Regulating financial crises in the USA, the dialectic and beyond part A

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Abstract: Regulation against the next final crises is a tragic tale of regulatory missteps. Regulators are cowered by congressmen who are in the pockets of lobbies and vested interests. The Volker Rule that attempts to separate the high risk investments by the large banks from their commercial banking (the latter is FDIC insured) and the banks have lobbied to have their high risk investments protected by the FDIC funds. The Volker Rule simply attempted to prevent the banks high risk investments from enjoying a back stop using the public funded FDIC. Without Volker, the banks would engage in what is termed a ‘morale hazard’. Volker’s original simple one-page solution has been batter-down by congressional lobbies into a 100 pages plus list of ‘exceptions’ (read loop-holes).

Keywords: financial crises; regulation; dialectic; USA; Volker; FDIC; SEC; Dobb Frank.

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Prologue

Volker is not the only casualty of the congressional lobbies. The Dodd-Frank Act created the interagency Financial Stability Oversight Council (FSOC) preceded Volker and also forced the banks to separate their high risk investment banking from their federally insured high street banking. Congress in response to it’s ‘donors’ has refused to renew the Dobbs-Frank legislation.

It might be worth noting that many of the banks including Citi and Chase are now larger now that they were prior to the last banking crisis of 2002 that shook the entire world economic system.

The problem is two-fold: first, as before, banks are inter-locked with the indebtedness, and no-one could ascertain who was holding toxic assets (and therefore who were candidates for default and failure). As a consequence, interbank lending would dry up, causing a freeze in the liquidity markets.

Second, with such large banking entities, a contagion effect is likely. The banks are likely to go down like dominoes. The old doctrine that banks are ‘too big to ‘fail’ that was first muted when the 4th largest bank in the USA – Continental Illinois – was rescued by the government. There is now a new doctrine ‘Too Big to Save’. Many banks are larger in assets than the countries in which they are domicile.

Section 1

For those scholars who fail to heed the lessons of the past are destined to repeat the same mistakes again. For this reason we will visit some of the history of financial meltdowns, beginning with the ‘Big Bang’ in London’s financial district in 1988; this was preceded by New York’s Mayday’ some 13 years prior. These crises were without precedent in the history of capitalism.

The scale and scope differs significantly from past currents differing according to the names of felons and the places in which they occurred. Importantly, our collective experience is knowledge-reflected in our contemporary institutions, customs, and social practices. Of course, they are quite different from events in the past. Even though they served as examples in the past. There is always a temptation to view the present is unique and that the past is irrelevant to grasping the present and the future.

The assumed uniqueness of Mayday Big Bang and is understandable: as they arouse strong intellectual and emotions. Hence, many commentators on Mayday and the Big Bag
view these events as symbolic snapshots that astound us with their drama, affinity, and urgency.

Unfortunately, the exceptionality of current events often gives them a perseverance and precedence that may dominate and disguise all other aspects; especially with what they share with past events. The current deregulatory changes are connected to the past in both an obvious and a less obvious way. In its obvious way, the Big Bang and Mayday crises clearly is embedded in prior historical processes. Fundamentally, however, in the spirit of a Marxist analyses, these incidents may have been seen as return of earlier phenomena that are merely symptomatic of the antagonisms that underlying the capitalist system.

Section 2

Accordingly, the record of banking incidents US banking history will be presented here as integral to the evolution of corporate regulation in the USA. We stress the social antinomies and conflicts that animate this history, establishing themselves in periodic ‘contradictions’, ‘crises’, and ‘temporary resolutions’ [the ‘negation of negation’ as Adorno (1973) succinctly put it].

This dialectical view of history preserves both the uniqueness and the commonalties of phenomena like the Big Bang. Such events are unique because they represent much-needed ‘resolutions’ that a social system that has failed to acquire and retain from its previous history. In a dialectical perspective, such events (resolutions) have commonalties with the past because they represent a further outbreak (crisis) that threatens the reproducibility of the capitalist social system, emanating from the antagonisms (contradictions) between the growing socialisation of production (specifically, of banking and financial services) and their private appropriation. This is the repetitive tale that we find in the history of US financial regulation (Adorno, 1973; Adorno and Horkheimer, 1944).

Section 3

The medieval vestiges in American corporate law

Some 40 corporations were chartered prior to the Constitutional Convention in 1787. These entities bore little resemblance to those corporate entities found today. Colonial corporations inherited through English tradition and law, retained a distinctly feudal character. The corporation at that time was considered to be an extension of the state, and as such, was a public (as opposed to private) entity.

Colonial assemblies of chartered corporations were created for specific public purposes. The charter defined the terms of existence of the corporation: it specified the service to be performed by the corporation and granted, in exchange for the provision of this service, perpetual existence for the corporate collectivity, exclusive rights of trade in a particular area (for instance, the East India Company that was given the monopoly to plunder India’s spice and other sundry items, and the Hudson Bay Company that gave the company monopoly control over the animal pelts). The status of a legal personage for the corporation that enabled it to purchase and hold property, and sue or be sued collectively.
These were, as Senator Joseph O’Mahoney noted, privileges not rights. Corporations in the colonial era usually enjoyed monopoly privileges and, for this reason, authorities were reluctant to charter many entities. Accordingly, corporations were restricted to specific localities and lines of business (predominantly agriculture in the early years) and played an insignificant role in the UK economy.

After independence of the new USA, the restoration of commerce became a first priority of the new republic, and this called for economic and social projects that elevated the business corporation to a new status. Bridges, canals, banks and bridges and insurance services could not be financed directly by the states; they financially too fragile after the war of independence to support this. Thus, state authorities granted valuable monopoly privileges and rights of incorporation to encourage private investment in what were essentially public enterprises. Most important, the limited liability provision encouraged investment with little risk of lost beyond their initial investment. This latter became the problem of ‘morale hazard’ where some operators engaged in high-risk/high return adventures without suffering the cost of a default (currently bankrolled by the Federal Insurance Corporation. Bear Sterns was the poster boy of this operation that created hundreds of small investment entities that were covered by federal insurance. When Bear Stern’s collapsed under a wave of margin calls, the state was forced to pick up the pieces.

The original private bank was the Bank of North America in Philadelphia. It was awarded a national chartered under the Articles of Confederation by the Continental Congress in 1781; it was later re-chartered in 1782 in Pennsylvania because of uncertainties about the authority of the Continental Congress to issue a charter. The bank was run by Robert Morris who became a rich man during his tenure as the manager in control of the financial affairs of the government during the Revolutionary War. Alexander Hamilton’s Bank of New York was chartered in 1784, the same year as Massachusetts chartered the Bank of Massachusetts. From three state banks in 1984, the number grew to 87 by 1812, and 332 by 1831.

Section 4

In November 1790, Hamilton presented to congress a proposal to establish the first federally chartered first bank of the USA. This was the beginning of several notable cases where the US Government has sponsored its own corporations. The first and second banks of the USA were examples, as were the nationally chartered banks created by an Act of Congress in 1864. World War 1 that accelerated the expansion of government owned corporations, as did the Great Depression of the 1930s.

Hamilton contended that the federally chartered first bank of the US would enable the productive use of capital in the USA and serve as a means by which the government could raise financial support in times of emergency and provide facilities for the payment of taxes.

Hamilton’s First Bank of the USA was sanctioned by Congress and President Washington in 1792 with a 22 year charter, and $12M capital, four-fifths of which was contributed by private sources and the remainder was covered by the federal government.

When the charter of the first bank came up for renewal in 1811, it was opposed by private banks and by Jefferson. Jefferson opposed the renewal because they felt that the
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Bank would unduly concentrate power in the hands of a few who would support business interests in opposition to agricultural interests.

The private banks, strongly opposed the charter’s renewal for their commercial interests. They coveted the lucrative business of being the government’s banking agent; a post that might have fallen to them if the bank was not re-chartered. In addition, the first (like the second) bank served as a significant check on the issue of bank notes by private banks.

Private banks feared that re-chartering would lead to greater government regulation of their activities. Making loans to shareholders and managers/officers was common practice among these banks. Many had issued bills/notes that were traded at a discount. These banks were concerned that a re-chartered first bank might refuse to discount their notes. Their opposition to re-chartering prevailed, and the first bank was dissolved in 1811 – the first significant ‘deregulation’ in the USA. As a now par for the course, investors were repaid their initial stake and a profit.

Concerns about the influence of private banks were well-founded and in 1816, the second bank of the USA was chartered for a 21 year tenure, with a total capital of $30 M, four-fifths of which was contributed by a public offering and the remaining one-fifth subscribed by the federal government.

This second bank was authorised to certify whether bank notes issued by private banks were acceptable in payment of the government debts. In addition, it was authorised to control the money supply by making loans. The control of monetary development was the source of dispute between the regions: the West and the South favoured an inflationary monetary policy whilst the East preferred a ‘hard money’ policy.

The economic recovery was an important issue underlying the increase in new incorporations in the early years of the new country. In the last ten years of the 18th century, the number of corporations chartered increased from 36 to 335. 68 of these were involved in banking and insurance. As in the colonial era, the majority of incorporations were still devoted to the improvement of inland navigation (220 charters) and a small number of 9 charters were devoted to manufacturing. In the subsequent era, the number of manufacturing charters rose dramatically. In New York alone chartered 166 for manufacturing between 1809 and 1816.

As the number of corporations increased in the early 19th century, so the corporate form began to shed the remainder of its feudal vestiges and acquire a familiar form.

In the colonial period, the, distribution of privileges in the form of the assignment of monopoly control was used by colonial authorities to encourage the formation of corporations. These distributional perks were often boosted with loans and grants from state funds.

One clear advantage of the new corporate entity was that it protected investors by limiting their personal liability for the debts of the corporation up to the amount of capital that they had contributed.

Corporate liability had been ‘unlimited’ in the colonial era in-as-much as a creditor could recover his/her debts by attaching the personal wealth of the corporate shareholders. Such arrangements favoured those in the business of money-lenders and creditors, but deterred the creation of incorporating. Granting of limited liability status, with its attendant reduction of risk to investors was seen then, and now, as a distributional triumph for those engaged in the investing solicitation and accumulation of capital.
This also had ‘macro’ advantages to the capitalist economy at large. Increasing the amount of investment stimulates economic growth. With competitive market forces to induce production more with less (meaning shedding labour) this process ‘deferred’ the potential unrest that would result in unemployment. Of course, there is an inherent contradiction in this process; growth cannot sustain capitalist expansion indefinitely. Corporations must find new sources of ‘cheap’ off-shore labour to substitute for the more expensive labour at home (USA and Europe).

Section 5

New York State first granted limited liability in 1812; by 1850, most states assumed authority write limited liability. It was ten years later before such arrangements became universally available in England. After the introduction of limited liability, bank and manufacturing corporations multiplied, thereby weakening the image of the corporation as an object restricted to ‘public’ purposes, and encouraging the idea of the corporation as a ‘private’ enterprise, separate from public enterprises.

These differences were finally acknowledged as legitimate by the seminal decision by the US Supreme Court in 1919 in of the Dartmouth College case. It was decided that private corporations used their property primarily for the benefit of their shareholders in contrast to public corporations that served largely for public purposes.

Section 6

Jackson’s war on the second bank of the United States

The promotion of private interests over public interests – signified the rise of the corporate form – was attracted a significant amount of criticism and political scrutiny. At the time of Andrew Jackson’s presidency, anti-corporate feeling had reach fever pitch; this focused on the charter of the second bank of the USA.

In 1832, the Bank’s president, caved in to pressure from opponents of Jackson and petitioned to have the bank re-chartered for four years before the charter’s expiry. Re-chartering became an election issue in 1832. Jackson was re-elected in 1832 and in 1833. He banned the Act extending the charter of the bank in 1832 with the argument that it that concentrated power ‘in the hands of a few men irresponsible to the people’. Jackson objected to, “laws [that] undertake to add to … natural and just advantages [an] artificial distinctions… to make the rich richer.”

Jackson’ did not oppose the corporate form per se, but against the monopoly rights that were conveyed by a special charter. There was a basic fear of monopoly power that according to Justice Brandeis,

“[T]he fear of domination…more generally, the fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear that the absorption of capital by corporations, and their perpetual life …. There was a sense of some insidious menace inherent in large aggregations of capital.”

In the process of closing down the second bank of the USA, Jackson withdrew government deposits from the bank, and redistributed them among a select few state
banks. This provided the state banks with funds to make loans that exploded into a speculative frenzy, particularly in the acquisition of land in Florida. Some of this land was ten feet under water; but this did not deter the speculators who were only interested in the explosive growth in value of their holding. As with all speculative bubbles, the bubble eventually bursts, which usually results in panic selling. The Florida bubble burst in the latter part of 1833. A financial crisis followed, and the Treasury suffered substantial losses. In consequence, congress created an ‘Independent Treasury’ system, where government funds were placed in ‘strong’ banks, and payments of government debt were made in cash.

Jackson policies were not aimed at destroying the corporate form in particular, but he aimed to secure the advantages and privileges that would be enjoyed more widely available. Accordingly, in the Jacksonian era, several states withdrew the authority of their legislatures to invest in corporations by special charters as the purpose of incorporation could be achieved by general laws.

In consequence, the monopolistic advantages attached to a special charter could not be attained by an influential lobby in a state legislature. As a result, incorporation was automatically available to those who met the minimum requirements as specified in the general laws.

Section 7

It was in the Jackson era that the Supreme Court began to curtail the implications of the Dartmouth College case. Dartmouth College was the first major step in liberating the corporate form from government regulation; the Charles River Bridge case, in 1837, severely restricted the freedoms won in Dartmouth College by insisting that monopolistic advantages could never be conferred by charter, even by implication, and even if, without such advantages, the charter would be worthless. Such advantages were, it was declared, the sole prerogative of the state and to relinquish them to corporate entities would be to abdicate its primary function.

The Jacksonian curtailment of privileges enjoyed by charters was hand in glove with the wave of democratisation. The admittance to such privileges echoed the liberal business philosophy that was on the rise in this epoch. The period between 1831 and 1862 was an era of growing business activity. The USA was a leader in the production of military hardware equipment, textiles were totally mechanised by 1860s, and smelting, iron production and coal and steam power were in general use. Railroads assumed the major mode of transport. Factories were retooled for producing sewing machines, tin, clocks, and glass products, and by the end of the 1860, there was a record number of incorporations.

Incorporation in the Jackson period still retained a number of limitations. The size of corporations was caped. There were some states that were authorised to issue capital for a corporation in excess of $1 million. The amount of indebtedness that could be assumed was curtailed and cross-investments in other corporations were banned. There were also limits on the scale of the power of corporations. In addition, there were restrictions on the types of business that an entity could enter. Charters were not perpetual, but were typically awarded for a limited period up to 50 years. Furthermore, states also limited
corporations by prohibiting them from owning property or doing business outside the state of their incorporation.

Liberal democrats emboldened shareholder position over the directors, managers and directors. Shareholder meeting became a place for important decisions. This extended to changes in share capital, by-laws and asset structure. These issues were discussed and debated and required unanimous approval. Directors were elected by votes and could be ejected by a vote of the majority. Meetings were held on an annual basis.

Jacksonian policies expanded in a particular period of US history. This was a time when the US economy was ruled by small business entities that were confined to particular territories. Sales and the distribution – of mineral and farming products were controlled by agents who handled different kinds of products from other producers.

Section 8

Michigan, in 1837, ratified the first free banking chartering law. This was copied in the next year by Georgia and New York. There was a considerable difference between the chartering laws instigated by states. There laws permitted anyone to create a bank charter provided that minimum conditions to equity capital contribution and the securing notes were met. Also, the deposit of a specified amount of bonds had to be deposited with a state’s agent so that the state could sell the bonds if the notes/bills were if the bank dishonoured its bills/notes.

In this free banking era, the ‘wildcat banks’ emerged. They earned this epithet because they registered in so called ‘wildcat’ territory – that made it hard if not possible for bondholders to redeem their notes. These wild-cat banks attracted a great amount of infamy because many of these wildcat banks would issue notes and then shut-up for business before the bills/notes could be redeemed.

Banking collapses were frequent in the free banking period, however the incidence of failure varied from state to state because the major differences in state regulations. State insurance plans for banknotes and deposits emerged during the free banking era, beginning in 1929 with New York. Sometimes deposit and bill/note guarantee schemes were run by state governments, in other cases, they were supported by a mutual agreement of several banks.

Section 9

The national banking system

1832 was the year that Colt completed the six-shooter. Morse devised the first telegraph that worked. For ten years, he struggled to secure backing from New York businessmen to develop his invention; however, it was dismissed as a mere a curiosity. In 1842, Morse finally raised enough funds to link Governor’s Island and the Battery in New York; Two years later he connected Baltimore and Washington. Morse’s telegraph abolished the requirement for geographically dispersed stock auctions. Philadelphia eventually conceded the field to New York in 1860,
Western Union connected New York to every major American city, making Wall Street the nation’s premier financial centre. Newspapers throughout the country started carrying financial information and stock prices.

In 1869, Wall Street itself was also transformed by the inception of introduction of the ticker tape. In 1878, telephones began to appear eight and this aided the improvement of market transactions. At this moment there established a single effective national market for transacting securities, thus in place was now a facility for a broad public participation in market trading.

Section 10

Dealing with the problem of state banks and wildcats

By 1860, the banking sector included over 1,600 state banks. They had already acquired a poor reputation for trust and reliability. This was accentuated by the activities of the wildcat banks. In 1864, congress passed legislation to establish a system of National Banks. The federal authorities started to charter national banks that were subject to minimum capital reserve requirements, a percentage of was to hold in US Treasury bonds. This served as security for the bills/notes that were in possession of these banks – this decision had the benefit of increasing the market for government bonds and thus assisted in funding the Civil War.

The National Banking System established the first real system of federal bank regulation. It provided the US with a common currency; it created the office of controller of the currency with the task of administering the law, supervising and investigating existing banks, and screening proposals for new ones. The 1863 Banking Act imposed limits on the size and type of loans that national banks could assume. It also installed a system of minimum reserve requirements. Most important, bill or note holders were protected because national banks were required to deposit with the US Treasury a specified amount of government bonds that could be realised to pay off noteholders if the bank defaulted when notes were presented for payment.

State banks were slower to register charters as the national banks. In 1865, congress introduced a tax on the bills/notes issued by state banks. This tax resulted in a surge of applications by state banks for registration as national banks. By 1863, the number of state banks and national banks was 1,410 and 468 respectively; by 1870, there were 1,609 national banks and only 326 non-national banks.

These developments resulted in an expansion of public share ownership that helped finance the Civil War. Lincoln’s Secretary of the Treasury, Salmon Chase had problems raising the cash needed to finance the war was having difficulty raising funds to conduct the war. He turned to his brother-in-law, Jay Cooke who ran the investment house of Jay Cooke. Cooke agreed to sell a $500 M of 6% government bonds, redeemable after five years and that otherwise matured in 20 years. They were termed, the ‘five and twenties’.

To sell the bonds, Cooke innovated the first door to door selling syndicate that included a array of star banking interests. Together they recruited a sales force of 2,600 that travelled to every town and village in the country nation. This was backed by a national publicity campaign that deployed posters, handbills and adverts. They talked up the need for patriotism and self-interest.
Thousands of Americans acquired the securities as a consequence of Cooke’s campaign, however interest in the bonds quickly diminished after the war. Cooke’s firm was one of the gold brick actors to fail in the panic of 1873. This was the first collapse of individual investing. But the practice had now been established as the mass mobilisation of vast pools of individual investor capital. By 1894, there were now a projected 1.26 M individual investors, by 1901, the number had reached 4.5 M and by 1911, there were 7.5 M.

Section 11

Economic consolidation and the emergence of the trusts

The American civil war ended the Jacksonian era of atomistic commodity production. The US economy underwent a major revolution after the civil war. In 1868, the transcontinental rail line was completed in Utah. In the subsequent years, some 20% of all new capital formation was invested in rail transportation through the Mid-Atlantic states and the North Central states, across the Great Plains, and ultimately into the South.

The expansion of the railroads was at a cost. It destroyed the lands of indigenous native Indian communities and embarked on the ex-appropriation of their lands for agricultural and mining production.

The railroads succeeded in expanding markets for the agricultural economy and increased the accelerated the growth of existing commercial centres such as New York, St. Louis, and Philadelphia. It also installed new metropolises such as Dallas, Atlanta, Kansas, Chicago, and Minneapolis. The percentage of these urban populations increased from 11% to 28% during the 11 ears ended 1881; by 1992, it had reached 42%.

The new urban centres presented market opportunities in terms of scale, and completely new products. With the new and growing national transportation system, producers were not locked in to a specific region or locality or region. They now had access to the national market. The appeal of a national market led to the growth of monopolies. Costs and risks could be obviated by eliminating wasteful advertising and competition. As a result, this increased the ability to raise new capital.

Section 12

The first to exploit this new monopolistic power were the Eastern railroad companies. These schemes were subsequently deployed by the infamous John D. Rockefeller. They used discriminatory pricing s (and refusals to haul) to take t control over anthracite and bituminous coal, boilers, matches, candles, furnaces, kerosene, and water heaters. Monopolistic practices were not limited to the railroad operators: ‘gentleman’s agreements’ (‘pools’) as to price and output flourished in gunpowder, cordage and whiskey, etc.

John D. Rockefeller extracted secret rail rebates for his Cleveland-based Standard Oil’s refining business by exploiting the competition between rail operators and between rail and canal transport. In 1873, Rockefeller and a cabal of other refiners colluded to fix
substantial freight rebates (up to 50%) for all oil movements by railroad between several major eastern cities. Additionally, Rockefeller forced the rail operators to pay a tariff of 40% of the standard rate, for every competitor’s barrel of oil that was shipped between New York and Pennsylvania.

Rockefeller’s control tactics in transportation were used to force a fire-sale of independent Cleveland oil refiners. There were 25 independent refiners prior to the rail agreement, 22 were compelled to sell out within four months. Unfazed by the censure of a congressional committee, that condemned the Southern Improvement Company (SIC) as a ‘most enormous and audacious conspiracy’, Rockefeller used his stock holdings in Standard Oil to acquire controlling interest in refining companies in New York, Philadelphia and Pittsburgh. By 1991, he was using the rail rebate racket on a national scale. He now has 96% of all refined oil shipments.

Rockefeller by-passed the state chartering laws that limited corporate size and stopped a business from holding 96% of the nation’s refining assets. Rockefeller’s legal counsel, S.C.T. Dodd, conceived a plan whereby corporate trust were legally separate corporations deposited with a common board of trustees a controlling interest of their stock in exchange for a contractual right to dividends. The whole scheme was keep under lock and key. Not until many years later that New York, Pennsylvania and Ohio state authorities discovered that the common trustee (Standard Oil) was justly a resurrection of the SIC.

Rockefeller was just one of the first inventors of the corporate trust. At the end of the decade of 1890, over 24 trusts had been formed, including lead, sugar, cotton and whiskey.

The trusts encountered political outrage at both the federal and state assembles. By 1892, 28 states had legislated to stop monopolies. In addition, 16 states took steps to incorporate antitrust requirements in their constitutions.

Congress established the Interstate Commerce Commission in 1888 and passed the Sherman Act in 1890, that specified that,

> “Every contract, combination, in the form of trust or otherwise, or conspiracy, in restraint of trade…is declared illegal.”

The Sherman Act failed to expunge the trust and monopoly because it resorted to the device of competition rather than a law that would prevent the formation of monopolies. As a result, the law did nothing to reign in the monopolies.

The common law ultra vires standards provided that if a corporation is found to be outside the range of its jurisdiction, this became the opportunity for prosecutions against the trusts (rather than the antitrust laws). Standard Oil alone survived the subsequent attack against the trusts. Rockefeller achieved this by simply breaking the law. Rockefeller’s SIC continued to function as an unlawful organisation For five years, Rockefeller refused to comply with an 1892 Ohio court order for the SIC’s dissolution. Rockefeller’s SIC continued to violate laws concerning common carriers. Rockefeller bribed employees and customers to secure in information about competitors. It was alleged that he bribed the entire Ohio state legislature. He tampered with the election processes to the US Senate. On six separate occasions, he tried to bribe the Attorney General to desist in his antitrust prosecution. Standard Oil ducked the revocation of its charter by a fortunate easing of chartering laws in New Jersey (NJ) that allowed the firm to reincorporate there.
Section 13

In 1901, President Theodore Roosevelt declared, in his message to congress declared that,

“The first essential in determining how to deal with the great industrial combinations is knowledge of the facts-publicity …. The Government should have the right to inspect and examine the workings of the great corporations engaged in interstate commerce.”

Roosevelt proposed a Bureau of Corporations which congress adopted. This became part of the Department of Commerce in 1904. This soon became the 1914 Federal Trade Commission; charged with enforcing the Clayton Act. The Bureau was not created to investigate the trusts, but instead aimed to expose ‘bad’ trusts. The activities of the Bureau were not well coordinated with the antitrust enforcement of the Justice Department. This did little to quell the public outrage against trusts.

Section 14

The emergence of NJ as the new refuge for registering defactors

It is to be expected, that absence of federal registration of corporations, the states would step in to collect handsome registration and other fees. Kindleberger’s (1978) was an early commentator regarding the federal abdication of its corporate registration task. Kindleberger declared, that ‘the nation state was dead’.

Although most corporations were increasingly national in character, the main means of public regulation and surveillance remained in the hands of the states. This became a major source of income; states not only collected registration fees and stamp duties; they also controlled much of the accounting business. They charged fees for students who were taking the exams, annual fees for accrediting and registering CPA’s in their state’s jurisdiction.

NJ took the lead in attracting this lucrative business. It became obvious that eventually, other states would want a piece of the action and get into the game. So the states found themselves in competition with each other for the bounty of corporate chartering and other accreditation activities – which as not limited to fees for corporate chartering and accountancy, but plumbers, electricians builders, etc., all need to be registered with the state – with and renewable annual fee in order to continue doing business in their jurisdiction.

The problem with inter-state completion was that, in order to compete and retain business, there came about a ‘race to the bottom’; by watering down the standards and requirements. For instance, the qualifications of directors were not vetted (thus even those with criminal records were allowed to serve.

It was not long before NJ, in 1891, ran into a major financial crisis in 1891. This, together with a series of bribes to secure the support of senior politicians and the governor to make NJ the ‘Mecca for corporations’ by taking the state, full steam, into the charter-mongering business.

Incorporation in NJ became simple exercise, for payment of an incorporation fee and an annual franchise tax, corporations were allowed a free hand in doing whatever they
pleased. These very attractive liberal terms were hyped throughout the Union in an attempt to entice corporations to register and re-register in NJ.

Section 15

NJ’s rise as the de-facto state to be registered with

To further improve the states competitive status, in 1891, NJ legalised the acquisition and disposal of stock by one corporation in another, thus allowing for the creating of holding companies (that is, trusts). In 1893, NJ removed its antitrust statutes from its books.

NJ in 1896 set the minimum standards that became the blue-print for other states to follow. They created the rudimentary character of the corporation as it exists at the present. Limits on the size of corporations and their concentration were for all intents and purposes abolished. Holding co. laws were watered down, opening the door to a wave of intercompany ownerships, mergers and acquisitions. This included permitting corporations to choose the value of assets received in exchange for a share issue, thus opening the door ‘stock watering’ whereby unwary shareholder groups suffered catastrophic collapse in the stock’s value. This was made possible because insiders (such as directors) were given away stock at fire sale prices, causing ‘outside’ shareholders left holding the can.

Further legislative legerdemain by NJ involved abolishing restrictions on the life of a corporation thereby making corporate life ‘eternal’ – and the ‘de-stooling’ of shareholder control. This had been the Jacksonian core of corporate governance. In this case, the issue of non-voting stock was permitted, as was the strengthening of the powers of directors’ vis-à-vis shareholders; by allowing directors to act in a range of matters independently of shareholder approval.

Between 1896 and 1900, Corporations swamped NJ. Some estimates put the number of corporations in the USA as high as 95%, including Rockefeller’s Standard Oil, Dale Carnegie’s US steel. Most of the ‘Greater Industrial Trusts’ jumped on the bandwagon; including those associated with John Moody all re-incorporated in NJ.

The attraction of NJ, for corporations is shown by the growing number that sought incorporation. Before 1895, only 14 corporations with authorised capital in excess of $22 M had incorporated in NJ, by 1905, 105 firms were incorporated.

In 1896, NJ gave 850 charters with a take to the state in excess of $800 K. By 1905, 2,094 charters were awarded, earning the state a cool $3.2 M. From 1903, these earnings to NJ were so considerable that NJ was able to pay down the state’s debt, and eliminate property taxes.

These changes were instigated a groundswell of consolidations and mergers that transformed US industry from reasonably competitive markets to monopolies and oligopolistic structures. It was forecasted by Shaw Livermore that, in the five years prior to 1905, there were 329 combinations, that exercised control over two-fifths of the manufacturing sector. The Brookings Institute assessed that of the 92 major trusts in 1904, 78 controlled more than 50% of their industry’s sales; 27; of the remaining 78; they controlled more than 80%.

NJ’s ‘free-for-all’ laws engender major ire from other states. But they had now solution for challenging NJ however no practical form of redress was available to them. In 1886, the US Supreme Court had awarded the status of ‘citizen’ under the constitution.
Thus, if an entity was incorporated in one state, this status extended to all other states, just as though they had been incorporated in those other states.

But NJ’s laws protected firms incorporated in the state: NJ refused to recognise court judgements by other states. And when those states penalised or taxed firms incorporated in NJ, inflicted a charge of a similar amount on that state’s firms operating in NJ.

Rather than fight NJ, the other states chose to compete with NJ on charges for franchises and other sources, and be providing more lenient laws. Delaware, Kentucky Virginia, Maryland and Maine, adopted similar efforts at charter-mongering business, Even Massachusetts and New York (NY), degraded their tax laws in order to secure the NY tax base.

Section 16

The rise and fall of the NJ Empire

From 1904, The Committee on Uniform Incorporation Law expressed concern that state laws were sinking to the lowest common denominator. This did not give adequate protection against fraud and offered little support for productive activity and honest and fair dealing. Overall, very few of the old restrictions on incorporation remained: there were no longer any curtailments on the purpose (as long as it was ‘lawful’) or size, the rules governing mergers and holding companies had been considerably liberalised, and the power of directors relative to shareholders had again been bolstered.

NJ proceeded to reform the stature it had previously accomplished, That is, its reputation as the ‘the Mother of all Trusts’ was rolled back by its 1913 incorporation laws in 1913. The ‘Seven Sisters Acts’ outlawed the trust and holding company settlements, and a number of other anticompetitive practices. NJ’s reforms were only a minor deviation and were repealed in 1918 Nonetheless, the reputation of NJ, had suffered a serious blow of confidence, and many big clients began to shop elsewhere.

Section 17

The future of selling securities to the general population

Finance and banking and finance acquired a strong presence in the early 1900s. The incomes of individuals were now flush as was never before. This offered a pool of monies that was available for stock market investment. The mass marketing techniques devised in by Jay Cook in an earlier period were further developed during this latter period. By 1911, a financial analysis wrote:

“A dozen years or so ago, the small investor could hardly get anybody on Wall Street to look at him … Bond and stock houses alike were busy begging favors from the rich man’s table. But by 1912, the tables had turned. The individual investor could be called the ‘master’ of the investment world.”

While the establishment investment houses carried on business as usual, favouring a just a few institutions and to large individual investors; limited to a few hundred clients. But the rising newer and younger firms began courting small investors with municipal, utility, and industrial issues who assembled a sales force with outlets in all the major cities. Their
customer lists grew as the number of new clients reached the tens of thousands. A sale of $4,000 was quite common; a sale of $10,000 was top of the heap.

To increase further the mass-marketing of shares, a kind of ‘easy-credit’ was developed as a kind of part-payment plan was arranged so that people on salaries could pay for odd lots of shares in instalments.

By 1910, this plan was termed by newspapers as ‘time-tried and panic tested’. New issues of shares were aggressively promoted, even by advertised, not just in the business press, by in channels such as Harper’s and the Saturday Evening Post.

These practices continued into the 1920s when corporations split stock to keep the price within the reach of small investors. Many firms encouraged their employees to buy stock. By 1928, the number of shareholders had reached 460,000, and by 1932, the number had grown to 32.5 M. Selling shares directly to the public had become a unique American pastime. By 1941, more than 12,000 were registered as salesmen who worked around 1,600 branch offices. By 1975, there were almost 43,000 working in more than 35,000 offices.

Section 18
The rise of the Federal Reserve

A national banking system was initially created to open the door of regulating the capital markets. The 1864 law appears to have run its course; and was no longer up for the job. There were a numbers of factors behind this failure: to begin with, there were several reasons for this: quantity of credit in the economy was not adequate to accommodate the requirements of business. Unfortunately, it was the in-elastic supply of the quantity of bills/notes that were in circulation. The bills/notes were restricted by the quantity of gold held by the Treasury. This tied to the productive efforts of gold miners and the balance of trade. Thus, the amount of bonds issued by the government – these, were restricted to the size of the national debt.

Additionally, the national banks were driven by the profit motive as all profit making business. Hence, they were subject to ‘moral hazard’ – a conflicts of interest between their public duties and private profit making interests, for instance, the control over the money supply.

The financial crises of 1874, 1884, 1895, and 1907 were accused by banks ‘pyramiding’ their reserve requirements with interbank holding. Finally, as the charged with regulating the money supply that rested with Treasury (and thus the fickle habits of whoever was serving as Secretary of Treasury at that moment). The problem was that the Treasury was responsible for depositing monies with the national banks, and this could negatively affect the quantity of money released into circulation at a moment in time.

As a consequence of there were numbers of bank suspensions beginning in the early 1900: 490 banks in 1892, and 106 banks in 1909. These financial panics resulted in congressional investigations into the banking system; that climax into the creation of the Federal Reserve Act of 1913 under the Wilson Administration. The Federal Reserve Act was an unholy compromise between complete government regulation and private (self) regulation.
The Act required that any national bank that was part of the Federal Reserve System. This was another attempt to 'send flowers' to the 'states’ rights, as membership of state banks was voluntary.

Regional Federal Reserve Banks were created to check on member banks; the Regional Reserve banks were held by private banks but had board members that included representatives of non-banking interests. Additionally, the Act established a Board of Governors of the Federal Reserve System that was required to coordinate policy.

The Federal Reserve Banks were charged with a limited control over the size of reserves held by member banks; thus giving the Reserve some control over the money supply. In this fashion, the priorities of business achieved a growing status in controlling the money supply. This helped increase the level of demand in the economy at large; adding to the amount of business and increasing the level of credit by an infusion of commercial paper that was backed by Federal Reserve notes.

By excluding state banks from the control and scrutiny of the Federal Reserve System led to an increase in more state bank chartering in an attempt to circumvent the costly fees of membership of the Federal Reserve System. Moreover, as state banks were still restricted by minimum reserve requirements, although a new system of non-uniform reserve requirements was created and was in place until 1981.

After 1923, national banks were not permitted open local branches, notwithstanding that they functioned in states that permitted branching. From 1922, the then comptroller of the currency ruled that national banks in such states could establish branches. This ruling engendered the ire of competitors, and the ruling was withdrawn by Congresses in the passing of the McFadden Act in 1927.

The McFadden Act had become well-known for the geographical restrictions it placed on interstate banking. Actually, it was meant to fix the problems of earlier legislation that restricted the effect of the federally controlled banks. The purpose was to stimulate national bank chartering, by relaxing the branching and investment powers of national banks, and thereby increasing the attraction of membership to the Federal Reserve System. National banks were allowed to setup branches in any state that permitted it, and thus broadened the power of banks to acquire power to invest in corporate bonds and other securities, and eventually enter the real estate business.

_Delaware declares a coup in securing the chartermongering business_

It would be incorrect to overestimate the impact of federal oversight in the beginning of the 20th century. The substantial powers the Federal Reserve failed to stop the Great Crash of 1929.

The states still controlled the chartering business. Delaware passed charter-mongering laws in 1898. NJ’s was still one step ahead because it was first in the chartering business and was adjacent to the large corporate metropolis of New York. This drove Delaware into the sidelines.

Delaware’s opportunity arose when NJ’s reversed its regulatory reform in 1913 (that was repealed in 1917). Delaware passed a law that provided a new low water mark in corporate regulation.

Delaware promoted its state as ‘the place to charter’, showing its advantages over NJ. In fact indeed, the Delaware’s law was a copy of the standards created by NJ’s. In contrast to NJ, Delaware offered much lower registration fees and the franchise tax rates; there we no provision for meetings of stockholders and directors in the state in which
they were incorporated. There was no requirement to retain stock transfer books in the state; they could be kept at any location of the directors choose (thereby reducing the possible interference of troublemakers.

There were other advantages Delaware offered corporate clients. Delaware was rather small relative to other states – sometimes derided as ‘the pygmy state’, after it had the cheek to go up against NJ.

Also, the condition that a charter describes the aims, purpose, or scope of business activity was discarded and directors were authorised to underwrite any line of business. This ‘self-determination’ rule of Delaware’s delivered the coup de grace that removed the private corporation from its public moorings.

The Delaware intervention gave capital accumulation a major boost. The relaxation of the rules governing the holding companies to allow inter-company ownership, but in addition the rules were weakened governing leverage (bond issues for instance). These changes led to massive amounts of debt relative to the equity cushion, opening the door to heightened financial risk; risk of failure. For in the event of (say) a collapse in a firms asset base, and there is a default in payment of bond interest and re-payment of the bonds principal, the bondholders have the authority to force the firm into a winding up (bankruptcy).

This ‘stock pyramiding’, as it is so-called, involved a heavily leveraged activity that was compounded by the excessive use of leverage at each level in a hierarchy of interconnected firms. Regulating these hierarchical arrangements rested within the holding company at the top of the hierarchy. Thus, a combination worth more than a billion dollars could be managed from a modest personal investment (a very small part of the equity in the entire hierarchy).

Notwithstanding these risks, Delaware produced even more creative innovations in the 1920s: shareholders were further marginalised giving control to management, financiers, and promoters. This was accentuated by allowing the issue of restricted shares, non-voting shares, limited shares and contingent shares.

This he creation of ‘blank stock’ in the latter part of the 1920s, allowed financiers and managers to call on big blocks of authorised but unissued stock on their own by simply ‘writing in’ the terms of voting power at their discretion.

The speed of industrial concentration increased after Delaware’s outstanding performance in the charter mongering business. In the early 1930s, Professors Berle and Means (1932) raised the alarm, by showing that some 47 of the 200 largest US corporations (many registered in Delaware) were controlled by a minority (sometimes as low as 15%).

References