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Break from Tradition: Questioning the Primacy of Self-Regulation in American Securities Law

John I. Sanders
Kilpatrick Townsend & Stockton LLP

BREAK FROM TRADITION: QUESTIONING THE PRIMACY OF SELF-REGULATION IN AMERICAN SECURITIES LAW

*John I. Sanders**

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INTRODUCTION

The history of Anglo-American securities law is much lengthier than one might imagine.[1] It dates, at least, to the thirteenth-century trading of bonds and securities of government-sanctioned corporations in England.[2] By 1700, there was English legislation specially designed "to protect investors against unscrupulous manipulation by stock jobbers and stock brokers."[3] There is no evidence, however, that any American colony enacted securities laws or regulations before the American Revolution.[4]

Around the time of the American Revolution, there were thriving stock exchanges in several major colonial port cities.[5] Philadelphia had the largest exchange in the colonies, followed closely by New York.[6] Following the English tradition, these exchanges met in coffee houses.[7] In New York, for example, the coffee house primarily used by brokers was aptly named the "Merchant's Coffee House."[8] These stock exchanges

* John I. Sanders is an associate at Kilpatrick Townsend & Stockton LLP. His practice focuses on business and finance, securities, and mergers and acquisitions.

1. *See, e.g.*, *Securities Law History*, CORNELL L. SCH. LEGAL INFO. INST., https://www.law.cornell.edu/wex/securities_law_history (last visited Feb. 1, 2016) (explaining, quite mistakenly, that securities law history is primarily the study of the New Deal statutes with some background material pulled from the Blue Sky laws) [hereinafter Cornell History].

2. THOMAS LEE HAZEN, BROKER-DEALER REGULATION IN A NUTSHELL 13 (2d ed. 2011).

3. *Id.*

4. Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L. REV. 849 (1997).

5. Andrew Beattie, *The Birth of the Stock Exchanges*, INVESTOPEDIA, http://www.investopedia.com/articles/07/stock-exchange-history.asp (last visited Jan. 12, 2016).

6. *Id.*

7. *Id.*

8. *Id.*

seem to have operated smoothly until a stock manipulation scandal roiled the New York market in 1792, inspiring a legislative response that would forever change the trajectory of American securities law.[9]

This Comment outlines the circular path of American securities law—one that begins and ends with the primacy of self-regulation. Part I of this paper describes American securities law between 1792 and 1911 (the "Buttonwood Era"). In this era, a group of New York stock brokers utilized private contract law to create securities regulation for their private club, thereby establishing a tradition of self-regulation. Part II describes a short period of history in which individual states attempted to regulate the securities market through state statutes, the so-called "Blue Sky Laws." Part III details the creation of the federal securities law regime during the New Deal Era. Part IV describes the transition from centralized federal regulation of the securities industry to the return of the primacy of self-regulation. Part V serves as the paper's conclusion.

Part I: The Buttonwood Era and the Foundations of Self-Regulation

The New York stock broker scandal of 1792 brought about the first known securities law in American history.[10] The statute, passed by New York's legislature and signed into law by Governor George Clinton on April 10, 1792, was titled "An Act to prevent the pernicious practice of Stock-Jobbing, and for regulating sales and public auctions."[11] The statute was designed to restrict the trade of stocks by unscrupulous persons.[12] To that end, it limited the number of public auctioneers to no more than twenty-four at a time.[13] As a result, the statute immediately created a schism within the community of stock brokers in New York City.

Before the New York legislature successfully passed the April 1792 statute, a small group of stock brokers responded to the scandal by instituting a new public stock exchange at 22 Wall Street in March of 1792.[14] When the New York statute severely limited the public auctioning of stocks, however, the brokers devised a new plan.[15] They met at Corre's Hotel to draft an agreement that would create and govern a *private* stock exchange.[16] This agreement—now known as the Buttonwood Agreement—began the American securities law tradition of self-regulation.[17]

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9. *See generally* Banner, *supra* note 4, at 850.

10. *See Id*.

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

12. *Id.*

13. *Id.*

14. Robert Irving Warshow, The Story of Wall Street 31 (1931).

15. N.Y. Laws, *supra* note 11.

16. Warshow, *supra* note 14, at 32.

17. Daniel Gallagher, *Time for a Fresh Look at Equity Market Structure and Self-Regulation*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Oct. 19, 2012), https://

Under the Buttonwood Agreement, the exchange members adopted the principles of New York contract law to regulate their new private exchange.[18] The terms of the agreement were quite short, consisting of a single paragraph.[19] The terms stated that the twenty-four signatories would charge a set minimum rate in the trading of stock and give each other preference in the trading of stock.[20] The agreement also "effectively limited membership . . . to the wealthier financiers in New York," who would provide regular market liquidity.[21]

The key to the agreement was a set of three principles. The first principle was to list stocks for sale on the exchange that were actually marketable (i.e., desirable). Due to the wealth and influence of its members, the market governed by the Buttonwood Agreement attracted the issuers necessary to achieve this goal.[22] The second crucial aspect of the agreement was its prohibition of extra-exchange dealing by member brokers. The text of the Buttonwood Agreement "wouldn't allow brokers to trade listed securities anywhere except the exchange."[23] The third pivotal element of the agreement was the tight control of broker membership in the exchange. From the beginning, "[t]he 'private club' character of the Exchange made no guarantee of admission" and barred bad actors.[24] By regulating itself according to these principles, the exchange became the dominant securities market in the United States.[25]

While a substantial portion of the "public stock" traded in the years between the American Revolution and the War of 1812 was "the same as modern government bonds," bank shares were occasionally traded as well.[26] Many of the listed securities had connections to the era's most prominent politicians, and these connections were a source of great intrigue. Treasury Secretary Alexander Hamilton, for instance, had connections to bond syndicates in New York, Philadelphia, and Boston.[27]

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corpgov.law.harvard.edu/2012/10/19/time-for-a-fresh-look-at-equity-market-structure-and-self-regulation/.

18. Richard G. Kethum, *The Fifth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law,* 10 FORDHAM J. CORP. & FIN. L. 203 (2005).

19. RICHARD J. TEWELES, EDWARD S. BRADLEY & TED TEWELES, THE STOCK MARKET 109 (6th ed. 1992).

20. *Id.*

21. Jerry W. Markham, *High-Speed Trading on Stock and Commodity Markets – From Courier Pigeons to Computers*, 52 SAN DIEGO L. REV. 555, 578 (2015).

22. Gallagher, *supra* note 17.

23. Floyd Norris, *ICE Deal for NYSE Creates Global Powerhouse*, N.Y. TIMES (Dec. 20, 2012), http://www.nytimes.com/2012/12/21/business/global/ice-deal-for-nyse-creates-global-powerhouse.html?_r=0.

24. Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J. L. ECON. & POL'Y. 311, 319 (2008).

25. Beattie, *supra* note 5, at 3.

26. WARSHOW, *supra* note 14, at 31.

27. *Id.* at 23.

Additionally, his chief legislative aide in the United States Senate, Robert Morris, was the head of the largest syndicate.[28] Possessing material non-public information, these gentlemen were rumored to make millions of dollars off of securities market transactions.[29]

Despite opposition, government and Wall Street continued to intermingle in ways that might seem unconscionable to modern Americans.[30] For example, Hamilton's service as Secretary of the Treasury "made it possible for his friends and political allies to make millions" off of material non-public information.[31] His political opponents, not to be outdone, opened rival trading operations on Wall Street.[32] The man who would later kill Alexander Hamilton in a duel, Aaron Burr, opened the Manhattan Company at 23 Wall Street for that very purpose in the 1790s.[33] Perhaps the success of early American political leaders within the securities market is one reason the tradition of self-regulation went unchecked.

Despite the pervasive use of insider information, the 1792 Buttonwood Agreement "was stringently enforced" by its members.[34] As scholar Robert Warshow notes, "So effective were its provisions, that not until 1817 was any more formal or detailed written agreement considered necessary."[35] Changes in stock market regulation were finally shown to be necessary by the advent of demands associated with the War of 1812. The flurry of issuances and activity on the exchange during the war elevated the exchange's profile. *The New York Commercial Advertiser,* a newspaper, began to carry a complete listing of exchange quotations in 1815.[36] The exchange list included government bonds as well as stocks of at least seven banks and a manufacturing company.[37]

Some exchange members believed reforms were necessary to deal with the higher demand for federal debt securities catalyzed by the War of 1812.[38] On February 25, 1817, a resolution changed the name of the exchange to the New York Stock Exchange Board ("NYSE").[39] On May 8th, a new board of directors was elected and new rules were written for

28. *Id.* at 26.

29. *Id.* (citing a *New York Daily Advertiser* article claiming that Robert Morris alone stood to make $18,000,000 off of one deal).

30. *Id.* at 35–36 (naming James Madison and Thomas Jefferson as among the most vocal critics).

31. *Id.* at 50.

32. *Id.* at 43–44.

33. *Id.* at 47.

34. *Id.* at 32.

35. *Id*.

36. *Id.* at 59.

37. *Id.* at 60.

38. *See* Stuart Banner, *The Origins of the New York Stock Exchange, 1791–1860*, 27 J. Legal Stud. 113, 115 (1998).

39. Warshow, *supra* note 14, at 60.

the NYSE.[40] These new rules, numbering seventeen in all, are known as the "1817 Constitution."[41]

The 1817 Constitution departed from the Buttonwood Agreement by including specific rules "to govern trading and admission of new members."[42] It also gave the NYSE, for the first time, the ability to discipline its members for misconduct.[43] Specifically, the new rules held that "members could be fined for certain infractions" and that "any member who did not comply with [NYSE] rules could be expelled with a two-thirds vote of the membership."[44]

Through the nineteenth century, the role of the NYSE in the national economy greatly expanded.[45] Increased listings, volumes of trades, and membership were met in turn with heightened NYSE self-regulation. During the nineteenth century, the NYSE operated a "miniature legal system."[46] The agreement between members and the NYSE guaranteed brokers orderly executions of transactions, assurance of the counterparty's creditworthiness, access to knowledge about the market, and a ready mechanism for resolving disputes.[47] As before, the NYSE relied on New York state contract law to enforce these rules.[48]

Notably, the particular rules adopted by the NYSE during the nineteenth century share similarities with modern securities law. The NYSE had "its own rules governing securities trading and its own mechanism for resolving trade-related disputes."[49] Additionally, it ordained a body called the Governing Committee to exercise legislative, judicial, and executive power within the NYSE.[50] This body was known to require "more rigid obedience to its doctrines than any governmental banking department" of the late nineteenth or early twentieth centuries.[51]

The Governing Committee acted forcefully in the nineteenth century to maintain the NYSE's reputation as a high-quality business when the "more speculative [stocks] were driven off the NYSE . . . by the NYSE's

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40. *Id.* at 61.

41. *See* Banner, *supra* note 38, at 115.

42. *Id.* at 115.

43. Alan Lawhead, *Useful Limits to the Fifth Amendment*, 2009 Colum. Bus. L. Rev. 210, 214–15 (2009).

44. *Id.*

45. *See* Banner, *supra* note 38, at 119.

46. *Id.* at 132.

47. *Id.* at 120–21, 123, 125.

48. *See* William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace – Revisited*, 23 Ann. Rev. Banking & Fin. L. 727, 728 (2004).

49. Banner, *supra* note 38, at 132.

50. Warshow, *supra* note 14, at 344.

51. *See id.* at 344.

high-cost commission structure."[52] In light of this phenomenon, the NYSE adopted one of its most significant quality control rules in 1863.[53] The rule required listed companies to "disclose financial information, operate with more transparency, associate with local bankers, and issue annual reports."[54] Ultimately, the NYSE began to specify "certain minimum behavioral and reporting requirements that each issuer must meet before the [NYSE] would even consider listing" the issuer's securities.[55] By the end of the nineteenth century, "listing on the NYSE came to represent a sort of 'NYSE-seal-of-approval' " that unsophisticated investors could rely on.[56] Evidence suggests that these efforts to vet issuers were quite successful.[57]

The NYSE also adopted rules that enhanced market integrity. For example, brokers were required to "stand by their posts on a regular basis" to make a market (i.e., stand ready to trade) in the listed securities.[58] This requirement remained as operating hours expanded[59] so that the NYSE operated on a "dependable, continuing basis."[60] Another rule enhancing market integrity stated that those engaging in fictitious trades would be expelled.[61]

Of course, it was not always a world of law and order at the NYSE. The nineteenth century gave rise to the first market manipulators and the first known short-sellers.[62] In this environment, the sophisticated process of justice envisioned by NYSE rules did not always come to fruition. After falling victim to a swindle, for example, Cornelius Vanderbilt wrote the following note to a member of the NYSE: "Gentlemen, you have undertaken to cheat me. I will not sue you because the law takes too long. I will ruin you. Sincerely yours, Cornelius Vanderbilt."[63]

Those individuals with greater patience than Vanderbilt had the option of bringing a claim before the NYSE's membership or the New York state court. While both options were available, the NYSE "represented an alternative to the official legal system that was probably faster and less

52. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control,* 111 Yale L.J. 1, 36 n.107 (2001).

53. *See* Brian Murphy, *The Rise of an American Institution: The Stock Market*, Gilder Lehrman Inst. of Am. History, https://www.gilderlehrman.org/history-by-era/economics/essays/rise-american-institution- stock-market (last visited Jan. 12, 2016).

54. *Id.*

55. Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. Ill. L. Rev. 315, 317 (1985).

56. *Id.*

57. *See* Warshow, *supra* note 14, at 344.

58. Macey & Haddock, *supra* note 55, at 317.

59. Warshow, *supra* note 14, at 70.

60. Macey & Haddock, *supra* note 55, at 317.

61. Banner, *supra* note 38, at 139.

62. Warshow, *supra* note 14, at 63–64.

63. *Id.* at 89.

costly, and in which one was assured of more knowledgeable decision makers."[64]

Those who chose to bring a claim in New York state courts found the NYSE was given special deference. In fact, New York state courts expressly affirmed the power of the NYSE to make and enforce private securities laws.[65] Accordingly, appeals of the NYSE's decisions were "strictly limited."[66] An appeal would fail so long as the NYSE had acted within its own constitution and with good faith.[67] The basis of this view was that the NYSE's identity as a "voluntary association of individuals" with freedom of contract required the court's recognition and respect.[68]

History reveals that the nineteenth century was a period in which the NYSE had no regulatory rival in local, state, or federal government. In 1836, for example, the New York Senate passed a bill that "would have prohibited the NYSE from closing its trading sessions to non-member traders."[69] The NYSE, however, prevented this result by sending members to Albany to lobby against the bill.[70] On several more occasions "in the 1830s and 1840s, the NYSE succeeded in defeating similar bills."[71] Thus, the tradition of self-regulation was reinforced throughout the nineteenth century.

The Buttonwood Agreement "established the NYSE as a self-regulatory organization controlled by its membership."[72] Its apparent success and the efforts of its members to prevent legislative interference established self-regulation as an unquestioned tradition in the United States' primary securities market. The primacy of self-regulation only came into question after a series of public scandals harmed middle-class Americans. Such scandals swept across the country in the early years of the twentieth century and spurred state legislatures to undertake earnest regulation of the securities industry for the first time.

PART II: THE BLUE SKY LAWS ERA

For well over a century, the NYSE remained a relatively exclusive club capable of resisting "the efforts of outsiders to dictate its policy or of governmental agencies to supervise its activities."[73] At the start of the twentieth century, however, the stock market began to attract a flood of middle-

64. Banner, *supra* note 38, at 126.
65. Lawhead, *supra* note 43, at 215.
66. *Id.* at 215.
67. *Id*.
68. *Id*. (citing Cohen v. Thomas, 209 N.Y. 407, 410 (N.Y. 1913)).
69. Markham, *supra* note 21, at 578.
70. *See* Banner, *supra* note 38, at 131.
71. *See id.* at 130.
72. Kethum, *supra* note 18, at 207.
73. WARSHOW, *supra* note 14, at 338.

class investors.[74] The early twentieth century introduced middle-class Americans to "new means of getting rich without working" through securities speculation.[75] More than fifteen million Americans were stock market investors by 1922.[76] In those areas far from Wall Street, "promotional and manipulative swindling in connection with stocks and bonds flourished."[77] When novice investors were defrauded, they demanded "constitutional and statutory provisions" to regulate the securities industry.[78]

Fraud in the securities market reached new heights during World War I with the introduction of two schemes. The first of these concerned "liberty bonds" issued by the United States government during the war.[79] Notably, many Americans participated in the securities market for the first time through Liberty Bond investments.[80] Unfortunately, con-men took advantage of many of these novice investors by inducing them to exchange their government-backed Liberty Bonds for valueless corporate stock.[81]

The other scheme concerned "watered stock."[82] Watered stock is "issued with a value much greater than the value of the issuing company's assets."[83] Essentially, stock brokers would solicit substantial investments from retail investors for a company with no assets. Allegedly, these stocks represented "nothing but blue sky—nothing terrestrial or tangible."[84] This notion would supply the name for the new state securities laws—the Blue Sky Laws.

The first state to pass a Blue Sky Law was Kansas in 1911.[85] Initially, there was a great deal of enthusiasm in the states regarding the passage of Blue Sky Laws.[86] By the end of 1913, over twenty states enacted Blue Sky

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74. *See id.* at 332.

75. *Id.*

76. *Id.*

77. Forrest B. Ashby, *The Operation of Blue Sky Laws,* 1 TEMP. L.Q. 103, 103 (1927).

78. William W. Cook, *"Watered Stock" – Commissions – "Blue Sky Laws" – Stock Without Par Value,* 19 MICH. L. REV. 583, 588 (1921).

79. *See* WARSHOW, *supra* note 14, at 332.

80. *See id.*

81. JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492-1900) 85 (2002).

82. Cook, *supra* note 78, at 588.

83. *Watered Stock,* INVESTOPEDIA, http://www.investopedia.com/terms/w/wateredstock.asp (last visited Feb. 3, 2016).

84. Cook, *supra* note 78, at 590.

85. H.S. Richards, *Watered Stock and Blue Sky Legislation*, 2 WIS. L. REV. 86, 91-92 (1923).

86. *See generally* Lee. J. Perrin, *The "Blue Sky Laws"*, 10 BENCH & B. N.S. 483, 483-84 (1916).

Laws of their own.[87] By 1923, the count rose to forty-one,[88] and by 1927, forty-six of forty-eight states had adopted Blue Sky Laws.[89]

Generally, the Blue Sky Laws introduced "a prohibition under severe penalties against selling, offering for sale, or negotiating for the sale of securities within the state" until a filing was made.[90] This requisite filing contained information from which the designated state agency would determine whether "the seller and the securities conform to certain prescribed general standards."[91] It amounted to an "elaborate system of licenses based upon inspection and examination."[92] Such a system, though novel, was deemed appropriate because a similar approach had been taken with respect to plumbers, pharmacists, doctors, and lawyers.[93]

While most states constructed similar basic licensing systems, there was still a wide variety of experimentation from one state to another. For example, the laws of some states, including California, reached stockbrokers and securities dealers.[94] Others, like North Carolina, required a showing that the business issuing the stock was "safe and solvent" before a license would be granted.[95] At least one state classified each proposed security as either a growth or value stock and required different disclosures from issuers depending on the classification of their stock.[96]

Before long, various plaintiffs began challenging the constitutionality of certain states' Blue Sky Laws.[97] A 1914 case in the Northern District of West Virginia, for example, held that the state's Blue Sky Law was unconstitutional because it imposed "a restraint and burden upon interstate commerce."[98] Another case invalidated a Blue Sky Law on due process grounds because the securities transactions "were not properly within the state police power."[99] In total, six lower federal courts held Blue Sky Laws to be unconstitutional.[100]

One commentator, Lee Perrin, noted that it was "in accord with precedent and the workings of our government that the discovery or realization of a prevalent economic ill should be followed by a veritable fusillade of state laws, unworkable from a practicable standpoint and unjustifiable

87. *Id.*
88. *See* Richards, *supra* note 85, at 92-93.
89. *See* Ashby, *supra* note 77, at 103.
90. Perrin, *supra* note 86, at 484.
91. *Id.*
92. Richards, *supra* note 85, at 87.
93. *Id.* at 87-88.
94. Perrin, *supra* note 86, at 484-85.
95. *Id.* at 485.
96. Richards, *supra* note 85, at 96.
97. Perrin, *supra* note 86, at 486-88.
98. Bracey v. Darst, 218 F. 482, 496 (N.D. W. Va. 1914).
99. Perrin, *supra* note 86, at 489.
100. Ashby, *supra* note 77, at 103.

constitutionally."[101] Perrin, nonetheless, believed the states would work their way to "comparatively well-considered and practicable laws."[102] This view would prove to be correct. By 1916, state laws had been so amended that the Supreme Court of the United States would validate them in a set of three opinions.[103]

With the question of constitutionality removed, states continued to experiment with Blue Sky Laws. One area of experimentation was in the realm of securities market administration. This area of securities law sought "to prevent fraud before its perpetration by supervising, through a state securities commission, either sellers of securities or the securities themselves."[104] The initial results from the Kansas Blue Sky Law suggested that it, in fact, did prevent fraud. This conclusion was based on the fact that a large number of registrants "suddenly changed their minds and withdrew their applications" when they learned of the state's requirements.[105] A study from 1927 showed a "decline in both the number of applications and the percentage of rejections," evidence of the effectiveness of the laws.[106]

The other area of experimentation was in legislation to prevent securities fraud.[107] These anti-fraud laws sought to "prevent financial chicanery by following and punishing securities swindlers."[108] Nearly all Blue Sky Laws provided that prosecutions could be originated by the state attorney general or a county prosecutor.[109] In addition, most allowed individual investors to bring civil actions against those who had defrauded them.[110] While states seem to have been zealous in prosecuting securities market misdeeds, records suggest that prosecutions failed because the cases were "administered by prosecutors and courts inexperienced in corporate finance."[111]

The Blue Sky Laws were considered a step in the right direction, but it was evident that state regulation was insufficient. The most pressing problems were the following: (i) states' inability to stop fraudsters operating by mail; (ii) state and local prosecutors' lack of necessary expertise to

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101. Perrin, *supra* note 86, at 496.

102. *Id.*

103. *See* Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Merrick v. Halsey & Co., 242 U.S. 568 (1917).

104. Ashby, *supra* note 77, at 103-04.

105. E.R. Chapman, *The Initial Financing of an Enterprise,* THE BRIEF, 1912, at 211, 217.

106. Ashby, *supra* note 77, at 105.

107. *See id.* at 103-04.

108. *Id.*

109. *Id.* at 107.

110. *Cf. id.*

111. *Id.* at 103.

successfully prosecute securities law cases; and (iii) the states' lack of necessary resources to properly monitor the secondary securities markets.[112]

Even where resources were sufficient, motivation to police the market was often lacking.[113] This phenomenon likely sprung from the states' tendency to write competing laws. In fact, one commentator argued that states were engaging in a race to the bottom in an effort to attract securities issues.[114] He wrote, "The chief difficulty lies in the rivalry of the states" attempting to attract business.[115] After a while, it became apparent to some that amending the existing Blue Sky Laws would not be sufficient to end the practice of securities fraud.

As early as 1920, there were calls for a national solution to the growing problem of securities fraud.[116] National solutions progressed down two distinct tracks. One such track was the drafting and adoption by the states of a uniform securities law.[117] A uniform statute adopted by each of the states would have solved one of the major problems of the Blue Sky era—large offerings requiring a multistate solicitation were required to navigate a patchwork of unique state laws.[118] A uniform securities law, which would have been widely applied and interpreted, may have also helped courts and prosecutors develop the necessary expertise to successfully try securities fraud cases. The National Conference of Commissioners on Uniform State Laws produced an initial draft of the Uniform Sale of Securities Act in 1924.[119] The act was promulgated in 1930, but was not met with much enthusiasm by the states, and only five adopted it.[120]

The other track taken by those who wished to improve upon the Blue Sky Laws was via the passage of a federal securities law under Congress' authority to regulate interstate commerce.[121] This alternative was viewed as having three principal benefits. First, a federal scheme should be more effective at stopping "mail swindlers" than independent enforcement by the states.[122] Next, many believed that a federal investigatory body would be more proficient at prosecuting sophisticated securities frauds than the "underpaid, overworked, inexperienced, or venal district attorneys" re-

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112. *See id.* at 111-16.

113. *See* Richards, *supra* note 85, at 91.

114. *See id*.

115. *Id.*

116. *See* Robert S. Stevens, *Stock Issues Under the Uniform Business Corporation Act,* 13 CORNELL L.Q. 399 (1928); *Hearing on H.R. 188 Before the H. Comm. on the Judiciary*, 66th Cong. 1 (1919) [hereinafter *1919 Hearing*].

117. *See* Stevens, *supra* note 116, at 417.

118. *See* Ashby, *supra* note 77, at 111.

119. Stevens, *supra* note 116, at 417.

120. Richard W. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROBS. 194, 220, 221 n.168 (1958).

121. *See* Herman Goralnik, *Securities as Subjects of Interstate Commerce*, 19 ST. LOUIS L. REV. 69 (1933).

122. *Id.* at 69.

sponsible for enforcing the Blue Sky Laws.[123] Third, a federal law would present benefits to issuers, which had struggled to conduct multi-state offerings under the patchwork of Blue Sky Laws.[124]

PART III: A FEDERAL SECURITIES LAW

The first promising attempt to pass a federal securities law was made in 1919 by Senator William S. Kenyon of Iowa.[125] The proposed bill, referred to as the "Federal Stock Publicity Act,"[126] regulated, by way of federal registration, any company organized for or with the power to engage in interstate commerce that wished to make an interstate offering of shares.[127] It was reported at the time that the bill was "strongly supported."[128] Indeed, President Woodrow Wilson had endorsed the bill in a Congressional address by stating that "its adoption would serve a great and beneficent purpose."[129]

During the hearings regarding the Kenyon Bill in 1919, several state commissioners testified in support of the national bill. The Secretary of State for Tennessee argued that the sale of all securities should be "supervised by some department of the Federal Government."[130] James R. Young, insurance commissioner of North Carolina, testified, "I know of no law upon our statute books that can be made of greater value to the people than [a national securities] law."[131] Law review articles were also written in support of a federal securities law.[132] Congress, however, did not adopt the bill due to a concern that the bill represented an unauthorized exercise of Congress's Article I commerce power.[133]

After the failure of Senator Kenyon's bill, both interstate stock fraud and political progressives' desire to pass a federal securities law continued to grow. Accordingly, in 1922, Congressman Edward E. Denison of Illinois introduced another federal securities bill.[134] Congressman Denison, cognizant of the constitutional concerns that derailed the Kenyon proposal, carefully introduced his own bill to the Senate Committee on Interstate Commerce. Congressman Denison articulated its constitutional

123. Ashby, *supra* note 77, at 114. *See* Watson Washburn, *Control of Securities Selling*, 31 MICH. L. REV. 768, 775 (1933).

124. *See* Ashby, *supra* note 77. at 111.

125. *1919 Hearing, supra* note 116.

126. *Id.* at 3.

127. *Id*. at 4.

128. Richards, *supra* note 85, at 93.

129. *1919 Hearing, supra* note 116, at 12.

130. *Id.* at 9.

131. *Id.* at 8.

132. *See* Richards, *supra* note 85, at 102.

133. Regulating Sale of Securities: Hearing on H.R. 10598 Before the H. Subcomm. Of the Comm. On Interstate Commerce, 67th Cong.11 (1922) [hereinafter *1922 Hearing*].

134. *Id.* at 1.

purpose, stating, "The State securities laws are sufficient to regulate the sale of securities and prevent the sale of fraudulent and worthless securities within [the states'] respective borders, they cannot, of course, control interstate commerce in such securities."[135] He argued that this federal securities law was necessary to prevent 500 million dollars per year of fraudulent securities transactions from passing through interstate commerce, and thus, the bill was constitutionally permissible as an exercise of the commerce power.[136]

To further address constitutional concerns, Denison stressed the limited nature of his bill. In a seeming nod to the autonomy of the states and their police forces, Denison told the Senate subcommittee that "preventing the sale of fraudulent and worthless securities is a matter that belongs properly to the states themselves."[137] He clarified that the bill simply made it a crime to use "mail and other agencies of interstate commerce" in the sale of fraudulent securities.[138] He noted that a more sweeping bill calling for a federal securities commission and federal registration of securities was abandoned after consultation with state regulators and industry experts.[139] Denison then bragged that his new bill was so limited it would not "provide for a new bureau" or even "create a single job."[140]

The Denison Bill, perhaps because of its limited nature, received strong support from the states and the financial industry.[141] The American Investment Bankers' Association supported the bill.[142] Both the NYSE[143] and the New York Curb Market also approved of the bill.[144] Additionally, the state commissioners responsible for enforcing Blue Sky Laws supported the Denison Bill and actively participated in its drafting.[145]

Despite this support, the Denison Bill met considerable opposition. Samuel Adams, appearing before the subcommittee as a member of the brokerage firm Jones and Baker, believed that the act "was not a wise one."[146] Mr. Adams stated that although it was "advocated as if it were a gentle, lovely, remedial act," it actually was "a very savage" act.[147] He took issue with the slate of exemptions from registration within the bill.

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135. *Id.* at 2.
136. *Id.* at 3.
137. *Id.*
138. *Id.* at 5.
139. *Id.* at 6.
140. *Id.* at 3.
141. *See id.* at 63.
142. *Id.* at 4.
143. *Id.* at 112.
144. *Id.* at 34.
145. *Id.* at 63.
146. *Id.* at 53.
147. *Id.* at 54.

He described the cumulative effect of the bill to be that "Wall Street . . . can issue or do anything they choose, and other people cannot."[148] Franklin Leonard Jr., appearing on behalf of the San Francisco Stock Exchange, agreed that Wall Street was getting unreasonable exemptions from the bill's measures.[149]

During the 1920s, as the Denison Bill was under consideration in Congress, securities fraud was declared "irredeemable because of the deficiencies of state corporate law."[150] Still, securities regulation was not a national priority. The majority of the nation seemed to prefer laissez-faire economic policies, as suggested by the statement of popular president, Calvin Coolidge, that "[t]his is a business country . . . and it wants a business government."[151] The Denison Bill passed the House almost unanimously, but never made it out of the Senate Judiciary Committee.[152]

Although multiple bills were introduced between 1919 and 1927,[153] another serious attempt at passing a federal securities law was not made until 1932.[154] By then, the nation had experienced a terrible stock market collapse and had fallen into the period now known as the "Great Depression."[155] Between September 1, 1929 and July 1, 1932, the market capitalization of the NYSE fell from $90 billion to $16 billion.[156] In March of 1932, with a general election ahead, both Republicans and Democrats on the Senate Banking Committee announced their desire for "necessary remedial legislation."[157] Even President Herbert Hoover, a staunch advocate of the laissez-faire treatment of markets, called for national securities legislation.[158]

While the stock market collapse put securities regulation back on the congressional agenda, the Pecora Hearings, so-named for the counsel of the Senate Banking and Currency Committee, Ferdinand Pecora, were instrumental in moving national sentiment in favor of regulatory reform and, ultimately, federal securities legislation.[159] The first witness called at the hearings was Richard Whitney, President of the New York Stock Exchange, who asserted that all claims of manipulation were pure fiction.[160] The very next day, Pecora called Fiorella LaGuardia, who produced docu-

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148. *Id.* at 53.

149. *Id.* at 140.

150. Joel Seligman, The Transformation of Wall Street: A History Of The Securities And Exchange Commission And Modern Corporate Finance, at x (1982).

151. *Id.* at 2.

152. *Id.* at 50.

153. *Id.* at 49.

154. *See generally id.* at 6-15.

155. *See generally id.* at 1.

156. *Id*.

157. *Id.* at 13.

158. *See id.* at 12.

159. *Id.* at 1-2.

160. *Id.* at 15.

ments showing that journalists employed by both the New York Times and Wall Street Journal had been paid to print stock-moving rumors.[161] In just two days, the credibility of the NYSE in managing securities fraud appeared to have been seriously called into question before the Senate committee and the public.[162] This uncertainty opened the door for government regulation to supplant self-regulation as the primary means of regulating of the securities industry.

As the Pecora Hearings continued, Democratic presidential candidate Franklin D. Roosevelt "assumed a commanding position among those advocating federal securities legislation."[163] Once Roosevelt was elected and enjoyed a strong majority in both houses of Congress, he made the passage of a federal securities law a legislative priority.[164] Unsure of the specifics, he appointed one individual, Samuel Untermyer, and one group, consisting of Huston Thompson, Attorney General Homer Cummings, and Secretary of Commerce Daniel Roper, to draft competing versions of a federal securities law.[165]

Untermyer produced a bill that placed enforcement power over the interstate securities market in the United States Post Office.[166] His proposal found little support, and focus shifted to the work of the competing group. This second group proved more successful. After reviewing the existing Blue Sky Laws and former federal bills to draw out what were seen as effective and well-conceived securities provisions, Huston Thompson, with the aid of Attorney General Homer Cummings and Secretary of Commerce Daniel Roper, drafted what is now known as the Securities Act of 1933 (the "Securities Act").[167]

"The initial public and congressional response was almost universally favorable" for Thompson's draft.[168] The Wall Street Journal predicted that "the country will insist upon its passage."[169] The bill faced a tough fight in the House, however, with opponents claiming that that the bill was too stringent. Specifically, these opponents protested provisions for civil liability for misstatements in securities registration and the ability of the Federal Trade Commission to revoke registration upon its determination that the registrant's business model was not sound.[170] The bill underwent significant revisions, and the provision granting revocation power to the Federal Trade Commission was stricken. A revised draft was completed

161. *Id.* at 16-17.

162. *See id.*

163. *Id.* at 19.

164. *Id.* at 52.

165. *Id.* at 51-52.

166. *Id.*

167. *Id.* at 52-53.

168. *Id.* at 54.

169. *Id*.

170. *Id.* at 56.

by April 21, 1933, that retained the provision requiring "hard-won scheduled items to be disclosed" in registration statements.[171] Then, on May 27, 1933, the Securities Act was signed into law.[172] For the first time in United States history, the primary means of securities regulation was not self-regulation.

In April of 1933, prior to the passage of the Securities Act, President Roosevelt tasked the young Felix Frankfurter with helping to draft the Securities Act.[173] Frankfurter had been disappointed that Thompson's draft did not deal with "the mischief of peddling securities from door to door or over the phone."[174] He was also concerned with the delegation of legislative power to the Federal Trade Commission.[175] Although he was not able to address these issues in the Securities Act, he would get his chance with the Securities Exchange Act of 1934 (the "Exchange Act").

While the Securities Act passed with not insignificant objection, the legislative effort to pass the Exchange Act could be properly characterized as a political brawl. At the time, the battle was "one of the most bruising lobbying struggles ever waged in Washington."[176] The intense debate most likely concerned the fact that the Exchange Act acted on the NYSE and its members directly rather than on issuers. NYSE President Richard Whitney responded to the proposed legislation by giving lectures, delivering radio broadcasts, and presenting congressional testimony against regulation of the NYSE.[177] He boldly asserted that "the Exchange is a perfect institution."[178]

On April 5, 1933, Whitney met with Roosevelt in the White House to strike a deal.[179] He argued that the NYSE could correct itself through self-regulation if only given the opportunity.[180] Unfortunately for Whitney, in the President's eyes, the reforms enacted by the NYSE in 1933 were too little, too late.[181] Roosevelt was convinced that the Exchange Act was necessary because NYSE members had an "inability to understand the country or the public or their obligation to their fellow men."[182] Evidently, Roosevelt did not trust that self-regulation of the securities industry was sufficient to protect the investing public.

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171. *Id.* at 65.

172. Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (1933).

173. Seligman, *supra* note 150, at 57. Frankfurter later served as an associate justice on the Supreme Court of the United States.

174. *Id*.

175. *Id.* at 64-65.

176. *Id.* at 73.

177. *Id.* at 75.

178. *Id.* at 88.

179. *Id.* at 75.

180. *Id.* at 76.

181. *Id*.

182. *Id.* at 88.

However, the lobbying efforts of the securities industry did have an effect. The initial version of the Exchange Act was withdrawn so that additional testimony could be taken and revisions could be made.[183] The Governor of New York personally lobbied the President.[184] Additionally, the President's own cousin, Archie Roosevelt, testified on behalf of municipal bond dealers against the bill.[185]

One of the revisions made to the bill to address the opponents' criticisms entailed the creation of a Securities and Exchange Commission ("SEC"), an agency that would have responsibility for regulating the securities market.[186] Ferdinand Pecora opined to the President that the Exchange Act would "be a good or bad law depending upon the men who administer it."[187] Roosevelt apparently took Pecora's view seriously. He responded by appointing some of the most capable people to ever lead the SEC.[188]

In the six years that followed the passage of the Exchange Act, many viewed federal regulation of the securities market as an unquestionable success.[189] In those years, "the SEC earned the reputation as one of the most ably administered federal regulatory agencies" of the New Deal era. [190] Arguably, the SEC's first three chairs—some of the most capable people to ever hold the position—were responsible for the agency's success. The first Chairman of the SEC, Joseph P. Kennedy,[191] achieved for the commission a reputation of competence.[192] The next Chairman, James Landis, was a Harvard professor whose influence on securities legislation and the creation of the SEC was substantial.[193] After Landis, Roosevelt appointed the future Associate Justice of the Supreme Court of the United States, William O. Douglas.[194]

Of the three men, it was Douglas whose "chairmanship was the most accomplished in the SEC's history."[195] Douglas routinely leveraged the

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183. *Id.* at 88.

184. *Id.* at 90.

185. *Id.* at 92.

186. *Id.* at 97.

187. *Id.* at 100.

188. *See id.* at 121-57.

189. *See id.* at x.

190. *Id*.

191. Joseph P. Kennedy was the father of President John F. Kennedy, Senator Robert "Bobby" Kennedy, and Senator Ted Kennedy. His inclusion in this story, along with that of Alexander Hamilton, Felix Frankfurter, and James O. Douglass, is remarkable in its own right, but more so because these historical figures are not found in the offices or positions with which we most readily associate them when they interact with the history of self-regulation in American securities markets.

192. SELIGMAN*, supra* note 150, at 121.

193. *See generally id.* at 154-57.

194. CHRISTOPHER L. TOMLINS, THE UNITED STATES SUPREME COURT 475-76 (2005).

195. *Id*. at 157.

power of the SEC to force the NYSE into rule changes and administrative reorganization.[196] When Richard Whitney was indicted for larceny and arrested by Thomas E. Dewey,[197] Douglas took advantage of the scandal by getting a self-regulatory body "to police over-the-counter brokers and dealers."[198] Ironically, Douglas' response to the Whitney scandal marked the beginning of a transition back toward the regime of self-regulation found in the Buttonwood Era and preferred by the NYSE.

Part IV: A Return to Buttonwood

It is often written that the federal securities laws of the New Deal era are the basis of modern securities law.[199] It is more accurate, however, to view the passage of those laws as a high-water mark or as an inflection point in the history of American securities law. Since the enactment of the New Deal laws, the American securities regulatory regime has been on a clear trajectory, returning to the supremacy of self-regulation as experienced during the Buttonwood Era. In fact, this journey began before the New Deal was even complete.

In hindsight, the return to self-regulation in American securities law is not surprising. Even while New Deal federal securities laws were under consideration, a law review article implored readers not to overlook "private agencies that protect the investor" because those agencies had adequate rules for policing market participants and issues.[200] Additionally, a history of the NYSE written in 1929 (and commissioned by the NYSE itself) claimed, "its internal operation is recognized to be as careful, and the supervision of its own members as rigid as any legal control could make it." [201] It seems many agreed with Richard Whitney's claim that the NYSE was "a perfect institution" against all evidence to the contrary.[202] These views continued to be expressed after the passage of the Securities Act and Exchange Act.[203]

Despite witnessing the 1929 stock market collapse and the evidence presented in the Pecora Hearings first-hand, even some members of the Roosevelt administration and of the SEC believed that the securities industry could effectively regulate itself.[204] As early as 1935, James Landis began to publicly float the idea of a self-regulatory agency for the securi-

196. *Id.* at 163.

197. *Id.* at 169 (This is the same Thomas E. Dewey who later ran for President of the United States and narrowly lost to the incumbent, Harry S. Truman, and who appears in the now infamous Chicago Daily Tribune Headline "Dewey Defeats Truman.").

198. *Id.* at 183.

199. *See, e.g.,* Cornell History, *supra* note 1.

200. Richards, *supra* note 85, at 88.

201. Warshow, *supra* note 14, at 339.

202. Seligman, *supra* note 150, at 88.

203. *See generally id.* at 183.

204. *See id*. at 183-84.

ties industry.[205] Notably, securities brokers had already taken steps toward such an agency even before the public release of Mr. Landis' comments by leveraging the tools of the New Deal.[206] Specifically, securities brokers used the National Industrial Recovery Act ("NIRA") to get a statutorily-approved code of fair competition and fair trade. This code permitted an organization called the Investment Bankers Code Committee (the "IBCC") to serve as a quasi-official securities market police force.[207]

When the Supreme Court deemed the NIRA an unconstitutional delegation of legislative authority in *Schechter*,[208] it cast grave doubt on the legitimacy of the IBCC. Presumably, the *Schechter* opinion alerted the SEC and IBCC members to the need for change.[209] Either the SEC would need to assume the functions of the IBCC, or it would need to push for legislation expressly allowing for self-regulation of the securities industry.

Recent history gave little reason to believe that the best solution was the authorization of self-regulation. In fact, early reviews of the IBCC showed that it had been an "ineffective policeman" for the securities industry.[210] Additionally, a survey conducted by the SEC showed that fraud among IBCC members was rampant.[211] Chairman Douglas, nonetheless, was sure that the SEC couldn't handle the additional responsibilities of the IBCC for two reasons.[212] First, the SEC lacked the resources necessary to monitor the everyday practices of the securities industry.[213] Second, Douglas viewed the SEC as poorly equipped, from a legal perspective, to prescribe best practices in the "realm of ethics and morality."[214]

After deciding in favor of a self-regulatory organization ("SRO"), Chairman Douglas set to work on two courses of action to win support for a proposal that would become known as the Maloney Act.[215] Douglas first needed to persuade Congress and President Roosevelt that a SRO was necessary. Secondly, he needed to persuade the securities industry to take on this role despite the caveat of strong oversight by the SEC.

As the recession that began in 1937 continued into 1938 and federal resources dwindled, Chairman Douglas found strong support for the Maloney Act in Congress and in the White House.[216] A key argument to

205. *See id*. at 183.

206. *Id.* at 184.

207. *Id.*

208. A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

209. *See* Seligman, *supra* note 150, at 184.

210. *Id.* at 185.

211. *Id.*

212. *Id.* at 186.

213. *See id.*

214. *Id*.

215. *See id.* at 186-87.

216. *See id.* at 212.

winning this support was Chairman Douglas' now-famous shotgun metaphor, which promised that a well-equipped SEC would be ready to act if the SRO failed.[217] Pursuing the support of the White House and Congress before the support of the securities industry, however, turned out to be a tactical blunder on the part of Chairman Douglas.

By January 1938, the White House and Congress had committed support to the passage of the Maloney Act and the creation of an SRO for the securities industry.[218] Sensing that Chairman Douglas now needed their support to attain his goal of establishing an SRO, the Investment Bankers Association ("IBA") feigned opposition to the proposal to extract greater power for the SRO.[219] In February 1938, the president of the IBA told the Senate Banking Committee that the idea of a securities industry SRO was "inherently dangerous."[220] A surreal political battle ensued in which the White House, Congress, and the SEC begged Wall Street to police itself.[221]

The bill was revised considerably between January and February 1938 at the request of the IBA despite the association's "rather close cooperation" with Senator Maloney on the original draft of the bill.[222] Over the next several months, the IBA obtained provisions in the bill that granted its Wall Street members greater latitude in the management of the SRO.[223] One of the early revisions eliminated the SEC's "extensive power to impose rules on the association."[224] Even after that revision was made, the industry complained that "[t]he bill would not be self-regulating but overregulation of an already sorely harassed industry."[225] Unless the securities industry was offered true self-regulation, the IBA would not support the bill.[226] In light of this fact, additional concessions were made before an agreement was reached. The Maloney Act became law in June of 1938 with support from the SEC and securities market organizations.[227]

217. *See id.* at 185-86 (In this metaphor, the SEC stands ready with regulatory powers akin to a loaded shotgun should securities fraud breach the barrier of self-regulation.).

218. *See id.* at 186-87.

219. *Id.*

220. *Id*. at 187.

221. *See id.* at 186-87.

222. *Regulation of Over-the-Counter Markets: Hearings Before the Comm. on Banking and Currency United States Seventy-Fifth Cong. Third Sess. on S. 3255*, 75th Cong. 6 (1938) (statement of Sen. Maloney) [hereinafter *Maloney Hearings*].

223. *S*ee SELIGMAN, *supra* note 150, at 186-87.

224. *Maloney Hearings, supra* note 222, at 11 (statement of Comm'r Mathews).

225. *Id.* at 66 (statement of Francis E. Frothingham, President Investment Bankers' Association of America).

226. *Id.* at 67.

227. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010*, THE SEC HISTORICAL SOC'Y, http://www.sechistorical.org/museum/galleries/sro/sro04b.php (last visited Feb. 5, 2016) [hereinafter *SRO History*].

The Maloney Act embodied a reversion to the primacy of self-regulation in American securities law akin to that seen during the Buttonwood Era.[228] In 1938, for example, SEC Commissioner Mathews told the Senate Committee on Banking and Currency that the ideal regime was one in which the industry regulated itself once more.[229] The SEC hoped that the government would exercise "appropriate supervision in the public interest" yet occupy only "a residual role." [230] Further supporting this view, just a few months after the passage of the Maloney Act, Commissioner Mathews announced to the annual conference of the Investment Bankers Association of America that the SEC espoused an objective of "a minimum of interference with the normal processes of business and the establishment of high professional standards of conduct and competence."[231] Mathews promised, "The industry should eventually play the predominant role in its own regulation and development."[232]

The National Association of Securities Dealers ("NASD") registered as the only SRO under the Maloney Act on August 7, 1939.[233] By the end of 1939, 2,616 broker-dealer firms had joined the NASD.[234] As the NASD's power grew, the SEC's waned.[235] In April 1939, Chairman Douglas left the SEC to join the United States Supreme Court.[236] It was contemporaneously described as a "sad occasion," and it ultimately marked the moment "the SEC passed its historic zenith."[237] After Douglas' departure, it became clear that the SEC would continue to lose power with "just a handful of staff to keep up with the armies of innovators deployed on Wall Street."[238]

Chairman Douglas, in pushing for the passage of the Maloney Act, had conceded that there would be little incentive for the SRO to police the industry in the absence of a strong, vigilant SEC.[239] Within a few years of his departure from the Commission, the SEC was reduced "to one of the smallest of the alphabet agencies."[240] A weakened SEC realized too late

228. George C. Matthews, Comm'r, SEC, *A Discussion of the Maloney Act Program at the Annual Convention of the Investment Bankers Association of America* (Oct. 23, 1938) [hereinafter *Mathews Speech*].

229. *Maloney Hearings, supra* note 222, at 16 (statement of Comm'r George C. Mathews).

230. *Id*.

231. *Mathews Speech*, *supra* note 228, at 1.

232. *Id.* at 2.

233. *SRO History, supra* note 227. The NYSE would continue to regulate itself until its regulatory arm merged with the NASD in 2007.

234. *Id.*

235. SELIGMAN, *supra* note 150, at 212.

236. *Id.* at 211.

237. *Id.* at 211-12.

238. *See* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 4 (2013-14).

239. SELIGMAN, *supra* note 150, at 185-86.

240. *Id*. at 212.

that it had granted "quasi-official status to a trade association that thereafter opposed—frequently successfully—further SEC legislative initiatives."[241] By the time the Truman administration took over, there was already a "discernable increase in securities fraud" to which the NASD turned a blind eye and to which the SEC had no effective response.[242]

Since the enactment of the Maloney Act in 1938, the securities industry has been overseen by "a self-regulatory organization that monitored and supervised its own trading under the sometimes cursory supervision of the Securities and Exchange Commission." [243] Compared to the SRO, the SEC has "long been understaffed and outgunned."[244] This is an essentially singular phenomenon in American legal history.[245]

In 2007, the NASD merged with the NYSE's internal regulatory body.[246] This produced a single self-regulator for the entire securities industry for the first time.[247] At the time of the merger, some argued that the consolidation eliminated a necessary competing view in the process of self-regulation, but that argument was summarily dismissed, leaving regulation of the securities markets in the hands of a select cadre of industry members.[248] Contemporary detractors of this scheme argue that Financial Industry Regulatory Authority ("FINRA"), the SRO that precipitated from the merger, has established itself as the "fifth branch of the federal government," blurring the line between governmental and private bodies.[249] Most concerning is that the balance of power is continuing to move in favor of FINRA, causing some to argue "there are forces inexorably driving the government and the various other players into a less optimal equilibrium."[250]

While—as described in the preceding paragraph—many are concerned with the concentration of power solely in the hands of FINRA, in the past few years, prominent government officials have called for greater control

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241. *Id.* at 189.

242. *Id*.

243. Floyd Norris, *ICE Deal for NYSE Creates Global Powerhouse*, N.Y. Times (Dec. 20, 2012), http://www.nytimes.com/2012/12/21/business/global/ice-deal-for-nyse-creates-global-powerhouse.html?_r=0.

244. Birdthistle & Henderson, *supra* note 238, at 3.

245. There are many self-regulatory organizations (*i.e.*, state bar associations and realtor associations). However, these self-regulatory organizations differ from the NASD in two regards. First, they are state-specific. Second, the industries they regulate do not compare to the size of the financial sector.

246. *Self-Regulatory Organizations*, Exchange Act Release No. 34-56145, 2007 SEC LEXIS 1640 (July 26, 2007).

247. *Id*. at 2-3.

248. *See generally id.* at 18.

249. Birdthistle & Henderson, *supra* note 238, at 5.

250. *Id*.

of the securities market by FINRA.[251] SEC Commissioner Elisse Walter told an audience that "all financial professionals should be required to be members of one or more self-regulatory organizations . . . that are empowered with both enforcement and standard setting authority and are subject to the oversight of the Commission."[252]

In fact, Commissioner Walter has delivered several strong arguments in support of shifting even more authority to FINRA.[253] Walters argued, for example, that "[t]he SROs could handle routine examinations of financial professionals, while the Commission devoted its examination resources primarily to SRO oversight and risk-based analysis, inspection, and oversight of the industry." In this manner, the SEC would be stripped of a great deal of its current powers and relegated to special investigations that require the utilization of the resources of a federal agency.[254] An alleged advantage to this arrangement is that FINRA faces fewer constraints than the SEC, allowing it the "authority to establish ethical as well as legal standards."[255] Moreover, Walters has argued that the SEC's limited resources make it incapable of fulfilling its oversight functions of the complex and growing market.[256] One wonders, of course, how an SEC that is incapable of understanding the complexities of an industry could possibly be competent to perform risk analysis and conduct inspections. This is the sort of logical inconsistency routinely exhibited by supporters of SROs.

In sum, the overarching theme of Walters' proposal is that effective oversight of the securities markets can be had if FINRA is given a greater role because of its proximity to the market and its possession of the expertise necessary to fill the "oversight gap."[257] Although this familiar argument is unsupported by historical evidence or reason, it seems to always enjoy support at the highest levels of the federal government.[258] Even the "proponents of heightened financial regulation may celebrate the prospect of more powerful and governmental SROs."[259] For instance, Bernie Sanders and Elizabeth Warren, recognized as the harshest critics of Wall Street in today's U.S. Senate, have never once publicly questioned the primacy of self-regulation. In fact, Senator Warren has repeatedly attacked

251. *Speech by SEC Commissioner: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? By Commissioner Elisse B. Walter,* SEC (May 5, 2009), https://www.sec.gov/news/speech/2009/spch050509ebw.htm [hereinafter *Walters Speech*].

252. *Id.* at 6.

253. *Id*.

254. *Id*.

255. *Id*.

256. *Id*.

257. *Id*.

258. *E.g.,* Lawhead, *supra* note 43, at 212 (describing Treasury Secretary Hank Paulsen strongly recommending "preserving and strengthening" the self-regulatory framework during the recent financial crisis.).

259. Birdthistle & Henderson, *supra* 238, at 6.

the SEC; in turn, such criticism seemingly strengthens Wall Street's ability to self-regulate with minimal oversight.[260] It is time to stop this progression. It is time to re-examine the fundamentals of American securities law; it is time to examine the utility and the necessity of self-regulation.

Professor Emily Hammond, an expert in administrative law, recently described the system of self-regulation as one that "undermines accountability and fails to adequately guard against arbitrariness."[261] The primary issue is that agencies like the SEC "are deferential either in practice or as a matter of statutory design to both rules and orders originating from SROs."[262] The problem is compounded by the deference given by the courts to the agencies, creating a "double deference" to SROs with "numerous incentives to dampen participation of statutory beneficiaries, engage in anticompetitive conduct toward weaker members, and ratchet regulatory law toward the lowest common denominator."[263] All of this is carried out by an entity (*i.e.*, FINRA) that, given its private nature, is neither transparent nor accommodating to public comment.[264]

Though the primacy of self-regulation in American securities law has proven to be enduring, it is not unchangeable. In fact, this country's foundational securities laws contain provisions that envision a rebalancing of power from FINRA to the SEC. For example, the Exchange Act contemplates a process by which SROs must file rules with the SEC that would then be reviewed, subjected to notice and comment procedures, and finally scrutinized by the SEC.[265] The problem, however, lies in the working practices of the SEC under this law. The SEC is deferential to such a degree that it rarely, if ever, disapproves a FINRA rule.[266] Between 2009 and 2011, only once did the SEC disapprove of a rule promulgated by the authority.[267] Notably, those rules carry with them the force of law.[268]

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260. *See* Andrew Ackerman, *Elizabeth Warren to Obama*: *Fire SEC Chief Mary Jo White*, WALL ST. JOURNAL (Oct.14, 2016), https://www.wsj.com/articles/elizabeth-warren-to-obama-fire-sec-chief-mary-jo-white-1476439200 (The methods employed by Senator Warren raise the question of whether the former professor of U.S. Constitutional law has a basic understanding of the securities industry she rails against in speeches or the laws and regulations that govern it.).

261. Emily Hammond, *Double Deference in Administrative Law,* 116 COLUM. L. REV. 1705, 1705 (2016).

262. *Id*. at 1710.

263. *Id*. at 1709-10.

264. *Id*. at 1715.

265. *Id*. at 1735-36.

266. *Id*. at 1736. *See also,* Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry,* 35 BROOK. J. INT'L L. 665, 670 (2010); David G. Tittsworth, *H.R. 4624: The Pitfalls of a Self-Regulatory Organization for Investment Advisers and Why User Fees Would Better Accomplish the Goal of Investment Adviser Accountability,* 87 ST. JOHN'S L. REV. 477, 486 (2013).

267. U.S. Gov't Accountability Office, GAO-12-625, Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority (2012).

268. *See* Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 201 (2d Cir. 1999) (holding such rules preempted conflicting state law); *see* Charles Schwab & Co. Inc. v. Fin.

The view espoused by this paper, that the role of self-regulation is a historical accident in need of a fundamental reimagining, is hardly unique. There are many proposals for adjusting the balance of power between the SEC and FINRA. In a report prepared by the Boston Consulting Group in 2011, the SEC was advised to re-think its relationship with FINRA and practice more thoughtfulness both in its communications with the SRO and its review of rules.[269] The creation of an oversight committee, either at the congressional or agency level, has also been suggested.[270] Others have resorted simply to praying or hoping that FINRA will reform itself *sua sponte* to eliminate its shortcomings.[271] Even the threatened use of the "nuclear option", whereby the SEC would exercise its right to relieve FINRA of any responsibility given to it by statute, has been suggested to encourage greater diligence in self-regulation.[272] I would advocate a different approach. I propose that the SEC *actually exercise* its rights under the Exchange Act to break from tradition and relieve FINRA of most of its responsibilities.[273] For the first time in recent memory, there are signs that the SEC may be open to this proposal.[274]

There would, of course, be objections to overthrowing the tradition of self-regulation, and those should be addressed. There are three main arguments in favor of the primacy of self-regulation. The first argues that the SEC lacks the expertise to regulate Wall Street.[275] This defect can easily be overcome by proper recruiting and retention practices; in fact, many other agencies that regulate significant industries already employ such techniques. The Food and Drug Administration, for example, employs scientists and physicians to regulate the pharmaceutical industry rather than relying on self-regulation of pharmaceutical companies.[276] While the financial sector is admittedly complex, it would be difficult to argue that it is more complex than the scientific pharmaceutical industry.

Next, proponents of sustaining the primacy of self-regulation in the securities market argue that SROs are more "nimble" and "efficient" in re-

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Indus. Regulatory Auth., 861 F. Supp. 2d 1063, 1065 (N.D. Cal. 2012) (noting FINRA rules have "force and effect of a federal regulation").

269. SEC, Organizational Study And Reform 8 (2011), http://www.sec.gov/news/studies/2011/967study.pdf.

270. David R. Burton, *Reforming FINRA* 6, The Heritage Found. (Feb. 1, 2017), http://www.heritage.org/sites/default/files/2017-02/BG3181.pdf.

271. *See id*.

272. Hammond, *supra* note 261, at 1768.

273. 15 U.S.C. §§ 78s(g)(2)-(h)(1) (2010).

274. SEC, *SEC Announces 2017 Examination Priorities* (Jan. 12, 2017), https://www.sec.gov/news/pressrelease/2017-7.html.

275. Hammond, *supra* note 261, at 1714. *See also* Sidney A. Shapiro, *The Failure to Understand Expertise in Administrative Law: The Problem and the Consequences,* 50 Wake Forest L. Rev. 1097 (2015).

276. *See* Food and Drug Admin., Staff Directory, http://www.fda.gov/AboutFDA/CentersOffices/OfficeofMedicalProductsandTobacco/CBER/ucm123224.htm (last visited Nov. 15, 2016).

sponding to misconduct.[277] Facts suggest that the SEC is, in fact, quite capable of action. For instance, the SEC has finalized 204 rules related to the Dodd-Frank Act alone.[278] Additionally, the SEC has led all federal agencies in terms of the quantity of finalized major rules since 2009.[279] Further, the SEC has set a record for enforcement actions each of the past two years.[280] If given greater resources, there is every reason to believe the SEC could be sufficiently nimble and efficient.

The final argument I've noted for maintenance of the status quo is that the SEC does not have the requisite resources to monitor the securities market. The solution to this quandary is simply a matter of raising revenue. Currently, FINRA members finance FINRA's operations through a myriad of fees.[281] A tax or licensing fee could be introduced that would shift the funds currently flowing from securities firms to FINRA to the SEC instead. This should not lead to any greater financial burden being placed on securities firms. In fact, elimination of the rubber-stamp relationship between the self-regulatory agency and the SEC, thereby eliminating a layer of resource-consuming oversight, may actually save the regulated entities time and money (and deliver better returns to investors by extension).

Conclusion

The securities laws of the United States support a securities industry that touches the lives of Americans in countless ways and influences events around the globe. Yet, the most enduring principal of American securities law, self-regulation, is a notoriously ineffective tradition rooted in a one-paragraph contract between twenty-four men seeking to avoid the effects of an eighteenth-century state law. A thoughtful examination of the primacy of self-regulation in American securities law is long overdue. Where history or logic lead to the conclusion that self-regulation is inadequate, we must break from tradition. Such severance can be accomplished by leveraging existing laws to reclaim regulatory authority properly held by Congress and the SEC. Only by engaging in this examination and reclamation of regulatory authority can the effectiveness of American securities laws be optimized.

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277. *Id*.

278. *See* James L. Gattuso & Diane Katz, *Red Tape Rising 2016: Obama Regs Top $100 Billion Annually,* The Heritage Found. (May 23, 2016), http://www.heritage.org/research/reports/2016/05/red-tape-rising-2016-obama-regs- top-100-billion-annually.

279. *See id*.

280. *See* Jean Eaglesham, *SEC Breaks Record for Number of Enforcement Cases*, Wall St. Journal (Oct. 11, 2016), http://www.wsj.com/articles/sec-on-track-to-break-record-for-number-of-enforcement-cases-1476198436.

281. FINRA, *Registration/Exam Fee Schedule*, available at http://www.finra.org/industry/crd/fees.