

Historical Perspectives of the SEC

Of all the New Deal agencies created in Franklin Roosevelt's first term, none began life with more publicity, interest and glamour than did the SEC. In these respects, it could be compared to the congressional committees investigating Watergate corruption and considering impeachment. Roosevelt had come to office at the bottom of the worst depression in American history and the nation's greatest crisis since the Civil War. The public already had its scapegoat—Wall Street—and was convinced the bad times had been signalled by the Great Crash of October, 1929. The public demanded action, by way of punishment and reforms. F.D.R. was prepared to offer both.

Robert Sobel, *Inside Wall Street* (New York: Norton, 1977), p. 167.

The SEC is widely regarded as one of the more prestigious and effective of the federal regulatory agencies. Its broad charge of protecting investors and maintaining fair and orderly markets grew out of the stock market crash of 1929 and the perception that fraud, security price manipulation, short selling, bear raids, pooling, and other unsavory investment practices were the root of the ensuing Great Depression. The nation needed a scapegoat, and Wall Street was an attractive candidate. The SEC, which actually was not launched until nearly five years after the crash, was perceived by the public as the mechanism that would offer protection against unscrupulous inside traders and security issuers and perhaps even against future security losses.

The period immediately following the stock market crash brought considerable debate as to the necessity and form of any federal security regulation. The final product actually was the result of several evolutionary efforts to develop capital market regulation, and the compromises reflect not only the historical role of security regulation but also the tenor of the times and the political beliefs of the major characters for formulating the regulations.

1.1 Historical Development of Capital Market Regulation

Before the SEC came onto the scene, participants in the markets had developed their own, fairly elaborate version of self regulation: the exchange system. The trading of securities in the late 1700s and

through the early 1900s was a function of the existing communication and information systems. Because of the costs of such communication networks and the early accumulation of wealth in New York, Philadelphia, and Boston, the trading of stocks and bonds tended to be concentrated in those areas. Traders simply congregated together to execute stock transactions and soon developed formalized exchange rules to govern the charges for executing trades, the traders' conduct, and specifications of exchange trades. The earliest such agreement was the famous Buttonwood Tree Agreement, to which the New York Stock Exchange (NYSE) traces its roots. On May 17, 1792, a group of twenty-four traders signed the following agreement under that famous tree:

We the undersigned, brokers for the purchase and sale of public stocks, do hereby promise and pledge ourselves to each other that we will not buy or sell from this date for any person whatever, any kind of public stocks at less rate than one quarter of one percent commission on the specie value, and that we will give preference to each other in our negotiations.

The two basic premises of that agreement, fixed commissions and trading priorities to members, have historically characterized all exchange rules in one form or another. These principles remained unchallenged until the 1970s when the SEC at the direction of Congress deregulated commission rates and began the movement toward a national market system.

The first major external regulatory structure governing the capital markets was that initiated by the individual states. Massachusetts enacted legislation in the 1850s, and other states followed with additional "blue sky laws." All of this legislation was centered around control of new issues and often was implemented through the state chartering of corporations. Blue sky laws never attempted to regulate or influence the trading of existing securities, although some states (most notably New York) did institute a tax on all transactions effected in that state.

The second major type of legislation that affected the issuance and trading of stocks and bonds was the antitrust legislation. The trust-busting era of the early 1900s affected not only the issuance of new securities but also the formation of new corporations. The concern about corporate monopolies, which began in the late 1800s and resulted in the elaborate antitrust regulatory structure in the Justice Department, consistently has been a central theme of security or capital

market regulation. Even the SEC, when it came on the regulatory scene, was given some duties in this area for specialized kinds of corporations—public utility holding companies.

Aside from the state blue sky laws and the federal regulation of antitrust laws, there was little formal regulation of the securities markets prior to the SEC. In particular little attempt was made to regulate either the secondary trading of stocks and bonds or the disclosure of financial information in any consistent manner or on a national basis. These areas were left to the private sector and increasingly to the emerging self-regulatory bodies.

Although there was little government regulation of the trading of securities or the disclosure of financial information prior to the SEC, there was a growing demand in the private sector for establishing and enforcing certain rules and codes of conduct. A wide range of self-regulatory bodies met these demands, including the stock exchanges already mentioned, national organizations of brokers like the National Association of Securities Dealers or the Put and Call Dealers Association which governed nonexchange trades, and various accounting organizations. Some of the roles of these self-regulatory organizations included setting and enforcing codes of conduct in dealing with the public, setting and enforcing fee structures, and determining accounting and other standards of corporate disclosure to the public.

With the establishment of the SEC government oversight of the self-regulatory bodies was introduced. The major responsibilities of the commission fall into two areas that have their bases in the historical development of capital market regulation. First, the commission was most active in assuming control of the corporate disclosure programs of the self-regulatory bodies, via oversight of accounting organizations and exchanges. The federal regulations in the area have far surpassed the state blue sky laws or exchange issuer disclosure requirements in importance. The expansion and enforcement of these accounting procedures have remained a major activity of the SEC to the present day. The second major activity that the SEC assumed concerned establishing and enforcing codes of conduct for brokers and dealers, particularly with respect to fraud and stock price manipulation, once left completely to exchanges and broker-dealer organizations.

1.2 The Purposes of the Securities and Exchange Commission

At the time of the stock market crash in 1929 and the alleged loss of investor confidence in the securities markets, the range of proposed legislation in the area of securities and securities markets was broad, ranging from complete government control of the markets to something close to complete *laissez faire*. As with many legislative initiatives, the final result was a compromise, and the commission itself has developed and changed its focus over the years.

Herbert Hoover, who was president during the years of the stock market crash and the beginning of the depression, in spite of strong public sentiment consistently avoided initiatives to regulate the securities market, claiming that the private institutions and states should govern themselves. He maintained that state blue sky laws which governed corporation chartering and security issuance were the appropriate arm for security and market regulation and wondered whether federal regulation could even be authorized under our Constitution.

When the exchanges did not appear to be willing to take strong oversight initiatives, and stock market abuses continued to make headlines, Hoover finally appealed directly to the exchanges, Richard Whitney, head of the NYSE, in particular, to eliminate manipulation and restrict trader activities on exchange floors. Whitney was an eloquent defender of the freedom of the marketplace and the NYSE's role in the maintenance of the integrity of the market. In 1931, after the NYSE failed to take measures in response to Hoover's expressed dissatisfaction, Hoover initiated a Senate investigation. That investigation continued through 1932 and the presidential election and produced numerous headlines about security manipulations, bucket shops, stock watering, and short-selling bear raids. The Senate committee's findings of fraud and abuse formed the foundation of a Democratic plank, advocating federal regulation of holding companies, public utilities, and security and commodity exchanges.

Federal regulation of securities was an interesting campaign issue for the 1932 presidential race because Hoover's opponent, Franklin D. Roosevelt, was the governor of New York, the state in which many of the alleged abuses were occurring and, as Hoover was quick to point out, states were responsible for security and exchange regulation. Hoover generally took the tact that specific wrongdoings should be punished and that there was doubtful authority for federal regulation

of securities under the Constitution. The Roosevelt New Deal approach which had a flower of experimentation with concrete remedies, particularly in the areas of business and finance, seemed to win over the American public, and the mandate for securities regulation coming out of the 1932 election was clear. FDR's proposals for wide-ranging banking and finance regulation could be implemented with the blessing of the American public.

Roosevelt's first securities regulatory reform bill which called for the regulation of securities by the Federal Trade Commission (FTC) was introduced in both Houses in March 1933. Although the bill was subject to considerable debate and was modified somewhat before it was finally signed on May 27, 1933, the Securities Act of 1933 was substantially as Roosevelt had suggested and was billed as a part of the long-term development of a regulatory program for securities.

By passing the 1933 act, sometimes called the truth-in-securities law, Congress opted for a disclosure approach to securities regulation: issuers of securities were required to disclose the financial underpinnings of stock and bond issues. It was believed that disclosure in the glaring light of publicity would provide investors with sufficient information to be able to make informed investment decisions that would serve to self-regulate the allocation of capital. This concept was implemented through the registration of securities with and administration by the FTC. The 1933 act has two basic purposes: to provide investors with sufficient material information to enable informed investment decisions and to prohibit fraud in connection with the sale of securities. The disclosure and antifraud provisions of the 1933 act remain a central focus of federal security regulation today.

One year later, and even while the FTC was beginning the administration of the 1933 act, Roosevelt continued his quest of regulating the financial markets by addressing the regulation of the trading of existing securities (as opposed to the regulation of the primary market which is covered by the 1933 act). Regulation of existing securities would encompass exchanges, broker-dealer activities, and even investor activities.

Roosevelt appointed a committee, headed by Secretary of Commerce Daniel C. Roper, to examine the need for and form of a regulatory structure for stock and commodity markets. The Roper report recommended a very mild form of exchange regulation, basically the federal registration and licensing of exchanges and the formation of a new agency. The report even recommended that the administration of

the new agency be drawn from the staff of the stock exchanges since security regulation would involve considerable technical expertise. Although the Roper report recommended a mild dose of federal regulation, the bills introduced in both Houses were much stronger and showed the influence of several congressional committees that advocated more stringent exchange-regulation and oversight by the FTC. For example, the Senate version was drafted by Ferdinand Pecora, counsel for the Senate Banking and Currency Committee which was investigating exchange practices and producing a number of headlines related to investment banking and exchange practices.

Wall Street mounted a massive campaign against the congressional versions of the bill, arguing that the FTC would be able to control all corporations, that nationalization of all industry surely would result, and that the demise of capital markets and capital formation was imminent. Roosevelt firmly supported the strong congressional bills and FTC oversight. In an effort to stave off perceived disaster, Wall Street then argued for a separate agency, hoping to develop friendly ties in the fledgling regulatory agency.

The final bill which was passed as the Securities Exchange Act of 1934 did call for a separate agency, but no other concessions were made. In fact Roosevelt seems to have lost little when the scope and composition of the new commission is examined. Roosevelt's initial appointees included three people from the FTC (James M. Landis, George M. Matthews, and Robert E. Healy), Ferdinand Pecora (one of the drafters of the bill), and Joseph Kennedy as chairman. With the exception of the appointment of Kennedy, Wall Street could take little comfort in the formation of a new separate agency. In fact most of the securities division of the FTC was transferred directly over to the SEC.

The early years of the SEC were devoted to taking over the administration of the 1933 act and carrying out the mandate of the 1934 act. The major requirements of the 1934 act include registration of securities traded on national exchanges, certain periodic financial reports of those securities, registration of exchanges and broker-dealers, anti-fraud provisions, prohibitions against wash sales (allegedly no-risk sales with repurchase agreements to create the illusion of volume and investor interest), standards for transactions among managers, board members, and others with nonpublic material information (called insiders), proxy solicitation, and tender offer solicitations and enforcement of margin credit restrictions imposed by the Federal Reserve

Board. In 1938 the Malony act extended the 1934 act to cover the over-the-counter (OTC) market and the regulation of qualified broker-dealer associations. Although the registration of exchanges resulted in the closing of nine exchanges (including a one-person exchange in a poolroom in Hammond, Indiana), the early years of the SEC were marked by Kennedy's speeches and efforts to support and encourage the mainstream of the flagging financial markets. He touted the SEC's better business bureau role and suggested that the SEC could protect the honest exchanges, traders, and investors from the fraudulent dealers.

The SEC quickly established itself as a reputable and reasonable regulatory agency under the leadership of Kennedy and as such was soon the recipient of additional regulatory powers. One of Roosevelt's strongest personal public service interests, dating even before his days as governor of the state of New York, lay in the area of power and public utility holding companies. Roosevelt believed that electricity was of such vital importance to everyone that control over that resource meant virtual control over the public's money. Such power, he believed, should not be concentrated in powerful corporate entities. A study of public utilities by the FTC had been ordered under the Coolidge administration, and it was completed in early 1935 under the direction of Robert E. Healy, the general counsel of the FTC, who later came over to the SEC as a commissioner. The report, the well-known desire of Roosevelt to curb utility power, and the widely perceived popularity of controlling the monopoly power of the public utilities soon combined to produce several versions of public utility holding company bills in Congress, all of which called for the death sentence of the holding companies.

When the import of the bills was widely understood, the utilities and Wall Street began a strong and active lobby campaign to block passage and even enlisted the support of the shareholders who believed that the death sentence would erode their stock values. Congress found itself caught in the middle and sought the safe harbor of requiring utility holding company disclosure, keeping the death sentence in the bill, but making the SEC the arbiter.

The Public Holding Company Act of 1935 also contained a mandate for the SEC to study the functions and activities of investment trust and investment companies. The reports submitted to Congress formed the basis for the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940. The Trust

Indenture Act requires that publicly traded debt securities be issued only under a SEC-approved trust indenture and only when a trustee meeting certain minimum requirements is appointed. The two acts passed in 1940 govern the registration and disclosure of investment companies and advisers, prevent fraud in connection with investment companies and advisers, and define certain prohibited transactions. The registration/disclosure themes of all three of these acts are similar to the regulatory modes established in the 1933 and 1934 acts, although the three later acts have never achieved the same levels of importance as the first two enabling acts for the SEC.

1.3 The Regulatory Evolution of the SEC

As a result of both a number of congressional mandates and the interests of some of the early chairmen, a number of studies were undertaken by the SEC. Joe Kennedy and James Landis who succeeded Kennedy as chairman after only fifteen months persuaded William O. Douglas, one of the drafters of the 1933 act and a respected law professor at Yale, to head a study of corporate reorganization. That study was to be the basis for Chapter IX Bankruptcy legislation, under which the SEC acts as an advisor to the courts. At the same time the SEC staff studied investment companies, trust indentures, and the governance of stock exchanges. As mentioned earlier, the first two studies resulted in recommended legislation, but the latter report was submitted to Congress and recommended that no further legislation was needed for the proper regulation of the exchanges. By that recommendation the SEC reinforced its role as a disclosure and anti-fraud agency, not as a regulatory arm to restructure the marketplace. The SEC was to correct specific wrongs and maintain fair and orderly markets, not disrupt or reorganize the basic functionings of the capital markets.

It is interesting to note that the NYSE underwent some reorganization and reform in the late 1930s at the initiation of NYSE members and under the prodding of the SEC's third chairman, William O. Douglas. Chairman Douglas virtually threatened the NYSE with a SEC takeover if reforms were not instituted. Grudgingly the NYSE undertook a reorganizational effort that was speeded by an internal scandal. Richard Whitney, the leader of the old guard of the exchange actually was indicted for misappropriation of securities belonging to the NYSE pension trust fund. Reformers within the exchange were

Table 1.1 The changing size of the Securities and Exchange Commission

	Number of personnel ^a	SEC budget as a percent of total federal outlays
1935	369	0.0233
1936	879	0.0352
1937	1,121	0.0474
1940	1,587	0.0594
1945	1,130	0.0046
1950	1,062	0.0149
1955	692	0.0070
1960	952	0.0088
1965	1,393	0.0129
1970	1,388	0.0109
1975	1,911	0.0136
1976	1,987	0.0138
1977	1,912	0.0133
1978	1,955 ^b	0.0137
1979	2,015 ^b	na

Sources: *Report of the Secretary of the Treasury*, 1978, pp. 10–12; *Budget of the U.S. Government*, various years.

^aOn account of the data available, before 1945 the number of authorized positions is reported, and for the later years the average number of employees is reported.

^bEstimated.

able to accomplish considerable reforms. Further market declines in the late 1930s hardly made Wall Street a likely candidate for reform by zealous SEC regulators. Douglas resigned to take a seat on the Supreme Court in 1939. He was the last of the early influential leaders of the SEC.

Throughout the 1940s and 1950s the SEC almost disappeared from the regulatory scene, losing both budget and employees during the period, see table 1.1. After its dramatic growth in the 1930s and even with new regulatory responsibilities to administer in the 1940s, the SEC actually shrank until the 1960s. A staff of 1,600 in 1940 shrank to slightly over 1,000 by 1950 and to 690 in 1955. The agency was moved to Philadelphia during World War II and may not even have been missed. A series of chairmen during that period were hardly notable, and the SEC itself became known as the toothless tiger and a training ground for Wall Street securities lawyers.

The election of John F. Kennedy in 1960 coincided with the climax of a stock manipulation scandal on the Amex. Kennedy asked

former SEC Chairman Landis to prepare a report on the regulatory commissions. Completed late in 1960, the report was particularly critical of the SEC. Kennedy asked Congress to fund and oversee a special study of the securities markets. The special study completed in 1963, under the direction of Milton Cohen, resulted in the Securities Act Amendments of 1964 which extended the disclosure requirements of the securities of companies that trade over the counter, created more stringent standards for broker-dealers, and gave the SEC new powers to regulate the markets.

The special study and Kennedy's first chairman, William Cary, seemed to give the SEC new life, a revival in the New Deal tradition, but the weakness of the market in 1962 caused some moderation in the Kennedy-Cary reform effort. The SEC chairman under Johnson, Manuel Cohen, concentrated on enforcement and tended to ignore market regulation issues. President Nixon's first chairman, Hamer Budge, generally was regarded as pro-NYSE and did little to pursue regulatory reform despite exchange back office problems, financial failures of commission houses, demands for deregulation of fixed commission rates, challenges from the third market for market restructuring, and pressure from congressional oversight committees. The Securities Investor Protection Act (SIPA) of 1970 was passed by Congress to respond to the paper crunch problems and commission house failures in the late 1960s. Under Budge the SEC was viewed as so weak that, when the SIPA of 1970 was passed, a separate corporation was set up to protect investors outside of the SEC authority: the Securities Investor Protection Corporation.

The next two chairmen appointed by Nixon did little to change the direction of the SEC. William J. Casey restored the morale of the staff and encouraged their efforts to deregulate commission rates. G. Bradford Cook got caught up in Watergate improprieties and resigned after two and a half months in office. Ray Garrett, however, reasserted SEC leadership, encouraged more aggressive enforcement actions by Stanley Sporkin, chief of the Enforcement Division, and helped guide through Congress the 1975 amendments to the securities acts. Most of these amendments were to the Securities Exchange Act of 1934 and mandated the SEC, among other things, to eliminate anticompetitive exchange rules, deregulate commission rates, and facilitate the development of a national market system. The commission is still in the process of trying to carry out these mandates.

Roderick Hills, who was appointed by President Ford, initiated a

massive reexamination of the corporate disclosure requirements, under the direction of former Commissioner Albert A. Sommers. Hills also encouraged the developments of the fledgling stock options markets, and continued to carry out the mandates of the 1975 amendments, including fixed commission rate deregulation and facilitation of the development of the national market system. His tenure was less than two years, and many of his projects were left uncompleted. Chairman Harold Williams who was appointed by President Carter has discouraged the growth of the options markets, but it may be too early to discuss the influence of his chairmanship on the direction of the SEC.

1.4 Summary

The SEC, which came out of Roosevelt's New Deal, saw a burst of energy in the 1930s. The young agency, under the direction of such regulatory conservatives as Joe Kennedy, James Landis, and William O. Douglas developed a regulatory philosophy that pervades all of its jurisdictions. SEC regulation has as its central principles full disclosure, antifraud provisions, and self-regulation. The most important of the SEC acts today remain those first passed in 1933 and 1934.

The commission has throughout its tradition been expanded as the result of congressional or SEC staff studies. We find ourselves at a possible watershed for the future of the SEC. On the one hand, the SEC has successfully overseen the deregulation of the NYSE fixed commission rates, as mandated by the 1975 amendments. But, on the other hand, the national market system as mandated by these amendments seems far from determined, and some would say has foundered. In a similar vein the disclosure report begun under the leadership of Chairman Hills has not produced any cries for massive regulatory reform, as has often been the case with previous commission studies. Rather the premises of the original disclosure philosophy have not changed, and the basic message of the disclosure report is that we should expand the disclosure system.

Why do we observe these three very different regulatory phenomena in such an established regulatory agency? Before we can address these questions, a theoretical framework of regulation must be developed to allow a careful economic analysis of disclosure, fixed commission rates, and market structure.