A Brief History of the 1930s Securities Laws in the United States – And the Potential Lesson for Today

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ABSTRACT

The Securities Act of 1933, one of the first laws enacted as part of the New Deal era of President Franklin Delano Roosevelt, signaled the rise of federal government regulation of business in the United States. As 2008 marks the 75th anniversary of that statute's passage, it is timely to consider the political and economic circumstances leading to the landmark law. The 1933 act and the broader law that followed the next year, the Securities Exchange Act of 1934, were strongly criticized by the business world at the time. Now, however, they are widely accepted as providing the legal and regulatory foundation needed for restoring and maintaining investor confidence in the world's strongest securities markets. With the more recent Sarbanes-Oxley Act of 2002 still enduring similar criticism from the corporate world, could the history of the 1930s legislation provide any useful guidance today?

INTRODUCTION

Public companies in the United States have seen a notable increase in securities law enforcement and litigation in recent years. Of course, this trend resulted primarily from a surge in corporate fraud cases, such as Enron and WorldCom, and the resulting passage by Congress of the Sarbanes-Oxley Act of 2002.[1] Because Sarbanes-Oxley is accurately referred to as the most significant corporate reform legislation in the United States since the 1930s, it could be useful to reexamine the circumstances that prompted enactment of the first federal securities law in the United States during the Great Depression.

This paper will analyze the economic and political conditions leading to the Securities Act of 1933[2] and the Securities Exchange Act of 1934.[3] These two laws came to exemplify both the New Deal era and the rapid growth of federal government regulation of the business world. Today, 75 years after the landmark 1933 securities statute became law, it is interesting to note a number of parallels between that era and the more recent business experience of the 1990s and early 21st Century.

THE ROARING TWENTIES

The 1920s were a period of strong economic growth and swift technological change, especially in the United States. That led to a speculative boom in stock prices during much of the Roaring Twenties decade, similar to the bull market of most of the 1990s. The parallels of the two decades continued, as stock market indexes roughly tripled between 1925 and 1929, and again between 1995 and 1999. Much like the Internet and dot-com stocks fueled rampant market speculation in the 1990s, the relatively new communication medium of radio, and the stock of Radio Corporation of America, helped drive the 1920s rally.[4]

In both eras, a high-ranking government official in the United States gave an early warning about stock speculation several years before the markets were to collapse, though no real action was taken to address the looming problem. Herbert Hoover, while serving as Secretary of Commerce in 1925, noted "the growing tide of speculation" in the stock market of that era.[5] Similarly, in 1996, Federal Reserve Board Chairman Alan Greenspan used his now-famous term of "irrational exuberance" in describing the securities markets.[6]

However, the good times came to an abrupt end. The October 1929 crash began an era of depression that lasted for virtually all of the 1930s, as the economy in the United States did not recover fully until wartime production began in the early 1940s. In the more recent era, the dot-com collapse started in early 2000. In both eras, a prolonged bear market was then exacerbated by reports of rampant corporate fraud and related business scandals. Congressional investigations were begun amid calls for new laws to regulate the securities industry – efforts that led ultimately to the securities legislation of the 1930s and the Sarbanes-Oxley Act of 2002.

Undoubtedly, the 1929 Crash and subsequent Great Depression caused far greater and more widespread harm to the U.S. economy as a whole than the bear market and corporate scandals of 2000-02. As just one example, almost 13 million Americans were unemployed in 1933, or an estimated one-fourth of the American work force.[7] Five years later, by 1938, the unemployment rate had declined only slightly, to roughly one in five persons.[8] (The federal government did not compile precise unemployment rates in the 1930s.) By contrast, unemployment was only 4.7 percent in 2001 and hovered near 6 percent for much of 2002 and 2003. The 2001 recession in the United States was a very brief and mild downturn compared to the 1930s, despite the destabilizing influence of the September 11 terrorist attacks in 2001.

Nevertheless, there are reasons to suggest that 2000 through 2002 produced the worst stock market conditions since the 1930s. The Dow Jones Industrial Average declined each year from 2000 through 2002, for the first three-year losing streak since 1939 through 1941.[9] The only period of four consecutive down years for the Dow since 1900 came from 1929 through 1932, in the depths of the Depression.[10] Although the 38 percent decline for the Dow Jones Average between 2000 and 2002 pales in comparison to its 89 percent free fall between 1929 and 1932,[11] the Nasdaq Composite Index's 78 percent plunge in 2000-02 is roughly comparable to the Dow's collapse in the Depression era.[12]

CONGRESSIONAL INVESTIGATION

Soon after the 1929 crash, several members of Congress began to introduce bills seeking federal regulation of various aspects of the securities markets, as oversight of securities then came only from the states.[13] Those proposals were resisted by the Republican-dominated Congress and President Herbert Hoover. Having assumed the presidency only seven months before October 1929, Hoover could not be fairly blamed for the economic conditions leading to the crash.

On the other hand, Hoover, as the leader of the pro-business and laissez-faire Republican Party, was overly reluctant to act in response to the market turmoil, or to address the needs of millions of unemployed Americans who suffered from the resulting Depression. Far too often, he indicated that the economy was on the verge of turning around, only to be disappointed. By 1932, Hoover had become frustrated that the New York Stock Exchange had not taken stronger self-regulatory action in response to reported market abuses. He then supported a congressional investigation into market manipulation, which he believed had contributed to the crash.[14]

The Senate Banking and Currency Committee, under the leadership of Chairman Peter Norbeck, a Progressive Republican senator from South Dakota, began the hearings in April 1932. The committee's work was interrupted by the November 1932 election, when Democratic nominee Franklin D. Roosevelt was elected President and the Democratic Party captured strong majorities in both houses of Congress. Before Roosevelt was inaugurated in March 1933, Norbeck selected Ferdinand Pecora, a prosecutor and supporter of former President Teddy Roosevelt's Bull Moose Party in 1912, to lead the hearings as chief counsel to the Banking Committee.[15] A new Democratic committee chairman, Duncan Fletcher of Florida, officially assumed control in 1933, but it was the work of Pecora that had the greatest impact on the reinvigorated probe. His role was so prominent that the committee's investigation unofficially became known as the Pecora Hearings.

Furthering the parallels between the two eras, the allegations unearthed in the 1930s were strikingly similar to revelations heard more recently in various congressional probes after the stock market bubble burst in 2000. The 1930s investigations revealed a wide variety of efforts to manipulate prices of specific stocks and the markets as a whole. As a surprise witness before the Senate committee, New York Congressman Fiorello LaGuardia (prior to becoming mayor of New York City in 1934) produced evidence purporting to show that one public relations person had received nearly $300,000 over a decade, with the funds being used to pay off reporters of major newspapers to ensure that overly favorable news stories about specific companies were published.[16] The alleged intent, of course, was to increase the stock prices for those companies.

Separately, the Senate committee found evidence of corporate officers and family members, such as Harry Warner of Warner Brothers and Mrs. David Sarnoff, wife of the chief executive officer of Radio Corporation of America, profiting from trading in their own companies' stock (at a time when there was no federal securities law prohibiting insider trading).[17] Testimony provided many other examples of stock manipulation and speculation.

The congressional hearings focused also on high salaries and interest-free loans for corporate executives, on various tax avoidance schemes, and on an investment bank allowing a number of politicians and corporate executives on "preferred lists" to make quick profits by being sold stocks at low prices before the companies went public.[18] The names of many leading business and political figures of the era were found on these "preferred lists," including former President Calvin Coolidge, Roosevelt's then-Secretary of the Treasury, William Woodin, and even a member of the Senate Banking Committee that was holding the hearings.[19] With thorough newspaper coverage of the Pecora Hearings, the clear impression left on the general public was that privileged insiders had profited greatly, at the expense of the average investor.

Ironically, the high salary and interest-free loans revealed in the 1930s investigation related to officers of National City Bank and National City Company, predecessors to Citigroup Inc. In 2002, the compensation and actions of Jack Grubman, formerly a telecommunications stock analyst for Citigroup's Salomon Smith Barney unit, were prime topics of a congressional investigation. Drawing scrutiny were Grubman's favorable recommendations on WorldCom stock, as well as WorldCom's high pay and low-interest loans to its chief executive officer, Bernie Ebbers. Moreover, in 1933, the allegations involving "preferred lists" focused on J.P. Morgan & Co. Its successor company, J.P. Morgan Chase & Co., was one of many securities firms in recent years agreeing to settle civil charges alleging problems with stock research and the allocation of initial public offerings in the late 1990s.

LEGISLATIVE PROCESS

While the congressional investigation provided an important basis for federal securities legislation, the strong support of President Roosevelt was the prime impetus for its enactment. Roosevelt had signaled his interest in securities regulation in his speech accepting the Democratic Party nomination for President in July 1932. Addressing finance and credit problems, Roosevelt said, "I list an important place for that prize statement of principle in the platform here adopted calling for the letting in of the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public."[20] He continued to address the need for securities legislation throughout the presidential campaign.

By early 1933, Roosevelt advisors began to draft legislation that would regulate both the stock exchanges and the issuance of new stock. That initial effort yielded typical squabbling and divisions among various aides, eventually prompting Roosevelt to decide to separate the two issues and to focus only on the securities registration aspect for 1933. By March 29, only 25 days after his inauguration on March 4, the President sent a message to Congress asking for a new law that would "put the burden of telling the whole truth on the seller" of securities.[21] Proposing an addition to the prevailing *caveat emptor* rule of the day, Roosevelt added: "Let the seller also beware."[22]

The initial draft of the legislation sent to Congress was criticized by the business world, in part because it would allow the government to judge the merits of stock offerings and thus approve or disapprove them. In response to the opposition, Harvard law professor (and future Supreme Court Justice) Felix Frankfurter was called in to develop a revised bill. Frankfurter's team, including James Landis, Benjamin Cohen, and Tommy Corcoran, drafted a bill following the British securities law approach, based primarily on full disclosure of material information – leaving it to investors, rather than the government, to judge the merits of any stock offering.

This new plan was shepherded through the House of Representatives by powerful Commerce Committee Chairman (and future Speaker) Sam Rayburn, and the House approved the bill on a voice vote. Meanwhile, the Senate passed a securities bill that was still based on the earlier draft, which would have granted the government authority to judge the merits of specific stock issues. In the ensuing conference committee, Rayburn ensured that the House bill's general approach was chosen over the Senate version.[23] That crucial decision had the effect of establishing the prevailing scheme of all securities regulation, as U.S. law today is still based primarily on a disclosure theory. On May

27, less than two months after Roosevelt's message to Congress, the Securities Act of 1933 was signed by the President and became law.[24] The legislation became one of the hallmarks of the first Hundred Days of the Roosevelt Administration.

The business world clearly was not pleased with the 1933 act, as it established the principle of federal government authority over the regulation of securities in the United States. However, the business lobby was in a poor position to mount significant opposition at the time. The nation's economy had reached the lowest point of the Depression in early 1933, with bank closings in the final days of the Hoover Administration prompting the "bank holiday" declared by Roosevelt as one of his first acts as President. The reputation of the financial industry as a whole was in tatters because of the continuing revelations of the Pecora Hearings, not to mention lingering resentment over the effects of the 1929 Crash. Roosevelt was in his honeymoon as President, and the overwhelmingly Democratic Congress was generally inclined to give him what he wanted, especially considering the dire economic circumstances.

As the financial crisis began to subside somewhat in the next few months, it soon became clear that the Securities Act of 1933 pleased neither side – ardent New Dealers nor the business community. Many New Dealers thought the legislation was ineffective and outdated, yearning for more vigorous government involvement in the stock markets (and the economy as a whole).[25]

By contrast, business leaders began to speak out more forcefully against the 1933 law. Even some of the more conservative members of the Roosevelt Administration favored amendments that would weaken the act. Reflecting the growing concern about the new law, the *St. Louis Post-Dispatch* reported in November 1933: "There is no greater murmuring in the land than that which rises against the Securities Act."[26] Similarly, a prominent corporate attorney of the day wrote in *Fortune* magazine that the law might "seriously retard economic recovery" by making it difficult for companies to raise capital – causing "American corporations to go abroad for capital."[27] Arguing in effect that the law was overkill, attorney Arthur Dean added: "With the purposes of the Act, the writer is in full sympathy, but it seems hardly necessary to burn down the house to exterminate vermin."[28]

THE 1934 ACT

In fact, the 1933 law was actually rather limited in its official scope, dealing only with the issuance of new stock and imposing civil liability for violations of the act. When Roosevelt returned to Congress in 1934 for additional securities legislation, he encountered much more vigorous opposition. The draft sent to Congress in February provided specifically for regulation of stock exchanges, prompting New York Stock Exchange President Richard Whitney to spearhead the opposition. The bill, however, went much further – requiring registration of all securities on stock exchanges, not merely of newly issued stock. That would give the government regulatory power over all listed securities. Moreover, the proposed law would prohibit virtually any manipulation of the markets, including many of the activities being revealed in the continuing Pecora Hearings about market dealings in the 1920s.[29]

Whitney, the New York Stock Exchange president, predicted dire consequences if the bill were passed. He said that capital markets would "dry up" and that the nation would see "tremendous, if not universal, withdrawal" of public companies from the stock exchanges.[30] By rallying many business leaders to speak out against the proposal, he triggered the strongest business opposition to the New Deal to that point. The lobbying was effective in part, leading to a complete rewrite of the original bill and many amendments to the new draft. Roosevelt finally had to weigh in personally in favor of the bill, arguing against further weakening of the proposal by stressing the need for legislation that "has teeth in it."[31] The congressional committees studying the legislation continued to make compromises with the business leaders, resulting in more changes to the proposed new bill and some amendments to the Securities Act of 1933. Ultimately, the House of Representatives passed the bill by the wide margin of 281-84 (but with 61 abstentions), and the Senate approved a similar version 62-13.[32]

A key difference between the House and Senate versions dealt with what government agency would administer the law. The House bill left securities regulation with the Federal Trade Commission, where it had been placed by the Securities Act of 1933. The Senate proposed establishing a new commission that would focus on securities matters alone. House Commerce Committee Chairman Rayburn officially opposed creating what would become the Securities and Exchange Commission, though it was suspected that his position might have been merely an effort to obtain some influence over the initial appointments.[33] Roosevelt also initially expressed a personal preference for leaving enforcement of both the 1933 and 1934 securities acts with the FTC, although he did not press that point. Legislative bargaining in the conference committee allowed the Senate's preference for a new agency to prevail, and Roosevelt did not object.[34] As a result, the Securities and Exchange Commission was created – another significant legislative decision with long-lasting ramifications.

Roosevelt signed the Securities Exchange Act on June 6, 1934. Ironically, that was exactly one decade before an even more crucial date in the Roosevelt presidency and U.S. history – 1944's D-Day, when the Allied forces in World War II landed on the beaches of France and started the drive that ended the war against Germany. Though it might be a case of overreaching, one could argue that June 6, 1934, with the enactment of the Securities Exchange Act of 1934, was a type of D-Day for securities regulation in the United States and even the world. That is because the 1934 law, far more than the 1933 act, established the framework and foundation for securities regulation that still prevails today. Along with other New Deal legislation, the statute clearly signaled a greatly enhanced role for the federal government in regulation of the business world.

This legal framework included a section in the 1934 act that would become a powerful tool in future securities regulation. Section 10(b) of the act prohibits, in connection with the purchase or sale of securities, "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[35] The approach was typical of much of the 1934 act – leaving many of the enforcement details to the rule-making power of the SEC. That Section 10(b) provision proved to be especially important, as it served as the statutory basis for an even broader prohibition on fraud – the SEC's Rule 10b-5, now the most important anti-manipulation provision in U.S. securities law. Adopted in 1942, Rule 10b-5 makes it illegal:

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit a state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[36]

SECURITIES AND EXCHANGE COMMISSION

Clearly, whoever was chosen to be the first chairman of the Securities and Exchange Commission would play a major role in setting the tone for how the agency would regulate securities and the New York Stock Exchange. Therefore, Roosevelt surprised many with his plan to name a major fund-raiser for his 1932 presidential campaign to the position – Joseph P. Kennedy, the father of future President John Kennedy. Some of Roosevelt's own aides and many New Dealers vehemently criticized the choice because Joseph Kennedy was believed to be a stock manipulator himself. In fact, Kennedy was specifically mentioned in the Senate Banking Committee hearings as being part of a group that profited from a case of stock manipulation as recently as 1933.[37]

Securities law historian Joel Seligman, in his 1982 book *The Transformation of Wall Street*, quoted from the diary of a Roosevelt cabinet member, Interior Secretary Harold Ickes, commenting on Roosevelt's choice of Kennedy as SEC chairman:

> He has named Joseph P. Kennedy for that place, a former stockmarket plunger. The President has great confidence in him because he has made his pile, has invested all his money in Government securities, and knows all the tricks of the trade. Apparently he is going on the assumption that Kennedy would now like to make a name for himself for the sake of his family, but I have never known many of these cases to work out as expected.[38]

Kennedy's appointment clearly was an effort to mollify the business world's opposition to the new law and to the SEC by naming a well-known businessman to be its first chairman. As Roosevelt historian Arthur M. Schlesinger, Jr. explained in 1958, "Kennedy knew Wall Street and might inspire its confidence; his knockabout business career had given him long experience in bringing mutually suspicious people together."[39] The decision was also politically astute in the summer of 1934, with midterm congressional elections approaching in November and Roosevelt seeking a "truce" with the business community.

The President's selections for the four other commissioners somewhat reduced the concerns about Kennedy. That group included Pecora, the Senate investigator, and Landis, one of the drafters of the securities legislation, as well as two liberal Republicans. Ultimately, Kennedy served only fourteen months as SEC chairman. He left an impressive record by establishing the commission's authority and setting its initial course for active regulation, while still maintaining a cooperative relationship with the business community.[40]

Nevertheless, critical commentaries on the securities laws continued. "Most consider the costs thus far are disproportionate to the benefits," according to one newspaper in 1935.[41] A financial publication that year added: "One year of implementation has passed. … No one enjoys the prospect of a similar year in the future."[42] (Of course, in today's era, many business leaders have made similar comments about the enactment and enforcement of various provisions of Sarbanes-Oxley.) Despite this criticism and earlier predictions about the securities laws' negative effect on raising capital, many companies returned to the markets for new capital as the economy began to show signs of improvement in 1935.[43]

CONCLUSION

The history of the U.S. securities legislation of the 1930s may be interesting in itself – but could it also be instructive? Today, 75 years after the 1933 act, very few businesspeople would dispute that those controversial laws of the 1930s were in fact needed, both then and now. The Securities Act of 1933 and the Securities Exchange Act of 1934 were crucial to restoring confidence in the securities markets in light of the excesses of the 1920s. Those two laws and the regulations that they yielded remain the bulwark of public trust in the U.S. securities markets.

As a result, the U.S. markets today are seen as the most desirable and trustworthy securities markets in the world, despite periodic problems and scandals. In simple terms, the process of securities registration and regulation is now seen as merely a cost of doing business for public companies. That cost, although not insignificant, has returned far more gain over the long term, because of easy access to capital markets and the resulting creation of wealth for both businesses and individual investors. The dire predictions of critics of the 1930s securities laws did not prove to be correct.

More recent times have seen market activity somewhat reminiscent of the excesses and scandals of the 1920s. Once again, Congress stepped in to pass a significant new law aimed at public companies and the stock markets – the Sarbanes-Oxley Act of 2002. Once again, many business leaders criticized the new law, forecasting very negative consequences for public companies and the U.S. markets. Admittedly, some aspects of Sarbanes-Oxley and its implementing regulations are not flawless, and could still benefit from fine-tuning. The long and complicated statute was a hastily drafted combination of several different legislative proposals, resulting in both ambiguities and inconsistencies. As a whole, however, Sarbanes-Oxley was needed to restore public trust and confidence in the markets after a turbulent era, just as the 1930s securities legislation was necessary for similar reasons.

Could it be that, several decades from now, business leaders will look back on Sarbanes-Oxley just as today's executives view the 1930s legislation? Will Sarbanes-Oxley be seen as a necessary cost of doing business, and one that has more than paid for itself over time? One cannot say with certainty what the leaders of the future will think about the legislation of today. But if history is any indicator, the much-maligned Sarbanes-Oxley Act might indeed be vindicated with the perspective of time.

ENDNOTES

[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in 15 U.S.C. §§ 7201-7266 and scattered sections of 15 U.S.C. and 18 U.S.C.). The statute was named after its two primary sponsors, Senator Paul Sarbanes, a Maryland Democrat and chairman of the Senate Banking, Housing, and Urban Affairs Committee, and Representative Michael Oxley, an Ohio Republican and chairman of the House Committee on Financial Services. The Sarbanes-Oxley name was added late in the legislative process, as the final law was actually a combination of several separately named bills.
[2] Securities Act of 1993, 15 U.S.C. §§ 77a-77z, 77aa (2007).
[3] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2007).
[4] JOHN KENNETH GALBRAITH, THE GREAT CRASH 12 (1988).
[5] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 3 (1982).
[6] Floyd Norris, *Greenspan Asks a Question and Global Markets Wobble,* N.Y. TIMES, Dec. 7, 1996, at A1.
[7] GALBRAITH, *supra* note 4, at 168.
[8] *Id.*
[9] E.S. Browning, *Indexes May Undergo Three Straight Years of Declines, a Novelty,* WALL ST. J., Dec. 3, 2002, at C1.
[10] E.S. Browning, *Investors Seek Ray of Hope -- After Three Straight Years of Stock-Market Misery, Many Remain Hunkered Down Amid Risk of Another Slump,* WALL ST. J., Jan. 2, 2003, at R1. The 1800s also saw only one period of four straight years of declines, from 1836 through 1839. *Id.*
[11] The 89 percent decline is based on a fall from 381.17 in September 1929 to 41.22 in July 1932. Dow Data, Dow Jones Indexes, *available at* http://www.djindexes.com/jsp/avgDecades.jsp?decade=1920,
http://www.djindexes.com/jsp/avgDecades.jsp?decade=1930. In the more recent era, the Dow peaked at 11,722.98 in January 2000 and bottomed at 7,286.27 in October 2002 for a 38 percent decline. *See* E.S. Browning, *Bears Claw Markets Yet Again, As Dow Industrials Fall Nearly 3%,* WALL ST. J., Oct. 10, 2002, at A1.
[12] The Nasdaq Composite Index was not established until 1971. The 78 percent decline is from a high of 5048.63 in March 2000 to a low of 1114.11 in October 2002. *See* Browning, *supra* note 11.
[13] SELIGMAN, *supra* note 5, at 5.
[14] ARTHUR M. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 434 (1958).
[15] *Id.*
[16] SELIGMAN, *supra* note 5, at 16-17.
[17] *Id.* at 17.
[18] *Id.* at 25-26, 34.
[19] *Id. a*t 34.
[20] THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, VOL. I, at 653 (1938).
[21] SCHLESINGER, *supra* note 14, at 441.
[22] *Id.*
[23] *Id.* at 442.
[24] *Id.*
[25] *Id.* at 444-45.
[26] *Id.* at 444.
[27] SELIGMAN, *supra* note 5, at 77.
[28] *Id.*
[29] SCHLESINGER, *supra* note 14, at 457.
[30] *Id.* at 463.
[31] SELIGMAN, *supra* note 5, at 95.
[32] *Id.* at 98.
[33] SCHLESINGER, *supra* note 14, at 466-67.
[34] SELIGMAN, *supra* note 5, at 99.
[35] 15 U.S.C. § 78j (2007).
[36] Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2007).
[37] SELIGMAN, *supra* note 5, at 106.
[38] *Id.* at 105.
[39] SCHLESINGER, *supra* note 14, at 466.
[40] *Id.* at 469.
[41] James H. Quigley, *Please Be Patient,* WALL ST. J., May 25, 2006, at A14.
[42] *Id.*
[43] SCHLESINGER, *supra* note 14, at 469.