’s existing line of credit. If this occurred, the firm could simply stop doing business with that bank and find another lender. The problem is that once a firm establishes a relationship with a commercial bank, over time the bank tends to provide the firm with more favorable terms for loans and other financial services as a reward for their loyalty. In addition, the credit market is tightening and it has become very difficult, even for large corporations, to retain important bank credit lines. Thus it may be in the firm’s best interest to allow the bank’s securities affiliate to carry out its securities underwriting, as it may be unable to find such favorable lending terms, or any lending whatsoever, from a different bank that it has not done business with in the past. The ability of the bank to entice large corporations to contract with their securities affiliates for underwriting services unquestionably provides the bank with a competitive advantage over non-affiliated investment banking firms. This competitive advantage is definitely a threat to non-affiliated investment banking firms. But if these same commercial banks could also use their existing relationships with their smaller, less influential customers as leverage to coerce them into contracting with their securities affiliate for underwriting services, such an arrangement would constitute a very potent, anti-competitive weapon, which if used on a large enough scale, could spell disaster for unaffiliated investment banks.

The good news for unaffiliated investment banking firms is that such coercive arrangements may be illegal under the Bank Holding Company Act (BHCA). The anti-tying provision of the act states that a “bank

125. Id. at 177.
126. Id. at 176.
127. Id. at 176-77.
128. Id. at 172.
129. Id.
shall not in any manner extend credit . . . on the condition or requirement . . . that the customer shall obtain some additional credit, property, or service from such bank.” This provision also applies to products or services that might be offered by a bank’s affiliate or subsidiary, which is obviously important here because an underwriting/lending tying arrangement would involve the bank’s affiliate or subsidiary.

Although this statute seems to explicitly outlaw commercial banks from engaging in such tying arrangements, there are several reasons why it may not. First, the provision of the BHCA was added in 1970, when the Glass Steagall Act restrictions on affiliations between investment and commercial banks were still in effect. Thus it is questionable whether the BHCA’s anti-tying provisions apply to an underwriting/lending tie because Congress probably did not even contemplate the fact that such a tying arrangement was possible. Second, the BHCA may not apply to an underwriting/lending tie because for a tie to exist, there must be two separate products, and a commercial bank could simply argue that lending and underwriting are both forms of corporate finance, and not two separate products. Whether or not this argument would prevail remains to be seen because there has been no litigation involving this matter. A third problem with BHCA’s applicability to such tying arrangements involves the burden of proof, required on the part of the plaintiff, to succeed in an anti-tying action. A tie is difficult to prove in the absence of a contractual provision that expressly establishes it, and there appear to be no examples of such requirements in any loan document, thus far, that expressly condition the granting of a loan on the borrower using the bank’s securities affiliate for underwriting services. This is probably because banks are well aware of the fact that the existence of such a clause would constitute clear and convincing evidence of a tying relationship.

The final and most important reason that the BHCA’s anti-tying provisions may not apply to underwriting/lending ties has to do with the fact that banks are probably engaging in implied rather than express tying arrangements. An express tying arrangement occurs, under the BHCA, when a bank states, either orally or in writing, that the customer cannot purchase one banking product if he does not purchase another. Assuming that the BHCA does apply to underwriting/lending ties, if a bank demanded that a customer did business with its securities affiliate in order to obtain a loan, such an action would constitute tying.

131. § 1972(1)(A).
132. § 1972(1)(B), (D).
133. § 1972.
134. Johnson, supra note 1, at 187.
135. Id.
136. Id. at 183.
137. Id.
138. Id. at 185.
140. Johnson, supra note 1, at 182.
ever, it is much more likely that banks are engaging in implied tying arrangements, in which the bank threatens to reduce or cut off credit unless the borrower agrees to use the bank’s securities affiliate for its underwriting needs. Evidence of such implied tying arrangements stems from the fact that commercial banks have been very aggressive in publicizing that a customer should give to the commercial bank other non-lending business if it wants the commercial bank to continue lending to them. Some commercial banks have even gone so far as to limit their lending to customers who do not purchase additional services from them. As counterintuitive as it may seem, such implied tying arrangements may not violate the BHCA’s anti-tying provisions. According to the statute, a bank may not extend credit on the condition or requirement that the customer shall obtain some additional credit, property, or service from such bank. In defending its implied-tying practices, a bank could argue that it had already extended credit to its customer and was simply threatening to cut off the customer if it failed to purchase underwriting services from the bank’s securities affiliate. Such an argument is plausible in that situation because the implied-tie would not seem to violate the statute on its face. Whether such an argument would be successful in court is uncertain because there has not yet been any litigation dealing with implied ties under the BHCA.

Despite problems with the application of the BHCA to underwriting/lending ties, it seems unlikely that courts would shy away from ruling that such arrangements violated the anti-tying provision of the BHCA. The wording of the anti-tying provision suggests that Congress passed the measure to prevent banks from blackmailing their customers into purchasing additional products. If banks are indeed conditioning the granting of credit on the purchase of underwriting services, such activity would seem to constitute the type of coercion the statute was designed to prevent. While there is a compelling argument that the anti-tying provision may not apply to implied ties, there is also a very strong argument that it does. When a bank threatens to cut off credit to an existing customer if the customer refuses to purchase underwriting services, it is true that the bank did not make the purchase of such services a condition of the credit initially. However, the bank conditions the granting of additional credit on the purchase of underwriting services. Such action on the part of the bank seems to violate the anti-tying provision on its face. Even if a court rules that the provision does not apply to implied ties, then general anti-trust law, which does outlaw implied ties, may still apply. Congress, the General Accounting Office (GAO), and banking regulators are currently investigating these alleged tying violations on the

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141. Id. at 185.
142. Id.
143. Id.
144. Id. at 184.
145. Id.
146. Id.
part of commercial banks, so it is possible that new laws or regulations could be enacted that specifically bar banks from engaging in such activity.

D. The Potential Monopolization of the Underwriting Industry by Commercial Banks and the Resulting Threat to the Safety and Soundness of the Banking System

Assuming that commercial banks are not allowed to engage in underwriting/lending ties, they still have a substantial competitive advantage over unaffiliated investment banks due to their ability to make low-interest loans to perspective underwriting clients. Large commercial banks have obviously exploited this advantage, as evidenced by the growing concentration of securities activities within a small number of these large entities. If this trend continues, it is possible that these large commercial banks could one day dominate the industry, exposing these banks to an enormous amount of underwriting risk. This in and of itself might not be a problem, if it were not for the fact that large banks, such as those that have become revenue leaders in the underwriting industry, also dominate in the lending industry. The ten largest banks in the country now control 49 percent of the industry’s assets, including over $1 trillion in deposits. If these banks were to become the dominant firms in the underwriting industry, they would be exposed to both substantial underwriting risks and substantial default risks that stem from their status as the preeminent firms in the lending industry. It is well known that the rate of loan defaults rises drastically during recessions. Securities also tend to suffer during a recession since the rate of junk bond defaults rises and stocks tend to depreciate in value. With these facts in mind, one could conclude that large banks with significant exposure to loans, junk bonds, and stocks could find themselves in a great deal of financial trouble during a recession, much more so than they would if they were only involved in lending. This suspicion was recently confirmed by a study that found that large banks engaged in capital market ventures faced higher risks and were more vulnerable to macroeconomic fluctuations than smaller banks that engaged primarily in lending. As a result, the growing concentration of securities activities within a small number of large banks greatly increases the likelihood that the failure of any of these institutions could result in a costly bailout by federal regulators. More disturbing is the proposition, made by the FRB, that if more than two of these banks failed, there is a high probability that the Bank Insurance Fund’s current reserves would be insufficient to bail them out. The implications of

147. Id. at 179.
148. Wilmarth, Jr., supra note 63, at 250.
149. Id. at 252.
150. Id. at 250.
151. Id. at 224.
152. Id. at 247.
this are clear. If the concentration of securities underwriting and other securities activities continues to increase within a small number of large banks, the probability of this country facing a large-scale financial catastrophe also continues to increase. The failure of one of these large banks would probably not lead to such a catastrophe, but a government bailout of the bank would cost the taxpayers a great deal of money, and such a failure could start another banking scare in the short-term. If more than two of these banks failed, and federal regulators did not have adequate funds to bail them out, this could ignite a full-blown banking crisis.

V. INHERENT CONFLICTS OF INTERESTS

Besides the risks associated with securities underwriting and anti-competitive activities, Congress was also deeply concerned with conflicts of interest that could arise from the relationship between a commercial bank and a securities affiliate. More specifically, Congress feared the detrimental effects such conflicts could have on overall public confidence in the bank and its solvency.\(^{153}\)

A. BANKS LENDING MONEY TO THEIR FINANCIALLY-DISTRESSED SECURITIES AFFILIATE

One potential conflict of interest addressed by Congress involved situations in which the bank’s securities affiliate fell on hard times, and the bank responded by making unsound loans to its affiliate, disregarding its duty to protect its depositors’ funds, in an attempt to rescue the affiliate from insolvency.\(^{154}\) The financial risks associated with a bank lending funds to its financially distressed securities affiliate are obvious, but the possibility that the affiliate might default was not the extent of Congress’ concern. Public confidence is essential to the solvency of a bank,\(^{155}\) and the U.S. Supreme Court believed that the framers of the Glass Steagall Act were concerned that if the public became aware that a given bank’s securities affiliate was in financial distress and that the bank was making rescue loans to the affiliate, this could undermine public confidence in the bank which could threaten its solvency.\(^{156}\) Such a scenario may pose an even greater threat today than it did during the period in which the Glass Steagall Act was enacted. In the early 1930s, radio and newspapers were the primary media outlets. Today, with the Internet, television, and even a cable station specifically dedicated to financial news exist, there is a much greater probability that a large majority of the public would be aware that a securities firm was in financial trouble, which bank that firm was affiliated with, and that the bank was making unsound loans to that institution in hopes of rescuing it.

\(^{153}\) Camp, 401 U.S. at 631.
\(^{154}\) Id.
\(^{155}\) Id.
\(^{156}\) Id.
B. Banks Recommending Speculative Securities, which their Affiliates Underwrote, to their Depositors

Another conflict of interest which concerned Congress involved a scenario in which commercial banks might provide biased investment advice to their depositors by recommending that they purchase stocks that the bank's securities affiliate underwrites. Senator Bulkley addressed this risk in a statement that he made during the Glass Subcommittee Hearings, stating:

Obviously the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit.

In commenting on the possibility of a depositor losing money on an investment that the bank had recommended, the Senator said that, "although such a loss would possibly not result in any substantial impairment of the resources of the banking institution owning the affiliate . . . there can be no doubt that the whole transaction tends to discredit the bank and impair the confidence of its depositors." Stated more simply, Senator Bulkley was arguing that if a bank recommended to its depositors the purchase of securities, underwritten either by the bank itself or its securities affiliate, this constituted a conflict of interest, and that if those depositors then suffered a loss resulting from investment in those securities, the confidence they had in the bank would be impaired. In addition to the possible undermining of public confidence, Congress feared the detrimental effects that such conflicts of interests could have on the stock market. They were concerned because they believed that these conflicts of interest contributed to the stock market crash of 1929, in that they believed that many banks were guilty of pushing the sale of speculative or worthless stocks, which they or their affiliates had underwritten, on the market. Given these risks, the question arises as to whether such a scenario could come about today. Unfortunately for the investing public, the answer is probably yes, based on the fact that a nearly identical scenario, involving the underwriting and sale of securities, came about very recently.

This scenario involved the treatment by securities analysts of stock issues that had been underwritten by their firms. In April 2002, New York Attorney General Elliot Spitzer announced shocking findings that analysts at Merrill Lynch consistently skewed reports and stock recommen-

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158. Id.
159. Id.
160. S. Rep. No. 73-77, at 6, 8, 10 (1934).
dations to generate business for their investment banking division.\textsuperscript{161} Among the charges included that analysts strongly recommended the purchase of securities that their investment banking division issued to the public, while privately referring to those same securities as "dogs" or "junk" in emails to each other.\textsuperscript{162} It was also revealed that Merrill's analysts hardly ever gave downgrade or sell recommendations on the securities that they covered.\textsuperscript{163} In fact, such recommendations\textsuperscript{164} were virtually non-existent. Perhaps more shocking than this was the revelation that involved a memorandum, sent to analysts at Morgan Stanley, by the managing director of corporate finance of that firm, which stated:

As we are all too aware, there have been too many instances where our Research Analysts have been the source of negative comments about [investment banking] clients of the Firm. . . . Our objective is . . . to adopt a policy, fully understood by the entire Firm, including the Research Department, that we do not make negative or controversial comments about our [investment banking] clients as a matter of sound business practice.\textsuperscript{165}

The implications of these two revelations are clear. Research analysts, who are supposed to provide independent and unbiased advice to their firm's brokerage clients, were skewing their recommendations in an effort to push securities that their firm had underwritten. There are many reasons that the senior management of highly reputable securities firms, such as Morgan Stanley, authorized this activity. First, positive coverage of companies that have used the securities firm for underwriting helps ensure that the securities firm will retain those companies as underwriting clients for future offerings.\textsuperscript{166} Second, a firm whose analysts have a strong reputation for pushing the securities that their firm underwrites should be able to solicit new underwriting business with relative ease.\textsuperscript{167}

Under section 16 of the Glass Steagall Act, commercial banks are allowed to purchase and sell securities at the direction of their customers,\textsuperscript{168} and there is no law that prevents bank employees from recommending the purchase of securities that their affiliate underwrites. Thus there is no legal barrier to such activities. This would unfortunately provide banks, much like securities firms that manage money and offer investment-banking services, with multiple motivations to encourage their employees to engage in such recommendations. For instance, if the bank has loaned its affiliate the funds to finance an issue, the bank has a very strong interest in the success of that issue so that the affiliate can pay
back the loan. More importantly, the financial holding company (FHC), which controls both the bank and the securities affiliate, has a very strong interest in the success of the securities affiliate’s issues because the highly lucrative underwriting fees, which are deducted from the funds that the underwriter obtains from selling the securities to the public, could greatly contribute to the overall profit of the FHC.

One could argue that because no law currently prevents banks from pushing securities that have been underwritten by unaffiliated securities firms to which the bank has loaned money, there is no reason to enact a law or regulation that prevents banks from engaging in the same activity for the benefit of their own securities affiliate. While this is a somewhat plausible argument, it does not recognize the fact that, for two important reasons, the two situations are very different. The first reason is obvious. Besides the ability of an unaffiliated securities firm to pay back the loan, a commercial bank has no stake in the fortunes of an unaffiliated securities firm to which it has provided financing. In contrast, a FHC that has a securities affiliate has a significant stake in the profits of that affiliate. The second reason relates to the repeal, by the GLB Act, of section 32 of the Glass Steagall Act, which prevented banks and securities firms from having the same management.169 Now that commercial banks and securities firms can come under common management, there is a much greater potential for the instatement of such a policy than under a scenario in which a commercial bank simply made a loan to an unaffiliated securities firm. If such a policy was adopted by an FHC, and if depositors lost money on investments recommended to them by their commercial bank, public confidence in that bank could definitely be compromised. It does seem a bit pessimistic to assume that the management of FHCs, which are often made up of large, prestigious financial institutions, would advise their employees to exploit their customers’ trust in such a manner. But the management of Morgan Stanley and other large prestigious financial institutions were doing just that.

VI. CONCLUSION: THREE NEW REGULATIONS THAT COULD SUBSTANTIALLY MITIGATE OR COMPLETELY ELIMINATE THESE RISKS

Despite the substantial risks that commercial banks face in affiliating with securities firms, the promulgation of three new federal regulations by the relevant banking authorities could mitigate or completely eliminate these risks. The FRB and the OCC would have the ability to promulgate these regulations under their power to regulate the “safety and soundness” of covered banking institutions.

A. Regulation Forbidding Banks to Make Loans to Firms That Have Used Their Securities Affiliates for Underwriting Services

The first of these three regulations should forbid banks to make loans to companies that use their securities affiliate for underwriting services. This proposal does seem a bit extreme, but it would completely eliminate a commercial bank's ability to engage in anti-competitive activities to the detriment of unaffiliated investment banking firms. One of the primary motivations for the passage of the GLB Act was to stimulate competition in the financial industry by putting commercial banks on even footing with investment banks.\textsuperscript{170} What it has ended up doing, however, is giving commercial banks a huge competitive advantage over unaffiliated investment banking firms, threatening those firms' very existence. Thus, in the spirit of competition, there is no reason why this rule should not be enacted. Not only would it allow the unaffiliated investment banks to compete on even footing with the securities affiliates of commercial banks, but it would also help reduce the risk of future failures of commercial banks due to their excessive exposure to the securities market. It is no secret that as these large banks continue to monopolize the underwriting industry, their exposure to the securities market increases exponentially. A bad securities market could threaten the safety and soundness of these commercial banks, particularly if they have already committed substantial amounts of capital to underwriting endeavors. Analysts believe the Bank of the United States failed because of its exposure to the securities market.\textsuperscript{171} If one of these large banks fails for the same reason, a costly government bailout is sure to follow. The FRB has already said that if more than two of these banks fail, it will not have sufficient funds to bail them out.\textsuperscript{172} Thus, a stagnant securities market could theoretically trigger another banking crisis. This regulation should be passed to reduce the probability of this occurrence and to stimulate competition among unaffiliated and affiliated underwriters.

In addition to reducing the anti-competitive risks, this new regulation would do away with the first of the two double exposure risks, which is that banks will make loans to their affiliate to underwrite the securities of a particular firm and later make additional loans to that firm. While it is true that banks would still be allowed to make loans to their securities affiliates and to firms whose securities were underwritten by other unaffiliated securities firms, the bank would not face the two-tiered exposure through such endeavors. This regulation will force banks that wish to gain a strong presence in the securities markets to diversify their efforts across different firms, rather than having underwriting commitments and commercial loans tied up within single firms. This diversification and the increased competition from unaffiliated investment banking firms,

\textsuperscript{170} Schooner & Taylor, supra note 13, at 234.
\textsuperscript{171} Johnson, supra note 1, at 164.
\textsuperscript{172} Wilmarth, Jr., supra note 63, at 247.
brought on by this regulation, would greatly contribute to the safety and soundness of these large commercial banks that have large stakes in the securities industry.

B. Regulation Mandating that Commercial Banks Seek FRB Approval before Making Rescue Loans to their Securities Affiliate

Not allowing securities firms to collateralize loans from their commercial banking affiliates with securities might be too extreme of a measure, especially in light of the fact that securities firms do not generally keep a great deal of cash on hand. However, a regulation that requires securities, used as collateral, to be of a low-risk nature might be a good idea. Securities such as high-grade corporate or municipal bonds are generally considered to be both low-risk and highly liquid. If all loans between the bank and its securities affiliate were collateralized with securities such as these, the bank would probably have very little trouble finding a buyer for these securities in the event that the affiliate defaulted on its loan. Even this requirement may be too demanding on securities firms because they may prefer to hold higher risk securities, such as stocks and junk-debt, because of the high profit margins that they can earn from their sale. A much more extreme rule should be enacted to deal with a scenario in which the loan in question is a rescue loan to be made by the bank to its affiliate, when the affiliate has yet to repay other loans made to it by the bank because such a scenario could lead to a double default stemming from the second type of double exposure risk, in which the bank initially makes loans to its affiliate to engage in underwriting endeavors and then makes rescue loans to the affiliate, when that affiliate finds itself in financial hardship and has yet to pay back the initial loans. The rule should not necessarily prevent securities firms from collateralizing rescue loans with securities when it still has outstanding loans from its commercial banking affiliate. Instead, such a rule should prevent commercial banks from making rescue loans to their affiliates without FRB approval, when they are still owed money from that affiliate. The rule would not only mitigate the risk of a double default, but it may also help mitigate the public perception risk that comes with the conflict of interest in which commercial banks might make unwise loans to their struggling securities affiliates to the detriment of their commercial depositors.

In deciding whether to approve such a bailout, the FRB’s inquiry should include, but not necessarily be limited to, an analysis of the financial situation of the commercial bank. If the bank is financially sound to the point that it could withstand a potential double default on the part of its affiliate, there is probably no reason to prevent it from rescuing the affiliate, except for the fact that this might damage public confidence in the bank. As earlier discussed, banks that affiliate with securities firms are very large and have access to vast amounts of capital, so such a move probably would not scare the depositors to the point that a run would
result. If the bank was not operating in a financially sound condition, the FRB should definitely not allow it to rescue its affiliate. A double default on the part of a securities affiliate could definitely jeopardize the safety and soundness of a struggling bank, even if the loan were well collateralized. There is no guarantee that the bank would be able to cover its losses through the sale of the collateral securities because it may not be able to sell the securities at all, or may be forced to sell them at a price lower than one that would cover the default. In addition to this risk, if the bank’s depositors found out that their struggling institution was making very large loans to its struggling affiliate, this could incite a run on that bank, no matter how well collateralized the loans were. This regulation would give the FRB veto power over such rescue loans, rather than leaving the decision solely to the officers of the commercial bank, and is appropriate for two reasons. First, the FRB is in the best position to decide whether such a loan is appropriate in regard to safety and soundness concerns because they have a long history of dealing with bank failures and are well aware of the warning signs that precede them. Second, the FRB has a very strong interest in ensuring that such loans will not threaten the safety and soundness of a particular institution because if the institution were to fail, it must bail the bank out. While a commercial bank’s officers may have some knowledge pertaining to bank failures and certainly have a strong interest in not allowing their bank to fail, the temptation to rescue a struggling securities affiliate may overcome their better judgment.

C. Regulation that Forbids Commercial Banks from Recommending Securities, Underwritten by Their Affiliates, to Their Depositors

The third regulation would address the conflict of interest that would result if bank employees engaged in pushing the securities that the bank’s affiliate underwrote. Congress enacted section 501 of the Sarbanes Oxley Act to deal with the phenomenon of securities analysts pushing stocks that were underwritten by their firm. This section basically requires the Securities and Exchange Commission and other self-regulatory organizations to promulgate regulations designed to curb the predominance of this phenomenon. The potential conflict of interest involving banks, however, needs to be dealt with in a more stringent fashion. A regulation should be enacted that prevents banks from pushing any security underwritten by its securities affiliate. Though there may be certain fiduciary duty obligations already in place that deal with this issue, the effectiveness of common law fiduciary duty rules in preventing self-dealing is indeed questionable.

A regulation that, if violated, could subject the perpetrator to jail time would be a much more effective deterrent. This measure may seem ex-

173. Fisch & Sale, supra note 166, at 1038.
174. Id.
treme, but overall public confidence in banks is much too important to be
protected by fiduciary rules alone. There is a real potential for self-dealing
given the fact that banks and securities firms can come under the
same management if they are affiliated with each other under the um-
brella of a FHC. In addition, banks deal with millions of depositors who
could all be potential investors in the securities markets, and the tempta-
tion to push these depositors into investing in securities underwritten by
their affiliates may be very strong indeed given the fact that the overall
profits of the FHC are derived in part from the profits of the securities
affiliate. If banks were able to convince their depositors to invest in se-
curities underwritten by their affiliates, and if a substantial number of
those securities turned out to be “dogs” or “losers,” not only could this
scenario be very detrimental to the banking system, in terms of lost public
confidence, but it could wreak havoc on the stock market as well. If
enough of these securities did not perform well, the commercial bank’s
depositors may lose confidence in the bank and withdraw their funds. If
enough depositors did in fact withdraw their funds due to this loss in con-
fidence, the resulting run could cripple the bank and perhaps even cause
it to fail. Also, if the commercial banks were able to push a large number
of depositors into speculative or sub-par securities, these could lead to an
overvaluation of these securities and could trigger a widespread overvalu-
ation in the stock market as a whole. When the market realizes that its
securities are overvalued, people will start dumping their stock as quickly
as possible, which could result in catastrophe for the market. This scena-
rio may seem far-fetched, but this is exactly what Senator Glass, a major-
ity of Congress, and a large number of banking regulators believed to
have happened in 1929.175 They believed that commercial banks had
pushed their depositors into speculative stocks, and that this had been a
substantial factor in bringing about the crash of 1929.176 It is also useful
to note that if the market does face a rapid decline, any firm with out-
standing underwriting commitments is probably going to face some level
of financial hardship, including affiliated securities firms and their com-
mercial banking affiliates that loaned the money to finance their under-
writing endeavors. In light of all of these factors, there is simply too
much risk involved in allowing commercial banks to attempt to entice
their depositors to invest in securities underwritten by their affiliates.

175. Benston, supra note 5.
176. Id.