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Stuart Banner

Washington University School of Law

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WHAT CAUSES NEW SECURITIES REGULATION? 300 YEARS OF EVIDENCE

STUART BANNER*

Computers are just the latest in a long series of technological innovations that have reduced the cost and increased the speed of transmitting information. At each previous step in the process, speculators have been very quick to take advantage of whatever was at the cutting edge of information technology. In the early 18th century, agents of speculators would race back to England with news of foreign wars, to be the first to use that information to buy or sell government debt.¹ In the winter of 1791-92, only a year or so after regular securities trading began in the United States, three express stagecoaches were running daily between New York and Philadelphia, and speculators were sending agents back and forth to arbitrage between prices in the two cities.² Securities traders were among the earliest to use the new inventions of the 19th century, first the telegraph and then the telephone.³ There are few areas of life, if any, where knowledge translates so directly into money as it does in the stock market. Whenever technological change has made information cheaper or faster to receive, speculators have been eager purchasers. In this respect, computers are nothing new.

Previous developments in information technology have *not* led to new securities regulation. There was a great deal of securities regulation in the 19th-century United States, but there were no bursts of new regulation that can plausibly be traced to the invention of the telegraph or the telephone. In earlier times, the development of faster stagecoach lines and faster ships was not followed by any new regulation.

Securities markets have existed in England and the United States for

* Associate Professor of Law, Washington University. Much of the material presented here is discussed in more detail in STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS 1690-1860* (Cambridge Univ. Press forthcoming 1998).

1. DANIEL DEFOE, *THE ANATOMY OF EXCHANGE-ALLEY: OR, A SYSTEM OF STOCK-JOBING* 3-4 (London, E. Smith 1719).

2. BENJAMIN RUSH, *THE AUTOBIOGRAPHY OF BENJAMIN RUSH* 217 (George W. Corner ed., 1948); 1 JOSEPH STANCLIFFE DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* 286 (1917).

3. ROBERT SOBEL, *THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET* 52-53 (1965); JOSEPH EDWARD HEDGES, *COMMERCIAL BANKING AND THE STOCK MARKET BEFORE 1863*, at 39 (1938).

over three hundred years, and they have been regulated by governments all the while. Information, meanwhile, has been growing cheaper and faster, often in bursts similar to the recent spread of computers. There has not been much of a relationship between the two developments. Unless there is something about computers that sets them apart from previous instances of technological change, this experience supports the prediction of Paul Mahoney⁴ and many of the other participants at this conference that the new technology of the late 20th century will have little effect on the regulatory framework for securities trading.

If new technology doesn't cause new securities regulation, what does? In a nutshell, crashes. All of the 18th-century English regulation, and even all of the 18th-century *proposed* regulation, came immediately after sustained price declines.⁵ The first significant American securities regulation, passed in 1792 in New York, followed the big crash of that year.⁶ And of course the federal securities acts of the early 1930s came soon after the crash of 1929. This is just a general trend, not an absolute rule. There have been sharp price declines without subsequent regulation, and of course there has been regulation without immediately preceding price declines. But most of the major instances of new securities regulation in the past three hundred years of English and American history have come right after crashes.

To understand why this is so, one needs to consider the history of popular thought concerning securities markets. As long as securities have been traded, Anglo-American popular culture has contained a few strands of thought suspicious of trading and hostile to speculators. The securities market has been widely thought to involve more deceit than markets in other items, because securities have been consistently perceived to be more susceptible to price manipulation than anything previously known. The political power of speculators—their incentive and perceived ability to nudge public policy in the direction that will push securities prices up or down—has been a constant source of public concern. The belief that securities trading is a nonproductive sphere of the economy, one that

4. Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH. U. L.Q. 815 (1997).

5. Prices dropped in 1720, 1733-34, 1746-48, 1753-56, 1758-62, and the early 1770s. PHILIP MIROWSKI, *THE BIRTH OF THE BUSINESS CYCLE* 235-38, 243, 247-48 (1985). Parliament considered new regulation in the early 1720s, 1733-34, 1746, 1756, 1771, and 1773.

6. N.Y. Laws, 15th Sess., ch. 62 (1792).

drains resources from more fruitful activities, has been ever present. These strands of thought were pervasive in England in the 1690s, and they are still pervasive in the United States today. Lynn Stout's paper at this conference is a particularly well-stated example of the last point.⁷ Ever since securities markets were invented, they have come under constant criticism for these reasons.

As long as the market has been rising or at least holding steady, however, these strands of thought have been kept in check by the simple fact that too many people have been making too much money to favor regulation restricting trading. But when prices drop, much of that opposition to regulation is removed. People who were proponents of securities trading in good times become critics in bad. The result, more often than not, is that new legislation gets introduced, and often that legislation gets passed. New securities regulation thus tends to follow crashes.

Lynn's paper demonstrates the persistence of some of these strands of thought, even when surrounding circumstances have forced changes in the precise arguments capable of being made by critics of speculation. From the beginning, many people argued, just as Lynn argues, that securities trading was harmful because it was a zero-sum game, in which repeat players could make consistent gains at the expense of wave after wave of neophytes. As Jonathan Swift saw the market in 1721,

One fool may from another win,
And then get off with money stored;
But if a sharper once comes in,
He throws at all, and sweeps the board.⁸

Thomas Gordon made a similar point a few years later, using the standard pejorative term for securities trading, "stock-jobbing," a word whose gradual disappearance from standard usage in the 19th century signalled an equally gradual transformation in the status of the stock market in popular consciousness. "[T]he Practice of Stock-jobbing," Gordon argued, consists of trying "to gratify the immoderate and insatiable Desires of some covetous and ambitious Persons, at the Expence

7. Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791 (1997).

8. Jonathan Swift, *Upon the South Sea Project (1721)*, in JONATHAN SWIFT: THE COMPLETE POEMS 209-10 (Pat Rogers ed., 1983).

of lessening the Substance, and procuring the irreparable Loss and Calamity of others.”⁹

This zero-sum redistribution of wealth was considered bad for three reasons. First, the losers were understood to be honest investors, while the winners were perceived as slightly shady characters. The redistribution thus had moral implications. That moral shading is still present to some degree in the popular conception of the stock market.

Second, the zero-sum nature of securities trading made it look very much like gambling, which of course already had a long history of being criticized largely for the same reason. “Stock-jobbing, properly speaking, is only another word for Gaming,” suggested Daniel Defoe, one of the prominent early proponents of regulation.¹⁰ A play about stock speculators, performed in London in 1720, contained the following verse:

Some rise, and some fall,
The Devil and all,
All Fools here their fortunes to try,
The Prospect is gain,
They ne'er can attain,
Like Gamesters at Hazard and Dy.¹¹

Third, people complained about what we would today call the opportunity costs of speculation. This zero-sum enterprise was absorbing a great deal of labor and capital, resources that could be more profitably used for productive purposes. In 1697, when the market was only a few years old, one critic already claimed that it was “to the Discouragement of the Trade of this Kingdom,” because it diverted “the [money] and Time of the Traders, whose Heads and Tongues being busied how to Outwit and Circumvent one another, are not at leisure to mind and follow their proper Trades and Callings.”¹² Every unit of labor expended in the stock market was one less unit left for the productive parts of the economy, as one poet lamented in 1720, the year of the South Sea Bubble.

9. THOMAS GORDON, AN ESSAY ON THE PRACTICE OF STOCK-JOBGING 2 (London, J. Peele 1724).

10. DANIEL DEFOE, THE GAMESTER: A BENEFIT-TICKET FOR ALL THAT ARE CONCERN'D IN THE LOTTERIES 12 (London, J. Roberts 1719).

11. EXCHANGE-ALLEY: OR, THE STOCK-JOBBER TURN'D GENTLEMAN; WITH THE HUMOURS OF OUR MODERN PROJECTORS 26 (London, T. Bickerton 1720).

12. A PROPOSAL FOR PUTTING SOME STOP TO THE EXTRAVAGANT HUMOUR OF STOCK-JOBGING 1 (1697).

But now th' old-fashion'd Ways are laid aside,
 And Men Post-haste to Wealth and Honour ride.
 Who to the Waves would ev'r intrust his Store,
 Or weltring lie in his own reeking Gore?
 Who flatter Courtiers? Who at Bar would plead?
 Torture a text, or sow the Teeming Seed?
 When one small Venture in the *South-Sea* Stocks,
 Exceeds the wealthiest Farmer's choicest Flocks[?]¹³

In the 18th century, people didn't yet speak of "transaction costs," but their overall point was the same as the point Lynn is making.¹⁴ Securities speculation added nothing to the national wealth—it was a zero-sum game—but it entailed costs, and so in the aggregate it was harmful.

This way of thinking crossed the Atlantic, and reappeared in the United States when the first American securities markets began operating in the 1790s. "Ships are lying idle in the wharfs," Thomas Jefferson complained in 1791, "buildings are stopped, capitals withdrawn from commerce, manufactures, arts, and agricultures, to be employed in gambling" in stocks.¹⁵ The same year, an anonymous New York poet observed:

The humble arts are fairly now contemn'd,
 And honest Commerce in derision's nam'd;
 'Tis found a far more profitable job
 To pilfer private men—the public rob.¹⁶

From the beginning of securities trading in the United States over two hundred years ago, many people shared Lynn's concern that speculation was wasteful.

Lynn differs from her predecessors, however, in that she is working within a very different intellectual climate. Eighteenth-century critics inhabited a culture in which it was widely believed that *all* internal trade was a zero-sum game.¹⁷ As a resident of colonial Massachusetts put it,

13. J.B., A POEM OCCASION'D BY THE RISE AND FALL OF *SOUTH-SEA* STOCK 11 (London, Samuel Chapman & John Williams 1720).

14. Stout, *supra* note 7, at 797.

15. Letter from Thomas Jefferson to Edward Rutledge (Aug. 25, 1791), in 25 THE PAPERS OF THOMAS JEFFERSON 74 (Julian P. Boyd et al. eds., 1950-).

16. THE GLASS; OR, SPECULATION: A POEM 4 (New York 1791)

17. J.E. CROWLEY, THIS SHEBA, SELF: THE CONCEPTUALIZATION OF ECONOMIC LIFE IN EIGHTEENTH-CENTURY AMERICA 86-88 (1974); JOYCE OLDHAM APPLEBY, ECONOMIC THOUGHT AND IDEOLOGY IN SEVENTEENTH-CENTURY ENGLAND 158-64 (1978).

If the same Goods are bought by *Ten Persons* one after another, each of those *Ten Persons* aims at Gain in passing thro' his hands, . . . yet the *Province* or *Publick* is not enrich'd *one Farthing* by their Labour. . . . Their meer *handing of Goods one to another*, no more increases any Wealth in the Province, than *Persons at a Fire* increase the *Water in a Pail*, by passing it thro' *Twenty* or *Forty* hands.¹⁸

Actually making something, or exporting something, was an activity understood to add to the national wealth. Internal trade was not.

Securities trading fell within this general presumption that internal trade was not productive. Eighteenth-century critics focused on the same features of securities Lynn focuses on—they are much easier to buy and sell repeatedly than anything that had ever been traded before, because storage costs are negligible, they do not deteriorate, and they cannot be consumed. For 18th-century critics, however, this ease of circulation exacerbated a wastefulness that was already present, even in internal trade in other kinds of goods.

Lynn, of course, lives in a very different climate. The general assumption within the subculture of late 20th-century economists and law professors is that internal trade *is* productive, in the sense that it adds to national wealth. So Lynn has a much more difficult argument to make. She cannot argue that the increased velocity of trading associated with securities merely causes a *quantitative* difference in social harm—i.e., that since trading is wasteful, more trading is more wasteful. Instead, she has to identify a *qualitative* difference. She has to separate trading into categories, and argue that some categories are productive and others are not. So while Lynn is making a very old argument, the argument necessarily has to include a step that did not need to be made in the 18th century. While her task is harder in this sense, it is easier in that she has a much wider array of tools to work with than people did in the 18th century—portfolio theory, the concept of transaction costs, and so on. Lynn is thus able to make distinctions that could not have been made before the 20th century. The core of her argument is three hundred years old, but changes in the surrounding intellectual environment have forced

18. THE PRESENT MELANCHOLY CIRCUMSTANCES OF THE PROVINCE CONSIDER'D, AND METHODS FOR REDRESS HUMBLY PROPOSED 6-7 (Boston, B. Gray & J. Edwards 1719).

modifications in the details.

Arguments like Lynn's are as old as securities markets. In the past three hundred years, they have periodically persuaded governments to regulate the market so as to restrict trading. Such episodes of regulation have been closely linked to price declines. If one wants to know what future event would be most likely to persuade governments that Lynn is right, the answer is *not* new developments in information technology. The answer is a crash.

