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The Impact of Recombining Commercial and Investment Banking[*]

Samuel L. Hayes III[†]

This paper will address the rejoining of commercial and investment banking functions under one roof in the wake of the repeal of the Glass-Steagall Act in 1999. While this recombination has not returned the United States to the capital market environment prevailing before the Glass-Steagall Act was passed in 1933, it has engendered some conflicts of interest with attendant harm to investors.

At the time of the passage of the Glass-Steagall Act and other reform legislation in 1933 and 1934, the institutional investor community was quite small, both in number and as a proportion of the investor universe. Sales of new offerings, as well as secondary trading, were directed predominantly toward individual investors. Today, it is just the reverse. The huge contemporary institutional investor community dominates the markets and is sophisticated enough to take care of itself in most cases.

One could argue that, taken as a whole, contemporary investors are much better equipped to protect themselves against these abuses than was true seventy years ago when reform legislation was first put in place. But individual investors, although now constituting a smaller share of the pie, are still quite vulnerable. Thus, while *caveat emptor* might be an appropriate regulatory stance for institutional investors, it is not a sufficient decision rule for the interests of individual investors. However, because a wholesale restructuring of the banking system is no longer practical, any protection of individual investors and the integrity of investment banking

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will depend upon patchwork legislation and self-regulation within the existing regulatory framework.

Part I of this paper will briefly review the banking environment in the U.S. before and during the Glass-Steagall Act. In the *pre*-Glass-Steagall world, discussed in Part I.A, a wide portfolio of activities could be performed by the same vendor. The resulting conflicts of interest and other economic factors present during the 1920s culminated in the stock market crash of 1929, and the ensuing economic depression precipitated the passage of the Glass-Steagall Act in 1933. Part I.B explains how the market conditions that developed over the middle of the twentieth century led to the repeal of the Act in 1999. Part II of this paper will contrast the *post*-Glass-Steagall world of finance and business, providing some examples of instances where the unregulated recombination of commercial and investment banking has permitted conflicts of interest. Finally, Part III of this paper considers the claim that contemporary investors are sufficiently equipped to protect themselves and concludes that individual investors will be harmed without some modification to the existing regulatory framework.

I. COMMERCIAL AND INVESTMENT BANKING BEFORE AND DURING THE GLASS-STEAGALL ACT

A. *The Pre-Glass -Steagall World*

The Pre-Glass-Steagall world was a largely unregulated one where rampant conflicts of interest were accepted as the norm. Individual executives could wear multiple hats with impunity and could personally enrich themselves with deals and participations that would be barred to modern day professionals. For instance, George F. Baker, the man who built the First National Bank in the late nineteenth and early twentieth centuries, was a particular protégé of J.P. Morgan.[1] Not only did Morgan regularly include Baker's bank in deals he was engineering, but Morgan also made available to George Baker opportunities to benefit personally in a number of deals.[2]

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[1] SHERIDAN A. LOGAN, GEORGE F. BAKER AND HIS BANK, 1940-1955 (1981).

[2] Baker's personal wealth grew to such an extent that he was able to single-handedly finance the building and endowment of a new Harvard Business School campus in 1925. The timing was inauspicious, because Baker's blind optimism about the U.S. economy caused not only his bank to suffer but also resulted in grievous losses to him personally in the aftermath of the 1929 Crash. *See id.* at 236–49.

Similarly, a senior executive of the New York Life Insurance Co., George H. Perkins, Jr., was invited to join J.P. Morgan & Co. as a full partner in 1901 without giving up his leadership position at New York Life.[3] Needless to say, the degree of collaboration between these two financial institutions was extremely close during that period, raising serious conflict-of-interest issues. Such was the loyalty and trust in Morgan on the part of senior officers of most of the leading money center banks that he essentially had access to a "blind pool" of funds to be called on at his discretion.[4]

That was also a world in which a banker's personal "honor" and his institution's sense of "noblesse oblige" were the main assurances which investors and the public at large could rely upon for fair dealing.[5] Unfortunately, that was not a uniformly shared trait among bankers and, moreover, the definition of "good behavior" was subject to wide interpretation. As a consequence, "stock pools" and other schemes to manipulate securities prices, "watered" stock issues, and a variety of other maneuvers (many of which had the effect of defrauding small, unsophisticated investors) were rampant, with little if any regulatory machinery to either curb or punish the initiators.[6]

Thus, the reform legislation of the 1930s had as one of its most important objectives the elimination, or at least the curtailment of, blatant conflicts of interest inherent in the "universal" banks that had up until then dominated the U.S. financial marketplace.[7] The Glass-Steagall Act was clearly aimed at the inherent potential for abuse when a single financial firm could accept deposits, speculate in the securities markets using depositors' funds, hold substantial (including control) positions in their corporate customers, underwrite these companies' new securities offerings, and, if convenient, stuff slow-moving offerings[8] into mutual funds or individual

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[3] JOHN ROUSMANIERE, THE LIFE AND TIMES OF THE EQUITABLE 74 (1995).

[4] RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE (1990).

[5] *See, e.g.*, 1 CYRUS ADLER, JACOB H. SCHIFF: HIS LIFE AND LETTERS 22–24 (1928).

[6] JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929 (1979) (1954).

[7] *See, e.g.*, *Stock Exchange Practices, Part 8, Chase Securities Corporation: Hearing Before Senate Committee on Banking and Currency*, 73d Cong. (1933).

[8] That is, in offerings where a syndicate of banks had promised to underwrite a securities issue at a fixed price and subsequently found there was scant demand at that price level.

investment accounts they managed. The reform legislation anticipated that the industry would largely police itself through its self-regulatory organizations (SROs), which included the New York Stock Exchange and the National Association of Securities Dealers. The Securities and Exchange Commission would set certain standards and would serve as a watchdog, ready to intervene when the SRO system faltered.

B. *The Business World Climate During the Glass-Steagall Act*

The Glass-Steagall Act forced the split-up of the previously comprehensive banking houses into their commercial banking and investment banking components.[9] This split, however, did not lead to a stampede of resources to the securities side of this new Chinese Wall. Indeed, at the time of its passage, the grass was comparatively greener in commercial banking's back yard than in the securities business. The stock market was in complete disarray (down almost 80% from its pre-1929 high), U.S. business activity had imploded, and, far from issuing any new securities, most corporations were undergoing massive layoffs and in many cases declaring bankruptcy.[10] While the U.S. commercial banking operations were hard hit, they were by comparison a stronger and much larger part of most banking houses' total assets and revenue stream than the securities activities. Therefore, the "best and the brightest" of the personnel and most of the physical assets usually stayed with the commercial banking side in the forced separations. The securities business was by contrast a small appendage in both assets and revenue, and oftentimes the less highly-regarded executives were assigned to be spun off with that business.[11] A long decline in commercial banking's share of the country's financing and savings business began shortly after World War II.[12] The

[9] The term "investment banking" was the name subsequently given in the U.S. to these securities business spin-offs, in part to distinguish them from the European "merchant" banks, which in most countries were free of the legislated division imposed on their American counterparts.

[10] GALBRAITH, *supra* note 6.

[11] *See, e.g.*, JOSHEPH AUERBACH & SAMUEL L. HAYES, INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION? 86 (1986); Samuel L. Hayes, *Investment Banking Power Structure in Flux*, 49 HARV. BUS. REV. 138 (1971).

[12] *See* Dwight B. Crane et al., Capital Market Intermediaries: Summary Observations on a Workshop Held at Harvard Business School (May 2003) (unpublished manuscript on file with author).

diminutive investment banking units that had been cast adrift in the 1930s began to thrive and grow as corporate financing activities moved into the public markets arena, from which the U.S. commercial banks were largely barred.

Glass-Steagall had isolated the fledgling investment banks in a unique environment, somewhat like the species on the Galapagos Islands. They were forced to cut their teeth in this vibrant market and develop a range of skills and an organizational culture which would prove to be extremely valuable in today's marketplace.[13] The commercial banks, on the other hand, were stuck in what increasingly came to be regarded as a financial backwater. Thus, in the 1960s, they began clamoring for regulatory permission to move back into the securities business. The profit margins earned by the securities firms were now contrasting favorably with the generally shrinking margins available in the conventional commercial banking sector.

II. THE POST-GLASS-STEAGALL ENVIRONMENT

Today, the situation is the reverse of the 1930s. The securities firms are the contemporary five hundred pound gorillas, and it is the commercial banks who now salivate for the investment bankers' lines of business. Constant pressure by the commercial banks for relief from the constrictors imposed by Glass-Steagall led to the erosion and ultimately the repeal of the Glass-Steagall Act in 1999. This has brought about a competitive restructuring which has been characterized as a "convergence" of commercial and investment banking. That is something of a misnomer. The reconfigurations have been mostly a one-way street. U.S. investment banks have had little interest in stand-alone corporate lending or other relatively low-margin, asset-intensive commercial banking businesses. It is the large money center banks who have rushed into the investment bankers' backyards, pursuing the lush pickings of high-margin, securities-related fees for midwifing mergers and acquisitions, raising new capital in the public markets, and engaging in certain securities trading operations. They have accomplished

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[13] There is considerable research on the importance of a vigorously competitive home market in sharpening a vendor's skills in competing abroad. *See, e.g.*, Mariko Sakakibara & M.E. Porter, *Competing at Home to Win Abroad: Evidence from Japan Industry*, 83 REV. ECON. & STAT. 310 (2001).

this almost exclusively by purchasing well-established securities firms after earlier efforts to grow these lines of business internally fell short of their goals.[14]

The following sections discuss a few of the potentially problematic areas that have arisen in the wake of the repeal of the Glass-Steagall Act. These include the development of a credit war which has implications for the integrity of the banking system, the debasement of public trust in the value of Wall Street brands, concerns about the accuracy of securities pricing, difficulties with organizational structure and risk exposure, and certain conflicts of interest inherent in the multiple roles which financial institutions now play.

A. *The Credit War*

Commercial banks have used their lending capabilities to attract underwriting and mergers and acquisitions business away from the traditional investment banks.[15] Presumably, in a number of cases they have offered below-market interest rates on these loans and one suspects that in other instances they have extended volumes of credit beyond what their credit committees would have normally thought prudent. Banks have also been charged with "tying in" high margin investment banking mandates in exchange for cheap loans. Traditional investment banks have fought back, not by acquiring large commercial banks as a vehicle for extending comparable credit, but by directly utilizing both their own balance sheets and their loan syndication skills to match many of these bank-funding blandishments.

The upshot of this credit war is that the initial advantage enjoyed by the commercial banks in new business solicitation has been substantially neutralized. Many potential securities issuers now expect *any* vendor soliciting their investment banking business to provide large and sweetened lending facilities as a *quid quo pro*. This is a "reverse tying" phenomenon. The net affect of demanding this commercial loan

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[14] Chemical/Chase Bank was a holdout for the "make" rather than the "buy" strategy until it finally threw in the towel with the 2000 purchase of J.P. Morgan & Co. Ironically, J.P. Morgan was the only money center commercial bank, which had managed to internally grow a robust investment banking arm, although it required some 25 years to accomplish it!

[15] Jathon Sapsford, *Banks Give Wall Street a Run for its Money*, WALL ST. J., Jan. 5, 2004, at C1.

"subsidy" is to effectively reduce the margins on investment banking services that have been bundled with such loans.[16]

This phenomenon raises questions about the credit quality of these lending facilities and potentially threatens the integrity of individual lenders as well as of the U.S. banking system as a whole. A case in point is the credit backing for the issuance of commercial paper. Some large commercial banks appear to be materially underpricing the standby bank lines that they write for corporate customers' short-term commercial paper operations as an inducement to obtain their investment banking assignments.[17] What is the actual credit quality of these lines? Are there adequate loss reserves booked, particularly where the loan maturity is less than one year? These questions are beyond the scope of this paper but research is clearly needed in this area.

B. *Debasement of Public Trust in Wall Street Brands*

It is not yet clear what impact the entrance of commercial banks into the securities business will have on the brand images of the firms they have purchased. The imprimatur of the major Wall Street securities firms used to be a source of solid reassurance to investors, both pre-Glass-Steagall and for several decades following World War II. In that era, investors in new securities offerings shepherded by leading U.S. securities firms could assume that careful due diligence on a securities issuer had been undertaken, and that the underwriter stood foursquare behind the representations of quality for the product being offered. Relationships between companies and particular underwriters were long-standing, and, over time, the investment bankers came to know their clients intimately. If a company's affairs went awry, its bankers were expected to go to work and help fix the problems, and in fact they often did.[18]

Today, investors cannot routinely rely on underwriters' due diligence investigations to undergird new securities offerings. The widespread use of "shelf" registrations has turned many debt underwritings into *de facto* competitive

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[16] *See, e.g.*, Randall Smith, *Pay to Play? Companies Put a New Squeeze on Their Investment Banks*, WALL ST. J., Aug. 26, 2003, at A1.

[17] While research does not disclose any systematic studies on this practice, some market participants have alleged to me that it is occurring.

[18] *See* ADLER, *supra* note 5, at 141–48.

bidding events. Underwriters might not undertake due diligence, instead relying completely on the issuers' periodic SEC filings.[19] Even if an underwriter works with a company to bring its equity shares to the public market for the first time, there can be no expectation of long-term loyalty on the part of the underwriter. If an issuer's business seriously falters or some malfeasance is uncovered, that underwriter is likely to cut and run (after fulfilling the bare minimum required by law) rather than stand by the company and extend aid. By the same token, today's typical corporate customer feels little loyalty to investment banks with whom she has done past business, and, if her bargaining position is strong, often adopts an attitude of "what have you done for me lately?"[20] Any concern about the "subtle hazard" of too close an identification of the investment bankers with their corporate clients' top management must therefore assume a short-term context.

Commercial banks, on the other hand, have a long tradition of working with their corporate customers when they encounter trouble. Perhaps this is because, unlike the underwriters in the aftermath of a public offering, the bank is the one with its own money still at risk and in adversity there is unlikely to be anyone willing to take their place. Whether this commercial banking practice and culture will be effectively transferred to the new role as investment banker remains to be seen.

C. *Concerns About Accurate Pricing*

One might assume that today's vastly larger and more efficient securities markets would give investors confidence that the pricing of new securities issues will be much more reliable than in past decades, thereby mitigating the reduced underwriter oversight discussed in the previous section. On straight debt offerings that is likely to be true. However, it is still difficult for investors to assess the fairness of the pricing of new issues of hybrid (derivative) securities. And initial public offerings (IPOs) are the trickiest of all. Traditional investment banks as well as commercial bank entrants into the securities

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[19] AUERBACH & HAYES, *supra* note 11, at 117.

[20] *Institutional Investor* magazine used to publish a "Who's with Whom" list of each investment bank's ongoing clients. It was discontinued in 1979 after many protests from companies that did not want to be identified with *any* particular investment bank.

business have recently been caught up in scandals involving the pricing of such initial offerings, their allocation to favored investors, and promises obtained for further price-boosting purchases in the aftermarket.[21] Another group of players in this market sector, the leveraged buyout firms and the private equity venture firms, have reportedly also played the "spinning" game[22] but have thus far escaped significant regulatory attention.

A fairer way to handle the pricing and distribution of new securities might be provided by the "Dutch Auction" method of securities offering. Under this approach, bids are accepted for specific quantities of the security at specific prices. The least favorable price at which all the securities are taken up becomes the price at which the entire offering is sold. This has the result of obtaining maximum sale proceeds for the issuing company and largely eliminating the potential for rapid run-up of the offering price in the immediate aftermarket. It thus also eliminates the potential for abuse in the allocation of shares in hot IPOs where large short-term windfall gains are available.[23]

This form of offering is not favored by the leading securities underwriters, however. They argue that a Dutch Auction precludes any opportunity for the underwriter to arrange for a judicious apportionment and placement of the securities among institutional and individual investors, and complicates efforts to manage an orderly secondary market. Although not usually mentioned by investment bankers, it also removes much of the rationale for the high gross spreads which persist in IPOs.[24]

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[21] *See, e.g.*, *Inside Frank Quattrone's Money Machine*, BUS. WK., Oct. 13, 2003, at 104; Don Jamieson, *Grubman's Goodbye*, ON WALL ST., June 1, 2003, *available at* LEXIS, News & Business, News.

[22] That is, they have allocated valuable IPO shares to institutions or individuals in return for favors.

[23] Randall Smith, *Controlling IPOs: New Steps Would Limit Big 'Pops'*, WALL ST. J., May 30, 2003, at C1.

[24] Although the Dutch auction has been used in the past with certain types of debt offerings, William Hambrecht & Co., a west coast securities boutique, has been the lone promoter of this distribution method for equity IPOs. Ravenswood Winery was the first Dutch auction IPO Hambrecht undertook, in 1999. Since then, the firm has done seven more such offerings. Most recently, the search engine firm Google has announced that it, too, will utilize a Dutch auction when it goes public in late summer 2004.

D. *Concerns about Organizational Structure and Risk Exposure*

In a number of instances of alleged abuses within securities firms, it has been strategically placed individuals who have led both the firm and investors into disaster.[25] This observation highlights another characteristic of the securities business which makes it vulnerable to conflicts of interest and abuse: its necessarily heavy reliance on the skill and integrity of key employees. To encourage innovation and an entrepreneurial drive for profits, securities firms tend to be decentralized, with relatively flat management structures. This, of course, leaves the firms exposed to miscreant actions by individuals that can have an outsized impact on the firm and on associated investors. While traditional investment banks have in most cases managed to survive the severe buffeting which out-of-control employee actions have on occasion caused, the dramatic growth in their size and complexity in recent years is worrisome for the future.

Commercial banks, on the other hand, have long employed a much more hierarchical structure, with checks and balances to limit the damage that single individuals or small groups can inflict on the bank's overall risk exposure and operating results. While this pyramid structure is an advantage in curbing the danger from rogue employees, it is better suited to traditional commercial banking activities than to the securities business. The commercial banks that have entered the investment banking business in recent years are thus not necessarily well equipped, by either experience or organizational culture, to manage the decentralized reporting structure, which the securities business requires.

Further, the trend toward commercial banking concentration that is creating trillion dollar mega banks does nothing to assuage fears of commercial banking missteps in the securities business. The long-term difficulties in managing these huge holding companies are daunting, and the likelihood that they will produce the synergistic results currently being

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[25] *See, e.g.*, Sara Web et al., *Baring Brothers Teeters over Huge Losses by Trader, Sparking Market Fears*, ASIAN WALL ST. J., Feb. 27, 1995, at 1; *Rotten at the Core*, THE ECONOMIST, Aug. 17, 1991, at 69.

touted by their advocates is not promising, particularly if past experience is any guide.[26]

E. Other Conflicts of Interest

Many of the conflicts of interest that have garnered the most public attention in the past several years are not a function of whether or not commercial banks are involved in the securities business. These conflicts are present for *any* vendor who operates in these markets. Several of them deserve mention here.

In recent years, securities analysts have replaced "new business" professionals as the most effective rainmakers to obtain lucrative underwriting and merger and acquisition assignments. Corporate executives are no longer interested in talking to the investment banking "generalists" who had long served as liaisons with both current and potential corporate clients. Because the potential compensation to a securities analyst for working with the firm's investment bankers usually dwarfs the stingy soft dollar rewards from advising institutional investors, it is not surprising that a number of analysts have been lured into an unhealthy collaboration with their firms' investment banking groups. This collaboration has produced egregious misbehavior, and individual investors are often the biggest losers.

Securities firms' ownership of major specialist firms, which make markets on the New York and other stock exchanges, has similarly been ill-advised from the start. Given most securities firms' large proprietary trading operations, it is puzzling that they should also be allowed to own the market-making organizations through which many of their trades are funneled. Recent revelations of "front running" by specialist firms with confidential knowledge of buy and sell orders in the "book" is totally unacceptable. Some of that information may

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[26] Securities analysts and other market participants promote the idea that the combined entity can fuse complimentary and/or overlapping businesses to obtain substantial back office savings, more effective marketing and distribution of products and services, and, overall, a powerful integrated entity which can take business away from smaller and less comprehensive competitors. The complexities of merging large, well-established entities and reconciling their cultures and turf claims has proved daunting in past combinations and it has sometimes taken many years to yield much synergy. *See, e.g.*, PHILIPPE C. HASPESLAGH & DAVID B. JEMISON, MANAGING ACQUISITIONS: CREATING VALUE THROUGH CORPORATE RENEWAL (1991). *See also* Chirstopher A. Bartlett & Sumantra Ghoshal, *Beyond the M-Form: Toward a Managerial Theory of the Firm*, 14 STRATEGIC MGMT. J. 23 (1993).

even leak back to the trading desks of the investment banks who *own* the specialist firms.

It has long been understood that a number of potential conflicts of interest are presented when the same firm undertakes multiple activities that are dependent on the same information base. Nevertheless, a number of leading securities firms have proprietary risk arbitrage desks which can earn lucrative returns by picking up bits and pieces of undisclosed information and trading on it. These same firms typically have corporate finance groups, which are in close touch with companies of interest to the arbitrageurs. These firms also have securities research groups who obtain insights that may not be known to the investing public. Once the research groups have formulated an overall opinion on the company in question, there is a period of time before their report is publicly released. That advance information could be quite valuable to the arbitrage desk. Affording protection to confidential information arising from a commercial banking function in a financial vendor's portfolio of business lines only adds to the potential for abuse. The critical component here is the management and protection of the flow of sensitive information *within* a securities firm.

III. CONCLUSION

This paper has already dismissed the possibility that the U.S. will return to anything like the unregulated pre-Glass-Steagall financial market world. Although there are some gaps in the regulatory coverage, remedies for many of the holes discussed above are currently being considered.[27] Over the years, most activities in the financial sector have been assigned to one or more governmental regulatory bodies as well as the SROs. The Graham-Leach-Bliley Act, in supplanting the Glass-Steagall Act, is designed to provide guidelines for the operations of the multi-line holding companies that have emerged.

Though today's financial world is heavily (if unevenly) regulated by multiple federal and state governmental agencies, self-regulation has become a necessity because the size, scope, and complexity of the financial markets make detailed

[27] These include regulatory moves to separate investment research from investment banking and to provide greater equity in the distribution of new securities issues.

oversight impractical. Legislative statutes and administrative rules abound and the ever-present fear of litigation has an important positive impact on individual and institutional behavior. The incentive for the industry to do an effective job of policing itself has been the threat of both severe punishments for offending individuals and firms and the imposition of additional onerous rules and/or legislation. The SEC, despite some recent stumbles, has been an effective "big stick" and is widely copied around the world.

The regulatory skein that is in place today is not ideal, however. Like Topsy, it "just growed" over time in response to unfolding needs and problems. It is not the structure one would fashion if one were starting with a blank canvas. The U.S. regulatory apparatus has largely been constructed to deal with clusters of like-function financial firms. Thus, for instance, the SEC has focused on securities firms and the Federal Reserve, and the Comptroller of the Currency have supervised commercial banks. But as we observe the proliferation of financial activities and business lines under one corporate umbrella, the historical institution-focused regulation looks increasingly outdated. Conceptually, a functional approach makes a lot more sense. But, like the arbitrary and sometimes dysfunctional political subdivisions long ago mapped out by European colonial powers in regions of Africa and the Middle East, it is probably too late to think of dismantling existing regulatory structures and starting over. We will have to work within the structure we have now, patching the holes as they become visible and hoping that we aren't creating such a labyrinth of rules, regulations, and duties that we crush the private financial market goose that has over time laid many golden eggs for investors and supported the economic growth that has benefited the public at large.