Business and Politics

Volume 13, Issue 3

2011

Article 2

THE DOMESTIC FOUNDATIONS OF IPE: THE U.S. CASE IN
CURRENT AND HISTORICAL PERSPECTIVE

The Domestic Political Origins of Global Financial Standards: The Agrarian Roots of American Securities Regulations

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Recommended Citation:

Carney, Richard (2011) "The Domestic Political Origins of Global Financial Standards: The Agrarian Roots of American Securities Regulations," *Business and Politics*: Vol. 13: Iss. 3, Article 2.

DOI: 10.2202/1469-3569.1360

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Richard Carney

Abstract

America's securities markets constitute a central distinguishing feature of its brand of capitalism. What are their political origins? In contrast to arguments which point to business owners as determining the institutional foundations of America's political economy, this paper argues that farmers played a leading role. Indeed, the rules and regulations governing U.S. securities markets were created in opposition to the wishes of business owners, and without farmers' political influence, the U.S. may have developed a financial system similar to that found in continental Europe. Moreover, to the extent that U.S. securities regulations serve as a template for international financial standards, the paper shows that the humble American farmer inadvertently contributed to the financialization of the modern global economy.

KEYWORDS: corporate finance, corporate governance, corporate ownership, securities and exchange commission, farmers, New Deal, financial regulations, international standards

Author Notes: I would like to thank participants at the AIB Meeting in 2008 for which an early version of the article was selected for the best paper proceedings. Mark Roe, John Ravenhill and an anonymous reviewer provided helpful comments on an earlier version. I would also like to thank Barka Shah for excellent research assistance.

Introduction

After several financial crises of the 1990s, most notably the Asian Financial Crisis, the leading institutions with influence over the global financial system – the U.S. Treasury, U.S. Federal Reserve, G7/G8, IMF, Bank for International Settlements, World Bank – reinvigorated the development and implementation of universal standards of best practice in such areas as corporate governance, financial accounting, and data dissemination. The aims of this group shifted from “liberalize the market”, as embodied in the Washington Consensus, to “standardize the market” on a global scale. To implement and enforce adoption, the IMF would conduct surveillance of countries’ compliance and make public the results. Enforcement would occur through the response of financial markets. These core standards have been supplemented and refined with additional codes from private sector agencies such as the International Accounting Standards Board, the International Organization of Securities Commissioners, the International Federation of Stock Exchanges, and the Institute for International Finance. The main consequence of these new standards and surveillance mechanisms is to pull countries toward the Anglo-American model of finance capitalism, and its emphasis on financing via securities markets.

Despite the initiative for countries to adopt these standards, Walter has shown that, in the wake of the Asian Financial Crisis, emerging economies have exhibited ‘mock’ compliance with them when the domestic political economy produces incentives for actors to arrange economic activity differently from that prescribed by international financial authorities.¹ The 2008 crisis has done little to change this posture since these economies went relatively unscathed and see little reason to change. If we wish to anticipate whether countries are likely to sincerely comply with these standards, it would be helpful to understand their political origins. Because international financial standards are heavily influenced by the United States,² this article focuses on the following question: what are the political origins of American securities regulations?

I argue that *farmers* played a central role in the development of U.S. securities markets regulations. Rather than being relegated to the dustbin of pre-industrial history, the organization and power of agriculture has had a profound influence on modern financial institutions. Indeed, farmers were critical to the passage of legislation that would protect minority shareholders and dismantle corporate pyramids, as well as the formation and remit of the Securities and Exchange Commission. This article offers new quantitative evidence from congressional votes in the House and Senate demonstrating the critical role that

¹ Walter 2008.

² Mattli, 2003; Securities and Exchange Commission 2003; Singer 2004, 531-65; Mattli and Büthe 2005; Nolke 2005, 1-7; Posner 2009.

members of Congress from agricultural states played in the passage of the Securities Exchange Act of 1934, the Public Utilities Holding Company Act of 1935, and the Revenue Act of 1935.

Other scholars have examined the influence of farmers on the development of American financial regulations.³ But rather than focusing on the creation and remit of the SEC as in this article, these other studies turn their attention toward banking, antitrust regulations, and exchange rates. It is clear that farmers exhibit varying types of cleavages across financial domains. For example, interstate bank branching was resisted by Northern and Midwestern wheat farmers because the farm land that they owned constituted the bulk of their assets, making them vulnerable if the local (unit) bank closed, or reduced lending, or charged higher lending rates (which was likely to occur with interstate banking). By contrast, southern plantation owners did not strongly resist interstate branched banking because a larger fraction of their assets was tied to the ownership of slaves, which could be easily bought in one state and then transported to another.⁴ With respect to international trade and exchange rate policies, farmers' support varied according to whether their commodities were near-term perishable and (hence) whether their revenues depended upon export markets and international competition. Export-dependent farmers would behave quite differently from dairy and fruit farmers. But with regard to regulations governing equities markets, farmers were more unified partly because none was large enough to consider listing on a stock exchange, as will be discussed below.

Explanations for securities regulations – with regard to both the protection of minority shareholders and the presence or absence of corporate pyramids – can be placed into three general approaches. The law and finance perspective, advanced by La Porta, Lopez-de-Silanes, Shleifer, and Vishny, set off a torrent of work on explaining corporate ownership arrangements by demonstrating robust correlations between legal regimes and the diffusion of corporate ownership around the world.⁵ A second approach argues that minority shareholder protections are due to how political institutions, such as the electoral system, mediate conflicts of interest over the security of property rights.⁶ However, the legal tradition and political institutions perspectives have difficulty accounting for both the specific type of securities regulations adopted by the United States, as well as the timing. The third approach emphasizes interest groups and the cleavages that form among them; it offers a more persuasive explanation for the

³ Bensel 1984; Bensel 1990; Bensel 2000; McCraw 1984; Sklar 1988; Calomiris 2000; James 2000.

⁴ Calomiris 2000.

⁵ La Porta et al. 1998; La Porta et al. 1999.

⁶ Verdier 2003; Pagano and Volpin 2005.

American context.⁷ Roe in particular offers an excellent historical account of how populist interests contributed to the development and regulation of American equities markets.⁸ But, as Becht and De Long point out, Roe's argument has some "holes."⁹ First, Roe has a hard time answering why politics was so strong in corporate finance, yet weaker in labor-management relations. Second, Roe's argument has difficulty explaining why corporate pyramids do not exist in the United States, as they do in other countries. But these "holes" in Roe's argument are likely due to combining farmers and labor into one general populist category. This term is frequently used to refer to those with low incomes, but this is problematic since farmers and labor can have widely divergent preferences over regulations governing corporate finance. Narrowing the focus to farmers can help resolve these problems.

In addition to understanding the domestic political origins of modern global financial standards, which is an important area for research in light of the recent financial crisis, there are two additional reasons for examining the political origins of U.S. securities regulations.¹⁰ First, such an analysis sheds light on the origins of modern capitalist institutions in the United States. Recent work points to conflict between labor and business in the late nineteenth century as contributing to institutional configurations that distinguish Liberal Market Economies from Coordinated Market Economies.¹¹ These authors see business as wielding greater influence in the United States than elsewhere. However, a central distinguishing feature of the U.S. political economy is its financial system; specifically, rules governing corporate finance.¹² This paper argues that the rules governing American corporate finance were created *in opposition to* the wishes of big business, and are instead due to the political power of farmers. Moreover, the critical point in time marking the origins of modern finance capitalism is found in the 1930s rather than the late nineteenth century. As Franklin Delano Roosevelt wrote in 1942, and as Simon likewise documents (both published in the *American Economic Review*), the U.S. exhibited a Continental European/German style of finance capitalism up through the early twentieth century.¹³

But of potentially greater importance is the role of corporate pyramids in the maintenance of crony capitalism. Corporate pyramids are the structures that permit a tiny group of elites to control the greater parts of the corporate sectors of some countries.¹⁴ And where legal systems are underdeveloped, they permit the

⁷ Roe 2003; Rajan and Zingales 2003.

⁸ Roe 1994.

⁹ Becht and DeLong 2005.

¹⁰ Mosley and Singer 2009.

¹¹ Cusack, Iversen and Soskice 2007; Martin and Swank 2008; Iversen and Soskice 2009.

¹² Hall and Soskice 2001.

¹³ Simon 1998.

¹⁴ Morck 2009.

owners of large business empires to tunnel money from firms at the lower tiers of the pyramid to the firm, or family, at the top.¹⁵ There are only a handful of countries that have outlawed the existence of pyramidal corporate ownership arrangements (including the U.S., U.K., Japan, and Germany) – the U.S. was the first.¹⁶ Understanding how corporate pyramids were dismantled in the early development of the U.S. may provide insights into the mechanisms that can mitigate crony capitalism among today's emerging economies.

The paper proceeds as follows: (1) a presentation of the argument; (2) a brief overview of the political battles waged with regard to securities regulations in the United States prior to the 1930s, followed by a focused analysis of key legislation that laid the foundations for the regulation of American securities markets in the twentieth century, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Revenue Act of 1935; and (3) a summary conclusion of the key findings.

The Argument

The argument that farmers are central to understanding U.S. securities regulations is consistent with those arguments that see political power concentrated in the hands of a few as leading to worse shareholder protections and the preservation of pyramidal groups, but comes from the opposite perspective; where political power is widely held (i.e., democratic), shareholder protections are likely to be stronger and pyramidal groups will disappear. However, the argument here focuses on the preferences of farmers as distinct from labor since Roe argues that workers favor concentrated corporate ownership, and pyramidal groups are common throughout continental Europe.¹⁷ Thus, democratic politics is a necessary but insufficient condition for minority shareholder protections and the dissolution of corporate pyramids. The power of farmers will be shown to provide a sufficient condition in the context of the United States.

Why do farmers dislike concentrated corporate ownership and pyramidal corporate groups, while labor tolerates, if not prefers, them? And why would business owners (and investment bankers) initially resist stronger shareholder protections and the break-up of pyramidal groups? To answer these questions, let us begin with a review of the benefits that accrue to business owners (and investment bankers) as a result of concentrated ownership and corporate pyramids.

¹⁵ Johnson et al. 2000.

¹⁶ Morck 2009.

¹⁷ Roe 1994.

Business Owners (and Investment Bankers)

The benefits of concentrated ownership are most apparent when considering why business owners prefer pyramidal groups and the holding companies that usually stand at the apex of these structures. Investment bankers commonly share owners' preferences since they may act as the owner of a holding company or are actively involved in the financial transactions that create the pyramids often found beneath them. In such situations, there are two main mechanisms by which a holding company magnifies profits for its owners: (1) economies of scale; and (2) pyramidal control. Economies of scale confer four profit-enhancing advantages. The first is due to the ability to expand production and/or services at a declining marginal cost per unit. In turn, these services can then be offered over a wider area.¹⁸ Insofar as the service is exclusively offered by that company (e.g., railroads and utilities), then monopoly pricing can cover a larger customer base, which is a second advantage. In the third place, lower costs of financing are often possible through a holding company. Small companies usually are not well known, making buyers for their securities harder to find. A holding company can sell securities of its operating companies at a lower cost of capital than if the operating companies tried to find buyers. As a result, holding companies may offer a saving in the costs of financing to their operating affiliates.¹⁹ A final advantage is due to large-scale buying of supplies and equipment. Via the holding company, a number of small companies can pool their purchases and obtain discounts.

While holding companies confer substantial benefits through economies of scale, an additional and even more profitable component of the holding company structure occurs through pyramiding. Pyramidal business groups are able to magnify merely large family fortunes, or private wealth (e.g., private banks), into control over corporate assets worth vastly more. To see how this works, assume a family firm is worth one billion dollars. Now, suppose the family firm controls B1 and B2, firms also worth a billion dollars each, by owning a fifty percent block plus one share in each. This puts an additional two billion dollars worth of corporate assets under the family's control. The next tier multiplies control over these two corporations into control over four billion dollar corporations, and the next tiers multiply this into control over eight, then sixteen, and then thirty-two billion dollar corporations. By adding tiers, the family can lever its billion dollar fortune into control over the assets of an arbitrarily large group of operating companies in the lowest tier. As a result, *tunneling* often ensues.²⁰ This occurs when the controlling family tunnels resources between group firms, so profitable

¹⁸ Chandler 1977.

¹⁹ Philips 1984.

²⁰ Johnson et al. 2000.

firms can subsidize individually unprofitable firms whose existence is nonetheless necessary to the group as a whole. However, tunneling can also enrich the controlling shareholder, which is denounced by corporate governance advocates as “expropriation” of public shareholders’ wealth. This temptation to enrich the ultimate owners can lead to a variety of abuses in the management of the group and its firms, and especially in the pursuit of magnifying the holding company’s earnings in order to bid up its share price.²¹ For example, it can cause managers to neglect good management of operating companies, especially by failing to provide for adequate depreciation (i.e., artificially inflated values of stock and equipment) or via excessive write-ups. An example of the latter problem would involve inflating the prices of assets when company B acquires assets held by company A and then claims that they are worth far more than the investment that company A made for them. A second abuse involves the exaggeration of profits by unsound, deceptive accounting. A third problem regards the pursuit of exorbitant profits from service fees from subsidiaries. This occurs by the holding company charging excessive fees to its operating companies for services rendered by a controlling company to lower-tiered companies. The lower-tiered companies would then pass on the extra costs to the consuming public. A fourth abuse regards the disbursement of unearned dividends from the lower-tiered firms to the holding company which can greatly magnify the rate of earnings for the top holding company. And fifth, the promotion of speculation in the prices of the group’s shares on the stock exchanges.²²

Who pays for these abuses? The costs are normally diffusely distributed among customers who buy the services (often at inflated or even at monopoly prices) and those who buy securities in the holding company or in the firms affiliated with the group. But in the context of the U.S., the diffuse costs have tended to be focused on actors with the capacity to overcome their collective action problems, namely farmers.

Farmers

With regard to their role as consumers, the concentration of industry can lead to higher transportation, energy, and other business services costs for farmers as large firms take the best and cheapest resources, and charge customers (farmers) higher prices as a result of monopoly.²³ Smaller, less wealthy farmers suffer more due to monopoly prices, as do farmers with more perishable crops, though all oppose monopoly pricing.²⁴

²¹ On holding company abuses, see the Federal Trade Commission 1935.

²² Philips 1984.

²³ Chandler 1977.

²⁴ Sanders 1999; Bense 2000.

As investors, volatile commodities and land prices can make farmers more vulnerable to share price devaluations if they buy securities in good times. Wealthy farmers are more likely to bear the costs of poor investor protections since they would have a larger investment at stake, but they are also more capable of lobbying for regulatory changes. Cleavages among farmers emerge only once corporate farms become important since they would be able to list shares on an exchange; but during the early part of the twentieth century that was not an option for even the largest farms.

Labor

Labor tends to favor more concentrated corporate ownership because it reduces pressure for managers to focus on short-term performance benchmarks (i.e., quarterly earnings reports) that often lead to layoffs during a downturn in the business cycle.²⁵ Moreover, the diffusion of corporate ownership facilitates mergers and acquisitions (particularly hostile ones), which likewise lead to layoffs (to cut costs). Because concentrated ownership and accompanying pyramidal groups foster greater employment stability, pyramidal groups are likely to be tolerated (consider that they are common in Western Europe).²⁶ This is especially true when most of the jobs are located in the same urban areas that workers are found.

As income levels of workers permit more savings to be invested in equities markets, they too will favor stronger securities regulations.²⁷ But during the early twentieth century, workers' incomes were generally too low to inflame passions over securities markets regulations.

But an important reason for workers not to be as supportive of pyramidal groups is the consequences for monopoly pricing. As consumers, labor will pay higher prices, particularly for energy (utilities). However, the costs that they bear are likely to be far less than farmers who pay for them both as a business and as an individual consumer. Thus, as investors and as consumers, workers will be less opposed to corporate pyramids than farmers, but favorable to concentrated ownership (independent of the pyramidal structure).

Evidence

This section proceeds in three parts. The first part presents the historical context for the key legislation of the 1930s. The second section analyzes the politics of important 1930s legislation, including the Securities Act of 1933, the Securities

²⁵ Aoki and Patrick 1994; Dore 2000; Roe 2003.

²⁶ Högfeldt 2005.

²⁷ Höpner 2007.

Exchange Act of 1934, the Public Utility Holding Company (PUHC) Act of 1935, and the Revenue Act of 1935. These pieces of legislation formed the foundation upon which American securities markets evolved and have informed many of the core principles espoused by international organizations with regard to international financial standards. The third section presents quantitative analyses of the latter three pieces of legislation, which were the most fiercely contested, to identify the key interests that led to their passage.

Historical Background to the 1930s Legislation

Pressure for federal legislation regulating stock markets and the sale of securities has its origins in farmers' early experiences with commodities speculation, anti-trust legislation, state-level securities regulations known as blue sky laws, as well as the Pujo Committee Hearings of 1912. Each is discussed in turn.

Commodities Speculation

Commodities markets are different from equities markets. Yet agitation over commodities markets mobilized farmers to pay attention to capital markets generally, though interest in equities markets came later.

The futures contract, occasionally used before the Civil War, began to receive unprecedented attention from speculators in the latter quarter of the nineteenth century causing increased volatility of prices around harvest time.²⁸ Farmers' economic position, worsened by the droughts after 1886, had declined, and ultimately led to the "Populist Revolt." In 1892, the Hatch Bill, named after Representative William H. Hatch of Missouri, sought to eliminate speculative futures trading. In 1893 the bill passed the House, 167 to 46, and the Senate, 40 to 29; all that remained was House concurrence on Senate amendments. However, a suspension of rules was required since only a few days remained in the fifty-second Congress and the bill was too far down the calendar to reach the floor before adjournment. The vote on suspending the rules fell short of the required two-thirds by twenty-six votes.²⁹ Thus the bill failed to become law although 80 percent of the Congress favored it in some form.

The Hatch Bill represented the first clear expression of farmers' desire to regulate capital markets at the federal level and the votes set a pattern for

²⁸ Cowing 1965.

²⁹ The votes were Yea 172, Nay 124. On January 22, 1894, the House again passed the Hatch bill, 150 to 89. It was reported out of the Senate Agriculture committee but never came to a vote. See Parker 1911.

subsequent exchange-related regulations. Cowing offers a breakdown of the votes by sections of the U.S.³⁰

Those opposing the bill included the Middle Atlantic states, reflecting the interests of its financial centers. Congressmen from Midwest financial hubs sided with their colleagues from the Middle Atlantic states. Those in favor of the bill included representatives from Northern New England which was heavily rural. The South exhibited a marked divergence between Senators and Representatives - congressmen, spurred by resentment against urban cotton speculators, strongly favored the bill, while Senators, well-to-do and better insulated from the populace opposed the bill largely on states' rights grounds. Lawmakers from the West and Southwest, with only a few exceptions, were overwhelmingly in favor of the bill.

Table 1. Votes by Sections of the United States

		Hatch Bill 1893 Percent Yea	SEC Act 1934 Percent Yea	PUHC Act 1935 Percent Yea	Revenue Act 1935 Percent Yea
Mid-Atlantic/ The Speculator Seaboard (MD, DE, PA, NJ, NY, CT, RI, MA)	House	48.3	40.9	58.5	48.7
	Senate	14.3	31.2	37.5	25
Northern New England (ME, NH, VT)	House	100	40	85.7	40
	Senate	100	17	17	17
South (WV, VA, NC, SC, GA, FL, MI, AL, LA, AR, MO, KY, TN)	House	88.5	83.1	88.2	71.2
	Senate	41.7	72.7	52.6	76.1
East Central Midwest (OH, MI, IN, IL, IA, WI, MI)	House	81.4	68.5	72.2	65.7
	Senate	76.9	71.4	64.2	57.1
Anti-Speculator Tier (ND, SD, NE, KA, TE, OK*)	House	100	84.3	89.7	86
	Senate	77.7	92.3	84.6	84.6
West (WA, OR, CA, ID, NV, MT, WY, CO, AZ*, NM*, UT*)	House	83.3	73.3	82.6	76.5
	Senate	80.8	75	80	65
Total	House	77.3	66.4	74.8	65.3
	Senate	57.3	64.8	60.2	58.8

*OK, AZ, NM, and UT are not included for the Hatch Bill

Note: The 1930s bills are discussed below, but presented here for concision.

³⁰ Cowing 1965.

Those representing the Great Plains states, labelled the Anti-Speculator Tier, which raised spring wheat, winter wheat, cotton, and corn – crops vulnerable to speculators – strongly favored the bill.

Antitrust Legislation

Political battles over the regulation of railroads created further antagonism between a broad cross-section of rural areas and the urbanizing Northeast, notwithstanding varying levels of support among agricultural states.³¹ Railroads' monopoly control over rail lines extending to rural areas allowed them to charge high rates. These high transportation charges combined with declining commodities prices led to a series of strong state regulations in Iowa, Illinois, Minnesota, and Wisconsin between 1871 and 1875, collectively known as the Granger Laws after a farm organization called the Grange which supported state regulatory legislation.³² The regulation of railroads with federal legislation eventually occurred with the Interstate Commerce Act of 1887 and the Sherman Antitrust Act of 1890, and were strongly supported by Southern and Midwestern representatives; opponents were overwhelmingly Northeasterners and Republicans.³³

Despite overtures to organized labor unions by farmers' groups, labor leaders were persuaded by arguments that the restraint of "destructive" competition was advantageous for workers (by reducing employment instability), and they resented the use of the Sherman Act against strikes and boycotts. Thus, the American Federation of Labor gave no support to the antitrust movement.³⁴

The economic collapse of 1893 generated price wars that cartels could not remedy, forcing them to integrate into groups via a wave of mergers and reorganizations.³⁵ Banks implemented these changes which contributed to their control over many railroads and industrials via voting trusts or board representations.³⁶ By the late 1890s, railroads exercised monopoly power in their own right and, through common ownership and conferral of special rates, built up other monopolists in the form of warehouses, elevators, grain and cotton dealers, and fertilizer and equipment manufactures. Complaints about the interrelationship of railroads with other monopolies exploiting the farmers were made by

³¹ While farmers generally opposed trusts, Sklar (1988) observes that agrarian organizations displayed varying levels of support.

³² Buck 1963; Miller 1971.

³³ Sanders 1999, 194.

³⁴ Thorelli 1955, 157; Mowry 1958, 78.

³⁵ Chandler 1977.

³⁶ De Long 1991; Simon 1998.

spokesmen for the National Grain Growers Alliance and the National Farmers' Alliance and Industrial Union.³⁷

Despite Theodore Roosevelt's trust-busting campaign, consolidation continued under bankers' leadership. By 1912, 18 financial institutions sat on the boards of 134 corporations. Of these 18 institutions, five banks were dominant: J.P. Morgan & Co., First National Bank, National City Bank, Guaranty Trust Co., and Bankers' Trust sat on the boards of 64 financial institutions and 68 nonfinancial corporations. Together, these five banks controlled industrial assets (on behalf of others) representing 56 percent of the country's GNP.³⁸

Blue Sky Laws

During the first decade of the twentieth century, Kansas along with other Middle Western farm states enjoyed a period of unprecedented prosperity. Prosperity attracted to Kansas numerous promoters, swindlers, and "blue sky merchants" determined to separate the affluent farmer from his savings by enticing him to invest in fraudulent, financially unsound, or highly speculative enterprises. Suffering heavy losses during the Panic of 1907, the victims of these frauds agitated for legislation, resulting in the passage of the first blue sky law in Kansas in 1911. Laws of this type came to be called "blue sky" because their purpose was to prevent fast-talking swindlers from selling a piece of sky to the gullible.

Because of its comprehensiveness, effective enforcement procedures, and widespread impact, the Kansas blue-sky law is generally regarded as inaugurating the modern era of securities regulation. The law went far beyond the fraud and disclosure principles incorporated in the British Companies Act or earlier state statutes regulating securities.³⁹ Arizona, Louisiana, and South Carolina enacted similar laws in 1912; twenty other states followed in 1913. The commercial East was hostile to the Kansas statute and its imitators. Opponents, led by the Investment Bankers Association, charged that the blue sky laws were "foolish, crude, and unconstitutional," and complained of the nuisance and expense of having to conform to different laws in different states.⁴⁰ The East did not pass any general security laws until after World War I, and those they did ultimately enact were much weaker than the Western blue sky statutes.⁴¹

³⁷ See *Chicago Conference on Trusts* 1900, 202-18. The tendency of railroads, especially after 1900, to build up a few favored enterprises at the expense of others is described in Ripley 1981, 185-92.

³⁸ Simon 1998.

³⁹ Carosso 1970, 164.

⁴⁰ Cowing 1965, 69.

⁴¹ *The Nation* 1913.

Pujo Committee Hearings

Farmers' complaints against futures markets, monopoly prices due to the consolidation and control of railroads, as well as the lack of securities regulations led to an outcry for investigations following the Panic of 1907. The Pujo Committee Hearings of 1912 were the result. The investigation of the "Money Trust" revealed the structure and anticompetitive practices of the financial and industrial empires controlled by the directors of a half dozen New York and Boston banks, principally, J. P. Morgan, John D. Rockefeller, and George F. Baker.⁴² Republican Senator Robert La Follette of Wisconsin articulated the anger of many when he publicly denounced the "group of financiers who withhold and dispense prosperity," and accused them of being "deliberately" responsible for having "brought on the late panic, to serve their own ends."⁴³

The 1912 Democratic platform, written by William Jennings Bryan (the famous defender of farmers' interests and the Cross of Gold speech) drew on the early revelations of the Pujo hearings and called for, "the prevention of holding companies, of interlocking directorates, of stock watering, of discrimination in price, and the control by any one corporation of so large a proportion of any industry as to make it a menace to competitive conditions."⁴⁴

Brandeis echoed these ideas in his book, *Other People's Money and How Bankers Use It*.⁴⁵ His impact was enormous both because he became a leading Supreme Court Justice, and because New Deal reformers such as Ferdinand Pecora and Adolphe Berle openly espoused Brandeis's ideas. He argued that banks that control industrial corporations encourage wasteful monopolies: "More serious, however, is the effect of the Money Trust in directly suppressing competition. That suppression enables the monopolist to extort excessive profits...." In his view, the social and political costs of monopoly and the concentration of power were so onerous that interlocking directorates should be forbidden.⁴⁶

In early 1913, the Pujo Committee recommended a range of legislation to diminish elite domination of the financial system.⁴⁷ As a result, the Clayton Act was passed in 1914 which banned interlocking bank directorates and prohibited banks and corporations from purchasing stock in competing firms where the effect might be to substantially lessen competition. To get the bill passed, agrarian

⁴² Willis 1975, 90-115; Sheldon 1983.

⁴³ *The Banker's Magazine*, April 1908, p. 480; *The Commercial & Financial Chronicle*, 8 March 1913, p. 680-81.

⁴⁴ Johnson and Porter 1973, 169. On Bryan's authorship, see Coletta (1964-69, 2, 62).

⁴⁵ Brandeis, 1914.

⁴⁶ Brandeis 1914, 33.

⁴⁷ *The Commercial and Financial Chronicle*, 5 April 1913, p. 975, held the Pujo investigations indirectly responsible for Morgan's death a few months later.

antitrust advocates struck a deal to appease their pro-labor colleagues who did not see any particular advantage in anti-trust laws.⁴⁸ But because of Pujo's retirement, opposition by Senator Glass and core Republicans, and the perceived exigencies of the European war, the committee's major recommendations for the regulation of banking practices and securities transactions were set aside.

The 1930s

During the 1920s an agricultural depression ensued at the same time that urban areas prospered, leading to an agrarian backlash following the crash of 1929. The Pecora Commission Hearings were launched to investigate wrongdoing on Wall Street, and they provided the ammunition for the subsequent legislative battles, including the Securities Act of 1933, the Securities and Exchange Act of 1934, the Public Utilities Holding Company Act of 1935, and the Revenue Act of 1935. These are discussed in turn below.

As the historical antecedents suggest, the main political battles over securities regulation occurred between agrarian interests versus big business and financial institutions (particularly investment bankers) mirroring core-periphery battles in other areas.⁴⁹ Labor did not figure prominently in these debates for five reasons: (1) few nonagricultural workers belonged to trade unions, making labor weak politically;⁵⁰ (2) workers did not have a substantial stake (in terms of their savings and income) invested in equities markets; (3) their interest in the topic was overwhelmed by the intensity of corporate and financial interests who were located in the same urban areas and represented by the same members of Congress; (4) trusts generally located their facilities in urban areas and these offered more stable employment arrangements than competitive inter-firm rivalry would likely permit, thereby dampening labor's desire to join farmers in cracking down on financial institutions and large corporations; and (5) the Democratic Party primarily served the export-oriented agricultural producers whose economic interests differed fundamentally from that of industrial workers, who were more protectionist.⁵¹

Pecora Commission Hearings

The Pecora Hearings began exactly one year prior to FDR's swearing in as President on March 4, 1933. As a result of public anger that had been building with the committee's revelations, FDR was able to sign into law both the

⁴⁸ Sanders 1999, 287-97.

⁴⁹ Hansen 1991; Carpenter 2001.

⁵⁰ *United States Bureau of Labor Statistics*, 1976.

⁵¹ Sanders 1999.

Securities Act and the Glass-Steagall Act within his first 100 days in office (on May 27 and June 16, respectively). To identify the main political impetus for these and subsequent acts, it is useful to review some key details of the Pecora Hearings.

To many, the hearings were a vivid reminder of the excesses of the markets that had been left unaddressed in the wake of the Pujo Hearings a generation earlier. But this time, not only were the railroads again forming huge conglomerates, utilities companies now constituted the primary threat. Leading the charge was Peter Norbeck, the Republican Senator from South Dakota.

Norbeck was known as a champion of the farmers and his career reflected the agricultural discontent prevalent in the Great Plains states after 1915. Norbeck was also one of the earliest and strongest advocates of federal legislation to control and regulate stock markets. He declared that more simple corporate structures were necessary and that more straightforward accounting and auditing systems were needed.⁵² He also argued that directors and officials of the stock market should be held responsible for fraud and deceptions, and that a federal license to sell securities in interstate commerce was needed.⁵³

According to John T. Flynn, a contemporary Wall Street critic, "It was Norbeck, big, honest, calm, filled with common sense, who made this an investigation of Wall Street, who kept doggedly at the probe, who finally engaged Ferdinand Pecora ... and who more than any other man gave the investigation its tone, its character, and direction. He must come first in any distribution of awards for the results."⁵⁴

His earnestness in the investigation was partly due to the collapse of the Insull empire in April 1932, which was one of the largest corporate failures in American business history at the time. Many of Norbeck's constituents, mainly farmers, in South Dakota had suffered heavy losses as a result of Insull's collapse, and they expected the Senator, as Chair of the Senate Committee on Banking and Currency, to do something about it. Universally acknowledged as one of the most creative utility magnates, Samuel Insull was intimately identified with the rapid and successful growth of electrical utilities for over three decades.⁵⁵ Starting in 1881 as a special secretary to Thomas A. Edison, Insull moved to the midwest to become President of the Chicago Edison company, and thereafter proceeded to build an enormous utility empire. The empire spread over 32 states and served over 4.5 million people.⁵⁶

⁵² Fite 1948.

⁵³ *Congressional Record*, 73rd Cong., 1st Sess., (11 May 1933), p. 3223-33.

⁵⁴ Flynn 1934.

⁵⁵ Wasik 2006.

⁵⁶ McDonald 1962, 75-304.

For three days Pecora questioned witnesses on the many operating firms and holding companies that Insull had created and the methods Halsey, Stuart & Co., an investment banking firm, had employed in selling the securities of these corporations.⁵⁷ Under Pecora's intense scrutiny, the head of Halsey, Stuart admitted that their promotions of Insull's stocks were tainted by many conflicting interests and he revealed that they had hired an economics professor from the University of Chicago to "boom" Insull's shares on what was supposedly an unbiased, educational radio show.⁵⁸

The Insull revelations so shocked the country that Norbeck then instructed Pecora to look into the affairs of the National City Co., the nation's largest investment banking house and the security affiliate of the National City Bank of New York, the world's second largest bank. Witnesses disclosed a wide variety of abuses. Investors were lured into buying issues sponsored by the National City Co. and were told few, if any, pertinent facts concerning the quality of the securities recommended.⁵⁹ The climax of the hearings came with the revelation that two giants of the New York banking world, Charles E. Mitchell of the National City Bank and Albert H. Wiggin of the Chase National Bank, had, for years, successfully evaded the payment of income taxes. Disclosures concerning the activities of other bankers soon followed. Public reaction was vehement.⁶⁰

Pecora then turned his attention to the private bankers. Like Untermeyer a generation earlier (the lead investigator in the Pujo Hearings), Pecora and the more progressively minded members of the subcommittee were greatly disturbed with the concentration of financial power in a small number of firms in New York City. He was concerned about the many close, continuing ties that existed between a few Wall Street private investment houses and most of the country's largest railroads and industrial corporations and the great influence these bankers exercised over the securities markets generally. For example, in 1930, 90 percent of all operating companies were controlled by 19 holding companies. The strength of the holding companies was intensified by the existence of interlocking directorates. The Federal Power Commission commented that: "48 major projects fall under the control of 10 groups which service 12,487 communities with a population of more than 42 million. The community of interest between the 10 groups is evidenced by the fact that 19 directors or officers were directors in at least 2 groups."⁶¹ Pecora accused Morgan and the other interrogated bankers of refusing to compete with one another, using directorships to control the corporations they financed, and fighting competitive bidding in order to protect

⁵⁷ Carosso 1970, 328.

⁵⁸ Burk 1985.

⁵⁹ Carosso 1970, 330-2.

⁶⁰ Burns 1974, 78.

⁶¹ *Federal Power Commission* 1933.

their own profits.⁶² To Pecora, the “Money Trust” seemed just as entrenched as it had been in Pujo’s day, and consumers in rural areas – farmers – were paying for it.⁶³

Upholding views long held by his father, Wisconsin’s Republican Senator Robert La Follete Jr. inveighed that the inquiry demonstrated “the despotic hold” that Morgan and New York City “interests” had on the economy. Nebraska’s Republican Senator George Norris posted similar conclusions when he confronted the Senate with “the Spider Web of Wall Street,” an eight-foot chart depicting control of 120 major corporations by interlocking directorates traced to eight New York banks.⁶⁴

The uproar resulting from the hearings led Winthrop W. Aldrich, the new chairman of the governing board of the Chase National Bank, to state that “commercial banks should not be permitted to underwrite securities, except securities of the United State Government and of the states, territories, municipalities and certain other public bodies in the United States.”⁶⁵ This statement helped to break the political resistance to the separation of commercial and investment banking activities, as proposed in the Glass-Steagall Act.

With a popular mandate to reform the financial system upon winning the presidential election (with 57% of the popular vote and carrying all but six states), FDR signed the Glass-Steagall Act into law on June 16, 1933. Compared to subsequent financial legislation, the resistance in the Senate and House was relatively tepid, although scholars have since questioned the conclusions reached by the Pecora Hearings that led to the act.⁶⁶

Securities Act of 1933

After his inauguration, Roosevelt immediately sought to pass a Federal Securities Act. A bill was first introduced to the Senate through the Committee on Banking and Currency under Democratic Senator Duncan Fletcher’s chairmanship, who had replaced Norbeck.⁶⁷ It was introduced simultaneously in the House by Democrat Sam Rayburn of Texas. The new bill would require full disclosure in prospectuses and registration statements for new securities sold in interstate commerce.⁶⁸

⁶² Carosso 1970, 340.

⁶³ Stock Exchange Practices: Hearings, 73rd Cong., pt. 2, p. 904-07, 940-42. See also U.S. v. Henry S. Morgan et al., “Plaintiff’s Exhibit No. 112” November 9, 1948, 266-70.

⁶⁴ Horowitz 1996.

⁶⁵ Aldrich 1933, 6-7.

⁶⁶ White 1986; Benston 1990; Kroszner and Rajan 1994.

⁶⁷ *Congressional Record*, 73rd Cong., 1st Sess., LXXVII, Part I, 1019-20.

⁶⁸ Carosso 1970, 356.

In 1892, Fletcher took his seat in the state legislature from Duval County, in the northeastern corner of Florida. The economy was dominated by cotton, and Fletcher strongly supported their interests in Washington, D.C.⁶⁹ Sam Rayburn was from the rural red-clay area of northeastern Texas, an area tinged with Populist thought. His main interests were in railroad and transportation legislation, and he had attempted, unsuccessfully some years before, to introduce legislation regulating the securities issues of railroads through the Interstate Commerce Commission.

A key provision was added to the bill by the Republican Senator from California, Hiram Johnson.⁷⁰ Billions of foreign governmental securities (mostly in Latin America) had been sold to the public (many of whom were constituents, often farmers, of California) by many of the larger New York investment banking firms, and the bonds had gone into default. Johnson sought and won an amendment to the bill that would ensure protections for investors of foreign bonds similar to those who would buy corporate securities.

Farmers' historical experiences with speculation causing price volatility on commodities markets also led to a provision being introduced to reduce the use of margin by Democratic Senator Bulkley of Ohio. It was strongly supported by Republican Senator George Norris of Nebraska, who thought it was "magnificent" and that it is was "more important than the whole bill."⁷¹ Republican Senators Arthur Capper of Kansas and Lynn Frazier of North Dakota also broke ranks with their Republican colleagues in support of the stronger margin restrictions. However, the amendment faced stiff opposition and ultimately failed, although margin rates would be stiffened in the final bill.

The most strident opposition to the bill came from segments of the investment banking community. Telegrams of instruction to their members stated that while the intent of Federal legislation was to be approved, both bills as drafted were unworkable and constituted "a serious menace to industry."⁷² An organization issuing similar instructions was the United States Chamber of Commerce. As read on the Senate floor, a communication from this group prescribed the language in which objections to Congress should be couched: "You are in sympathy with the intent of Congress to regulate the issuance of securities but believe both bills (giving their numbers), as drafted, are unworkable and also are a serious menace to industry and business generally."⁷³ Due to the public's strong desire for some form of federal securities regulation following the 1929 crash as well as the recent disclosures from the Pecora Hearings, the legislation

⁶⁹ Proctor 1979.

⁷⁰ Landis 1959-60, 29-49.

⁷¹ Cowing 1965, 245-46.

⁷² De Bedts 1964, 38-39.

⁷³ *Congressional Record*, LXXVII, Part IV, p. 3801.

passed both chambers by wide margins: the Senate voted 62 to 18 in favor of the bill and it was passed by a voice vote in the House.

Securities Exchange Act of 1934

With the furor over the Pecora hearings revelations subsiding, the Securities Exchange Act of 1934 was far more bitterly contested. The bill embodied the Brandeisian philosophy of disclosure rather than the regulatory one common to most state blue-sky laws.⁷⁴ Bills were again introduced into the Senate by Duncan Fletcher of Florida and into the House by Sam Rayburn of Texas immediately following Roosevelt's message of February 9, 1934, asking for legislation regulating the exchanges and eliminating, "so far as it may be possible ... unnecessary, unwise and destructive speculation."⁷⁵

Opposition to the bill was intense. Corporate executives and stock exchange officials raised the greatest outcry. The former disapproved of the new registration and listing requirements; the latter strongly opposed regulation of any kind. Richard Whitney, president of the NYSE, who had told Pecora that "the Exchange is a perfect institution" capable of regulating itself, predicted that if the bill were enacted "the security markets of the Nation will dry up." Many other business and financial leaders joined him in denouncing the measure as entirely unnecessary, unworkable, impractical, deflationary, unconstitutional, and even Communist-inspired.⁷⁶

Rayburn told his colleagues that no bill ever introduced in all his years in Congress had ever been attacked "as viciously and in many instances as senselessly as this legislation." Referring repeatedly to "the most vicious and persistent lobby ever known," Rayburn read letter after letter from brokers' employees forced to sign petitions against the bill and even compelled to contribute fifty cents each for lawyers' fees to oppose it.⁷⁷ The campaign carried on by financial and industrial leaders seemed to be having an effect on public opinion, bolstering resistance to the legislation. The White House prepared a comprehensive tally that reflected the shifting of opinion. Data compiled from 219 papers showed a dramatic decline in support for the proposed legislation from January through April, 1934. As of the latter month, those 77 journals that still favored regulation tended to discount the need for stringent measures.⁷⁸

⁷⁴ Loss 1961; March 1933.

⁷⁵ Rosenman 1969, 3rd volume, 91; U.S. Senate, Committee on Banking and Currency, 73rd Cong., 2nd Sess., Federal Securities Exchange Act of 1934: Report No. 1455 (Fletcher Report), Washington, (1934), 1-11.

⁷⁶ Schlesinger 1958, 457-60; Sobel, 1965, 298-300. *Newsweek* 1934.

⁷⁷ De Bedts 1964, 72.

⁷⁸ De Bedts 1964, 70.

On March 26, facing pressure from groups in Midwestern states who strongly supported securities regulations, Roosevelt made it clear that he intended no further delays or concessions. "I am certain," he wrote Fletcher, "that the country as a whole will not be satisfied with legislation unless such legislation has teeth in it." The revised bill, he said, "seems to meet the minimum requirements. I do not see how any of us can afford to have it weakened in any shape, manner or form."⁷⁹

As enacted on June 6, 1934, the SEC Act contained many provisions that had been endorsed by investment bankers. The law established an independent commission composed of five members, no more than three of whom could belong to the same party, and entrusted it with wide discretionary authority, just as Kinnicutt and other investment bankers had recommended.⁸⁰

Certain manipulative devices of the stock exchanges were prohibited, and false or misleading statements by brokers, dealers, sellers or buyers became a penal offense. The act also addressed corrupt practices of corporate insiders. Any officer, director, or stockholder holding more than 10 percent of any class of a corporation's stock was required to file a report of his holdings. All directors, officers, and major stockholders were expressly forbidden to sell short the stock of their own company.⁸¹

The SEC was given the authority "to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed ... to assure that investors are furnished with information necessary for informed investment decisions."⁸² Administration and enforcement of the 1934 Securities Exchange Act as well as the 1933 Securities Act were brought under the SEC's jurisdiction.

Public Utilities Holding Company Act of 1935

While the SEC Act of 1934 faced fierce opposition, the PUHC Act was one of the most bitterly contested pieces of New Deal legislation.⁸³ Before 1914, holding companies such as Electric Bond and Stone and Webster fulfilled a useful role in dealing with financial, technical and managerial problems peculiar to the power industry.⁸⁴ The primary impetus behind the creation and rapid expansion of holding companies in the 1920s, however, was the desire for quick profits by investment bankers. In 1920, only twenty-three holding companies existed in the

⁷⁹ Rosenman 1969, vol. III, 170.

⁸⁰ Carosso 1970, 379.

⁸¹ U.S. Statutes at Large, XLVIII, Part I, p. 881 ff.

⁸² Securities and Exchange Commission 1973; Chatov 1975, 95; van Riper 1994, 5f.

⁸³ De Bedts 1964; Funigiello 1968; Krikun 1971; James 2000.

⁸⁴ Buchanan 1936.

industry; in the following decade another forty-six were created.⁸⁵ But of greater significance was the growth of a few giant holding companies. By 1929 the 13 largest holding companies controlled over three-fourths of the entire privately owned industry, and more than forty-five percent was concentrated in the hands of the three largest groups – United Corporation, Electric Bond and Share Corporation (created by General Electric in 1905), and Insull (with origins going back to 1882, three years after Edison developed a practical light bulb). The United Corporation, created in 1927 by J.P. Morgan, was the largest multi-billion dollar utility holding company and in 1929 it controlled over 20% of the generating power within the United States.⁸⁶

The growth of these interstate utility holding companies alarmed a number of public power advocates such as Gifford Pinchot, Governor of Pennsylvania, and George Norris, Senator from Nebraska, who believed a “Power Trust” menaced the nation. Since holding companies were not legally considered public utilities, neither State Commissions nor the Federal Power Commission could regulate their issuing of securities, accounting methods, or service fees.⁸⁷

As a newly elected governor of New York in 1928, FDR quickly identified himself with this critique of utilities. Committed to the belief that utility rates in farm and rural areas were too high, Roosevelt throughout his governorship advocated and fought vigorously for the development of public power on the St. Lawrence River and for strengthening the regulation of utilities.⁸⁸ He carried this commitment to the White House.

When Insull collapsed in 1932, the FTC was in the midst of an eight-year investigation of utility holding companies that was completed in 1935, and embodied in 96 volumes (70,062 pages). It was a massive indictment of utility holding companies, cataloguing in detail innumerable abuses. “It is not easy,” the Commission stated, “to choose words which will adequately characterize various ethical aspects of the situation without an appearance of undue severity. Nevertheless the use of words such as fraud, deceit, misrepresentation, dishonesty, breach of trust, and oppression are the only suitable terms to apply if one seeks to form an ethical judgment on many practices which have taken sums beyond calculation from the rate paying and investing public.”⁸⁹

Pyramiding, stock watering, write-ups, and excessive service fees to subsidiaries all contributed to the problem. The rapid and extremely complex financial growth of these holding companies, not subject to direct commission regulation, created innumerable opportunities for their managers to engage in a

⁸⁵ Clemens 1950, 491.

⁸⁶ McDonald 1962, 245-92.

⁸⁷ Krikun 1971, 45.

⁸⁸ Bellush 1955, 208-68.

⁸⁹ Federal Trade Commission 1935, 63.

host of illicit activities profitable to top holding companies rather than their subsidiaries.⁹⁰ Indeed, the National Power Policy Committee reported: “Fundamentally, the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry.”⁹¹

Because the struggle over the bill promised to be bitter and long, Roosevelt chose two of the most influential and powerful Congressional leaders to lead the fight: Sam Rayburn, who had already demonstrated considerable political skill in fighting for the passage of the Securities Acts of 1933 and 1934, and Senator Burton K. Wheeler, a public power advocate from Montana who had attacked the growing power of utilities throughout the 1920s.⁹²

A bill was introduced simultaneously on February 6, 1935 in the House and Senate.⁹³ It proposed the gradual extinction of holding companies with its (in)famous “death sentence” clause. Many southern congressmen joined in support of the bill as their farming constituents stood to benefit from the improvements and lower electric rates at hand in the valley of the Tennessee River. And the entire state legislature of Texas, Rayburn’s home state, quickly put itself on record with a joint resolution addressed to the United States Congress approving the national Democratic administration’s assault on the public utilities holding companies.

The major opposition to the bill in the Senate was led by Daniel Hastings, Republican of Delaware, and William Dietrich, Democrat of Illinois.⁹⁴ Interest groups opposed to the bill, such as the Chamber of Commerce, argued that it was aimed at eventual nationalization of the nation’s entire capitalist structure.⁹⁵ Once the utilities industry was mastered, *Forbes* editorialized, “then logically...the President would proceed to attack all industrial organizations having far-flung properties.” Obviously the ambition of the administration was “to tear our most useful corporate enterprises limb from limb.”⁹⁶

Correspondence received by congressmen was very similar to the previous year’s Securities Exchange Act. Senator Wheeler explained that many of these letters were the result of tactics of firms such as Electric Bond and Share, which required its employees to write cards of protest either to the House or to the Senate committee handling the bill. But an even larger number of letters strongly opposed to the “destruction” of holding companies came from stockholders. A

⁹⁰ Ripley 1926.

⁹¹ Quoted in Loss 1961, Vol. I, 389.

⁹² Krikun 1971, 95.

⁹³ H.R. 5423 and S. 1725 *Congressional Record*, 74th Cong., 1st Sess., 1935, LXXIX, Part II, 1624, p. 1513.

⁹⁴ Krikun 1971, 152.

⁹⁵ Krikun 1971, 117-8.

⁹⁶ *Forbes*, 1 March 1935, 7; 1 May 1935, 8.

group of telegrams to the President from Columbus, Ohio denounced the bill as “unamerican” and a “step toward” communism.⁹⁷

After one of the most bitter legislative battles the capitol had seen in decades, the bill was signed into law on August 26, 1935. Its purpose was to break up the huge utility holding company empires that had been built in the 1920s and place the industry under “local management and local regulation.”⁹⁸ To achieve these ends, the law required electric holding companies and their subsidiaries to register with the SEC. It was authorized to enforce the statute’s famous “death sentence” provision, limiting utility holding companies to “a single, integrated ... system.” The SEC also was to review and pass upon their new security issues, determine their type, price, and methods to be employed in offering them, and supervise their relations with investment bankers. These and many other matters, including accounting standards, made it the most regulatory of all federal securities laws and gave the SEC sweeping new regulatory powers.⁹⁹ These powers were extended beyond the utilities industry with the Revenue Act of 1935.

Revenue Act of 1935

President Roosevelt, in a special message to Congress on June 19, 1935, declared: “Our revenue laws have operated in many ways to the unfair advantage of the few and they have done little to prevent an unjust concentration of wealth and economic power.”¹⁰⁰ He then made several tax recommendations, including taxes on intercorporate dividends as a measure to “prevent the evasion through affiliates” of the corporate income tax.

Robert Jackson, Assistant General Counsel to the Treasury Department, presenting the reforms to the Senate Finance Committee, “stressed the secondary effects of such taxes on dividends in discouraging undesirable practices of holding companies” (pyramidal groups), and gave some examples of the problem:

The tax problems arising out of systems of holding companies, subholding companies, operating companies, and mixed companies, are very serious. For example, one such system as of December 31, 1933, contained approximately 270 companies of which 128 were public utility operating companies located in several and widely separated states, and at least 31 of which would be classed as subholding companies. The corporation filed

⁹⁷ Telegrams to F.D.R. from Columbus, Ohio, regarding the Public Utility Holding Company Act, April 17, 1935, Roosevelt Papers.

⁹⁸ Loss 1961, vol. I, 135.

⁹⁹ Loss 1961.

¹⁰⁰ Blakey and Blakey 1935.

consolidated returns showing no tax due in any of the years 1929 through 1933. The system was not so modest about its profits in its reports to stockholders, and the Bureau began the task of audit. The auditing to date has required the services of 108 field agents for an aggregate period of 11,488 days, the service of 16 auditors for a period of 2,640 days, as well as the services of the supervising staff. The task is not yet nearing satisfactory completion. The investigation is complicated by the great volume of security transactions among the different companies of the group. In some instances securities were transferred through as many as 10 intermediary companies on the way from starting point to destination. A dollar of earnings would likewise run through several companies before reaching a resting place. Some of these holding companies have imposed charges upon underlying operating utilities for the income-tax liability, which the operating companies would have paid if they had filed a separate return. Then by eliminating the profit through the consolidated return, no tax was paid to the government. The holding company had collected the tax and kept it for itself. One company collected from its subsidiaries between 1926 and 1929 in excess of one and one-half million dollars on this basis.¹⁰¹

Those opposed to the bill – corporate executives and Wall Street types - claimed that it was a “soak-the-rich” program and based upon “social control” fantasies.¹⁰² Blakey and Blakey summarize the Roosevelt administration’s taxation objectives this way: “There can be no denying that the President’s message was an attack upon wealth; he and his followers would say, not upon innocent wealth, but upon concentrated, monopolistic, tax evading, unsocial wealth, and particularly upon that taken from the masses by the vicious, pyramided, consciousness holding companies.”¹⁰³ That this accurately reflected the view from the White House is also clear. Roosevelt writes in the *American Economic Review*, “Tax policies should be devised to give affirmative encouragement to competitive enterprise. Attention might be directed to increasing the intercorporate dividend tax to discourage holding companies”¹⁰⁴ Roosevelt elaborated:

¹⁰¹ *Senate Finance Committee Hearings*, 223-224.

¹⁰² Blakey and Blakey 1935.

¹⁰³ Blakey and Blakey 1935.

¹⁰⁴ Roosevelt 1942.

Close financial control, through interlocking spheres of influence over channels of investment, and through the use of financial devices like holding companies and strategic minority interests, creates close control of the business policies of enterprises which masquerade as independent units. ... Private enterprise is ceasing to be free enterprise and is becoming a cluster of private collectivisms; masking itself as a system of free enterprise after the American model, *it is in fact becoming a concealed cartel system after the European model.*¹⁰⁵ (italics mine)

In summary, an important purpose of the Revenue Act of 1935 was to subject dividends passed through layers of firms in pyramidal groups to multiple taxation, and thereby render such groups unviable. It was signed into law on August 30, 1935, four days after the PUHC Act.

Quantitative Analysis

To supplement the qualitative analysis and assess whether farming states exhibited a clear tendency toward protecting minority shareholders and breaking up corporate pyramids in contrast to states dominated by finance, industry and labor, analyses of sectional voting patterns as well as House and Senate votes on key pieces of securities legislation are examined. Table one demonstrates votes by section of the United States for the three most hotly contested bills: the SEC Act of 1934, the PUHC Act of 1935, and the Revenue Act of 1935.¹⁰⁶ To assess regionally specific voting patterns, and whether they correspond to the Hatch Bill of 1893, the votes are listed according to Cowing's sectional categories.¹⁰⁷ One general pattern is clear, the changing levels of support for the three bills compared to the Hatch Bill of 1893 mirror the industrialization of the American economy; overall, there is less support for the 1930s acts, and this decline is clearest in the region that experienced the most rapid industrial growth – the East Central Midwest.

Opposition to the 1930s legislation was centered in the Mid-Atlantic and Northern New England sections. Lawmakers from the remaining sections generally supported the bills, with those representing the Anti-Speculator (Great Plains) states exhibiting the strongest support. Aside from the Senate's slim majority favoring the PUHC Act in the South, the legislators from the South and

¹⁰⁵ Roosevelt 1942.

¹⁰⁶ There is insufficient space in the paper to examine agenda-setting votes, however, James 2000 presents evidence on this with regard to the PUHC Act that is consistent with the argument made in this paper.

¹⁰⁷ Cowing 1965.

West also gave solid support. Lawmakers from the East Central Midwest provided more tepid support for the bills, corresponding to the industrialization and urbanization of the region since the 1890s. Overall, the House, more closely reflecting popular sentiment, was more inclined to pass the bills than the Senate. These patterns mirror general sectionalist patterns regarding other legislative battles with respect to core versus periphery interests.¹⁰⁸ Aggregating and testing sectional patterns is suggestive of the influence of agriculture on legislators' votes. However, cross-country analysis and work on American politics suggest that partisanship (or party affiliation in the U.S.) matters most.¹⁰⁹ Probit tests are thus used to examine the relationship between the likelihood for a legislator to vote in favor of each law and the economic structure of the legislator's state, while controlling for party identification.

For the tests conducted here, the dependent variable is the legislator's 'yea' vote for a bill (coded as 1 or 0 otherwise), obtained from the *Congressional Record*. As a basic measure of the importance of farmers in each state, the total value of agricultural production as a fraction of state income is used.¹¹⁰ Owners of capital (business owners and financial institutions) are seen as having greater influence (and importance to a state's economy) as the proportion of capital used in the manufacturing process increases; thus, their influence is measured by the level of manufacturing value added minus total wages as a fraction of the state's total income.¹¹¹ Workers' influence is likewise measured by the proportion of a state's total wages relative to the state's income. Congressional members are also identified as Democrat or Republican. Because we would expect new members of Congress elected in 1932 or 1934 to be more likely to favor financial regulations, controls are added to account for this. Specifically, new members from the 1932 elections are controlled for in the SEC Act of 1934 tests and new members from both the 1932 and 1934 elections are controlled for in the PUHC and Revenue Acts of 1935 tests. Finally, a control variable is included for the AntiSpeculator states to assess whether they are driving the results independently of other states. Table two presents the results from probit estimations for House and Senate votes on these three pieces of legislation.

In all of the tests, the signs of the coefficients for agriculture are opposite to those for the value of workers' wages and capital value added when analyzed individually. The coefficients for the former variable indicate support for the

¹⁰⁸ James 2000.

¹⁰⁹ Roe 2003; Cox and McCubbins 1993.

¹¹⁰ Data for the value of farm production are from the *Yearbook of Agriculture, 1931*: Gross income of crops and livestock combined, 1929, 977. This value is then divided by total state income; data for state income is from *State Personal Income: 1929-1987*, U.S. Department of Commerce.

¹¹¹ Data on Capital's Value Added by Manufacture comes from the 15th Census of the U.S.: Manufactures, Reports by States, 1930. Wages data are from the same source.

legislation in every case, while the coefficients for the latter variables indicate consistent opposition. When all variables are tested together, only the agriculture variable and the Democratic party identification variable display consistently robust correlations suggesting that the importance of agriculture may account for those Republicans who voted for the acts.

Turning to an examination of each individual act, it is clear from an analysis of the votes that the SEC Act of 1934 had enough Democratic support in the House without the need to rely on Republicans, though 24 Republicans did vote in favor, and the results suggest that agriculture may account for these changes. In the Senate, however, Democrats lacked a majority (45 yes votes for the SEC Act), and 15 Republicans voted with Democrats; the statistical significance of the agriculture variable suggests that the importance of agriculture to Republicans' home state may account for their votes.

With regard to the PUHC Act of 1935, Democrats again had enough votes to pass the legislation in the House without Republican support, though some Republicans did vote in favor and appear to have done so in line with the importance of agriculture to their home state as James (2000) likewise documents for votes on amendments to the final bill. Senate voting occurred primarily along party lines so it is not clear how important agriculture was. Democrats had sufficient votes to pass the Revenue Act in the House, though 26 Republicans voted for it. In the Senate, however, the Democrats relied on Republican support (Democrats only had 46 yes votes), which appears to be influenced by the importance of agriculture to the Senator's state (8 Republicans voted yes) since the agriculture variable again displays statistically significant results at the one percent level.

Overall, the Senate votes were much closer than those in the House. Indeed, two of the acts would not have passed without some Republican support. Close investigation of the voting record reveals that a core group of eight Republican Senators voted in favor of each of these acts, making their support particularly critical to the establishment of modern securities regulations. Table three lists these Senators and their backgrounds; it is clear that farming is a common link.¹¹²

In summary, the evidence demonstrates that farmers played an important role in weakening bankers' control over corporations, and that farmers were critical to the creation and remit of the SEC which was charged with protecting the individual investor and minority shareholder.

¹¹² Sources include *American Political Leaders* 1994; and Garraty and Carnes 1999.

Table 2. Interests and U.S. Securities Legislation: Probit Tests

Panel A. DV: Yes vote for the Securities Exchange Act, 1934								
	House				Senate			
Value of Farm	0.03***			0.01***	0.02***			0.02**
Production	(6.77)			(3.31)	(2.72)			(2.13)
Capital Value		-0.03***		-0.002		-0.01		0.06
Added		(-4.63)		(-0.18)		(-1.04)		(1.59)
Value of Workers'			-0.06***	-0.02			-0.05***	-0.05
Wages			(-5.57)	(-0.94)			(-2.33)	(-0.89)
Democrat				1.6***				1.01***
				(9.63)				(2.9)
New Member 1932				0.15				-0.07
				(0.98)				(-0.18)
Anti-Speculator				-0.16				0.58
State				(-0.53)				(0.9)
Pseudo-R ²	0.09	0.039	0.05	0.3	0.07	0	0.04	0.18
N	428	428	428	428	94	94	94	94
Log-Likelihood	-250.23	-266.34	-261.22	-193.71	-57.2	-60.97	-58.72	-50.01

*** statistical significance at the 1% level; ** statistical significance at the 5% level.

Z-statistics are shown in parentheses.

Panel B. DV: Yes vote for the PUHC Act, 1935								
	House				Senate			
Value of Farm	0.03***			0.02***	0.02***			0.018
Production	(5.44)			(2.79)	(2.83)			(1.44)
Capital Value		-0.028***		-0.03**		-0.039***		-0.01
Added		(-3.83)		(-2.06)		(-2.74)		(-0.78)
Value of Workers'			-0.04***	0.03			-0.07***	0.004
Wages			(-3.8)	(1.38)			(-3.02)	(0.08)
Democrat				1.76***				0.79**
				(10.53)				(2.09)
New Member				0.09				0.35
1932/34				(0.6)				(1)
AntiSpeculator				-0.11				0.59
State				(-0.35)				(0.95)
Pseudo-R ²	0.07	0.03	0.03	0.34	0.075	0.06	0.07	0.17
N	425	425	425	425	92	92	92	92
Log-Likelihood	-221.24	-231.28	-231.34	-156.78	-57.68	-58.45	-57.59	-51.77

*** statistical significance at the 1% level; ** statistical significance at the 5% level.

Z-statistics are shown in parentheses.

Panel C. DV: Yes vote for the Revenue Act, 1935								
	House				Senate			
Value of Farm	0.02***			0.01**	0.024***			0.03***
Production	(4.74)			(1.91)	(2.81)			(2.67)
Capital Value		-0.02***		-0.007		-0.02		0.02
Added		(-3.51)		(-0.57)		(-1.46)		(0.83)
Value of Workers'			-0.04***	0.007			-0.05**	-0.006
Wages			(-3.87)	(0.3)			(-2.47)	(-0.11)
Democrat				1.4***				1.4***
				(9.08)				(3.67)
New Member				0.18				-0.62*
1932/34				(1.27)				(-1.75)
AntiSpeculator				0.43				0.1
State				(1.48)				(0.17)
Pseudo-R ²	0.04	0.02	0.02	0.22	0.072	0.01	0.049	0.2
N	426	426	426	426	94	94	94	94
Log-Likelihood	-262.43	-268.29	-266.86	-211.7	-58.85	-62.35	-60.28	-50.42

*** statistical significance at the 1% level; ** statistical significance at the 5% level.

Z-statistics are shown in parentheses.

Table 3. Republican Senators Who Voted for Securities Regulations

Senator	State and Senate Term	Background
Borah, W. E. 1865-1940	Idaho 1907-1940	Born to farmers. Borah's visibility soared when the Populist crusade and the Free Silver issue shattered party lines in the mid-1890s. He was a superb orator, especially adept at playing upon popular emotion against the "interests." He joined the Silver Republicans in deserting the party in 1896, supporting Democratic presidential candidate William Jennings Bryan and mounting his own unsuccessful campaign for election to the U.S. House of Representatives. In 1902 Borah returned to the Republican party and ran for the U.S. Senate. He was blocked by the party regulars, however, who remembered his defection and disliked his identification with the rising tide of progressivism.
Capper, A. 1865-1951	Kansas 1918-1949	Son of a tinner and hardware merchant. In 1893 he bought a newspaper, the North Topeka Mail. Capper's early reputation was based on his editorial opposition to railroad domination of Kansas politics. He was a leader in the Farm Bloc, a bipartisan group of Senators devoted to farmers' interests that lasted from 1921-1933.
Frazier, L. J. 1874-1947	North Dakota 1922-1940	Son of farmers. Frazier was an early supporter of the Nonpartisan League, a farmers' organization founded in North Dakota. The league's program promised farmers freedom from the exactions of railroads, bankers, millers, and other middlemen.

Johnson, H. W. 1866-1945	California 1916-1945	Son of a politician. As governor, he approved regulation of railroads and other public utility corporations. He helped create the Progressive party in 1912 as a vehicle for Roosevelt to seek the presidency, and the new party nominated him for vice president. With the collapse of the national Progressive party in 1916, Johnson returned to the Republican party to run for the Senate. He characterized the campaign as a struggle that pitted “rotten big business and crooked politics against the very essence of democracy.”
La Follette, R. M., Jr. 1895-1953	Wisconsin 1925-1946	Son of Wisconsin governor and senator. La Follette championed many of the causes of his father, such as trust-busting and progressive taxation. He was a champion for farmers and industrial workers, and criticized Roosevelt for not going far enough to combat the depression or to curb the maldistribution of wealth.
Norbeck, P. 1870-1936	South Dakota 1920-1938	See Pecora Commission Hearings subsection.
Norris, G. W. 1861-1944	Nebraska 1912-1942	Born to farmers in Ohio. Norris attacked the privileged positions of urban big business and finance and battled on behalf of western farmers. In the 1920s, Norris gained greatest attention for his long and persistent political efforts to convert the federal government’s World War I Muscle Shoals facilities in Alabama into a public power program, which was accomplished with FDR’s support during his “One Hundred Day’s” special session in 1933, despite the direct confrontation with powerful private utility companies.
Nye, G. P. 1892-1971	North Dakota 1925-1944	Son of a newspaper publisher. He was active in the agrarian radical Non-Partisan League. Both in his role as a newspaper editor and as a U.S. Senator, Nye spoke out aggressively for reforms beneficial to rural America. He disapproved of special privileges showered upon urban business interests.

Conclusion

Three clear conclusions stand out. The first regards the likelihood for countries to comply with global financial standards, as mentioned in the introduction. The paper offers a new explanation for why some countries may not sincerely comply. The political origins of securities regulation in the U.S. illustrate that two conditions are necessary: (1) strong democratic institutions; and (2) a sufficient number of individual investors with political influence -- farmers in the context of the early twentieth century United States. Farmers played a critical role in that the general antipathy towards large financial institutions and urban industry, based on decades of urban-rural political battles, led to a bloc of representatives and senators from both parties who favored a broad array of financial regulations during the New Deal, including securities regulations. This bloc was sufficiently strong to withstand the decline in popular support for financial reform after initial passage of the Securities Act of 1933. Although farmers may not have been on the front lines of the legislative battles over the Securities Exchange Act of 1934, their historical experiences with blue sky laws as well as anti-trust legislation underpinned their commitment to weaken financial institutions and provided the necessary bedrock of electoral support for securities regulations to be passed into law. In this way, farmers played a critical role in ensuring the passage of the Securities Exchange Act of 1934 as well as extending its remit with the Public Utilities Holding Company and Revenue Acts of 1935.

But in most developing and middle-income countries business owners wield disproportionate political influence. The evidence in this paper indicates that in countries where business interests dominate the political process (as in East Asia), it is unlikely that they will favor U.S. style financial regulations. Thus, the paper offers an explanation for why East Asian countries (among others) have exhibited mock compliance in the wake of the 1997 Asian Financial Crisis. Of course, the adoption of securities regulations in the U.S. may not be the only path by which countries initiate sincere compliance with global financial standards, but the paper illustrates the political preconditions for other countries to follow in the U.S.'s footsteps.

The second conclusion is that different spheres of the capitalist system may change at different times. The institutional origins for the distribution and redistribution of wealth, for example, may be found in the late nineteenth century,¹¹³ but the findings in this paper point to the 1930s as the critical moment marking the origins of modern American finance capitalism.

A third conclusion is that farmers, rather than workers, strongly favored securities regulations. They should not be combined into a single "populist"

¹¹³ Iversen and Soskice 2009.

category. Clearly specifying these actors' preferences, and accounting for their differing political power neatly fills Roe's "two holes" and remains consistent with his broader argument. The first "hole" about politics being important to corporate finance, but not to labor-management relations is easily answered from this perspective. Farmers were politically powerful, and they were focused primarily on dismantling and regulating trusts and securities markets. Farmers care little about labor-management relations. The second "hole" about the failure of pyramids to emerge is also consistent with distinguishing between politically powerful farmers and politically weak labor. In other countries where labor is strong (e.g., Austria and France), pyramids do exist. Left-wing parties (and their labor union counterparts) view them as useful for implementing labor-oriented policies across a wide range of enterprises. But farmers would not benefit from such concentrated financial and economic might. Indeed, such arrangements would be to their detriment as such oligopolistic power would almost inevitably lead to higher transportation and other business services costs.

Thus, farmers have been instrumental to the development of modern American capitalism by establishing federal regulations that would break up and guard against a return to the concentration of power wielded by industry and financial institutions. Indeed, it is because of farmers that the United States established strong protections for minority shareholders, that large pyramidal corporate groups were dismantled, and that the Securities and Exchange Commission was created. An understanding of the institutional origins of Anglo-American capitalism and the origins of international financial standards is thus incomplete without considering the important role of the American farmer.

North and Weingast demonstrate how restrictions on the power of the English king enabled the British to borrow more than before because lenders were more confident that their loans would be repaid.¹¹⁴ In the same way, farmers created more confidence in American equities markets as a safe place for individual investors, and thereby contributed to their remarkable growth in the ensuing decades both in the U.S. and by serving as a template for the standardization of markets throughout the globe. As a consequence, in seeking to protect their local communities from predatory industrial and financial titans, the humble American farmer inadvertently contributed to the financialization of the global economy and enabled the rise of financial institutions that dwarf those of the 1920s.

¹¹⁴ North and Weingast 1989.

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