INVESTMENT BANKING BY NON-INVESTMENT BANKS

DEMOSTHENES B. DONATO

I. INTRODUCTION

During the first eight years of the 1920s, the prices of shares listed on the New York Stock Exchange grew by approximately 100%.[1] While impressive, this growth rate was not out of line with the rise in corporate profits which increased by about 80%.[2] Within the subsequent 18-month period however, specifically from March 1928 through August 1929, the share prices again grew by almost another 100%.[3] This time, the securities market soared beyond the reasonable bounds of comparable corporate profits.[4]

Come September 1929, the great bull run finally became undone.[5] Between September 1929 and July 1932, the value of all shares listed in the New York Stock Exchange declined from a total of almost $90 billion to just under $16 billion.[6] During the same period, the value of all bonds so listed shrank from about $49 billion to about $31 billion.[7] Approximately half or $25 billion of the $50 billion worth of new securities sold during the post-World War I decade proved worthless.[8]

Meanwhile, in a related spectrum of the financial system, the number of bank failures increased at alarming proportions, from 642 in 1929, to 1325 in 1930, and to 2298 in 1931.[9] By 1933, over 11,000 banks had failed or had to merge, reducing their number by about 40% from 25,000 to 14,000.[10] Several state governors closed their states' banks.[11] In March of the same year, President Roosevelt closed all the banks in the country.[12]

In the light of the stock market crash and the overwhelming wave of bank failures, the Senate Banking and Currency Committee during the period 1932-34 undertook an extended investigation of stock exchange practices, commonly known as the Pecora Hearings.[13] While formally, the purpose of the hearings was to determine the causes of the drastic decline in security values, it in fact assumed a political character.[14] Galvanizing public contempt of commercial and investment bankers, the hearings paved the way for the transformation of national political sentiment from a laissez-fair ideology to a regulatory-reform ideology.[15]

Riding on the crest of broad public support, the Pecora hearings led to the passage of the Securities Act of 1933, mandating direct federal regulation of the securities markets, and the Glass-Steagall Act, effectively separating investment banking from commercial banking.[16]

II. INVESTMENT BANKING

The case of United States v. Morgan characterizes investment banking or more specifically securities underwriting, as the raising of funds through the distribution of stocks or bonds.[17] The underwriting process covers a gamut of activities, ranging from the design of the issue, preparation of the prospectus and registration statement, through the actual public offering.[18] In a sense, we may appropriately classify investment banking or securities underwriting (defined as the distribution of securities), like commercial banking (defined as the taking of deposits and extension of loans), as a mode of financial intermediation between capital owners and capital users. Under this financial transaction, the investment bank intermediary, functioning like the commercial bank intermediary, pools the capital resources of the capital owners and channels them collectively to the capital users. The crucial difference is that in the investment banking transaction, the capital owners end up with a direct relationship with the capital users as the latter's shareholders or bondholders, while in the commercial banking transaction, no such relationship results, since the capital owners retain only claims as creditors of the commercial bank intermediary, which claims subsist independently of the bank's own claim as creditor of the capital users.

III. HAZARDS OF INVESTMENT BANKING BY COMMERCIAL BANKS

The engagement in investment banking by commercial banks has been said to involve various financial hazards, to wit: (1) losses in high risk securities transactions, (2) unsound loans to securities affiliate, (3) unsound loans to companies issuing securities, (4) unsound loans to customers purchasing securities, (5) conflict of interests in promotion of securities and rendition of disinterested investment advice, (6) loss of public confidence in the bank, and (7) exposure of federal safety nets to high risk securities transactions.

Losses in Securities Transactions. The case of Investment Company Institute v. Camp (ICI I) observed that among the hazards is "the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments."[19] Relevant studies indicate that securities underwriting is a volatile business with wide variations in profit and insolvency.[20] Investment banking by commercial banks therefore purports to expose them to the financial dangers of losses from high risk securities transactions.[21]

Unsound Loans to Securities Affiliates. Subtle hazards have also been seen to arise when the securities affiliate fares badly, since the bank may tempted to shore up the affiliate through unsound loans.[22] Investment banking by commercial banks therefore arguably impairs their ability to function as an impartial source of credit in relation to their securities affiliates.[23]

Unsound Loans to Companies. Another subtle hazard is the risk of unsound loans to companies issuing the securities, under pressure to make the particular investment and the affiliate successful.[24] Investment banking by commercial banks therefore avowedly impairs the ability of the same to serve as an impartial source of credit in relation to the companies in whose stock or securities the banks or their affiliates have invested or are otherwise involved.[25]

Unsound Loans to Customers. Closely related to the foregoing is the perceived danger of unsound loans to customers purchasing securities, further fueling speculation.[26] Investment banking by commercial banks therefore purportedly impairs their ability to act as an impartial source of credit in relation to the customers who may be expected to purchase stocks or securities.[27]

Conflict of Interests. Another potential hazard arises from self-dealing transactions where the bank or its securities affiliate may be driven to unload excessive holdings through the bank trust department.[28] Investment banking by commercial banks therefore apparently gives rise to conflict situations between the interests of the investment banker to promote the distribution and sale of securities, and the interests of the commercial banker / trustee to render impartial investment advice and purchase securities for investment.[29]

Loss of Public Confidence. Commercial banks perform vital functions in the economy.[30] They serve as depositaries to safekeep the savings of the public, and as intermediaries to channel funds for investments and payments to meet consumer and business needs.[31]

The banks' capability to perform these vital financial functions depends largely on their capability to attract and retain deposits.[32] The latter capability in turn depends on the actual and perceived safety of the deposited funds, the availability of funds to depositors on demand, and the payment of deposits at par.[33]

The viability of commercial banks therefore depends largely on public perception of profitability and safety.[34] Absent this public perception, the banks immediately experience the most telling manifestation of customer risk aversion -- the bank run.[35] As a result, they suffer illiquidity which leads almost instaneously to insolvency.[36]

In the light of the vital financial functions of commercial banks and their heavy dependence on depositor sensitivity to risk, we may consider the speculative nature of securities transactions.[37] Noteworthy is the public perception of the high business risks involved in securities underwriting.[38] The reputation of commercial banks for prudence and restraint may therefore be undercut by the risks perceived as necessarily incident to investment banking.[39] In this sense, investment banking by commercial banks arguably exposes them to the risk of loss of public confidence, posing serious threats to their continued viability.[40]

Straining of Safety Nets. Commercial banks are generally covered by federal safety nets in the form of deposit insurance by the Federal Deposit Insurance Corporation and access to discount window borrowings by the Federal Reserve System.[41] These safety nets effectively strengthen the financial capability of the banks by allowing them access to cheap and enormous financial resources.[42] In this sense therefore, they facilitate the assumption by the banks of greater risks in securities transactions, than otherwise optimal, causing a further drain on the resources of the federal government.[43] Investment banking by commercial banks therefore avowedly strains the overly extended resources of the federal government, further weakening its capability to provide stabilizing support to the banking system.[44]

IV. SEPARATION OF INVESTMENT BANKING FROM COMMERCIAL BANKS

The Glass-Steagall Act separated investment banking from commercial banking.[45] Specifically, the Act refers to sections 16, 20, 21 and 32 of the Banking Act of 1933.[46] As codified in the United States Code, the statute refers to 12 U.S.C. 24 [16], 377 [20], 378 [21] and 78 [32].

Section 24 [16] governs the direct securities operations of national commercial banks. As a general rule, the provision prohibits the banks from purchasing any security for its own account. By way of exception, it allows such purchase of debt securities commonly known as investment securities to the limited extent of 10% of their capital and surplus. Also as a general rule, the provision bars the banks from underwriting any security. Again as an exception, it allows such underwriting of specified government debt securities as obligations of the United States, general obligations of any

State or of any political subdivision thereof, obligations of certain international government organizations to a limited extent, among others.[47]

Section 377 [20] covers the affiliation of member banks. The provision prohibits the affiliation of member banks with any investment company or investment bank or organization engaged principally in the issue, flotation, underwriting, public sale or distribution of securities.[48]

Section 378 [21] governs the financial intermediation operations of investment companies and investment banks or organizations engaged in issuing, underwriting, selling or distributing securities, by prohibiting them outright from taking deposits of any kind.[49]

Section 78 [32] covers the affiliation of investment companies and investment banks or organizations primarily engaged in the issue, flotation, underwriting, public sale, or distribution of securities. The provision prohibits the officers, directors or employees of the aforementioned organizations from serving at the same time as officers, directors or employees of any member bank.[50]

V. BENEFITS OF INVESTMENT BANKING BY COMMERCIAL BANKS

In contrast to the financial hazards of investment banking by commercial banks, the beneficial aspects of such undertaking have also been acknowledged, to wit: (1) financial stability through diversification of portfolio of assets, (2) operational efficiency through economies of scope, and (3) enhanced competition from new industry participants. Furthermore, where the investment banking activity is undertaken through a securities affiliate of a commercial bank, there is also the added benefit of: (4)

operational efficiency through specialization.

Financial Stability. Confinement to a specialized line of business subjects the enterprise to substantial risks of failure, where unfavorable economic and financial conditions face the industry. This is because the limitation deprives the enterprise of flexibility in adjusting to adverse changes in the economic and financial environment.

A case in point is the failure of hundreds of savings and loan associations during the period 1981-86.[51] Records show over 230 of the associations failed (constituting about 6% of the total number of institutions operating), over 300 had to merge to avoid failure, and an additional 500 or more became economically insolvent.[52] These associations specialized in fixed-interest long-term mortgage loans funded with short-term savings deposits.[53] When short-term interest rates (US Treasury three-month bills) rose sharply from 6% in September 1977 to 15.5% in August 1981, they suffered massive capital losses.[54] This experience undoubtedly shows the considerable risks inherent in a specialized banking system.[55]

Enabling commercial banks to undertake investment banking activities would therefore strengthen their financial standing by allowing them to diversify their portfolio of assets.

Efficiency of Scope. Economies of scope is obtained through the production or purchase of goods together.[56] It is achieved through pooled central facilities and expertise, multi-purpose use of information, joint delivery of services, savings on transaction costs, and reduced cost of risk through diversification.[57] For instance, the same computer equipment may be used to process different transactions (i.e. deposits, loans, securities transactions).[58] The same information may be utilized to discern the optimal mix of services (i.e. fund transfers, loans, securities services, financial advice).[59] Consumers save time and expense by procuring all their financial requirements from one organization.[60]

Authorizing commercial banks to offer investment banking services would therefore facilitate the achievement of economies of scope by allowing a single banking organization to offer a wider range of financial services, thereby promoting the more efficient use of banking resources.

Enhanced Competition. Enabling commercial banks to undertake investment banking functions naturally enhances competition by facilitating the entry of new participants in the securities underwriting industry.[61] This widens consumer choice among more suppliers of financial services.[62] This increased competition should lead to lower prices and better quality of services that benefit the public.

Efficiency of Specialization. Firms that undertake a specialized line of business achieve economies of scale through various means.[63] They may hire experts, use special purpose forms and equipment, and reduce consumer search costs by informing potential consumers of their services.[64]

In this light, we can see that securities underwriting may be conceivably undertaken through a specialized securities affiliate of a commercial bank. This mode of operation should promote economies of scale through specialization.

Accordingly, if commercial banks were authorized to offer investment banking services, the undertaking should be made through specialized securities affiliates to facilitate the more efficient use of banking resources.

At this point, we may note the observation made in the case of Securities Industry Association v. Board of Governors (SIA II), that the entry of commercial banks into the securities industry increases competition and promotes efficiency without creating any undue concentration of resources.[65] While the cited case itself pertains to retail securities brokerage and not to securities underwriting, the ruling nonetheless presents a glimpse of the potential benefits that may be derived from the engagement in investment banking by commercial banks.

VI. ENGAGEMENT IN INVESTMENT BANKING BY COMMERCIAL BANKS

In the light of the benefits of investment banking by commercial banks, let us consider the actual engagement in securities underwriting by commercial banks, as otherwise authorized by statutes and jurisprudence.

We may note that by the language of Secs. 377 [20] and 78 [32] regarding the affiliation of member banks, investment companies and investment banks, these provisions do not apply to state non-member banks.[66] Savings and loan associations are also not covered by the cited sections.[67] These excluded organizations are therefore free to affiliate with any securities underwriting entity.[68]

It is also noteworthy that commercial banks are not forbidden from underwriting and dealing in securities outside of the United States.[69] Accordingly, in all the other major financial markets outside of the territorial jurisdiction of the United States, the banks may legally engage in securities underwriting.[70]

Fairly recent jurisprudence have further eroded the wall erected by the Glass-Steagall Act to separate commercial banking from investment banking. These rulings may be summarized as follows: (1) that Sec. 24 [12 U.S.C. 16] applies only to banks and not to bank holding companies, as held in the case of Board of Governors v. Investment Company Institute (ICI II);[71] (2) that private placements of commercial paper to sophisticated institutions do not constitute to underwriting under Sec. 24 [12 U.S.C. 16], as held in the case of Securities Industry Association v. Board of Governors;[72] (3) that Sec. 377 [12 U.S.C. 20] prohibits member banks and bank holding companies from affiliation only with organizations "engaged principally" in underwriting, as held in the case of Securities Industry Association v. Board of Governors (SIA II);[73] (4) that the prohibition under Sec. 377 [12 U.S.C. 20] against the affiliation of banks with organizations "engaged principally" in underwriting, does not prohibit the affiliates from engaging in securities activities which banks themselves may engage in directly, as held in the case of Securities Industry Association v. Board of Governors;[74] and (5) that as long as the affiliates derived no more than 5% - 10% of their gross revenues from underwriting activities, they would not be "engaged principally" in underwriting under Sec. 377 [12 U.S.C. 20], as held in the case of Securities Industry Association v. Board of Governors.[75]

VII. SAFEGUARDS IN INVESTMENT BANKING BY COMMERCIAL BANKS

Considering the overall potential benefits that may be derived from the engagement in investment banking by commercial banks, taken in relation to the actual experience of bank participation in the securities industry to the extent lawfully permissible, we can see good and reasonable grounds for authorizing commercial banks to undertake securities underwriting. Nonetheless, the identified financial hazards cast clouds of doubt over investment banking by commercial banks. Accordingly, in order to clear away these clouds, the hazards must all be cautiously re-assessed and correspondingly addressed.

Among the safeguards proposed to ensure the safe and sound investment banking by commercial banks are as follows: (1) setting of a quantifiable limit on the amount of bank investments in securities underwriting business, (2) setting of qualitative restrictions on loans to troubled or failing securities affiliates, (3) prohibition of loans to companies whose securities are being underwritten by the bank, (4) prohibition of loans to customers for the purpose of purchasing securities being underwritten by the bank, (5) prohibition of purchase by the bank trust department of securities being underwritten by the bank, (6) requiring transaction of securities underwriting through a qualified securities affiliate.

Limitation of Investments in Securities Underwriting. It is the common perception that the most serious concern about the engagement of commecial banks in investment banking, is the prospect of losses in high risk security transactions. This perception has become so remarkably believable that it has been accepted as truth even without any inquiry into its veracity.

As Congressional records reveal, there was scarcely any concrete evidence produced to prove this point.[76] Amidst the overwhelming economic depression of the 1930s, only one example could strangely be cited by the legislators to show the purported evils of securities affiliates -- that of the Bank of United States.[77] This notwithstanding the undeniable circumstance that none of the said bank's affiliates was in fact engaged in securities underwriting.[78] As to how this gross misconception arose, the answer perhaps lies lost in the confusion of the times.

Further contradicting the common perception about the hazards of securities underwriting, relevant studies would indicate that the real reasons for the wave of bank failures in the 1930s were in fact financial panics and pervasive debtor insolvency.[79] These factors were seen to converge upon an inherently weak banking system made up of small independent banks operating in a depressed economy.[80] Accordingly, the conditions created became conducive to a massive bank failure.

Finally, as subtle reason would show, while the prospect for losses is indeed a concern, the securities business just like any other business, also presents prospects for returns. Considering the operational network and financial expertise of commercial bankers, there is hardly any reason to presume that their participation in the securities industry would in all probability only lead to business losses.

Notwithstanding these circumstances, prudence dictates that the cited bases for the legislative policy of separating investment banking from commercial banking, should not be lightly disregarded. Accordingly, to effect a compromise in this contentious area of overlapping banking and securities regulation, this paper proposes that while commercial banks should be authorized to engage in the business of securities underwriting, there should be established a concrete safeguard against potential losses, by setting a quantifiable limit on the amount of investments that commercial banks may undertake for purposes of securities underwriting. This limit could be a percentage of capital and surplus, or of total assets, or of any other reasonable and quantifiable measure. Due to the limitations of the present study however, this paper would not at this stage propose any specific numerical measure. It would only suggest a further detailed study by the concerned industry associations and appropriate federal regulatory agencies.

Limitation of Loans to Securities Affiliate. Considering the affinity of interests between a commercial bank and its securities affiliate, it is not difficult to understand that in cases involving a troubled or failing securities affiliate, the affiliate bank would naturally be more predisposed to assume greater risks to rescue its securities affiliate, as compared to other non-affiliate banks. In these instances therefore, the danger of unsound loans cannot be discounted, since the affiliate bank would be faced not only by objective considerations of profits, but also by subjective considerations of goodwill.

Accordingly, in order to ensure that commercial bank resources will not be unduly prejudiced by an overzealous undertaking to rescue a troubled or failing securities affiliate, this paper proposes that in cases where the securities affiliate suffers financial trouble or failure, the bank affiliate be restricted from extending or renewing any and all loans to said securities affiliate, unless the express approval of the appropriate federal banking regulatory agency is secured after due consideration of the safety and soundess factor. Considering the limitations of the present study however, this paper would not at this stage recommend the specific quantifiable financial conditions that should trigger the application of the approval requirement. Rather, it would suggest a further detailed study by the concerned industry associations and appropriate federal regulatory agencies.

Prohibition of Loans to Companies. Regarding the identified hazard of unsound loans to companies whose securities are being underwritten by the bank, it would seem that a closer examination of the business factors surrounding the transaction renders this concern of doubtful significance.[81] This is because for practical purposes, the extension of such a loan only entails so much more risk to the bank compared to the prospect of gain from the securities underwriting transaction.[82]

Nonetheless, if only to plug any inadvertent loophole and guard against possible changes in the financial market that may eventually create business incentives for the grant of such unsound loans, this paper proposes that there be a prohibition against the extension of a loan to companies whose securities are currently being distributed by the bank, and corollarily, that there be a prohibition against the bank underwriting the securities of companies that have outstanding loan obligations. This should effectively foreclose all the possibilities for the occurence of this problem.

We may note that the prohibition of a loan is limited to the period of distribution of securities, while the corollary prohibition of underwriting is consistently limited to the period that a previously extended loan remains outstandinng. This should ensure that the restrictions on the business activities of the bank are made effective only to the extent necessary to address the potential problem of unsound loans to companies whose securities are being underwritten by the bank, without placing any undue restrictions on other business transactions under appropriate conditions.

Prohibition of Loans to Customers. With respect to the hazard of unsound loans to customers for the purpose of financing the purchase securities being distributed by the bank, the similar lack of reasonable prospects to gain overall profits from these related transactions, also casts serious doubts on the purported danger.[83]

Notwithstanding these doubts however, it would seem to be the better part of judgment that the contemplated reform of the securities industry should be approached with caution. In this light, in order to eliminate any possibility of unsound loans to customers, this paper proposes that there be an outright prohibition against the extension of loans to customers for the purpose purchasing securities being underwritten by the bank. This straightforward prohibition should avoid the regulatory problem of distinguishing between sound and unsound loans. Nonetheless, for considerations of public policy, an exception may be provided for government issued securities under Sec. 24 [12 U.S.C 16].

Prohibition of Purchases by Trust Department. The potential hazard of self-dealing or conflict of interests arising from purchases by the bank trust department of securities underwritten by the bank, is concededly a serious concern. This is an instance where the danger of abuse is undeniably real. The problem is further compounded by the difficulty of detecting such abuses and of drawing a clear-cut line between sound and unsound purchases of securities.

In view of this hazard, in order to ensure that no such abuses in securities transactions may occur, this paper proposes that there should be an outright prohibition of purchases by the bank trust department of securities being distributed by the bank. An exception may be provided only with respect to government issued securities listed under Sec. 24 [12 U.S.C 16] for public policy considerations. The prohibition of course should take effect only during the period of distribution. Otherwise, the business discretion of the bank trust department would be unduly curtailed.

Transaction of Business through a Securities Affiliate. Direct engagement in securities underwriting by a commercial bank poses serious regulatory concerns and problems of unfair access to federal safety nets. While the functional delineation of regulatory authority is conceivable, so that the appropriate federal banking regulatory agency will retain authority over banking matters and the Securities and Exchange Commission will be vested with authority over securities matters, the arrangement by itself of having two distinct and unrelated government agencies regulating a single organization, is conducive to administrative conflict and confusion. Furthermore, there lies the danger of a bank abusing its access to federal deposit insurance and discount window borrowings, to support high risk security transactions.

Considering these hazards, this paper proposes that the contemplated underwriting activities should be allowed to commercial banks only if conducted indirectly through a securities affiliate that is subject to the regulation of the Securities and Exchange Commission and entitled to membership in the National Association of Securities Dealers.[84] This would effectively obviate the anticipated problems of government regulation. Furthermore, when taken in relation to the limitations on the amount of bank investments in securities underwriting and the restrictions on loans to troubled or failing securities affiliates, it would cut off unfair access to the built-in advantages of federal safety nets, specifically the ability to borrow funds from the federal discount window.[85]

Consistent with the purpose of avoiding any overlap in regulatory functions, this paper further recommends that the securities affiliate should be qualified to include only those companies directly or indirectly controlled by or under common control with the bank, excluding those companies directly or indirectly controlling the bank. We may note that companies controlling a bank are specifically denominated as bank holding companies,[86] subject to regulation by the Board of Governors of the Federal Reserve System.[87] Accordingly, if these bank holding companies were authorized to directly engage in securities underwriting, it would lead to the unwarranted situation where the bank holding companies would be subject to regulation by both the Board of Governors and the Securities and Exchange Commission.

Regarding the quantifiable characterization of control, this paper would not at this stage propose any exact numerical measure due to the limitations of the present study. It would only suggest a further detailed study by the concerned industry associations and appropriate regulatory agencies. For purposes of reference however, we may note that the law variably defines control. While the provisions of the Bank Holding Company Act[88] and the Federal Reserve Act[89] define control as ownership of 25% or more of voting shares, another provision of the latter statute[90] defines control as ownership of more than 50% of voting shares.

Public Confidence. It may be noted that the factor of depositor confidence in the stability of the banking system, cannot realistically be subject to any objective government regulation. Rather, this factor is largely dependent on the subjective perception of the public on the soundness or unsoundness of the banking system in the context of prevailing economic conditions.

Accordingly, to obviate any detrimental effect on public confidence in the banking system pursuant to the contemplated reform in the securities industry allowing entry of commercial banks in the field of securities underwriting, it would seem prudent that any such policy shift should be preceded by a massive information campaign on the real causes of bank failure, the benefits of investment banking by commercial banks, and the safeguards against potential hazards that may arise. Absent any other alternative, this approach is perhaps the only effective way of securing the trust of the public.

VIII. CONCLUSION

In sum, it may be fairly stated that the contemplated engagement of commercial banks in investment banking or specifically securities underwriting, should reasonably result in the following industry benefits: (1) financial stability through diversification of portfolio of assets, (2) operational efficiency through economies of scope, and (3) enhanced competition from new industry participants. Furthermore, where the investment banking activity is undertaken through a securities affiliate of a commercial bank, there is also the added benefit of: (4) operational efficiency through specialization.

On the other hand, it may likewise be reasonably stated that adequate safeguards may be established to ensure the safe and sound conduct of securities underwriting by commercial banks as follows: (1) setting of a quantifiable limit on the amount of bank investments in securities underwriting business, (2) setting of qualitative restrictions on loans to troubled or failing securities affiliates, (3) prohibition of loans to companies whose securities are being underwritten by the bank, (4) prohibition of loans to customers for the purpose of purchasing securities being underwritten by the bank, (5) prohibition of purchase by the bank trust department of securities being underwritten by the bank, (6) requiring transaction of securities underwriting through a qualified securities affiliate.

Consistent with legislation that may be enacted to implement these safeguards, all the four provisions of the Glass-Steagall Act, i.e., sections 16, 20, 21 and 32 of the Banking Act of 1933, respectively codified as 12 U.S.C. 24, 377, 378 and 78, should be expressly repealed. This should effectively level the playing fields of both the banking and securities industries, where commercial banks may engage in investment banking through qualified securities affiliates, and corollarily, investment banks may engage in commercial banking through qualified bank affiliates.

Considering the benefits and safeguards of the proposition, taken in context of an underlying information campaign, this paper concludes that the groundwork has now been laid for investment banking by non-investment banks.

Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commissio
d Modern Corporate Finance 2 (1992).

Id.

Id.

Id.

Id. at 2-3.

Id. at 1-2.

Id.

Id.

George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act
visited and Reconsidered 218 (1990).

. Id. at 1.

. Id.

. Id.

. Seligman, supra note 1, at 1.

. Id. at 2.

. Id.

. Id. at 38.

. United States v. Morgan, 118 F.Supp. 621, 650-654 (S.D.N.Y. 1953). The case provides as follows:

> The problem before an issuer is in no real sense that of selling a commodity or a manufactured article. In essence what the issuer wants is money and the problem is how and on what terms he can get it. Basically, it is simply a question of hiring the money . . . .
>
> Where the services of an investment banker are used, the typical transactions are . . . varied. The principal ones are:
> 1. A negotiated underwritten public offering.
> 2. An underwritten public offering awarded on the basis of publicly invited
> sealed bids, an investment banker having been retained on a fee basis to shape up the issue.
> 3. A negotiated underwritten offering to existing security-holders. Here the investment banker enters into a commitment to "stand by" until the subscription or exchange period has expired, at which time the investment banker must take up the securities not subscribed or exchanged.
> 4. An underwritten offering to existing security-holders awarded on the basis of publicly invited sealed bids, an investment banker having been retained on a fee basis to render the necessary assistance.

5. A non-underwritten offering to existing security-holders, with an investment banker acting as agent of the seller on a negotiated basis.

6. A private placement with an investment banker acting as agent of the seller on a negotiated basis . . . .

Generally the money is needed for a special purpose at a particular time, which may or may not be determined at the will of the issuer. Examples are: for expansion, the building of a new plant, the purchase of existing facilities, the scrapping of one set of elaborate and costly machines and their replacement by others more efficient and up-to-date, or for refunding. Often it is deemed important by the management that there be a wide distribution of the securities or that they be placed with investors in a particular geographical locality or among those who utilize the services of the issuer or purchase its products. When good will is involved or favorable treatment of existing security-holders is desired, the issuer may have sound reasons for not wishing to obtain the highest possible price for the issue.

If a given type of transaction is tentatively selected, the issuer has before it an almost infinite number of possible features, each of which may have a significant bearing on the attainment of the general result. The method to be pursued may be through an issue of bonds or preferred or common stock or some combination of these. If a debt issue is contemplated there are problems of security and collateral, debentures or convertible debentures, serial issues, sinking fund provisions, tax refund, protective and other covenants, coupon rates and a host of other miscellanea which may affect the rating (by Poor's or Moody's, Fitch or Standard Statistics), or the flexibility necessary for the operation of the business and the general saleability of the issue in terms of market receptivity. These details must each be given careful consideration in relation to the existing capital structure and plans for the future. If equity securities seem preferable on a preliminary survey, the available alternatives are equally numerous and the problems at times more vexing. What will do for one company is not suitable for another, even in the same industry. At times prior consolidations and reorganizations and an intricate pattern of prior financing make the over-all picture complicated and unusually difficult. But in the end, sometimes after many months of patient effort, just the right combination of alternatives is hit upon.

The actual design of the issue involves preparation of the prospectus and the registration statement, with supporting documents and reports, compliance with the numerous rules and regulations of the SEC or ICC or FPC and the various Blue Sky laws passed by the several States . . . .

Thus we find that in the beginning there is no "it." The security issue which eventuates is a nebulous thing, still in futuro. Consequently the competition for business by investment bankers must start with an effort to establish or continue a relationship with the issuer . . . . This is the initial step; and it is generally taken many months prior to the time when it is expected that the money will be needed . . . .

Sometimes an investment banking house will go it alone at this initial stage. At times two or three houses or even more will work together in seeking the business, with various understandings relative to the managership or co-managership and the amount of their underwriting participation. These are called nucleus groups . . . .

The tentative selection of an investment banker to shape up the issue and handle the financing has now been made; and there ensues a more or less prolonged period during which the skilled technicians of the investment banker are working with the executive and financial advisers of the issuer, studying the business from every angle, becoming familiar with the industry in which it functions, its future prospects, the character and efficiency of its operating policies and similar matters. Much of this information will eventually find its way in one form or another into the prospectus and registration statement. Sometimes engineers will be employed to make a survey of the business. The investment banker will submit a plan of the financing, often in writing; and this plan and perhaps others will be the subject of discussions. Gradually the definitive plan will be agreed upon . . . .

In the interval between the time when the investment banker is put on the job and the time when the definitive product begins to take form, a variety of other problems of great importance require consideration. The most vital of these, in terms of money and otherwise, is the timing of the issue. It is here, with his feel and judgment of the market, that the top-notch investment banker renders what is perhaps his most important service. The probable state of the general security market at any given future time is a most difficult thing to forecast. Only those with ripe trading experience and the finest kind of general background in financial affairs and practical economics can effectively render service of this character.

At last the issue has been cast in more or less final form, the prospectus and registration statement have been drafted and decisions relative to matters bearing a direct relation to the effective cost of the money, such as the coupon or dividend rate, sinking fund, conversion and redemption provisions and serial dates, if any, are shaped up subject to further consideration at the last moment. The work of organizing the syndicate, determining the participation positions of those selected as underwriters and the making up of a list of dealers for the selling group or, if no selling group is to be used, the formulation of plans for distribution by some other means, have been gradually proceeding, practically always in consultation with the issuer, who has the final say as to who the participating underwriters are to be. The general plans for distribution of the issue require the most careful and expert consideration, as the credit of the issuer may be seriously affected should the issue not be successful. Occasionally an elaborate campaign of education of dealers and investors is conducted.

Thus, if the negotiated underwritten public offering route is to be followed, we come at last to what may be the parting of the ways between the issuer and the investment banker - negotiation relative to the public offering price, the spread and the price to be paid to the issuer for the securities. These three are inextricably interrelated. The starting point is and must be the determination of the price at which the issue is to be offered to the public. This must in the very nature of things be the price at which the issuer and the investment banker jointly think the security can be put on the market with reasonable assurance of success; and at times the issuer, as already indicated in this brief recital of the way the investment banker functions, will for good and sufficient reasons not desire the public offering price to be placed at the highest figure attainable.

> Once agreement has been tentatively reached on the public offering price, the negotiation shifts to the amount of the contemplated gross spread. This figure must include the gross compensation of all those who participate in the distribution of the issue: the manager, the underwriting participants and the dealers who are to receive concessions and reallowances. Naturally, the amount of the spread will be governed largely by the nature of the problems of distribution and the amount of work involved. The statistical charts and static data indicate that the amount of the contemplated gross spreads is smallest with the highest class of bonds and largest with common stock issues, where the actual work of selling is at its maximum . . . .

> And so in the end the "pricing" of the issue is arrived at as a single, unitary determination of the public offering price, spread and price to the issuer.

. Id.

. Investment Company Institute v. Camp, 401 U.S. 617, 630 (1971).

. Vincent Di Lorenzo, Public Confidence and the Banking System: The Policy Basis for Continued paration of Commercial and Investment Banking, 73 Am. Univ. L. Rev. 647, 675-676 (1986).

Investment Company Institute, 401 U.S. at 630.

. Id., at 630-631. The case provides as follows:

> The legislative history of the Glass-Steagall Act shows that Congress also had mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations. For example, 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. And since public confidence is essential to the solvency of the bank, there might exist a natural temptation to shore up the affiliate through unsound loans or other aid.

. Id.

. Id. at 631. The case provides as follows:

> (T)he pressure to sell a particular investment and to make the affiliate successful might create a risk that the bank would make its

credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved. Congress feared that banks might even go so far as to make unsound loans to such companies.

. Id.

6. Id. at 632. The case provides as follows:

> There was also perceived the danger that when commercial banks were subject to the promotional demands of investment banking, they might be tempted to make loans to customers with the expectation that the loan would facilitate the purchase of stocks and securities. There was evidence before Congress that loans for investment written by commercial banks had done much to feed the speculative fever of the late 1920's. Senator Glass made it plain that it was "the 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.

. Id.

. Id. at 633. The case provides as follows:

> Another potential hazard that very much concerned Congress arose from the plain conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice. Senator Bulkley stated:
>
> > 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 or a distribution profit or a trading profit or any combination of such profits.
>
> Congress had before it evidence that security affiliates might be driven to unload excessive holdings through the trust department of the sponsor bank. Some witnesses at the hearings expressed the view that this practice constituted self-dealing in violation of the trustee's obligation of loyalty, and indeed that it would be improper for a bank's trust department to purchase anything from the bank's securities affiliate.

. Id.

. Di Lorenzo, supra note 20, at 648.

. Id.

. Id. at 648-649.

. Id.

. Id. at 667.

. Id.

. Id.

. Id. at 675-676.

. Id.

. Investment Company Institute, 401 U.S. at 631-632. The case provides as follows:

> Congress was also concerned that bank depositors might suffer losses on investments that they purchased in reliance on the relationship between the bank and its affiliate. This loss of customer good will might "become an important handicap to a bank during a major period of security market deflation." More broadly, Congress feared that the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities, and that this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business.

. Id.

. Benston, supra note 9, at 13.

. Id.

3. Id.

. Id.

. Seligman, supra note 1, at 38.

Benston, supra note 9, at 6-7.

12 U.S.C. 24 (Supp. 1993). The section provides as follows:

> Sec. 24 [16]. Corporate powers of associations . . . .
>
> Seventh . . . . The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired

and 10 per centum of its unimpaired surplus fund . . . . As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . . .

. 12 U.S.C. 377 (1988). The section provides as follows:

> Sec. 377 [20]. Affiliation with securities corporation . . .
>
> (N)o member bank shall be affiliated in any manner described in section 2(b) hereof [12 U.S.C. 221a(b)] with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities: Provided, That nothing in this paragraph shall apply to any such organization which shall have been placed in formal liquidation and which shall transact no business except such as may be incidental to the liquidation of its affairs.

For cross-reference, the cited section provides as follows:

> Sec. 221a. . . . (b) Except where otherwise specifically provided, the term "affiliate" shall include any organization, business trust, association, or other similar organization --
>
> (1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions; or
>
> (2) Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank; or
>
> (3) Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
>
> (4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of

> the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees.

. 12 U.S.C. 378 (1988). The section provides as follows:

> Sec. 378 [21]. Dealers in securities engaging in banking business . . .
>
> (I)t shall be unlawful . . . (for) any person, firm, corporation, association, business trust, or similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: Provided, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 5136 of the Revised Satutes, as amended [12 U.S.C. 24]: Provided further, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase obligations evidencing loans on real estate . . . .

50. 12 U.S.C. 78 (1988). The section provides as follows:

> Sec. 78 [32]. Certain persons excluded from serving as officers, directors or employees of member banks.
>
> No officer, director, or employee of any corporation or unincorporated association, no partner or employee or any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives customers regarding investments.

. Benston, supra note 9, at 182.

. Id.

. Id.

. Id.

. Id.

. Id. at 188.

. Id.

. Id.

. Id.

. Id.

. Id. at 200.

. Id.

. Id. at 187.

. Id.

5. Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207, 8, 209 (1984). The case provides as follows:

> Specifically, the Board identified as public benefits the increased competition and the increased convenience and efficiencies that the acquisition would bring to the retail brokerage business . . . . As to possible adverse effects, the Board determined that the proposed acquisition would not result in the undue concentration of resources, decreased competition, or unfair competitive prices . . . .
>
> The Court of Appeals held that the Board had acted within its statutory authority in authorizing BAC's acquistion of Schwab under Sec. 4(c)(8) of the BHC Act. The court accordingly affirmed the Board's order . . . . We . . . now affirm.

. Benston, supra note 9, at 9.

. Id.

. Id.

. 12 C.F.R. pt. 211.5(d)(13) and (14) (1994). Benston, supra note 9, at 9-10.

. Id.

. Board of Governors v. Investment Company Institute, 450 U.S. 46, 58-59 (1981). The case provides as llows:

> We agree with the Court of Appeals that Secs. 16 and 21 apply only to banks and not to bank holding companies. Section 21 prohibits firms engaged in the securities business from also receiving deposits. Bank holding companies do not receive deposits, and the language of

Sec. 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits. As the following colloquy, cited by the Court of Appeals, between Senator Glass, cosponsor of the bill, and Senator Robinson indicates, the drafters of the bill agreed with this construction:

"Mr. GLASS. . . . Here [Sec.21] we prohibit the large private banks, whose chief business is investment business, from receiving deposits. We separate them from the deposit banking business. . . .

"Mr. ROBINSON of Arkansas. That means if they wish to receive deposits they must have separate institutions for that purpose?

"Mr. GLASS. Yes." 77 Cong. Rec. 3730 (1933).

Section 16, which prohibits a national bank from "underwriting" any issue of a security, by its terms applies only to banks. Although respondent contended here and in the Court of Appeals that the bank and its holding company should be treated as a single entity for purposes of applying Secs. 16 and 21, the structure of the Glass-Steagall Act indicates to the contrary. Sections 16 and 21 flatly prohibit banks from engaging in the underwriting business. Organizations affiliated with banks, however, are dealt with by other sections of the Act. Section 19(e), 48 Stat. 188, repealed in pertinent part, 80 Stat. 242, prohibited bank holding companies from voting the shares of a bank subsidiary unless the holding companies divested itself of any interest in a subsidiary formed for the purpose of or "engaged principally" in the issuance or underwriting of securities. More importantly, Sec. 20 of the Act, 48 Stat. 188, prohibits national banks or state bank members of the Federal Reserve System from owning securities affiliates,
defined in Sec. 2(b), 48 Stat. 162, that are "engaged principally" in the issuance or underwriting of securities. Thus the structure of the Act reveals a congressional intent to treat banks separately from their affiliates. The reading of the Act urged by respondent would render Sec. 20 meaningless.

. Securities Industry Association v. Board of Governors, 807 F.2d 1052, 1062-66 (D.C. Cir. 1986). The
se provides as follows:

(W)e find that the Board reasonably concluded that an "underwriting" defeats the section 16 exemption only if it includes a public offering; private placements therefore do not for this purpose constitute statutory "underwriting." The Board's reliance on the distinction between public offerings and private placements is reasonable because the distinction derives support from congressional intent embodied in contemporaneous securities legislation and reasonably relates to concerns that the Glass-Steagall Act sought to meet.

1. Contemporaneous Securities Legislation . . . .

Only the Securities Act of 1933 define the term "underwriter" (although the Securities Exchange Act of 1934 provides useful evidence on the meaning of that term as used in the Securities Act). While the evidence of the ordinary congressional cognizance of the term "underwrite" or "underwriter" thus comes from only one piece of similar legislation, that legislation, the Securities Act 1933, is the closest to Glass-Steagall in time and purpose of the various statutes relied on in SIA. The Securities Act and the Glass-Steagall Act were signed into law within three weeks of each other and both statutes were among the legislative reforms that marked President Roosevelt's first hundred in office. Thus, while the precise purposes of the Securities Act and the Glass-Steagall Act may differ, both emerged from the same effort to restructure the American financial markets; absent any contrary indication, we must consider Congress' understanding of the financial terms it used in one statute highly relevant to discovering the meaning attached to similar but ambiguous terms in the other. With that rule in mind, we turn to the Securities Act of 1933 . . . .

The Securities Act in section 2(11) defines an "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a direct participation in the direct or indirect underwriting of any such undertaking." 15 U.S.C. Sec. 77b(11)(1982). An "underwriter" thus cannot exist unless a "distribution" exists.

As originally introduced in the House bill that was to become the Securities Act of 1933, the exemption . . . applied to "transactions by an issuer not with or through an underwriter." See H.R. 5480, 73d Cong., 1st Sess. Sec. 4(1) (1933). The House Committee added to this language the phrase "and not involving any public offering." H.R.Rep. No. 85, 73d Cong., 1st Sess. 1(1933). While the deliberate inclusion of both "not with or through an underwriter" and "not involving a public offering" would ordinarily support the conclusion that Congress viewed the coverage of the two phrases as being different, other legislative history shows that, in fact, both phrases had the same coverage. In interpreting the statute contemporaneously with its passage, the Federal Trade Commission, the agency originally charged with administering the securities laws, observed that a statutory "distribution" necessarily involved a "public offering," thus making it clear that one could not be an "underwriter" in the absence of a public offering. See H.R.Conf.Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934). Acknowledging the correctness of the Commission's interpretation, the same Congress that had passed the Securities Act of 1933 eliminated as "superfluous" the language "not with or through an underwriter" when it amended the Securities Act in Title II of the Securities Act of 1934. Id.; see ch. 404, Sec. 203(a)(1), 48 Stat. 881, 906 (1934); see also 1 L.Loss, Securities Regulation 551 & n. 307 (2d ed. 1961) (distribution "more or less synonymous with" public offering). While by no means conclusive, this history offers support for the reasonableness of the Board's view that Congress understood "underwriting" (and, for that matter, "distribution") of securities to connote a public offering, and that the private offerings of commercial paper effected by Bankers Trust do not come within the Glass-Steagall Act's meaning of "underwriting". . . .

2. Legislative Purposes -- As the Supreme Court has amply documented, the legislative history of the Glass-Steagall Act shows that, besides "the obvious risk that a bank could lose money by imprudent investment of its funds in speculative securities," Congress sought to address "the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent

and enters the investment banking business." SIA, 468 U.S. at 145, 104 S.Ct. at 2984 (quoting Camp, 401 U.S. at 630, 91 S.Ct. at 1098). The hazards identified by the Court included the danger to the impartiality of the bank as a dispenser of financial advice. For example, "Congress concluded that it was unrealistic to expect a banker to give impartial advice about [whether and how best to issue equity or debt securities] if he stands to realize a profit from the underwriting or distribution of securities." SIA, 468 U.S. at 146, 104 S.Ct. at 2984 (citing 75 Cong.Rec. 9912 (1932) (remarks of Sec. Bulkley)). Moreover, the Court pointed to congressional fears that commercial-bank involvement in investment banking might lead to the use of a bank's credit facilities to "shore up a company whose securities the bank sought to distribute" or to facilitate the purchase of securities of the bank's commercial customers. See id. at 146-47, 104 S.Ct. at 2985. Congress, in sum, did not believe that bankers could act as proper fiduciaries if faced with the "pressures" of "involvement in the distribution of securities." Id. at 146, 104 S.Ct. at 2985.

Congress recognized that these pressures largely resulted from the heavy fixed costs incurred by commercial banks in running investment banking operations. In the period immediately preceding the financial collapse that precipitated the enactment of Glass-Steagall, the distribution of an issue of securities took place through an elaborate syndication involving various tiers of purchase, banking, and selling groups managed by an originating banker who handled the negotiations with the issuer. See 1 L. Loss, Securities Regulation 164-66 (2d ed. 1961). The precise details of the distribution process, as it then existed, are not important for our purposes. What is important is that "a large number of the leading originators of securities, particularly the security affiliates of commercial banks," developed "large selling organizations" in this period. Gourrich, Investment Banking Methods Prior to and Since the Securities Act of 1933, 4 Law & Contemp. Probs. 44, 49 (1937). Indeed, the "bank affiliates were particularly active in constructing substantial retail organizations" to distribute the securities to which they had committed themselves as originators or members of a purchase group. Id. at 48 n. 8. . . .

In light of the specific congressional focus on the large fixed costs that accompanied retail participation in public distributions, it seems highly plausible that one line Congress might have drawn in adopting the permissive language of section 16 of the Glass-Steagall Act was at the point of public offering, a line which could well explain the prohibition against underwriting. While regular involvement in private offerings of securities undoubtedly produces some fixed costs and some attendant pressures, it seems reasonable to think that Congress might have found these relatively minor expenses acceptable when compared with the much heavier fixed burden of having a far-flung retail network to distribute securities to the public. Although implementation of this distinction through the prohibition of commercial-bank underwriting would not address all the "subtle hazards" with which Congress was concerned (for example, it would do nothing to meet the fear that a bank would sell securities for an issuer to help the issuer repay loans to the bank), the prohibition of underwriting is only one of the limitations that section 16 imposes on banks that desire to deal in securities. We believe that the distinction between public and private offerings as drawn by the Board reasonably interprets the prohibition of underwriting and reasonably relates to the elimination of some of those hazards.

Securities Industry Association, 468 U.S., at 216-218. The case provides as follows:

> A bank holding company's subsidiaries are bank affiliates within the meaning of Sec. 20. 12 U.S.C. Sec. 221a(b). Section 20, therefore, prohibits BAC's proposed acquisition if Schwab is "engaged principally" in any of the activities listed therein. . . .
>
> "Public sale" is used in conjunction with the terms "issue," "flotation,"
> "underwriting," and "distribution" of securities. None of these terms has any reference to the brokerage business at issue in this case. Schwab does not engage in issuing or floating the sale of securities, and the terms "underwriting" and "distribution" traditionally apply to a function distinctly different from that of a securities broker. An underwriter normally acts as principal whereas a broker executes orders for the purchase or sale of securities solely as agent. Under the "familiar principle of statutory construction that words grouped in a list should be given related meaning," Third National Bank v. Impac, Ltd., 432 U.S. 312, 322 (1977) (footnote omitted), the term "public sale" in Sec. 20 should be read to refer to the underwriting activity described by the terms that surround it, and to exclude the type of retail brokerage business in which Schwab principally is engaged.

. Securities Industry Association v. Board of Governors, 839 F.2d 47, 58, 60, 62 (2nd Cir. 1988). The
se provides as follows:

> Section 20 was Congress' solution to the problem of affiliates and establishes the boundary separating banks from their securities affiliates. While Sec. 21 prohibits firms "engaged" in investment banking activities from accepting deposits, Sec. 20 prohibits commercial bank affiliation with firms "engaged principally" in underwriting and dealing in securities. The inference following from this different terminology is obvious: Sec. 20 applies a "less stringent standard" than the absolute bar between commercial and investment banking laid down by Secs. 16 and 21. ICI, 450 U.S. at 60 n. 26, 101 S.Ct. at 283-84 n.26. . . .
>
> Congress' concern was primarily with bank affiliate activities in bank-ineligible securities. Bank affiliates often "devote[d] themselves . . . to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank." 1933 Senate Report, supra, at 10. According to Senator Glass, "[w]hat the committee had foremost in its thought was to exclude from commercial banking all investment securities except those of an undoubted character that would be surely liquidated; and for that reason we made an exception [in Sec. 16] of United States securities and of the general liabilities of States and subdivisions of States." 76 Cong. Rec. 2092 (1933). Given that Glass-Steagall was a means to sever commercial banking only from

more speculative, "perilous" investment activities, in which bank-eligible activities were not included, an interpretation of "securities" in Sec. 20 that excluded bank-eligible securities from its reach is entirely consistent with Congress' aim.

An elucidation of SIA's suggested interpretation of Sec. 20 shows the anomalies that an over-literal interpretation of the term "securities" in that section might bring. If bank-eligible securities are included in the prohibitions of Sec. 20, an affiliate could "engage" (but not principally) in bank-ineligible securities activities. Alternatively, the same affiliate could engage to the identical extent in bank-eligible securities activities. SIA's construction would permit either, or both, types of activity -- up to a certain point. Two banks could each have an affiliate, one engaged in underwriting and dealing in high-risk securities prohibited to banks, and the other engaged in the government obligations that Congress felt to be of such negligible risk that it allowed, and encouraged, banks themselves to deal in them. It is paradoxical to presume that it was Congress' purpose to place both affiliates on the same footing. . . .

In sum, the Board's contruction of Glass-Steagall is not only reasonable, but dictated by a thorough examination of the legislative history of Glass-Steagall and of the hazards that Congress sought to prevent when enacting Sec. 20. We hold that it was not Congress' purpose in Sec. 20 to preclude a bank affiliate from engaging in the same activities to the same extent as a member bank and we uphold the Board's determination that the reference in Sec. 20 to "securities" does not encompass those securities which Sec. 16 allows banks themselves to underwrite.

. Id. at 64, 66- 67. The case provides as follows:

An example illustrates how equating "principally" in Sec. 20 with "chief" or "first" begets the dangers foreseen by Congress. Such an interpretation would allow a member bank to become affiliated with any large integrated securities firm. One commentator has pointed out that reading "principally" as "chief" would allow a bank to be affiliated with Merill Lynch & Co., Inc., one of the nation's largest investment bankers. See Plotkin, What Meaning Does Glass-Steagall Have for Today's Financial World?, 95 Banking L.J. 404, 414-16 (1977). It cannot be supposed that the Congress that enacted Glass-Steagall would have intended that Sec. 20 would not prohibit such affiliations. This is not to say that "principally" cannot in some contexts mean "chief" or "first," but rather that in Sec. 20 the term must be given a definition that is both sensible and in harmony with legislative purpose.

Moreover, the logic of the holding company's position is that "principally" in Sec. 20 is a directly quantitative, not a qualitative, term. "Substantially," on the other hand, reflects the qualitative aspects of "principally." When Congress wanted to use a quantitative test in the Banking Act of 1933, it knew how to do it. See Sec. 2(b), (c), 48 Stat. at 183 (collateral requirements for loans to affiliates); Sec. 16(Seventh), 48 Stat. at 185 (limitations on banks' purchase of securities for own account), Sec. 19(b), 48 Stat. at 187 (level of assets for holding company affiliates to be maintained free of any liens); Sec. 19(c), 48 Stat. at 187 (shareholders' liability determination). Because in Sec. 20 Congress departed from a quantitative approach, the argument that a qualitative test should be controlling is all the more compelling. . . .

Consequently, the Board's view of "engaged principally" as meaning any substantial activity is reasonable and consistent with Congressional purpose. . . .

(W)ith regard to "engaged principally" versus "primarily engaged," Secs. 20 and 32 differ; accordingly, there is justification for interpreting them slightly differently.

The legislative history also supports the conclusion that the Board's stringent quantitative interpretation of Sec. 20 is reasonable. What became Sec. 20 was proposed by Eugene Meyer, a governor of the Federal Reserve Board, as a substitute for the section which eventually became Sec. 32, see 1932 Hearings, supra, at 387-88, because he believed that the language in the predecessor to Sec. 32 -- in relevant respects identical to Sec. 32 -- was overbroad and that it would therefore be ineffectual. See id. at 387. Meyer commented on the "difficulties in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply," id. at 388, and tentatively suggested substituting what is now Sec. 20 for what is now Sec. 32. It defies logic that Sec. 20 should be interpreted less restrictively than Sec. 32, based on Meyer's comments that Sec. 20 was intended to be more restrictive than Sec. 32.

Further support for a stricter interpretation of Sec. 20 than of Sec. 32 is derived from the fact that the dangers resulting from affiliation are arguably greater than those resulting only from personnel interlocks. The public associates a member bank and its affiliate because of their common ownership and often similar names. The potential for the public to associate the misfortunes of the affiliate with the bank is far greater than the association of firms with personnel interlocks, which are generally unknown to the public.

Given these considerations, we defer to the Board's determination that Sec. 20 allows an affiliate to engage in bank-ineligible securities activities so long as those activities do not exceed five to ten percent of the affiliate's gross revenue. This range is both reasonable and consistent with the statute. Because of the Board's exeprtise we also defer to its decision to set the gross revenue limitation at five percent.

. Benston, supra note 9, at 217-218.

. Id.

. Id.

. Ben S. Bernanke, Nonmonetary Effects of the Financial Crisis in the Propagation of the Great pression, 73 Am. Econ. Rev. 257, 258 (1983).

. Id. at 218.

. Securities Industry Association, 807 F.2d, at 1068. The case provides as follows:

> The Board has also advanced an argument not considered by the Court in SIA to explain why the arrangement adopted by Bankers Trust will not lead to the lending of money to "shore up" customers of the bank's commercial paper service. The Board points out that the profit from the placement of commercial paper is small, amounting to a commission on the order of one-eighth of one percent of the total amount of the issuer's commercial paper, computed on an annualized basis. The rewards from these commissions are so small compared to the cost of the loans the bank would have to write to make an unsound issuer's paper more attractive to the market that writing such loans would not be worth the risk. Board Statement at 40-41, J.A. at 234-35. A judgment such as this, that the economic realities of the financial marketplace would preclude banks from making loans to shore up troubled issuers, is precisely the kind of exercise of delegated expertise that deserves our full deference.

Id.

. Id. at 1068. The case provides as follows:

> As for the second "subtle hazard," the possibility of the bank's making self-interested loans to finance the purchase of commercial paper it helps issue, the Board provides a persuasive argument, again not before the Supreme Court in SIA, that no such hazard arises here. Turning again to an analysis of financial markets, the Board asserts that it is wholly impractical for a commercial bank to make such loans because the yields on commercial paper are generally lower than the interest rates the loans would have to bear. Board Statement at 41n. 39, J.A. at 235 n. 39. In the absence of any evidence that this conclusion is wrong, the Board is again entitled to our deference.

. Joseph Michael Heppt, An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagal oklyn L. Rev. 281, 319-320 (1986).

. Id. at 321.

. 12 U.S.C. 1841(a)(1) and (2) (1988).

. 12 U.S.C. 1841-1850 (1988 & Supp. 1993).

. 12 U.S.C. 1841(a)(2)(A) (1988).

. 12 U.S.C. 371c(b)(3)(A)(i) (1988).

. 12 U.S.C. 221a(b)(1) and (4) (1988).