Anglo-American Securities Regulation

Cultural and Political Roots, 1690–1860

Stuart Banner

Washington University School of Law

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Introduction

This book is about the regulation of the earliest securities markets in England and the United States. Because that regulation was the product of widespread attitudes toward securities markets, the book necessarily discusses those attitudes as well. And because popular attitudes toward securities trading depended heavily (although not entirely) on what the market was like at any given time, the book is as much about the institution being regulated as it is about the regulation itself.

I

The subject is one that has been, with a few minor exceptions, largely overlooked. Accounts of securities regulation in the United States tend to begin with the Securities Act of 1933, or at best with the state "blue sky" laws of the preceding two decades. When the seventeenth, eighteenth, and nineteenth centuries receive any attention, they are usually brushed aside with the poorly informed assumption that securities markets were subject to no law at all. As one account of the nineteenth-century market puts it, "speculators were bound by no rules beyond the natural ones of the market."[1] Or in the words of one widely-used American securities law treatise, "[s]ecurities regulation in this country began around the turn of the century."[2] The assumption should seem dubious to anyone familiar with Anglo-American legal history, and this book will demonstrate its falsity. During the period covered by this book, English and American securities markets were intensively regulated – in some respects, more intensively than they are regulated today.

The notion that securities markets were unregulated before this century is partially due to the lack of attention the subject has received, but it is also in large part indicative of a fundamental misconception of

[1] John Steele Gordon, *The Scarlet Woman of Wall Street* (New York: Weidenfeld & Nicolson, 1988), xviii.

[2] Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation,* 3rd edn (Boston: Little, Brown, 1995), 9.

the nature of legal development. That misconception, usually assumed pre-rationally rather than elaborated explicitly, is that new institutions or new technologies are born naked into the world; that they emerge into a legal vacuum, where they remain untouched by law until the legal system responds with regulation. It would make sense, given this assumption, to suppose that securities markets could have existed in England and the United States for centuries before the managers of the legal system got around to devising a legal framework for them. Securities markets, one might think, were never large enough during this period, and only rarely controversial enough, to be considered a "problem" deserving the legal system's attention.

One goal of this book is to provide an extended example to demonstrate the error of this view of legal development. No institution in the Anglo-American world is born unregulated, because no institution, no matter how new, is so new that judges and legislators cannot instantly place it in the same conceptual category as more familiar institutions.[3] As we will see more clearly in chapters 1 through 3, securities were a form of property new to late seventeenth-century England. The market that grew up in London to trade them was an institution the likes of which had never been encountered by the English legal system. But securities were in some ways similar to older forms of property; the securities market was in some ways reminiscent of older markets; and once these categorizations had been made the managers of the English legal system had well-established legal principles governing older property and older markets to draw upon. Nothing needed explicitly to be done to regulate the new market; like any new institution, it could easily be assimilated to older categories and rules. This pattern is typical of Anglo-American legal change. We can see a similar process taking place today, with new technologies like computer software and new institutions like the Internet often analogized for regulatory purposes to older technologies like books and older institutions like public parks. Securities markets are a familiar institution today, but they were often perceived as strange and threatening when they first began. By taking a close look at how they were regulated at the start, I hope to be able to clarify the manner in which Anglo-American legal change relates to institutional and technological change.

A second goal of the book is to add to our understanding of the

[3] By "institutions" I mean, following Douglass North, "the humanly devised constraints that shape human interaction." Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), 3. A securities market, for instance, is an institution – it embodies a collection of written and unwritten restraints on participants' behavior that enables participants to do something they would otherwise have great trouble doing.

process of legal change itself. Students of the process have tended to divide into two camps, one emphasizing the ways in which new law is generated within the professional community of lawyers, the other emphasizing the effects of non-legal developments – changes in economic circumstances, in political thought, and so on – on the law. The origin and development of securities regulation provide an excellent case study, because they incorporate aspects of both. Legal change was sometimes transparently the result of external forces, but it was also sometimes clearly generated by an internal process of reasoning by analogy from older legal rules and categories. This book accordingly takes both an "external" and an "internal" view of its subject; that is, it discusses the political and economic trends that influenced the development of securities law on the one hand, and the changes in legal doctrine confronted by lawyers and speculators on the other.

The evidence presented in this book, I will argue in the concluding chapter, illustrates the relationship between the two types of change. I will briefly state the conclusion here: Where legal change was produced by an autonomous process of legal reasoning, that reasoning was predicated upon analogies to decisions reached by earlier generations of government officials, decisions which were themselves the products of external developments when they were made, and regarding which the relevant political and economic pressures had not changed in the interim. As we will see in chapters 3 and 5, for example, the law of usury was adapted to the new securities market through an internal reasoning process accessible only to lawyers, but the pertinent aspect of the law of usury had itself embodied a compromise of a tension in economic thought reached centuries earlier.

One thus cannot understand why securities markets were regulated the way they were without situating them in the broader culture, not just of the time but of earlier times as well. How people in England regulated speculation in government debt in the early eighteenth century, for instance, was strongly influenced by what they thought about speculation in government debt at the time, but that thought in turn was strongly influenced by what they thought about grain speculation in the sixteenth century. How people in the United States regulated transactions in the shares of business enterprises in the middle of the nineteenth century, to take another example, often followed from their ideas about corporations at the time, but those ideas in turn were in large part drawn from what people in early eighteenth-century England thought about speculation in the public debt. Regulation has cultural roots in two overlapping but analytically distinct senses; it draws upon both the culture of its own time and the

culture of the past. The evidence presented in this book will, I hope, be ample proof of both.

The book's third goal is to demonstrate that most of the ways of thinking about and regulating securities markets characteristic of the twentieth century were present in England and the United States long before securities markets were important economic institutions. The familiar modern rift between Wall Street and Main Street – between a community of securities professionals pursuing its private interest while certain that it is meanwhile essential to the public welfare, and a wider political community suspicious of both the practices and the power of the securities industry – is as old as securities trading.[4] The common current beliefs that securities transactions involve more deception than transactions in other kinds of property, that stock speculators immorally profit from events harmful to the nation as a whole, that stock speculation is tantamount to gambling, that money invested in the market is diverted from more productive pursuits[5] – all date back to the late seventeenth and early eighteenth centuries. Most of today's regulatory techniques, including prohibitions of certain types of transactions, mandatory disclosure rules, minimum holding periods, and rules forbidding deception and price manipulation, were tried or at least suggested in the eighteenth and early nineteenth centuries. The market and the government were both much smaller, but a good part of the landscape would be familiar to a twentieth-century lawyer.

This conclusion has two consequences. First, it casts some doubt on the common assumption that the regulation of the early twentieth century was prompted solely by contemporary events. Popular attitudes toward the market in the late nineteenth and early twentieth centuries, to the contrary, inherited and built upon a centuries-old tradition of Anglo-American thought. The growth of the market and the conduct of speculators around the turn of the century may have triggered our current scheme of regulation, but behind that trigger lay hundreds of years of preparation.

Second, awareness of the previous centuries of thought about securities markets opens up all sorts of questions that have long been hidden from view. Our securities regulation in the late twentieth century rests in large part on the answers judges, legislators, lawyers, and traders provided to a host of questions in the seventeenth, eighteenth, and

[4] On that split, see Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton: Princeton University Press, 1994).

[5] See, e.g., Molly Ivins, "Budget Deal More About People Than Numbers," *Charleston Gazette*, Dec. 8, 1995, 6A; Roy Fish, Letter to the Editor, *Houston Chronicle*, Sept. 26, 1995, 19; Tom Petruno, "Any Way You Look at It, Investing in Stock Market is a Gamble," *Dallas Morning News*, Oct. 8, 1995, 14H.

nineteenth centuries, but we have lost sight not just of the choices they made but of the fact that the choices even had to be made. Should securities trading be allowed? Does the risk involved make it a form of illegal gambling? Does a high rate of return make the investment illegal usury? Should trading be banned, on the ground that excessive speculation harms the public? Are futures contracts enforceable? What if the seller does not actually own the stock he is purporting to sell? If the price drops between the contract date and the date delivery is due, can the buyer rescind on the theory that the stock was not truly worth the purchase price? May the parties settle a futures contract by netting the difference between the prices on the contract date and the delivery date, or must they physically transfer the stock? Should a small number of brokers be permitted to form a cartel – a stock exchange – and trade only among themselves? Today most of these questions seem so basic that we forget they once had to be answered, but the answers were far from obvious when the questions first arose.

My own background and training – I am an American law professor – may go a long way toward explaining some of the book's emphases. The book's first three chapters track English developments from the seventeenth century only through the early nineteenth century; that is, only insofar as English events and English thought had a strong influence on patterns of thought and behavior in the United States. The rest of the book, chapters 4 through 8, covers the United States, from the beginnings of organized American securities trading in the early 1790s through the middle of the nineteenth century. As a result, the book nearly tells a single chronological story running from approximately 1690 to approximately 1860, but the location of that story jumps from England to the United States (and jumps a bit backwards chronologically) between chapters 3 and 4. Readers primarily interested in England will notice the absence of any extended discussion of English events after roughly 1800. Throughout, the book focuses primarily on law, and treats other aspects of life only to the extent that they are useful in explaining how and why the law developed. This is only one of a handful of conceivable modes for writing legal history, and for some purposes it may not be the most fruitful, but it seemed the most useful for answering the questions of how and why English and American people chose to regulate early securities markets in the ways that they did.[6]

The beginning of the time period covered by this book, the 1690s, requires little explanation. That was the decade when England saw its

[6] See Louis E. Wolcher, "The Many Meanings of 'Wherefore' in Legal History," *Washington Law Review* 68 (1993): 598–607.

first substantial securities trading, and its first securities regulation. The book's ending, approximately 1860, is less dictated by the subject, but there are three good reasons for stopping there. First, one of my objectives is to demonstrate that all the primary forms of twentieth-century popular thought about securities markets were already widespread in England and the United States well before securities markets were important economic institutions. The American Civil War serves as a useful stopping point, because the American market grew so substantially during and after the war.[7] Second, the two paradigmatic eighteenth-century regulatory measures – Sir John Barnard's Act in England (discussed in chapter 3) and New York's stockjobbing act (discussed in chapter 5) – were repealed in 1860 and 1858 respectively. Beginning in the late 1850s and early 1860s, a common class of securities transactions was given recognition by the legal system for the first time since the market was in its infancy. The middle of the nineteenth century saw the rejection of the main products of eighteenth-century legal thought concerning securities markets, and is thus a convenient place to end. Finally, the mid-nineteenth century is the last logical stopping point before the enactment of the federal securities statutes in the 1930s, but the period from the 1860s to the 1930s, which in the United States included two intense bursts of regulatory activity, deserves a book to itself. To attempt to include that material here would have resulted in a book approximately twice the length of this one. Although 1860 in some respects is an arbitrary cutoff point, for these reasons it seemed less arbitrary than any other. As a result, this book does not tell a story from beginning to end, nor does it describe a neat transition from one state of affairs to another. It starts at the beginning, but it leaves off somewhere in the middle, because the story it tells has no clear end.

The subject of this book and the sources it incorporates cut across conventional disciplinary boundaries. I hope it will attract readers from a few different walks of life. I have accordingly tried to minimize the amount of technical legal and financial detail in the book. Where such detail was essential to an accurate picture of events, I have tried to provide explanations as brief as possible, so as not to bore specialists. There were many points at which such decisions had to be made. These were among the most difficult judgment calls involved in writing the book.

The book's interdisciplinary nature also prompts two apologies. The first is the standard one. I am by no means an expert in securities law,

[7] Richard Franklin Bensel, *Yankee Leviathan: The Origins of Central State Authority in America, 1859–1877* (Cambridge: Cambridge University Press, 1990), 249.

finance, English or American history, or English or American literature. I have tried to learn enough of each, but I ask the indulgence of specialists, who are likely to find only partial coverage of the relevant portions of their fields. My second apology is occasioned by the inconsistent conventions of the different disciplines. Law professors and lawyers, accustomed to scholarship presenting normative conclusions, may be disappointed that I offer none. I do not argue that the law of any particular time was good or bad, nor do I take sides in the debates I describe. I do not claim that the past offers any lessons as to what our securities law should or should not be like today, because it does not: Both the market and the state were so much smaller and so qualitatively different that it would be absurd to base current policy on anything that happened during the period covered by this book. Economists, accustomed to discounting what people *say* about markets and focusing on what people actually *do* in markets, may be frustrated by the attention I pay to the arguments for and against securities trading. Throughout, I devote more attention to what people thought about the market than to whether they were right, simply because their thought, right or wrong, was what drove them to regulate the market the way they did, and that is what I am trying to explain. Specialists in literature, finally, accustomed to close readings of individual texts, may be unhappy with the rapid accumulation of snippets of large numbers of texts. Where I use poems or plays as evidence, however, I am not primarily interested in the poems or plays in themselves; I am interested in them as evidence of widespread thought when they were written, and they can serve that purpose best when they are piled up in groups.

Throughout this book I will be speaking of the market in and the regulation of "securities." Lawyers will recognize that as a technical term the word is ambiguous around the edges,[8] but I intend only its modern colloquial sense, which includes two types of financial assets – shares of government debt and shares of business corporations. The first type, which was much more common than the second in the eighteenth century, usually entitled the holder to a periodic payment from the government, normally expressed as a percentage of the face value of the instrument. Today these are usually called "bonds," but during the period covered by this book they were generally called "stock." The second type, which probably became more common than the first around the middle of the nineteenth century, usually entitled the holder to a periodic dividend from the corporation, to some voting power in the affairs of the corporation, and to a share of the corporation's assets after

[8] See, e.g., *Reves* v. *Ernst & Young*, 494 U.S. 56 (1990); *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681 (1985); *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946).

the claims of creditors had been satisfied. During the period covered by this book, the shares of corporations were also generally called "stock," as they are today. The people whose thought I describe would thus have been likely to use the word "stock" where I use "securities," particularly in the seventeenth and eighteenth centuries, but I use "securities" as the umbrella term to avoid confusing modern readers. The category of "securities regulation" is likewise a slight anachronism, as there was no such category of legal thought in England or the United States at the time, but the term's familiarity to lawyers today makes it a useful shorthand way of referring to all the rules of law with a direct effect on the securities market.

II

The book's attempt to link the development of law with the wider culture in which that law was situated raises three groups of methodological questions that will be familiar to historians, but may not be to other readers.

First, throughout the book, I infer from the available evidence that particular ways of thinking were "widespread," or "common," or "popular." There were no public opinion polls during the period covered by this book, of course, nor were many of the issues discussed in the book ever put up to an explicit vote. Estimates of the pervasiveness of thought are thus necessarily open to question. For any given period, I have tried to find every published expression of opinion relative to securities markets, but of course the points of view that were published may not be representative of the points of view that were generally held, the surviving evidence may not be representative of the spectrum of opinion that existed at the time, and the evidence I have been able to discover may not be representative of the evidence currently in existence. This potential for sampling error is inherent in the attempt to write any sort of cultural history beyond accounts of the thought of individual people. The best one can do is to make educated guesses, based on a sense of the arguments people at the time would have considered plausible and on a feeling for the relative frequency with which particular arguments are made. Guidelines like these only help a tiny bit, but they at least convert blind guesses into reasonable hypotheses worth further testing. In chapter 2, for example, I assert that many English people in the early eighteenth century understood the securities market as a zero-sum game, and that they therefore assumed that for every winner in the market there had to be a loser. My direct evidence for this claim is slim; it consists of only a few people who actually said

so. But this understanding of the market fits in well with the belief that the domestic economy as a whole was a zero-sum game, a belief that Joyce Appleby has found present in seventeenth-century England and J. E. Crowley has observed in the eighteenth-century North American colonies.[9] And while I have found only a few people making this argument, I have found none making the contrary argument. The claim that many people held this belief has not, strictly speaking, been proven, but it has been shown to be more probable than not on the basis of the evidence uncovered so far. It can then serve as the basis for the gathering of new evidence, which will strengthen or weaken it.

The question of representativeness is particularly difficult because of the subject matter of this book. The volume of published criticism of securities trading, I quickly discovered, tended to swell every time the market declined, which raises the question of whether it is important to distinguish between short-run sour grapes and more permanent dissatisfaction with the market, and if so, how that might be done. I decided not to attempt to distinguish the two categories, because both contributed to legislative proposals, enacted statutes, and the outcomes of judicial decisions. Sour grapes or not, new regulation tended to come immediately after price declines. The two sorts of criticism were thus equally relevant to understanding legal developments. The volume of published support for the market, meanwhile, proved to be a function of the likelihood of regulation; that is, when regulation seemed imminent, people who ordinarily published nothing about securities trading would rush to defend the market in print. (This relationship became even more apparent in the early twentieth century, when the prospect of state and then federal regulation launched a flotilla of published defenses of trading.) The volume of published evidence is thus a poor indicator of public interest in and acceptance of securities trading. A better indicator is the size of the market at any given time, measured either in money or in investors. People vote with their pocketbooks, in effect, much more often than they set their opinions down on paper.

An additional difficulty concerning the representativeness of published opinions stems from the fact that one's interest in the stock market, in both the past and the present, is pretty clearly dependent upon one's wealth. That is not to say that people without money to invest lack opinions about the market. Some of those opinions, usually strongly negative, will be discussed in this book. But such evidence is

[9] Joyce Oldham Appleby, *Economic Thought and Ideology in Seventeenth-Century England* (Princeton: Princeton University Press, 1978), 158–64; J. E. Crowley, *This Sheba, Self: The Conceptualization of Economic Life in Eighteenth-Century America* (Baltimore: Johns Hopkins University Press, 1974), 86–88.

normally much more difficult to come by than the opinions of the propertied. Most of the evidence cited in this book, on both sides of any question, was produced by people who were wealthy enough to invest in the market if they wanted to, who had associates who invested in the market, and who spent time thinking about whether the market's growth was desirable. My references to "widespread thought" and the like should be taken with this in mind. The word "popular," in particular, may carry for some readers a uniquely working-class connotation that is inapplicable in this context.

The second group of methodological questions is more fundamental. Even apart from the question of the representativeness of evidence, what does it mean to say that a particular mode of thought was "widespread" or "widely held"? What percentage of a population has to believe something before that belief can be said to be "popular"? Words like these obviously conceal a great deal of uncertainty as to how many people held the belief. The best definition one can give is "more than a trivial number." If one considers the United States today, for instance, I think all would agree that many people believe the stock market to be equivalent to a casino. That is a belief, one senses, that is widely held, even if one cannot specify how many people hold it. When I use similar language with reference to periods in the past, I mean to suggest a similar notion. Because the concept does not imply any given percentage of the population, much less a majority, two incompatible beliefs can both be widely held. That is, the belief that the stock market is a casino, and the belief that the stock market is not a casino, can be (and probably are) both widely held, by different groups of people, or sometimes even by the same people.

This sort of vocabulary can be maddeningly imprecise, but it is at least an improvement over the sort of history where one reads that during a particular period "people thought X," or that the period was "an age of X." Even if one cannot know how many people thought what, one can at least acknowledge that at all periods inconsistent beliefs are simultaneously present.

A third set of methodological questions concerns the particular types of evidence cited in this book, which include polemical pamphlets, fictional sources (including poems, plays, novels, and songs), and court opinions. How valuable are such sources in getting a sense of public attitudes? Are some more trustworthy than others?

Each type of source has strong points and weak points. Pamphlets are often reliable indicators of the writer or speaker's own personal views, because the conventions of the medium, unlike others (especially court opinions), permit him to state his honest opinions. As Lawrence

Friedman has suggested, however, pamphlets are "notoriously unreliable as measures of actual feeling among a diverse population."[10] Pamphlets are often written by zealots, or by deliberately provocative writers, who are writing precisely because they wish to state an unpopular opinion. The English and early American tradition of writing pamphlets anonymously or under a pseudonym further complicates the question, because one never knows whether these devices were chosen because the author feared that his views would be unpopular. If so, then the existence of the pamphlet is actually weak evidence of its own unrepresentativeness. These difficulties can never be surmounted, but they can be minimized by two strategies. First, one can take account of sheer numbers; if one or two pamphlets state a proposition, it should be taken with a grain of salt, but if many pamphlets over a long period of time state the same proposition, it is more likely to have commanded the assent of many people. From a single author, the idea that stock speculators are unusually deceitful might be the opinion of a crackpot, but when scores of authors distributed over a century say so, one can be more confident that one is seeing a widely shared belief. Second, one can use the pamphlets not for what they say directly but for their unstated assumptions. A large variety of pamphlets published in 1720 and 1721, for instance, expressed different opinions about the South Sea Bubble, but every author tacitly assumed that readers were familiar with the details of the story, including the fact that stock in business enterprises had been bought and sold in unprecedentedly large amounts. The pamphlets, taken together, thus support the assertion made in chapter 2 that the Bubble focused public attention on the still relatively new securities market.

The use of fictional sources like novels, plays, poetry, and songs raises problems of its own.[11] Themes are sometimes common in such sources because they are common in life. In the popular songs of the last forty years, for example, heterosexual love between young people is by far the dominant topic, probably appearing with a frequency in excess of all other subjects combined. A future historian of the period would be correct in deducing the topic's importance to a large number of people. Popular songs might in fact be the best evidence to use for that purpose; they might be superior, for instance, to books by psychologists or other self-professed experts on the subject. On the other hand, themes are

[10] Lawrence M. Friedman, *A History of American Law*, 2nd edn (New York: Simon & Schuster, 1985), 95.

[11] This paragraph owes a great deal to John Boswell, *The Kindness of Strangers: The Abandonment of Children in Western Europe from Late Antiquity to the Renaissance* (New York: Pantheon, 1988), 3–22.

often common in fictional sources precisely because they are unusual in real life, and thus provide more entertaining material for the audience. The historian of recent popular culture unfamiliar with the concept of "love" as it was understood in the late twentieth-century United States would be likely to conclude, upon studying the lyrics of the most popular songs, that for most people love involved oscillating between two states, one of complete bliss and the other of the darkest despair. The result would be a misleading picture, because it would be based upon only those aspects of love that make for the most dramatic songs. To choose another example, the future historian might reasonably conclude, from a study of the films of the 1970s and 1980s, that many American houses of the period were either haunted or inhabited by psychotic killers. Again, the problem of representativeness arises because of the audience's preference for the dramatic.

The only way to minimize this difficulty is to compare common fictional themes with the themes appearing in non-fictional sources of the period. In chapter 6, for instance, I will show that much mid-nineteenth-century American fiction contained derogatory references to the stock market. Were these references representative of anti-market sentiment among readers, or were they dramatic devices, like haunted houses? I will suggest that the former is more probable, on the ground that contemporary non-fictional sources included similar anti-market arguments in contexts where a dramatic function seems unlikely. As with the pamphlets, the claim cannot be "proven" in a strict sense of the word. All one can do is show it to be more probable than any of the alternatives.

The interpretation of court opinions, finally, requires an awareness of all the constraints on expression faced by Anglo-American judges.[12] During the time period covered by this book, like today, the informal norms of the profession limited the judges to resolving the disputes before them by using preexisting rules of law. It was considered improper by nearly all judges and lawyers for judges to state their personal opinions on the issues in controversy, to let personal opinions influence decisions, or explicitly to invent new law. Most of the opinions discussed in this book, as a result, have a flatness and a matter-of-factness that cannot be taken as representing the judges' own views. Toward the end of the eighteenth century and the beginning of the nineteenth, opinions tended to become longer, and occasional eruptions of personality became a little more frequent. Particularly in the United

[12] See G. Edward White, "The Appellate Opinion as Historical Source Material," in G. Edward White, *Patterns of American Legal Thought* (Indianapolis: Bobbs-Merrill, 1978), 74–95.

States, one finds early nineteenth-century judges a bit more willing to express approval or disapproval of social developments, and slightly more prone to providing explicit policy justifications for their decisions. I have emphasized such passages, despite their rareness, for the insight they provide into the judges' thinking, perhaps at the risk of leaving non-lawyers with a misimpression of the overall composition of the opinions. Because I am primarily interested in understanding why the law developed as it did, such explanatory comments on the part of judges assume particular importance.