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Banks on Board: Banks in German and American Corporate Governance, 1870-1914

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Abstract:

As part of a series of related papers, the authors examine the conceptual foundations of German and American corporate governance, specifically highlighting the role of banks' relationships to corporations and the stock market. This paper focuses on how the regulatory and macroeconomic environments of the two countries helped shape how banks, especially money-centred bankers, actually interacted with their clients. Prior to 1914, despite many regulatory obstacles, American banks wielded more power over U.S. corporations than the legendary German ones because they had more "opportunities" for intervention. The U.S. suffered larger booms and busts ("panics" and bankruptcies), had more foreign investment, as well as saw more corporate consolidation than in Germany. By contrast, German companies seemed to have less need for active bank management and largely maintained their distance from activist banks, although German banks could *potentially* wield great power through board membership and proxy voting. Additionally, German regulators and investors turned more readily to banks to bolster controls on equity and debt capital markets to dampen dangerous speculation of "productive assets." They encouraged banks to play a crucial intermediary role in solving the agency problem in firms and correcting the perceived weaknesses of financial markets—unlike U.S. regulators. Germans also expected banks to save companies from financial distress, but these occasions were more rare in Germany than in the United States.

Surprisingly, the debates in Germany and the U.S. about the role of banks had many common features, yet the two countries increasingly found alternative solutions to classic corporate governance dilemmas. Whereas American regulators tended to suspect banks' insider relationship with companies and stock markets, and then endeavored to destroy this "money trust," German regulators turned to banks as institutional stabilizers to tame market turbulence and speculation. Over time, they bolstered rather than undermined banks' special relationship to firms and capital markets. Key institutional choices set the stage for a much greater divergence during the interwar period.

Q.: Taking the present situation as you find it, Mr. Reynolds, what is your judgment as to whether that situation [concentration of the control of money and credit] is a menace?
A.: I am inclined to think that the concentration, having gone to the extent it has, does constitute a menace. I wish again, however, to qualify that by saying that I do not mean to sit in judgment upon anybody who controls that, because I do not pretend to know whether they have used it fairly or honestly or otherwise.[1]
(Transcript of Mr. Reynolds, President of the Continental & Commercial National Bank of Chicago, answering questions at the Pujo Commission 1912/1913)

For all of these forms of concentration of capital and power provide the central headquarters with a more exact overview of the general state of industry and the needs and cycles of individual industrial branches, in addition to a thorough knowledge of the condition of property, creditworthiness and trustworthiness of an extensive circle of clients. Both [are accomplished] through knowledgeable and objective reports to such information services, which on one hand are well versed in local circumstances and, on the other hand, are closely related to and friendly with the central headquarters.
Through these methods that provide an exact oversight and detailed knowledge, the central headquarters gains increasing potential:
a) to find a broad and secure basis for the sale of its issuing securities, which it can purchase in ever greater extent and with greater patience, combined with the certainty that these securities in respect to their lasting capital value will find their way into the hands of good buyers. Therefore, they will not be so quickly thrown back on to the market and have to be resold…..[2]
(Jacob Riesser, President of the Central Association of German Banks and Bankers, in *Zur Entwicklungsgeschichte der deutschen Grossbanken* [Development History of German Banks](1906))

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[1] [Pujo] *Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration of Control of Money and Credit*, February 28, 1913 (Washington: Government Printing Office, 1913).
[2] Jacob Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken mit besonderer Rücksicht auf die Konzentrationsbestrebungen* (Jena: Gustav Fischer, 1906), p. 292. In English, Riesser, *The German Great Banks and their Concentration*, published by the National Monetary Commission (Washington, DC: Government Printing Office, 1911).

I. Introduction

Over the past fifteen years, a voluminous wave of corporate governance studies debating the proper control of corporations has become an important part of contemporary academic and business discussions. In our current environment of scandals and competing systems, none of which seems able to inspire a global consensus around a set of economic, social or ethical goods to which the corporation should dedicate itself, it understandable that the study "the direction and performance of corporations" occupies a central stage in management and popular literature.[3] Yet less studied and well understood is how and why different national systems of corporate governance evolved, and how various national systems and institutions influenced each other's development from a transnational or comparative perspective.[4] Prior to 1914 and now, massive flows of cross-border capital investment, spearheaded by banks and other financial institutions were an integral part of globalization, and they placed much pressure on national systems of corporate governance and financial reporting to conform to "internationally accepted practices," which today ironically – and largely incorrectly – is associated with American standards, to which world markets are ostensibly and relentlessly converging. As two corporate law scholars recently declared: "The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured.[5] The issue has become even more acute as new emerging markets search for an appropriate mixture of indigenous institutions and borrowed foreign ones—as did countries "emerging" prior to 1914.

Although some political scientists such as Gregory Jackson or Sigurt Vitols have integrated a historical perspective, historians have engaged only sporadically in these

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[3] Robert Monks and Nell Minow, *Corporate Governance* (Cambridge, Mass.: Blackwells, 1995), p. 1. For a good discussion of the multifaceted influences on why corporate governance systems diverged, see also Randall Morck, "The Global History of Corporate Governance: An Introduction," in *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, (eds) Randall K. Morck (Chicago: University of Chicago Press, 2005), pp. 1-64. Jeffrey R. Fear, "Constructing Corporations: The Cultural Conception of the Firm," *Big Business and the Wealth of Nations*, (eds.) Alfred D. Chandler, Jr. and Takashi Hikino (Cambridge, Mass.: Harvard University Press, 1997), pp. 546-574.
[4] Gary Herrigel, "Corporate Governance: History without Historians," *Oxford Handbook of Business History*, (eds.) Geoffrey Jones and Jonathan Zeitlin (Oxford: Oxford University Press, forthcoming).
[5] Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law," *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004), pp. 33-68.

discussions.[6] Much contemporary literature juxtaposes a fairly static and stylized Continental (usually Germany as a proxy or ideal-type) or Japanese bank-based model against an "Anglo-Saxon" capital market model.[7] This literature tends to anachronistically read both countries' corporate governance system of the present into the period prior to 1914 and tends to neglect historical change within national governance systems. Indeed, theorizing about institutional change has become *the* most problematic issue in political science, which is increasingly turning history to shed light on these matters, but the primary reliance is still on variations of "system" theory and "institutional complementarities." By contrast, the economics literature tends to rely either on an outdated Gerschenkronian model, an over-stylized model of relationship banking (or fluid, efficient capital markets), or black-and-white anachronistic dichotomy of common law versus civil law difference that starkly divide capital market-oriented economies from bank-oriented ones. The notion that banks play an important role in successful economies, especially developing ones—once near universally held—has also been the subject of considerable debate. While some economists have looked to bank-based systems as facilitators for emerging market growth or as an antidote to chaotic, short-term "market-based" systems, others point to their persistence as evidence of a retarded economic development through insufficiently developed equity markets. Caroline Fohlin even called into question whether Germany's financial system prior to 1914 deserves to be described bank-based at all because of its vibrant market for

[6] See their contributions in Wolfgang Streeck and Kozo Yamamura, *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca: Cornell University Press, 2001).

[7] Michel Albert, *Capitalism vs. Capitalism* (New York: Four Walls Eight Windows, 1993). Glenn Morgan, Richard Whitley, and Eli Moen, *Changing Capitalisms?: Internationalization, Institutional Change, and Systems of Economic Organization* (Oxford: Oxford University Press, 2005). Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001). Streeck and Yamamura, *Origins of Nonliberal Capitalism*. Ronald Dore, *Stock Market Capitalism: Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (Oxford: Oxford University Press, 2000). Herbert Kitschelt, Peter Lange, Gary Marks, John D. Stephens, *Continuity and Change in Contemporary Capitalism* (Cambridge: Cambridge University Press, 1999). Thomas K. McCraw, *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions* (Cambridge, Mass.: Harvard University Press, 1997). J. Rogers Hollingsworth and Robert Boyer, *Contemporary Capitalism: The Embeddedness of Institutions* (Cambridge: Cambridge University Press, 1997). Jeffrey A. Hart, *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (Ithaca: Cornell University Press, 1992). Klaus J. Hopt, et. al. (eds.), *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford: Clarendon Press, 1998). S. W. Black & M. Moersch (eds.) *Competition and Convergence in Financial Markets: The German and Anglo-American Models* (Amsterdam: Elsevier, 1998).

industrial securities. In contrast to some economic historians who have recently applied the distinction between bank- and market-based financial systems from the 21st century to the 19th, we too argue that before World War I these ideal types make little sense in describing the layout of financial markets. In both countries, banks played an enormous role in the corporate governance of firms and in capital markets offering a broad range of services well beyond pure banking or even investment banking as practiced at the turn of the 21st century. Finally, there is an astounding disconnect between economists and leading German business historians who have become increasingly skeptical about the catalyzing effects, guiding role, or alleged information advantage of banks over industry even in a system of relationship banking. The models simply do not fit our close empirical research of the Deutsche Bank, Schering, Thyssen, Stinnes, Siemens, or among other capital-intensive industries such as chemicals, coal and steel, or electrotechnical industries with significant bank involvement, leaving aside the vast area of the important German *Mittelstand*, which was neglected by the big investment banks until the 1960s and is still largely neglected by the literature.[8]

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[8] Ross Levine and Aslı Demirgüç-Kunt (eds.), *Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development* (Cambridge, Mass.: MIT Press, 2001). Levine shows that at a historical, *macroeconomic* level bank-based systems can contribute to economic growth (GDP) just as effectively as capital markets—or at least they do not necessarily underperform. Both systems channel capital to firms in different manners and thus have different microeconomic and institutional consequences. Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, Mass.: Belknap, 1966). Contrast Marco Da Rin and Thomas Hellmann, "Banks as Catalysts for Industrialization," *Journal of Financial Intermediation*, 11 (2002), 366-397 that follows the older Gerschenkronian position with Caroline Fohlin, "Universal Banking in Pre-World War I Germany: Model or Myth?, *Explorations in Economic History*, Vol. 36 (1999), pp. 305-344. Sheilagh Olgilvie and Jeremy Edwards, "Universal Banks and German Industrialization: A Reappraisal," *Economic History Review*, 49, 3 (1996), pp. 427-446 provides a brief overview of this new literature in English. The revision in business history begins with Volker Wellhöner, *Großbanken und Großindustrie im Kaiserreich* (Göttingen: Vandenhoeck & Ruprecht, 1989). Caroline Fohlin offers the most sustained revision of the Gerschenkronian view in her recent book, *Finance Capitalism and Germany's Rise to Industrial Power* (Cambridge: Cambridge University Press, 2007) and her numerous related articles offered in the bibliography. It builds on range of literature questioning bank guidance of industrial strategy. See Harald Wixforth, *Banken und Schwerindustrie in der Weimarer Republik* (Köln: Böhlau Verlag, 1995). Wilfried Feldenkirchen, „Zur Finanzierung von Grossunternehmen in der chemischen und elektrotechnischen Industrie Deutschlands vor dem Ersten Weltkrieg," *Beiträge zur quantitativen vergleichenden Unternehmensgeschichte*, (Hg.) Richard Tilly (Stuttgart: Ernst Klett, 1985), pp. 94-130. Dietmar Petzina (Hg.) *Zur Geschichte der Unternehmensfinanzierung* (Berlin: Duncker & Humblot, 1990). In English, see Jeremy Edwards and Klaus Fischer, *Banks, Finance, and Investment in Germany* (Cambridge: Cambridge University Press, 1994). William Carney, "Large Bank Stockholders in Germany: Saviors or Substitutes," *Journal of Applied Corporate Finance*, Vol. 9, Winter 1997. Timothy Guinnane, "Delegated Monitors, Large and Small: Germany's Banking System, 1800-1914," *Journal of Economic Literature* XL (2002), pp. 73-124. Gerald D. Feldman, "Banks, *Bankenmacht*, and Financial Institutions from 1900 to 1933,"

For some social science studies of the German economic system, moreover, only statistics seem to count as evidence of the measure of the role of banks. Although providing important data, some of the conclusions of these studies suffer from over-aggregation of data and insufficient historical contextualization and analysis of their meaning.[9]

Relying on a historical narrative, we argue here that bankers on corporate boards and in securities markets in *both* the U.S. and Germany, the two most important emerging markets of the late 19th century, served as necessary "Gatekeepers" or "special intermediaries" performing a wide range of activities in these nascent financial markets.[10] We too believe that the traditional Gerschenkronian view about the dominance or guiding role of the great German universal banks needs tempering. And counterintuitive to received wisdom, we will argue that no Berlin-based German universal bank wielded the power of a J.P. Morgan or other major New York investment houses. American bankers were just as present in U.S. firms as their German counterparts, in some crucial respects even more. Yet it was not the power or guiding role that made German banks different but their universalism, the range of services they could offer firms as all-purpose *clients* (not guides) that was the crucial difference between the U.S. and Germany. It is less a

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Finanzmarkt-Kapitalismus: Analysen zum Wandel von Produktionsregimen (Wiesbaden: VS Verlag für Sozialwissenschaften, 2005), pp. 316-330. Caroline Fohlin, "The History of Corporate Ownership and Control in Germany," in Randall K. Morck, ed. *A History of Corporate Governance around the World* (Chicago: University of Chicago Press, 2005), pp. 223-277. Caroline Fohlin, "Does Civil Law Tradition (and Universal Banking) Crowd out Securities Markets?: Pre-World War I Germany as Counter-Example," *Enterprise and Society* (forthcoming). Richard Deeg, *Finance Capitalism Unveiled: Banks and the German Political Economy* (Ann Arbor: University of Michigan Press, 1999). Jan P. Krahnen and Reinhard H. Schmidt, *The German Financial System* (Oxford: Oxford University Press, 2004) offers the best contemporary overview in English. For an exception to the rule, see Timothy Guinnane, "Cooperatives as Information Machines: German Rural Credit Cooperatives, 1883-1914," *Journal of Economic History*, 61/2 (2001), pp. 366-389.

[9] See Fohlin's *Finance Capitalism and Germany's Rise to Industrial Power*. Fohlin compares German firms' leverage ratios and financial returns with bank involvement, and finds that increased bank-involvement has no correlation with better use of leverage and higher profitability. Moreover, in the light of low income tax rates before World War I, the gearing ratios of the German companies might be interpreted as extraordinarily high.

[10] See John C. Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006). Coffee stresses the wide range of services that accountants and other professional groups play in regulating financial markets in much the same way we discuss banks in Germany and the United States in 1900. Eugene N. White, "Were Banks Special Intermediaries in Late Nineteenth Century America?," *Federal Reserve Bank of St. Louis Review*, (May/June 1998), pp. 13-36.

question of their relative (un)importance, but of their increasingly different roles, perceived or otherwise. In Germany, banks served as a kind of insurance for the system; as with insurance, banks' involvement became more extensive when there was a problem. Although banks clearly had relationships with untroubled companies, one of their many economic services was to intercede with distressed ones. Germany regulators *expected* banks to expand their role and the services banks offered, rather than increasingly circumscribing them as in the U.S and driving them out of this role. Indeed, German banks could offer almost all functions except issuing notes and mortgages.

These dramatically different contemporary expectations and perceptions about the meaning of banks on board industrial firms that became institutionalized into regulation, and became part of the historical reality, is the heart of this article. Fohlin too stresses the "impact of political, social, and cultural environments, along with historical accident, in molding financial systems" and the importance of historical contextualization, which we highlight here from a comparative perspective.[11] Whether banks actively managed companies or not, *if investors* believed that they did and were more willing to invest because of that perception, *reliance* on the good judgment and close bank-client relationships, for example, became an important part of the Germany's financial system. Some American bankers such as J.P. Morgan tried to make similar arguments, yet American public opinion and regulators vilified them. Such expectations made all the difference in the world.

Yet we should still not overplay the differences before 1914, possibly even before 1933. In *both* the American and German economic systems, banks played an enormous, but somewhat different role in the corporate governance of firms and as stock market intermediaries to a degree that is almost unimaginable for even the well-informed reader today. A transnational banking elite understood how banking worked across many countries, leading to tremendous cross-border investment flows. Both countries had hybrid bank-based and capital market systems that were entwined with one another (but in different ways, discussed below); both were built on relationship banking with its large

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[11] Fohlin, *Finance Capitalism and Germany's Rise to Industrial Power*, pp. 66, 345 Fohlin's excellent study neglects the whys of regulation, just that they were put in place. Although she makes some reference to political and cultural dynamics, she has little to say about why the historical contexts of laws and their implementation matter.

major corporations; both had active stock exchanges for issuing and trading corporate securities. To be clear, we are not claiming that the two financial systems were comparable as there are many other dimensions that we do not discuss comprehensively (i.e. unit banking versus branching or universal banking, different types of banks, federalism, the ability to branch nationally, mortgages, etc.), but focus on services banks provided directly to firms and in corporate governance, which are key features of relationship banking. One of the key virtues of relationship banking is the potential to rescue of firms during times of distress or financial overextension due to close bank involvement (voice and restructuring instead of exit), which we argue, was more prevalent and more necessary in the U.S., so that New York investment banks had more power and control over U.S. corporations than Berlin banks over German firms.[12]

What is more, the vaunted corporate governance relationships of German banks in firms prior to 1914 were probably *less* important than their legislated, mediating role in the stock exchange; regulators encouraged dedicated responsibility for the companies whose securities they brought to market and sold off to customers. Because of different contemporary assumptions (many of which find their place in today's financial economics literature) and fears about banking power, American legislation eventually erected barriers to banks engaging in the governance of corporations as well as to their maintaining broad powers in capital markets. For instance, the 1914 Clayton Act banned banks from simultaneously sitting on rival firms in the same business to prevent collusion, whereas German bankers regularly sat on numerous boards, allegedly *pace* Gerschenkron, to stop fraticidal competition among its children.[13] Foreign and domestic

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[12] For an insightful discussion, see Ralf Elsas and Jan Pieter Krahnen, "Universal Banks and Relationships with Firms," in The German Financial System, (eds.) Jan Pieter Krahnen and Reinhard H. Schmidt (Oxford: Oxford University Press, 2004), pp. 197-232. Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (Cambridge, Mass.: Harvard University Press, 1970). Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *The Journal of Finance*, 48/3 (July 1993), pp. 831-880

[13] For example, Mark Roe, *Strong Managers, Weak Owners* (Princeton: Princeton University Press, 1994). Roe emphasizes the structure of the American and German political systems and different interest groups to explain how the two countries' systems of corporate governance evolved. Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, Mass.: Belknap, 1966), p. 15. Jeffrey Fear, *Organizing Control: August Thyssen and the Construction of German Corporate Management* (Cambridge, Mass.: Harvard University Press, 2005), pp. 235-260 offers a critique of the role of banks in constructing cartels. Fundamentally different attitudes toward competition help explain American and German stances toward cartels, much like they institutionalized different roles for banks.

investors in the U.S. also demanded activist management for their holdings by banks, but American banking regulation eventually curtailed many control mechanisms enjoyed by German banks. By contrast, German legislation anchored banks in company corporate governance and (often inadvertently) strengthened the hand of banks in the economy.[14]

Before 1914, we find more structural convergence regarding this gatekeeping role rather than divergence along with surprising parallel debates that often found very different institutional solutions to combat the same problem (for instance: agency issues, futures trading, crashes and panics, universal banking, or banks on board).[15] Both countries wrestled with fundamental issues of building trust in large corporations and capital markets; "speculators" and "trusts" in both countries were strongly suspected.

However, regulators slowly began answering these issues of establishing trust and control in different ways. The institutional differences we find laid the tracks for the great divergence after 1914. It is a complex story, not easily reduced to one single category of explanation. Yet the assumptions behind these regulations and institutions—*only after* World War I—tended to lock-in a particular form of corporate governance that continues to influence German and American business. The divergence between the two systems began around 1900 with the American financial panics and the great merger movement, yet picked up pace after the shock of World War I. In contrast to Mark Roe and John Coffee**,** we argue this divergence was neither caused just by a series of "political accidents" nor purely a function of each country's legal framework, but rather of deep-

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[14] Jeffrey Fear and Christopher Kobrak, "Diverging Paths: Accounting for Corporate Governance in America and Germany, *Business History Review*, 80 (Spring 2006), pp. 1-48. See Jeffrey Fear and Christopher Kobrak, "Making Capitalism Respectable: *Sonderwegs* in Germany and the U.S.," forthcoming. Preliminary thinking about the impact of the 1873 Crash can be found in our conference paper, Jeffrey Fear and Christopher Kobrak, "Origins of German Corporate Governance and Accounting 1870-1914: Making Capitalism Respectable" (conference paper—presented at International Economic History Association, Helsinki, August 21-25, 2006), available at www.helsinki.fi/iehc2006/papers3/Kobrak.pdf, accessed October 12, 2006. In these pieces we spend a good deal more time elucidating the cultural and political determinants of the different paths of German and American corporate governance systems.

[15] Louis Galambos, *The Public Image of Big Business in America, 1880-1940: A Quantitative Study in Social Change* (Baltimore: Johns Hopkins University Press, 1975). David A. Zimmermann, *Panic: Markets, Crises, and Crowds in American Fiction* (Chapel Hill: University of North Carolina Press, 2006). Jonathan Ira Levy, "Contemplating Delivery: Futures Trading and the problem of Commodity Exchange in the United States 1875-1905," *American Historical Review*, Vol. 111, No. 2 (April 2006), pp. 307-335.

seated attitudes about capitalism that informed political decisions, legal precedents, and accounting standards.[16]

The paper is divided into two main sections. The first section has two parts. The first describes the main activities of investment bankers in the U.S. and Germany circa 1900, their role on corporate boards and other activities. The second part highlights early 20th century discussions of the issues that played a role in regulatory debates prior to 1914 to derive the very different assumptions regarding banking power. The second section, which shows how certain base assumptions shaped legislation, has two parts. The first part analyzes the early development of German corporate governance (*Aktienrecht*) of 1884; and the second part narrates the introduction of important securities laws (*Börsen- oder Wertpapiergesetz*) of 1896. We tend to concentrate on the less familiar story of German corporate governance, but contrast them with more familiar U.S. developments. We highlight especially how fundamentally different assumptions (or meanings) about banks on board drove institutional reforms to the great divergence.

I. Investment Banking ca. 1900

1.1 The Meaning of Banks on Board

Before World War I, even in the United States, where long before Glass-Steagal regulations limited the activities of bankers, banks individually or in groups working together performed many of the functions today associated with management consultants, accountants, private equity managers and stock brokers, in addition to their straight banking and financing roles. Companies had controllers and general managers responsible for financial matters, but few, if any, had a Chief Financial Officer, in a modern sense. With the growth of complicated business entities and transactions outstripping the training of new management expertise, banks were not only the repository for funds but also for financial sophistication and general business acumen. Although Ron Chernow might have been premature in pronouncing the "death of the banker," he certainly was right that the activities of bankers since their heyday in before

[16] Roe, *Strong Managers, Weak Owners*. Mark J. Roe, "German 'Populism' and the Large Public Corporation," *International Review of Law and Economics* 14 (1994), 187-202.

World War I, though still extraordinarily powerful in the 21st century, have become more circumspect.[17]

In the 19th century, money-center banks in Germany and in the United States were the preeminent intermediaries for all types of businesses, providing their clients with investment credit and a large range of services. Not until new accounting methods, more fluid commercial paper and securities markets, and credit rating agencies developed were they slowly dislodged from this central position (Eugen White). Some of the services offered by German banks were forbidden or impractical to implement for American financial institutions for a variety of reasons. Nevertheless, the great cultural and physical distances that separated investors from companies, the turbulence of financial markets as well as the great many American restructurings also provided American banks with more than ample opportunity to insert themselves in the affairs of their client firms. This was not unusual. Many of these activities were essential in both countries for even closely-held companies with little need for external financing.

It is, therefore, necessary to review those services and understand precisely who was delivering them around 1900. Though still performed by banks today, many of these services have been automated and routine in nature, or are performed more directly between commercial companies and securities markets, a process often referred to as disintermediation. Although financial systems of Germany and the United States shared many characteristics, many of which differentiated them both from today's financial world, by 1900, their distinctive economic and regulatory environments began producing banking systems, which were adapted to the perceived needs of customers and, most importantly for regulatory reformers, in the national public interest. Indeed, precisely in those sectors deemed by American reformers as public-service utilities, railroads and utilities, did modern financial regulation, financial innovations, and accounting reforms begin.[18]

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[17] Ron Chernow, *The Death of the Banker* (New York: Vintage Books, 1997). Eugene N. White, "Were Banks Special Intermediaries in Late Nineteenth Century America?," *Federal Reserve Bank of St. Louis Review*, (May/June 1998), pp. 13-36.

[18] Fear/Kobrak, "Diverging Paths." Paul Miranti, "The Mind's Eye of Reform: The ICC's Bureau of Statistics and Accounts and a Vision of Regulation, 1887-1940," *Business History Review* 63 (Autumn 1989), 469-509.

German banking regulation, however, gave German banks a geographic and type-of-service breadth unmatched in the United States. As universal banks, they were free to take deposits all over Germany, lend to corporations, own securities, and performed numerous kinds of "consulting" services, all of which reinforced their efficacy in syndicates for launching domestic and foreign securities, even though Germany exported less capital than Britain and France.[19] Even underwriting securities, a core element of investment banking, played an important but not exclusive role. For Germany, as Otto Jeidels, one of Germany's leading bankers, wrote, "It has to be considered as only one track in an entirety, the center of which is current accounts in their broadest sense, of all transactions which are part of the bank's business connection with enterprises."[20] The purely investment banking function was just one part of the relationship. Investment banking services accounted for less than 25% of the total profits of the three largest German banks. The underwriting activity was most useful as a means of gaining entry into firms, but because of the risks normally done in conjunction with other banks in a consortium. According to Jeidels, banks recognized that taking positions in their customers' securities, which often, at least for a while accompanied the underwriting activity, entailed more risk for the bank than other activities and required greater involvement in the customers' affairs. Banks were obliged to "manipulate" the market to preserve price stability and hold the security for a time. Once the relationship was created, though, other services could be offered for which the bank earned good fees, with less risk, and which gave the bank the opportunity to monitor, at least the short-run activities of their customers.[21] The whole practice of universal banking, with the point of the relationship begun through current account lending, was based on cross-selling—ironically a business plan replicated by Citigroup or Bank of America today. These included providing straight bank loans, issuing bank acceptances, taking deposits, and handling transfers, especially international ones that required a foreign exchange transaction. In reality, all these activities did not imply that the German banks controlled

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[19] Youssef Cassis, *Capitals of Capital: A History of International Financial Centres, 1780-2005* (Cambridge: Cambridge University Press, 2006), pp. 110-113.
[20] Otto Jeidels, *Das Verhältnis der deutschen Grossbanken zur Industrie mit besonderer Berücksichtigung der Eisenindustrie* (Leipzig: Duncker & Humblot, 1905), p. 130.
[21] Jeidels, *Das Verhältnis der deutschen Grossbanken*, pp. 127-139.

companies in spite of *Finanzkapital* conspiracy theories. They merely reinforced the impression that well-informed interested stakeholders exercised some oversight and that in times of distress the "appropriate" action could be undertaken in a timely fashion.[22]

Sitting on the boards of client companies symbolized this "fiduciary" role and institutionalized the close connection to firms in both countries, but had many *disadvantages* for the banks as they invited unwanted public scrutiny and distrust. After the turn-of-the-century, both Germans and the U.S. debated the issue of interlocking directories and concentration of power—with good reason. Unlike today, the role of bankers, especially helping clients with mergers and acquisitions or launching public securities (investment banking) involved a great deal more active management for companies. This often resulted in having banks on board for three broad reasons: 1) Related lending might enhance access to capital for firms and reduce monitoring costs for banks as they had inside information; 2) Banks on board might act as a certification mechanism, a signal that firms were ongoing ventures worth of equity investment or a sign of creditworthiness for other lenders; 3) Entrepreneurs or corporate executives might want the advice of bankers regarding their financial structure or the issuing of new securities. The exact relationship would vary from firm to firm, but banks and firms needed one another, creating a symbiotic relationship between them.[23]

Exhibit 1 offers an overview of the degree of interlocking directories among banks and firms in both countries. In general, interlocks grew more strongly in Germany than in the U.S. after 1900, but especially after 1914.

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[22] For the classic *Finanzkapital* interpretation, see Rudolf Hilferding, *Das Finanzkapital: Eine Studie über die jüngste Entwicklung des Kapitalismus* (Wien: Ignaz Brand & Co., 1910). A recent historiographical overview on the state of the literature is provided by Gerald D. Feldman, "Banks, *Bankenmacht*, and Financial Institutions from 1900 to 1933."

[23] Caroline Fohlin, *Finance Capitalism and Germany's Rise to Industrial Power* (Cambridge: Cambridge University Press, 2007), pp. 48-64. Aldo Musacchio, "Corporate Governance and Networks: Bankers in the Corporate Networks of Brazil, Mexico, and the United States circa 1910" (unpublished paper). Both offer theoretical overviews of what banks on boards might mean with an accompanying bibliographic literature.

Exhibit 1:
Banking Networks of Largest Firms in the United States and Germany 1896-1938
(U.S./German)

Dimension	1896/1900	1914	1928	1938
Number of Largest Firms	249/*212*	242/*323*	369/*377*	409/*361*
Stand-alone Firms (non-interlocked) (%)	9.2/*26.4*	20.2/*9.6*	10.8/*2.9*	8.3/*4.2*
Weakly-linked Firms (1-2 interlocks with other firms) (%)	19.3/*28.8*	21.1/*15.8*	16.3/*2.9*	19.6/*6.9*
Avg. Size of Board of Directors	13.3/*7.9*	14.4/*12.7*	17.5/*21.7*	16.5/*15.0*
Total Number of Interlocks	1579/*513*	1466/*3081*	2538/*12374*	2091/*6967*
Avg. Interlocks per Firm	6.34/*2.42*	6.05/*9.54*	6.88/*32.8*	5.11/*19.3*
Density of Network*	3.2/*1.61*	3.34/*4.23*	2.49/*10.8*	1.64/*7.0*
No. of Directed Interlocks only #	468/*136*	395/*438*	812/*1416*	715/*1156*
Multiple Directed Interlocks (%)	12.4/*5.1*	10.9/*7.5*	10.6/*15.3*	8.5/*14.9*
Avg. Directed Interlocks per Firm	1.88/*0.64*	1.63/*1.36*	2.2/*3.76*	1.75/*3.2*
Number of Banks in Sample	**46/*30***	**49/*47***	**62/*59***	**77/*47***
Directed Banking Interlocks to Industrial Firms	122/*76*	137/*207*	258/*426*	262/*252*
Avg. Directed Interlocks per Bank	2.7/*2.5*	2.8/*4.4*	4.2/*7.2*	3.4/*5.4*
Industrial Firms with Banker on Board (%)	32.5/*25.3*	36.2/*40.9*	43.0/*59.4*	46.1/*48.4*
Industrial Firms with 3+ Bankers on Board (%)	6.9/*3.8*	8.3/*7.2*	11.4/*18.9*	7.5/*7.6*
Banker as Chairman/President (%)	2.5/*13.7*	2.1/*14.5*	8.5/*23.0*	10.2/*24.8*

Source: Paul Windolf, "Unternehmensverflechtung im organisierten Kapitalismus: Deutschland und USA im Vergleich 1896-1938, Tables 1 and 4, available at www.uni-trier.de/uni/fb4/soziologie/apo/netzwerk1896.pdf. U.S. 1900; Germany 1896.
*Density of Network means the ratio of actual interlocks to the potential total ones available.
#Directed interlocks signify that a member of the executive board of Firm A holds a position in the supervisory firm of Firm B; undirected interlocks mean that a person sits on the supervisory board of Firms A and B. The distinction measures the degree of intentionality and potentially the tightness of control over another firm.

Based on these figures, around 1900 one might argue that the U.S. had the more "organized capitalism" and bank-based economy, but by 1928 Germany evolved many of the attributes that have held until the 1990s. In 1896, over 25% of large German firms had no interlocking directories as opposed to just 9% of American firms, but these figures nearly reversed by 1914; by 1928 just 3% of the largest firms in Germany were completely independent. The percentage of firms in both countries with 1-2 interlocks were roughly comparable in 1914, but diverged dramatically by 1928. A striking result is that German firms had smaller boards of directors in 1900 than American ones, but average German board sizes surpassed American boards by 1928. Also the average number of interlocks per firm were three times less in Germany around 1900, yet were nearly five times the American average in 1928; the density of the interlocking network was two times as high in the U.S. in 1900, but reversed to five times as high in Germany in 1928. Executive directors sat on other firms' boards to a greater extent in the U.S. in 1900, roughly comparably by 1914, but they grew steadily in Germany by 1928.

Most counterintuitively, banks were *more* present in American firms in 1900, roughly comparable in 1914, but increasingly made their presence felt by 1928 in Germany. Even in the bank-suspicious U.S., the number of banks on board increased in the 1920s, but more slowly than that of Germany. That nearly one-quarter of the largest German firms had a banker as supervisory board chair indicates the significant role that banks played in German capitalism. If one of the distinctive features of the German model is bank representation on boards, then it must lie in this last feature because the U.S. also had a high proportion of interlocking directories. Armed with a number of assumptions about falling profits, the increasingly long-term nature of investment, and (wrongly) identifying the supervisory board chair as the crucial entrepreneurial figure on corporate boards, Rudolf Hilferding's 1910 *Finanzkapital* concluded that banks increasingly dominated industry.[24]

But bank presence on board and even share ownership is not necessarily evidence of bank control of corporations. The corporate governance expert, Mark Roe, thought that the English translation of '*Aufsichtsrat*' should really be translated as "advisory board," which stresses consultancy and influence rather than control; even today the political costs of high profile corporate governance roles could be significant.[25] A considerable literature debunks this theory and the spread of banks on boards in Germany

[24] Rudolf Hilferding, *Das Finanzkapital: Eine Studie über die jüngste Entwicklung des Kapitalismus* (Wien: Wiener Volksbuchhandlung, 1910). In English, *Finance Capital: A Study in the Latest Phase of Capitalist Development* (London: Routledge & Kegan Paul, 1981).
[25] Roe, "German 'Populism' and the Large Public Corporation," pp. 195-198.

is independent of their power or "dominance." The *meaning* of such bank representation still needs calibration.

What exactly banks' role on German boards has been one of the most heavily debated issues in German history since the appearance of Rudolf Hilferding's *Das Finanzkapital*—not surprisingly—in 1910 at the height of the debate about banking concentration and power in both Germany and the U.S. One German economist, Adolf Weber, noted that in 1902, it was difficult finding material about banks, yet by 1914 the mass of material and literature was overwhelming.[26] The two poles of the German debate about banking appeared in this decade and have never really disappeared. Hilferding interpreted such interlocks, let alone, bankers holding the key position as the supervisory board chair as a sign of banking "dominance" and control. Riesser's book on the *Concentration of German Banks* appeared slightly beforehand, but addressed the same suspicions put on its Marxist point by Hilferding. As the above quote indicates, however, Riesser viewed such concentration largely as economically advantageous. He also argued that concentration in a small number of large banks based in Berlin eased negotiations in regards the economic and geopolitical diplomacy of the empire, for instance, regarding submarine cables, railroads, and other colonial ventures. Riesser took time to address the two main concerns of contemporaries by arguing that banking power over industry was "quite exaggerated;" industry dictated their own strategies—including cartel-building—according to their own needs, not that of banks. He also did see some issues with the decline of private banks, but chalked it up to the economics of the banking industry that paralleled industrial concentration. However, as long as banks had "careful leaders as has so far been the case" who did not overextend themselves and who retained their "social-political insight" and sensitivity, everything would be fine. Riesser even proved sympathetic to placing a labor representative on boards of directors to responsibly align workers' interests with that of the company![27] You will not find a major business spokesperson in America who would even entertain such an idea. But Riesser's logic for

[26] Adolf Weber, *Depositenbanken und Spekulationsbanken: Ein Vergleich deutschen und englischen Bankwesens* (München/Leipzig: Duncker & Humblot, 1915), p. v-vii. A closely read, comparative analysis of these debates is missing.
[27] Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken*, pp. 288-306.

banks on board, let alone providing a seat for workers, was the same—to build trust through voice and long-term responsibility to productive capital.

We cannot complete a thorough review of the historical literature about banking dominance here, but the notion that banks wielded significant power over firms, guided the strategic investments of firms, or formed cartels to stop the competitive sibling rivalry of its corporate investments is at the very least debatable. While noting the distinctive size of German banks among the largest twenty-five firms by book value, Toni Pierenkemper and Richard Tilly have recently argued: "It does not make much sense, we believe, to speak of a 'German model' of development" in the nineteenth century.[28] Volker Wellhöner largely confirms Riesser's 1906 assessment that if anything banks followed the lead of industrialists.[29] Wellhöner demonstrated that *the* "prime example" of banking power over industry, the forcing of Phoenix into the steel cartel, was actually driven on by the industrialist, August Thyssen, who "frightened" banks. Many banks' clients were sufficiently cash rich that they were able to dictate terms to the banks. Large German industrial firms regularly played banks off of one another or developed financial strategies to minimize banks' leverage over them.[30] The concentration process of the great German banks had to keep pace with the concentration process in German industry, which outgrew the financing capabilities of banks (Riesser, Wellhöner). Wilfried Feldenkirchen and Richard Tilly among others statistically proved that most heavy industrial firms could rely rely on self-financing and retained earnings to finance long-term investment, thus further reducing the power of banks. Finally, Wellhöner stressed the conceptual inadequacy of the idea of "dominance" or "banking power."[31] Caroline

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[28] Toni Pierenkemper and Richard Tilly, *The German Economy during the Nineteenth Century* (New York: Berghahn Books, 2005), p. 161.

[29] Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken*, pp. 279-306.

[30] Volker Wellhöner, *Großbanken und Großindustrie im Kaiserreich* (Göttingen: Vandenhoeck & Ruprecht, 1989), esp. pp. 84-87 on Phoenix. Also Jakob Tanner, „'Bankenmacht': politischer Popanz, antisemitischer Sterotyp oder analytische Kategorie?," *Zeitschrift für Unternehmensgeschichte* (ZUG), 43/1 (1998), pp. 19-34.

[31] Feldenkirchen, *Eisen- und Stahlindustrie*, pp. 283-303. Wellhöner, *Großbanken und Großindustrie im Kaiserreich*, pp. 237-244. Volker Wellhöner and Harald Wixforth, "Unternehmensfinanzierung durch Banken—Ein Hebel zur Etablierung der Bankenherrschaft? Ein Beitrag zum Verhältnis von Banken und Schwerindustrie in Deutschland während des Kaiserreichs und der Weimarer Republik," (Hg.) Dietmar Petzina, *Zur Geschichte der Unternehmensfinanzierung* (Berlin: Duncker & Humblot, 1990), pp. 11-33. On Mannesmann, see Wellhöner, *Großbanken und Großindustrie im Kaiserreich*, pp. 125-146; also Horst A. Wessel, "Finanzierungsprobleme in der Gründungs- und Ausbauphase der Deutsch-Österreichischen

Fohlin notes about the 1920s "that expanding networks of interlocking directorates may be associated with the weakening of ties between banks and firms rather than with the increasing dominion of banks over industry." Exhibit 1 shows the dramatic expansion of bankers on board large firms in the 1920s, but the great interwar crises weakened banks ability to finance and control dramatically. Yet even before the 1920s, when many observed a weakening of bank power over industry, banks on boards of German industry grew after 1890, well after industrialization was underway.[32] Even Gerschenkron noted that the influence of universal banks weakened after the upswing of the business cycle after 1895. These assessments by historians mirror the 1905 opinion of Emil Kirdorf, the head of the largest German coal company, Gelsenkirchen, who said to resounding applause: "Never has the influence of large banks on the big business of Rhineland-Westphalia been so low as it is at present."[33] Riesser even suggested holding corporate equity reflected poorly on the ability of a bank to effectively issue shares or was planning to speculate with its shareholding.[34] Finally, as stressed today, such directorates might better promote cushy cross-shareholdings that led more to favoritism than a real supervisory check on management executives. Then, as now, minority shareholders on

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Mannesmannröhren-Werke AG. 1890-1907," (Hg.) Petzina, *Zur Geschichte der Unternehmensfinanzierung*, pp. 119-171. Harald Wixforth and D. Ziegler, "*Bankenmacht*: Universal Banking and German Industry in Historical Perspective," The Evolution of Financial Institutions and Markets in Twentieth-Century Europe, (eds.) Youssef Cassis, Gerald Feldmann, and U. Olsson (Aldershot: Scholar Press, 1995), pp. 249-272. For the 1920s, see Harald Wixforth, *Banken und Schwerindustrie in der Weimarer Republik* (Köln: Böhlau Verlag, 1995). Although heavy industry had considerable difficulty financing their investment activities after the end of the inflation, banking influence ebbed still further.

[32] Caroline Fohlin, "The Rise of Interlocking Directorates in Imperial Germany," *Economic History Review*, 52, 2 (1999), pp. 307-333, quote from p. 309. Volker Wellhöner und Harald Wixforth, "Unternehmensfinanzierung durch Banken—Ein Hebel zur Etablierung der Bankenherrschaft? Ein Beitrag zum Verhältnis von Banken und Schwerindustrie in Deutschland während des Kaiserreichs und der Weimarer Republik," (Hg.) Dietmar Petzina, *Zur Geschichte der Unternehmensfinanzierung* (Berlin: Duncker & Humblot, 1990), pp. 11-33. Harald Wixforth, *Banken und Schwerindustrie in der Weimarer Republik* (Köln: Böhlau, 1990). Harald Wixforth und Dieter Ziegler, "Bankenmacht: Universal Banking and German Industry in Historical Perspective," *The Evolution of Financial Institutions and markets in Twentieth-Century Europe*, (eds.) Youssef Cassis, Gerald Feldmann, and U. Olsson (Aldershot: Scholar Press, 1995), pp. 249-272. Dieter Ziegler, "Die Aufsichtsräte der deutschen Aktiengesellschaften in den zwanziger Jahren: Eine empirische Untersuchung zum Problem der 'Bankenmacht'," *Zeitschrift für Unternehmensgeschichte*, 43/2 (1998), pp. 194-215.

[33] Quoted from Emil Kirdorf's speech at the *Verein für Socialpolitik*, 27/28 September 1905, reproduced in *Kartelle in der Wirklichkeit*, (Hg.) Ludwig Kastl (Köln: Carl Heymanns Verlag, 1963), p. 109.

[34] Fohlin, *Finance Capitalism*, pp. 106-168. Fohlin, "Rise of Interlocking Directorates," pp. 320-329; Fohlin, "Relationship Banking, Liquidity, and Investment in the German Industrialization." See also Lothar Gall et al. (ed.), *The Deutsche Bank, 1870-1995* (London: Weidenfeld & Nicolson, 1995), pp. 26-52.

supervisory boards that provided a critical perspective on the condition of the enterprise were “not very popular,” according to the contemporary skeptic, Richard Passow.[35]

In short, the reasons why banks take seats on directors’ boards of firms are complicated, needing careful analysis of specific modalities of their relationships with business. Clearly, banks on boards do overcome informational assymetries. Indeed, one of the clear motivations for German corporate governance reform in 1884 and 1896 after the disastrous 1873 founders’ crisis was to have banks on board to certify those ventures as creditworthy and trustworthy on stock markets (see discussions below). If banks were on board, they signaled to outsiders that dedicated insiders had a stake in the firm as an ongoing firm, not just an insecure piece of paper floating on the winds of the speculative stock market. In times of distress, banks had a stake to step in to save the firm, its shareholders, and its employees. It should also not be underestimated just how desperate banks were, particularly in the 1920s, to appear as willing servants of productive national enterprises. They acted as loyal advisors, hoping to attract the business of their customers. Then as now, the ability to cross-sell and be there when firms needed additional loans, float bonds, or issue shares. Banks had to behave as loyal clients, not controllers.

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[35] Rudolf Passow, *Die Aktiengesellschaft*, pp. 387-461, esp. 444-447, quotes from pp. 419, 421, 422. The experience of the 1920s suggest that banks desired to cultivate firms’s business and ‘being there’ on boards, preferably as many as possible, provided better information about firms and general developments (see the Riesser quote) so that when the firm needed some sort of financing the suitor bank was potentially first in line. Easily rolling over plain vanilla current account credits demonstrated loyalty to industrial clients, there to offer services to the firm when something more important arises: underwriting, financing new investments, etc.—i.e. cross-selling. One must also not forget the (lucrative) prestige factor about being on board a powerful, high profile industrial firm. In the 1920s, the corporate governance expert, Richard Passow, even downplayed the board’s *capability* of supervising a firm. Without denying the potential economic benefits of such bank representation, Passow emphasized the prestige or “decorative” occupation of board seats; many board members were retirees, good friends, relatives, or just plain “royalty hunters” (*Tantiemejäger*). Often board members lacked the financial or technical competence needed, met only a few times a year, lived distant from the geographical vicinity of the company headquarters, ‘controlled’ on the basis of loose sampling, or worse, used materials provided by companies’ managing executives themselves. Sometimes important universal bank representatives, such as Carl Klönne or Oscar Schlitter of the Deutsche Bank or Jakob Goldschmidt of DANAT, sat on numerous firms or were responsible for whole districts like the Ruhr, lessening their ability to monitor and control effectively. (In 1929 Goldschmidt sat on around 125 firms’ supervisory boards). In 1914, the Deutsche Bank had seats in 186 different companies. One individual director held 44 seats and over 100 in 1930, see Jürgen Kocka, “Big Business and the Rise of Managerial Capitalism: Germany in International Comparison,” *Industrial Culture and Bourgeois Society: Business, Labor, and Bureaucracy in Modern Germany* (New York: Berghahn, 1999), pp. 156-173, figures from p. 167.

But most importantly for our argument**,** whatever the specific reasons for banks on board, it is clear from Exhibit 1 that *whatever theory applies to Germany should also apply to an analysis of the U.S.*—at least prior to 1914. At minimum, German "organized capitalism," "coordinated capitalism" or "insider governance" (Deutschland AG) began to take shape prior to 1914, but was still comparable to the U.S.; it became more "coordinated" or "organized" after the 1920s. At the same time, the U.S. took its road to an "equity revolution;" regulators backed by popular opinion systematically began to reduce banks on board after 1914 with legislation. The banks-on-board, insider governance divergence begins with World War I, although key assumptions and decisions laid tracks beforehand.

Americans grew increasingly uncomfortable with such insider governance, which was construed as a "money trust," while German regulators actively encouraged such interlocks because they thought it helped tame the volatility of capital markets, the quality of securities, and the financial stability of firms.[36] This notion of 'taming' or smoothing inherently anarchic markets underlay much regulation. The "great reversal," that is, the beginning of the end of relationship banking and shift to more capital market orientation in the U.S. begins in the 1920s, while the war, hyperinflation, depression, and Third Reich near permanently wrecked Germany's equity markets. Indeed in the 1920s and 1930s, the hypernationalist reasoning for these corporate interlocks to protect home industry came to the fore in Germany, which still did not stop Germany's largest firms and municipalities from borrowing from Wall Street in the 1920s to the chagrin of many nationalists.

Without overstating similarities, German banks enjoyed many regulatory advantages for underwriting securities and maintaining close relationships with clients that their American counterparts did not. In the U.S. many of the services routinely provided by German banks were statutorily or for other reasons open only to private banks or trust companies, or specialized service companies, whose sources of capital and control of companies were more limited than those of large public universal banks in

[36] **Donald J. S. Brean and Christopher Kobrak, "Corporate Governance in the Twenty-First Century," in** *Corporate, Public and Global Governance: The G8 Contribution***, eds. Michele Fratianni, et al (Aldershot: Ashgate, 2007), pp. 55-77. Add Colin Mayer.**

Germany. German banks not only excelled at investment banking functions, but also these activities were complemented by handling "trust accounts," retail deposits over large regional areas, auditing, consulting as well as short- and long-term commercial loans, activities which were by and large segmented among different types of banks in the U.S. Nevertheless, American banks had plenty of opportunity to profit from working closely with companies, often in conjunction with far larger European banks. One of the main functions of banks in both countries, reorganizing companies, was more prevalent in the U.S. because more firms fell into distress requiring active management and massive follow up.

The stories of two very important American companies illustrate how new and troubled companies required not only active bank management but new investment practices in both Germany and the United States, especially when foreign funds were involved. When Edison General Electric was launched in 1889, the bankers and other sponsors, many of whom were from Germany, reluctantly agreed to hold the shares until the moment was ripe for a public sale. With jittery U.S. capital markets at the time, the syndicate leader extended the no-sale clause several times much to the chagrin of his partners. At the very least, the bankers wanted to keep the company on a short leash while their funds were tied up. When the Edison company was merged with a competitor to form GE, the Germans, who had already watched their control of the old company diminish and who knew they would have even less opportunity to influence the operations of the new company because of J. P. Morgan's predominant position, chose to sell off their interest. Similarly, in 1896, the reorganization of the Northern Pacific Railroad required of the lead of American and European banks, which not only made a substantial capital commitment but also active management. German investors, especially, only agreed to the reorganization when they felt confident that their interests would be well represented in the new company by Deutsche Bank representatives, along with the J. P. Morgan and other American bankers. The Voting Trust to oversee the railroad lasted five years.[37]

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[37] Christopher Kobrak, *Banking on Global Markets: Deutsche Bank and the United States, 1870 to the Present* (Cambridge: Cambridge University Press, 2007).

Generally, as these stories illustrate, banks in 1900 were generally not anxious to take large positions in companies, especially if they could not control firms, but often shareholding was unavoidable. In Germany, quite simply, banks were expected to hold enough of their clients' securities to gradually bring issues on to the market and keep share prices stable (see the lead Riesser quote). The objectives and role that the large Berlin-based banks played on the stock market (not necessarily in the corporate governance of companies or as substitute entrepreneurs) and the range of services offered by one-shop, universal banks were the crucial differences in bank-firm relationships between the two countries.

Maintaining these activities, the universal approach to banking services, was never really questioned in Germany. Although the Germany banking sector was highly segmented into its famous "three pillar" structure (large commercial universal banks, savings banks, and cooperatives), the breadth of activities of the large public universal banks gave them much more *potential* influence than their American counterparts. A look at their revenues and profits will help understand their businesses. By 1900, Deutsche Bank, for example, had recognized that holding on to large amounts of securities entailed many risks. Apart from short periods, which signified distress in companies, the securities owned by Deutsche Bank directly rarely exceeded 10% of the banks total assets before 1910. Far more assets – roughly from three to four times more – was tied up in bank acceptances and bills of exchange, which corresponded to foreign exchange trading. By 1900, trading in securities had fallen to approximately 6% of total revenues, roughly the same amount as bank acceptances and roughly one-third the revenue contribution of dealing in bills of exchange.[38] Any client engaged in foreign business, then, needed the services of a large bank, at the very least to process payments and handle trade payments, services which often called on a bank to vouchsafe the credit worthiness of its client to others.

While underwriting clients' securities was an important service, contrary to popular opinion, investing and holding equity or debt positions in client companies were not important activities of banks in Germany or the U.S. As the Edison and Northern

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[38] Walter Hook, *Die wirtschaftliche Entwicklung der ehemaligen Deutschen Bank im Spiegel ihrer Bilanzen* (Heidelberg: Carl Winter, 1956), pp. 63-64, and Table 10.

Pacific stories illustrate, Riesser felt that if banks held large industrial shareholdings, it was a sign of poor performance: "…excessive holdings of securities would understandably be interpreted to mean either that the times were not been propitious for the issue businesses of the bank, or that it maintains excessive speculative engagements, or that it is involved to an excessive extent in speculative transactions on its own account…or, finally, that it has been unable to find sufficiently profitable employment for its funds."[39]

Like their German counterparts, national banks did not own a great many of the securities launched by their corporate clients. In 1900, the vast majority of the assets of National City Bank were in straight short-term or long-term loans and government securities; just over 10% were in the form of securities issued by private companies.[40] National City earned a great deal of its income from foreign exchange trading and discounting bank acceptances drafted in London.[41] Unlike European continental banks, National City's powerful position as a U.S. investment bank was based on the combination of its corporate deposits, correspondent relationships, and partnerships with private banks whose own funds were limited. They had to borrow from banks like National City to hold securities, even those they were merely distributing to other investors. As with private equity today, riding out soft patches in the market to sell securities gradually required the private banks to have financial back-up from the public banks.[42] These loans added to the costs and risks of issuing securities, a problem that was somewhat alleviated in Germany by internalizing the source of funds as well as the distribution of securities. Although German banks worked in syndicates too, the capacity of the big banks like Deutsche Bank to underwrite the issue, finance the holding period, and speed up distribution internally gave them a huge advantage over their smaller competitors, an advantage that neither private nor public banks had in the U.S.

One service – holding and administering customers' securities bequeathing proxy voting rights—which German banks could perform and contributed to their influence in companies, could not be performed at all by American commercial banks. Only trust

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[39] Riesser, *German Great Banks* (1911), pp. 402-404, quoted in Fohlin, *Finance Capitalism*, p. 107.
[40] *Citibank*, p. 50.
[41] *Citibank*, p. 43.
[42] *Citibank*, pp. 46-47.

companies could hold securities accounts; some U.S. trust companies even became active managers of the funds entrusted to them. Originally designed to serve the relatively wealthy, after the passage of the National Banking Act (1864) trust companies had the power to receive deposits of money and securities and to purchase securities of business firms, but they could also moved into traditional banking areas. Reflecting the important market niche they filled, their numbers grew from 42 in 1886 to 1564 in 1914. By one estimate, they enjoyed a 25 fold increase in their assets during the same period.[43] They performed many of the securities administrative functions in the U.S. that universal banks did in Germany.

As an off balance sheet activity and one that was not discussed in annual reports, however, it is hard to know the exact extent of this activity was in Germany. We do know that it was extensive and held many advantages for all concerned—except the large banks' competitors. Holding securities by banks was already a widespread practice before World War I. Customers often allowed banks to vote their shares for them at annual meetings, although the practice was not highly regulated or even controlled by banks' own policies. According to one expert historian on German banks, from the turn of the century on, with a few exceptions, large banks cast the vast majority of votes at annual meetings, although the actual amount varied widely from year to year.[44] Still the question remains how German banks actually used this potential influence (discussed further below in Section 2).

For the most part, in Germany the practice of entrusting administration of securities to banks and allowing the banks to vote shares was perceived to have many advantages, seemingly for all concerned. There were the obvious advantages for the clients: safety; collection of dividends and interests, especially for foreign securities, and overseeing changes to the form of securities, for example, when debt was exchanged for equity; or travel expenses.[45] Like today, one can easily imagine that few shareholders wanted to take the time to review financial information, oversee managers, and go to

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[43] Eugene Nelson White, *The Regulation and Reform of the American Banking System, 1900 -1929* (Princeton: Princeton University Press, 1983), pp. 70-71.
[44] Wellhöner, p. 80.
[45] Carl Otto Stünzner, *Banken und Wertpapierbörse: Beiträge zu der Stellung der Banken auf dem Wertpapiermarkte* (Altenburg, S.-A.: Oskar Bonde, 1911), pp. 1-23, esp. 12-17.

shareholder meetings to vote their opinions. Banks' influence on companies, then, was not built just on their power to bring issues to market, for which the depot accounts were no doubt also useful, or to lend, but rather on their network of branches, each with customers willing to deposit their securities, whose voting power was controlled by the bank. Indeed, the post-1891 initiative that led to the passing of the Bank Deposit Law of 1896 (*Bankdepotgesetz*) began as the large Berlin banks with their special role as intermediaries on the Berlin stock exchange were voting and trading shares of stock held in deposit for local bankers (who in turn held shares for individual customers) without the permission of the individual shareholders and with disastrous results.[46] As will be discussed in greater depth, customers could also avoid the Stamp Tax when buying or selling shares through the bank. These customers probably expected to be the recipients of privileged information and to have first shot at new issues brought to market by the bank, which was expected to give its assurances about the quality of the issue. The State, for its part, expected that the banks would use their power to establish and maintain "fair prices" for securities and, thereby, to avoid "haphazard" price fluctuations. The banks helped companies insure that votes would be cast at annually meetings – and probably how – avoiding unnecessary embarrassment or worse for management. Early on, banks recognized that this power could be a double-edged sword.[47] Voting shares added to the perception that the banks were carefully overseeing a company's activities, making them more responsible should the company fail to fulfill expectations.

It is important to understand the organization and procedures of annual meetings in Germany. To vote at the meetings, shareholders had to have their ownership interest certified with the company, with designated banks or with a German notary, a process made easier for those whose shares were already deposited with a bank.[48] While agreements prior to 1900 make no mention of voting at annual meetings, by 1910, Deutsche Bank deposit conditions with clients stipulated that the bank maintained the right to vote shares in the interest of its "business friends" unless "in individual cases the

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[46] Jacob Riesser, *Das Bankdepotgesetz* (Berlin: Otto Liebmann, 1924).
[47] Letter from E. Rathenau and F. Deutsch (Deutsche Edison Gesellschaft) to Deutsche Bank, May 8, 1887, in Manfred Pohl, *Emil Rathenau und die AEG* (Mainz: Hase und Koehler, 1988), p. 67.
[48] *Reichsanseige und Königlich Preusische Staatenanzeige*, March 6, 1911, Schering AG Archive, BO/ 311/2.

client intends to."[49] Banks actually organized the lists of shares that had been certified. Larger banks, such as Deutsche Bank or the Berliner Handels-Gesellschaft, even voted the shares of smaller banks, especially those from outside of Berlin. Smaller banks or their clients may have owned the shares themselves.[50] At some meetings, large banks cast virtually all the votes.[51] Remarkably, the German Bankenquete of 1908, the Reichstags examination of the German banking system which followed the worldwide financial crisis in 1907, makes no mention of German banks near automatic voting of their clients' shares.[52]

Despite their attempts to demur and some public criticism even before 1914, the practice was widespread before and after World War I. Even some scholars who have cast doubt about the power of banks in the German economy have backtracked about the importance of proxy voting and come to recognize the virtual unparalleled potential influence banks could exert due to this widespread practice, perhaps even required by some banks, of clients turning over voting power at general shareholder meetings to bank administrators.[53]

Yet, ironically, U.S. investment banks, particularly J.P. Morgan exercised more overt control over American firms than German banks did over their counterparts. One of the largest differences between both countries was the nature of investors that banks intermediated and the necessity for direct, activist management during volatile business conditions. In contrast to their German colleagues, American bankers had to seek and deal with investors over much wider distances and from foreign lands. With vast areas being opened up by the capital-intensive railroad, American investors found themselves very far from the sources of their wealth. Although the amounts of capital that came

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[49] Deutsche Bank, Filiale Frankfurt, Geschäfts Bedingungen, HADB.
[50] Jacob Riesser, *Das Bankdepotgesetz* (Berlin: Otto Liebmann, 1924).
[51] Anmeldung an der am 30 März 1911 General Versammlung, Oberschleschische Kokswerke & Chemische Fabriken AG, Schering AG Archive, BO-311/2.
[52] *Bankenquete 1908, Stenographische Berichte*, Die Verhandungen der Gesamtkommission zu den Punkten I-V des Fragebogens (Berlin: Siegfried, 1909)
[53] Caroline Fohlin, *Financial System Design and Industrial Development: International Patterns in Historical Perspective* (Cambridge: Cambridge University Press, forthcoming), pp. 2-4. Fohlin, *Finance Capitalism*, pp. 144-167. Except in well-known cases such as Mannesmann or Phoenix, the paucity of examples of active bank management was not a function of a lack of bank leverage with clients but rather from the lack economic reasons to devote the time and effort. Bankers now and then are always doing a cost benefit analysis. The phrase "if it ain't broke don't fix it" comes to mind. Nevertheless, regulators, investors, and the general public counted on German banks' ability and expertise to step in if necessary.

from Europe, primarily Britain, varied, the powerful New York banking houses had to have a foothold with investors in London, Berlin, Paris, and other European centers of capital.[54] By 1914, foreigners owned over $7.0 billion in U.S. securities, the majority still in railroads but other investments made up approximately 60%. In 1914, America played host for more foreign direct investment than all of Western Europe combined.[55] Given the poor state of accounting information and the dismal, patchwork state of America regulations, drawing foreign investors into American securities posed special responsibilities. The private bankers, such as Morgan, Speyer, Belmont, and Kuhn Loeb who drew on their mostly European contacts to seek funds, had to give their assurances that errant companies would be sorted out and that they would do their utmost to limit the damage caused by America's poor macroeconomic policy making caused by lack of a central bank.

This entailed not only shoring up periodic crises of faith in the value of the dollar and the soundness of the banking system in general, but also micromanaging many new companies and old ones that, especially during the frequent panics, lending overextensions, restructurings, mergers and acquisitions, or times of excess competition, when firms found themselves in financial distress. To be sure, Germany had a long bout of deflation and financial crises but fewer in magnitude than the U.S., which witnessed five from 1884 to 1997, and certainly none after 1873 with the kind of market panic, severe questions about the banking system, widespread bankruptcies, and volatility that seemed all-too commonplace in the U.S. Many contemporaries and historians noted how much German industrial growth was less volatile than in the U.S. or Britain (sometimes attributing it to cartels).[56] In comparison to the "unbelievably ruthless" American practice of "throwing workers into the streets," German firms maintained a steadier

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[54] Youssef Cassis, *Capitals of Capital: A History of International Financial Centres, 1780-2005* (Cambridge: Cambridge University Press, 2006), p. 117.

[55] Mira Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, MA.: Harvard University Press, 1989), pp. 147 and 198. These figures include portfolio and foreign direct investment (FDI). Geoffrey Jones, *The Evolution of International Business: An Introduction* (London: Routledge, 1996), p. 31.

[56] Alexander J. Field, "The Relative Stability of German and American Industrial Growth, 1880-1913: A Comparative Analysis," *Historische Konjunkturforschung*, (Hg.) Wilhelm Heinz Schröder und Reinhard Spree (Stuttgart: Franz Steiner, 1980), 208-233.

overall employment level.[57] In spite of severe downturns in 1901 and 1907, German steel firms overall employment levels did achieve steadier employment figures than American steel firms, which frequently laid off over 20% of their workforces, unheard of in German firms.[58]

Without sufficient holdings themselves, without the trust accounts of German banks with their voting privileges, and limited by regulatory barriers, private American banks had to invent elaborate schemes to reassure investors that could keep control. One of J. P. Morgan's great innovations after company reorganizations was to install a Voting Trust agreement, by which the shareholders who benefited from his financial engineering had to assign bankers their share voting rights for a period J. P. deemed sufficient to insure the future health of the company in question.[59] J. P. employed this device several times. With the Philadelphia and Reading line, for example, Morgan refused to give back responsibility for the reorganized company back to its former managers. He established a five-year long Voting Trust, of which he remained chairman, to "guide" management and restore trust among American and European investors. Having his son at the helm allowed J. P.'s father Junius to convincingly reassure skittish London investors. Such agreements were put into place in situations that seemed to call for active investor management, but where the shareholders themselves could or did not want to participate.[60] Statistics about interlocking shareholdings and directorships fail to capture the importance of these arrangements.

German banks also derived influence by providing other financial services. In sharp contrast to the United States, German banks led the way in establishing accounting and audit firms, which at times held securities and reorganized companies. Although most of the dramatic changes occurred after World War I, by 1914 American

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[57] Robert Liefmann, *Kartelle und Trusts und die Weiterbildung der volkswirtschaftlichen Organisation* (Stuttgart 1910), esp. 109-142. Various editions available.
[58] Compare the average employment levels between 1907-1914 in Feldenkirchen, *Eisen- und Stahlindustrie*, Table 104 a/b with Gertrude G. Schroeder, *The Growth of Major Steel Companies, 1900-1950* (Baltimore, 1953), pp. 216-218. Average yearly employment levels do not take into consideration the considerable turnover rates of German unskilled workers.
[59] Kobrak, *Banking on Global Markets*, Forthcoming.
[60] Jean Sprouse, *Morgan: American Financier* (New York: Perennial, 2000) pp. 246-253.

accountancy started to develop along very different lines than its German counterpart.[61] American accounting organizations worked very hard to gain their independence in defining accounting and auditing standards. Central to the formation of the new profession was a sense of its independence and monopoly on defining how accounting information should be generated and audited. Although there was still a good deal of regional differences, rival organizations, jealousies between big and small firms as well as between those with and without foreign affiliates, they labored against what they perceived were undue influences from government agencies, other private individuals and even foreign, mostly English colleagues. Although there was never a complete consensus before 1914, American accountants chalked up many successes including winning effective control of licensing, accounting education, and the generation of acceptable accounting principles in many important regional jurisdictions such as New York. Fearful of federal and state control, they strove to legitimize their own institutions with the authority to adjudicate conflicts. Despite their profiting greatly from Britain's strong accounting tradition, many American accountants wanted to create an American model of public accounting. For example, one of the chief ethical concerns of the nascent profession was eliminating non-accountant ownership and control of accounting firms. By 1929, banks were forbidden from performing audits. Indeed, bankers, especially those responsible for foreign funds invested in U.S. companies, which by 1900 had nearly tripled since the end of the Civil War, were among the most consistent demanders of accounting and audit services. Even federal efforts to define accounting standards in some sectors relied greatly on professional accountants. In short, although divisions remained in the profession, by 1914, accountants had organized themselves into relatively powerful organizations, which shared a collective vision of professional independence from other organizations and a responsibility for defining professional standards.[62]

The different development and configuration of German accountancy is quite striking. In the last decade of the 19th century, all the major German banks were offering

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[61] Fear and Kobrak, "Diverging Paths." Stephen E. Loeb and Paul J. Miranti, Jr., *The Institute of Accounts: Nineteenth-Century Origins of Accounting Professionalism in the United States* (London: Routledge, 2004).
[62] Miranti, *Accountancy Comes of Age*, pp. 1-99.

auditing and reorganization services through separate subsidiaries, which often maintained offices at the banks branches. These controlled firms took a leading part in molding German accounting and also in the management of troubled firms.[63] During most of the period under discussion, German accountants were divided among firms that were closely tied to other institutions and small independent firms that were not. In much the same way as American accounting and auditing in the last quarter of the 20th century became tied to other activities and institutions such as consulting, which reduced their independence, much of the German profession had little independent status, in part because it was controlled by institutions with other activities and interests.[64] Deutsche Bank, for example, ran its own audit firm as a subsidiary with offices in its branches. Originally formed as an American investment trust, in the early 1890s, after a series of American financial crises, the founder reconstituted the firm to audit all companies and to deal with firms in financial distress. The Deutsche Treuhand Gesellschaft (DTG), as it eventually was called, solidified Deutsche Bank's role with clients as their principal provider of financial services and as a general business consultant. For the bank, it seemed to be a natural extension of its fiduciary responsibilities with clients and even a part of bankers' duties as members of *Aufsichtsräte*.[65] By 1900, banks owned the most powerful auditing firms in Germany and they were not run by publicly chartered accountants. Not all the impetus for entrusting banks with many corporate governance functions derived from German political or economic reasons. One of Germany's first bad experiences with American foreign investments thrust the banking sector into providing audit and bankruptcy services, first for foreign investments, then later for domestic ones.[66] Well before the 1930s, a good deal of these activities had begun to fall into the hands of other specialized institutions in the United States, such as specialized

[63] See Fear and Kobrak,, "Building Solidity," and See Reiner Quick, "The Formation and Early Development of German Audit Firms," *Accounting, Business & Financial History*, Vol. 15, No. 3, 317-343, for an excellent discussion of the early history of German auditing. The distinction between inside (private) and outside auditing so prevalent by the 1990s also began prior to 1914, see Christian Leuz and Jens Wüstemann, "The Role of Accounting in the German Financial System," *The German Financial System*, (eds.) Jan P. Krahnen and Reinhard H. Schmidt (Oxford: Oxford University Press, 2004), pp. 450-481.

[64] For a discussion of the problems for accounting firms caused by consulting see Christopher McKenna, *The World Newest Profession* (Cambridge: Cambridge University Press, 2006)

[65] Kobrak, *Banking on Global Markets*, and Fear and Kobrak, "Building Solidity,"

[66] Kobrak, *Banking on Global Markets*.

accounting firms or consultants,[67] and private banks or other institutions, whose power rested from a different set of competitive strengths and whose activities were, because of their very private nature, even more scrutinized and attacked by the public, even though they had little to do with share ownership or board membership.

The profitability of large public and powerful private banks was the subject of heated debate in Germany, but nothing on the scale of Morgan's money generation, in part because the opportunities were not there. Morgan's pricing of issues and apparent gains seemed to many an abuse of financial power to the detriment of the public good. Only the gravity of American crises and the degree of information asymmetries could account for his power and profits. For example, within twelve years, Morgan spearheaded three efforts to save the American currency and banking system; he earned large financial rewards and public outrage each time. By some accounts, the Morgan syndicate earned $6-7 million in 22 minutes with the 1895 Gold Bond alone to the chorus of denunciations in Congress.[68] Like most U.S. private bankers, Morgan's success in this in many other transactions depended on his ability to forge tight relationships with European bankers, especially British and German banks.[69]

The transportation sectors best illustrates how America's hunger for capital, high returns, and financial fragility all combined to expand the role of banks. The differences between Germany and the United States are striking. Whereas the sector called for maximum bank intervention in the U.S., by 1900, virtually all German lines had been nationalized. Banks had not only earned huge commission for aiding the State buy up private lines during the last 20 years of the century, they and their clients had to look elsewhere for large transportation investments, which helped make German investors one of the leading groups active on U.S. capital markets and as agents for listing American securities on German markets.

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[67] McKenna, pp. 16-17.
[68] Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Touchtone, 1990), p. 76. With each of these undertakings, Morgan earned less money and more public acrimony.
[69] See Claudia Langen, Tradition, *Expansion und Kooperation: Deutsch-Amerikanische Bankenbeziehungen von 1900 bis 1917*, (Cologne Disseration, 1995) and Christopher Kobrak., "The Rise and Fall of Family International Banking," in Harold James, *Family Business*, Forthcoming.

The importance to capital markets of railroad and their frequent financial distress created opportunities for bank involvement in companies that was unmatched in Germany. In the early 1870s, railroad failures had a great impact on German capital markets and the German psyche, but Bismarck's nationalization of most of the railroads was nearly completed by the time he left office, providing a series of transaction windfalls for some banks, but effectively removing financial institutions from rail management and the stock market in Germany.[70] Around the same time, railroads accounted for approximately 35% of American equity markets, 180,000 miles of track, nearly seven times the amount in Germany. By 1893, however, 74 rail companies were in receivership, with $1.8 billion in capital and 30,000 miles of track.[71] Moreover, by the early 1890s, roughly a third of U.S. railroad securities were in the hands of foreigners.[72]

As one of the chief conduits of European and American money into the fast growing and often troubled railroad sector, Morgan and his men gave financial advice, hired and fired managers, engineered or defended against takeover attempts, and monitored investment to prevent "ruinous" competition for dozens of lines. He was reported to have said to one stubborn rail man, "your roads belong to *my* clients."[73] Except perhaps for the Mannesmann brothers, booted out by the Deutsche Bank, and the deep disappointment of Phoenix managers whose banks did not back their refusal to join the Steel Works Association because their housebanks were afraid of August Thyssen, we cannot think of an example of a German industrialist writing a book railing against their bankers entitled *Cannibals of Finance: Fifteen Years' Contest with the Money Trust*.[74]

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[70] Fritz Stern, *Gold and Iron: Bismarck, Bleichröder, and the Building of the German Empire* (New York: Alred A. Knopf, 1977)

[71] Karl Helfferich, *Georg von Siemens: Ein Lebensbild aus Deutschlands großer Zeit* (Berlin: Verlag von Julius Springer, 1923), Vol. 2, pp. 223 and 253-254. Helfferich's biography of the first head of Deutsche Bank contains a lot of interesting information about the American rail sector. The weight he gives it serves as testimony for the importance of this sector to Deutsche Bank's history.

[72] Mira Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, MA.: Harvard University Press, 1989) pp. 197-198.

[73] Quoted in Jean Strouse, *Morgan: American Financier* (New York: HarperCollins, 1988), p. 196. For a detailed discussion of how Morgan and Deutsche Bank actively managed the affairs of the Northern Pacific, see Christopher Kobrak, *Men, Markets, Cooperation and Conflict*, forthcoming.

[74] Arthur Edward Stillwell (Builder of the Kansas City Southern Railroad, The Kansas City, Mexico and Orient Railroad, The Port Arthur Channel and Dock), *Cannibals of Finance: Fifteen Years' Contest with the Money Trust* (Chicago: Farnum Publishing, 1912).

Like his German counterparts, Morgan also helped create new commercial enterprises. As in Germany, this tended to increase the scope of active management in Germany. But American markets provided an additional opportunity for active bank management that was less prevalent in Germany: mergers. Both Germany and the U.S. witnessed a bounce in merger activity at the very end of the 19th century, but the number of companies lost to mergers in the U.S. was 100 times higher than in Germany.[75] With mostly bank encouragement, German companies tended to mitigate the effects of competition and achieve some benefits of scale more by use of cartels, rather than outright mergers. Indeed cartels were designed to slow merger activity that might lead to American-style trustification. The cartelization of business left room for many banking services, but reduced the need for active bank management in complicated corporate restructurings or with bankruptcies, which ironically promoted many financial innovations.[76] Moreover, with more founding families remaining in German businesses, the need for an external institution to adjudicate conflicts was reduced.

In short, with all these sources of cumulating power, it is no wonder that the general population and regulators worried about Morgan's influence. Because business and communication was so transnational during the first wave of globalization—symbolized by the brother Warburgs—we have a good deal of information from the other side of the Atlantic about the specific roles and interests of banks on boards in the U.S. and Germany before World War I. Even Morgan's German banking colleagues in an era of stupendous combinations and in spite of his many great successes, were aghast at times. At least one German colleague, who had worked closely with Morgan, confided his fears of Morgan megalomania to his representative in New York.

> You will have heard possibly of the latest German philosopher Friedrich Nietzsche, who died in a lunatic asylum last year and in my judgment was crazy all his life. In one of his much read and much quoted books he puts forward, as a consummation to be wished the development of man into the 'Uebermensch,' ignoring good and bad. Mr. Morgan seems to be well on his way towards Nietzsche's ideal.[77]

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[75] C. J. Schmitz, *The growth of big business in the United States and western Europe, 1850-1939* (Cambridge: Cambridge University Press, 1993), p. 40.
[76] Peter Tufano, "Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century," *Business History Review*, Vol. 71, 1 (Spring 1997), pp. 1-40. Fear, *Organizing Control*, pp. xx-xx.
[77] Gwinner to Adams, October 5, 1901, HADB, A-0045.

What better indication of the different regulatory and political perceptions of bankers in the two countries than the dramatic contrast between their being ennobled and elected to the Reichstag in Germany (Georg Siemens of Deutsche Bank), and J. P. Morgan being hauled up in front of Congressional commissions (Pujo Hearings) in the U.S. for financial conspiracy against the public.

Consider more specifically the contrast between the activities of the Deutsche Bank and J. P. Morgan. Founded in 1870, just before the great boom and bust of the early 1870s, Deutsche Bank's merger with several German banks greatly increased its customer base and customer contacts, positioning it to become Germany's largest bank, as measured by assets, by the end of the century.[78] Deutsche Bank cultivated close corporate and individual clients at first using communities of interest (*Interessengemeinschaften*) with independent banks and later built a large network of its own branches. Nevertheless, it could hardly be said to have dominated the management of its closest corporate clients. At Krupp, for which Deutsche Bank had launched the bank's first public bond issue (1879), and at Siemens & Halske, which Deutsche took public in 1896 and with whom the bank enjoyed a strong familial bond, the bank still did not hold sway over management matters. Krupp was so embarassed by its financial distress in the 1870s that its business policy was never to permit banks again to have such leverage. Hugo Stinnes, who regularly worked with a lot of debt and had nothing to complain about regarding his banking relations, still thought that it was somehow "unworthy" to be so dependent on bank credit.[79] Carl Klönne and Oscar Schlitter, both of the Deutsche Bank and some of the most powerful men in the Ruhr, were often simply baffled and surprised by Thyssen—and Klönne was a close personal friend. Deutsche Bank acted as a trusted advisor – as a sort of outsourced financial staff – whose primary business interest was selling services. Most of its income came from pedestrian banking services such as interest charged and processing bills of exchange rather than commission payments related to floating securities and other more sophisticated services. Even with

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[78] Lothar Gall, "The Deutsche Bank from its Founding to the Great War 1870-1914," in Lothar Gall, et al., *The Deutsche Bank: 1870-1995* (London: Weidenfeld & Nicolson, 1995, p. 21.

[79] Hugo Stinnes to August Thyssen 26 March 1908, quoted in Manfred Rasch und Gerald D. Feldman (Hg.), *August Thyssen und Hugo Stinnes: Ein Briefwechsel 1898-1922* (München: C.H. Beck, 2003), p. 415.

its managers serving as members of corporate clients' *Aufsichtsräte* or where the bank was clearly considered the company's *Hausbank*, Deutsche Bank managers seemed to have little involvement in the day-to-day management of companies such as Krupp, BASF, and Siemens & Halske, for which they provided varied financial services. Indeed, for much of the period under discussion that kind of activity was expressly forbidden to *Aufsichtsrat* members. Only when established companies—such as AEG in the 1880s and Mannesmann in the 1890s—ran into severe financial difficulty did bankers begin to actively manage companies, and then often through intermediaries.[80] But the greater stability of the German economy, the 'liquidity guarantee' of a existing Central Bank, and the greater clarity of its creditor-friendly bankruptcy law made such interventions rarer and of shorter duration. Like their American counterparts, they sometimes did serve as venture capitalists. With the start-up companies they helped to establish – such as, in the construction of the Baghdad railway, the creation of Deutsche Petroleum Aktiengesellschaft, or Mannesmann, then Deutsche Bank managers had a more detailed involvement in business decisions.[81]

We are not arguing that bankers did not play a very important role in the German economy, but the relationship with firms was symbiotic, more advisory, consultative, and more or less partner-like than directive, let alone more "universal" in the services they offered. Till this day, although German Mittelstand firms have extremely low equity ratios and are deeply dependent on bank credit, German banks are not expected to interfere in their activities except when asked as advisors or during distress. Like their larger counterparts, medium-sized Mittelstand firms tended to work with multiple bank relationships to activate competition, which led to the use of banking pools if workouts were needed.[82] Banks' connection to capital markets, as a conduit of funds from those with excess funds to those who needed financing including funneling investments from Germany abroad, rather than as active managers of companies. In fact, the Deutsche Bank probably had as much or more experience with active management of companies

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81 Gall, pp. 30-77. Fear, *Organizing Control*.

82 Hartmut Berghoff, "The End of Family Business: The Mittelstand and German Capitalism in Transition, 1949-2000," *Business History Review*, 80/2 (Summer 2006), pp. xx-xx. Elsas and Krahnen, "Universal Banks and Relationships with Firms."

outside of Germany than inside it.[83] In contrast to their American counterparts, they were encouraged by legislation, regulation, and informal norms to serve this capital market role by taking responsibility for the securities they issued and recommended; when problems arose, they needed to intervene to ameliorate them (see Riesser quote above). They should serve ‘productive’ capital, rather than ‘speculate.’ In fact it was common at the time to distinguish between “deposit banks” (commercial-retail banking) and “speculation banks” (investment banks).[84] Although several governmental inquiries investigated the roles of banks in German society, eligible voters and regulators by and large accepted their social utility as long as they did not “speculate” with healthy, productive companies.[85] Holding large shareholding was deemed an emission failure, problems in the company, or viewed with suspicion. Finally, in part as a public relations stance and in part because of the tighter world of German national, regional, and municipal banking, German bankers were more “socialized” than U.S. investment bankers on Wall Street known for their rapaciousness even amongst their clients.

By contrast, in many sectors America took longer to get its “regulatory act together,” which meant that banks in the U.S., including the Deutsche Bank, not only had to perform some functions that were certainly not unknown to the Europeans, but they also had to perform them more often, a fact that contributed to banks being considered a part of the problem, rather than its solution. The Deutsche Bank, for example, may have had its most intense experience “controlling companies” in the U.S. Deutsche Bank’s own managers and representatives were active in the restructuring of several American companies. Deutsche Bank managers and their representatives helped engineer the reorganization of at least one major U.S. railroad, oversaw with tight control the first five years of that restructured railroads’ life, restructured the forerunner of General Electric, as well as creating a coking joint-venture. Its “management team” served in some cases as the president of the companies or chaired boards of directors. Under American law, the president of the board of directors was not prohibited from involvement in day-to-day

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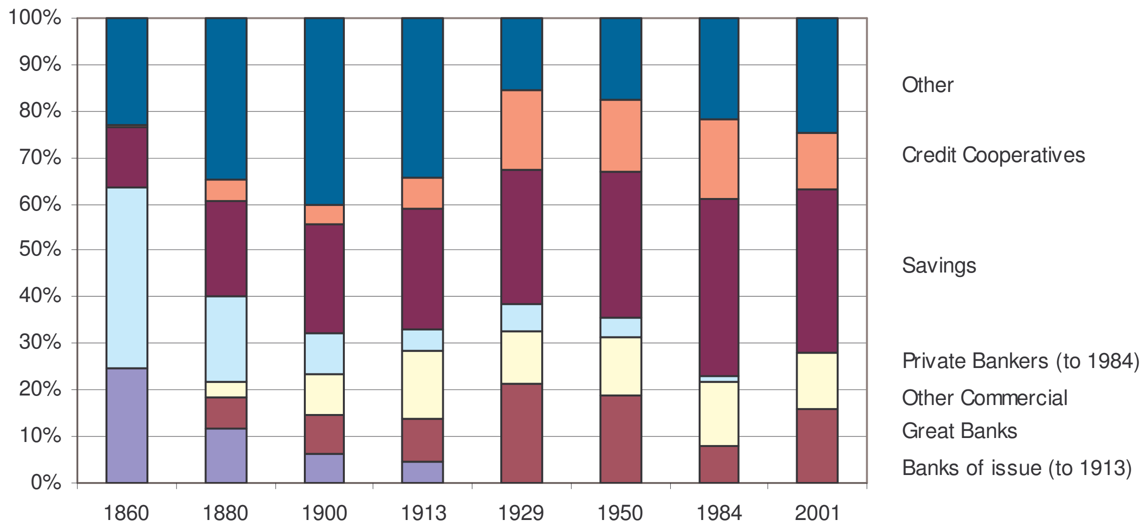
[83] Kobrak, *Banking on Global Markets.*.
[84] Weber, *Depositenbanken und Spekulationsbanken*.
[85] Gall, pp. 1-127.

management—unlike the German two-tiered board.[86] No German bank was as active as J. P. Morgan in restructuring whole industries, creating massive mergers, or simply taking over distressed firms and reorganizing them.

Finally, we need to contextualize the great Berlin banks within the German banking system as a whole. Their dominance in the financing of business was highly concentrated in heavy industries such as mining and metal production, not in the more cash-rich sectors such as chemicals and electrical industries. Most importantly, before the 1960s the large private commercial banks completely neglected the massive *Mittelstand*, still the backbone of the German economy. The large German banks were also counterbalanced by a powerful savings bank and cooperative sector that catered to this Mittelstand.[87]

Exhibit 2: Total Assets Held by German Financial Institutions by Sector, 1860–2001



Source: Richard Tilly, *Short History of the German Banking System*, p. 302.

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[86] Christopher Kobrak, *Men, Markets, Cooperation and Conflict: Deutsche Bank and the United States, 1870 to the Present* (Cambridge: Cambridge University Press, forthcoming).
[87] Richard Deeg, *Finance Capitalism Unveiled: Banks and the German Political Economy* (Ann Arbor: University of Michigan Press, 1999). Deeg discusses mostly the post-1945 period, but the patterns began much earlier. See also Timothy Guinnane, "Delegated Monitors." On the development of the savings banks and its credit operations, see Günter Ashauer, *Von der Ersparungscasse zur Sparkassen-Finanzgruppe: Die deutsche Sparkassenorganisation in Geschichte und Gegenwart* (Stuttgart: Deutscher Sparkassenverlag, 1991). Jürgen Mura, *Entwicklungslinien der deutchen Sparkassengeschichte* (Stuttgart: Deutscher Sparkassenverlag, 1987).

The famous Berlin banks controlled just 10% of total banking assets in Germany in 1913 and just about 14-15% today. Private commercial banks (including private bankers) controlled about 28% of total assets in 1913 (29% today) versus 63% in 1900 and 1922 and 27% in the U.S in 1990.[88] Not until the early 1920s after a wave of consolidations did Berlin banks begin to swallow up other provincial commercial banks. But most importantly a strong, socially-oriented savings bank sector was the largest single sector. Mortgage banks and other such specialized lending institutes were also larger in terms of banking assets. In short, in 1913 as today, Germany remained a highly fragmented banking system built along the "three-pillar" model of private commercial, savings, and cooperative banks—a highly class-stratified banking model.

Nevertheless, in some respects, the German banking system was concentrated and coordinated.[89] The *Interessengemeinschaften* and participations in local banks offset, to a large extent, the need for as large a network like their English competitors. The state itself limited the growth of large bank networks by operating its own offices.[90] Some regional and local banks were even owned and run by state and local governments. As in America, the number of local banks mushroomed. In Prussia alone, there was an enormous increase in small local savings banks (*Sparkassen*). From 1839 through 1913, their number grew from 85 to 1765. In 1913, there were 3113 *Sparkassen* with assets of 20,547 million Marks.[91] In 1913, *Sparkassen* had over double the assets of the large banks (9). Provincial banks in total (151) had roughly the same level of assets as the nine large banks, whose share of the total assets was less than 14 percent.[92]

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[88] White, "Were Banks Special Intermediaries," p. 14.
[89] Manfred Pohl, *Entstehung und Entwicklung des Universalbankensystems: Konzentration und Krise als wichtige Faktoren* (Frankfurt/Main: Fritz Knapp Verlag, 1986)., 200-202. The concentration of German banking took many forms during this period, but the form of German regulation hindered, however, other forms of concentration. From 1870 through 1913, the large banks acquired 504 banking companies, 367 of those acquisitions occurring between 1901 and 1913. As early as 1880, independent banks were organized into *Interessengemeinschaften* (Communities of Interest), permitted by regulatory authorities to "coordinate business in a communal fashion" for pooling business and dividing profits. The concentration of banking gave the large German banks greater economies of scale and enormous market power with their clients, but their branch networks were nowhere near as large as those in England, because of high registration and administrative costs for branches
[90] The Reichsbank also operated 487 branches throughout Germany, which provided various banking services. Pohl, 203.
[91] Pohl, *Enstehung und Entwicklung des Universalbankensystems*, 272.
[92] Pohl, *Enstehung und Entwicklung des Universalbankensystems*, 280.

Although the German banking system was sufficiently fragmented to produce the same kind of political conflicts that Mark Roe believed helped explain the severe limits placed on banking in the U.S. during the first half of the 20th century as well as potentially causing a dispersed shareholder structure like America, regional and money-center banks in Germany seemed less threatening to one another than in the U.S.[93] Certainly the degree to which the smaller banks held assets is not a good indication of the relative power of the banks within the financial sector or with clients, especially the public companies. The German financial system is best characterized as cooperative, with certain kinds of divisions of labor. Whereas the regional banks maintained a closer relationship to Mittelstand companies, where the division of management and ownership was less pronounced, the bigger banks specialized in the services of more interest to large public companies that were largely self-financing especially after 1895. As discussed, the smaller banks had to work through the large, money-center banks for many matters, including depositing their shares and those of their customers with the money-centered banks, a practice that contributed to the big banks' leverage with their own clients.

1.2 Review of the Regulatory Debates: Transparency versus Responsibility

The debate over the proper role of banks in the economy is long-standing and international. In both countries, discussions about the proper role of banks in the economy heated up in the last decade of the 19th century, contributing to their **respective** evolutionary institutional paths. Scholars, bankers, and journalists recognize that the conceptual foundation for how banks and stock markets might contribute to a stable, just, and effective economy needed thorough examination.

In the United States, in great contrast to Germany, limiting the power of large banks haunted the Progressives. Those eager for reform were torn between their desire to avoid centralization of power and the necessity to control private interests eager to step into the financial and regulatory void. Even stalwart business leaders wanted to see some alternative to the great private banks authority over the banking system and the economy as a whole. They had no trouble recommending stripping private banks, like J.P. Morgan, of their quasi-public role. Morgan provided credit to banks, the government, saved the

[93] Roe, *Weak Owners, Strong Managers*. Roe, "German 'Populism' and the Large Public Corporation."

Gold Standard, and practically substituted for a central bank, as almost all other major national economies had. Many railed at the concentration of pure financing power in private banks like Morgans and Kuhn Loeb. As Louis Brandeis, the most famous leader of the reform movement wrote in his extremely popular book, *Other People's Money and How the Bankers Use It*, about the concentration of financial power in the United States:

> But the compelling reason for prohibiting interlocking directorates is neither the protection of stockholders, nor the protection of the public from the incidents of inefficiency and graft. Conclusive evidence (if obtainable) that the practice of interlocking directorates benefited all stockholders and was the most efficient form of organization, would not remove the objections. For even more important than efficiency are industrial and political liberty; and these are imperiled by the Money Trust. Interlocking directorates must be prohibited, because it is impossible to break the Money Trust without putting an end to the practice in the larger corporations.[94]

While Brandeis's views may not have been mainstream in 1900, the White House and American legislature were controlled for most of the next 20 years by politicians and parties that favored significant reform of the banking system that would further strip powers away from bankers.[95] Moreover, although the testimony of the president of Continental and Chicago National Bank at the Pujo Commission hearings (see lead quote) may not have represented the majority of bankers' opinions, it does point to certain conflict among large bankers or at least some resignation about the political limitations of bankers. Unlike Germany, in the United States, bankers outside of New York not only resented the power of private investment banks and larger public banks, they had long before succeeded in removing them as competitors in some fields and hoped for even more successes before 1914.

Ardent reformers had no difficulty finding political allies from business segments threatened by big, money-center banks (see lead quote). As Mark Roe argued nearly 100

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[94] Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, edited with an introduction by Melvin I. Urofsky (Boston: Bedford Books of St. Martin's Press, [1913] 1995), p. 76.

[95] In the pro-reform group, we have put Roosevelt and Wilson, among Presidents. Collectively, they account for 15 of the 20 years. The legislative branch is somewhat more difficult to assess, but clearly anti-status quo sentiments were prevalent in both the House and the Senate, which finally led to some significant reforms, including the Federal Reserve Act. For the degree of anti-bank sentiment prevalent before 1900, see Richard Franklin Bensel, *The Political Economy of American Industrialization, 1877-1900*. (Cambridge: Cambridge University Press, 2000) ,pp. 136-140.

years later, "American corporate structures are in considerable part the result of political decisions, many long forgotten, about the organization of financial intermediaries."[96] Such political decisions were a product of particularly American circumstances, which included: American populist ideology that emphasized the dangers of large powerful economic and political institutions; interest group politics, which allowed small financial institutions, small businesses, and managers to effectively resist financial concentration, and, finally, federalism, which gave local and regional interests a loud voice. For Roe, the fact that non-American systems dealt differently with the technologically-driven economic necessity faced by all modern firms to achieve greater economies of scale and scope proves that America's model of distant shareholders and centralized management was determined by the particularities of American political history. While Roe recognizes here and in other places that the choice of corporate governance system had a profound relationship to a country's entire social system – a fact not lost on contemporaries in Germany and the U.S. – he de-emphasizes the broader attitudinal and historical differences between the two nations, which account for the different directions their banking and corporate governance systems took before and after World War I.[97]

The potential opposition of small private banks, other financial institutions such as savings banks or cooperatives (largely because they operated in separate spheres), or their clients had no comparable success in Germany before World War I. The powerful Marxist-influenced Social Democratic left had the strongest anti-big bank rhetoric, but that was the problem, they were socialist; on top of this the concentration in German banking was for them the natural evolution of capitalism. Opposition to large money-centered banks *never coalesced* into a political force in Germany, in large part because resentment never attained the strength and breadth of feeling there that it witnessed in the U.S. According to one contemporary British banking expert: "Considering the

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[96] Mark J. Roe, *Strong Managers, Weak Owners* (Princeton: Princeton University Press, 1994), Preface. Idem, "Political Preconditions of Separating Ownership from Corporate Control," *Stanford Law Review*, Volume 53, Number 3, December 2000; "Rents and Their Corporate Consequences," *Stanford Law Review*, Volume 53, Number 6, July 2001; "The Shareholder Wealth Maximization Norm and Industrial Organization," *University of Pennsylvania Law Review*, Volume 149, Number 6, June 2001; Lucian Arye Bebchuk and Mark Roe. "A Theory of Path Dependence in Corporate Ownership and Governance, *Stanford Law Review*, Volume 52, Number 1, November 1999. We wish to convey my thanks to Martin Müller of the Deutsche Bank Archiv and Michael Allen of Georgia Tech, and Mark Roe for their assistance
[97] Roe, *Strong Managers, Weak Owners*, p. 213. For a larger discussion of the attitudinal differences and Roe's views, see Fear and Kobrak, "Competing *Sonderwegs*."

recognised activities of the German banks, the public at large does not find anything disquieting or unsafe in the manner in which they employ the funds entrusted to them. Its mentality is a different one. Confidence in the administration of the banks, and in the integrity and responsibilities of the Boards of Directors, which are mostly composed of capable and influential men, and in the ability of the management, has in the course of years been so much strengthened that only a serious catastrophe could shake it."[98] Although some German businessmen, especially the founding fathers of Second Industrial Revolution companies, were suspicious of bankers' motives, even those mostly-family businesses maintained cordial relations with bankers and respected their general role in the German economy. The relationship between Deutsche Bank and Germany's two electrical giants, Siemens and AEG, hardly fit into either extreme of complete dependence or conflict. For family and other reasons, the bank maintained a special relationship to both companies and played an active role in their financial planning for most of the period under discussion.

We also cannot think of a comparable tract written by a major corporate executive for Germany until World War I such as *Cannibals of Finance: Fifteen Years' Contest with the Money Trust*. Arthur Stilwell, a promoter who built over one thousand miles of the Kansas City, Mexico and Orient Railroad, the Kansas City Southern Railroad, and Port Arthur Channel and Dock, the Liberty Bell mining Company of Colorado, among other ventures, wrote this book calling the President to "once and for all end the injustice of the Money Trust, and no longer allow the Comptroller's office to be a tool whereby Wall Street may call the loans of any man they wish to ruin." Stilwell complained that if his businesses had been blown up by dynamite, he would have at least had recourse to the law, but instead it was "destroyed by a combination of rich men:" The greatest power in America today is the money god. He rules the Government; he rules the factory; he rules the railroad, the farm, the home. The center of Government of the United States is not in Washington. It is in Wall Street!"[99] With friends, clients, and fellow businessmen such

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[98] Leopold Joseph, *The Evolution of German Banking* (London: Charles & Edwin Layton, 1914), p. 112.

[99] Arthur Edward Stilwell, *Cannibals of Finance: Fifteen Years' Contest with the Money Trust* (Chicago: Farnum Publishing Co. 1912), quotes from p. 14-15, 35. We also cannot think of a comparable quote: "Not only were most of [Mellon's] enterprises wholly integrated operations but his interests as a whole were integrated. New York Shipbuilding built Gulf tankers out of Union Steel, all financed and insured through

as these and Mr. Reynolds of the Chicago National Bank at the Pujo hearings (see lead quote), who needed enemies. Even American private bankers recognized the need for significant reform of the American banking system and, in 1911, actively participated in a doomed Senate plan for the reformation of many aspects of American finance.[100]

Two of the most important Progressive debates during the first decades of the 20th century involved reducing banker control of corporations and general coordination of money and banking. Even before World War I, Progressives not only enjoyed electoral successes, but also regulatory ones, too, not the least of which was the legislation leading to the Federal Reserve. Indeed without a central bank, coordination of the money supply had largely been left in private hands. The Platform of the Progressive Party in 1912, then led by Teddy Roosevelt, recognized that concentration in business was an economic and national necessity, but called for tighter federal control and transparency, an anathema to the special relationship between bankers and corporations, as the best antidote to placing economic power "in the hands of few."[101] According to Roosevelt and others, the affairs of corporations needed the widest spread publicity: "In the interest of the public, government should have the right to inspect and examine the workings of the great corporations engaged in interstate business."[102] The great industrial concentrations and money trust appeared to call into question American federalism (division of power) and democracy.

Ten years later, for many reformers, despite Washington's trust busting zeal, what still stood in government's way for creating more transparency was the Money Trust, the concentration of financial power led by J. P. Morgan & Co., the two largest national banks in New York, and several other private banks. Together, they and their controlled

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Mellon companies. Alcoa's laborers lived in houses financed by Union Trust, built on Mellon lots out of Mellon lumber, heated by Mellon coal, lit by Mellon utilities, and they rode to work on Mellon streetcars. If they had any money left at the end of the week, it went into a Mellon bank." Perhaps Krupp or Thyssen, but not a bank. Quoted in David Koskoff, *The Mellons: The Chronicle of America's Richest Family* (New York: Crowell,1978), p. 125

[100] *Citibank*, p. 60-61. Morgan, Benjamin Strong, of Bankers Trust, and Paul M. Warburg of Kuhn Loeb were among the bankers who assisted Senator Nelson Aldrich, a Republican from Rhode Island. With the Democratic victory in the 1910 Congressional elections, the plan, which included a Central Bank modelled after the Bank of England, had little chance of passage.

[101] "Progressive Party Platform of 1912," in *The Progressive Movement 1900-1915*, Richard Hofstadter, ed. and intro. (Englewood Cliffs: Prentice Hall, 1963), p. 128.

[102] "Roosevelt's First Annual Message to Congress," in *The Progressive Movement 1900-1915*, Richard Hofstadter, ed. and intro. (Englewood Cliffs: Prentice Hall, 1963), p. 143.

Trust companies, such as Bankers and Guaranty, used their own resources, and perhaps more importantly, the resources of others that they administered, to control 34 banks, 10 insurance companies, and 32 transportation companies with total assets of over $20.0 billion, an amount roughly equivalent to Germany's Gross National Product that year.[103] The House Majority Report on the Pujo Committee's Investigation, in contrast to that of the Senate, chastised the investment banking community's concentration of power, especially the degree to which the dominated the economy by sitting on so many corporate boards and led credence to incoming President Wilson's efforts to reform the entire banking system. That report also became the basis of Brandeis's famous book, a work not by a "mere political radical" but rather a close advisor to Wilson and later a Supreme Court Justice.

Nonetheless, there were some striking parallels in the timing and overall structure of the debates—but increasingly *not* with the interpretation of problems and, most importantly, their solutions.[104] To summarize briefly, German traumatic experiences with capital market instability especially after "founders crisis" of 1873 reinforced already-existing suspicious attitudes against *laissez faire* liberal capitalism (*Manchestertum*), joint-stock companies, and speculation, leading to calls for a system in which stability, reputation, and respectability became a paramount virtue—classic bürgerlich (*bourgeois*) values. Germans tended to think unfettered markets were a source of disorder, not the equilibriating order of Adam Smith. Cartels allegedly created a form of industrial branch management but also prevented American-style trustification and union-busting. Family or personal ownership control was encouraged. Insider governance by people or institutions with an ownership 'stake' in the company was implicitly held to be a virtue, not a vice. Distant shareholders (speculators or *Gründer* (founders or promoters)) were viewed as footloose, potential parasites draining healthy businesses of necessary investment capital. (Hearing echoes of today's fear of "locusts" devouring good, solid German companies is more than warranted.) We must remember that the separation of

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[103] "The Pujo Committee on the Money Trust," in *The Progressive Movement 1900-1915*, Richard Hofstadter, ed. and intro. (Englewood Cliffs: Prentice Hall, 1963), p. 158-160.
[104] We spend much more time on the historical-cultural approach to identifying such attitudes, assumptions, or preferences in Fear and Kobrak, "Sonderwegs," forthcoming. See Fear and Kobrak, "Origins of German Corporate Governance and Accounting 1870-1914: Making Capitalism Respectable" (conference paper, Helsinki 2006).

ownership and control was one of the most worrying issues of modern corporate life also in the U.S.; Germans 'solved' it by wanting to keep families or owner-entrepreneurs involved. Large banks and bankers profiled themselves as responsible "trustees" or "stewards" for investors as well as comported themselves as pillars of social cohesion, bourgeois respectability, and as instruments of national economic interest.[105] Interlocking directories certainly were a form of concentration, but those links proved that banks were dedicated to those productive enterprises rather than treating them as commodities on the stock market. This comportment, too, was also a result of anti-big bank, and anti-speculative behavior that all-to-often shaded into anti-Semitism. Accounting regulations encouraged building reserves to smooth earnings and dividend payments (allegedly stabilizing the volatility of capitalism) and enhancing the solidity (*Substanz*) of the firm—*not* an accounting trick to fleece shareholders from their rightful money. While not mutually exclusive, Americans tended to demand transparency and deconcentration of power, while Germans demanded dedication, solidity, and responsibility.

In Germany, as regards banks, mainstream criticism revolved around harnessing banking power for the public good—not destroying bank power. Indeed, in 1901, Jacob Riesser, head of the influential Central Association of German Banks and Bankers (*Centralverband des deutschen Bank- und Bankiergewerbes*, today the Association of German Banks), founded it to help counter such anti-big-bank sentiment. Riesser and this association attempted to reform the more odious regulations, such as the 1896 Stamp Act, but also engaged in public relations to legitimize the role of large banks in corporate governance. Among such differing groups of German bankers, moreover, considerable conflict and competition arose among the cooperatives (split into two rivals), savings banks (highly federalist or local), and private commercial banks that also became divided among provincial banks, private equity banks, and the great Berlin universal banks. Federalism too played a large role in Germany, but in a way that bolstered a powerful savings bank system built along federalist lines. One German solution to the

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[105] See Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken*," pp. 304-306. Morten Reitmayer, *Bankiers im Kaiserreich: Sozialprofil und Habitus der deutschen Hochfinanz* (Göttingen: Vandenhoeck & Ruprecht, 1999). Hartmut Berghoff and Ingo Köhler, „Redesigning a Class of its Own: Social and Human Capital Formation in the German Banking Elite, 1870-1990," *Financial History Review*, 14/1 (2007), pp. 63-87.

concentration of banking power among private commercial banks as they stretched their bank networks into the provinces, was to permit the savings bank system to become more "bank-like" in their federal states by permitting checking and a clearing house system after 1908, essentially creating a branch system, that strengthened local banking. This branching in the savings bank system did not threaten—indeed may have bolstered – certain activities of the money-center banks (discussed later). Not until the 1920s did the savings bank system and commercial banks begin to clash. So, consensus within the larger group of German bankers, let alone the public at large, was nearly impossible**,** but universalizing instead of splintering was the preferred solution.

On the highly critical left, the classic *Finanzkapital* interpretation appeared in 1910 at the height of such debates about the concentration of banking power. As a Marxist economist, Hilferding argued that the bank dominance he observed in Germany was a natural outgrowth of capitalism, the logical consequence of competition. For Hilferding, banks moved from giving short-term credits to providing long-term financing for companies, which gave them the power to dominate the management of industrial concerns. For these critics, perhaps mistakenly, the growing role of banks on boards was one key indicator. According to his argument, falling profits due to competition in both industry and finance would lead to further consolidation, leading to more power for the remaining banks, which had monopoly control over the sources of long-term funds for the ever-increasing industrial financing demands. However, Hilferding accepted the concentration of industry as an industrial-capitalist necessity (it proved Marx's evolutionary theory correct), so he attacked banks and industry for encouraging cartels and preventing a more profitable further consolidation of companies. Cartels created just enough "monopoly power" for the companies to survive and just enough weakness for the companies to become dependent on banks. Their financial weakness, then, became the strength of banks. Cartels worked then against public interest and the laws of history. Finally, socializing a few big companies that already managed crucial economic sectors bureaucratically rather than through freely competitive markets would be easier than socializing a great many companies.[106] Such an opinion helped to justify greater mergers

[106] Volker Wellhöner, *Großbanken und Großindustrie im Kaiserreich* (Göttingen: Vandenhoeck & Ruprecht, 1989), pp. 25-31.

even among the left when Hilferding was Finance Minister that led to such mergers as IG Farben, the Vereinigte Stahlwerke, or the unnerving merger of Deutsche and the Disconto-Gesellschaft in the 1920s.[107]

In America, the concerns of reformers notwithstanding, regulators had since the mid-19th century succeeded in segmenting the sector through state-based unit banking laws. For most Europeans, the U.S. banking system seemed oddly splintered. The history of American banking and other regulation reflects American long-standing biases against concentrations of power and helps explain the differences between the German and America debates about finance. Long before the 1930s, National banks labored with severe limitations on their lending and deposits, as well as holding securities in trust. For the period under discussion, the U.S. banking system was a complex mixture of nationally and state charted public banks, trust companies, and a variety of different kinds of private banks, which were by virtue of their corporate organization privileged and disadvantaged in their operations. Banks that were charted under federal law, national banks, such as First National Bank of New York and National City Bank, were prohibited from creating acceptances – short-term tradeable securities resembling commercial paper today, which were the bedrock of foreign trade and financing until the last third of the 20th century – for customers and from opening foreign branches, standard practice in Germany among banks and firms.[108] State banks had a variety of different restrictions depending on the state in which they were incorporated, but were by and large prohibited from engaging in business outside of their states, many prohibited branch banking, and from handling bank acceptances. After 1908 even the highly localized savings bank system in Germany could form statewide branching networks and check clearing houses.

In contrast, private banks like Morgan had few restrictions but little capacity to enter retail business. In Germany, universal banking, the strength of the large German banks, was commonplace, in the U.S. virtually inconceivable. American banks lived with many restrictions on their geographic and business segment reach, which did not

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[107] See Charles S. Maier, *Recasting Bourgeois Europe: Stabilization in France, Germany and Italy in the Decade After World War I* (Princeton: Princeton University Press, 1988), pp. 217-218.

[108] Harold van B. Cleveland and Thomas F. Huertas, *Citibank: 1812-1970* (Cambridge: MA.: Harvard University Press, 1985), pp. 23-43 and Richard Sylla, "Federal Policy, banking market structure, and capital mobilization in the United States, 1863-1913, in *Historical Perspectives on the American Economy*, ed. Robert Whaples and Dianne C. Betts (Cambridge: Cambridge University Press, 1995), pp. 482-508.

impede German banks as much—the socioeconomic class of business however did. To demonstrate U.S. logic, when American New Deal reformers broke up the big German banks after 1945 along federalist lines and attempted to reform the German banking system along American lines, British banking experts could only comment that the Americans were introducing "the worst banking system in the world."[109]

Although the two countries shared some institutional structures, such as a federal system of banking, interlocking directories of banks on board, and suspicions about speculation, in terms of their attitudes towards markets, cartels, banks, central banks, and stock exchanges they remained oceans apart. These contemporary *assumptions*, rightly or wrongly, drove real politics, real regulatory solutions that led to a great divergence. Two examples involving cartels and central banks highlight this great Atlantic divide before moving on to assumptions underlying banking regulations more specifically (Part II).

The passing of the 1890 Sherman Anti-Trust Act became *the* symbol of Americans distrust of big business and concentration of power. Although not immediately enforced until the Knight trial of 1894, it ushered in a wave of anti-competitive legislation culminating in the Clayton Act of 1914 designed to counteract this insidious concentration of economic power. Paradoxically, American anti-trust legislation was ostensibly directed against "trusts" such as the Rockefeller oil empire, but most effectively curbed the growth of price-fixing agreements among firms, that is, cartels. Germans not only legally sanctioned cartels in 1897 on grounds that they helped stabilize industries in bad times (as "parachutes"), but as an *anti-trust* or anti-monopoly measure since they blocked or slowed concentration into one big firm, which horrified them. Moreover, the American use of antitrust legislation against unions effectively destroyed potential German support for it from the Social Democrats; even such conservatives such as Gustav Schmoller or liberals such as Lujo Brentano sympathized with the principle of liberal association and collective bargaining.[110]

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[109] Theo Horstmann, *Die Allierten und die deutschen Grossbanken: Bankpolitik nach dem Zweiten Weltkrieg in Westdeutschland* (Bonn, 1991), p. xx.
[110] The cross-cutting intentions, measures, and implications involved with sanctioning cartels between the U.S. and Germany are contrasted in Jeffrey Fear, *Organizing Control: August Thyssen and the Construction of German Management* (Cambridge, Mass.: Harvard University Press), pp. 235-260. Also

Another major difference centered on the money supply and the need (or not) for a Federal Reserve, which had been for the most part a moot point in Germany since the 1870s. The final passage of the legislation establishing a new central bank in the U.S. required a whole series of further panics to jumpstart talks, especially after the 1907 panic. Ironically, they took advice from German financial leaders about the benefits of the Reichsbank model; a very personal transnational German-American connection symbolized by Max and Paul Warburg, the latter helped design the Federal Reserve. Finally, it required convincing many populists and progressives that a federal bank was inevitable and placing it in the hands of the government was clearly the lesser of two evils, the greater evil being J. P. Morgan and an all-controlling "Money Trust."[111]

German and Americans also found their corporate villains in slightly different places, for different reasons. Although J. P. Morgan essentially made very German arguments for responsible bank stewardship of the economy, American populist distrust of bankers safely using "other people's money" eventually eliminated such a solution. Indeed Americans translated Jacob Riesser's neutrally entitled book on the "Development History of German Large Banks" into the more problematically entitled *Concentration of German Banks* in 1911. Riesser's fairly moderate views found a place in the American debate, but to little avail. Americans found enough villains, speculators, "moneycrats," and "robber barons" in their midst—particularly *bankers* and stock market tycoons—so that financial crises became a sort of inexplicable, frenzied, hysterical, collective "panic," an exercise in irrational crowd psychology more or less manipulated by insiders belonging to a mysterious, dark "money trust." Sunshine was the best remedy. In Louis Brandeis' immortal words: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." The assumption was if markets were open, free, and fair, they would work.

Germans, however, found their villains elsewhere in "founders," shareholders without scruples and no stake in firms as a solid, productive, ongoing entities; such stock manipulators duped or fleeced innocent investors who dared to place their money in firms

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Jeffrey Fear, "German Capitalism," *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions*, (ed.) Thomas K. McCraw (Cambridge, MA: Harvard University Press, 1997), pp. 135-182. The German *liberal*, Lujo Brentano, used the term "parachute."

[111] Richard Hofstadter, *The Age of Reform: From Bryan to FDR* (New York: Vintage Books, 1955).

barely worth the paper they issued with their names on the header. The founders' crash of 1873 proved to many Germans that cutthroat capitalism could not work and it needed management, which helped justify a Reichsbank. Someone too was needed to shield investors from their inexperience and ensure only honest firms appear on the stock exchange. It was a paternalist assumption and that role increasingly fell to banks as responsible "stewards" and screeners of the respectable industrial firm—even though many Germans remained suspicious of bank*ers*. In fact, Riesser thought that small investors should responsibly stay away from equity investments because of the volatility of share prices. By 1913, in effect the German business system was successfully "Morganized"—and that was largely considered good, not bad, as in the U.S., although considerable controversies still arose. Having a Central Bank in Germany also helped to dissociate the "panics" from the "manipulations" of an inside "money trust." Paradoxically, the establishment of the Federal Reserve in the U.S. could be viewed as a means of taking power out of the hands of private bankers.

To be sure, banking and bankers in Germany certainly had its critics. The great Berlin banks came in for the most criticism unlike the trustworthy local savings banks and cooperatives. Although bankers were still associated with craven money making and unwelcome changes to traditional society, detested by some elites and other social groups, for many Germans, relationship banking brought "gravitas," influence (often viewed problematically as domination), stability, and cooperation. It was the bankers' very association with industrial entrepreneurs who created real value and whose efforts on export markets became a source of national pride. Regulators, who attemped to mitigate some of the harsher effects of capitalism by permitting smoothing or taming volatility, gave banks a key role in Germany's capitalist world. Social sanctions against strictly profit-oriented motivations and economic success were not strong enough to prevent entrepreneurial behavior, but, nevertheless, they helped shape the attitudinal and institutional context of commercial behavior.[112]

The founding of the Central Association of Banks and Bankers was driven in part by the poor reputation of private bankers. Among the Social Democrats, they represented

[112] Jürgen Kocka, *Industrial Culture & Bourgeois Society: Business, Labor, and Bureaucracy in Modern Germany* (New York: Berghahn Books, 1999), p. 87.

a hidden monied elite that dominated firms; Hilferding's *Finanzkapital* was the best expression of that strain of criticism. Unlike England with its close alliance between the old and new elites, bankers formed an economic elite, but had difficulty as a social and political elite forming alliances with the old aristocratic elite. Among aristocrats and political conservatives, bankers remained too liberal, parvenu, and too Jewish. A good deal of the conservative (in an economic and personal sense), *bürgerlich* image as stewards cultivated by elite bankers was designed to counteract these suspicions, which made bankers an fairly homogenous social elite in terms of their social *habitus* and personal carriage. Bankers became a bastion of liberal *Bürgerlichkeit* (Victorian-era respectability and bourgeois behavior). Bankers' image also became immensely important for legitimizing their activities and raising their own social status.[113]

In spite of these suspicions, close banking relations with firms and their implicit screening and vetting role in founding new firms—a product of 1873—Germans tended to view such banking relations as a lesser evil—even if they distrusted bank*ers*. Banks were at least better than the stock market; they permitted good industrial firms from being traded like commodities on the immoral casino of the stock market (see Riesser's lead quote). Many entrepreneurs such as August Thyssen could work closely and collegially with many bankers, as long as they did not try to intervene in his business, but refused to entertain the idea of listing or issuing shares on the stock market.[114] Whereas America finally opted for markets controlled by public regulators and accounting information, (transparency to investors and the broader public), Germany relied much more on its private "financial" experts, that is, bankers dedicated to firms as ongoing concerns (responsibility).

In the U.S., J.P. Morgan tried in vain to make very German, very Riesser-like arguments about banks as a source of order, stewardship, and support, but suspicions of this inside "money trust" diluted banking power, especially after 1914. The basic

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[113] Reitmayer, *Bankiers im Kaiserreich*, esp. pp. 274-299, 345-363; quotes from p. 274, 352. Berghoff and Köhler, "Redesigning a Class of its Own." Recent literature has overturned the idea of feudalization and a social alliance among the business elite and aristocracy, see Jürgen Kocka, "The European Pattern and the German Case," *Bourgeois Society in Nineteenth-Century Europe*, (eds.) Jürgen Kocka and Allan Mitchell (Oxford: Berg, 1993), pp. 3-39. For the use of the term bourgeoisie to analyze American history, see Sven Beckert, *Monied Metropolis: New York City and the Consolidation of the American Bourgeoisie, 1850-1896* (Cambridge: Cambridge University Press, 2001).
[114] Fear, *Organizing Control*.

schizophrenia of U.S. financial life was its effective reliance on Wall Street investment bankers as an implicit central banker whom it really despised and did not trust. Wall Street had such a poor image on Main Street that Paul Warburg declined the first offer to head the Federal Reserve because of the "rampant prejudice in this country against a Wall Street man;" Warburg had worked at Kuhn, Loeb and Co.[115] Precisely because of this heavy reliance on investment bankers' leadership, a "money trust" of insiders resulted that was subsequently skewered in the Pujo Committee report of 1913.[116] Except for the boom and bust cycle of 1873, the German stock market and economic growth was also not as volatile as the American one because of the Reichsbank's role of lender of last resort and inter-bank cooperation. Germans desired insiders to tame, stabilize, smooth (another alleged virtue of universal banking), and make capitalism respectable.

In the U.S., the basic assumption was that markets would work effectively if people either did not lose their heads in a panic or if evil speculators could not work their misdeeds in the dark. The U.S. evinced a strange mixture of Christian messianism combined with Adam Smith's condemnation of urban merchants as insiders and market manipulators. This was the major difference in attitudes and perception between the dominant American ideology and that of Germans. In Germany, markets were indeed necessary but inherently volatile, needed taming by countervailing institutions, and made to be stable and respectable by responsible stewards—a role that fell to banks as institutions, paradoxically, in spite of considerable suspicions regarding bank*ers*. Indeed, Hartmut Berghoff and Ingo Köhler stress: "The more powerful bankers got, the more they had to translate their professional success into distinctive social and cultural resources that would prove their honest and legitimacy to the public."[117] In theory, banks became dedicated shareholders, responsible supervisors—share-holders not share-hoppers. Bankers 'socialized' themselves to this political environment. In the U.S. the virtue of transparency dominated, in Germany the virtue of responsibility.

Although banks in both countries enjoyed similarly close relationships with many large companies until being rent apart, these relationships meant something different in

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[115] Whitehouse, "Paul Warburg's Crusade."
[116] *Report of the [Pujo] Committee* 1913.
[117] Berghoff and Köhler, "Redesigning a Class of its Own," pp. 64-65.

Germany and the U.S. The specific configuration of financial circumstances in the U.S. probably required *more* bank intervention than in Germany. By default or design, both countries used banks to overcome some of the chief problems in corporate governance, the free rider problem and informational asymmetries. For a time, they also allowed bankers to reap higher rents by intervening in corporate governance. In modern terminology, governments outsourced some corporate governance functions.

Ironically, Germans eventually institutionalized a version of capitalism envisioned by J. P. Morgan, whereby responsible bankers presided over the economy. J. P. Morgan might be characterized as a good 'German' banker. Before World War I, the U.S. practiced a "Morganized," bank-mediated economy, which resembled many features of the classic, so-called German model. Just as banks on board of directors grew in the first few decades of the 20th century in both countries, the financial strength of some of the larger companies and the development of stronger financial markets started to weaken the bank influence over companies. The process was more intense in the U.S., especially after World War I, when the development of an equity culture was later followed by legislation that undermined bank intermediation. Nevertheless, given U.S. banking law, poor capital market regulation and dependence on foreign capital, we come down on the side of those who argue that "Morgan's Men" created value, but with qualifications. "Morgan and his Men" were not more sophisticated then their European counterparts, as some would maintain.[118] Their "great innovations" were to recognize the fault lines of the American economy and financial system, and then bridge them, which brought them intense notoriety. In a financial environment in which political ambivalence about a strong federal government and centralization of financial power made effective regulatory financial oversight ineffective and attracting foreign investors more difficult, their activities may have been indispensable.

What differentiated the American experience to a large extent from that in Germany was "Morgan's" perceived lack of "socialization"—Wall Street not Main Street. Unlike his German counterparts, Morgan and his type of investment bankers

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[118] See J. Bradford De Long, "Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism," in Peter Temin, *Inside the Business Enterprise: Historical Perspectives on the Use of Information* (Chicago: University of Chicago Press, 1991) and See Les Hannah, "What did Morgan's Men really do?" University of Tokyo, Discussion Paper ,CIRJE F465, January 2007.

aroused a great deal of hatred. The proposition that his many efforts to reorganize troubled companies or calm down panicky capital markets, which earned him huge fees, contributed to the public good seemed implausible. The failure of the U.S. to create effective financial institutions to avoid severe panics and corporate corrupt created huge "regulatory" holes through which Morgan gladly drove huge "trucks" laden with "goodies." The German decision to create a central bank to stabilize monetary policy versus the U.S. decision to do without one, until J.P. Morgan had to step in as one during times of distress as if J.P. Morgan was the relationship banker for the country, helped turn populist Americans against banks on board in general. This greater role in private corporate governance played by American banks may have ignited a greater public outcry for limiting the power wielded by U.S. banks than was heard in Germany.

The next section details how banks became anchored in German corporate governance, and particularly, as intermediaries on the stock market. The crucial difference between Germany and the U.S. was not banks on boards of firms, but their role in capital markets and their universalism that (allegedly) 'smoothed' corporate dividends and issuing securities.

II. Institutionalizing Assumptions into Regulations: Making Companies "Solid" and Capital Markets "Respectable:" Germany.

2.1 The 1884 Joint-Stock Company Law

In the last quarter of the 19th century, liberal German politicians and academics worked to reform corporate and market governance sufficiently to tame more threatening conservative and radical challenges to industrialization and private property. Discussions about reform of joint-stock company law began almost immediately following Eduard Lasker's dramatic speech about corporate-government corruption that signaled the end of the founding bubble following the victory over France. Assembling Germany's top economic intellectuals, the *Verein für Socialpolitik*, founded in 1872 made the first 1873 volume in their famous research series about the need to reform joint-stock companies. According to the Association of German Lawyers (*Deutscher Justiz-Tag*) reforms should above all "prevent unsolid foundings or abuses in the administration of joint-stock companies." According to the Prussian Commerce Minister as well as the legal historian, Peter Hommelhoff, the main problem was that "founders" (*Gründer*)—a derogatory term at the time—started up new companies only as a means to make a profit, then cashed out, a sort of shell game with gullible investors. Corporate law reform after 1873 was designed to counteract the fraudulent or frivolous creation of companies as mere "stock exchange commodities" (*Börsenware*) by unscrupulous founders or shareholders. Insiders also sold their stock more quickly, leaving outside investors holding *Pfennigs* on their investment. Indeed the crash regularly saw 50-90% drops in the share price of even 'solid' firms.

For Germans, the founder's crash cemented the attitude and image of backroom shareholders, not as venture capitalists or heroic owner-entrepreneurs, but as mere speculators, let alone potential cheats. The intention to protect the long-term "objective needs of the enterprise" from the short-term, profit-taking of disinterested, potentially dangerous shareholders ran like a "red thread" through the history of German corporate law, according to Hommelhoff. The Nazis enshrined an extreme version of this attitude in its corporate law of 1937 that essentially made shareholders parasites on the body of the corporation, which was the healthy "cell" or "working community" of the national economy.[119]

This fundamental attitude permeated German corporate governance in ways that tended to protect the enterprise as an ongoing concern rather than protect investors as in the U.S., although the 1884 company law strengthened shareholder protection as well. Indeed, one of the main goals of the reform was to make the shareholders' general assembly the ultimate decision-maker and arbiter for the firm—in theory. One of the fundamental principles invoked by the 1884 company law was the strengthening of shareholder rights, especially vis-à-vis (dishonest) promoters. In practice, it did not quite work in the intended way for reasons discussed immediately below.[120] Until Nazi-sanctioned total managerial control that excluded shareholders, German reformers bounced between the poles of too much "Smithian" *laissez faire* or too much prescriptive

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[119] Peter Hommelhoff, "Eigenkontrolle statt Staatskontrolle—rechtsdogmatischer Überblick zur Aktienrechtsreform 1884," *Hundert Jahre modernenes Aktienrecht* (Berlin: Walter de Gruyter, 1985), p. 56. Also Werner Schubert, "Die Entstehung des Aktiengesetzes vom 18. Juli 1884," *Hundert Jahre moderenes Aktienrecht* (Berlin: Walter de Gruyter, 1985), pp. 1-13, quote from p. 6.
[120] See esp. Hommelhoff, "Eigenkontrolle statt Staatskontrolle," pp. 87-102.

regulatory control, which played itself out in the debate about corporate governance reform.

The 1884 company law successfully avoided greater state supervision of corporations (advocated by the influential conservative economist, Adolph Wagner) by strengthening "self-control" (*Eigenkontrolle*) among three counterbalancing private interests represented by the three main "organs" of the joint-stock company: executive board, supervisory board, and general assembly. In spite of some attempts to outlaw the joint-stock form altogether, or nationalizing or founding state-owned enterprises to counteract private monopolies, cooler heads prevailed in the commission appointed to reforming German corporate governance. Liberal incorporation laws were essentially retained, but the reforms strengthened the role of banks, dedicated shareholders, or other firms on German supervisory boards. The ultimate goal of reforms was to create "full transparency and responsibility" ("*volle Oeffentlichkeit und Verantwortlichkeit*") particularly in regards the founding of new firms.[121] The solutions proved highly robust, laying the foundations for German corporate governance until the 1990s. As we argue, Germans tended to stress responsibility **and voice** more than transparency **and potential exit**, **eventually** leading to stunningly different corporate governance paths.

The debates surrounding corporate governance reform were surprisingly modern, sensible (even if one could debate their finer points or disagree with the particularities about the solution), and broached classic, sensitive issues of corporate governance. They argued about issues about how prescriptive and detailed regulations could become before constraining entrepreneurial freedom too much. The Reich's Imperial Court stressed that complicated, detailed rules would only raise the costs of business, particularly in a depressed time that needed to see an economic upswing. Some thought no amount of rules could save people from unethical entrepreneurs or from their own greed or inexperience as investors; proscribing too many rules would never be sufficient. How much liability should board members have? How could one differentiate dishonest abuse from poor business judgment? How independent should supervisory board members be and how much influence should they have over the executive board? Should there be

[121] Schubert, "Die Entstehung des Aktiengesetzes," p. 5, from *Verhandlungen des Vereins für Socialpolitik*, 12-13. Okt. 1874, Schriften des Vereins für Socialpolitik, Bd. IV.

independent audits and who should carry them out, and how often? How much should the state be involved with setting standards? Or how much should autonomy should business have to establish self-governing professional rules? Should there be one-share, one-vote or should the law continue to permit non-voting shares or preferred shares? Should a required reserve fund be established or should all profits go to shareholders?[122]

The key commission established in 1882 to sort these issues out tried to find a balance between the two extremes. The commission consisted of a number of business luminaries (such as Adalbert Delbrück, politician and banker; Richard Koch, later Reichsbank President, or Emil Russell, director of the Berliner Disconto-Gesellschaft), academics (Adolph Wagner, Hermann von Sicherer, Levin Goldschmidt), and slew of government officials. A full discussion cannot be attempted here, but a few of the main debating points highlight key assumptions that shaped this crucial law.

One of the liveliest debates regarded minimal nominal share values, which bounced up and down between a suggested 1000 and 5000 Marks. Some recommended minimal shares as high as 5000 Marks to "protect small investors" from themselves. It would also help prevent the founding of subquality firms that damaged the whole economy; only serious firms would be founded. In Parliament, left-liberal and national liberal parties thought they detected a certain "spirit of suspicion and mistrust" in regards the joint-stock company. They complained that minority protections and the liabilities of directors were too high. Banks issuing shares were also held liable for any dishonest dealings during the startup phase. Another parliamentarian warned about the creation of a potential "fee-oriented and clique-based system" on boards. Delbrück criticized the law as being "mistaken" (*verfehlt*), "distant from practice," and granting too many powers to the "dead capital" of the general assembly. He objected to the law declaring the totality of shareholders of the general assembly as the ultimate decision-maker for the firm (*Willensorgan*). The wealth of nations, he said, was not made up by the "fullness of property," but by the "fullness of the acquiring powers" (*erwerbenden Kräfte*). Another official thought that with all the protections against abuse in boards, all the new regulations simply moved the "unscrupulousness" to the backrooms of the shareholders

[122] The discussion is based on Schubert, "Die Entstehung des Aktiengesetzes," pp. 7-52; all quotes here.

or their "dark" representatives, which would make the company the "game ball of the most dishonest interests."

The 1884 law strengthened key shareholder protections. Especially through the supervisory board and shareholders' meeting, shareholders could alter company statutes or hire and, most importantly, hire and fire executive board members, one of the key new powers of control of the supervisory board over management. Corporate governance reformers drew the conclusion to strengthen the supervisory capacity of the supervisory board, while circumscribing their executive activities. It delineated more closely supervisory board responsibilities and prohibited them from intervening in day-to-day decision-making; the supervisory board could also call for special corporate audits with a majority. Individuals could not be present on both boards simultaneously.

Shareholder control was asserted primarily by their annual election of their representatives to the supervisory board. Another basic idea was to strengthen managerial autonomy from activist, meddling shareholders merely out to maximize their short-term dividends in the interest of the ongoing concern. While each individual shareholder had the right to appeal or contest stipulations, certain share proportion thresholds limited small investor activism. Over time—and inadvertently—this supervisory board representation of shareholder interests strengthened the influence of banks on board.

The 1884 joint-stock law ultimately raised minimum par value of shares to 1,000 Marks ($ 240 at the time, but equal to roughly $ 40,000 in today's dollars) in order "to protect small investors, who cannot judge the business condition and management of a joint-stock company, from participating in it and potentially losing their savings." Only other companies or the relatively rich could buy stock. The state essentially evoked a paternalistic act to protect its less rich citizens, but, along with other measures, this helped dampen equity markets in favor of credit-based banks.[123]

The thrust of corporate law reforms (and stock market reforms, discussed below) encouraged long-term investment in and commitment to manufacturing companies,

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[123] Quoted in Eube, *Der Aktienmarkt in Deutschland*, 36; on the important 1896 Exchange Act, see 43–49. For greater detail, see Hommelhoff, "Eigenkontrolle statt Staatskontrolle." The book reproduces the individual drafts and revisions of the law in detail.

reflecting German discomfort with impersonal, speculative capitalism. They and this corporate governance law evinced a general preference for what one economist has called voice and loyalty (working to inside institutions to influence their behavior) to exit (simply disengaging).[124] German corporate governance seemed to be designed to concentrate power so that a small number of dedicated, responsible, and respectable entrepreneurs, managers, and financiers—prior to 1914 to a large extent personally connected with one another and increasingly concentrated in Berlin—could responsibly steer a "productive" economy, which was becoming technologically and organizationally ever more complicated, let alone beset by conflicting social pressures. The regulations were expressly designed to avoid the tragedies surrounding the founding of new companies.

Even outsiders appreciated what measures had been taken in Germany to protect markets and shareholders. Contrasting British and German company and stock market laws, one English observer found that in Germany every conceivable measure had been taken to protect investors from being deceived or misled by misstatements in a prospectus. Germany had created the most stringent responsibilities for directors. The admissions committee of the stock exchange, which included able bankers and business people, went well beyond the British practice of certifying the prospectus for technical correctness. The committee's opinion gives a clear indication of the merit of a security, even at the risk of being sued for libel. The committee demanded explanations for information and carefully investigated the facts and figures presented in the prospectus. Moreover:

> The prospectus has to be signed by the issuing firms, which make themselves responsible for the correctness of statements, and at the same time place their prestige and credit as issuing houses at stake. …
> All this is apt to create an atmosphere of confidence and trust in industrial stocks, the more so as the banks themselves are represented on the Boards of Directors and exercise considerable influence in the management of affairs, not only in its financial, but also in its general aspects. The experience of bankers being connected with a vast number of different concerns (some of them are on the Boards of 40 or more companies, and the Dresdner Bank states in its jubilee publication that it is represented on the Boards of 200 companies), thereby gaining inside knowledge of

[124] Albert O. Hirschman, *Exit, Voice and Loyalty* (Cambridge, Mass.: Harvard University Press, 1970)

> various industries, is often very valuable even in technical matters, and especially in question of amalgamations and the formation of cartels, etc.[125]

There is no reason to believe at face value that German company law solved all the issues involved with the corporate governance of modern corporation, but they dealt in the 1880s effectively with fundamental issues still relevant today; this contemporary inadvertently makes regulators' goals, objectives, and assumptions clear: responsibility.

As discussed above, large universal banks increasingly played an important role in the supervisory boards of most large, listed German firms. Most contemporary policy makers agreed with Karl Helfferich, director of the Deutsche Bank and Finance Minister during the war, when he wrote that in the face of enormous capital needs, shortages of capital for Germany's great advances in technical, industrial development during the 25 years preceding World War I, German banks had succeeded in "keeping the proper balance between intensive capital employment and fundamental security."[126] Part of that balance lay in preserving independent companies, coordinated by large industrial organizations like cartels, syndicates or communities of interest (*Interessengemeinschaften*), which had, according to Helfferich, many of the benefits of the large American Trusts, such as limiting production, but avoided "the chaotic competition" and economic waste and tensions inherent to "unplanned" commercial endeavors.[127] Again, whether true or not or whether truly effective or not, these stated values reflected attitudes of many contemporary Germans that translated into the objectives of regulation.

As financial advisors, market makers, and members of *Aufsichtsräte,* they could provide investors with an acceptable tradeoff between security, liquidity, and overall returns by **allegedly** smoothing fluctuations for both markets and companies. Even though separation of banking activities was proposed in Germany long before the Glass-Steagall Act of 1933 was passed in the United States, it was rejected because Germans, by and large, felt comfortable with the role of banks as an acceptable antidote to

[125] Joseph, *Evolution of German Banking*, pp. 116-117.
[126] Karl Helfferich, *Deutschlands Volkswohlstand 1888-1913* (Berlin: Georg Stilke, 1915), p, 44.
[127] Ibid.

instability, corporate volatility, and a means of achieving balanced economic growth. Universal banking and stewardship in industrial firms ensured smoothing of financial results. The influential business professor, Adolf Weber, justified universal banking so:

> The investment banking activity (*Spekulationstätigkeit*), in particular the emissions business, seems to me to become a reasonable goal of a solid joint-stock company first when it is bound to regular banking business. A large private banking house can deal with this even during the 'quiet times' that might last years. It is much more difficult to do this for a pure joint-stock investment bank (*Spekulationsaktienbank*). The care of regular [commercial] banking business is on one hand capable even in periods of bubbles to put a stop to the desire to speculate by bank executives within appropriate limits; on the other hand, it makes possible even in those times in which equity markets competely collapse to distribute 'decent dividends,' by which the [combination] of investment and commercial banks (*Spekulations- und Depositenbank*) achieve a solidity and stability that an institute, which exclusively devotes itself to irregular banking business, even with the most careful direction is hardly possible to be reached. On top of this there is a further advantage in the combination of activity, by which the investment bank has available as a commercial bank through numerous 'current-account clients' to encourage and place new emissions speedily and securely with relatively low costs…[128]

Weber went on to argue that the venture capital provided by German banks proved increasingly "more solid" over time because the large German banks learned from experience to spread risk geographically and over many industrial sectors, thereby creating a greater "quiet in the rhythm of our national economy."[129] Hedge funds today might not say it any better.

Not surprisingly, banks, the main creditors of major businesses made it a policy to smooth the issuing of securities and individual corporate dividends over time—to the advantage of creditors and underwriters, that is, banks. Another contemporary British expert contrasted the British and German relationship of banks to clients, especially those clients whose securities the banks underwrite:

> The banks recommend industrial securities to their clients, and regulate the market if there is need. Important transactions take place daily in Berlin and on the other German bourses, and the public invests largely in

[128] Adolf Weber, *Depositenbanken und Spekulationsbanken: Ein Vergleich deutschen und englischen Bankwesens* (München: Duncker & Humblot, 1915), pp. 340-341.
[129] Weber, *Depositenbanken und Spekulationsbanken*, p. 341.

them, knowing that they are carefully managed and supervised. Under banking influence, it has become more and more the policy of industrial companies to build up such reserves as to avoid too sharp fluctuations in the dividend distributions. The balance sheet of the General Electric Company [AEG], Siemens & Halske, Gelsenkirchen, Phoenix, Höchster Farbwerke [Höchst], and many others, give clear evidence to that effect. Actually some of the bigger concerns strengthened their financial position to such an extent that they have come independent of banking credit, … . Nevertheless intimate relations with the banks are continued.

The manner in which issues of securities are guaranteed and manipulated differs from the underwriting syndicate in England…. When the issue has been made and has been fully subscribed, the syndicate may be, but need not necessarily be, dissolved, because, for the purpose of activating and stabilising the market, the syndicate leaders may decide to keep it together, in order to be able to repurchase stock that is offered by subscribers after the issue. If the issue is unsuccessful, the syndicate continues until the date fixed, and may even be prolonged. There is this advantage, firstly, the market cannot be prejudiced and spoiled by underwriters who sell below issue price in anticipation of an allotment, thereby—taking into consideration the underwriting commission—still securing a profit, and secondly that, after the issue, support is forthcoming, whilst the syndicate members, who are tied up, and do not get possession of the securities, cannot dispose of their interest. On the other hand, the English underwriting system is bound to bring the plain facts, the real state of affairs, to light; after the issue the underwriters are informed of the result and they can deal with the amount which they are called upon to take up at their discretion. Consequently a genuine market becomes established, the new securities will find their own level. Should there be little or no inquiry for new issues in normal times, even at attractive prices, it proves that no capital is available for investment, and underwriters unable to sell or only able to sell at considerable loss are warned in this way. *In other words the English system creates a natural market, the German system in many cases an artificial one.* [130] (Our stress)

Such were the tradeoffs between transparency and responsibility.

This tradeoff and implicit collective *preference* behind political decisions made banks in German corporate governance, as this historian Richard Tilly wrote:

Finance (in Germany) is a matter of small-group negotiation rather than the reading of anonymous price signals, and it frequently reflects banker initiative. 'Universal banking' – union of commercial and investment activities–had banks closely monitoring their customers' activities,

[130] Joseph, *Evolution of German Banking*, pp. 120-121.

> sometimes controlling the latter, always treating the relationship as an ongoing (long-term) one.[131]

This role of banks, moreover, contributed to many political goals of the state and consistent with many other measures taken after 1873 to protect society from the effects of industrialization such as more proscribed rights for workers, nationalization of some important industries, higher tariffs on many goods, cartelization of much of German industry, and increased pressure on banks to moderate the harsh effects of capitalism by lending even through hard times—one of the key alleged virtues of relationship banking. German banks cooperated with the government to root out speculative profits and abusive transactions in the stock market, such as buying stocks at their face value and reselling them to the market at a higher price.[132]

By holding deposits and investing in corporations, Deutsche Bank and the other German universal banks, served as a useful long-term bridge between investors and industry that appeared to be largely in the public's interest. The otherwise intolerable mismatch of deposits with risky industrial investments inherent to banking was also somewhat mitigated by steady investment guidance of the universal bankers, who advised both the users and the providers of loanable funds. The banks with their seats and active participation on supervisory boards preserved the personal dimension of capitalism that many Germans liked about entrepreneurial firms.

The inevitable conflicts of interest between the bank's role as overseer and principal seller of financial services was hardly questioned during prosperous periods, as it was seen as an acceptable price, agency cost, of effective social and economic control of firms. Partly because of public suspicion, German bankers knew that they had to foster an image of reliability, social consciousness, and high cultural prestige (such as with philanthropy or support of the arts). (To this day, the Deutsche Bank has one of the largest art collections in the world, which makes no sense from a purely functional economic viewpoint.) Banks took risks as venture capitalists in new Second Industrial Revolution firms, but their responsibility as the public trustee of capitalism weighed

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[131] Tilly, 110.
[132] Gall, 1-24.

heavily on bankers, who worked hard on public relations campaigns to dissociate themselves from the evils of the stock market.[133]

Ultimately, then German corporate governance was designed to protect individuals from themselves, from instability and from, above all, speculation, which was ill defined, but associated with short-term money making or, more generally, making money from money, as Aristotle put it, the "breeding of money."[134] As one contemporary noted: "'The Stock Exchange must bleed' was a popular cry for a long time."[135] However suspicious, banks offered a sort of paternalistic, guarding, protective role for investors and their clients, the industrial firms. They became anchored in the supervisory boards of German companies, somewhat inadvertently, but they played the intended dedicated role promoted by the 1884 law. This stabilizing, guardian role extended to their role in public accounting and on the stock exchange.

2.2 The Stock Exchange, the Stamp Act, and Banking Stewardship

In spite of the weight in the *Finanzkapital* historiography accorded to banks on German corporate boards, we want to argue in this next section that the most peculiar aspect of German corporate governance in regards banks' role was Germany's capital-market legislation, which gave large banks a privileged role in equity transactions. There was no path-dependency or 'lock-in effect' until capital markets collapsed after the war, which made bank financing even more important. The key 1896 Stock Exchange Act tightened regulations and strengthened the role of banks as key intermediaries on the stock market in the interest of corporate solidity, dampening unhealthy speculation, and mitigating volatility.[136] One measure what a decisive turning point this Act marks is that

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[133] Gall, 49. The Central Banking association's house journal, *The Bank Archiv*, as well as other journals praised banking for its national consciousness and responsible oversight of industrial development. These efforts were relatively successful. Before World War I, the view that the banks were already working in the national interest, had adequate self-regulation, and, therefore, needed no further state regulation was widely held inside and outside Germany.

[134] "Politics," *The Basic Works of Aristotle* (New York: Random, 1941) 1141.

[135] Joseph, *Evolution of German Banking*, p. 29.

[136] Key texts on this Act are Steffen Eube, *Der Aktienmarkt in Deutschland* (Frankfurt/Main: Fritz Knapp Verlag, 1998), on the important 1896 Exchange Act, see pp. 43–49. Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen: Scripta Mercaturae Verlag, 1992). Max Weber, *Börsenwesen, Schriften und Reden 1893–1898*, ed. Knut Borchardt (Tübingen, 1999). Also Henry

not until 1989 were futures and options again permitted on the Deutsche Börse; more complicated derivatives could not be developed or traded until the First Financial Market Promotion Act of 1990, which also eliminated myriad taxes on securities trading.

Futures and options were the first derivatives and they came in for heavy criticism particularly in the commodity grain trade in *both* the U.S. and Germany**.** Brokers appeared to gamble with the most necessary staple of ordinary life and with the livelihoods of ordinary farmers. In both the U.S. and Germany, the association of the stock market with a casino, a "fictitious," "unnatural", "phantom," "immoral," "unproductive," game (*Börsenspiel*) was more than common. One German contemporary, Joseph Neuwirth, called the stock exchange a "pure hellish gambling den" (*pure Spielhölle*). When the liberal, Eduard Lasker, spoke of the stock market as an "academy for circumventing the law," he met roaring, approving laughter by his fellow Parliamentarians. Even prior to the 1873 crash, the exchange seemed to many nothing more than a rigged casino offering limitless reward with little risk. The free, uncontrolled movements in prices seemed to be incontrovertible evidence that there was nothing objective (*sachlich*) in their pricing. Those movements offered too many opportunities for speculation. By contrast, long-term banking relations built on equity, credit transactions, and supervisory board relations, however, helped transform banks from mere investors (speculators), into partners with industrial enterprises. Speculative fever was fueled especially by seemingly exotic transactions like uncovered forward sales or futures or shorting (*Termingeschäft, Differenzgeschäft*, "differences," "setting-off," shorting (borrowing shares to buy them back at a lower price) or "naked shorts" (without even borrowing)), all of which "one could sell, what one doesn't have, and one can buy what one never wants to take possession of." Futures, the first derivatives, came in for particular criticism as they arbitraged time contracts, derivatives, rather than the actual physical delivery of commodities—the ultimate airy speculation let loose like a balloon from the real world. But it affected people's lives, particularly that of powerful agrarian

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Crosby Emery, "The Results of the German Exchange Act of 1896," *Political Science Quarterly* 13 (1898): 286–320; Caroline Fohlin, "Regulation, Taxation and the Development of the German Universal Banking System, 1884–1913," *European Review of Economic History* 6 (2002): 221–54.

interests in both the U.S. and Germany, a sector hit hard by globalization and declining prices.[137]

What is remarkable about the discussions regarding the stock exchange and speculation in the U.S. and Germany is how parallel they were (beginning with a vehemence in 1891), but the results diverged dramatically because of differing attitudes toward banks (more accurately, relationship banking) and the political weight of agrarian power. For instance, in regards futures trading in both countries, rising pressure to bank futures simmered in the 1880s, but burst forth in the early 1890s. In 1894, the U.S. Congress held hearings on futures trading, which was referenced in the 1896 German parliamentary debates and subsequent 1896 legislation. In 1891, the populist National Farmers' Alliance put the first organized proposal to prohibit futures. As a result of sinking prices in 1892, German agrarians formed the powerful Association of Agriculturalists (*Bund der Landwirte*), one of the most powerful lobbies of pre-1913 Germany. Their program called for "sharper state supervision of commodity exchanges to prevent an arbitrary, damaging price formations harming agriculturalists and consumers in an equal manner." One Catholic party member declared that futures trading

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[137] Glagau, *Börsen- und Gründungschwindel*, Bd. 1, p. 4 quoted in Meier, *Entstehung des Börsengesetzes,* p. 9; Neuwirth quote also from Meier, p. 9; for a discussion about futures, see pp. 27-43. Also see Knut Borchardt (Hg.), *Max Weber Börsenwesen: Schriften und Reden 1893-1898* (Bd. 1-2) (Tübingen: J.C.B. Mohr (Paul Siebeck), 1999); see Bd. 1, pp. 26-31 for the public perceptions of stock markets and how it influenced legal prescriptions. American popular opinions of the stock market were hardly more positive at the time and futures on grain were just as controversial. See Jonathan Ira Levy, "Contemplating Delivery: Futures Trading and the problem of Commodity Exchange in the United States 1875-1905," *American Historical Review*, Vol. 111, No. 2 (April 2006), pp. 307-335. See David A. Zimmerman, *Panic: Markets, Crises, & Crowds in American Fiction* (Chapel Hill: University of North Carolina Press, 2006), esp. pp. 81-122 on Thomas Lawson. Lawson was a former Wall Street insider, who published *Frenzied Finance: The Crime of the Amalgamated* (New York: Ridgway, 1905). Julia Ott marks the war bonds drive during WWI as the crucial turning point in American attitudes toward the stock market, see Julia Ott, "The 'Free and Open' 'People's Market:' Public Relations at the New York Stock Exchange 1913-1929," Business and Economic History On-Line, Vol. 2 (2004), 1-43, aailable at www.thebhc.org/publications/BEHonline/2004/Ott.pdf. It is based on her dissertation, Julia Ott, *When Wall Street met Main Street: The Quest for an Investors' Democracy and the Emergence of the American Retail Investor 1900-1930* (Dissertation: Yale University, 2006). Especially after the depression and the Second World War, the New York Stock Exchange had major legitimation issues, see Janice Traflet, "'Own Your Share of American Business:' Public Relations at the NYSE during the Cold War," *Business and Economic History On-Line*, Vol. 1 (2003), pp. 1-21, available at www.thebhc.org/publications/BEHonline/2003/Traflet.pdf. *Ibid.*, "Spreading the Ideal of Mass Shareownership: Public Relations and the NYSE," *Essays in Economic and Business History* (2004), pp. 257-273. Ibid., *Spinning the NYSE: Power and Public Relations at the Big Board* (Dissertation: Colombia University, 2004). As we noted in our article "Diverging Paths," the collapse in value of German war bonds in the great inflation and the continuing weakness of equity markets in the Weimar Republic had the opposite effect on German investors.

should be “bled to death” through high taxes; another wanted generally higher taxes on stock exchange trading: “the higher, the better.”[138]

Aside from the one goal of dampening (if not destroying) futures trading as well slowing short-term “speculative” trading, the creation of the Stamp Tax (a tax on security transactions) is the best example demonstrating the political willingness to stress universal banking as an acceptable social control on investing. Under the original Stock Exchange Taxation Act of 1881, all stock market transactions entailed a tax for the first time, initial issues as well as seasoned offerings and subsequent trading. Only the securities of central and state governments, and the transactions of charitable and public organizations, such as professional groups, were exempted. A later 1884 amendment, prompted by conservative parties, substituted a fixed tax per transaction for one based on a percentage of the amounts traded.[139] The act was modified many times.[140] Initially, the amount of the tax was relatively small, initially amount to 1/10th of a percent per 1000 mark of market value, or 10 pfennig for a one-thousand mark transaction, but posed many potential problems for financial institutions and their customers.[141] Both parties to a transaction were libel for the tax. Merely keeping track of what was owed added a lot of new transaction costs for brokers; those that could afford to do it were large banks.

By 1894, the amounts for some transactions had trebled, causing great concern for traders, brokers, and bankers. Although his bank would ultimately profit enormously from these pre-World War I laws and regulations governing securities transfers, Georg Siemens, chairman of Deutsche Bank’s *Vorstand* and a member of the Reichstag, argued that the stamp tax was deliberately aimed at reducing capital movement and risked

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[138] Compare, Levy, “Contemplating Delivery,” pp. 322-327; Borchardt, “Einleitung,” *Max Weber Börsenwesen*, pp. 66-74; quote from p. 70. Also Meier, *Entstehung des Börsengesetzes*,” p. 238.

[139] Gall, 82 -84.

[140] Karl Bott, ed. *Handwörterbuch des Kaufmanns: Lexikon für Handel und Industrie* (Hamburg: Hanseatische Verlagsanstalt, 1927) 385-386.

[141] Riesser, *Die deutschen Großbanken und ihre Konzentration*, p. 502. According to Fritz Neumark in “Die Finanzpolitik in der Zeit von dem I. Weltkrieg,” in *Währung und Wirtschaft in Deutschland 1876-1975*, ed. Deutsche Bundesbank (Frankfurt am Main: Fritz Knapp, 1976), p. 90, the amounts collected from the tax in 1913 made up a significant portion of the Reich’s income, but he does not give basis of calculation in that year. According to *Statistisches Jahrbuch für das Deutsche Reich*, (Berlin: Puttkammer & Mühlbrecht, 1913) 334, the tax amounted to nearly 7% of all Reich *tax* collections. Collections from the tax were up by 50% from the amount collected in 1909. It is important to remember that Germany had no income taxes and that total “federal” and state expenditures were only 14% of Germany’s Mark 40.0 billion in GDP.

driving business outside of Germany. He also addressed what he considered the broader intentions of those who designed the law, namely to exercise greater control over economic activity, which he believed to be a dangerous tendency. According to Siemens, business people were the ones who lived and died by knowing their markets and matching needs with resources, not bureaucrats. Like Gerson von Bleichröder, one of Germany's leading private bankers, he feared that the law would entail more regulatory intrusion into bank affairs.[142] Implementing the tax law would require the government to investigate, or at least, be capable of investing all transactions. A lot of information about transactions had to be recorded and open to minor bureaucrats, who might use that information in ways that might be harmful for the banks' business interests. "Precisely with this control issue, the creators of the law are hitting business people in their most vulnerable place."[143] Because of the bureaucratic requirements, only larger banks could afford to transact more heavily. Between the costs of heavy trading and bureaucracy, Riesser argued that this led to greater bank concentration—which, of course, those legislators did not want either. In addition, the stamp tax hurt the competitiveness of German stock markets relative to other national stock exchanges and harmed the liquidity and fluidity necessary on the stock exchange so that it would reflect proper pricing (so Riesser).[144] So ironically, although the taxes actually drove business and more responsibility into the hands of the larger banks, few German bankers actually liked it.

Like several other pieces of legislation proposed around the same time, such as a direct tax on passive income, the stamp tax seemed directed at those who made their living with passive income and to thwart stock-market speculation by adding to the transaction costs of buying and selling stocks quickly. For the general public, the stock market provided no more social value than a casino. One German *Commerce* minister called the stock exchange "a poison tree … casting a baleful shadow over the nation."[145] As one historian wrote, "Dealing on the stock exchange was regarded as peculiarly unproductive sin as it brought no visible results, created no values and basically served

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[142] Stern, *Gold and Iron*, pp. 220-221.
[143] Georg Siemens speech to the Reichstag, January 21, 1885, *Stenographische Berichte des Deutsches Reichstags* (Berlin, 1885).
[144] Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken*, pp. 187-199.
[145] Quoted in Gall, p. 82.

no purpose but that of speculation."[146] The framers of the bill hoped that it would encourage stability (few trades and less panic) and long-term capital investment, while hurting mostly Jewish stock brokers, who were in their eyes the true culprits behind the speculation and panic. The association of speculation and anti-Semitism was always close. Jews were overrepresented in the banking profession relative to their proportion in the total population that 'proved' to those who wanted to believe it that Jews were wire-pullers of the exchange.

Despite resistance from the banking community, a new stamp tax law was passed in 1885 and went into effect in 1886. It proved to be a boon for the large ones, in another way. Banks effectively began to substitute for the stock market in individual transactions in-house, circumventing the tax, leaving the stock exchange itself principally for clearing settlements already transacted among banks. It is unclear whether the intent of the law was to make the large banks intermediary institutions that would somehow protect individuals from that den of inequity, the stock market. Some believed that this was the intention of the framers, but it was probably mostly unintentional. As early as the spring of 1884, the *Frankfurter Zeitung* wrote that the new law would lead "to a monopoly of bank business in a few powerful hands."[147] Others believed that the economic ignorance of legislators was so great that there was no telling what the laws that they draft would produce.[148]

The stamp tax was also passed for several reasons, not the least of which was to raise central government revenues, which, because of Germany's constitution was a regular source of conflict. Some supporters disappointingly hoped that it would strengthen the position of small- and mid-sized banks. That it led to the exact opposite effect for those banks – that is, strengthening the large banks – requires understanding the history of the law and the structure of the banking sector.

There were three types of banks in Germany: large, universal banks, like Deutsche Bank; small private banks, like the Berliner Handels-Gesellschaft, and small regional banks. Of the three, only the universal banks had large a wealthy client base and

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[146] Gall, p. 82.
[147] Quoted in Riesser, p. 502. May 26, 1884 issue, nr. 147.
[148] Riesser Speech, *Verhandlungen des ersten Allgemeinen Deutschen Bankiertages, September 19 und 20, 1902, Stenographischen Niederschrift* (Berlin: Bankiergewerbes, 1902), p. 2.

a seat on the exchange. Within a few decades, the law had weakened the position of even important private bankers, who sat on exchanges and executed trades for clients, forcing them into strategic alliances with the universal banks.[149] Wealthier customers or firms had an incentive to use the large banks or their branches rather than their local banks, because the large banks had direct access to the stock market.[150] The more intermediary sales there were, the greater the overall costs. In addition to lower transaction costs, the large banks could offer other services such as dividend collection that were harder for smaller private or regional banks to perform.

Moreover, the authorities' interpretation of the legislation added to the competitive advantage of the large banks vis-à-vis smaller banks. These included the large banks ability to make sales internally (*Kompensationsgeschäfte*), which will be discussed in more detail shortly, and the higher capital requirements of the new stock exchange law, which effectively excluded the small and medium-sized banks from daily speculation and arbitrage transactions, because of higher transaction costs.[151]

Whereas banks may have been able to avoid some of the burden of the tax with "private" transactions, the threat of the new law was sufficiently important and unwelcome to the banks that in 1883 the twelve major large and private banks founded the *Stempelvereinigung* (Vereinigung Berliner Banken und Bankiers, which later represented banks in other regulatory matters), ostensibly to clarifying the regulations regarding the application of the stamp tax, but, in reality, the organization actually lobbied for reduction of the tax, or better, yet complete exemption from it.

The association was eventually able to win some exceptions to the law, which played to the strengths of the larger banks. As discussed, one of the many advantages of the larger Berlin banks, which undermined the competitive position of smaller local banks and private banks, was their large wealthy client base. Not only did this client base give access to funds for launching new equity and debt securities, their transaction costs were lower. All the big banks had to do was arrange for sales among their clients, thereby avoiding the stock market, which lowered overall transaction costs as well. Somewhat

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[149] Paul Wallich, *Die Konzentration im Deutschen Bankwesen* (Stuttgart: J.G. Cotta, 1905),pp. 83-92.
[150] Riesser, *Die deutschen Großbanken und ihre Konzentration* (Jena: Gustav Fischer, 1912), pp. 502-503.
[151] Riesser, pp. 504-505.

unintentionally, increases in the Stamp Tax internalized transactions inside banks, effectively turning them into a sort of silent stock exchange. During the 1890s, the stamp tax was nearly doubled and a new calculation method developed that increased the cost and added further limitations on what would qualify as a tax free transactions on the exchange, further reinforcing the position of the large banks. The price was for this unintended competitive benefit was the prohibition of forward sales (*Terminhandel*) and greater rights for shareholders to claim damages for losses, all of which were intended in the 1896 Stock Exchange Law (*Börsengesetz*) to reduce speculative trades.[152]

The Stock Market Law of 1896 was also a product of anti-capitalist resentment, agricultural concern over indebtedness, and general fears about financial capitalism. It also witnessed some debate that included comments about (Jewish) conspiracies with international capitalism that foreshadowed Nazi attacks on capitalism. The law tried to impede speculative purchases of securities, by taxing speculative transactions and punishing banks that engaged in them. Although the new Stock Market Law, which came into effect (January 1, 1897), was the culmination of a long debate about speculative capitalism, it left many questions about security transactions unanswered. Chief among these were the rules that would be applied to transactions of shares of stock held by banks on behalf of their clients. Using a loophole in the Stock Market Law of 1896, banks were able to convince regulators that securities traded within the bank required no stamp duty at all. The original drafts of the law had specifically exempted shares deposited with banks from the rules pertaining to securities transactions. The final draft made no mention of them. Bankers managed to argue successfully with regulators that because the law was silent on the matter, in effect, that meant they were exempted. All this ostensibly required further clarification, but for decades there was no legislative action, leaving the banks and bank regulators a great deal of room for maneuver. Some regulators believed that how these deposits should be regulated should be left to the banks and to "public opinion." As monies deposited with the banks were necessary for the welfare of markets, companies as well as landed interests, regulators were prone to

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[152] Manfred Pohl, *Konzentration im deutschen Bankwesen 1848-1980* (Frankfurt am Main: Fritz Knapp, 1982), pp. 178-180.

leave the legal loophole, as long as speculation was controlled and economic crises were avoided.

In essence, the banks were entrusted to ensure that the deposits were "properly employed." In order to achieve this, banks and bankers in many regions established rules regarding different types of deposits, segregating those deposits that could be invested in risky securities and those that could not.[153] Banks were encouraged to make stable investments, because the distinction between speculative and non-speculative was hard to make and because customers could sue them if any of the investments recommended by the bank turned sour (*schief ging*).[154] One important contemporary American observer whose expertise informed American reforms, Henry Crosby Emery, noted how much this Act again drove exchanges into the arms of banks.[155]

While psychological and attitudinal preferences for banks rather than stock markets propelled political reforms—*often against the wishes of bankers*—politics and power ultimately explain the prohibition of futures trading. Max Weber, chair of the commission regarding futures, tried to justify futures, but was overruled. Like Weber, those who argued that such trading was desirable in the interest of national strategic interests and competitiveness, pro-futures Americans thought such a ban would only hurt European exchanges. The powerful Association of Agriculturalists tipped the balance, which then saw the National Liberal party change its tune as they catered to their upset, populist voters. Unlike the U.S. whose populist protest came from a vast mass of small farmers, the populist protest in Germany also had the backing of powerful aristocratic elite (*Junkers*) ensconced in the heart of government. The act banning futures was passed 200 to 39. The only parties to vote against it were the liberal Independent People's Party (*Freisinnige Volkspartei*) and, ironically, the Social Democrats. The futures debate also took a decidedly contentious turn in the U.S., which eventually landed the issue at the pro-business Supreme Court after twenty years of debate (and continued effective trading). The Supreme Court ruled in favor of futures as a form of hedge and insurance, thereby diversifying risk. Like Riesser, the U.s. Supreme Court ruled there were

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153 Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen: Scripta Mercaturae, 1992), pp. 322-325.
154 James, *Verbandspolitik*, pp. 9-10.
155 Emery, "Results of the German Exchange Act of 1896."

legitimate and illegitimate forms of futures trading; one needed to distinguish among them.[156] In contrast to Germany, the Supreme Court "diluted" public opinion to save futures trading.

By 1908, the large banks and key private bankers with seats on the Berlin exchange had achieved their dominant position in German equity markets.[157] With ordinary Germans slower to develop a faith in equity investment, German banks gave the German economy a way of funneling cash into risky investments, in a way that was quasi-equity. That is, bank deposits promised a "regular return," like bonds. Such funds were invested into firms in the form of equity and debt, which ironically gave German companies more access to equity investment than in England because of the intermediary role played by the banks, according to Richard Tilly.[158] The combination of stock market reforms of the 1880s and 1890s and the banks' powerful role in the management of companies seemed to reassure investors that adequate information would be provided and reasonable directors would be appointed. Confidence the 1873 crash was restored to a degree that individuals also bought shares, but generally through the bank.[159]

The universal banks thus solved, not perfectly but reasonably well, several classic economic or informational dilemmas of corporate governance and served German psychological needs in particular. The dedicated personal control of companies restored Germans' faith in equity investment after the 1873 crash discredited it. In spite of considerable suspicions, one can hardly call the pre-1914 German stock exchange(s) a failure. The Berlin Stock Exchange became one of the most influential exchanges in the world: "In New York, it was asked: "How was Berlin doing?"[160]

Exhibit 3: Stock Market Capitalization Relative to GDP (in %)

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[156] Borchardt, "Einleitung," *Max Weber Börsenwesen*, pp. 77-81. Levy, "Contemplating Delivery," pp. 332-335. Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken*, p. 192.
[157] Pohl, Konzentration, pp. 180-182. They also managed to eliminate some of the most heinous aspects of the 1896 law.
[158] Tilly, **[cite]** 103.
[159] Tilly, **[cite]** 104.
[160] Christoph Buchheim, "Deutsche Finanzmetropole von internationalem Rang (1870-1914)," *Geschichte des Finanzplatzes Berlin*, (Hg.) Instituts für bankhistorische Forschung von Hans Pohl (Frankfurt/Main: Fritz Knapp, 2002), pp. 103-156; quote from p. 122.

	1913	1929	1938	1960	1980	1999
Germany	44	35	18	35	9	67
United States	39	75	56	61	46	152
United Kingdom	109	138	114	106	38	225
Canada	74	-	100	159	46	122
France	78	-	19	28	9	117
Italy	17	23	26	42	7	68
Japan	49	120	181	36	33	95
Sweden	47	41	30	24	11	177
Switzerland	58	-	-	-	44	323

Source: Adapted from Rajan and Zingales, "Great Reversals," Table 3.

We are aware of the considerable difficulties comparing such statistics, but the table does provide a ballpark comparative figure. For our purposes, we only have to demonstrate that German equity markets prior to 1914 were vibrant in historical perspective—*in spite of* the above constraints. Two caveats are in order. First, the U.S. statistics do not conclude the New York Curb Exchange, which would add 10-20% more to the U.S. figure. Second, in the U.S. in 1915 railroad and utility stocks accounted for 43% of stocks traded and 90% of bond issues.[161] But in Germany railroads and utilities were largely under public ownership, which makes the German ratio that much more impressive, but it also dampened the need for good public accounting practices, which these two "public service" sectors propelled in the U.S. German industrial firms raised a considerable amount through equity, but used the equity to take partial stakes in other firms and fund internal investment, while the U.S. and UK firms used the raised capital to fund growth through full acquisition, which increasingly led to a greater separation of ownership from control and larger business concentrations.[162] The bottom line is that Germany before 1914 had an effective hybrid financial system of banks and capital markets that makes our present day dichotomous understanding problematic. Exhibit 3 also demonstrates that the world of equity markets changed dramatically since 1980, so that we cannot generalize historically about schematic bank-based or capital-market-oriented developments even in the case of the U.S.

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[161] Mary O'Sullivan, "Theoretical Fashions and Historical Facts: The Expansion of the US Securities Markets, 1885-1930" (unpublished paper), Tables 3, 4,

[162] Frank/Mayer, *Origins of the German Corporation.*

Nevertheless, through their holding of shares for clients, which developed out of the Stamp Act and the Stock Exchange Law of 1896, coupled with the shareholder habit of delegating voting rights (*Depotstimmrecht*) to the banks, large commercial banks had a *potentially* large voice in the running of most German public companies. Although Germany had a hybrid bank-based *and* capital market system, key aspects of bank mediation of the stock exchange helped to transform Germany after 1918 into a more bank-based system (among other Continental European countries), but it took the shocks of war, hyperinflation, great depression, a controlled Nazi economy, and reconstruction to lock these aspects in. Unlike the U.S. war bonds drive that help to legitimize and popularize securities markets, German hyperinflation simply discredited government bonds and securities as unsafe, unwise investments. Any chance of participating in the "equity revolution" of the 1920s as in the U.S. was not helped by the poor showing of stocks in the mid-1920s and killed by the great depression. The crisis spurred reform of the savings bank sector so that these banks could more readily cater to Mittelstand investment, thereby strengthening banks instead of equity markets, which boomed in the U.S. in the 1920s. The Nazis then made broad shareholding irrelevant. Although there were some attempts to democratize shareholding (as with Mannesmann or the August Thyssen-Hütte with widely dispersed shareholding), reconstruction in the 1950s effectively sluiced investment funds for firms through banks.

Conclusion

In a nutshell, whereas Germany's culture and regulatory authorities were increasingly willing to integrate banks into the corporate oversight function in return for greater privileges **and** 'universal' scope; American attitudes in contrast, despite German influences some very German-like reasoning among bankers, conditioned just the opposite response. These assumptions underlying legislation permitted banks to play a decisive role in the future of German corporate governance and allowed (family) or concentrated ownership to remain strong. In the U.S., events and legislation institutionalized America's rather unique approach to banker involvement in corporate governance. The U.S. took the "special path," not Germany, in global perspective.

Unlike the vilification in the U.S., and in spite of the enormous size and market reach of universal banks before World War I at the commanding heights of German capitalism (Germany's three largest enterprises as measured by capital were banks, 17 of the top 25), such banks were generally seen as positive contributors to the German economy and general fabric of German society.[163] Through most of the 20th century, whatever criticism was directed at the large banks' power was partially counteracted by a consensus that the alternative was even worse, a casino *capitalisme a l'Americaine*, as we would call it today, the speculative rule of the stock market. The persistence of these corporate governance forms also indicates deep-seated attitudes toward capital markets. Moreover, this famous "three-pillar" structure of German banking has proved remarkably stable, which was partially a result of populist Mittelstand support. Many commentators were struck after World War I by the degree to which German economic reforms seemed more designed to coordinate business and add stability during the Weimar Republic, even at the cost of economic efficiency.[164] When economic conditions worsened at the end of the 1920s, criticism of banks and their actual financial weakness led to direct government control of the banks, but *not* a reduction in their powers and scope of activity vis-à-vis non-financial companies. According to the banking historian, Harold James, banks were under pressure in 1927 from Hjalmar Schacht, President of the Reichsbank, to reduce their holdings in companies, but these efforts came to naught. Even though the 1920s and 30s witnessed a voracious attacks on big banks, they were focused mainly on the banks flawed lending strategies, insufficient assessment of risk, and favoritism to large companies, not the centralization of power as such—except perhaps on the Marxist left, who welcomed centralization for other reasons.[165] There was still widespread consensus in the social and economic benefits of personalized, concentrated, and responsible control in the long-term life of the enterprise. And many preferred owner controlled, personalized enterprises rather than anonymous joint-stock companies and speculative equity markets.

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[163] Richard Tilly, "An overview on the role of the large German banks up to 1914," in *Finance and Financiers in European History 1880-1960*, ed. Youssef Cassis (New York: Cambridge University Press, 1992) 94.

[164] See Robert Brady, *The Rationalization Movement in German Industry* (Berkeley: University of Californian Press, 1933).

[165] Wixforth and Ziegler, 251.

Only the Nazi government ever posed a serious political threat to the universal banks' privileged position with clients. They nearly wiped out the important class of Jewish private banking houses. But even the Nazis, during the early years of their regime, used the banks' privileged position with clients to help "coordinate" business. Only during the late thirties did the regime take steps to limit the effective control of large shareholders and bank administrators, and then mainly to coerce companies to focus more on military priorities and removing Jewish influence.[166] Even under the Nazis, there was no attempt to remove bank representation on boards, ownership of shares, and deposit-taking activities. As Lothar Gall wrote, "[U]p to now, however, the state has never, as we have seen, intervened decisively in the universal banking system."[167] Instead of splintering banks into smaller units as in the U.S. through unit banking or Glass-Steagall, the German solution to banking instability was to 'universalize' the capacity of savings banks and cooperatives so as to better serve their industrial clients and enhance liquidity within their respective banking sectors.

To summarize: before World War I both countries were largely bank-based: firms had bank representatives on boards in roughly equal levels; intermediaries and relationships supplemented formal accounting information, which in both countries remained an inadequate control mechanism because of the lack of consistent and sufficient detail. Although Germany was ahead of America in requiring annual financial statements of public companies, both countries' public accounting lacked a system of universally applied accounting principles designed to inform shareholders of the value of their investments.[168] Both countries had vibrant equity markets of roughly equal importance to the overall economy, but with some crucial, significant institutional differences, particularly associated with banks. Whereas banks before and after the turn of the century were encouraged to help regulate companies and serve as intermediaries

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[166] See Harold James, *The Deutsche Bank and the Nazi Economic War Against the Jews* (Cambridge: Cambridge University Press, 2001)

[167] Lothar Gall, "The Deutsche Bank from its Founding to the Great War," in Gall, et al, *The Deutsche Bank, 1870-1995* (London: Weidenfeld & Nicolson, 1995) 28.

[168] See Fear and Kobrak, "Diverging Paths," and Paul J. Maranti, Jr., *Accounting Comes of Age: The Development of an American Accounting Profession, 1886-1940* (Chapel Hill: University of North Carolina Press, 1990)

between users of funds and investors in Germany, the U.S. witnessed the opposite development.

This rough congruence around 1900 began to change in the decade, especially in the U.S. with the "Great Merger Movement" that began to separate ownership from control, a series of exposés and investigations about the "money trust" after the 1901 and 1907 panics leading to the Pujo Commission of 1912/13, and the development of accounting in "public service" industries such as railroads and utilities (nationalized in Germany). Public pressure and resulting regulation helped (sometimes inadvertently) enhance capital markets in the U.S. in ways that increasingly encouraged a system of financial reporting and accountancy designed for outsiders rather than insiders.

In the U.S., populist and progressive reactions tended to cluster around the notion of fairness and transparency for outsiders (such as the "people's market" of Louis Brandeis, a "free and open" stock exchange, "industrial and political liberty," "sunshine commission" or "blue-sky laws," or "fair return" and "fair value" in accounting)—note the language of regulation. U.S. regulators increasingly built in safeguards to make markets more transparent for investors to save them from potentially rapacious insiders (bankers) abusing "other people's money."[169] In the U.S., interlocking directories of insiders—for years the standard way of doing business in both countries—became increasingly viewed as an insidious "money trust" that had to be combated.

In Germany, responsible insider governance was largely deemed good in order to "tame speculation," to manage market "excesses," to "smooth" inevitable capitalist volatility, and provide "solidity" to industrial enterprises. Banks became key stewards of

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[169] Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (New York: Frederick A. Stokes, 1914). Brandeis took the phrase "other people's money" from the notorious insider speculator *and* muckraker, Thomas Lawson, *Frenzied Finance: The Crime of the Amalgamated* (New York: Ridgway, 1905). We are grateful to Janice Traflet for this advice. Traflet's own work stresses that even after the depression and the Second World War, the New York Stock Exchange had severe legitimation issues, see Janice Traflet, "'Own Your Share of American Business:' Public Relations at the NYSE during the Cold War," *Business and Economic History On-Line*, Vol. 1 (2003), pp. 1-21, available at www.thebhc.org/publications/BEHonline/2003/Traflet.pdf. *Ibid.*, "Spreading the Ideal of Mass Shareownership: Public Relations and the NYSE," *Essays in Economic and Business History* (2004), pp. 257-273. Ibid., *Spinning the NYSE: Power and Public Relations at the Big Board* (Dissertation: Colombia University, 2004). Thomas K. McCraw, *Prophets of Regulation* (Cambridge, Mass.: Belknap Press, 1984). Also Julia Ott, *When Wall Street met Main Street: The Quest for an Investors' Democracy and the Emergence of the American Retail Investor 1900-1930* (Dissertation: Yale University, 2006).

entrepreneurs and firms, made risky industrial ventures respectable, provided better objective information and oversight in the economy, became dedicated shareholders, and acted as "careful leaders" (Riesser) guaranteeing the stability of firms under firm guardianship. The language is telling and signifies fundamentally different assumptions about the nature of capitalism. U.S. governance stressed primarily transparency and openness, while the Germans stressed responsibility and solidity. Both solutions, however, addressed universal, classic problems of corporate governance.

The U.S. hardly moved smoothly to a capital market system, but such language and the underlying assumptions pointed the way to the future. The U.S. struggled for another 20 years with issues of private property and federalism, before an alternative to bank-based capitalism could be started. Only in the wake of the Roaring Twenties did sufficient political consensus arise around a new approach to satisfying the often-conflicting demands of the progressives, populists, and business leaders. In some sense, 1929 became for Americans what 1873 had been for Germans: a catalyst for molding an "American" regulatory alternative to uncontrolled capital markets and concentrations of economic power. Within a decade of the Crash, banks and other financial institutions were, to a large extent, out of the corporate governance business. In their place was a fragile but lasting coalition of legislators, government-appointed regulators, private markets, and professional organizations, whose principle aim was to create enough *transparency* in capital markets for intelligent investors to make reasonable decisions about the economic value of securities.

A good argument could be made that in both countries banks served to mitigate market imperfections. As Eugen White noted nineteenth century banks in all countries had a "special relationship" to firms. Without their intervention, it is unlikely that firms would have been able to geographically and contractually expand their sources of capital. From the moment companies and owners felt compelled to move from internal sources or private equity and very simple forms of short-term financing, new sources and securities had to be invented and for-the-most part distant investors had to be convinced that their investments had a reasonable chance of bearing fruit. For a long time finance has understood that Modigliani and Miller's extremely-narrowly defined conditions for the their indifference propositions to hold did not reflect the real world and that companies having many good economic reasons for choosing from alternative forms of financing. Less is known about how institutional development has facilitated the broadening of choices and investor confidence.