The 1980s have witnessed an increasing trend towards bank deregulation. One important aspect of this trend has been the growth in the securities activities of banks and bank holding companies. These activities have taken several forms, including operating discount brokerage houses, selling commingled IRAs, and acting as advisors to closed-end mutual funds. However, one activity which banks are still expressly prohibited from entering (under the 1933 Glass-Steagall Act) is underwriting and dealing in corporate securities—stocks or bonds. Despite this, many large banks are vigorously lobbying Congress to be allowed back into securities underwriting (and, therefore, for the abolition of the Glass-Steagall Act).

Allowing banks to engage once again in corporate securities underwriting may well have important social benefits. First, it would probably ease the access of small firms into the capital market; commissions on the initial public offerings of these firms would decline, since increased competition would likely lower the very high underwriting fees. Indeed, a number of studies have shown that existing underwriters have persistently underpriced new offerings by small firms and have charged fees and commissions exceeding 10 percent of the gross

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revenues from the issue. Second, allowing bank holding companies' subsidiaries to underwrite securities may enhance their ability to diversify, which could significantly help stabilize bank holding companies' earnings.2

These benefits are sufficient to warrant a serious look at relaxing restrictions on corporate securities underwriting, particularly in today's financial environment. Indeed, banks and bank holding companies contend that advances in management controls and information technology can mitigate the problems of conflict of interest that, in part, gave rise to the restrictions. Regulators, however, remain concerned that allowing banks into securities underwriting raises questions regarding bank safety and soundness and heightens the potential for conflicts of interest. While potential conflicts of interest are present in virtually all buyer-seller relationships, they may be particularly acute in the context of a multiproduct (or multi-activity) bank or bank holding company with a great diversity of customers.3

Indeed, in the period leading up to the 1929 stock market crash, conflicts of interest in the securities activities of several major banks received considerable publicity and were a major factor prompting the restrictive Glass-Steagall provisions.

A BRIEF HISTORY AND BACKGROUND OF BANK SECURITIES ACTIVITIES

Prior to 1933, large banks were heavily engaged in securities underwriting. Although under the 1864 National Bank Act national banks were not authorized to underwrite securities directly, they avoided this restriction by establishing state-chartered securities affiliates. These affiliates played a major role in underwriting bonds issued by large railroad and industrial companies in the late nineteenth and early twentieth centuries, as well as in helping distribute government bonds, called Liberty Loans, in World War I. In 1927 the McFadden Act was passed. While this Act is perhaps best known for its prohibition on interstate banking, it also legalized national banks' underwriting activities by giving the Comptroller of the Currency the right to define approved securities. As a result, between 1927 and 1929 the share of national banks and their affiliates involved in new bond underwritings more than doubled from 22 percent in 1927 to 46 percent in 1929.4

The financial panic and great stock market crash of 1929, after which large numbers of banks failed or froze the convertibility of deposits (nearly 10,000 in the 1929-33 period alone), led to a number of contemporary investigations into its causes. One of the most influential of these investigations was undertaken in 1933 by the Senate Banking and Currency Committee and its counsel, Ferdinand Pecora. Pecora documented a considerable number of abuses that had occurred between large banks and their securities affiliates and customers in the pre-1929 period. For example, banks had made loans to purchasers of securities to help artificially fix securities prices; they had dumped "bad" securities with correspondents or in trust accounts; and they had engaged in insider trading. Indeed, publicity surrounding the Pecora hearings created an environment in which it was widely felt that greedy bankers were in part to blame for the crash, and that a sound banking system would result only if commercial banking activities were rigidly separated from investment banking activities.5

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1See, for example, the study by Stoll (1976).
2See the studies by Wall and Eisenbeis, and Saunders (1983).
3This organizational structure, in which a separately capitalized bank is linked to a separately capitalized securities underwriting affiliate through a holding company appears to be the most likely format should any future deregulation take place.

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4See Flannery (forthcoming).
5More recent evidence on the causes of the crash, however, have centered blame on the Federal Reserve's restrictive monetary policies (see Friedman and Schwartz...
The Glass-Steagall Act, passed in 1933, made it a felony for an organization that receives deposits to engage at the same time "in the business of issuing, underwriting, selling or distributing of stocks, bonds, debentures or other securities." The Act did allow four exceptions: municipal general obligation bonds; U.S. government bonds; private placements; and real estate loans.

For some thirty years commercial banks appeared content to accede to the restrictive intent of the Glass-Steagall Act. But, by the beginning of the 1960s, banks perceived they were earning a declining proportion of profits from traditional bank activities compared to their permitted nonbank activities. Moreover, they were often at the frontier in the computerization of financial products. These features of a changing financial environment led a group of large banks to challenge "gray areas" in the Glass-Steagall Act. This, in turn, brought them into conflict with the securities industry. As a result, the last twenty years have witnessed an almost continuous state of legal combat between commercial banks and their securities industry adversaries regarding the permissible securities activities of commercial banks (see LITIGATION HIGHLIGHTS).

Today, commercial banks legally can undertake a whole variety of agency functions on behalf of individual clients. These include buying and selling stocks, safekeeping securities, providing quotes on prices of securities, and switching funds between bank accounts and stock accounts. In addition, they continue to underwrite municipal general obligation bonds, as well as U.S. government bonds and Eurobonds (bonds issued outside of the U.S.). Thus, along with open-ended mutual funds and

LITIGATION HIGHLIGHTS

The legal battles over securities underwriting are too numerous to document fully, but the trends in the arguments and in the courts' decisions can be seen from looking at a few of the highlights. In 1963, following a ruling by the Comptroller of the Currency, a number of banks began underwriting municipal revenue bonds (in addition to the permitted general obligation bonds). The major argument here was that municipal revenue bonds barely existed at the time of the Act's passage (only approximately 3 percent of all municipal bonds issued in 1933 were revenue bonds) so that the Act did not apply to these instruments. However, in the case of Baker, Watts and Co. vs. Saxon in 1966, this underwriting activity was expressly prohibited as being contrary to the intent of Glass-Steagall. Similarly, in 1962 Citibank began selling shares in an open-ended mutual fund managed by the bank. This was challenged by the securities industry, arguing that Citibank had a direct "salesman's stake" in such a fund and that this was contrary to the intent of Glass-Steagall. In 1971, in Investment Company Institute vs. Camp, this activity was also declared illegal. In more recent legal disputes, commercial banks have had greater success, especially where it has been easier to establish that the bank has been providing an "agency function," rather than dispensing advice in the activity concerned. Thus banks were allowed to establish automatic investment services in 1977 and banks and bank holding companies were authorized to acquire discount brokerage houses in 1984. Although commercial paper was ruled a security in 1983, the district court, in A.G. Becker and the Securities Industry Association vs. the Federal Reserve Board, asked the Fed to make an initial determination of whether certain commercial paper activities constitute underwriting or whether they are permissible for bank holding companies. In June 1985, the Board decided that Banks' Trust's assistance to commercial paper issuers in private placement did not constitute underwriting so long as the bank did not promote the issue widely, take an ownership interest in the issue, or extend credit directly or indirectly to the issuer to compensate for unsold amounts. The court will review the Fed's opinion.
revenue bonds, underwriting and dealing in corporate securities remains the last major bastion of the securities industry.  

WHY SO MUCH CONCERN ABOUT CONFLICTS OF INTEREST?

Any further advances banks make into securities activities, and in particular, into securities underwriting, will hinge largely on the answer to a crucial question: if banks are allowed to engage in such activities, will the types of abuse and conflicts observed in the 1930s re-emerge and will they be as extensive? Any serious evaluation of this question has to look at the incentives and disincentives in today's legal, economic, and regulatory environment, and not that of the 1930s. An example of one change is that a whole body of securities laws and regulations has been passed since 1933 (for example, the Securities Act of 1934 which established the Securities and Exchange Commission). And today, the technology of disseminating and monitoring information is vastly superior to that of the 1930s.

But, even given these improvements in regulation and surveillance, serious problems could still ensue if conflicts of interest are exploited. First, public disclosure of a conflict of interest might lead to a loss of confidence in the bank and its management, resulting in an erosion of deposits (and revenue) which ultimately affects a bank’s stability or safety and soundness. In the extreme, a loss of confidence by depositors could result in a run on the bank and lead to its eventual demise—even if the bank were “solvent” before the adverse information was publicly disclosed. Realistically, however, it seems likely that only pervasive and widespread

In June 1985, the Federal Reserve Board concluded that Bankers Trust could continue to act as an agent and advisor to corporations in the private placement of commercial paper with a small group of institutional investors. If this position is accepted by the courts, banks will be able to participate in the limited distribution of commercial paper without violating the Glass-Steagall prohibition on underwriting corporate securities. 

abuses that were extensively publicized would lead to catastrophic runs. Second, exploitation of certain conflicts, such as unsound intercompany loans between a bank and its securities subsidiary, for example, could work directly to weaken the bank irrespective of any indirect confidence or disclosure effects. Third, conflict of interest raises important questions of equity. Specifically, small, less sophisticated firms, correspondent banks, investors, and uninsured depositors appear to be more susceptible to exploitation through conflicts of interest than larger ones. In a sense, these concerns are closely linked to regulators’ interest in protecting the welfare and savings of small investors, especially since small investors often have less access to information than larger investors and are unable to switch assets without bearing relatively high transaction costs, such as service fees. Of course, the more accurate, cheap, and widely disseminated information is, and the more competitive financial and banking markets are, the less easy it becomes to exploit smaller firms, and the less weight should be attached to this “equity” issue.

TYPES OF POTENTIAL CONFLICTS

The lobbying by commercial banks to be allowed back into securities underwriting, and their expansion into other securities activities, has helped improve our understanding of the types of potential conflicts of interest that might arise. The nine potential conflicts discussed below either have been raised at Congressional hearings leading up to the Glass-Steagall Act in the early 1930s, or have been suggested more recently by industry observers or by the securities industry in opposing bank involvement in private debt placements, open- and closed-end mutual funds, and other securities-related activities. Although it is difficult to classify the conflicts precisely, a unifying theme among

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6 See, for example, Investment Company Institute (1979), New York Clearing House Association (1977), and Securities Industry Association (1977).
them is that each conflict is related to problems of asymmetric information (where one party has more information than the other), or the abuse of monopoly power, or both.

The Conflict Between the Promotional Role of the Investment Banker and the Commercial Banker’s Obligation to Provide Disinterested Advice to Depositors. When a commercial bank affiliate underwrites securities, bankers may have incentives to encourage depositors or other customers (such as correspondent banks) to buy these securities. As a result, bankers may play a promotional role on behalf of the securities affiliate, a role which is in conflict with the best interests of its customers. For example, a customer might have chosen an alternative investment, with a superior risk-return trade-off, had a banker proffered “disinterested” advice. This potential conflict should be noted, is not confined solely to securities underwriting, but pertains to all “nonbank” activities undertaken by a bank holding company.

Using the Bank’s Securities Affiliate to Issue New Securities to Repay Unprofitable Loans. A bank may use the underwriting ability of its securities affiliate to transfer risk from itself to the bondholders (or equity holders) of a corporate loan customer. The scenario which is usually conjured up is that of a bank holding a partly collateralized risky loan. In order to avoid an expected loss on the loan, the bank may induce a loan customer to issue new bonds (or equity) through the bank’s securities affiliate and use the cash proceeds to pay off the loan. Thus, the bank eliminates its default risk exposure, and its affiliate earns a fee on the underwriting.

It is not clear that this potential conflict is ever likely to materialize. For example, why would any but a highly risk-averse bank prefer this arrangement to simply restructuring loan repayments? Further, it is not obvious that any incentives exist for the risky loan customer to take part in such a scheme, particularly since either its stockholders or bondholders (or conceivably both) stand to lose.

Economic Tie-Ins of Different Holding Company Products. A bank may use its potential leverage over customers, through its lending function and as a guarantor (for example, via stand-by letters of credit), to coerce them into buying other products. Specifically, threats of credit rationing, curtailing or refusing to renew credit lines, and increasing the cost of loans could all be used to “tie” existing customers to other products of the holding company, such as securities underwritings by its affiliate.

Placing Unsold Securities in the Bank’s Trust Accounts. This potential conflict might arise if the securities affiliate of a bank holding company has securities in its inventory that can only be sold off at a loss to outside investors. To avoid such losses, the affiliate may seek to place the securities, at prices favorable to the affiliate, in other parts of the holding company, for example, with the trust accounts of the affiliated bank. This conflict is unlikely to occur with large institutional trust or pension fund accounts, since owners of these accounts monitor their performance closely; however, this monitoring may be absent in the management of smaller personal trusts over which banks, as trustees, have considerable discretionary power.

Director Interlocks between Bank Holding Companies and Non-Financial Firms. With the ability of bank securities affiliates to underwrite debt and equity issues, the potential conflicts arising from director interlocks between banks and other firms (when a bank director also serves on the boards of non-financial corporations) may become more important. The combination of director interlocks and large holdings of corporate stock in bank trust departments, together with the ability of a bank holding company affiliate to offer underwriting services, may increase the potential for conflicts of interest.

8However, as Posner (1976) has argued, the market conditions under which a monopolist would rationally exploit a tie-in are quite restrictive.
For example, decisions made in the boardroom, such as whether to finance with loans or bond issues, bonds or equity, and which underwriter to choose, may all be influenced either directly or indirectly by the presence and voting powers of bank directors.

Bank Loans to Support the Price of a Security. In acting as an underwriter, the securities affiliate may want its underwriting effort to be seen as successful as possible. This may be especially true for new entrants into the underwriting business. As a result, bank loans may be made at relatively favorable rates to third-party investors on the understanding that part, or all, of these funds would be used to purchase certain new issues underwritten by the affiliate and its syndicates. In such a case, bank loans could be used to support the prices of those securities, sending favorable but misleading signals to the market regarding the true performance of the underwriter. Further, such a cheap loan policy might undermine bank profits, and thereby the safety and security of its uninsured depositors and the FDIC, which backs the insured depositors.

Imprudent Loans to Issuers of Securities Underwritten by the Affiliate. In this case a new issue of bonds is underwritten by a bank affiliate and subsequently the investment projects financed by the proceeds fail, or there is some other negative impact on the issuing firm’s (customer’s) cash flow which serves to increase its default risk. As a result, the bank may make new loans to the firm to keep it from failing, and thus avoid potential litigation costs arising from bondholders’ claims against the securities affiliate and holding company (relating to information disclosure and lack of due diligence in the original underwriting prospectus). If the new loans of the bank are subordinated (that is, junior—paid off last in the event of default) to the claims of existing bondholders, the market value of the firm’s bonds—including those just issued—will tend to rise. This is because the assets of the firm have expanded, while the stock of senior or unsubordinated bonds remains unchanged. Implicitly, bank management is subsidizing the risky claims of the issuing firm’s bondholders in conflict with the best interests of its depositors and the FDIC by threatening the bank’s safety and soundness through imprudent loans.

The Bank May Make Direct Loans to Its Securities Affiliate. If the securities affiliate is separately capitalized, it might seek to increase leverage through loans from the banking arm of the holding company. Although direct loans from a bank to its affiliate are subject to a ceiling of 10 percent of bank capital, (like loans to any unaffiliated firm or individual) and must be backed by more than 100 percent collateral, it is still possible that such loans could be made at less than an appropriate risk-adjusted interest rate. In such a case, the protection of bank depositors, via earnings, would be weakened. Or, loans could be made to a third party (such as another bank) and re-lent by the third party to the securities affiliate—perhaps for a direct fee or an increase in compensating balances held with the third party—in order to circumvent the 10 percent-of-capital loan ceiling.

Informational Advantages Regarding Competitors. As bank holding companies and other financial and non-financial firms cross traditional market and product boundaries, they encounter increasing competition. Since bank-affiliated underwriters may become privy to inside information regarding firms whose securities they underwrite, this information could be disseminated to other affiliates of the holding company, including the bank, in order to generate a competitive advantage in lending, leasing, and so forth.

CONFLICT CONTROL

The potential conflicts of interest that have been identified suggest that conflicts of interest would be pervasive if banks were allowed back

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9 Although the aggregate of junior plus senior debt has increased.
into securities underwriting. But several "controls" exist which would limit the exploitation of potential conflicts. These controls have three dimensions: economic, regulatory, and legal.

**Economic Controls.**

The Structure of Financial Compensation Schemes in Bank Holding Companies. Most of the conflicts described require some form of collusion or coalition between the managers of the bank and the securities affiliate. In addition, most involve a probable trade-off between short-run and long-run profits for the holding company. Thus a crucial question is: what are the economic incentives (salary or compensation structures) that make managerial conflict more or less likely? There is a growing recognition that managerial interests may diverge from those of stockholders.\(^{10}\) One reason is that managers' short tenure, relative to the expected life of the firm, may make them overly concerned with short-run profits. By contrast, stockholders will be more concerned with the long-run value of the firm, or with the value of the firm as a going concern. Under such conditions, managers may have greater incentives to exploit conflicts for short-run opportunities than if they shared the long-run profit interests of shareholders.

This short-run outlook of managers suggests that the structure of managerial compensation schemes could be very important for conflict control. Specifically, a compensation scheme in which financial rewards for managers in the bank and the securities affiliate were kept separate—such as in separate profit centers—and in which stock or equity bonuses played a significant part, would work toward reducing the incentives for bank and securities affiliate managers to form coalitions. In turn, such a scheme would better align managerial interest with those of stockholders. By comparison, a salary scheme that linked bank and securities

\(^{10}\)See Jensen and Meckling (1976), for example.

affiliates' managers' compensation to the consolidated current profits of the holding company would both accentuate the different time horizons between managers' and stockholders' interests and create incentives for bank and securities affiliate managers to create coalitions to ensure that the current consolidated profits of the holding company are maximized.\(^{11}\) Under this scheme any collective bank-securities affiliate activity, such as product or service "tiers," which produce an increase in holding company profits, would directly benefit both managerial teams. In sum, by creating separate profit centers and linking compensation partly to the long-run performance of the holding company, for example, through stock bonus schemes, stockholders can impose a degree of internal control over managerial incentives to exploit conflicts of interest. It also might be noted that stock bonus plans now play an increasingly important role in both investment and commercial bank compensation packages.

When there are no internal controls (or "carrots") which limit managers' incentives to exploit conflicts, or if those controls are weak, there are at least three external "market" control mechanisms (or "sticks") that limit managers from diverging too far from maximizing long-run holding company profits through conflict exploitation for short-run gains. These are: the market for corporate control, the market for bank and securities affiliates' products and services, and the monitoring role of bond rating agencies.

The Market for Corporate Control.\(^{12}\) The idea underlying the market for corporate control is that the current managers of the banking and securities affiliate arms of the holding company

\(^{11}\)For example, an incentive may exist for bank management to make subsidized loans to the securities affiliate or a third party if the net profit generated by the affiliate's activities more than compensates for any loss in bank revenues or profit.

\(^{12}\)See Jensen and Meckling (1976), and Jensen and Ruback (1983) for more detailed discussion.
are just two of many potential teams in the professional labor market offering their managerial services to the holding company's shareholders. Should existing managers overtly pursue short-run profits by exploiting conflicts, thereby adversely affecting or damaging the reputation of the enterprise, then shareholders will have an incentive to replace them with managers whose objectives are more closely aligned with their own long-run objectives. In addition, stockholders are increasingly seeking financial recourse in the courts against errant managers. For example, both Bank of America and Chase Manhattan are taking legal action against officers involved in, respectively, bad international loans and the failure of Drysdale Securities. Nevertheless, managerial change will only occur when the perceived benefits of managerial reorganization outweigh the expected costs involved. Often only a major crisis will cause managerial reorganization, although less dramatic personnel shifts can have the same effect.

The Market for Bank and Securities Affiliates' Products and Services. The ability of managers to exploit certain conflicts of interest is further limited by the degree of market power the bank or its affiliate managers have over customers—such as depositors, borrowers, and issuing firms. For example, tie-ins can only be exploited if the bank has a substantial degree of market power over the issuing firm in the provision of loans or other services. If a firm has a number of potential lenders and credit lines available, it is less likely to accede to bank pressure in that direction. Smaller firms or large firms in financial distress are likely to be the most susceptible to this type of pressure. Similar arguments can be made regarding the pressure to restructure debt. However, the deregulation of the financial system, together with the technological and information revolutions currently under way, imply that even smaller firms eventually will be able to escape or at least mitigate tie-ins and similar pressures. Indeed, in a fully competitive market in which all participants are fully informed, it would be impossible for any seller to exploit a potential conflict of interest that harms the buyer, since the buyer would be immediately aware of the situation and could switch to a competitor.

Bond Rating Agencies. The role of bond rating agencies such as Moody's and Standard & Poor's is to monitor externally and independently the financial performance of firms that issue bonds, and to provide investors with information regarding the default risk attached to those bonds. If carried out successfully, this monitoring would make it difficult for a bank-affiliated underwriter to unload a new issue of debt so that an issuing firm could pay off "bad" bank loans.

A critical question is how successful bond rating agencies are in detecting the default risk of firms issuing securities prior to the offering date. As there have been relatively few bond defaults in the last 40 years, studies of the default prediction ability of bond rating agencies have been unable to provide conclusive results. However, when the sample period is extended back to incorporate the pre-World War II period, studies have shown that an inverse relationship exists between changes in bond ratings and default rates; that is, a higher bond rating is usually associated with a lower default rate. Moreover, since bond rating agencies have to maintain a reputation—in order that their evaluations remain credible—they have to be correct on average. Thus, rating agencies provide the crucial function of improving the quality and increasing the quantity of information available to investors, which makes it more costly for banks or their affiliates to exploit conflicts.

13Although there has been a widely observed negative relationship between bond rating changes and bond yields.
14See West (1973) for a review of these studies.

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of interest, and have concentrated on factors that discipline managers. It is also important to analyze the role of market reputation in disciplining stockholders.

Given that stockholders, through boards of directors, want to maximize long-term profits, they will be vitally concerned with building and maintaining a good long-run reputation with their customers. Thus reputation, or the stock of "goodwill," can be viewed as an asset of the firm which has real value to existing shareholders and is reflected in binding commitments or implicit contracts with its customers. In this view, banking and securities underwriting activities undertaken by a holding company with its customers are similar to economic games which take place in a repeated, or dynamic, market setting. While the holding company may earn a net profit in the short run from exploiting a conflict with a given customer, such as promoting the sale of tainted securities or ties, in the long run the exploitation of conflicts, or breach of the implicit contract, may eventually impair the reputation of the holding company and its various affiliates, and damage its future growth and profit prospects.

Specifically, the customer who feels he has been exploited will seek to move his business to another institution, while adverse publicity will tend to deter new customers from forming permanent relationships with the bank or its securities affiliate. In particular, the greater the flow of information among customers, the higher will be the costs to holding company shareholders from conflict exploitation.

Regulatory Controls. In addition to economic disincentives, regulatory controls constitute a major restraint on exploiting conflicts of interest. Margin requirements and collateral requirements on loans to affiliates, combined with direct monitoring and examination by regulatory authorities, each impose external non-market constraints on conflict exploitation. Currently, margin requirements on securities purchases substantially limit the amount of credit (bank loans) that investors and brokers or dealers can use to purchase securities. Therefore, high margin requirements also substantially limit banks' ability to support the price of securities underwritten by their affiliates with third-party loans to individual investors. As noted earlier, direct bank loans to affiliates are subject to a ceiling of 10 percent of capital and must be backed by at least 100 percent collateral. Violation of these restrictions would lead to costly penalties being imposed on managers and shareholders if discovered by the SEC, the Federal Reserve, the FDIC or other regulatory agencies with examination authority. Regulatory examination and surveillance thus provides an additional disincentive to exploit conflicts. The more efficient are bank examiners, the higher is the expected cost of exploiting a potential conflict—with potential costs of penalties ranging from fines and criminal prosecution of bank officers to bank charter revocations.

As an external mechanism of conflict control, examination and surveillance would probably be most efficient if there were coordination between those examining the bank, its trust department, and the securities affiliate. This suggests that optimal surveillance might be achieved when each part of the holding company is examined by a single regulatory authority. If different regulatory agencies had examination powers and took an adversarial (rather than cooperative) stance over interagency information exchange, regulatory disincentives might be significantly weakened.

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15 This view is developed in Bull (1983), Klein and Leffler (1981), and Telser (1980). As Bull has noted: "... authors have suggested that concern by the firm for its reputation or brand name ... may lead the employer (principal) to fulfill his part of the contract. In other words, an appeal is made to a third party, here the market rather than the court for enforcement" (p. 659).

16 The Bush Task Force has proposed combining the federal bank regulators into a single entity, the new Federal
Legal Recourse. Bank and securities affiliate customers also have the option of turning to the courts in the event of a conflict exploitation, although the costs of legal action may often be prohibitive for the small investor, and the outcome far from certain. Such recourse has often been taken with respect to the trust activities of banks, when a customer (trustee) felt that the bank had violated its fiduciary responsibilities. Also, class action suits in the courts are becoming more frequent in cases where investors feel that underwriters failed to exercise due diligence, such as in fully disclosing information prior to a new issue. This might be particularly pertinent in the case where banks are tempted to induce a firm to pay off its loans through a new issue. The bad publicity surrounding such court cases acts as a clear disincentive for securities firms to exploit conflicts, apart from the legal costs involved in defending such cases. An example of a class action suit is the one currently outstanding against Merrill Lynch and Salomon Brothers, alleging failure to show due diligence over issues of Washington Public Power Supply System bonds in 1982-1983.

SUMMARY AND OUTLOOK
As part of the trend toward bank deregulation, banks are lobbying to be allowed to underwrite corporate securities—an activity they are expressly prohibited from by the Glass-Steagall Act of 1933. The major source of this prohibition, both 50 years ago and today, is concern about possible conflicts of interest. In the debate about this issue, several potential conflicts of interest have been identified. Although they seem to suggest that the potential for conflict is fairly formidable, there are a number of economic, regulatory, and legal controls in place which create strong disincentives to conflict exploitation. This is especially so given today's security laws, regulatory structure, and improvements in information technology. Moreover, regulatory and legal controls could always be strengthened if there were genuine concern that the current set of disincentives is not sufficiently strong. For example, new "Chinese walls" could be established between the securities affiliate and the bank, and between the securities affiliate and the bank's trust department. Thus, it seems that, suitably regulated, bank holding companies might be allowed to expand into corporate securities underwriting. Indeed, by allowing banks into securities underwriting, positive social benefits may well accrue. These benefits would include the ability of bank holding companies to diversify their earnings in a more optimal fashion, thereby enhancing bank safety and soundness. In addition, securities markets may become more efficient and competitive, with smaller firms finding access easier.

The current prospects for the abolishment of Glass-Steagall are unclear. In recent sessions of Congress, numerous draft bills have been debated. These bills have incorporated provisions allowing banks to offer open-ended mutual funds and to underwrite both municipal revenue bonds and mortgage-backed securities, proposals which represent significant modifications of Glass-Steagall. However, no serious proposal has been made to allow banks back into domestic corporate securities underwriting despite the apparent success of large U.S. banks in underwriting corporate (dollar denominated) Eurobonds. Nevertheless, there is little doubt that this difficult issue will remain at the center of the "deregulation" debate.

18The quality and quantity of corporate financial information available to outside investors is likely to be increased considerably in 1985 when the SEC puts its EDGAR System (Electronic Data Gathering and Retrieval System) into effect. Under this system companies will electronically file quarterly and annual reports with the SEC while investors, brokers and dealers will gain direct access to those files through their own office (or home) computer terminals. Thus information should be disseminated in a far more timely fashion and be available to a much wider audience.

Banking Agency, and transferring the regulation of securities activities of bank holding companies, and thus the securities affiliate, to the SEC—see Inside the Administration (1983).

17See Schotland (1980).
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