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Glass-Steagall: Some Critical Reflections

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Much ink has been spilled on the Glass-Steagall Act, ranging from passionate political rhetoric to arcane legal analysis. In this dispassionate and lucid article, the author, a Commissioner of the SEC from September 1977 to February 1980, tells why the Glass-Steagall Act was passed, why it is no longer working very well as a regulatory scheme, and why the policy decision to separate commercial from investment banking is nevertheless worth retaining.

Why Glass-Steagall Was Passed

The political climate in which the Glass-Steagall Act was passed is probably best evoked by the words of Ferdinand Pecora, who in 1933 and 1934 served as counsel to the Senate Committee on Banking and Currency in its investigation of stock exchange, banking and securities markets practices. This investigation led to the enactment of the federal securities laws, as well as the Glass-Steagall Act. (Pecora immediately benefited from these statutes by being appointed a Commissioner of the newly created SEC.) In 1939, when the Depression was waning, Pecora wrote a book to remind the public "what Wall Street was like before Uncle Sam stationed a policeman at its corner, lest, in time to come, some attempt be made to abolish that post." [1]

What Pecora and the Senate Committee found was "a shocking corruption in our banking system, a widespread repudiation of old-fashioned standards of honesty and fair dealing in the creation and sale of securities, and a merciless exploitation of the vicious possibilities of intricate corporate chicanery." [2]

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1 Pecora, *Wall Street Under Oath* XI (1939).

2 *Id.* at 283.

What Congress concluded was that commercial banks must divorce themselves from their security affiliates. This was accomplished by the Glass-Steagall Act, which, in Pecora's words, "decisively rescued commercial banking from its entanglement with the extraneous business of security flotation and market plunging." [3] In the words of a more current observer of the financial world: "In 1933, the Glass-Steagall Act forbade commercial banks to own common stock or to underwrite and sell stock or corporate bonds to their customers or depositors; and the banks slowly, grumblingly, returned to banking." [4]

The reader may well ask: If the issue was so decisively resolved, why the current concern with regulating the securities activities of commercial banks? The answer, of course, is that the Glass-Steagall Act did not totally bar commercial banks from the securities industry. Like so much New Deal legislation, it was a reactive and pragmatic response to specified perceived wrongs. The statute put restraints on certain banking activities, rather than enunciating a broad, philosophical rationale for dividing a formerly homogeneous financial community into two subcultures. Since some of those restraints are on potentially profitable activities, avoidance of the statutory restrictions has been a challenge for bankers and their lawyers.

The Fundamental Regulatory Issues

The most popular political theme in regulatory circles today is regulatory reform, and the Glass-Steagall Act is indeed susceptible to attack under the banner of deregulation. It is easy to argue that the law erects barriers to marketplace entry by firms anxious to let competition, rather than a bunch of federal bureaucracies, regulate the financial world. Further, half a century has passed since the 1929 stock market crash and many solutions of the Depression period have become the problems of our inflation-plagued economy. Nevertheless, before anyone becomes overeager to repeal the Glass-Steagall Act, either in one fell

[3] *Id.* at 284.

[4] Mayer, *The Bankers* 52 (1974).

swoop or by piecemeal amendment, Congress and the public need to consider what are the fundamental issues of national policy in the regulation of our financial institutions. These issues may be categorized as follows:

- What kind of regulation is necessary to insure investor protection in securities transactions and the safety of customer deposits and other property held by commercial and investment banks?
- How much concentration of power and wealth by the nation's financial institutions is appropriate and in the public interest?
- To what extent and how should the federal government direct and control the allocation of the nation's financial resources?
- What conflicts of interest by financial fiduciaries should be prohibited because they lead to abuses of trust which impair confidence in the financial markets?
- Assuming that a national consensus can be reached on any of the above issues, what kind of legislation will best achieve the objectives of financial institution regulation?

Unfortunately, most of these problems are not even addressed, let alone solved, by the Glass-Steagall Act or the suggestions for amending that law currently being debated.

The Particularities of Glass-Steagall

Regulatory ambiguities often occur because a law is written in an unduly general style. When it comes to the separation of investment and commercial banking, however, many ambiguities can be blamed on a law which was written with great particularity so as to address specific abuses which Congress believed led to the Depression of the 1930s. However, both commercial and investment banking are different industries today.

The foundation for the wall separating commercial and investment banking is Section 16 of the Glass-Steagall Act. This provision differentiates what is permissible for commercial banks from what is prohibited according to the character of the securities involved, rather than by the activities or services that the commercial banks would perform. That is, in some securities, a commercial bank may act as an agent for the account of a customer; in some securities, it may, subject to limitations and restrictions, purchase for its own account; and in U.S. obligations and general obligation municipals, it may deal, underwrite, or invest. Probably the statute was drafted with such particularity so as to be directed specifically at the abuses uncovered by the Pecora Investigation. Those abuses occurred in an era of booming equities markets. If banks had been involved instead in REITs or futures contracts on financial instruments when the "crash" came, the Glass-Steagall Act might have been drafted very differently.

Because the Glass-Steagall Act defines what activities are appropriate for commercial banks by the securities involved in a transaction, and because banks are not considered broker-dealers under the securities laws, the statutes have resulted in some anomalous regulation. Identical business activities performed by different institutions are frequently subject to dissimilar regulation. Also, regulation has been unable to effectively keep pace with the changing characteristics of particular securities and their markets.

Why Glass-Steagall Doesn't Work Today

Banks as Broker-Dealers

Let us turn to the problem of similar services being subject to different regulation. This is a problem to which the SEC directed its attention in its Report on Banks' Securities Activities —commonly called the Bank Study. In 1975, Congress adopted Section 11a(e) of the Securities Exchange Act of 1934 (Exchange Act), directing the SEC to study the extent to which banks maintain accounts on behalf of public customers for buying and selling publicly traded securities and whether the exclusions of banks from the Exchange Act's definitions of "broker" and "dealer" are consistent with the protection of investors and the other purposes of that Act. In short, Congress asked whether banks—which may effect agency transactions without restriction

—should be subject to the same regulation in effecting those transactions as the brokerage community.

The Bank Study identified a number of areas in which bank services that are functionally equivalent to those of broker-dealers did not appear to be subject to an entirely adequate regulatory structure. But although recognizing the need for uniformity in regulating similar securities activities, the Bank Study proceeded on the assumption that Congress sought to maintain, to the greatest extent possible, the regulation of bank activities by the federal banking agencies. Accordingly, the Commission recommended that the banking agencies enact and enforce specific rules and regulations governing the conduct of banks in their securities activities, that they upgrade their examination proceedings in respect to such activities, and that they advise the Commission of actual or potential violations of the federal securities laws that are uncovered in these examinations. In addition, in order to resolve a subtle but significant regulatory anomaly, the SEC recommended that the federal banking agencies should be specifically mandated to act for the protection of investors in addition to their existing statutory obligations.

Although the Commission's recommendations were introduced in a previous Congress by Senator Williams, no legislative action has yet been taken upon them.[5] The federal banking agencies, however, have adopted many—but certainly not all—of the Commission's recommendations as part of their rules and regulations.[6] Therefore, the disparity of regulation of similar services has been somewhat diminished, although not eliminated. But one continuing disparity that only Congress can remedy is to place on the bank regulatory agencies investor protection mandates in addition to their responsibilities to bank depositors.

Changing Composition of the Securities Markets

Another problem inherent in defining permissible banking activities according to the kind of security being bought or sold

[5] S.2131, 95th Cong., 1st Sess. (Sept. 22, 1977).

[6] See, e.g., Federal Reserve System Regulation, 12 C.F.R. § 208.8(k).

is that the composition of the securities markets has changed since the 1930s. Municipal securities, which were a minor financing medium during the Depression, subsequently became a major factor in the marketplace. Although the securities laws were amended to create the Municipal Securities Rulemaking Board, the Glass-Steagall Act has remained the same. Sometimes business reacts to marketplace changes by creating new arrangements to avoid the impact of a regulatory scheme. For example, major banks reportedly are interested in distributing presold principal revenue bonds in private placements in what they assert to be an agency capacity.[7]

New Securities Products

The regulatory lag caused by defining permissible activities according to the securities involved in a particular transaction is most obvious when new securities products are created. Such products raise hard questions as to statutory coverage because congressional intent is realistically nonexistent. In this connection, questions being raised concerning the continuing viability of the Glass-Steagall Act are due as much to the new business activities of investment bankers as to the alleged encroachment of the banking industry upon the traditional business of the securities industry.

New products being offered by the securities industry have led to complaints about encroachment by the banking industry. The use of margin security credit as a source of capital for making commercial loans to margin account customers, particularly when such funds can be accessed with a bank credit card, is receiving increasing attention. When such a program is combined with a money-market fund, the banking community has been claiming that brokers are effectively engaged in deposit banking.[8]

Money-market funds are another successful new product which seem to have eluded the categories established by the Glass-Steagall Act. Yet the largest of such funds now has almost

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[7] *Securities Week* 1 (Sept. 10, 1979).

[8] Rustin, "Want New Skis? Charge Them to Margin Account," Wall Street Journal, June 30, 1977, p. 12.

\$7 billion in assets.[9] Recently, the size of the money market industry in one month alone increased over \$3 billion.[10] When such funds have check redemption privileges as low as \$250, the distinction between them and NOW (negotiable order withdrawal) accounts is tenuous.

Because bankers and brokers are eager to provide similar services, and because new securities and services have been created which were not contemplated or imagined by Congress in 1933, it is not surprising that both sides are willing to pursue the possibility of profitable business in derogation of the principles of the Glass-Steagall Act. Further, it is not surprising that bankers and brokers each invoke the shield of the Glass-Steagall Act to claim unfair competition.

But the Glass-Steagall Act was not intended to be a shield against competition for any segment of the financial world. In punitively splitting the financial world into commercial banking and investment banking segments, Congress was not concerned about protecting either industry from the competition of the other. Rather, Congress intended to protect the public and the American economy against the banking abuses uncovered by Ferdinand Pecora. However, if the separation of commercial and investment banking is to be reaffirmed today, it should be because there is an ongoing need for such protection, or because there are new public needs that have arisen as a result of changes in the financial industry. As Brandeis warned years ago—fiduciaries should not be allowed to put other people's money at risk for their personal gain.[11] The financial health of both commercial banking and investment banking is, indeed, a proper subject for concern by the federal government.

What Is the Proper Legislative Solution?

The goals of the Glass-Steagall Act may not be the appropriate current rationale for the continued separation of investment

[9] Wall Street Letter, Aug. 20, 1979, p. 6.

[10] "Money Market Fund Sales Set a Record Again in August," Wall Street Journal, Sept. 26, 1979, p. 36.

[11] Brandeis, *Other Peoples' Money* (1914).

and commercial banking. Also questionable is whether that separation can continue to be accomplished by a statute which speaks in terms of particular transactions in specified securities rather than generally prohibiting economic activities or potential conflicts that are of governmental concern. Thus, the optimum resolution of the policies at stake is not the determination, on a case-by-case basis, of narrow legal issues, such as whether banks are acting as agents in privately placing revenue bonds, but the creation of a new legislative overview of the financial world which is relevant to today's challenges. Such an overview may well show that the abuses of the 1920s—and, in fact, the new abuses that have arisen as a result of changing products and markets—still require a segregation of functions. But if continued, the segregation of functions should be founded on a new legislative determination of the potential harms inherent in existing practices and not on what is increasingly becoming the semantical characterization of securities and the agency-principal dichotomy.

The Need for Greater Safeguards

Let us return to the five issues previously set forth as fundamental to the regulation of our financial institutions and ask how well the Glass-Steagall Act is addressing these problems. As to the safety of customer deposits and other property held by banks, the Glass-Steagall Act seems to have worked reasonably well with regard to commercial banks, but the Act did not address the financial safeguards appropriate for investment banks. The risks posed to commercial banks by speculative securities investments not prohibited by the Glass-Steagall Act (e.g., REITs, Ginnie Mae forwards, and short-term municipal bonds) would indicate a need for more, rather than less, rigorous prohibitions upon principal securities investments. The need for greater safeguards for the protection of customer property held by investment banks became apparent during the late 1960s and led to the enactment of the Securities Investment Protection Act of 1970.

At the same time, the low level of capital information in the nation's economy could lead to a policy of encouraging greater risk taking by our financial institutions. Their regulatory capital might best be utilized in equity investment.

Antitrust Considerations

In a variety of laws, Americans have traditionally demonstrated an aversion to the concentration of economic and political power by banks. It probably can be argued that the separation of commercial and investment banking mandated by the Glass-Steagall Act has proven a better regulator than the antitrust and other laws for curbing the excessive aggregation of banking power in only a few financial institutions.

Regulation of the securities industry must necessarily be concerned about the impact upon that industry which would be caused by the expansion of the securities activities of commercial banks (e.g., bank entry into the revenue bond market)—the public will not be well served by a further contraction and concentration of the securities industry. On the other hand, it hardly seems appropriate for the separate financial regulatory agencies to react to proposed regulatory changes by trying to protect their own jurisdictions. But if banks are permitted greater latitude in combining commercial and investment banking, some consolidation of supervisory regulatory agencies would probably be required for proper oversight. In short, antitrust-type considerations are among the most important, but also the most difficult, of resolutions and they only lurk in rather inchoate form in the Glass-Steagall Act.

The role of the federal government in allocating the nation's financial resources is addressed by the federal banking and securities laws. However, the specific prohibitions of the Glass-Steagall Act, and its failure to keep pace with marketplace developments, have permitted considerable disintermediation in the money markets. Moreover, the extent to which the growth of money-market funds has undermined Regulation Q, for example, is an important but unanswered question. However, the tax laws probably are a bigger factor in determining how national resources are allocated than either the banking or securities laws.

The prohibition of conflicts of interest perceived by Congress as improper is basic to the Glass-Steagall Act. Functional segregation of investment and commercial banking is a respectable regulatory mechanism for preventing conflicts of interest. Although in other areas federal law has resolved conflicts of interest by disclosure, the elimination of possible conflict situations is obviously more effective.

Conclusion

Updating and forming a new national consensus on the separation of commercial and investment banking will not be easy. The answers to the real policy problems posed are not obvious. Yet the mechanism by which the Glass-Steagall Act enforces such a separation is not in the best working order. If the basic objectives of the statute are not reexamined, and then either reaffirmed or rejected, commercial banks are likely to become more and more involved in securities activities and investment banks are likely to become more and more involved in encouraging their customers, among other things, to invest in money-market instruments outside commercial banking channels.

Our nation's financial institutions are too important to be permitted to drift in the absence of effective policy at the federal government level. It is fashionable today to say that the marketplace is the best regulator of economic activity, but one wonders. The objective of the marketplace is not to benefit the general welfare but rather individual participants. Further, maximizing economic efficiency is only one of many objectives of governmental regulation. Today, when the public distrusts government and business, failure of federal regulation to effectively control and direct financial institution resources for the public interest will further reduce public confidence in the economy.

The Glass-Steagall Act and related New Deal banking and securities legislation were the product of political groups which feared bigness generally and were particularly fearful of Wall Street domination of the economy.[12] Today, when the financial

[12] Schlesinger, *The Coming of the New Deal* 439-440 (1959).

markets are international, and many Americans are more concerned about the threat of the universal foreign banks than the Wall Street banks, a reexamination of the historically specific and provincial legislation of Roosevelt's hundred days is appropriate, even if only to reaffirm the political and economic judgments then made.

Improving the Corporate Facade

"We all know how the tax laws have set off their vigorous little race between corporations trying to think up nontaxable perks for their executives and IRS meanies trying to stop them. At least one physician reports that there's a new ploy on the horizon. Corporations are sending executives—and their wives—to have face-lifts, and picking up the bills. 'Why not?' asks the plastic surgeon. 'It's unique, expensive, and tax deductible as a medical expense.' And in the tough world of business, every little advantage counts.

"We wonder what other socially desirable habits the present incentive structure will be inducing in our business classes."

—*Wall Street Journal*
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