ATTACHMENT C

HISTORICAL BACKGROUND

Information concerning the principal abuses that arose during the 1920s and early 1930s in connection with the investment banking activities of commercial bank affiliates is largely limited to the extensive Senate investigation into stock exchange practices, which included the highly publicized Pecora hearings. A substantial portion of these hearings, which were held in 1933 and 1934, dealt with the activities of the securities affiliates of the country's two largest commercial banks, National City Bank and Chase National Bank.

The Glass-Steagall Act, which to a certain extent was the result of these hearings, was enacted primarily for three reasons. First, Congress believed the Act would help to protect and maintain the financial stability of the commercial banking system, and would strengthen public confidence in commercial banks. Second, Congress wanted to eliminate the potential for conflicts of interest that could result from the performance of both commercial and investment banking operations. The final Congressional concern was a belief that the securities operations of banks tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities activities.

The actual and potential abuses that were revealed during the Senate investigation can be categorized as follows: first, abuses that were common to the entire investment banking industry; second, abuses that may be attributed to the use of affiliates for the personal profit of bank officers and directors; and third, abuses related to conflicts of interest that resulted from the mixing of commercial and investment banking functions. The primary types of abuses relevant to each of these categories are discussed below. Analyses of the appropriate remedies for these abuses are presented, together with comments directed toward examining the degree to which the Glass-Steagall Act was an effective or desirable solution.

Abuses Common to the Investment Banking Business

The principal types of abuses common to the investment banking business during the 1920s and early 1930s included:

- underwriting and distributing unsound and speculative securities
- conveying untruthful or misleading information in the prospectuses accompanying new issues
- manipulating the market for certain stocks and bonds while they were being issued.

Examples of the first two types of abuses can be found by examining National City Company's involvement in the financial operations of the Republic of Peru. Throughout the 1920s National City Company received reports that Peru was politically unstable, had a bad debt record, suffered from a depleted Treasury and was, in short, an extremely poor credit risk. In 1927 and 1928, National City Company participated, nevertheless, in the underwriting of bond issues by the government of Peru. The prospectuses that were distributed made no mention of Peru's political and economic difficulties. As a result, the public purchased $90 million of the bonds, which went into default in 1931 and sold for less than five percent of their face value in 1933.

While the National City case may be one of the more flagrant examples of these types of abuses, it was generally acknowledged that the extremely competitive banking environment of the 1920s led bankers to encourage overborrowing, particularly by governments and political subdivisions in Europe and South America. Questionable practices were employed to induce the public to purchase the security issues that resulted from the promotional efforts of bank affiliates. In addition to falsifying or withholding pertinent information, National City Company and Chase Securities Corporation attempted, on occasion, to prop up the price of securities while the securities were being sold.

A large portion of the abuses uncovered during the Pecora hearings were common to the entire investment banking industry. Because these problems were not directly related to the relationship between banks and their affiliates, the Glass-Steagall Act was not the proper remedy for these kinds of abuses. There are several reasons why the problems just described are of less concern today. First, the Securities Act of 1933 and the Securities Exchange Act of 1934 hold individuals involved in the issuance of securities responsible for any misstatement of facts or failure to reveal pertinent information concerning the financial condition of governments and corporations issuing securities. Second, it is now the duty of the SEC to prevent any manipulation of the market while a security is being issued. Additionally, these safeguards may help deter banks from underwriting unsound and speculative securities.

Self-Dealing by Bank Officers and Directors

Bank affiliates not only attempted to manipulate the stock and bond prices of other business and governmental entities, they also attempted to manipulate the stock prices of their parent banks. The procedure generally employed was for the affiliate to organize investment pools that traded in the stock of the parent bank. While the pools were financed primarily by the affiliates, they were generally open to selected individuals, including bank

officers and directors. Bank officials claimed that the purposes of such trading accounts were to steady the market in order to maintain public confidence in the bank and to encourage increased distribution of the bank's stock. However, there were other motivations for such activity.

First, it is likely that many of the participants expected to benefit from their inside information and gain large profits from their trading activity. In practice, however, these expectations were not always realized. Chase's affiliates earned only $159,000 in profit on trades in Chase National Bank stock totaling $900 million. National City Company sustained $10 million in losses from dealing in the stock of its parent bank.

A second reason may have been that by advancing the stock's price it became more attractive to the stockholders of other banks that were acquired on an exchange-of-stock basis. Chase National and National City Bank each acquired several other banks during the period when their affiliates were trading in their stock.

In addition to the profits obtained by trading in their own bank's stock, bank officers and directors often received compensation from affiliates far in excess of that paid to them by their banks. For example, instead of permitting the stock of affiliates to be owned by bank stockholders, the stock was often wholly owned by officers and directors of the bank. This "ownership" may have been illegal and was clearly improper. Because the profit opportunities of the affiliates were a direct result of their association with their parent banks, any profits they derived rightfully belonged to the bank's stockholders.

The types of abuses just described sparked public outrage against commercial banks and their investment banking affiliates. However, the Glass-Steagall Act was not the proper remedy for such self-dealing and insider abuse. Trading accounts in the stock of parent banks by affiliates and the participation in such trading by bank officials could have been prevented by making it illegal for affiliates to deal in or own the stock of parent banks. The establishment of management funds is a problem mainly of concern to stockholders. With adequate disclosure of the salaries and bonuses distributed through such funds, stockholders can determine whether they are excessive. Affiliates owned entirely by bank officers and directors instead of by bank stockholders also could have been prohibited.

Abuses Arising From the Mixture of Commercial and Investment Banking

There were a number of abuses that occurred from the mixing of commercial and investment banking functions. Most of these relate to conflict-of-interest concerns, and while they have

implications for bank safety and soundness, there is no evidence that a large number of bank failures were due to interactions between banks and their affiliates. The types of abuses revealed during Senate testimony in 1933-34 included:

- Using the affiliate as a dumping ground for bad bank loans. In an example highlighted during the Pecora hearings, National City Bank transferred to National City Company $25 million worth of loans to Cuban sugar producers after the price of sugar collapsed and the borrowers were unable to repay the loans.

- Using the bank or its trust department as a receptacle for securities the affiliate could not sell. While examples where Chase National Bank bailed out its affiliates were revealed during the Senate investigation, it appears that trust departments generally were not used for such a purpose.

- Lending to finance the purchase of securities underwritten by the affiliate. This could have been another means whereby the affiliate's problems were transferred to the bank. That is, if the affiliate found it difficult to sell a particular issue, the bank may have chosen to offer loans to prospective purchasers under conditions disadvantageous to bank stockholders.

- Excessive lending to affiliates to finance underwritings. This practice may have led to an inadequate level of bank asset diversification, the significance of which would have depended upon the quality of the underwritings.

- There was a tendency for banks to invest too much in long-term securities. This practice caused liquidity problems that contributed to a number of bank failures during the late 1920s.

- Lowering the quality of bank assets by purchasing part of a poorly performing security after it had been issued. The reason for such action would have been that the bank was concerned with its image if a security its affiliate had underwritten or distributed began to lose value.

- Lending to a corporation that would otherwise have defaulted on an issue underwritten by the bank's securities affiliate. Again, this would have occurred if a bank was concerned that its image would be severely tarnished in the event a corporation defaulted on an issue the bank's affiliate had underwritten or distributed.

The first five problems outlined above could have been controlled with fairly simple legislative remedies. For example, to prevent the use of a bank or its affiliate as the dumping ground for the other's bad assets, federal authorities could have been given, and now have, authority to conduct simultaneous examinations on a periodic basis. Lending to finance the

purchase of securities underwritten by a bank's affiliate could have been prohibited. The concern that banks may lend excessive amounts to their affiliates could be handled by prohibiting such lending, by requiring that it be collateralized, or by simply placing a limit, perhaps as a percentage of bank capital, on the amount a bank may invest in any one and in all of its affiliates. However, the underlying concern in this case is that banks, by investing heavily in their affiliates, would not have a sufficiently diversified asset base. This concern can also be directly addressed by limiting overall investments in related markets or product lines. Similarly, the tendency for banks to invest too much in long-term securities could be controlled by prohibiting or limiting the number or amount of securities a bank could purchase from operating securities affiliates.

The potential for "tie-ins" also should be of concern. While it appears that investment banks can, and on occasion do, threaten to withhold certain services unless an entire "package" is purchased, the power of such a threat takes on a somewhat greater significance when it is a line of credit that might be withdrawn if an issuer does not choose a particular bank or bank affiliate as its underwriter. As with the previous two concerns it does not appear that examples of abuse were uncovered during the Pecora hearings.

The types of potential tie-ins that should be of concern to public policymakers are due either to self-dealing or to inadequate levels of competition. In neither case is a continued separation of commercial and investment banking an appropriate way to address effectively the problem. An example of the former is if a bank official tried to induce potential customers into purchasing a service (presumably, but not necessarily, at a relatively high price), in which the official had a personal interest, by tying-in and underpricing at the expense of the bank's or its affiliate's stockholders a second service in which the official's personal stake was less direct. Self-dealing of this kind can largely be prevented by other means.

In the absence of self-dealing at the expense of the benefactors of the proceeds of one of the tied-in services, the only way the tie-in threat can be effective is if the customer has no viable alternative. In competitive markets, customers would simply purchase the services elsewhere at more reasonable rates. This type of tie-in, to the extent it can occur, represents only one facet of a broader antitrust concern which is most appropriately dealt with through policies designed to foster greater competition. Since most banking markets are reasonably competitive, it is highly unlikely that investment bankers, as a group, will be at an unfair competitive advantage due to such tie-ins. Moreover, since nondepository institutions are becoming more involved in the extension of credit, it is difficult to argue that commercial banks should not be permitted to underwrite

corporate securities on the grounds that such tie-ins are possible.

Conclusion

By the 1930s, the general view in Congress was that the mixing of commercial and investment banking posed a threat to the safety and soundness of the banking system, created numerous conflict-of-interest situations and led to economic instability due to the channeling of bank deposits into "speculative" securities activities. To alleviate those concerns, the Glass-Steagall Act was enacted.

From the evidence gathered during the Senate investigation into stock exchange practices it appears that, to the extent the concerns of Congress were valid, they could have been handled through less disruptive legislative means. There is little evidence that the investment banking activities of commercial bank affiliates were a major factor in causing bank failures. Where investments in securities underwritten by affiliates contributed to an institution's failure, it was generally because the bank was illiquid due to an overinvestment in long-term assets. Affiliate losses were generally due to speculative activities unrelated to investment banking.

Most of the abuses that arose during the 1920s in connection with the operation of security affiliates by commercial banks appear to have been conflict of interest concerns rather than factors threatening the safety and soundness of commercial banks. However, it appears that most of these problems could have been remedied without having to resort to a forced separation of commercial and investment banking. Certain abuses which arise from mixing commercial and investment banking cannot entirely be controlled; but, they do not appear to have been so significant as to have warranted legislation separating commercial and investment banking. Finally, the provision of the 1934 Securities Exchange Act that authorized the Federal Reserve Board to regulate the extension of credit for the purchase of securities effectively achieved the third objective of the Glass-Steagall Act, which was to control the speculative uses of bank assets in the securities markets.

In conclusion, bank affiliates were not regulated, examined, or in any way restricted in the activities they could participate in until the 1930s. As a result, abuses occurred. A certain degree of supervision and regulation and some restrictions on bank affiliate powers would have gone a long way towards eliminating the types of abuses that occurred during this period.