It is "time to stop crying 'wolf.'"

–President Franklin D. Roosevelt to
U.S. Chamber of Commerce (1934)

XI. Industry Repeats Itself: Hysteria Over Financial Reforms, Then and Now

Taylor Lincoln[1]

(originally published June 2011)[2]

Bankers and business leaders described the reforms following the financial meltdown in foreboding language, such as "monstrous systems" imposing an "impossible degree of regulation" that would "cripple" the economy and set the country on a course toward socialism.

Many of the chieftains' complaints centered on matters affecting their own industries, but they portrayed regular Americans as the true victims because, they said, new laws and regulations were halting the flow of capital, grinding the nation's job creation engine to a halt.

Although readers could be forgiven for assuming that these complaints refer to the debate over the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the claims above are all about 75 years old.

The "monstrous" reforms of yesteryear created the Federal Deposit Insurance Corporation and the Securities and Exchange Commission, and required publicly traded companies to disclose their earnings and other material information. Today, these institutions and requirements are bedrocks of our financial system.

"It is an exceedingly dangerous bill."
—American Bankers Association President Francis S. Sisson on the measure creating the FDIC (1933)

In retrospect, the business community's wildly inaccurate forecasts over the New Deal reforms should serve as data points in evaluating whether the ominous predictions surrounding recent financial reforms should be taken seriously or dismissed as mere special interest hyperbole.

Creating the FDIC Was 'Exceedingly Dangerous'

Among the first New Deal actions was passage of the Banking Act of 1933, which, among other things, created the Federal Deposit Insurance Corporation. The FDIC provided government-backed insurance for most consumers' bank deposits and gave the government authority to take control of failed banks and sell them to solvent institutions.

When the plan was enacted, bankers were outraged and predicted its failure. Francis S. Sisson, president of the American Bankers Association, said that the bill was so unsound that it would "ultimately force its own repeal."[3]

"In my opinion, it is an exceedingly dangerous bill," Sisson said less than a week after the law took effect.[4] "You simply cannot cover up vice with this kind of virtue, by forcing the good banks to carry the burdens of the weak."[5]

Time characterized Wall Street's reaction even more stridently: "Through the great banking houses of Manhattan last week ran wild-eyed alarm," *Time* wrote. "Big bankers stared at one another in anger and astonishment. A bill just passed by both houses of Congress would rivet upon their institutions what they considered a monstrous system of guaranteeing bank deposits. Such a system, they felt, would not only rob them of their pride of profession but would reduce all U.S. banking to its lowest level. They saw their deposits which they had spent a lifetime to build up and protect with their good names confiscated by the government to pay for the mistakes and dishonesty of every smalltown bankster."[6]

The creation of the FDIC was "the structural change most conducive to monetary stability" since the Civil War.
—Milton Friedman and Anna Jacobson (1963)

But federal insurance of savings accounts soon proved an invaluable guardian against runs on banks. Less than a year after the American Bankers Association's president castigated the program as "exceedingly dangerous" and destined to fail, the ABA's executive council endorsed it.[7]

In 1933, 4,000 banks failed. In 1934, the FDIC's first year, only 52 failed, including only nine that participated in the insurance program.[8] Bank failures averaged fewer than 40 a year over the next decade, and never reached double digits in a single year in the ensuing three decades.[9] Since the FDIC's inception, nobody has lost a penny of insured deposits.[10]

The creation of the FDIC is now widely credited with helping restore confidence in the financial and banking industry. Perhaps the greatest homage to the FDIC was paid by Milton Friedman. The libertarian economist's opposition to government was so broad that he opposed licensure of doctors and regulation of prescription drugs.[11] But he and co-author Anna Jacobson Schwartz in 1963 praised the creation of the FDIC as "the structural change most conducive to monetary stability" since the Civil War.[12]

The Truth in Securities Act Threatened "Wholesale Defaults," Creating "Business Emergency of Vast Importance"

The Securities Act of 1933, also known as the Truth in Securities Act, required disclosure of accurate financial information for new offerings of securities (for example, stocks and bonds).[13] The law, largely modeled after state laws,[14] made corporate officers and others involved in underwriting securities liable for misrepresentations and deceptions in their filings.

Today, these requirements are considered vital to maintaining the public's faith in the markets. But in 1933, bankers blamed them for further harming the already ravaged economy.

> "A business emergency of vast importance has been created by the Federal Securities Act."
> —*Merchants Association of New York (1934)*

Investment Bankers Association President Frank Gordon said four months after the act's passage that its liability provisions were inhibiting investment to such an extent that they threatened to cause "wholesale defaults."

"All over the United States corporations are ready to undertake the necessary financing," Gordon said in an address to the IBA's members. "But no corporation director is going to risk existing resources by putting his name on financing under a law that makes him personally liable for the next ten years and adopts the unprecedented principle that he is to be judged guilty unless he can be proven innocent."[15]

The Merchants Association of New York warned, "A business emergency of vast importance has been created by the Federal Securities Act, which if not promptly corrected may result in seriously delaying business recovery and in increasing unemployment through bankruptcies which are practically certain to occur in industrial fields," a study commissioned by the association concluded.[16]

The Investment Bankers Association passed a resolution naming the liability clauses in the Truth in Securities Act the chief culprit for lagging investment in the capital markets. "The absence of a capital market may be attributable to several causes, including the present unsettled economic conditions, but in the opinion of our association, the most important single cause has been and is [the liability] provisions of the Securities Act," the resolution said. "This condition is seriously interfering with industrial recovery and re-employment."[17]

The liability provisions were amended slightly in June 1934, increasing the onus on investors to show that inaccuracies in registration statements were related to a decline in a stock's value, shortening the statute of limitations and modifying the standard of care bankers would need to demonstrate to avoid liability.[18] But

the fundamentals of the provision remained: individuals involved in new stock offerings were held liable for knowingly or negligently disseminating false information or omitting important information.

Industry's forecast that the provision would have dire effects on the economy was wrong. After shrinking by an average of more than 15 percent per year in the three years leading up to the law's enactment, the economy slipped by only 3 percent in 1933. From 1934 to 1936, the economy grew by an average of 14.1 percent per year.[19]

Stock offerings were few in the 1930s and 1940s because of the roiled economy, the second world war and the public's lingering distrust of the stock market following the 1929 crash. But the stock market flourished during most of the second half of the 20th century, most likely aided by laws ensuring accurate information about potential investments. New offerings of securities played a vital role in helping businesses raise capital.

SEC Bill Imposed 'Impossible Degree of Regulation' on Businesses; NYSE President Said It Would 'Destroy Our Security Markets'

Industry elevated its rhetoric during the debate over the Securities Act of 1934, which established the Securities and Exchange Commission.

The 1934 Act required publicly traded companies to file earnings reports and to issue timely notices of material events, such as major changes in personnel or significant losses of assets. This information was intended to enable investors to evaluate whether to buy or sell stock, and to combat insider trading.

Today, organizations such as the U.S. Chamber of Commerce revere the principles of the 1934 Act. For example, the Chamber's Center for Capital Markets Competitiveness wrote in a 2010 letter to the Securities and Exchange Commission that "America's well-regulated, efficient, and transparent markets promote economic growth and prosperity while also maintaining the U.S. as the premier global financial center."[20]

The bill creating the SEC would "not provide for regulation but destruction. It would help me by driving 85 percent of my competitors out of business, if I could manage to keep out of Atlanta or Leavenworth myself."

—Brokerage House manager Edward Pierce (1934)

That was not the attitude of the Chamber of Commerce or other business trade groups in 1934. Chamber President Henry I. Harriman said the proposal to require publicly traded companies to register their securities[21] would require a company to "sign away its constitutional rights to protect its property rights from being taken away from it without due process of law."[22] He predicted that the bill would lead to the federal government actually choosing who served on businesses' boards of directors.[23]

The proposal represented an "impossible degree of regulation of the credit agencies and business enterprises of the country," the board of directors of the Chamber of Commerce wrote.[24]

The Chamber's directors added that the 1934 Act "would produce even greater injury than the [1933 Act] in retarding or preventing the flow of securities into new and refunding issues, which are indispensable if employment is to be maintained and increased and the huge burden on the Treasury is to be relieved."[25]

The National Association of Manufacturers offered an equally gloomy forecast: "Taken together with the Securities Act of 1933, [the 1934 Act] will effectively bar the flow of capital into American business," association Vice President George Houston, told the Senate banking committee in March 1934.[26]

As with the 1933 Act, critics accused the 1934 Act of imposing untenable conditions on financial industry professionals.

The bill would "not provide for regulation but destruction," Edward Pierce, who ran one of the largest brokerage houses in the country, said in testimony to the House commerce committee. "It would help me by driving 85 percent of my competitors out of business, if I could manage to keep out of Atlanta or Leavenworth [prisons] myself."[27]

The bill creating the SEC "will not only destroy our security markets but will as a necessary consequence interrupt the flow of credit and capital into business."

—Richard Whitney, president of the New York Stock Exchange (1934)

In addition to regulating publicly traded companies, the 1934 Act prevented investors from borrowing more than 55 percent of the value of equities they purchased. During the 1920s, investors frequently borrowed up to 90 percent of the value of their investments, creating a vulnerability that exacerbated the impact of the stock market crash of 1929.[28] Wall Street's chiefs opposed these "margin" requirements, fearing that they would prompt investors to pull out of the market.

"I submit that no such rigid limitations should be placed upon the loans which may be made by banks," William C. Potter, chairman of the board of Guaranty Trust Co. of New York, testified to the Senate banking committee.[29] "Establishment of minimum margins is unfair and unnecessarily restrictive in principle," he said, warning that the limits would have a "harmful, deflationary effect."[30]

Nobody was more histrionic in his characterization of the proposed 1934 Securities Act than Richard Whitney, president of the New York Stock Exchange. "Banks, industry and all investors" would be harmed by margin requirements," he said.[31]

"There is no important aspect of the economic life of this country, whether it be agriculture, industry, banking or commerce, which will not be adversely affected by this bill," Whitney said in a newsreel film. "This bill, if passed by Congress, will not only destroy our security markets but will as a necessary consequence interrupt the flow of credit and capital into business."[32]

Whitney had reason to fear regulation and limitations on margin borrowing. In 1938, he was forced to declare bankruptcy after years of margin-financed investing caught up with him.

> Nobody with "any practical acquaintance with business process" could look at the Securities Acts of 1933 and 1934 "and arrive at any verdict other than they cripple and retard business rather than help revive it. The fact is even so clear that it is hard to keep from wondering if such a result were not actually intended."
>
> *—U.S. Chamber of Commerce Vice President Philip J. Fay (1936)*

Whitney was convicted of embezzlement schemes and sentenced to 5-to-10 years in prison. He ended up serving two years in New York's Sing Sing penitentiary.[33]

The complaints over the financial reforms were a part of a chorus of business community arguments that the New Deal was ruining the United States' capitalist system, perhaps even by design.

U.S. Chamber of Commerce Vice President Philip J. Fay, for example, said in 1936 that nobody with "any practical acquaintance with business process" could look at the two securities acts and other new laws and regulations "and arrive at any verdict other than they cripple and retard business rather than help revive it. The fact is even so clear that it is hard to keep from wondering if such a result were not actually intended."[34]

Recent Financial Reforms Equated to 'Summary Execution' of Corporations and 'Stalking Horses for Government Intervention'

Much of the rhetoric aired over the two major financial reform laws instituted during the past decade, the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, has echoed the alarmist language of the 1930s.

Sarbanes-Oxley—passed in the wake of accounting scandals accompanying the downfalls of Enron, WorldCom and other firms—enhanced the standards and accountability for public companies' financial disclosures.

Sarbanes-Oxley would "hand American corporations back to the trial lawyers for summary execution."

—U.S. Chamber of Commerce President Thomas J. Donohue (2002)

The law requires chief executives and top financial officers of publicly traded companies to certify that they know of no untrue statements or material omissions in their financial statements, and that they have designed internal systems to ensure that they would be alerted of such problems. The requirement is similar to language in the 1933 Act, but applies to ongoing financial reports.

The business community's opposition to the proposal was just as fervent as it had been 70 years earlier. "If the CEO of a $50 billion corporation operating in 112 countries is required to sign a document saying he guarantees under penalty of law that all these numbers are correct, there's not a CEO in America that will sign it," U.S. Chamber of Commerce President Thomas J. Donohue said as the bill neared passage.[35]

Donohue predicted that the bill would "hand American corporations back to the trial lawyers for summary execution."[36]

In fact, prosecutions stemming from the certification clause in Sarbanes-Oxley have been rare, perhaps too rare. The onslaught of litigation that Donohue predicted has not occurred. The annual dollar value of settlements from class action lawsuits has remained fairly constant since the law's passage.[37]

By 2010, Donohue had revised his view. "Fair enough," Donohue said of the regulations called for in Sarbanes-Oxley. "A lot of it was well worth doing."[38]

By then, Donohue had a new villain: Dodd-Frank. "When Dodd-Frank passed, it had something in the neighborhood of 300 mandatory regulations and 200 suggested regulations," Donohue said. "My grandchildren will be retiring before all that stuff gets done. That wasn't a regulation, that was stuff done in anger outside the normal lines of how you do business in the U.S. Congress."[39]

Dodd-Frank was the most comprehensive overhaul of financial sector regulation since the Great Depression. Among its many

facets, the bill regulated derivatives; set standards for mortgage lending; created the Consumer Financial Protection Bureau to ensure the safety of financial services products; increased capital requirements for banks; and gave the government the ability to take over failed investment institutions, similar to the FDIC's authority regarding commercial banks.

The Chamber weighed in to block creation of the Consumer Financial Protection Agency, which was later named Consumer Financial Protection Bureau.[40] Although the proposed agency would oversee financial services products, the Chamber portrayed it as a missile aimed at Main Street.

Corner butchers and bakers who let their customers "run a tab and pay the bill over time to help make ends meet" would be harmed, the Chamber warned, because "Washington wants to make it even tougher on everyone."[41]

If you were "a school, church or other non-profit that provides financial advice to low-income taxpayers," then "You guessed it!" a Chamber ad warned, you could be regulated by the CFPA."[42]

The CFPA, the Chamber said in an ad depicting a construction worker, would "cut access to credit for millions of small businesses, making it harder for growing companies to expand operations and hire new employees."[43]

Others criticized the bill for forms of regulation it actually would undertake. New rules for pay day lenders and check cashers, would reduce job creation by more than 4 percent because entrepreneurs would not obtain the credit they need, a pair of law professors predicted.[44]

A proposal to increase the capital that banks must maintain prompted JPMorganChase CEO Jamie Dimon to predict, "If we have higher capital requirements than the rest of the world, now you are just putting the nail in the coffin."[45]

"If we have higher capital requirements than the rest of the world, now you are just putting the nail in the coffin."
—JPMorganChase CEO Jamie Dimon (2011)

Many predicted that the law would result in a massive intrusion by the government into private sector affairs, much as Richard Whitney forecast for the Securities Act of 1934 before he was sent to Sing Sing.

A coalition of conservative and Tea Party groups wrote in a letter to Senate leaders that "Main Street non-financial businesses would be hit with taxation, regulation, and possible nationalization by the Federal Reserve."[46]

Proposals to give shareholders a greater say in corporate governance, the coalition wrote, would "empower union pension funds and other progressives by forcing companies to fund their Saul Alinsky-style campaigns for a company's board of directors" and would end up "kicking conservative media personalities off the air."[47]

Gregory Zerzan, a deputy assistant treasury secretary under George W. Bush, wrote that the proposals under discussion in Dodd-Frank were "stalking horses allowing government intervention into virtually every facet of the U.S. economy."[48]

In Zerzan's view, the government would categorize just about any major company as a "financial" business for the purpose of taxing it to raise money to pay for future "bailouts of failed financial services firms."

Thus, Zerzan continued, an airplane manufacturer that "holds customer down payments for future delivery" would be forced to pay for the losses of failed investment firms. But airplane manufacturers have little to fear. The law defined financial institutions as those that derive more than 85 percent of their revenue or assets from financial activities.[49]

The law would "push the government into the business of dictating the terms at which consumers and businesses can contract," wrote Mark A. Calabria, director of financial regulation studies at the Cato Institute.[50]

Your Republic is over!…the America we have grown up in is gone."

—Commentator Glenn Beck (2010)

"This has nothing to do with protecting consumers and everything to do with replacing consumer preferences with bureaucrats' choices," Calabria wrote.

Ominous forecasts and hot rhetoric have continued since the bill's passage.

A study commissioned by the U.S. Chamber of Commerce, Business Roundtable, derivatives advisor Chatham Financial and the National Association of Corporate Treasurers concluded the greater capital and margin requirements for derivatives trading would result in the elimination of 100,000 to 130,000 jobs.[51]

The 2011 study neglected to acknowledge the role of derivatives—which legendary investor Warren Buffett in 2002 labeled "financial weapons of mass destruction"[52]—for causing the financial crisis and the untold job losses that accompanied it.

Dodd-Frank's passage prompted television commentator Glenn Beck to hurl the 2,300-page bill at the camera and declare: "Your Republic is over!…the America we have grown up in is gone…America, you have no idea what you're facing."[53]

Conclusion

In May 1934, a month before the 1934 Securities Act was passed, President Franklin D. Roosevelt told the U.S. Chamber of Commerce that it was "time to stop crying wolf" and holding out "false fears" about the government's efforts to move the country toward recovery.[54] If history is a guide, the forecasts of doom surrounding Dodd-Frank soon will sound as absurd in retrospect as industry's rants over the New Deal reforms do now.