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BACKGROUNDER

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The Glass–Steagall Act: Unraveling the Myth

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Abstract

The 1933 Glass–Steagall Act is widely acclaimed for ending abusive and risky financial practices that led to the Great Depression, but it has a much better reputation than it deserves. The foundation of its supposed success is the Act's vaunted separation of commercial and investment banking. In truth, however, this separation was never absolute. The law implemented general prohibitions on certain activities, but included exceptions in every case. That is, the Act did not implement a complete separation of commercial and investment banking. Furthermore, there is virtually no evidence that the combination of commercial and investment banking threatened bank safety in the pre-Glass–Steagall era. In most cases the evidence supports the opposite conclusion, that the combination actually strengthened banks. In virtually all cases of supposedly abusive and unsound practices during the pre-Glass–Steagall era, the evidence cited either refers to a secondary source, is nonexistent, or is irrelevant because Glass–Steagall did not address the practice specifically.

Key Points

- The Glass–Steagall Act, the 1933 law that separated commercial and investment banking, gained a much better reputation than it ever deserved.
- There is virtually no evidence that allowing banks to engage in securities activities during the pre-Glass–Steagall era worsened their financial condition relative to those engaged in strictly commercial bank activities.
- Allowing banks to engage in both types of financial activities actually strengthened these commercial banks relative to their specialized peers.
- Glass–Steagall did not implement a complete separation of commercial and investment banking. Four of the bill's sections implemented the separation, and each one included exceptions, several of which were used from the beginning.
- The Glass–Steagall separation was little more than a pet project of Senator Carter Glass, who regarded securities investment as illegitimate speculative activity. Reinstating the Glass-Steagall separation would negatively impact financial intermediation.

The 1933 Glass–Steagall Act is still admired by many who believe its separation of commercial and investment banking banned the high-risk activities that caused the Great Depression. Yet there are so many myths and falsehoods surrounding this notion—and the Act itself—that it is difficult to comprehend how little supporting evidence Congress uncovered prior to passing the bill. In fact, there is virtually no evidence that banks engaging in securities activities before the Act passed were in worse financial condition than their specialized peers. The evidence actually suggests that banks engaged in both types of financial activities were stronger than those institutions engaged in only commercial banking.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3104**

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Nonetheless, Glass–Steagall's restrictions still enjoy widespread support more than 80 years after the Act's passage.

Numerous analysts have cited the many abusive and reckless investment practices Congress uncovered prior to passing the Glass–Steagall Act. But these assertions are exaggerated or untrue. The record shows that many of these claims refer to secondary sources rather than the original record, and to opinions and allegations rather than actual evidence of abuses. In some cases, commentators refer to evidence against practices that had nothing to do with the combination of investment and commercial banking, such as tax avoidance and excessive salaries. Nonetheless, over time, the mythical stature of Glass–Steagall has grown, especially in the wake of the 2008 financial crisis. This *Backgrounder* provides a summary of the many misconceptions surrounding Glass–Steagall and the truths behind them.

The GLBA Did Not Repeal or Deregulate

Perhaps the most recent Glass–Steagall myth is that its repeal caused the 2008 financial crisis. In particular, many cite the 1999 Gramm–Leach–Bliley Act (GLBA) as evidence that financial market deregulation caused the 2008 crisis. These critics maintain that the GLBA repealed the Glass–Steagall Act, thus leading to excessive risk-taking in deregulated U.S. financial markets.[1] There are several problems with this story, not the least of which is that the GLBA did not repeal the Glass–Steagall Act. The GLBA repealed only two sections of Glass–Steagall, leaving intact some of the restrictions the 1933 law placed on financial markets.[2] Furthermore, although it is true that the GLBA allowed some firms to engage in activities from which they had been previously restricted, all of these activities are still regulated.[3]

Prior to the GLBA reforms, the financial industry was mainly regulated based on industry boundaries.[4] In that framework, banks were regulated by banking regulators, insurance companies by insurance regulators, savings and loans by thrift regulators, and so on. The GLBA shifted the emphasis toward *functional regulation*, whereby specific commercial activities were to be regulated by the same regulator, regardless of industry boundaries. Under this new framework, whether a bank, insurance company, or broker-dealer engaged in a securities-related activity, the activity would now be regulated by the same financial regulator rather than three separate agencies.[5]

Thus, it is inaccurate to say that the GLBA *deregulated* financial markets.[6] The bill expanded allowable *regulated* activities for some financial firms. Furthermore, the GLBA contained five titles unrelated to Glass–Steagall that, in many instances, increased financial regulations.[7] Regardless, there is a great deal of confusion surrounding the GLBA and Glass–Steagall, and it begins with the Glass–Steagall Act itself.

1. See, for example, Jim Zarroli, "Visiting New York City, Bernie Sanders Attacks Clinton, 'Greed' Of Wall Street," NPR, January 6, 2016, http://www.npr.org/2016/01/06/462094414/visiting-new-york-city-bernie-sanders-attacks-clinton-greed-of-wall-street (accessed January 6, 2016); James Rickards, "Repeal of Glass-Steagall Caused the Financial Crisis," *U.S. News & World Report*, August 27, 2012, http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis (accessed December 21, 2015); and Joseph Stiglitz, "Capitalist Fools," *Vanity Fair*, December 31, 2008, http://www.vanityfair.com/news/2009/01/stiglitz200901-2 (accessed December 21, 2015).
2. Specifically, Section 101 of the GLBA repealed Sections 20 and 32 of the 1933 Act but left Sections 16 and 21 intact. A copy of the GLBA is available at http://www.gpo.gov/fdsys/pkg/BILLS-106s900enr/pdf/BILLS-106s900enr.pdf (accessed February 1, 2016).
3. Put differently, while the GLBA changed the financial regulatory framework in the U.S., it did not deregulate firms' activities. See Norbert J. Michel, "The Myth of Financial Market Deregulation," Heritage Foundation *Backgrounder* No. 3094, April 28, 2016, http://www.heritage.org/research/reports/2016/04/the-myth-of-financial-market-deregulation.
4. Aulana Peters and David Powers, "Functional Regulation: Looking Ahead," *Loyola of Los Angeles Law Review*, Vol. 18 (1985), pp. 1075–1098, http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=1459&context=llr (accessed December 21, 2015).
5. Securities activities are generally regulated by the Securities and Exchange Commission, but there is still some overlapping regulatory authority in the post-GLBA framework. See Simpson, Thacher, & Bartlett, LLP, "The Gramm-Leach-Bliley Act," November 17, 1999, http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub390.pdf?sfvrsn=2 (accessed March 9, 2016). See also Peters and Powers, "Functional Regulation: Looking Ahead," 1985.
6. It is true that the GLBA's sponsors referred to the bill as deregulatory, but this fact does not alter the actual details of what the bill accomplished. See Eric Lipton and Stephen Labaton, "Deregulator Looks Back, Unswayed," *The New York Times*, November 16, 2008, http://www.nytimes.com/2008/11/17/business/economy/17gramm.html?pagewanted=all&_r=0 (accessed November 19, 2015).
7. See Michel, "The Myth of Financial Market Deregulation."

The History of Glass–Steagall

The *Glass–Steagall Act* commonly refers to the Banking Act of 1933, the law that separated commercial and investment banking in the U.S.[8] Though this separation is often referred to as the Glass–Steagall Act (or simply *Glass–Steagall*), the legal separation was only part of a much larger bill. While the legal separation was implemented in four sections (16, 20, 21, and 32) of the Banking Act of 1933, the same law also authorized the creation of the Federal Deposit Insurance Corporation (FDIC) and the Federal Open Market Committee.[9]

Thus, it is certainly not the case that the GLBA repealed the Glass–Steagall Act. The GLBA repealed two of the four Glass-Steagall sections that separated commercial and investment banking.[10] Furthermore, despite the widely accepted view, this Glass–Steagall separation was never absolute. In other words, the Banking Act of 1933, also known as the Glass–Steagall Act, did *not* completely separate commercial and investment banking.

Sections 20 and 32, those that the GLBA repealed, *generally* prohibited commercial banks from affiliating with investment banks. Section 20 prohibited banks from affiliating with companies "engaged *principally* in the issue, flotation, underwriting, public sale, or distribution….of stocks, bonds…or other securities."[11] Similarly, Section 32 prohibited various types of affiliations between banks and securities firms, "*unless* in any such case there is a permit therefore issued by the Federal Reserve Board; and the Board is authorized to issue such permit if in its judgment it is not incompatible with the public interest."[12]

Section 16, which the GLBA left intact, *generally* prohibited banks from underwriting or dealing in securities.[13] Section 21, which the GLBA also left in place, *generally* prohibited investment banks from accepting demand deposits. Specifically, Section 16 prohibited nationally chartered banks from securities dealing *except* for buying or selling securities "without recourse, solely upon the order, and for the account of, customers."[14] Section 16 also prohibited nationally chartered banks from purchasing investment securities for their own trading account *except* "under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe."[15] In other words, Section 16 of Glass–Steagall did allow national banks to purchase investment securities under certain restrictions prescribed by a federal regulatory agency.

Section 16 also included certain statutory restrictions on how much of these activities the Comptroller could allow. For example, Section 16 explicitly limited the Comptroller so that "in no event…shall the total amount of the investment securities of any one obligor or maker…held by the association for its own account exceed at any time 15 per centum of the amount of the capital stock of the association

8. The bill was sponsored by Senator Carter Glass (D–VA) and Representative Henry Steagall (D–AL). Senator Glass spent 16 years in the U.S. House of Representatives (1902–1918), two as U.S. Treasury Secretary (1918–1920), and served in the U.S. Senate until 1946. As per the original Federal Reserve Act, Glass also, as Treasury Secretary, served as ex-officio chairman of the Federal Reserve Board. Representative Steagall was first elected to Congress in 1915 and served until his death in 1943. Representative Steagall was the Chairman of the House Committee on Banking and Currency from 1931–1943.
9. Adding to the confusion is the fact that Senator Glass and Representative Steagall also co-sponsored the Banking Act of 1932, legislation commonly referred to as the Glass–Steagall Act *prior* to the passage of the Banking Act of 1933. See Julia Maues, "Banking Act of 1933, Commonly Called Glass-Steagall," Federal Reserve History, November 22, 2013, http://www.federalreservehistory.org/Events/DetailView/25 (accessed December 22, 2015). Aside from the Glass–Steagall restrictions on commercial and investment banking, the 1933 Banking Act included 30 other sections. The full text is available at https://fraser.stlouisfed.org/scribd/?item_id=15952&filepath=/docs/historical/ny%20circulars/1933_01248.pdf#scribd-open (accessed December 22, 2015).
10. Section 101 of the GLBA repealed Sections 20 and 32 of the 1933 Act but left Sections 16 and 21 intact. Also see Peter Wallison, "Did the 'Repeal' of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty. Not Even Close," Networks Financial Institute *Policy Brief* 2009-PB-09, November 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507803 (accessed December 22, 2015).
11. The Banking Act of 1933, Section 20; 12 U.S. Code 377. (Emphasis added.)
12. The Banking Act of 1933, Section 32; 12 U.S. Code 78. (Emphasis added.)
13. The practice of *underwriting* securities refers to assuming the risk that an issue of securities (stocks and bonds, for example) will be fully sold to investors; the practice of *dealing* securities typically refers to holding an inventory of securities to facilitate trades (buying and selling) for customers.
14. The Banking Act of 1933, Section 16; 12 U.S. Code 24 (Seventh).
15. Ibid.

actually paid in."[16] Similarly, Section 21 included an exception that could allow non-financial firms to take deposits. This exception obligated such firms to, among other requirements, "submit to periodic examination by the Comptroller of the Currency or by the Federal reserve bank of the district…."[17]

Under the Glass–Steagall Act, "commercial banks were explicitly permitted to underwrite and trade U.S. Treasury securities and municipal general obligation securities, assist in customer merger and acquisition, and provide financial advice and counseling."[18] However, the status of many other securities activities, particularly those conducted through affiliates, were not clearly spelled out. In other words, the Glass–Steagall Act purposely left the legal ability of banks to engage in various securities-related activities to the interpretation of the banks, regulatory agencies, and courts.

No High Wall of Separation Existed. Before Glass–Steagall was enacted, banks administered dividend reinvestment and employee stock purchase plans by forwarding customer orders to a broker-dealer.[19] These services were essentially the precursor to what are now commonly called discount brokerage services.[20] From the day Glass–Steagall passed, federal regulators allowed banks to conduct these services, and the U.S. Supreme Court affirmed this regulatory interpretation in 1947.[21] As early as 1937, banks used *common trust funds*, an investment product functionally the same as those used by investment companies.[22] In the 1940s the Federal Reserve officially authorized banks to use these trust funds to invest money held for "true fiduciary purposes."[23]

In 1971 Wall Street partners Bruce Bent and Henry Brown launched the first money market mutual fund, and many other securities firms followed with their own versions during the high inflation period of the 1970s and early 1980s.[24] These funds are functionally equivalent to the checking accounts offered by banks. Money market funds were so successful that Congress passed two laws in the 1980s to help banks compete with their non-bank rivals. The 1980 Depository Institutions Deregulation and Monetary Control Act phased out interest rate ceilings on savings and time deposits at commercial banks and thrifts.[25] Later, the 1982 Garn–St. Germain Act created the money market deposit account (MMDA), a product that allowed banks to compete more directly with money market mutual funds.[26]

Another often ignored fact is that the Glass–Steagall commercial-investment banking separation only applied to U.S. banks' domestic operations. Internationally, U.S. commercial banks regularly offered various securities services to compete with firms that were not legally separated into distinct investment

16. Ibid.
17. The Banking Act of 1933, Section 21; 12 U.S. Code 378.
18. George Kaufman, "Securities Activities of Commercial Banks: Recent Changes in the Economic and Legal Environments," *Journal of Financial Services Research*, Vol. 1 (1988), p. 186.
19. See Peters and Powers, "Functional Regulation: Looking Ahead," p. 1082.
20. Ibid.
21. Michigan Law Review Association, "A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services," *Michigan Law Review*, Vol. 81, No. 6 (May 1983), pp. 1505–1509.
22. Peters and Powers, "Functional Regulation: Looking Ahead," pp. 1081–1085.
23. Ibid.
24. The SEC regulates money market mutual funds under the Investment Company Act of 1940, and the rules adopted under the Act, particularly Rule 2a-7. For a brief history of money market funds, see Mike Krasner, "Money Funds and the Regulators," *American Association of Individual Investors Journal* (June 2013), http://www.aaii.com/journal/article/money-funds-and-the-regulators.touch (accessed December 29, 2015). Also see E. Denby Brandon Jr. and H. Oliver Welch, *The History of Financial Planning: The Transformation of Financial Services* (Hoboken, NJ: John Wiley & Sons, 2009), p. 9.
25. The Banking Acts of 1933 and 1935 outlawed interest payments on demand deposits and gave the Fed the authority to set interest rate ceilings on time and savings deposits for member and non-member banks, respectively. See R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," Federal Reserve Bank of St. Louis, February 1986, pp. 22–37, https://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf (accessed December 8, 2015).
26. See Gillian Garcia et al., "The Garn-St. Germain Depository Institutions Act of 1982," Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 7, No. 2 (March 1983), pp. 3–31.

and commercial banks.[27] By the 1980s, the largest U.S. banks were particularly active in international markets. For instance, the top 30 Eurobond underwriters in 1985 were U.S. bank affiliates.[28] By 1988, Citicorp offered investment banking services in over 35 countries, and Chase Manhattan advertised that it had offices in almost twice as many countries as ten major investment banks combined.[29]

Overall, Glass-Steagall took a very narrow view of financial intermediation and did little to contemplate broader financial trends.[30] This fact is due largely to Senator Glass's preoccupation with keeping what he viewed as purely speculative investment activity out of commercial banks. Glass, as many others, failed to see that commercial lending involves many of the same types of financial risks as the securities activities he loathed. Many have failed to see, for instance, that there is no economic difference between a loan and an investment. What is remarkable, though, is that Glass failed to produce one shred of empirical evidence during hearings for the proposed bill showing that securities affiliates adversely impacted commercial banks' safety and soundness.

Glass–Steagall Legendary Status Undeserved

Glass–Steagall has attained near mythical status for securing a vital separation between commercial and investment banking in the U.S. Supposedly, this separation put an end to the risky financial activities that contributed to the Great Depression.[31] Yet, the record shows that separating commercial and investment banking was little more than a long-time pet project of Senator Carter Glass, one of the original authors of the Federal Reserve Act of 1913. Glass viewed securities investments as a purely speculative activity and in virtually no way a legitimate commercial endeavor. Consequently, he believed that the only way to ensure bank safety was to restrict bank lending to short-term financing of commercial activity.[32]

One reason this idea is flawed is that there was no general prohibition—before or after Glass–Steagall—against commercial banks providing operating loans to investment banks. That is, the firms engaged in the very speculative activity Glass abhorred regularly borrowed from commercial banks.[33] Regardless, the record shows that Glass had no empirical evidence to support his opinion. The definitive histori-

27. As of 1995, only two major industrial countries featured "a legal separation between commercial and investment banking: the United States and Japan. Other large industrial countries like Germany and Switzerland have universal banking, allowing banks to affiliate with other financial services firms, including insurance, real estate and securities firms." See Michelle Clark Neely, "Commercial & Investment Banking: Should This Divorce Be Saved?" Federal Reserve Bank of St. Louis, April 1995, https://www.stlouisfed.org/publications/regional-economist/april-1995/commercial--investment-banking-should-this-divorce-be-saved (accessed December 22, 2015). The U.S., in fact, forced Japan to employ this separation after World War II. See George Benston, "Universal Banking," *Journal of Economic Perspectives*, Vol. 8, No. 3 (1994), pp. 121–143, https://notendur.hi.is/ajonsson/kennsla2006/universalbanking.pdf (accessed December 22, 2015).

28. George Benston, *The Separation of Commercial and Investment Banking* (New York: Oxford University Press, 1990), p. 10.

29. Ibid.

30. Insurance companies, for example, were effectively engaged in the securities business by the 1950s because variable annuities are an investment product, but Glass–Steagall did nothing to address these safety and soundness concerns. Nor did Glass-Steagall address securities firm combinations with non-financial firms, a trend that began prior to the bill's enactment. For instance, Sears Roebuck formed Allstate Insurance Company in 1931, bought Dean Witter and Reynolds (the fifth largest brokerage house in the U.S.) in 1981, and introduced the Discover Card in 1985. See Sears Archives at http://www.searsarchives.com/brands/allstate.htm and http://www.searsarchives.com/history/history1980s.htm (accessed December 29, 2015).

31. See, for example, Kevin Cirilli, "Warren Calls for Return of Glass-Steagall," *The Hill*, July 14, 2015, http://thehill.com/policy/finance/247929-warren-calls-for-return-of-glass-steagall (accessed November 19, 2015), and Neil Irwin "What Is Glass-Steagall? The 82-Year-Old Banking Law That Stirred the Debate," *The New York Times*, October 14, 2015, http://www.nytimes.com/2015/10/15/upshot/what-is-glass-steagall-the-82-year-old-banking-law-that-stirred-the-debate.html?_r=0 (accessed February 1, 2016).

32. George Kaufman, "Securities Activities of Commercial Banks: Recent Changes in the Economic and Legal Environments," *Journal of Financial Services Research*, Vol. 1 (1988), pp. 183–199.

33. In 1932, just prior to the passage of the Glass–Steagall Act, the Federal Reserve Board included commercial banks' loans to brokers and dealers in the Board's Annual Report. See Federal Reserve Board, "Nineteenth Annual Report of the Federal Reserve Board," December 31, 1932, pp. 145–147, https://fraser.stlouisfed.org/docs/publications/arfr/1930s/arfr_1932.pdf (accessed February 1, 2016). Post-Glass–Steagall, the Fed has continued to monitor commercial banks' lending to securities dealers. See, for example, Federal Reserve Board of Governors, "Fifty First Annual Report of the Board of Governors," March 22, 1965, p. 79, https://fraser.stlouisfed.org/docs/publications/arfr/1960s/arfr_1964.pdf (accessed February 1, 2016).

cal study of Glass-Steagall shows that "the evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or caused the financial system to collapse."[34] In fact, the evidence suggests that pre-Glass–Steagall banks engaged in securities activities were *safer* than those exclusively engaged in commercial banking.

It is clear, for example, that banks engaged in both types of financial activities had lower failure rates. From 1930 to 1933, 26.3 percent of all national banks failed, but only 6.5 percent of the 62 banks with securities affiliates as of 1929 failed.[35] Similarly, only 7.6 percent of the 145 banks with large bond operations failed.[36] Another study reports that "there is no statistical foundation for the belief that specialized banking was superior to integrated banking," and that "the bonds of the private banks performing both commercial and investment operations were superior to those of the non-affiliate and affiliate banks."[37]

A separate investigation compares securities originated by the eight largest securities affiliates of commercial banks to those originated by the eight largest private investment banks. This study finds that, from 1925 to 1932, there was "very little, if any, significant difference between the success of the originations of the two groups."[38] A more recent examination finds "no evidence that commercial bank securities affiliates systematically fooled the public," and that "the public appears to have rationally accounted for the possibility of conflicts of interest and that this *constrained* the underwriting activities of the bank affiliates."[39]

What is so striking is how little this sort of evidence was even discussed at the hearings leading up to the passage of Glass–Steagall.[40] Much like the 2008 financial crisis and the passage of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, it seems most of the Glass–Steagall-related hearings were more focused on casting blame than shedding light on what actually caused the crisis.

The remainder of this *Backgrounder* presents a summary—but hardly a complete account—of how what actually took place during these hearings in the 1930s has been misconstrued. It relies heavily on George Benston's *The Separation of Commercial and Investment Banking*, an indispensable book for the full history of Glass–Steagall.[41]

Evidence Repeatedly Cited Though None Existed

Scholar George Benston identified seven original sources of information frequently cited as *evidence* of the abusive and unsound banking practices supposedly prevalent during the pre-Glass–Steagall period.[42] In virtually all of these cases, though, the evidence cited either refers to a secondary source, is nonexistent, counter to the allegation, or irrelevant because Glass–Steagall did not address the practice. Referring to the *Congressional Record* from 1932 and 1933, Benston finds:

> Several commentators and the Supreme Court cite and quote the statements of several senators, particularly Senators Glass, Bulkley, and Walcott, as if the senators were referring to documents, hearings, or other sources of data, or relating instances or allegations of wrongdoing. In every specific comment that I could trace, however, the senators

34. See Benston, *The Separation of Commercial and Investment Banking*, p. 41.

35. Eugene White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History*, Vol. 23 (1986), p. 40, https://campus.fsu.edu/bbcswebdav/users/jcalhoun/Courses/Growth_of_American_Economy/Chapter_Supplemental_Readings/Chapter_22/White-Before_the_Glass-Steagall_Act.pdf (accessed December 22, 2015).

36. Ibid.

37. George Edwards, "The Myth of the Security Affiliate," *Journal of the American Statistical Association*, Vol. 37 (1942), p. 232.

38. Terris Moore, "Security Affiliate Versus Private Investment Banker – A Study in Security Originations," *Harvard Business Review*, Vol. 12 (1934), pp. 480–482.

39. Randall Kroszner and Raghuram Rajan, "Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking before 1933," *The American Economic Review*, Vol. 84, No. 4 (1994), pp. 810–832, http://www.jstor.org/stable/2118032?seq=1#page_scan_tab_contents (accessed December 22, 2015). (Emphasis added.)

40. Benston, *The Separation of Commercial and Investment Banking*, p. 36.

41. Many, but not all, of the references cited in this *Backgrounder* were originally cited in Benston's book.

42. For details on all seven sources, see Benston, *Separation of Commercial and Investment Banking*, Chapter 2.

> only give their unsupported opinions. These occasionally misrepresented the record; more often they only expressed their expectations of abuses that might happen rather than citing studies or giving reports of actual occurrences.[43]

After Glass–Steagall was enacted, countless policymakers, congressional witnesses, historians, economists, and even the U.S. Supreme Court have cited these sources as evidence of the abusive and unsound practices that led Congress to pass the Glass–Steagall Act. Two sets of Glass's remarks during a Senate session on May 9, 1932, have gained particular notoriety. The first is as follows:

> It was because of that system of involuntary servitude [the system whereby large money center banks relied on country correspondent banks] that the great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with their utterly worthless investment securities, nearly eight billions of them being the investment securities of tottering South American republics and other foreign countries. Incidentally, I may remark that the State Department is largely culpable for the extent of these worthless loans.[44]

What is typically ignored, however, is what followed these remarks. Senator Norris broke in and asked Senator Glass whether "in the investigation of the committee any evidence was adduced that not only the State Department but the Treasury Department had been instrumental to some extent, through its examiners or otherwise, in inducing so-called country banks to make the investments the Senator has mentioned?"[45] Senator Glass responded as follows: "I do not know that we took testimony upon that particular point."[46] This exchange provides much-needed context through which to view the hearings leading up to the passage of Glass–Steagall.

The second—and perhaps the best—example of a widely repeated quote that gives rise to the belief that Glass uncovered actual evidence of abusive and unsound practices comes from the same Senate session as the above-cited remarks. Glass's statement is as follows:

> The committee ascertained in a more or less definite way—we think quite a definite way—that one of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression was made by these bank affiliates. They sent their high pressure salesmen and literally filled the bank portfolios of this country with these investment securities.[47]

This passage was reported in contemporaneous news stories during the 1930s, and has since been referenced in a 1979 federal court case, as well as several historical and scholarly accounts.[48] In 1984, the Chairman of the Securities Industry Association

43. Benston, *The Separation of Commercial and Investment Banking*, p. 18.

44. *Congressional Record*, Volume 75, Part 9 (May 2, 1932, to May 17, 1932), p. 9883. This passage was reported in contemporaneous news accounts and has frequently been cited since that time. See, for example, *The Commercial and Financial Chronicle*, May 14, 1932, Vol. 134, No. 3490, p. 3572, https://fraser.stlouisfed.org/scribd/?item_id=517074&filepath=/docs/publications/cfc/cfc_19320514.pdf#scribd-open (accessed December 29, 2015); William Shughart, "A Public Choice Perspective of the Banking Act of 1933," *Cato Journal*, Vol. 7, No. 3 (1988), p. 603, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1988/1/cj7n3-3.pdf (accessed December 29, 2015), (Shughart mentions there is little evidence to support the hypothesis.); Benton Gup, *Too Big to Fail: Policies and Practices in Government Bailouts* (Westport, CT: Prager, 2004), p. 104; and Arthur Sears Henning, "Glass Links U.S. Officials to 1929 Crash: Declares Reserve Bank Shares Blame," *Chicago Tribune*, May 10, 1932, p. 2, http://archives.chicagotribune.com/1932/05/10/page/2/article/glass-links-u-s-officials-to-1929-crash (accessed December 29, 2015).

45. *Congressional Record*, Volume 75, Part 9 (May 2, 1932, to May 17, 1932), p. 9883.

46. Ibid.

47. Ibid., p. 9887.

48. For just a few examples, see Henning, "Glass Links U.S. Officials to 1929 Crash: Declares Reserve Bank Shares Blame," Investment Company Institute, Petitioner, v. Board of Governors of the Federal Reserve System, Respondent, 606 F.2d 1004 (D.C. Cir. 1979), http://law.justia.com/cases/federal/appellate-courts/F2/606/1004/441437/ (accessed December 28, 2015); Kenneth M. Davidson, *Megamergers: Corporate America's Billion-Dollar Takeovers* (Cambridge, MA: Ballinger Publishing Company, 1985); and K. Sabeel Rahman, "Democracy and Productivity: The Glass-Steagall Act and the Shifting Discourse of Financial Regulation," *The Journal of Policy History*, Vol. 24, No. 4 (2012), http://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1300&context=faculty (accessed December 28, 2015).

repeated this theme in his Senate testimony. Referencing the pre-Glass–Steagall period, he testified that many of the "financial giants" abused the small country banks by using them as "a good dumping ground for second or third grade securities."[49] Given the definitive nature of Senator Glass's statements, it is easy to see how historians might have taken his remarks at face value. As difficult as it is to imagine, there was essentially no evidence for his claims. Perhaps more surprising is that the Senate actually heard testimony and gathered evidence that contradicted the Senator's statements.

Data Reviewed by the Glass Subcommittee

The only data the Glass Subcommittee reviewed prior to the 1933 passage of Glass-Steagall was obtained from two sets of questionnaires.[50] The first set was sent to each Federal Reserve District Bank, and the second was sent to "money brokers, bank examiners, and commercial banks."[51] The questions sent to the Fed District banks focused on items such as discount rate policy, open market operations, and the eligibility and acceptability of commercial paper at the discount window. None of these questions asked about commercial banks' securities activities.[52]

The committee did obtain some securities-related data from the second set of questionnaires, those sent to brokers, bank examiners, and commercial banks. However, none of this data supports the idea that losses on securities were the principal cause of bank failures (or even of serious financial distress).[53] Despite Glass's statements, there is even some contradictory evidence in the official subcommittee report.

For instance, Part 7 of the 1931 Glass Subcommittee report states "until the major deflation period in the bond market in the latter part of 1930 and 1931, losses on bank security investments were reported as being of moderate proportions."[54] The same document also reports the original cost (book value) of the 10 largest bond holdings of 13 banks (eight of which were from New York City), relative to their market values as of December 1930. These market values ranged from 87 percent of book value to 122 percent, with a value-weighted average of 99 percent.[55] While the data may not be representative of the broader market, it certainly does not support the idea that bond (securities) losses were the main cause of widespread bank failures.[56]

A separate Federal Reserve study, sent to Senator Glass prior to the passage of the 1933 Act, also suggests that bond losses were not a disproportionate cause of bank failures.[57] This study examined a sample of 105 member banks whose operations were suspended in 1931.[58] The study found that the principal cause of the failures was poor and dishonest lending practices, particularly "lax lending methods," "slack collection methods," "unwise loans to directors and officers," and "lack of credit data." Bond losses were

49. Benston, *The Separation of Commercial and Investment Banking*, p. 35.

50. This statement applies to Glass's subcommittee hearings conducted in both 1931 and 1932.

51. Benston, *The Separation of Commercial and Investment Banking*, p. 17.

52. Specifically, the questions did not address commercial banks' "securities affiliates, direct securities holdings, or securities-related services provided to customers (e.g., underwriting transactions)." Benston, *The Separation of Commercial and Investment Banking*, p. 17.

53. Benston, *The Separation of Commercial and Investment Banking*, p. 38.

54. Subcommittee of the Committee on Banking and Currency United States Senate Seventy-First Congress Third Session, Pursuant to S. Res. 71, a Resolution to Make a Complete Survey of the National and Federal Reserve Banking Systems, "Operation of the National and Federal Reserve Banking Systems," 1931, Appendix, Part 7, p. 1042. All seven sections of the report on the 1931 hearings are available at https://fraser.stlouisfed.org/title/675#!22457 (accessed January 5, 2016).

55. Benston, *The Separation of Commercial and Investment Banking*, p. 39.

56. Ibid., pp. 38–39.

57. The multi-volume study, commissioned in 1929, was "sent to Senator Glass, as the volumes were completed, in April and May 1933." The Glass–Steagall Act was passed in June 1933. See Federal Reserve Board, "Study by System Committee on Branch, Group, and Chain Banking," circa 1938, https://fraser.stlouisfed.org/scribd/?title_id=812&filepath=/docs/historical/federal%20reserve%20history/frcom_br_gp_ch_banking/study_syscommbrgrch_1938.pdf#scribd-open (accessed December 29, 2015).

58. Pages 39 to 41 of Benston discuss one chapter from the Fed study titled *225 Bank Suspensions: Case Histories from Examiners Reports*. The full chapter is available at https://fraser.stlouisfed.org/scribd/?title_id=797&filepath=/docs/historical/federal%20reserve%20history/frcom_br_gp_ch_banking/225_bank_suspensions.pdf#scribd-open (accessed December 28, 2015).

cited as "the primary cause of failure in six of the 105 banks selected from the 1931 suspensions, and an important contributing cause of failure in 4 other cases."[59]

This study makes no mention of securities affiliates' sales to correspondent banks; thus it cannot support Glass's claim.[60] Even if a greater proportion of banks than represented by this sample did fail due to bond losses, support for Glass's claim would still require two empirical findings. First, it would be necessary to show that banks would not have purchased these investments had their affiliates not offered them for sale. Second, it would have to be shown that the drop in the value of alternative investments, such as loans, would have been less than the decline suffered by these investments during the Great Depression. Nothing in the complete record indicates the subcommittee undertook such a study, or had such evidence.[61] Additionally, much of the witness testimony, though it was often no more than opinion, contradicted Glass's assertion.

Witness Testimony Contradicts Senator Glass

Benston describes the Glass Subcommittee hearings of 1931 as follows:

> No information was adduced about the extent to which banks obtained their long-term investments from bank securities affiliates. No studies were conducted, surveys taken, or data obtained. Although many of the witnesses were asked what they believed were the causes of the large number of bank failures, none identified banks' investments in securities as a cause, regardless of the source of the securities.[62]

Several witnesses during the 1931 hearings testified that securities investments were *not* related to the widespread bank failures. The main reasons cited as the cause were demographic changes, overbanking, fraud and mismanagement, and poor farming conditions. A summary of these witnesses' testimonies during the hearings is as follows.[63]

- Senator Glass asked Comptroller J. W. Pole: "What do you conceive to be the general cause of the numerous bank failures for the last five or six years?" The Comptroller blamed economic changes and stated, "I know of no instance where the shrinkage in value of collateral or bank investments as far as national banks are concerned, has been responsible for any bank failure or very, very few of them."

- J. H. Case, chairman of the Board of Directors of the New York Federal Reserve, blamed the crisis on too many banks relative to the demand for banking services (i.e., overbanking).

- H. Parker Willis, a key adviser to Senator Glass, asked the vice chairman of the First National Bank of Boston, B. W. Trafford, "Do you think those investments [bonds] have been a significant cause of bank suspensions in the Northeast or in other parts of the country?" Trafford stated, "The two that I know about were just crooked management; I think a couple more were unintelligent. But there were only five or six." Willis pressed further: "The security movement has had nothing to do with the bank failures in your part of the country at all?" Trafford responded, "Not this last year."

- President of the first National Bank of Fergus Falls, Minnesota, testified: "In the past eight years nine banks have failed in our country. No national bank failed. While the failure of these

59. See Benston, *The Separation of Commercial and Investment Banking*, p. 40, and Federal Reserve Board, *225 Bank Suspensions*, p. 105.

60. The chapter reviewed in Benston unequivocally makes no mention of this relationship. It also appears there is no mention of this relationship in the other nine chapters of the study, but only a summary of the full report is available online. The summary makes no mention of banks' securities investments other than to say that the "suspended banks had a somewhat *lower* proportion of open-market loans and a somewhat *lower* proportion of investment securities." (Emphasis added). See chapter titled "Summary of the Reports," p. 39, https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/frcom_br_gp_ch_banking/summary_of_reports.pdf (accessed December 29, 2015).

61. Benston, *The Separation of Commercial and Investment Banking*, p. 41.

62. Ibid., p. 37.

63. These exchanges are discussed in Benston, *The Separation of Commercial and Investment Banking*, pp. 37–38.

nine banks was due in part to unwise loans during the land boom period, there was dishonesty in nearly every one, and ten officials of the banks which failed in the Fergus Falls area were sent to the penitentiary…. Practically every one of these little banks which failed was in the farmland game."

- Senator Peter Norbeck (R–SD)[64] pointedly asked a member of the Federal Trade Commission, C. H. March, what he believed caused the Minnesota bank failures. March replied, "I attribute the failure to the condition of the agricultural country."

Unlike the 1931 hearings, the March 1932 Glass Subcommittee proceedings were directly related to the bill (S. 4115) that became the Banking Act of 1933 (i.e., the Glass–Steagall Act). At these hearings, the subcommittee heard from 37 bankers, four regulators, and one academic.[65] Almost every witness testified against the sections of the bill that would separate commercial banks from their securities affiliates. The two exceptions were J. W. Pole, Comptroller of the Currency, and Eugene Meyer, Governor of the Federal Reserve Board.[66] The other main original source of alleged abuses related to commercial banks' securities affiliates is the Pecora hearings conducted in 1933 and 1934.[67]

The Pecora Hearings: Sensationalized Abuses Outweigh Evidence

Ferdinand Pecora was the Chief Counsel for the Senate Committee on Banking and Currency, and the hearings he conducted in 1933 and 1934 won him the nickname *the hellhound of Wall Street*.[68] Pecora was the fifth Chief Counsel to conduct such hearings during the early 1930s, but only his proceedings, which began just prior to the national banking holiday, gained widespread notoriety.[69] During the financial meltdown of 2008, some Members of Congress even called for a new "Pecora Commission" to investigate the causes of the crisis.[70]

Before the hearings, Pecora assailed the "men of might" on Wall Street who had taken "millions and millions of the hard-earned pennies of the people."[71] He also expressed the hope that his hearings might "make it impossible for water and hot air to be sold to men and women for gold taken from their life savings."[72] The hearings were a success in that they provided public support for broad changes to securities laws (not simply the Glass–Steagall Act). They also embarrassed several high-profile

64. Senator Norbeck was the chairman of the Senate Committee on Banking and Currency from 1927 to 1933.
65. Benston, *The Separation of Commercial and Investment Banking*, p. 18.
66. Ibid. Benston also notes that the separate 1932 Glass Subcommittee Report "primarily addresses the relationship of bank lending to credit expansion and stock market speculation." In that report, "No material is given on bank insolvencies and security affiliates" and "[t]here is no mention of conflicts of interest or abuses."
67. Another frequently cited work is the 1934 Stock Exchange Practices (SEP) Report, a separate report that summarizes the Pecora hearings. See Benston, *The Separation of Commercial and Investment Banking*, p. 46. The nearly 400-page SEP Report contains seven chapters and it discusses information related to investment trusts that were not affiliated with commercial banks. According to Benston, the report does not provide a discussion of commercial banks' securities affiliates or operations. See Benston, *The Separation of Commercial and Investment Banking*, p. 18. The full citation for the SEP report is as follows: Stock Exchange Practices, Report of the Committee on Banking and Currency, 1934, pursuant to S. Res. 84 (72nd Congress) and S. Res. 56 and S. Res. 97 (73rd Congress) (Washington, DC: U.S. Government Printing Office).
68. A recently published book chronicles "the 10-day interrogation by chief counsel Ferdinand Pecora of executives of National City Bank (precursor to Citigroup)." See Michael Perino, *The Hellhound of Wall Street: How Ferdinand Pecora's Investigation of the Great Crash Forever Changed American Finance* (New York: Penguin Press, 2010).
69. Frank Partnoy, "Financial Reform: Lessons from 1929," Bloomberg Business, October 1, 2009, http://www.bloomberg.com/bw/magazine/content/09_41/b4150084819447.htm (accessed December 29, 2015).
70. Carla Marinucci, "Pelosi Calls for Panel to Probe Wall Street," SFGate, April 16, 2009, http://www.sfgate.com/politics/article/Pelosi-calls-for-panel-to-probe-Wall-Street-3244616.php (accessed December 29, 2015.) Ultimately the Financial Crisis Inquiry Commission was set up to study the causes of the crisis, and some hoped that it would "rip the lid off the crisis in the comprehensive way that the Pecora Commission did in the 1930s during the Great Depression." See Dave Clarke and Kevin Drawbaugh, "Bernanke: All But One Major Firm at Risk in 2008," Reuters, January 27, 2011, http://www.reuters.com/article/us-financial-regulation-fcic-idUSTRE70Q51X20110127 (accessed December 29, 2015).
71. See James Grant, "Out for Blood: A Portrait of the Prosecutor Charged with Investigating the Causes of the 1929 Crash," *The Wall Street Journal*, October 14, 2010, http://www.wsj.com/articles/SB10001424052748704380504575530392819077162 (accessed December 29, 2015).
72. Ibid.

executives, and ultimately forced the resignation of Charles E. Mitchell, the chairman of National City Bank and its securities affiliate, National City Company (NCC).[73]

Despite the political success, virtually none of the more than 11,000 pages of testimony from these hearings provide evidence on the *safety and soundness* of commercial banks and their securities affiliates.[74] Yet, the Pecora hearings are frequently cited as evidence of abuses that necessitated the separation of commercial and investment banking. One important historical account reads as follows:

> The abuses uncovered were so gross that the financial community itself was appalled.... "The only thing that some of our great financial institutions overlooked during the years of the boom," observed Heywood Broun, the noted Scripps-Howard columnist, "was the installation of a roulette-wheel for the convenience of depositors."[75]

Another historical account of the Pecora hearings reads as follows:

> [The] hearings...uncovered various abuses involving large banks and their securities affiliates. These hearings revealed that certain banks made loans to securities purchasers to help support artificially securities prices, dumped "bad" securities with correspondents or in trust accounts, and used securities affiliates to relieve the banks of their bad loans and to purchase stock in companies to which the banks had loaned money.[76]

As with historical references to the Glass Subcommittee hearings, the actual record does not support such claims. Some of the confusion comes from scholars' reliance on Pecora's 1939 account of the hearings rather than the actual record.[77] There is no doubt that Pecora characterized his hearings in a manner consistent with the above quotations, but the political nature of the hearings explains such a portrayal. Regardless, the Pecora hearings produced virtually no evidence of the problems the Glass–Steagall Act was designed to cure.

Evidence vs. Allegations. The Pecora hearings' alleged abuses refer mostly to activities conducted by two banks, their affiliates, and their chairmen. The initial hearings focused on Charles Mitchell, the chairman of National City Bank (the precursor to Citigroup) and its securities affiliate, NCC. The second set of hearings focused on Chase National Bank and its affiliate, Chase Securities Corporation. The charges against Chase and its chairman, Albert Wiggins, were made *after* Glass–Steagall was already enacted.[78] From the works of four well-cited historians and Pecora's own published account, Benston compiled the following list of specific charges alleged during the Pecora hearings.[79]

1. Avoidance, if not evasion, by Mitchell of personal income taxes;

2. High salaries and bonuses paid to Mitchell and other top executives that were not reported to stockholders;

73. In 1929, Senator Glass stated that "Mitchell more than any 50 men is responsible for this stock crash." See Binyamin Appelbaum, "Citi's Long History of Overreach, Then Rescue," *The Washington Post*, March 11, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/03/10/AR2009031003391_pf.html (accessed December 29, 2015).

74. Benston reports that he was "unable to find *any* testimony relating to the safety and soundness, competition, or concentration of power questions," [emphasis added] in the Pecora testimony. Benston, *The Separation of Commercial and Investment Banking*, p. 18.

75. Vincent Carosso, *Investment Banking in America: A History* (Cambridge, MA: Harvard University Press, 1970), p. 330.

76. Robert Litan, *What Should Banks Do?* (Washington: The Brookings Institution, 1987), p. 27. For other examples of these types of claims, see Carosso, *Investment Banking in America*; Thomas Fischer, William Gram, George Kaufman, and Larry Mote, "The Securities Activities of Commercial Banks: A Legal and Economic Analysis," *Tennessee Law Review*, Vol. 51 (1984), pp. 467–518; Susan Kennedy, *The Banking Crisis of 1933* (Lexington: University of Kentucky Press, 1973); J.P. Morgan and Company, *Rethinking Glass-Steagall* (New York: J.P. Morgan, 1984), W. Nelson Peach, *The Security Affiliates of National Banks* (Baltimore: Johns Hopkins Press, 1941); and Joel Seligman, *The Transformation of Wall Street* (Boston: Houghton Mifflin, 1982).

77. See Ferdinand Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers* (New York: Simon and Schuster, 1939). Pecora does include excerpts of actual testimony in his 1939 account of the hearings.

78. Benston, *The Separation of Commercial and Investment Banking*, p. 47.

79. See Benston, *The Separation of Commercial and Investment Banking*, pp. 48-49. The first 10 charges are from Carosso, *Investment Banking in America*.

3. Special lending facilities for officers but not for other employees;

4. Profiting by executives from individual participations in the affiliate's securities flotations;

5. Bonds sold with inadequate or misleading information given to investors;

6. Sales of domestic corporation stock under similar circumstances;

7. Ethically dubious activities, such as stock exchange speculation and participation in pool operations;

8. Steering depositors to the securities affiliate;

9. Trading in the stock of the National City Bank by its securities affiliate (to manipulate the stock price);

10. Use of the affiliate to disguise bad banking practices and to hide losses from stockholders;

11. A loan by National City Bank to the general manager of the port authority of New York before National City Bank received the right to issue $66 million in port authority bonds;[80] and

12. The plight of an investor who lost $100,000 as a result of churning and bad advice by National City Bank employees.

Most of these charges are completely irrelevant to the question of whether commercial and investment banking should be separated. At best, a few of the alleged abuses could be unique to the banking-securities affiliate relationship. However, charges such as excessive salaries and bonuses, ethically dubious behavior, insider profits, bribes, misleading customers, and tax evasion, are not unique to any one industry much less a given structure within an industry. Even the charge of hiding losses from stockholders through an affiliated company—potentially fraudulent behavior—cannot be considered unique to firms in any one industry. The following summary provides insight into the actual record of the Pecora hearings.[81]

Charge 4: Profiting by Executives from Individual Participations in the Affiliate's Securities Flotations. Pecora criticized the manner in which NCC floated[82] the stock offerings for Boeing Airplane and Transportation Corp. and United Aircraft. In particular, Pecora intimated that because NCC executives retained a large portion of the stocks, they profited at the expense of the investing public. NCC executives insisted that, to the contrary, they acted responsibly by retaining a large portion of the stock because "there was grave doubt at the time we bought these stocks…as to how the market would receive them."[83] Aside from the newness and uncertainty surrounding the airline industry, features which support the executives' defense, retaining the stock aligned management's interests with those of the investors. Furthermore, the fact that these share prices rose *after* they were sold to the public does not indicate that NCC executives benefited at the expense of anyone else.

Charge 5: Bonds Sold with Inadequate or Misleading Information Given to Investors. Vincent Carosso's widely cited historical account says that NCC "lured" investors into buying bonds, provided "few, if any, pertinent facts concerning the quality of the securities recommended," and pushed "low quality securities on unsuspecting investors, who had no way of learning their 'true value.'"[84] The details of the hearing flatly contradict this characterization, but a key source of confusion is that Carosso cites Pecora's 1939 description of the 1933 hearings instead of the actual record of the hearings. And there is no doubt that Pecora's

80. Seligman, *The Transformation of Wall Street*, lists charges 1, 4, 5 and 8, then adds 11.

81. Benston devotes two full chapters to the Pecora hearings and the above allegations. See Benston, *The Separation of Commercial and Investment Banking*, pp. 43–138.

82. Flotation is a term synonymous with taking a company public, whereby an underwriter (in this case the bank's securities affiliate) offers new shares for sale to the public.

83. Benston, *The Separation of Commercial and Investment Banking*, p. 51.

84. Carosso, *Investment Banking in America*, p. 330 and p. 331, respectively. Carosso cites Pecora, *Wall Street Under Oath*, pp. 96–100, and he also cites the 1933 Pecora hearings for an NCC executive's quote which explains why some financial transaction details were not disclosed to investors.

1939 account of the hearings casts NCC's executives as profit-hungry money changers whose excesses caused the crash.[85]

The alleged abuses centered on the following NCC bond issues: $8.5 million from a Brazilian State (Minas Gerais); $90 million from Peru; $15 million from the Cuban Dominican Sugar Company; and $32 million from the Lautrato Nitrate Company of Chile. NCC executives disputed Pecora's allegations for each bond issue. One former NCC vice president (Ronald Bynes) and one 1933 executive (George Train) testified that all of the information in the prospectus for the Minas Gerais bonds was accurate. Benston reviewed the testimony and concluded that "neither Carosso nor Pecora are justified in charging the NCC with fraud or misrepresentation in its offering of Minas Gerais bonds."[86]

The Peruvian bonds had lost nearly all their value by 1933, but this fact alone does not indicate NCC did anything improper. In fact, the NCC employee in charge of the Peruvian bonds, Victor Schoepperle, testified that the company did nothing fraudulent. He stated, "I thought, like a great many others, that I was in a new era, and I made an honest mistake in judgment."[87] Furthermore, at least one independent organization believed the bonds were a decent investment. Moody's initially rated the bonds "A" in 1927, and then downgraded them to "Baa" in 1928 with the comment that the "debt should be adequately protected."[88] Regardless, nothing in the record supports the allegation of wrongdoing, and later analysis showed that these Peruvian bonds amounted to only 2 percent of NCC's total underwriting commitments made during 1921 to 1929.[89]

The Cuban Dominican Sugar Company bonds were issued in 1924. In his 1939 account, Pecora charged that NCC failed to disclose "the Cuban sugar industry had collapsed in 1920 and had shown only a minor flurry of improvement in later years."[90] It is difficult to conceive how NCC could have hidden the collapse of the Cuban sugar industry from the public. Nevertheless, when Pecora asked NCC's chairman about the bonds, Mitchell explained, "I thought it was such a good investment that I went away buying the bonds myself and bought stock in the open market and put it away in my box, and it is there today."[91] The fact that Mitchell personally invested in the bonds and held onto them for nearly 10 years, even throughout the Depression, makes it highly doubtful that NCC fraudulently misled anyone as to the quality of the bonds.

Finally, in his 1939 account, Pecora charged that when NCC floated the Lautrato bonds in 1929, they "knew that the future of the Chilean nitrate industry, of which Lautrato Nitrate was a part, was greatly jeopardized by the development of synthetic nitrogen. But it neither passed on its information to the public, nor, when the bonds dropped precipitously…did it feel any tremors of remorse or responsibility."[92] Aside from the irrelevance of the executives' remorse or responsibility for the bonds' drop in value, the record from the 1933 hearings contradicts Pecora's 1939 account. NCC's vice president Byrnes testified that the company sent an engineer to study the company's process and, based on that report, NCC believed Lautrato would be able to compete with producers of synthetic fertilizers. He also testified that there was, of course, no way to be absolutely certain of how long the company would be able to do so.[93]

Charge 8: Steering Depositors to the Securities Affiliate. It was, in fact, company policy to direct any National City Bank depositor who sought investment advice to NCC. Hugh Baker, NCC's presi-

85. Pecora states that his account of the hearings is meant to "cast a vivid light upon the uninhabited mores and methods of Wall Street." Pecora, *Wall Street Under Oath*, p. xi.

86. Benston, *The Separation of Commercial and Investment Banking*, p. 55.

87. Benston, *The Separation of Commercial and Investment Banking*, p. 59, quotes 1933 Pecora hearings, p. 2115.

88. Benston, *The Separation of Commercial and Investment Banking*, p. 60.

89. They also had the worst record of any of NCC's foreign bond issues. See Benston, *The Separation of Commercial and Investment Banking*, p. 60, and Harold Cleveland and Thomas Huertas, *Citibank, 1812–1970* (Cambridge, MA: Harvard University Press, 1985), pp. 175–176.

90. Pecora, *Wall Street Under Oath*, p. 103.

91. Benston, *The Separation of Commercial and Investment Banking*, p. 61, quotes 1933 Pecora hearings, p. 1799.

92. Pecora, *Wall Street Under Oath*, pp. 103–104.

93. Benston, *The Separation of Commercial and Investment Banking*, pp. 62–63.

dent, testified that the "reason that I feel that is the proper way to do it is because of the facilities which we had in the National City Co. for a study of investments, and based upon that we made our recommendations."[94] With one *possible* exception, there is nothing in the record, beyond innuendo, to indicate that investors were given advice inconsistent with their investment objectives.

The possible exception regards an unproven allegation discussed in Pecora's 1939 account of the hearings. In this case, a bankrupt businessman, Mr. Brown, claimed he lost the proceeds from the 1928 sale of his business because of an NCC salesman's churning (regularly buying and selling rather than buying and holding) and bad advice. The Senate committee did not allow NCC to rebut Mr. Brown's testimony, and Benston's "extended search" found no evidence of *any other investors* claiming similar treatment by NCC or *any other* bank affiliate.[95]

Regardless, data shows that NCC's customers did at least as well as they would have done had they purchased securities from an independent agent instead of the bank's affiliate.[96] Furthermore, National City Bank was legally restricted to offering deposit services within New York City. Even though NCC was the bank's national affiliate, with offices in more than fifty cities, the bank had no opportunity to steer depositors in these other cities to NCC. State bank branching laws similarly restricted other banks throughout the U.S. Regardless, there is nothing inherently wrong with these referrals as long as customers receive advice consistent with their objectives. No proof of such wrongdoing was presented at the hearings.

Charge 9: Trading in the Stock of the National City Bank by its Securities Affiliate (to Manipulate the Stock Price). In his 1939 book, Pecora claimed that NCC drove National City Bank's stock price to "dizzy heights" by heavily trading the bank's shares.[97] At the actual hearings, Hugh Baker testified that NCC had undertaken a concerted effort to sell more shares in National City Bank and, since they could only be purchased together, NCC. He further testified, "It seemed to me that the more stockholders that the National City Bank had in the U.S. the more business opportunities there would be opened to the bank and the more people there would be interested in the business of the bank."[98] However, he flatly denied Pecora's charge. The following exchange between Baker and Pecora illustrates the two views.[99]

> *Pecora*: Wasn't it the studied purpose and policy of the company to try to control the market on City Bank Stock?
>
> *Baker*: I don't think so; no. We could not possibly. There were many, many dealers in bank stocks in New York. I don't know how many thousand shares of bank stocks they were dealing in, but certainly we were only a very small part of the market.

Aside from this type of questioning, there is nothing in the record to support any sort of market manipulation on the part of NCC. Baker also denied a related charge that NCC customers were encouraged to sell other stocks and purchase, instead, the bank's stock. He testified that portfolio changes—with respect to *any* securities sponsored by NCC—were recommended only when "in the judgment of our experts, [it] was a desirable exchange to make."[100]

Charge 10: Use of the Affiliate to Disguise Bad Banking Practices and to Hide Losses from Stockholders. Of all the above charges, this one is perhaps the most relevant to the Glass–Steagall

94. Benston, *The Separation of Commercial and Investment Banking*, p. 68, quotes 1933 Pecora hearings, pp. 2018–2020.

95. Benston, *The Separation of Commercial and Investment Banking*, p. 75. Benston reports that no other witnesses made similar allegations, and no such "letters or memorandum of complaints" are in the committee records.

96. Benston, *The Separation of Commercial and Investment Banking*, p. 68.

97. Pecora, *Wall Street Under Oath*, p. 110. Carosso, *Investment Banking in America*, repeats this phrase on p. 332.

98. Benston, *The Separation of Commercial and Investment Banking*, p. 70, quotes 1933 Pecora hearings, p. 1938.

99. Benston, *The Separation of Commercial and Investment Banking*, p. 71, quotes 1933 Pecora hearings, p. 1919. This exchange is not included in Pecora, *Wall Street Under Oath*.

100. Benston, *The Separation of Commercial and Investment Banking*, p. 71, quotes 1933 Pecora hearings, p. 2021. This testimony is not included in Pecora, *Wall Street Under Oath*.

separation of commercial and investment banking, even though such behavior could take place under an affiliate arrangement in any industry. The Pecora charge stems from a 1927 transaction involving loans to a Cuban sugar company, and the typical historical account is as follows:

> Such close ties as existed among these institutions, especially those between the bank and the investment affiliate, disguised bad banking practices and kept mistakse [sic] and losses from reaching the attention of stockholders. A striking example of this deception occurred in 1927; the National City Bank, criticized by federal examiners for having made some poor sugar loans, unloaded some $25 million of these on its affiliate and did so at the expense of the bank's stockholders and without their knowledge.[101]

As with most of the other charges, the actual record does not support this characterization and actually contradicts some of the alleged facts. It is true that NCC floated a new issue of $50 million in stock, and transferred half of the proceeds to National City Bank in exchange for $25 million of these sugar company loans. It is also true that bank examiners had criticized the loans, and that the loans eventually had to be written off. But these events do not constitute fraudulent or even improper behavior.

During the hearings, Pecora characterized the stock transaction as a bailout, but Mitchell strenuously objected. He insisted the transaction was in no way a "bail out" or an "unloading" of any sort, and asserted that in 1927 the loans were good though illiquid.[102] To support his claim, Mitchell read into the record the history of sugar prices from 1922 to 1933, as well as earnings projections for the sugar company. Prices had remained stable until 1932 when they fell from approximately 3 cents per pound to 0.125 cents per pound in 1933, at which time the loans were written off. Mitchell insisted that at the time of the transaction, 1927, the company's officers and directors had all agreed the loans were a good investment for NCC.

Mitchell also testified that the company did not inform the bank's stockholders of the specific transaction because it did not represent a new investment for them. Furthermore, dating back to 1921 the bank's annual reports (and special statements) informed shareholders of the status of the loans. It is also clear that the company did not hide anything from bank examiners who were on record as warning the bank that the loans were illiquid, a fact Mitchell acknowledged.[103] Finally, because the bank's shareholders were proportional shareholders in NCC, it is erroneous to argue that either group could have lost at the expense of the other.

Similar Charges Against Chase National Bank. The Pecora hearings also focused on similar alleged abuses that occurred at Chase National Bank and its affiliate, Chase Securities Corporation, under the leadership of chairman Albert H. Wiggin. Benston concludes, "Nothing in the record that Carosso or Pecora (the only writers who specifically refer to evidence) cite supports the contention that Chase's securities operations gave rise to abuses. Most of the allegations of abuses concern the activities of Chase's president, Albert Wiggin. But even these do not indicate much in the way of actual wrongdoing."[104] The incredible lack of evidence presented during any of these hearings underscores their purely political nature, and also casts doubt on the necessity of separating commercial and investment banking.[105]

101. Carosso, *Investment Banking in America*, p. 333; Carosso cites Pecora, *Wall Street Under Oath*, pp. 121–123.
102. Mitchell's objections to this characterization are absent from Pecora's 1939 account. See Pecora, *Wall Street Under Oath*, pp. 121–123.
103. See Benston, *The Separation of Commercial and Investment Banking*, pp. 72–74.
104. Ibid., p. 88.
105. For more on the issue of separation, see George Rich and Christian Walter, "The Future of Universal Banking," *Cato Journal*, Vol. 13, No. 2 (1993), pp. 289–313, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1993/11/cj13n2-8.pdf (accessed January 4, 2016); H. E. Boschgen, "The Universal Banking System in the Federal Republic of Germany," *Journal of Comparative Corporate Law and Securities Regulation*, Vol. 2 (1979), pp. 1–27, https://www.law.upenn.edu/journals/jil/articles/volume2/issue1/Buschgen2J.Comp.Corp.L.%26Sec.Reg.1(1979).pdf (accessed January 4, 2016); Michelle Clark Neely, "Commercial & Investment Banking"; George Benston, "Universal Banking"; George Edwards, *The Evolution of Finance Capitalism* (New York: Longmans, Green & Co., Inc., 1938) p. 143, http://socserv.mcmaster.ca/econ/ugcm/3ll3/edwards/evolutionfinancecapitalism.pdf (accessed January 4, 2016); and Paul Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University of Chicago Press, 2015).

Conclusion

There are many myths and falsehoods surrounding the 1933 Glass–Steagall Act and its separation of commercial and investment banking. Regardless of its mythical stature, there is virtually no evidence that pre-Glass–Steagall banks' securities activities led to disproportionately more bank failures than among their specialized peers. Evidence does suggest, however, that banks engaged in both commercial and investment banking were stronger than those firms engaged in only one type of financial intermediation.

Even though the actual record does not support it, many scholars cite the evidence of abusive and reckless practices Congress uncovered prior to passing the Glass–Steagall Act. Usually, these types of claims refer to a secondary source rather than the original record, to opinions and allegations rather than actual evidence, and even to practices that had nothing to do with the combination of investment and commercial banking. The Glass–Steagall separation of commercial and investment banking was never a complete separation, and it was little more than a pet project of Senator Carter Glass, a man who viewed securities investments as illegitimate financial speculation.

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