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The Domestic Political Origins of Global Financial Standards: Agrarian Influence and the Creation of U.S. Securities Regulations

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ABSTRACT

What are the political origins of America's securities regulations? In contrast to arguments that point to business owners as determining the institutional foundations of America's political economy, this paper argues that farmers play 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 United States may have developed a variant of the coordinated market economy found in continental Europe. Moreover, to the extent that U.S. securities regulations serve as a template for international financial standards, the paper will show that the humble American farmer has inadvertently contributed to the financialization of the modern global economy.

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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. While the recent financial crisis may raise questions about the viability of this initiative, its impact is likely to simply slow the process rather than to substantially alter its aims (in fact, some claim an even greater urgency for countries to adopt international financial standards, such as the International Federation of Accountants).

Despite the initiative for countries to adopt these standards, Walter (2008) has shown that, in the wake of the Asian Financial Crisis, countries are likely to exhibit "mock" compliance with these standards when the domestic political economy produces incentives for actors to arrange economic activity differently from that prescribed by international financial authorities. 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 U.S. securities regulations, this paper focuses on the following question: what are the political origins of American securities regulations?

Roe (1994) offers an excellent historical account of how politics affected the evolution of the U.S. financial system. He focuses on how populist interests, in combination with U.S. Federal political institutions, led to the fragmentation of a burgeoning, centralized banking (and broader financial) system in the early twentieth century. Securities markets later developed as a way to circumvent the inefficient and fragmented banking system in order to provide much needed financing to America's large industrial enterprises. But, as Becht and De Long (2005) point out, Roe's argument has "two holes". First, Roe has a hard time answering why politics was so strong in corporate finance, yet weaker in labour-management relations. Second, Roe's argument has difficulty explaining why pyramids did not emerge in the U.S., as they did in other countries. But these "holes" in Roe's argument are likely due to combining farmers and labour into one general populist category. This term is frequently used to refer to those with low incomes, but this is problematic since farmers and labour can have widely divergent preferences over regulations governing corporate finance.

This paper argues that *farmers* were central to the development of U.S. securities markets regulations. Indeed, farmers were critical to the passage of legislation that would protect minority shareholders and outlaw corporate pyramids, as well as the formation and remit of the Securities and Exchange Commission. 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, at both the national and international levels.

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 (Mosley and Singer, 2009), there are two additional reasons for examining the political origins of U.S. securities regulations. First, it sheds light on the origins of modern capitalist institutions in the United States. Recent work points to conflict between labour and business in the late nineteenth century as contributing to institutional configurations that distinguish Liberal Market Economies from Coordinated Market Economies (e.g. Cusack, Iversen and Soskice, 2007; Martin and Swank, 2008; Iversen and Soskice, 2009). 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, its rules governing corporate finance (Hall and Soskice, 2001). 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 (1998) likewise documents (both published in the *American Economic Review*), the United States exhibited a Continental European/German style of finance capitalism up through the early twentieth century.

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 (Morck, 2009). And where legal systems are underdeveloped, they permit the 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 (Johnson et al. 2000). There are only a handful of countries that have outlawed the existence of pyramidal corporate ownership arrangements (including the United States, the United Kingdom, Japan and Germany)—the United States was the first (Morck, 2009). Understanding how corporate pyramids were outlawed in the early development of the United States may provide insights into the mechanisms that can mitigate crony capitalism among today's developing nations.

The paper proceeds as follows: (1) a review of alternative explanations for the emergence of U.S. securities markets regulations followed by a presentation of the argument of this paper; (2) a brief overview of the political battles waged with regard to corporate finance 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 Glass-Steagall Act of 1933, 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 as well as a discussion of areas for future research.

EXPLANATIONS FOR SECURITIES REGULATIONS

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: (1) legal tradition; (2) political institutions; and (3) interest groups. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998, 1999) set off a torrent of work on explaining corporate ownership arrangements by demonstrating robust correlations between legal regimes and the diffusion of corporate ownership. They found that concentrated corporate ownership is more common in countries with civil law while nations with common law traditions exhibit more diffusion of corporate ownership. As a consequence of the better protections that common law systems seem to provide minority shareholders, equities markets tend to be larger (e.g. the United States, the United Kingdom, Australia, Canada, Singapore, Hong Kong, etc.). Furthermore, corporate pyramids are less prevalent in some common law countries (e.g. the United States and the United Kingdom), suggesting that minority shareholder protections may be a necessary precondition for their dissolution (Almeida and Wolfenzon, 2006).[1]

Other scholars emphasize the impact of political institutions. This view suggests that minority shareholder protections are due to how political institutions mediate conflicts of interest over the security of property rights when they affect the structure of the financial system. Verdier (2003) for example, argues that greater state centralization contributes to larger capital markets by denying local interests the capacity to keep finance local. Many also see state centralization as fostering conditions that permit corporate pyramids to thrive due to state-led development, as in Korea and other developing nations (Morck and Nakamura, 2007; Lim and Morck, 2009). Pagano and Volpin (2005) point to the effect of electoral systems (and broader consensus political arrangements) on corporate ownership outcomes: proportional representation systems grant more influence to labour who tends to favour more concentrated ownership (which reduces the propensity for mergers and acquisitions and their accompanying layoffs). At the same time, consensus political systems preserve the status quo, and insofar as concentrated ownership, and corporate pyramids, tend to be the common starting point, they are more likely to persist in such political systems.

However, many see interest groups as the main reason for variation in financial outcomes. As suggested by the mediating effects of consensus systems, labour's political

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[1] But corporate pyramids do exist in Canada, and they were outlawed in Germany and Japan due to rules imposed by the American Occupation Authorities.

influence is an underlying causal variable. Roe (2003), for example, emphasizes the role of labour in affecting the diffusion of corporate ownership; where labour's political influence declines, corporate ownership becomes more diffuse and a greater emphasis is placed on meeting shareholders' short-term earnings objectives. Gourevitch and Shinn (2005) build on this perspective by considering the outcomes that occur when labour interacts with owners and managers in the political arena, and the manner by which political institutions mediate interactions between these groups. Rajan and Zingales (2003), by contrast, argue that entrenched businesses lock up access to domestic finance via their political influence, but domestic capital markets do grow, and allow entrants access to finance, as firms turn to lower cost financing from international capital markets when trade and capital flows increase. The entrenched businesses commonly use a pyramidal structure in these countries, and underdeveloped legal systems and capital markets make such groups effective at internalizing factor markets so as to overcome incomplete contracting problems. Pyramidal groups may receive privileges from the government when there is a focus on a developmental strategy, with the state directing financing to strategically placed firms, thereby preserving their existence in such economies (Morck, 2009). Owners likewise benefit from these arrangements since state-led development commonly involves tunnelling resources between group firms, so profitable firms can subsidize individually unprofitable firms whose existence is nonetheless necessary to the group as a whole (Johnson et al., 2000; Khanna, 2000; Khanna and Palepu, 2000; Khanna and Palepu, 2005; Khanna and Yafeh, 2007).

The Argument

This paper falls into the interest group approach, but differs from the above arguments since it places farmers at the centre of the analysis. It 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 labour since Roe (2003) argues that workers favour concentrated corporate ownership, and pyramidal groups are common throughout continental Europe. 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 labour 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.

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 (Chandler, 1977). 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 (Philips, 1984). 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 per cent 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, *tunnelling* often ensues (Johnson et al., 2000). This occurs when the controlling family tunnels resources between group firms, so profitable firms can subsidize individually unprofitable firms whose existence is nonetheless necessary to the group as a whole. However, tunnelling 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.[2] 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,

[2] On holding company abuses, see the Federal Trade Commission (1935).

the promotion of speculation in the prices of the group's shares on the stock exchanges (Philips, 1984).

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 United States, the diffuse costs have tended to be focused on actors with the capacity to overcome their collective action problems, namely farmers.

Farmers

Concentrated economic and financial might is often detrimental to farmers as such oligopolistic power almost inevitably leads to funds being drained out of the interior, raising their own costs of financing (Roe 1994). Further, 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 (Chandler, 1977). And insofar as farmers' wealth is tied to potentially volatile commodities and land prices, they may be more vulnerable to share price devaluations if they buy securities in good times.

Labour

Labour tends to favour 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 (Aoki and Patrick, 1994; Dore, 2000; Roe, 2003). 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; Högfeldt, 2005). 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 favour stronger securities regulations (Gourevitch and Shinn, 2005). But during the early

twentieth century, workers' incomes were generally too low to inflame passions over securities markets regulations.

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 Glass-Steagall Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company (PUHC) Act of 1935, and the Revenue Act of 1935. The Securities Act of 1933 was the first federal securities regulation; the 1934 Act created the Securities and Exchange Commission (SEC), which was charged with overseeing the newly independent investment banks as legislated by the Glass-Steagall Act of 1933. The PUHC and Revenue Acts of 1935 were responsible for breaking up corporate pyramids and were enforced by the newly-created SEC. 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

The pressure for federal legislation regulating stock markets and the sale of securities have their 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. I will discuss each of these in turn.

Commodities speculation

Farmers' distrust of capital markets was initially due to their experience with futures exchanges. The futures contract, occasionally used before the Civil War, began to receive unprecedented attention from speculators in the latter quarter of the nineteenth century in Chicago and New York. The number of bushels and bales traded on the exchanges exceeded the annual production from 1872 on, and in several years amounted to seven times the annual crop. Prices moved widely before the war because of weather, economic instability, and imperfect crop information,

but since the information infrastructure had improved (via the telegraph) and the markets had become more liquid, many began blaming speculators for the increased volatility of prices around harvest time (Cowing, 1965).

Farmers' economic position, worsened by the droughts after 1886, had declined, and ultimately led to the "Populist Revolt". The futures system came under sharp attack, and Congressional bills to ban futures contracts and speculative trading multiplied (Hatch, 1892: 4–7). In 1892, a composite bill, called the Hatch Bill after the chairman, William H. Hatch of Missouri, emerged from the House Agriculture Committee; Senator William Drew Washburn of Minnesota sponsored a very similar measure in the Senate. The bills sought to tax sales of grain and cotton where the purchaser did not own the commodity but was selling what he expected to acquire later.

In 1893, the Hatch Bill passed the House, 167 to 46, and the Senate, 40 to 29; all that remained was the House concurrence on Senate amendments. However, a suspension of rules was required since only a few days remained in the 52th 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 26 votes (Parker, 1911).[3] Thus, the bill failed to become law although 80 per cent of the Congress favoured 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 subsequent exchange-related regulations. Cowing (1965) offers a breakdown of the votes by sections of the United States.

[3] Yea 172, Nay 124. On 22 January 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.

Table 1

Votes by Sections of the United States

		Hatch Bill 1893	SEC Act 1934	PUHC Act 1935	Revenue Act 1935
		% Yea	% Yea	% Yea	% 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.

Those opposing the bill included the Middle Atlantic states, reflecting the interests of its financial centres, although there were some House votes from Western Pennsylvania and New York that were exceptions, along with many prudent absences. Congressmen from the Midwest financial hubs sided with their colleagues from the Middle Atlantic states.

Those against 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 favoured 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 favour of the bill. 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 favoured the bill. The neighbouring states of Minnesota, Montana, Iowa, Colorado, New Mexico and Arkansas leaned in the same direction.

Anti-Trust Legislation

Political battles over the regulation of railroads created further antagonism between rural areas and the urbanizing northeast. 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 (Buck, 1963; Miller, 1971). The regulation of railroads with federal legislation eventually occurred with the Interstate Commerce Act of 1887, and was strongly supported by Southern and Midwestern representatives; opponents were overwhelmingly northeasterners and Republicans (Sanders, 1999: 194).

Antitrust agitation that led to the passage of the Sherman Antitrust Act in 1890 was clearly rooted in the political crusades of the Grange and the Farmers' Alliance of the 1870s and 1880s. While the agrarian revulsion against trusts was shared by a broad array of other groups nationwide, the geographic patterns of sponsorship of antitrust bills and the existence of state antimonopoly laws before 1890 testify to the agrarian origins of the antimonopoly impulse (Thorelli, 1955: 143–47; Neale and Goyder, 1980: 14–19; Seager and Gulick, 1929, 341–49). [4] However, lack of enforcement as well as lack of funding for the government agency to pursue

[4] For antitrust bills introduced before 1890, see U.S. House of Representatives (1914) and Thorelli (1955, 169–76). Fourteen states, mostly in rural areas, had constitutional provisions against monopoly, and six of these (Kentucky, North Carolina, North Dakota, South Dakota, Tennessee and Texas) also had antitrust statutes that predated the Sherman Act. Northeastern states generally did not pass such laws until after 1890.

antitrust claims meant that important cases were ignored (Sanders, 1999: 272). A decision by the Supreme Court in 1895 considerably weakened the act by finding that it did not apply to the American Sugar Refining Company's near-total monopoly of U.S. sugar manufacture because the contracts by which the trust was assembled concerned only production and not interstate commerce (Letwin, 1895).[5]

Despite overtures to organized labour unions by farmers' groups, labour 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 (Thorelli, 1955: 157; Mowry, 1958: 78).

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 (Chandler, 1977). Banks implemented these changes, which contributed to their control over many railroads and industrials via voting trusts or board representations (De Long, 1991; Simon, 1998). 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 spokesmen for the National Grain Growers Alliance and the National Farmers' Alliance and Industrial Union.[6]

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

[5] The case was U.S. v. E. C. Knight, 156 U.S. I (1895).

[6] See Chicago Conference on Trusts (1900, 202–18). The tendency of railroads, especially after 1900, to build up a few favoured enterprises at the expense of others is described in Ripley (1981, 185–92).

institutions and 68 non-financial corporations. Together, these five banks controlled industrial assets (on behalf of others), representing 56 per cent of the country's GNP (Simon, 1998).

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. Between 1900 and 1910, the total estimated value of farm land and buildings in the United States more than doubled, while the index of wholesale prices for all farm products rose approximately 50 per cent (Carosso, 1970: 163). Many farmers paid off their debts and accumulated cash savings. This 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. The problem was particularly acute in the West, where questionable mining and oil stocks were aggressively marketed to the public. 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.

The Kansas state legislature rejected the old caveat "let the buyer beware" and instead, designated a commission to certify the soundness of all securities sold in the state. In addition to requiring full disclosure, licenses, and monthly reports from brokers, the commission was empowered to determine whether the security seeking a permit "promises a fair return". Initially, the standards set by the commission were so high that less than 100 out of 1,500 applicants were granted permission to sell their securities in Kansas in the first year. Three-fourths of the applications were rejected as fraudulent propositions and another 12.5 per cent were declared to be too risky (Cowing, 1965: 67–68).

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 (Carosso, 1970: 164).

Arizona, Louisiana and South Carolina enacted similar laws in 1912; 20 other states followed in 1913. Generally speaking, the former Populist strongholds acted more swiftly and were more inclined to imitate the severity of Kansas. In Arizona and Idaho, where fraudulent mining stocks were abundant, penalties were especially harsh (Governors' Conference Proceedings, 1911: 245–47; Sykstra, 1913; Reed and Washburn, 1921).

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 (Cowing, 1965: 69). The East did not pass any general security laws until after World War I, and those that they did ultimately enact were much weaker than the Western blue sky statutes (*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" was wide-ranging, delving into nefarious dealings on the New York Stock Exchange as well as the manipulative, anticompetitive practices of New York's largest banks. The investigation revealed the structure of the financial and industrial empire controlled by the directors of a half dozen New York and Boston banks, principally, J. P. Morgan, John D. Rockefeller, and George F. Baker (Willis, 1975: 90–115; Sheldon, 1983).

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 argued for "such additional legislation as may be necessary to make it impossible for a private monopoly to exist in the United States". The platform specifically 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" (Johnson and Porter, 1973: 169).[7]

[7] On Bryan's authorship, see Coletta (1964–69, 2: 62).

Brandeis (1914) echoed these ideas in his book, *Other People's Money and How Bankers Use It*. His impact was enormous both because he became a leading Supreme Court Justice, and because New Deal reformers such as Ferdinand Pecora and Adolpe Berle openly espoused Brandeis's ideas. He argued that banks controlling 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 are so onerous that interlocking directorates should be forbidden (Brandeis, 1914: 33).

Brandeis also challenged the premise that banker control is the most efficient form of economic organization. He argued that a banker-director can force management to take actions that are detrimental to minority shareholders. This point was illustrated with the case of the New Haven railroad, a Morgan-controlled firm. It was blamed for several serious accidents that occurred between 1911 and 1913 (Chernow, 1990: 174–81); it had also recently skipped dividends and was under severe financial pressure. Brandeis (1914: 90–91) argued that the New Haven was driven to such a state by the bank, which saddled the firm with a huge debt and extracted large underwriting fees:

> Was there ever a more be-bankered railroad than the New Haven? […] Six years before the fall of that great system, the hidden dangers were pointed out to those banker-experts. Proof was furnished of the rotting timbers. The bankers took no action. […] Of the New Haven stockholders 10,222 were of such modest means that their holdings were from one to ten shares only. The investors were sorely in need of protection. […] But who, connected with those New England and New York banking houses (with stock in the railroad) […] raised their voice or pen against the continuous mismanagement of that great trust property or warned the public of the impending disaster?

Brandeis urged for the government to ban interlocking directorates, that banks should not be on the board of directors of any industrial firm, and that there should more stringent disclosure rules about bankers' activities and fees.

In early 1913, the Pujo Committee recommended a range of legislation to diminish elite domination of the financial system. [8] 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 antitrust advocates struck a deal to appease their pro-labour colleagues who did not see any particular advantage in anti-trust laws (Sanders, 1999: 287–97). 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 Glass-Steagall Act of 1933, 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 and big business and financial institutions (particularly investment bankers). Labour did not figure prominently in these debates for five reasons: (1) few non-agricultural workers belonged to trade unions, making labour weak politically (Bureau of Labor Statistics, 1976); (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

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

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 labour'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 (Sanders, 1999).

Pecora Commission Hearings

The Pecora Hearings began exactly one year prior to FDR's swearing in as President on 4 March 1933. As a result of public anger that had been building up with the committee's revelations, FDR was able to sign into law both the 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. When his party bungled the farm problem during the 1920s, he, as United States senator, became a spokesman of popular rebellion against existing economic conditions (Fite, 1948). 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. 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.[9]

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[9] *Congressional Record,* 73 Cong., 1 Sess., May 11, 1933, pp. 3223–33.

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" (Flynn, 1934: 149–50).

Norbeck pressed for an investigation into Samuel Insull and his utilities empire. Many of his constituents 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. For three days, Pecora questioned witnesses on the many operating firms, holding companies, and super-holding companies that Insull had created, and the methods that Halsey, Stuart & Co., an investment banking firm, had employed in selling the securities of these corporations (Carrosso, 1970: 328). Under Pecora's intense scrutiny, Stuart the head of Halsey 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 (Burk, 1985: 1023).

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. It was also learnt that National City Co. engaged in various other ethically dubious activities such as speculating on the stock exchange and participating in pool operations (Carrosso, 1970: 330–2). 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 (Burns, 1974: 78).

Pecora then turned his attention to the private bankers, whose sins he regarded as being of a more subtle nature. 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 by 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 per cent 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 (1933) 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". To Pecora, the "Money Trust" seemed just as entrenched as it had been in Pujo's day.[10]

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 their own profits (Carrosso, 1970: 340). The most disturbing revelations concerning the House of Morgan arose out its role in launching three great holding companies, all organized in 1929: the United Corporation, a super-holding company in the electric power industry; the Alleghany Corporation, which brought under its control various railroad properties; and Standard Brands, Inc., a merger of four large food companies (Pecora, 1939; McDonald, 1962: 249–50). Each of these transactions involved issuing a large amount of common stock, a type of security Morgan had never offered before. The firm arranged to offer them privately, at cost, to a select list of customers —people "whom we know", George Whitney, a Morgan partner, testified.[11] To Pecora, a majority of the subcommittee and the public, the lists appeared to be a form of polite bribery, a way of providing certain favoured individuals and banking firms with a convenient way to make some money without much risk.

[10] Stock Exchange Practices: Hearings, 73d Cong., pt. 2, 904–07, 940–42. See also U.S. v. Henry S. Morgan et al., "Plaintiff's Exhibit No. 112" (9 November 1948), pp. 266–70.

[11] Stock Exchange Practices: Hearings, ibid., p. 401.

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 “the spirit of speculation should be eradicated from the management of commercial banks”. Aldrich noted 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” (Aldrich, 1933: 6–7). This statement helped to break the political resistance to the separation of commercial and investment banking activities, as proposed in the Glass-Steagall Act.

Glass-Steagall Act of 1933

Norbeck, as head of the Senate Committee on Banking and Currency, turned the drafting of new banking legislation over to Senator Glass, who in 1931 headed a five-man committee responsible for investigating the operation of the national banking system. The two leaders were in substantial agreement that the misuse of credit must be prevented, that commercial and investment banking should be separated, and that a more efficient system of bank receiverships should be developed. But they disagreed sharply over the extension of branch, group, and chain banking. Siding with his Eastern colleagues, Glass favoured greater development of centralized banking; reflecting the views of his rural counterparts, Norbeck argued that the control of credit by a few was dangerous (Fite, 1948: 171).

In his speech accepting his party’s nomination, Franklin Roosevelt supported radical reforms to the nation’s banks. Later in the campaign, in an address delivered at Columbus, Ohio, he reasserted his support of those planks directly pertaining to banking when, in enumerating needed reforms, he advocated the following: “Investment banking is a legitimate business. Commercial banking is another wholly separate and distinct business. Their consolidation and mingling are contrary to public policy. I propose their separation” (Rosenman, 1969: 682–83).

Congress’s decision to separate investment banking from commercial banking was strengthened and made easier by Pecora’s disclosure of the National City Co.’s affairs and Winthrop Aldrich’s statement, in March 1933. This step followed closely upon similar steps taken by the National City Bank under the leadership of its new president, James Perkins. The

action taken by these two banks did much to undermine the resistance of the banking community to the divorcement of security affiliates (Burns, 1974: 85; Sisson, 1933: 253–55).

With a popular mandate to reform the financial system upon winning the presidential election (with 57 per cent of the popular vote and carrying all but six states), FDR signed the Glass-Steagall Act into law on 6 June 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 (White, 1986; Benston, 1990; Kroszner and Rajan, 1994).

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.[12] 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 interestate commerce (Carosso, 1970: 356).

As a young Florida liberal in 1892, Fletcher took his seat in the state legislature from Duval County, in the northeastern corner of the state. Presaging the advent of the Populist Party, the Ocala convention of the Farmers' Alliance in 1890 had called for means to get credit to the hard-pressed farmers and to halt the speculative trading in commodity futures (Proctor, 1950: 161). The cotton economy of northern Florida differed in no respect from that of neighbouring Southern states, and membership in the Farmers' Alliance, which militantly opposed the financial domination of agriculture, composed nearly half the voting population of Florida (Knauss, 1926: 304). Although not a member of the Alliance, Fletcher sympathized with and backed their views on commodity speculation.

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

[12] *Congressional Record*, 73 Cong., 1 Sess., LXXVII, Part I, pp. 1019–20.

attempted, unsuccessfully some years before, to introduce legislation regulating the securities issues of railroads through the Interstate Commerce Commission.

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" (De Bedts, 1964: 38–39). 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."[13] 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 passed both chambers by wide margins: the Senate voted 62 to 18 in favour of the bill and it was passed by a voice vote in the House.

Securities Exchange Act of 1934

With the furore 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 (Loss, 1961; March 1933, 514–15). 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 9 February 1934, asking for legislation regulating the exchanges and eliminating "so far as it may be possible … unnecessary, unwise and destructive speculation".[14] The bills contained stringent prohibitions against manipulation of prices, segregated the functions of broker, specialist, and dealer, provided for 40-per cent-margin requirements, and referred to the Federal Trade Commission as the administrating agency.

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[13] *Congressional Record*, LXXVII, Part IV, 3801.

[14] Rosenman (1970, Vol. III, 91); U.S. Senate, Committee on Banking and Currency, 73d Cong., 2d Sess., Federal Securities Exchange Act of 1934: Report … (Washington, 1934), pp. 1–11.

Opposition to the bill was intense. Corporate executives and stock exchange officials raised the greatest outcry. The former disapproved of the registration and listing requirements (see the end of the subsection for details); 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” quite 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.[15]

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 (De Bedts, 1964: 72). The campaign carried on by financial and industrial leaders seemed to have 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 favoured regulation tended to discount the need for stringent measures (De Bedts, 1964: 70). More and more emphasis in the financial journals advocated the creation of a new agency to take over the problem of stock exchange regulation.[16] Cynical views suggested that such an agency would be more sensitive to, and easily influenced by, Wall Street interests than one administered by the Federal Trade Commission (De Bedts, 1964: 56–77).

On March 26, 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

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[15] Schlesinger (1958, 457–60); Sobel (1965, 298–300). See also “Stock Exchange: ‘Kill the Bill’ Becomes Rallying Cry” *Newsweek*, III (7 April 1934), pp. 29–30.

[16] *Business Week*, 17 March 1934, p. 33.

minimum requirements. I do not see how any of us can afford to have it weakened in any shape, manner or form."[17]

As enacted on 6 June 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 (Carosso, 1970: 379).

Certain manipulative devices of the stock exchanges were prohibited, such as wash sales and matched orders, both of which had been commonly used to give false pictures of stock activity. Effective measures were taken to prohibit planted stock tips, even though the information might prove true, if they originated with brokers, dealers, or stock exchange employees. False and 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 per cent of any class of a corporation's stock was required to file a report of his holdings, plus monthly reports reflecting any changes that took place. Any profit made by selling the stock of one's own company within six months of the purchase date reverted to the company itself, and any stockholder might bring suit to recover such profit for the company. All directors, officers, and major stockholders were expressly forbidden to sell short the stock of their own company.[18] Prevention of abuses of one's official position were fondly termed by the Pecora staff as "anti-Wiggin" provisions, to commemorate the exploits of the Chase National Bank's former president (Pecora, 1939: 268–9).

Furnishing misleading information through deceptive balance sheets was stopped by requiring certified periodical audits for any corporation listing its securities on a national exchange, with discretionary power over the form and details of such reports vested in the new commission. Stock watering became impossible under the strict accounting standards required by

[17] Rosenman (1970, Vol. III, 170).

[18] U.S. Statutes at Large, XLVIII, Part I, 881 ff.

the act; and additional explanatory details were to be furnished if deemed by the Commission to be in the public interest.[19] Administration and enforcement of the 1934 Securities Exchange Act as well as the 1933 Securities Act were brought under the jurisdiction of the newly created Securities and Exchange Commission.

Public Utilities Holding Company Act of 1935

While the SEC Act of 1934 faced fierce opposition, the PUHC Act is generally regarded as one of the most bitterly contested pieces of New Deal legislation (De Bedts, 1964; Funigiello, 1968; Krikun, 1971). 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 (Buchanan, 1936). 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 23 holding companies existed in the industry; in the following decade, another 46 were created (Clemens, 1950: 491). 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 45 per cent 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 per cent of the generating power within the United States (McDonald, 1962: 245–92).

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 (Krikun, 1971: 45). Utility economists likewise argued that state commission regulations proved increasingly inadequate when confronting these abuses.

[19] U.S. Statutes at Large, XLVIII, Part I, 881 ff.

As a newly elected governor of New York in 1928, FDR quickly identified himself with this critique of utilities and commission regulations, and rapidly became one of its leading spokesmen. 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 (Bellush, 1955: 208–68).

The collapse of the Insull empire in April 1932 was one of the largest corporate failures in American business history at the time. Not only did Insull lose a fortune estimated between 100 million and 150 million 1932 US Dollars (between 1.4 billion and 2.2 billion 2010 US Dollars) but all the investments of thousands of stockholders, many of whom had responded to Insull's incessant customer-ownership campaigns. Estimated losses amounted to 700 million dollars (about 10.3 billion 2010 dollars). 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 (Wasik, 2006). 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. At its height, it consisted of five major properties: Middle West Utilities (111 subsidiaries), People's Gas Light and Coke Company (8 subsidiaries), Commonwealth Edison Company (6 subsidiaries), Public Service Company of Northern Illinois (1 subsidiary), and Midland United Company (30 subsidiaries). The empire spread over 32 states, served over 4.5 million people, and contained assets of more than 2.5 billion dollars (McDonald, 1962: 75–304).

When Insull collapsed, 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."[20]

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 host of illicit activities profitable to top holding companies rather than their subsidiaries (Ripley, 1926). 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."[21]

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 (Krikun, 1971: 95).

A bill was introduced simultaneously on 6 February 1935 in the House and Senate.[22] It proposed the gradual extinction of holding companies with its (in)famous "death sentence" clause. According to Corcoran, who worked for the Reconstruction Finance Corporation (which made loans to banks, railroads, and other businesses as well as state and local governments), prior to joining FDR's administration, the concentration of economic power and wealth was the "outstanding problem facing the continuation of a democratic form of Government and a democratic form of economic organization in this country".[23] Many southern congressmen joined in support of the bill as their constituents stood to benefit from the improvements and lower

[20] Federal Trade Commission. (1935). Summary Report, 63.

[21] Quoted in Loss (1961, Vol. I, 389).

[22] H.R. 5423 and S. 1725 (Congressional Record, 74 Cong., 1 Sess., 1935, LXXIX, Part II, 1624, 1513).

[23] U.S. Congress, Senate. Hearing Before the Committee on Interstate Commerce, pursuant to S. 1725: To Provide for the Control and Elimination of Public Utility Holding Companies operating, or marketing Securities, in Interstate and foreign Commerce and Through the Mails, To Regulate the Transmission and Sale of Electric Energy in interstate Commerce, To Amend the Federal Power Act, and For other Purposes (74th Cong., 1st Sess.), p. 179.

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 U.S. Congress approving the national Democratic administration's assault on the public utilities holding companies. Control of these giants, the Texans said, had become impossible, "and under Republican rule little or nothing was being done".[24]

When introducing the bill in the Senate, Wheeler bluntly stated that it was "intended to whittle down and eventually eliminate the public utilities holding companies." He went on to espouse "a Federal tax on bigness, i.e. a tax on corporations based on their size"[25], which would become a core feature of the Revenue Act of 1935.

Three days after the public utility holding company bill was introduced, the New York Stock Exchange released a statement that it had leased a large residence at 2416 Tracy Place, Washington D.C., for maintaining close contact with the nation's capitol. Queried as to its reasons, Exchange officials cryptically replied, "Economy, and freedom from interruptions."[26] However, the "Wall Street Embassy", as the large two-story brick mansion came to be known, represented a viewpoint and influence parallel yet definitely subordinate to the enormous resources of the nation's public utilities companies (De Bedts, 1964: 124).

The major opposition to the bill in the Senate was led by Daniel Hastings, Republican of Delaware, and William Dietrich, Democrat of Illinois (Krikun, 1971: 152). 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 (Krikun, 1971: 117–8). 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".[27]

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[24] *Congressional Record*, LXXIX, Part III, p. 3324.

[25] *Congressional Record*, LXXIX, Part II, p. 1525.

[26] *New York Times*, 9 February 1935.

[27] *Forbes*, 1 March 1935, p. 7; 1 May 1935, p. 8.

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 group of telegrams to the President from Columbus, Ohio denounced the bill as "unamerican" and a "step toward" communism.[28]

After one of the most bitter legislative battles the capitol had seen in decades, the bill was signed into law on 26 August 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" (Loss, 1961, Vol. I, 135). 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 the act's provisions with respect to reporting, proxies, insider trading, accounting standards, and many other matters made it the most regulatory of all federal securities laws and gave the SEC sweeping new regulatory powers (Loss, 1961). 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 19 June 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" (Blakey and Blakey, 1935). 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; graduated taxes on corporation incomes; heavier surtaxes on large individual incomes; inheritance and gift taxes,

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

earmarked for national debt reduction, in addition to existing estate and gift taxes; and the submission of a constitutional amendment authorizing the general taxation of income from federal, state and local government securities. The latter two were not included in the final version of the bill.

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 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.[29]

Those opposed to the bill—corporate executives and Wall Streeters—claimed that it was a “soak-the-rich” program and based upon "social control" fantasies (Blakey and Blakey, 1935). The House rejected the initial proposal for an intercorporate dividends tax rate of 15 per cent of the regular rate, and settled on a compromise rate of 10 per cent. However, Blakey and Blakey (1936) record that the 15 per cent figure was implemented in 1936.

Blakey and Blakey (1935) summarize the Roosevelt administration’s taxation objectives in 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, consciousless holding companies.” That this accurately reflected the view from the White House is also clear. Roosevelt (1942) 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 …” Roosevelt (1942) clarifies his views:

> 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*. (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 30 August 1935, four days after the PUHC Act.

[29] Senate Finance Committee Hearings, pp. 223–224.

Quantitative Analysis

Table 1 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. To assess regionally specific voting patterns, and whether they correspond to the Hatch Bill of 1893, the votes are listed according to Cowing's (1965) sectional categories. 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 centred in the Mid-Atlantic and Northern New England sections. Lawmakers from the remaining section generally supported the bills, with those representing the Anti-Speculator (Great Plains) states exhibiting the strongest support. Aside from the Senate's slim majority favouring the PUHC Act in the South, the legislators from the South and 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. Levels of support for the three bills also reflects the importance of agriculture to each section, but are these patterns robust when considering the influence of party identification?

Cross-country analysis (Roe, 2003) and work on American politics (Cox and McCubbins, 1993) suggest that partisanship (or party affiliation in the United States.) matters most. The following statistical tests will demonstrate that farmers were nevertheless critical to passage of these bills. For the tests conducted here, the dependent variable is the legislator's "yes" 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.[30] Workers' influence is measured by the proportion of a state's total

[30] Data for the value of farm production are from the *Yearbook of Agriculture 1931*: Gross income of crops and livestock combined, 1929, p. 977. This value is then divided by total state income; data for state income is from *State Personal Income: 1929–1987*, US Department of Commerce.

population that works in the manufacturing sector.[31] Owners of capital (business owners and financial institutions) are seen as having greater influence (and importance to a state's economy) relative to workers (and farmers), 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.[32] Congressional members are also identified as Democrat or Republican, a common identifier for voting patterns on financial legislation. Table 2 presents the results from probit estimations for the House and the 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 manufacturing population and the importance of capital. However, only the agriculture variable displays a consistently robust correlation in the presence of the Democratic Party identification variable, suggesting that it may account for those Republicans who voted for the acts. And recall that Democrats derived much, if not most, of their support from agricultural areas.

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 their Republican colleagues, though 24 Republicans did vote in favour, 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.

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[31] Data measuring states' manufacturing population are drawn from the *US 15th Census, 1930*; state population data are from the same source. The 16th Census corresponds to 1940, so the 15th Census provides more accurate measures for these variables.

[32] Data on Capital's Value Added by Manufacture comes from the 15th Census of the US: Manufactures, Reports by States (1930). Wages data are from the same source.

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 production	0.03*** (6.77)			0.01** (1.88)	0.02*** (2.72)			0.03** (2.19)
Capital value added		-0.03*** (-4.63)		-0.009 (-0.89)		-0.01 (-1.04)		0.03 (1.46)
Manufacturing population proportion			-0.12*** (-7.64)	-0.02 (-0.61)			-0.08*** (-2.88)	-0.1 (-0.27)
Democrat				1.6*** (9.44)				0.97*** (2.92)
Pseudo-R^2	0.09	0.039	0.11	0.29	0.07	0	0.07	0.16
N	428	428	428	427	94	94	94	94
Log-Likelihood	-250.23	-266.34	-244.85	-194.43	-57.2	-60.97	-57.16	-51.13
	Panel B. DV: "Yes" vote for the PUHC Act, 1935							
	House				Senate			
Value of farm production	0.03*** (5.44)			0.028*** (2.61)	0.02*** (2.83)			0.02 (1.43)
Capital value added		-0.028*** (-3.83)		0.05 (1.5)		-0.039*** (-2.74)		-0.02 (-0.89)
Manufacturing population proportion			-0.098*** (-5.83)	-0.02** (-2.01)			-0.09*** (-3.31)	-0.012 (-0.24)
Democrat				1.8*** (10.47)				0.86** (2.44)
Pseudo-R^2	0.07	0.03	0.07	0.34	0.075	0.06	0.094	0.15
N	425	425	425	424	92	92	92	92
Log-Likelihood	-221.24	-231.28	-219.91	-157.12	-57.68	-58.45	-56.46	-52.84

	Panel C. DV: "Yes" vote for the Revenue Act, 1935							
	House				Senate			
Value of farm production	0.02*** (4.74)			0.01 (1.25)	0.024*** (2.81)			0.02** (2.0)
Capital value added		-0.02*** (-3.51)		-0.008 (-0.88)		-0.02 (-1.46)		0.02 (1.06)
Manufacturing population proportion			-0.08*** (-5.61)	-0.008 (-0.27)			-0.1*** (-3.35)	-0.04 (-0.8)
Democrat				1.4*** (9.01)				1.1*** (3.0)
Pseudo-R^2	0.04	0.02	0.06	0.22	0.072	0.01	0.095	0.18
N	426	426	426	425	94	94	94	94
Log-Likelihood	-262.43	-268.29	-257.84	-213.55	-58.85	-62.35	-57.35	-51.75

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

Z-statistics are shown in parentheses.

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 favour and appear to have done so in line with the importance of agriculture to their home state. Senate voting occurred primarily along party lines so it is not clear how important agriculture was. The same can be said for the passage of the Revenue Act in the House. 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 (eight Republicans voted "yes") since the agriculture variable again displays statistically significant results at the five per cent level.

Overall, the Senate votes were much closer than those in the House. Indeed, two of the acts would not have been passed without some Republican support. Close investigation of the voting record reveals that a core group of eight Republican Senators voted in favour of each of these acts, making their support particularly critical to the establishment of modern securities

regulations. Table 3 lists these Senators and their backgrounds; it is clear that farming is a common link.

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 to 1933.
Frazier, L. J. 1874–1947	North Dakota 1922–1940	Son of farmers. Frazier was an early supporter of the Non-Partisan League, a farmers' organization founded in North Dakota. The league's programme promised farmers freedom from the exactions of railroads, bankers, millers and other middlemen.
Johnson, H. W.	California 1916–1945	Son of a politician. As governor, he approved regulation of railroads and other public utility corporations. He helped create the

1866–1945		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 programme, 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.

Sources: *American Political Leaders, 1789–1994* (1994); Garraty and Carnes (1999)

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.

CONCLUSIONS

Two clear conclusions stand out. One, 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 (Iversen and Soskice, 2009), but the findings in this paper point to the 1930s as the critical moment marking the origins of modern American finance capitalism.

A second conclusion is that farmers, rather than workers, were clearly responsible for modern American securities regulations. They should not be combined into a single "populist" 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 labour-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 labour-management relations. The second "hole" about the failure of pyramids to emerge is also consistent with distinguishing between politically powerful farmers and politically weak labour. In other countries where labour is strong (e.g. Austria and France), pyramids do exist. Left-wing parties (and their labour union counterparts) view them as useful for implementing labour-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 are illegal, and that the Securities and Exchange Commission was created.

North and Weingast (1989) 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. In the same way, farmers created more confidence in equities markets as a safe place for individual investors, and thereby contributed to its remarkable growth in the ensuing decades. Indeed, the core rules of the New York Stock Exchange have served as a template for other countries' exchanges and liberalizing financial reforms. 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.

By considering the importance of farmers to capitalist outcomes among today's wealthy economies, we can understand better the influence they have on developing countries. Indeed, many of today's developing countries are at a point in their development that resembles the process many wealthy countries went through at the beginning of the twentieth century. And in these countries, the agricultural workforce often comprises a large fraction of the population. Are these countries likely to comply sincerely with the standards advocated by the leading institutions with influence over the global financial system? This paper points to two key features: (1) strong democratic institutions; and (2) politically mobilized agricultural interests. Most developing countries lack the former, making the second irrelevant. However, India stands out as a possibility.

India's democratic institutions and decentralized federal political structure grants considerable power to local agricultural interests. Indeed, industrial development is heavily influenced by the political power that the rural sector wields (Varshney, 1998). This, in combination with the inheritance of legal and other institutions from its British colonial past, makes it strikingly similar to the United States. However, some important differences must be kept in mind; labour has a much stronger political tradition, and India has far greater cultural

heterogeneity. Nevertheless, does India possess the necessary ingredients to implement, and comply with, strong securities regulations? This is one question for future research. What about other developing, or middle-income, nations?

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