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How the Glass-Steagall Act struck a blow against Wall Street's power

by Richard Freeman

The Nov. 12 decision by President Bill Clinton, to sign into law the Gramm-Leach-Bliley "Financial Modernization Act," will take the nation backwards, to the era of the 1920s, when very little financial regulation existed, and the Wall Street-City of London financier oligarchy ran America's financial policy, and a good part of its economic policy, as its own fiefdom. The oligarchy used this power to engage in a speculative orgy that culminated in the Great Depression.

The Financial Modernization Act takes aim at the Glass-Steagall Act, which had passed the U.S. Congress by overwhelming margins: In June 1933, the U.S. House of Representatives passed the Act by a vote of 262-19; the Senate, which had been highly contentious on votes on other measures, passed the Act by acclamation. President Franklin D. Roosevelt, who, along with other patriots had pushed for the Act, signed it into law on June 16, 1933.

The principle that guided the Act's passage was that of national sovereignty: that a nation has the right and obligation to exercise control over its financial and economic affairs, shaping them to provide for the general welfare of current and future generations, and against the control by a financier oligarchy.

The Act was one of a series of pieces of legislation which attempted to undo the most egregious features of financier speculation and wanton criminal financial activity.

The Glass-Steagall Act targetted a crucial aspect of banking, and indeed a very sore point with the bankers, as attested to by the fact that the bankers have spent billions of dollars, and 65 years, trying to undo its provisions.

Glass-Steagall split commercial banking from brokerage/investment banking. Any financial institution engaging in both activities, either had to split into two, or forgo one or the other activity. No commercial bank was allowed to own an investment bank, and vice versa. No commercial bank could underwrite, deal with, trade, or own for its own account, securities—since that was the domain of the investment banks. No investment bank could take individual small customer deposits, which was the domain of the commercial banks.

To the outsider, the split of these two activities may seem arcane; but it actually addresses two very important matters.

First, if a single institution is allowed to carry out commercial banking and investment banking (and insurance) under one roof, a very great amount of power is concentrated in that institution's hands. Today, if the repeal of Glass-Steagall were combined with the repeal of the McFadden Act—which forbids interstate banking—then the United States could end up with 15 to 20 super-institutions, which would control every aspect of America's financial life. Such a process was advancing rapidly in the 1920s, and Glass-Steagall helped to halt it.

Second, by placing different pools of money in a single institution—pools from commercial banking, from investment banking, from insurance—one is creating the temptation that that institution will commingle the funds, and use them for whatever it pleases. This violates a basic tenet of banking. A commercial bank is, by definition, simply a *deposit-taking institution*. When an individual puts his money into a savings or checking account in a commercial bank, he expects to get some interest, but he is putting the funds there *for safe-keeping*. He is not trying to *invest* the funds, which is the purpose of an investment bank/brokerage house. The individual does not want the funds to be commingled with other funds, without his permission.

Now, precisely during the 1920s, these two matters were abused by the bankers. The banks were building up enormous power, and they were using funds as they saw fit. It was this abuse, as Franklin Roosevelt and other patriots saw, that had contributed mightily to the 1929-32 stock market crash, the breakdown of the banking system, and the physical economic depression which had left millions of people destitute.

Today, the bankers argue against the Glass-Steagall regulations with the lie that they are "outmoded." Ironically, the exact opposite is true: Such regulation is needed now more than ever. While up to now, the banks have not been able to unrestrictedly commingle commercial banking, investment banking, and insurance, they have nonetheless built up practices that are as deadly as anything that existed during the 1920s. The growth of derivatives is one such deadly practice (see accompanying articles). If one adds, to the highly unstable, speculative atmosphere that exists today, the hitherto outlawed practices of mingling commercial banking with investment banking and insurance, this will accelerate the rate of the blowout of the financial system. This will also accelerate the looting of the nation.

This article will look first at the conditions that prompted

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Among the principal creators of the speculative bubble of the 1920s were Treasury Secretary Andrew Mellon (shown on the right, with Paul Mellon), and banker John Pierpont Morgan, Jr. (above). The aim of the Glass-Steagall Act, and related legislation passed during the Roosevelt years, was to prevent such financial manipulations from ever again leading to a great depression.

the Glass-Steagall Act: the bankers' raw abuse of political power, their financial pyramids, and their violation of the separation of commercial and investment banks. Then it will examine the Act itself. Next, it will look at the attempts to undermine the Act, and finally, compare the conditions of the 1920s with those existing today.

The role of the House of Morgan

A well-publicized series of Senate Banking Committee hearings helped to bring to public attention the type of unrestrained speculative activity and criminal activity, including the foolhardy mixing together of commercial and investment banking activities, which Glass-Steagall would later redress.

The hearings started in 1932, reaching their high point during the spring and summer of 1933. They are alternatively called the Fletcher hearings, after Sen. Duncan Fletcher (D-Fla.), who chaired it in 1933, or the Pecora hearings, after the colorful and persistent chief counsel, Ferdinand Pecora, who conducted the investigation and did much of the questioning of witnesses. The hearings were held by a special investigative subcommittee of the Senate Committee on Banking and Currency. They issued their findings in a series of reports, entitled *Stock Exchange Practices,* dated 1932 and 1933.

The hearings had commenced under the prodding of President Herbert Hoover, who stated, at least in his *Memoirs,* that he distrusted some of the activities of Wall Street. But things picked up steam after Franklin Roosevelt was sworn in as President on March 4, 1933. On May 23, 1933, chief counsel Pecora called as his first witness J. Pierpont Morgan, Jr., or "Jack," as he was known. Jack Morgan was the son of J. Pierpont Morgan, and the head of the Morgan banking firm (although Thomas Lamont was running the firm on a day-by-day basis). Morgan's testimony gave a sense of the utter contempt in which the Morgan bankers held America, the raw power that they exercised over its institutions and political figures, and their points of control.

On Jack Morgan's first day of testimony, Pecora asked if he had paid U.S. income taxes. Morgan contemptuously answered, "I cannot remember." After repeated questioning, and consultation with his attorney, Morgan allowed as how he had not paid taxes in 1930, 1931, or 1932. It was then disclosed that the dozens of Morgan partners, each of them multi-millionaires, had collectively paid less than $50,000 in taxes in 1930, and paid no taxes in 1931. This did not sit well with a nation in which one out of four workers was officially unemployed, and where starvation was occurring.

On May 26, Pecora revealed that he had discovered a Morgan-maintained "preferred list," after going through re-

cords that he had subpoenaed from the House of Morgan banking empire. The "preferred list" was a group of men—"good, sound, straight fellows," as Jack Morgan called them—upon whom the House of Morgan had showered largesse, in order to have these men do their bidding. A Morgan partner explained, that the House of Morgan offered the men on the "preferred list" deals—in one case, Morgan Bank offered the stock of the Alleghany Corp., which was trading in the market at $35-37 per share, to people on the "preferred list" at $20 per share. One such "sound, straight" fellow, by selling his allotment of shares shortly after he got them, realized a profit of $229,000. Of course, Morgan expected something in return.

Among those who were on the Morgan "preferred list" were:

Former U.S. President **Calvin Coolidge;**

Mega-speculator **John J. Raskob,** who had been head of the Democratic Party. Raskob told a Morgan partner that he hoped there would, in the future, be "opportunities for me to reciprocate." Raskob was a leader of the Wall Street-steered American Liberty League, which tried to overthrow President Roosevelt between 1933 and 1937;

Owen J. Roberts, whom President Herbert Hoover appointed to the U.S. Supreme Court;

Financier **Bernard Baruch;**

Norman Davis, an Anglophile diplomat, who served in Roosevelt's administration.

Any investigation into the speculative bubble of the 1920s, would have to look at the roles of President Calvin Coolidge and Treasury Secretary Andrew Mellon. Coolidge was President from 1923 to 1929, the years that the bubble grew to its enormous size. President Herbert Hoover, who took office in March 1929, had only been in office for six months, when the stock market crashed: It was a "gift" he inherited from Coolidge. (Other powerful forces and events outside the United States, of course, contributed to the 1929-32 financial crash and depression.) Andrew Mellon played an even more pivotal role, as a member of the powerful London-controlled Mellon banking family. He served as Treasury Secretary from 1921 to 1932, under three administrations—those of Warren Harding, Coolidge, and Hoover—and often dictated to the U.S. President what financial and economic policy would be.

Goldman Sachs investigated

The Fletcher-Pecora hearings helped lift the veil from Wall Street's use of power to bulldoze any opposition to its looting and speculation. This included investigation of the practices of Goldman Sachs, then, as now, one of America's "first-tier" investment banks.

Goldman Sachs exemplified two tendencies. First, it had built up an enormous Ponzi scheme, operating beyond the pale of regulation (since virtually no regulation existed at this time). This significantly fed the financial bubble. Second, it conjoined under one roof, the operating activity of an investment bank, several commercial banks, and several insurance companies, and showed the fatal consequences therefrom.

Goldman Sachs had cultivated a reputation as following "rock-ribbed conservative" practices. This is quite humorous, given that they are the most wildly speculative of investment banks.

The key to Goldman Sachs's performance was the fervor with which it used leverage. The multiplier effect of leverage has been likened to cracking a whip. A certain force in the snap of the wrist, can result in many multiples of that force being discharged at the whip's end. To get this "snap," Goldman Sachs used investment trusts. These are simply corporations that don't do anything productive, but obtain their value by buying the stocks of other companies, and holding onto them. After World War II, these investment trusts soon merged into their very close cousins, which we know today as mutual funds.

The investment trusts worked on the principle that through leverage, they could conjure up vast amounts of fictitious value, thereby enriching themselves: that they would cause their own common stock price to increase in value at a higher rate of growth than that of the common stock of other companies that they were holding.

To see how this operated, let us create an imaginary investment trust, which will operate very much as Goldman Sachs's investment trusts actually did. We can call this Investment Trust A. In order to operate, Investment Trust A must have some cash. To obtain cash, it sells its own paper. Let us say that Investment Trust A obtains $150 million worth of cash, by issuing $150 million of its own paper: $50 million of its own bonds, $50 million of its own preferred stock, and $50 million of its own common stock. After the sale of its own instruments, Investment Trust A uses the $150 million in cash to buy the common stock of other companies, such as AT&T, Ford, GM, and U.S. Steel. These stocks are now called Investment Trust A's assets.

If one is operating during 1929, prior to the crash, one can expect the price of the common stock that one owns to go up. Assume all common stocks rise, on average, by 50% in value. Then, the assets that Investment Trust A owns, which were worth $150 million, would now be worth $225 million. If the value of Investment Trust A's *assets* are worth $225 million, then the value of the *paper* that Investment Trust A has issued–its bonds, preferred stock, and common stock—should reflect this increase, by also being worth $225 million.

Here's how the first level of leverage comes in. The value of the bonds and preferred stock that a company originally has issued does not change much, except if there is a change in interest rates. Investment Trust A originally issued $50 million worth of bonds and $50 million worth of preferred stock. They will still be worth, roughly, $50 million apiece.

Thus, the only paper that Investment Trust A issued that could rise in value, is its common stock. Since the total value of Investment Trust A's financial paper is now worth $225 million, then the value of common stock that Investment Trust A issued, must have risen in value from $50 million before, to $125 million now.

Notice what happened: The value of the assets—the common stock of other companies—that Investment Trust A owns, increased in value by 50%; but the value of Investment Trust A's own common stock increased in value by 150% (from $50 million to $125 million), that is, at a rate three times greater than the common stock of other companies that Investment Trust A owns. This constitutes leverage. In this example, the ratio of leverage is 3:1, between the increase in the value of common stock, and its production of a threefold increase in the value of Investment Trust A which owns these stocks. In each case, some multiple of leverage is at work.

The blindly ambitious would not stop there: Assume that one could further set up an Investment Trust B, which would buy up and hold the common stock of Investment Trust A. Investment Trust B would issue bonds, preferred stock, common stock, etc. Investment Trust B's value would increase, by a leverage-multiple, upon the increase in value of Investment Trust A, which itself increased, by a leverage-multiple, upon the increase of the common stock of other companies which it held. If the leverage of Investment Trust A to the common stocks it held was 3, and the leverage of Investment Trust B to investment Trust A was 3, then the leverage of Investment Trust B to the common stock in the portfolio of Investment Trust A was 9.

Using this principle of leverage, Goldman Sachs proceeded to establish three major investment trusts: Goldman Sachs Trading Company (starting in December 1928), Shenandoah Corp., and Blue Ridge Corp. Blue Ridge Corp. bought the common stock of other companies, such as AT&T and Ford. In turn, Shenandoah Corp. bought 86% ownership of the stock of Blue Ridge; and, Goldman Sachs Trading Company, along with an allied partner, bought up 80% ownership of the stock of Shenandoah Corp. By the time one gets up the ladder to Goldman Sachs Trading Company, one is getting leverage, upon leverage, upon leverage. Goldman Sachs investment bank owns and manages Goldman Sachs Trading Company. Thus, from this Ponzi scheme, Goldman Sachs raked in huge profits. But there is nothing real here: There is only paper based on other paper, based on other paper. This Ponzi scheme jacked up the value of each of the three Goldman Sachs-run investment trusts, which in turn underpinned the rising value of the U.S. stock market. Meanwhile, similar Ponzi schemes were being run by equally "rock-ribbed conservative" banks, such as J.P. Morgan, and the amount of leverage that was pumped into the U.S. stock market was enormous (other leverage was coming into the market through things like margin debt/borrowing).

But, having manufactured profits for itself out of the clear blue sky, Goldman Sachs could not stop there. Quickly, it developed a cash hoard in Goldman Sachs Trading Co. The goal became to pollute other parts of the economy. Goldman Sachs used the cash hoard to go on a spree, buying up *commercial banks*. Goldman Sachs bought the controlling stock in Manufacturer's Trust (the forerunner of Manufacturer's Hanover Trust), one of the most powerful banks in America. It compounded that by buying up Pacific Trust Co., Foreman State Bank of Chicago, and American Trust Co. of San Francisco. Not pausing to catch its breath, it bought up three insurance companies. It also had some of the banks that it had taken over, put in money to help take over the insurance companies. There was now an incestuous ring among investment bank Goldman Sachs, some commercial banks, and some insurance companies.

Goldman Sachs then turned to the next round of looting. It was one of the top bond trading firms in the country: it underwrote and traded bonds for industrial companies, for which it earned a fee. It instructed the commercial banks and insurance companies which it had gobbled up: "You will buy these industrial bonds." They complied, even if it was not in their own interests. In the case of the commercial banks, they were now putting their depositors' funds at risk to buy these bonds; in the case of the insurance companies, they were spending their policyholders' money to buy these bonds.

Goldman Sachs then took some of its spare cash, lent it to its captive commercial banks, charging them rates as high as 20%, so that the commercial banks would, in turn, lend it as "call money" to speculators who were playing the stock market.

The whole Ponzi scheme came tumbling down. Shenandoah Corp., which had been trading at $36 per share in late July 1929, fell to 53¢ in July 1932. The rapid de-leveraging of the Goldman Sachs empire, helped topple the financial markets.

Others were involved, too, in producing this outcome. There was the criminal behavior of Charles E. Mitchell, the head of National City Bank (today, Citigroup/Citicorp). This was paralleled by the criminal behavior of Albert H. Wiggin, the head of Chase National Bank (today, Chase Manhattan), and so forth.

Bankers horrified over Glass-Steagall

On March 4, 1933, Franklin Roosevelt was sworn in as President. Within days, Congress was meeting in session. Some of the broad outlines of the bankers' depredations had already been discovered, and the Fletcher-Pecora hearings brought more to light. The nation was still experiencing a financial downturn, three and one-half years after the October 1929 stock market crash.

The financier oligarchs had had their day; President Roosevelt and some others decided that it was time to assert na-

tional sovereignty.

The Fletcher-Pecora hearings had revealed some of the elements of the Goldman Sachs story, and had shed light on the danger of a single financial institution mingling the activity of a commercial bank, with that of an investment bank/ brokerage firm, with that of an insurance company. Prior to the 1929 crash, Goldman Sachs's power had grown to such an extent, that few could have checked it.

The Glass-Steagall Act aimed to take apart a pivotal part of the power. Its official name was the Banking Act of 1933, but it soon popularly bore the names of its two sponsors, Sen. Carter Glass (D-Va.), a senior member of the Senate Banking Committee, and Rep. Henry Steagall (D-Ala.), the chairman of the House Banking Committee.

The Act stated that no single institution or bank holding company could engage in both commercial banking and brokerage/investment banking. No commercial bank could own an investment bank, or carry out the functions of an investment bank. Sections 16 and 21 of the Act stated that no commercial bank could engage in the business of "issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stock, bonds, debentures, notes or other securities." (The exception is that commercial banks can sell and underwrite U.S. government bonds.) The sale, syndication, etc., of securities, is the domain of the investment banks. On the same grounds, no investment bank could take individual small customer deposits, which is the domain of the commercial bank. Neither commercial nor investment banks could own an insurance company.

The bankers understood that an important part of the cycle of the 1920s was being broken. W.C. Potter of the Morgan Bank-controlled Guaranty Trust characterized the proposal as "quite the most disastrous" he had "ever heard." The American Bankers Association led the fight against the bill, "to the last ditch," in its president's words.

The bill carried another useful provision. It created the Federal Deposit Insurance Corp. (FDIC), which gave Federal insurance for citizens' bank deposits up to a certain amount, for the first time in the nation's history. It announced that starting July 1, 1934, all deposits under $10,000 would be insured 100%; deposits in the range of $10,000 to $50,000 would be insured 75%; and deposits of $50,000 or larger would be insured 50% (today, all deposits up to $100,000 are insured 100%).

To counter some of the other practices of the 1920s, the bill also forbade any bank officer from borrowing from his own institution.

In mid-June 1933, the Glass-Steagall legislation passed both the House of Representatives and the Senate by overwhelming margins, and President Roosevelt signed it on June 16.

The Act, though carrying a powerful punch, was limited in its scope to curtailing certain abuses. It became part of a package that included:

- The Truth-in-Securities Act. This required full disclosure in the issue of new securities to the public. Heavy penalties would be levied for failure to give full and accurate information about securities to the government. This became law on May 27, 1933.
- The Securities Exchange Act. This set up the Securities and Exchange Commission (SEC) to regulate and oversee the securities markets. Certain manipulative practices (such as washed sales and matched orders) were prohibited. Insider trading was eliminated. This became law on June 6, 1934.

None of these laws was comprehensive: some of them were better than others in addressing individual problems, or in addressing the larger picture; yet together, they moved in the direction of asserting national sovereignty, on behalf the general welfare, and against the oligarchy. This provoked a fight with Wall Street, but some of the other necessary initiatives never made it through Congress. At the same time, other legislation was being passed to reverse the downturn in the financial system, to build infrastructure, provide jobs, and restore the physical economy.

The oligarchy's counterattack

The oligarchy saw Glass-Steagall as hitting a vital nerve, and began a process of chipping away at it. One of the biggest moves in that direction was the passage of the Garn-St Germain "Depository Institutions Act," which passed in October 1982, and deregulated the entire U.S. banking system. The Act did not address Glass-Steagall, but it had a deleterious effect on the Glass-Steagall provisions and the principle of regulation. Garn-St Germain helped eliminate usury ceilings. Along with the high interest rates imposed by Federal Reserve Board Chairman Paul Volcker in October 1979, it pushed the savings and loan associations into the crisis that would befall them in the 1980s.

It also pushed the United States in the direction of increased emphasis on speculation, and reduced agriculture and manufacturing production, which weakened the financial system and the economy as a whole.

In 1985 and 1986, the Comptroller of the Currency engaged in a duplicitous reading of the Glass-Steagall Act, to allow national banks to purchase and sell mutual funds.

In 1987, the Comptroller of the Currency concluded that a national bank may offer to the public, through a "subsidiary," brokerage services and investment advice.

In April 1987, the Federal Reserve Board of Governors interpreted a section of Glass-Steagall to allow underwriting activities if they were conducted through a securities subsidiary "not principally engaged" in underwriting. This was interpreted to mean not earning more than 5% of revenues therefrom.

Step by step, agencies sympathetic to the banks were rolling back the legislation.

In April 1998, Citicorp (a commercial bank) and Travelers Salomon Smith Barney (Travelers is an insurance com-

pany, Salomon Smith Barney is an investment bank) merged, thumbing their noses at Glass-Steagall.

Now, as a result of speculative activity, the banking-financial system is on the verge of a breakdown, several orders of orders of magnitude larger than anything that occurred in 1929-32. The same Wall Street firms that contributed to the 1929-32 meltdown, and ensuing depression, have built a bubble bigger than that of the late 1920s. Today, they use highly leveraged derivatives: In 1999, America is burdened by $55 trillion of derivatives outstanding, of which the financial institutions own more than 90%. In the 1920s, there weren't even $150 million of these instruments. Today, these Wall Street forces are carrying out an incredible array of corporate mergers—in 1998, mergers took place to the tune of $1.6 trillion; in 1929, less than $15 billion.

Thus, this is the worst possible time to undermine Glass-Steagall and the very principle of regulation of the financial system.

The Gramm-Leach-Bliley "Financial Modernization Act" will concentrate enormous speculative power into the hands of 15 to 20 institutions; along with the Federal Reserve Board, they will have control over every facet of financial life. This will speed up the process of looting and dissolution. A nation that tolerates such a retrogressive step, has abandoned its moral fitness to survive.

LAROUCHE ON
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Deregulation: a license to steal

by John Hoefle

The irony of a wildly, dangerously out of control group of parasites proclaiming that they are being "over-regulated," suffering from a "regulatory burden" so onerous that they cannot serve the "little people" as fully as they could were the government to get off their backs, should not be lost on anyone watching the bankers and their agents running roughshod over the very people they claim they want to serve. If it hadn't happened before one's very eyes, one might have trouble believing it.

Among the loudest whiners have been the biggest commercial and investment banks in the United States, some of whom are so "over-regulated" that the notional value of their off-balance-sheet derivatives bets is more than 30 times the assets they list on their balance sheets. Think about the implications of that for a minute, both in terms of the meaninglessness of balance sheets in such circumstances, and of the nature of a regulatory system which permits such incredible activity. In many areas of the business world, a company which reported such a tiny portion of its financial activities on its balance sheets would be indicted for fraud. But, not the big commercial and investment banks. The double standard is obvious.

In case after case, Federal banking regulators, from the Federal Reserve to Congress, have bent over backwards not only to ignore, but also to actively protect, the wild speculation which has taken over modern banking. When banks break the law, as in the clearly illegal merger of the insurance and investment banking giant Travelers Group with Citicorp, the regulators jumped through hoops to promise to change the law, a promise upon which they have now delivered with the Gramm-Leach-Bliley financial modernization act. In those rare occasions when some regulatory agency does raise questions about the derivatives frenzy, as in the cases of the Federal Accounting Standards Board and the Commodity Futures Trading Commission, the knives come out quickly.

They're not banks anymore

Over the past two decades, there has been a fundamental shift in the nature of banking in the United States, namely, that the big banks have increasingly turned from banking to speculation; more and more, they've become gamblers, not bankers.

Take the case of Chase Manhattan Corp. As of June 30, 1999, it reported $357 billion in assets on its balance sheet,