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INSTITUTIONAL INVESTOR
Advocate
A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

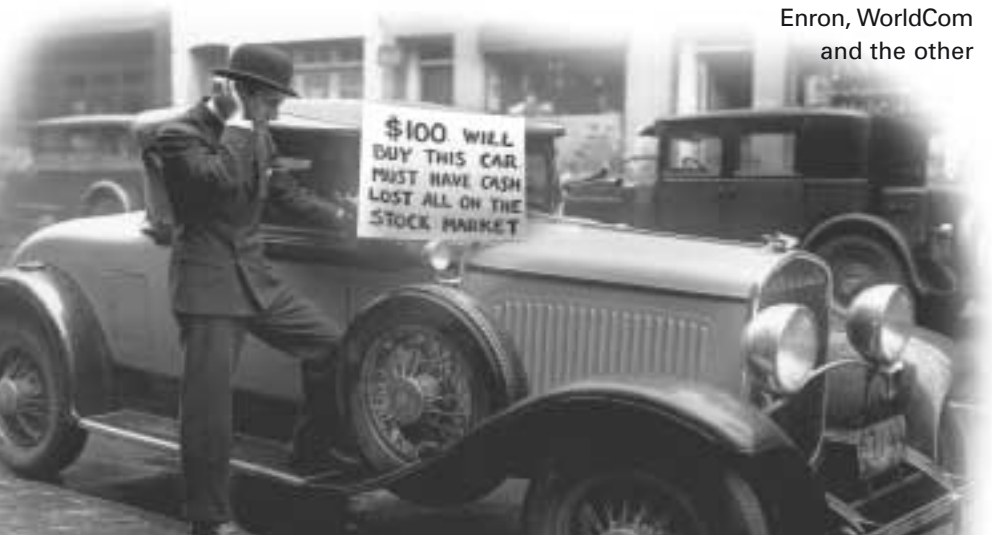
THE ORIGINS OF THE SECURITIES LAWS

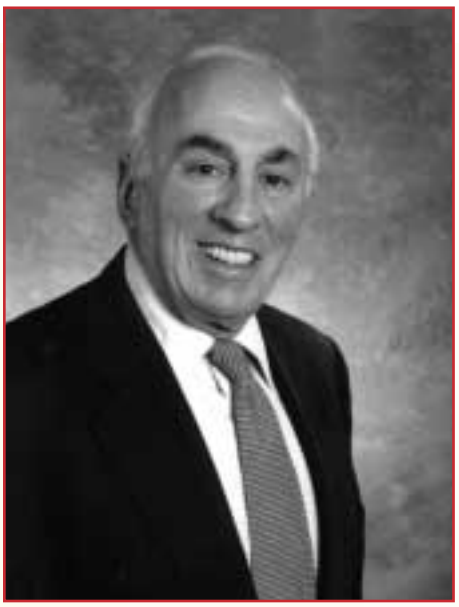
By Norman S. Poser

The corporate abuses that have come to light during the past few years are not unprecedented. Similar events led to the enactment of the federal securities laws seventy years ago. I have been asked to tell you something about the human side of these laws: the remarkable people who were present at their birth and who nursed them during their early days.

When Franklin D. Roosevelt took office on March 4, 1933, the country was in the depth of the worst Depression in its history. Thirteen million people, representing 25 percent of the work force, were unemployed — 800,000 in New York alone. Foreclosures of farms throughout the country, long lines at soup kitchens in the cities and towns, business and bank failures were signs as well as causes of the general despair.[1] The Great Crash of 1929 and its aftermath, which had wiped out 83 percent of the value of the stocks listed on the New York Stock Exchange, was still fresh in people's minds.

Many believed that corporate and stock market abuses had caused the Crash and that the Crash in turn had caused the Depression. Economists today disagree on both these propositions, but the important thing is that public anger against Wall Street far surpassed anything that we have seen as a result of Enron, WorldCom and the other scandals that led to the Sarbanes-Oxley Act. Securities reform was high on the list of measures contained in Roosevelt's New Deal program in 1933.





Norman S. Poser, Professor of Law, Brooklyn Law School. Professor Poser was a featured speaker at BLB&G's 10th Institutional Investor Forum.

In his nomination acceptance speech in Chicago, FDR made clear that his New Deal would include securities laws. He called for legislation that would "let . . . in the light on issues of securities, foreign and domestic, which are offered for sale to the investing public."[2] And now in his inaugural address, the new president used inflammatory language to denounce the "unscrupulous money changers [who] stand indicted in the court of public opinion, rejected in the hearts and minds of men.. . .The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths."[3]

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Inside Look

This quarter, the *Advocate* provides a fascinating look into the history of the securities laws in the United States and the individuals responsible for their creation.

On October 8, 2004, Brooklyn Law School Professor Norman S. Poser, a widely respected expert in securities regulation, delivered an extremely well-received speech on this topic as one of the featured speakers at our 10th Institutional Investor Forum. In "The Origins of the Securities Laws," Professor Poser further distills his fascinating look into the origins of the securities laws and litigation, told through the people responsible for the drafting, enactment, implementation and administration of these laws.

As we bid farewell to yet another year filled with corporate scandals and greed, we felt it was an appropriate time to reflect on the history of the securities laws. Beginning with the Great Crash of 1929, the ensuing Depression and Franklin D. Roosevelt's New Deal promise of securities reform, Professor Poser paints the picture of a country in despair and the public anger against Wall Street that lead to the creation of the Securities Act of 1933 and the Securities Exchange Act of 1934. Confirming that history does in fact repeat itself, the article tells of the revelations of excessive executive compensation, the spinning of IPOs and market manipulation, all while the legislation was still pending in Congress. Professor Poser also recounts the amazing story of Rule 10b-5, the agency's most important rule, which paved the way for defrauded investors to obtain recovery for a multitude of abuses, including insider trading and false corporate disclosures. We are proud to bring you Professor Poser's article and hope that you find it informative and fun to read.

Apart from the main article of this issue, I refer you to the regular *Eye on the Issues* column. As usual, we could fill the entire *Advocate* with news reports affecting securities and corporate law. This quarter, Benjamin Galdston makes his debut with an insightful compilation of the most significant developments in the field for your quick reference.

As previously referenced, we hosted our 10th Institutional Investor Forum on October 7 and 8, 2004 in New York City. We would like to again thank everyone who attended the Forum. We are told that the attendees found the Forum to be informative and enjoyable. If you would like to attend our next Forum on October 20 and 21, 2005, please contact us.

We hope that you will enjoy this issue of the *Advocate*. As always, we endeavor to make it worth reading and we welcome your comments, questions and input.

Mark W. Berger

SECURITIES LAWS

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To shape the securities laws, Roosevelt turned to Felix Frankfurter, a legendary Harvard law professor and now one of FDR's most trusted advisers, whom six years later he appointed to the Supreme Court. The actual work of drafting the statutes was done by an odd couple of Frankfurter proteges: Benjamin Cohen, a shy, soft-spoken religious idealist with a tough, practical lawyer's mind; and Thomas Corcoran (known to everyone as Tommy the Cork), an exuberant Irishman of great personal charm, who liked to sing ballads, accompanying himself on the accordian. However different their personalities, they shared a sophisticated approach to socio-economic problems and a capacity for hard, prolonged intellectual effort.[4]

Out of their labors came two statutes, the Securities Act of 1933, which regulated the distribution of securities; and the Securities Exchange Act of 1934, which sought to regulate the trading markets — meaning the New York Stock Exchange — and which outlawed market manipulation. Despite many amendments, these two statutes still stand in the same essential form in which Cohen and Corcoran drafted them.

Meanwhile, the Pecora hearings in Congress galvanized broad public support for the securities laws. Ferdinand Pecora, counsel to the Senate Banking Committee, was a fearless, aggressive Sicilian-born lawyer, with a flair for the dramatic, who delighted in taking on the captains of finance.[5] Many of the most outrageous revelations occurred during the first few months of the New Deal, while the Securities Act was pending in Congress.[6]

Some of these revelations have a familiar sound. There was tainted research. The Pecora hearings revealed that National City Bank (the predecessor of today's Citicorp) had aggressively pushed the sale of Peruvian bonds to the public, although the bank's own representatives in Peru had told the bank that Peru was unlikely to be able to repay interest or principal on the debt.[7]

There was excessive executive compensation. Charles Mitchell, president and chairman of National City, received a salary of only $25,000, but he and a few other National City executives divvied up 20 percent of the bank's profits each year. Mitchell made well over a million dollars in each of the years 1927 to 1929.[8] And that was real money in those days.

There was spinning of IPOs. The public learned from the Pecora hearings that

J.P. Morgan & Co., perhaps the most prestigious bank in the world, had a "preferred list" of influential individuals who received stock in securities distributions at a low price shortly before they went public at a much higher figure. This allowed them to sell the securities for a sure profit almost immediately after the offering.[9]

There was manipulation. The Pecora hearings revealed that the market abuses of the 1920s were continuing in full force during the opening months of the New Deal.[10] The operators of "manipulative pools" were skilled at "painting the tape," that is, creating a false effect of great activity and widespread buying that played on the gullibility and greed of the public.[11] The pool operators included members of prestigious investment banking houses, company officers, and specialists on the New York Stock Exchange. One pool operator was Joseph Kennedy, President John Kennedy's father.[12]

Disclosure of these abuses created broad public support for the legislation. Nevertheless, a strong hand was needed to guide it through Congress. That strong guiding hand belonged to Sam Rayburn of Texas, Chairman of the House Commerce Committee, later to become Speaker of the House.

Unlike the wealthy, aristocratic Roosevelt, Rayburn came from poverty. He was born on a 40-acre farm in Tennessee and had seen farmers invest in worthless securities. Rayburn hated the railroads, whose freight charges fleeced the farmers; he hated the banks, whose interest charges fleeced the farmers; he hated the rich; he hated the Republican Party, which he regarded as a tool of the rich; he hated Wall Street lawyers, especially the austere John Foster Dulles of Sullivan & Cromwell, who opposed passage of the securities laws tooth and nail, and was later to become Secretary of State under President Eisenhower.[13]

Rayburn had fought unsuccessfully for federal securities legislation twenty years earlier, when Woodrow Wilson was president. But now his time had come. His power in Congress was without rival. With great skill, he used this power to get the two laws through Congress. Yet despite his populist background and views, Rayburn was no revolutionary. Like Roosevelt himself and most of the New Dealers, his aim was to preserve capitalism, not to destroy it.[14]

Franklin Delano Roosevelt

FDR made clear that his New Deal would include securities laws. He called for legislation that would "let. . . in the light on issues of securities, foreign and domestic, which are offered for sale to the investing public."

Rayburn, like most of the intellectuals who formed Roosevelt's "brain trust," favored a philosophy of disclosure rather than substantive regulation. The 1933 Act was based on the belief that, if companies and their underwriters were required to disclose all information to investors, shady deals would be impossible. It was not necessary or desirable to tell a company how to run its business. The drafters followed Justice Louis Brandeis's belief that "sunlight is said to be the best of disinfectants."[15] This basic philosophy of disclosure still underlies the securities laws after 70 years.

The main purpose of the 1934 Act was to transform the New York Stock Exchange from a private club into a public institution that was accountable to the SEC. Despite the efforts of a succession of SEC chairmen, this goal has not been achieved. Back in 1934, Roosevelt had his doubts as to whether it was a realistic goal. He said: "the fundamental trouble with this whole Stock Exchange crowd is their complete lack of elementary education. I do not mean lack of college diplomas, etc., but just inability to understand the country or the public or their obligations to their fellow man."[16]

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Joseph Kennedy, the first Chairman of the Securities & Exchange Commission.

Many of the most outrageous revelations occurred during the first few months of the New Deal, while the Securities Act was pending in Congress. Some of these revelations have a familiar sound. There was tainted research. . . There was excessive executive compensation. . .There was spinning of IPOs. . . There was manipulation.

SECURITIES LAWS

Continued from page 3.

Roosevelt's words were strangely echoed last September by William Donaldson, the present SEC chairman and a former chairman of the NYSE. In an interview with the *Financial Times*, Donaldson expressed his exasperation with today's corporate executives: "The tone is set at the top," he said. "You must have an internal code of ethics that goes beyond the letter of the law to also encompass the spirit of the law. Does that concept exist in all companies? No."[17]

To administer the securities laws, Congress created the Securities and Exchange Commission, but who was to be its first chairman? To the surprise and consternation of most of his advisers, Roosevelt chose Joseph Kennedy, the well known operator of manipulative pools.

Kennedy was the exuberant son of a Boston saloon-keeper and Democratic Party leader. His language was earthy and his ethics questionable. But he was one of Roosevelt's few business supporters in 1932. He helped FDR both by raising money for him and by acting as a conduit to influential people, particularly to William Randolph Hearst, whose newspapers supported Roosevelt that year.

Kennedy had become rich as head of the stock trading department of Hayden Stone & Co., which later was absorbed by Shearson and eventually by Citicorp. During the early months of Roosevelt's administration, Kennedy complained loudly that his services to FDR had gone unrewarded. He had made his fortune; now he wanted respectability as a public servant.

Roosevelt, for his part, wanted an SEC chairman who would conciliate and reassure the business community, and above all someone he could trust. Jerome Frank, who several years later became SEC chairman himself, said the appointment was like setting a wolf to guard a flock of sheep. Roosevelt disagreed; to his closest advisers, he explained his appointment of Kennedy in simple language: "Set a thief to catch a thief."[18]

To the surprise of many, Kennedy turned out to be an effective chairman, in part because he had the support of the business community and in part because he had extremely capable fellow commissioners, including Ferdinand Pecora and James Landis, both of whom had badly wanted to be appointed chairman themselves. Landis was the son of a Presbyterian missionary in Japan. A protégé of Frankfurter, he was a thin-lipped, humorless man, who struggled all his life with incipient alcoholism. Landis succeeded Kennedy as chairman in 1935 and later went on to become dean of Harvard Law School. [19]

In the one year that Kennedy served as SEC chairman (1934-35), he rapidly organized the Commission, and he brought in talented staff members, including two future Supreme Court Justices, William O. Douglas and Douglas's assistant, Abe Fortas. A Yale Law School professor, Douglas was perhaps the country's foremost legal authority on corporate finance. He was tough, brilliant, and politically astute. In 1937, Roosevelt appointed Douglas as the SEC's third chairman.[20]

Although his tenure lasted only nineteen months, Douglas was probably the most effective leader in the SEC's history. Today, his long career as a Justice of the Supreme Court tends to obscure his accomplishments at the SEC. He reorganized and simplified the structure of the country's gas and electric utilities under the Public Utility Holding Company Act of 1935; he began the regulation of the over-the-counter market; and he imposed standards of accounting and corporate finance.[21] In 1939, Roosevelt appointed Douglas, then only 41 years old, to the Supreme Court, where he served until 1975, the longest tenure in the Court's history.

It was during Douglas's SEC chairmanship that one of Wall Street's most memorable and defining events occurred. At the time of the 1929 Crash, five years before Roosevelt took office, Richard Whitney had been President of the New York Stock Exchange. (In those days the exchange president was an active broker, not a professional administrator.) He was a man of arrogant, aristocratic pride, a highly respected Wall Street figure, whose firm acted as broker for J.P. Morgan & Co. on the floor of the Exchange. Later, he led Wall Street's powerful lobbying effort aimed at opposing and weakening the securities laws.

Whitney, however, was not a smart investor. This, combined with his weak sense of ethics, turned out to be his downfall. In 1933, anticipating Repeal of Prohibition, Whitney had invested heavily in the shares of Distilled Liquors, a New Jersey manufacturer of a potent drink known as "white lightning." Whitney posted the stock as collateral for loans he had incurred. But despite Repeal, Distilled Liquors did not flourish. In fact, it fizzled. Whitney tried to support the price of the stock by buying more shares, with the result that shareowners unloaded their shares on him. Whitney ended up owning 93 percent of the outstanding stock, which became essentially worthless.

Supreme Court Justice William O. Douglas. Appointed as the SEC's third chairman in 1937, Douglas was widely considered the most effective in the SEC's history.

As the price of Distilled Liquors declined, Whitney began using securities owned by the New York Stock Exchange Gratuity Fund, a fund created to support the widows and children of deceased members, as collateral for his personal loans. He also stole money from the New York Yacht Club and from estates he handled. In desperation, he tried without success to borrow money from other Exchange members, including some to whom he would not condescend to talk to during his years of prosperity.

In March 1938, Whitney reached the end of his ability to borrow or steal. His firm's bankruptcy was announced from the rostrum of the Exchange, and he was arrested for embezzlement personally by crime-busting New York District Attorney Tom Dewey, later to become a three-term Governor of New York and to run twice unsuccessfully for President. Whether an ambitious New York prosecutor can today use a Wall Street scandal as a step to higher office still remains to be seen. Whitney pleaded guilty to grand larcency and was sentenced to five to ten years in jail.

SEC Chairman Douglas used the Whitney scandal as a heaven-sent opportunity to reform the New York Stock Exchange. SEC hearings that he called to investigate the affair revealed that Thomas Lamont, the managing partner of J.P. Morgan & Co., had known about Whitney's embezzlement from the

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

Court Reduces Expenses Claimed by Lead Counsel in Enron Derivative Litigation. In the *Enron* litigation, Judge Melinda Harmon of the District Court for the Southern District of Texas was "disturbed" by certain travel and lodging expenses claimed by the lead counsel in their request for reimbursement. Lawyers for the lead plaintiff sought nearly $1 million reimbursement for meals, hotel and transportation expenses incurred during less than three years of litigation. Judge Harmon pointed out that "high-end lodgings" and first or business class travel do not benefit members of the plaintiff class. The Court reduced the amount of reimbursement by 20%, warning that it will require an explanation for any future travel and lodging expenditures that appear "excessive." *In re Enron Corp. Sec. Litig., Civil Action No. H-01-3624, Amended Memorandum and Order Awarding Lead Plaintiff's Counsel Partial Reimbursement of Expenses, at page 6. August 27, 2004.*

A Year For Investor Activism. Overall, corporate reform advocates faced stiff resistance in 2004, despite the well-publicized evaporation of shareholder value and implementation of the Sarbanes-Oxley Act. For example, the Business Roundtable led a well-coordinated effort to block shareholder nominations of directors. Late in the election season, the public was inundated with sensationalized rhetoric claiming class action litigation as "out of control." Despite this resistance, institutional investors achieved remarkable results in 2004 toward reforming corporate boards and persuading companies to adopt more stringent governance standards. Moreover, institutions won substantial recoveries for defrauded investors. Annual aggregated settlement values grew more than 40% over the past four years. And, in 2005, public funds are turning their attention to the enormous compensation packages provided to executives, even at companies with lackluster or declining stock prices. As former SEC Chairman Arthur Levitt put it: "Private suits are the primary method for compensating defrauded investors." Only by banding together can investors obtain the strength in numbers that can give them any hope of recovery against multibillion-dollar corporations. As the Fourth Circuit explained, "a class action serves important public purposes" in that it "afford[s] aggrieved [parties] a remedy if it is not economically feasible to obtain relief through the traditional framework of multiple individual damage actions." *Pensions & Investments, Nov. 29, 2004.*

U.S. Businesses More Litigious Than Individuals & Institutional Investors. Contrary to popular myth, individuals and institutional investors are *not* more litigious that businesses. In fact, U.S. businesses file four times as many lawsuits as individuals and institutional investors, according to a report published by the non-profit public interest research group Public Citizen. Most remarkably, the report found that businesses and their lawyers were almost 70% more likely to be sanctioned for frivolous claims or defenses. The report comes at a time when many politicians and business leaders have been campaigning feverishly for tort reform and heightened scrutiny of settlements and fees, and amidst a burgeoning effort to revise the Private Securities Litigation Reform Act of 1995. *Public Citizen (www.citizen.org).*

White Collar Crime On The Rise While Prosecutions Remain Unchanged. According to statistics published by the Administrative Office of U.S. Courts, there was no real change in the rate of criminal prosecution of financial fraud. For fiscal year 2001, there were 7,677 federal prosecutions for fraud of all types in the U.S., along with 99 prosecutions for securities and exchange fraud—one of the least prosecuted varieties. The total fell in 2002 and rose somewhat in 2003. But, for fiscal year 2004 ending March 31, there were 7,770 criminal fraud prosecutions, 97 of which were for securities and exchange violations. During the same period, the total number of federal criminal prosecutions increased from 62,870 to 70,132. Yet, during 2004, the number of private civil enforcement actions for securities fraud filed on behalf of investors rose only 8%. *Forbes News, November 2004 and Securities Class Action Clearinghouse, http://securities.stanford.edu/, January 2005.*

KPMG Punished For Turning A Blind Eye. Accounting giant KPMG was censured by the SEC and agreed to pay $10 million to Gemstar-TV Guide International shareholders for ignoring Gemstar's improper revenue statements. The case—*In the Matter of KPMG LLP, Rel. No. 34-50564, AAER No. 2125, Oct. 20, 2004*—demonstrates the SEC's tough stance on auditor independence. Although Gemstar earnings during the period of misconduct were misstated by a relatively small amount, KPMG repeatedly deferred to management representations even when those representations were contradicted by KMPG's audit work. In its settlement with the government, KPMG admitted no wrongdoing, but four of its auditors are prohibited from appearing or practicing before the SEC for periods of between 18 months to three years. As a condition of the settlement, KPMG also agreed to conduct additional training for its auditors on qualitative materiality and other related issues. *PCAOB Reporter, Nov. 8, 2004.*

First Criminal Convictions in Enron. A Texas federal jury convicted five former executives at Enron Corp. and Merrill Lynch & Co. for their part in a fraudulent Nigerian electricity-generating barge deal. A sixth executive was acquitted. According to the prosecution, in the 1999 deal Enron "sold"

two electricity generating barges off the coast of Nigeria to Merrill Lynch. Enron reported $12 million in earnings attributable to the sale. In actuality, the deal disguised a short-term loan by Merrill Lynch, which had no intention of actually purchasing the poorly-performing investments. The verdicts mark the first criminal convictions returned in a host of prosecutions related to Enron's 2001 collapse. The Houston-based company sought bankruptcy in December of that year after reporting billions of dollars in previously undisclosed debt that was hidden from regulators and investors through a maze of limited partnerships and fictitious derivative deals. *United States v. Bayly, et al., No. 03-CR-363 (S.D. Tex., Houston Div. Nov. 3, 2004).*

2004—The Year Of "Mega-Fraud." For 2004, the number of new class action filings alleging violations of the federal securities laws increased 18 percent over 2003, from 181 to 212 During the same period, however, lost market capitalization attributable to fraud nearly tripled from $58 billion to $169 billion, according to a study released in January 2005. According to the study, eight defendant companies each caused more than $5 billion in lost market capitalization. Three companies had disclosure dollar losses over $15 billion each, accounting for 45 percent of the total losses attributable to securities fraud in 2004. By comparison, only one filing in 2003 had a disclosure dollar loss of $5 billion or more. In other noteworthy trends, lawsuits alleging accounting practices in violation of Generally Accepted Accounting Principles ("GAAP") remained relatively constant in 2004, declining from 107 filings to 102 filings. Indeed, instead of accounting disclosures, many of the more sensational market implosions were attributable to product developments that had material adverse stock market price effects. For example, disclosures relating to insurance industry sales practices and concerns over the safety of COX-2 inhibitors marketed by Merck and Pfizer prompted some of the year's largest lawsuits, as well as a host of regulatory scrutiny. *"Securities Class Action Case Filings 2004: A Year in Review," Stanford Law School Securities Class Action Clearinghouse & Cornerstone Research, January 2005.*

Firms Scramble to Meet Year-End Audit Rules Under Sarbanes-Oxley Act. This year, Sarbanes-Oxley imposed stringent new reporting requirements. Section 404 requires that public companies vouch for internal financial controls and remedy any problems. For the first time, thousands of public companies and their auditors had to certify the strength of their financial checks and balances, an intense and costly effort that regulators call the most important reform to spring from the recent wave of accounting scandals. Despite initially opposing Sarbanes-Oxley, accounting firms are now reaping huge rewards as companies scramble to comply. A recent survey by Financial Executives International finds that, on average, companies will spend $3.1 million and 30,700 hours to comply—nearly double the estimates in a January poll. Much of that expense is revenue for privately held accounting firms. Audit fees are expected to jump more than 50% this year, says FEI, most of that attributable to new reporting requirements. *Business Week, Nov. 22, 2004.*

Court Upholds Sarbanes-Oxley Act's Requirement That Companies Certify Periodic Financial Reports. In *U.S. v. Richard M. Scrushy,* the District Court for the Northern District of Alabama denied former HealthSouth CEO Richard Scrushy's challenge to the constitutionality of Section 906 of the Sarbanes-Oxley Act, which establishes the duty of chief executive officers and chief financial officers of publicly-traded companies to certify the accuracy of the company's periodic financial reports filed with the SEC. Under the Act, failure to make a written certification is a criminal violation punishable by up to 10 years imprisonment and/or fines not exceeding $1 million. A "willful" violation is punishable by up to 20 years imprisonment and/or fines not exceeding $5 million. Scrushy contended generally that the statute is vague and, as a result, citizens are not meaningfully informed of their reporting responsibilities. The Court disagreed, finding the Act is both "sufficiently definite as to give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden, and specific enough to prevent arbitrary or discriminatory enforcement under its terms." *United States v. Scrushy, 2004 U.S. Dist. LEXIS 23820 (D. Ala. November 23, 2004).*

The Sweet Smell of Excess — Krispy Kreme's Scott Livengood Earns 2004 "Worst CEO" Honors. CBS financial commentator Herb Greenberg named Krispy Kreme CEO Scott Livengood as his annual pick for Worst CEO of the Year. Livengood was chosen over more than a dozen worthy candidates, including Disney CEO Michael Eisner, Oracle's Larry Ellison, and even Ray Gilmartin, who presided over Merck's Vioxx debacle. Livengood distinguished himself by his sheer hubris and greed by first blaming the company's unexpectedly lackluster results on former COO John Tate and then lamely pointing to the nation's fixation on carbohydrates. But, the overly-sweet donut makers' troubles run much deeper than the Atkins craze. The company bought bakery chain Montana Mills, only to sell it just two years later. Meanwhile, KK's efforts to expand its distribution channels by selling doughnuts through grocery stores and other retail outlets turned stale. It seems the company did not even understand the basic appeal of its own product: hot, freshly baked doughnuts straight from the oven —not sitting on a shelf for days at the local supermarket. After months of bad news, the board of the beleaguered company unceremoniously ousted Livengood with no severance package and replaced him at CEO with Stephen F. Cooper, a turnaround specialist who oversaw Enron's reorganization.*CBS MarketWatch, December 13, 2004; New York Times, January 18, 2005.*

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SECURITIES LAWS

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Gratuity Fund but had not thought fit to report it to the Exchange. J.P. Morgan, Jr., the head of the firm and the son of its founder, testified before the SEC, that while he did not know about Whitney's thefts, even if he had known he would not have told the Exchange authorities.[22]

Given this evidence of the Exchange's inability and unwillingness to regulate its own member, Douglas forced the Exchange to install a professional staff, headed by a full-time administrator as president, a post that was first occupied by William McChesney Martin, a young broker from St. Louis, who later became a legendary Chairman of the Federal Reserve Board.

But the culture of the NYSE has had an extraordinary resiliency. The Exchange's governing structure was again reformed during the 1970s after the NYSE proved itself incapable of dealing with a financial and "back-office" crisis that led to the failure of more than one hundred of its member firms. Recent events show that the "private club" aura still exists at 11 Wall Street. Today the Exchange is again being reorganized, only time will tell with what result.

Self-regulation in the securities industry has had a checkered history. The NYSE created it long before the federal securities laws were enacted—in 1869, to be exact—and not for altruistic reasons. In those days, managers of companies, most notoriously the Erie Railroad, fought off raiders who sought to gain control by the simple expedient of printing additional stock certificates.

This created a big problem for brokerage firms who sold securities to their customers on margin. The brokers held the securities as collateral for the loan, but the value of the collateral could not be determined if it could be so easily diluted by the uncontrolled issue of more shares. On the other hand, if stocks could no longer be purchased on margin, the boom days of Wall Street would be over.

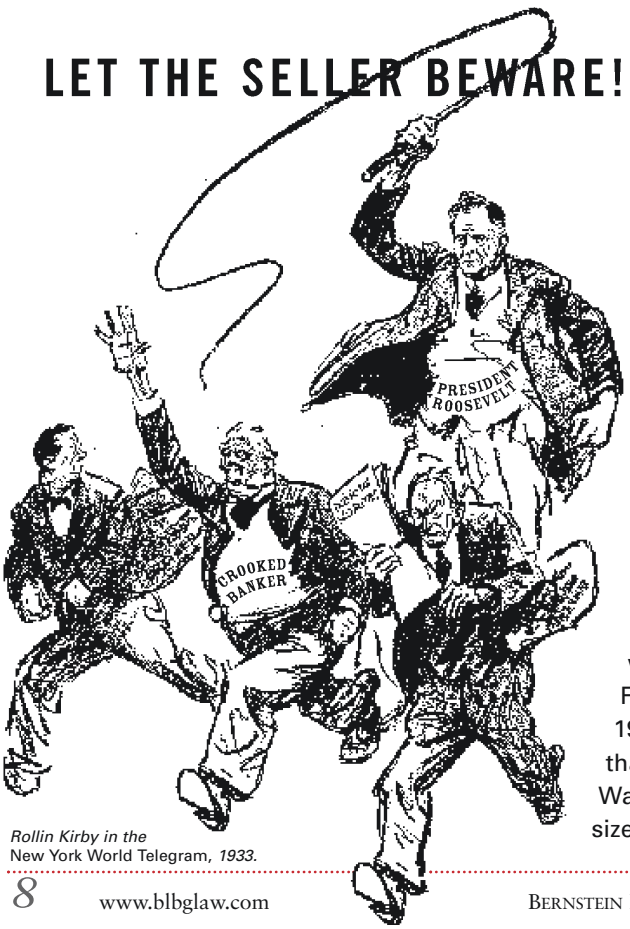
So, to protect its members' margin loans, the NYSE decided to become a regulator. It was in a position to dictate rules to its listed companies because it had recently merged with a rival exchange and had become the only stock exchange in New York. The NYSE forbade a listed company from issuing additional shares unless the shares were registered with a reputable financial institution.

Soon the Exchange added other rules, applicable to member firms as well as to listed companies. For sixty years until the 1930s, self-regulation rather than government would guide Wall Street as it increased in size, wealth, and power. The system was far from flawless, but most of the time it protected the public from outright fraud.[23]

FDR said: "the fundamental trouble with this whole Stock Exchange crowd is their complete lack of elementary education. I do not mean lack of college diplomas, etc., but just inability to understand the country or the public or their obligations to their fellow man."

The federal securities laws adopted the existing self-regulatory system and placed it under the supervision of the SEC. It was hoped that voluntary obedience to the law would be so complete that there would be nothing for the government to do, and that the self-regulators would impose ethical standards higher than the law could establish. William O. Douglas used the homely metaphor that government intervention would be like a shotgun kept behind the door, loaded, well oiled, cleaned, ready for use, but with the hope that it would never have to be used.[24]

Things haven't worked out quite the way Douglas hoped. In 1962, self-regulation completely broke down at the American Stock Exchange, where the specialists and floor traders freely sold and manipulated unregistered shares.[25] All this happened while Edward McCormick, a former SEC commissioner, was president of the Amex. McCormick was forced to resign when it came to light that Alexander Guterma, a stock swindler and corporate looter who was applying to the exchange for the listing of a company he controlled, had paid a $5,000



Rollin Kirby in the New York World Telegram, *1933.*

gambling debt of McCormick when the two executives partied together in pre-Castro Havana.[26] As in 1938 after the Whitney scandal, the Amex was reorganized under the SEC's supervision.

As a result of the NYSE's back-office crisis, which I mentioned earlier, in 1975 Congress gave the SEC much greater authority to supervise the self-regulatory agencies. Yet, in recent years it has been shown again and again that self-regulators cannot be relied on to police the market, even with the SEC as a well-armed watchdog.

The NASD sat by for years while Nasdaq market-makers colluded to fix their quotations; the NYSE allowed its floor brokers systematically to violate the SEC's rules prohibiting them from trading for their own account on the floor of the Exchange; most recently, the SEC found that seven NYSE specialist firms engaged in improper trading activity. And the *Wall Street Journal* recently reported that the SEC is preparing to bring charges against three smaller exchanges for failing to regulate their members.[27] To be fair, I would add that the NYSE and NASD handle most of the day-to-day regulation of their members, and much of the routine work is done well.

The SEC was especially aggressive during its early years. By the 1940s, however, it had become a more mature — and less forceful — agency. In large part, this was due to World War II. After Pearl Harbor, with the war to be won, securities regulation was hardly a priority; and in early 1942, the SEC was moved to Philadelphia to make room in Washington for government departments directly concerned with fighting the war. After the war, the SEC continued to be on the governmental backburner. President Truman had little interest in securities regulation, and he tended to appoint as commissioners political cronies and people to whom he owed favors. The SEC was considered so unimportant that it wasn't brought back to Washington until 1948, three years after the war ended.

In April 1938, Richard Whitney, the former NYSE President, was convicted of Grand Larceny in the theft of $214,000 of his client' funds. Here he is shown leaving Sing Sing prison on parole after serving 40 months of his sentence. From the gates of the grim prison, Whitney headed straight by auto for Barnstable, Massachusetts, where a job as manager of a dairy farm awaited him. He would run the farm, owned by former Lt. Gov. Caspar G. Bacon of Massachusetts for $200 a month and board. Terms of his parole barred him from Wall Street.

Ironically, it was during the SEC's Philadelphia exile that the most consequential event in the history of the securities laws occurred. In May 1942, investigators at the SEC's Regional Office in Boston learned that a company president was buying up shares from its shareholders without telling them of much improved earnings. When the lawyers at the SEC's Philadelphia headquarters scanned the statute and the rules, they found that there was no provision that the SEC could use to stop the fraudulent purchase (as opposed to the sale) of securities. Section 10(b) of the 1934 Act was designed to outlaw fraud generally, but it could be used only if the SEC adopted a specific rule implementing it.

So Milton Freeman, a young SEC attorney, quickly drafted a short, simple rule prohibiting fraud in connection with the purchase or sale of a security. He presented the new rule to the five-man Commission (there were no women commissioners until 1979, when President Carter appointed Roberta Karmel, who is now my colleague at Brooklyn Law School). The commissioners simply tossed the paper on the table saying they were in favor of it. One Commission member simply commented: "Well, we're against fraud, aren't we." Before the sun set that day, Rule 10b-5 was the law of the land. In those days, there was no Administrative Procedure Act, which now requires government agencies to publish proposed rules for comment before adopting them.[28]

Rule 10b-5 prohibits securities fraud, but it doesn't say anything about the right of a defrauded investor to sue the wrongdoer. In 1946, however, a lawyer in Philadelphia decided that the rule might be used as the basis for a private suit, and the federal judge agreed with him.[29] Since then, Rule 10b-5, which the SEC adopted in an almost absent-minded way on a day in May when the war was on most people's minds, has become, without doubt, the agency's most important rule. It has been the basis for many thousands of class actions and other lawsuits. The body of law inter-

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preting Rule 10b-5, including many Supreme Court decisions, is, in the words of Chief Justice Rehnquist, "a judicial oak which has grown from little more than a legislative acorn."[30] The rule has been used to obtain recovery for many kinds of abuses, including insider trading, false corporate disclosures, and a variety of abusive practices by brokerage firms and their employees.

Later in 1942, Milton Freeman, the draftsman of Rule 10b-5, turned his attention to drafting the SEC's new proxy rules. These rules provoked a fierce outcry from companies and from newspapers and magazines who supported the companies' point of view. One newspaper editorial complained that the proxy rules were unpatriotic: the SEC was fettering business while "American industry is doing such a magnificent job in helping win the war."[31] In Congress, Freeman was even called a communist. The SEC nevertheless adopted the proxy rules, but it decided not to adopt as part of the package a rule that would have given shareholders a say in nominating corporate directors. That proposal lay undisturbed somewhere in the SEC's files until last year, when, after the Enron, WorldCom and other scandals called attention to do-nothing, crony boards of directors, the SEC dusted it off and proposed a rather timid version of it. To date, it has not been adopted.

When President Kennedy took office in 1961, the revival of the SEC began. Kennedy appointed as SEC chairman William Cary, a Columbia Law School professor of fierce determination and ironclad ethical principles. Cary created the Special Study of Securities Markets, a two-year in-depth review of the markets and their regulation which I was fortunate enough to be a member of.

The Special Study led Congress to make two key changes in the securities laws. Beginning in 1964, over-the-counter (OTC) companies are required to make the same disclosures as listed companies. And in 1975, the NYSE and other stock exchanges were forced to stop fixing commission rates. These developments transformed the securities markets forever. Markets thrive on information, and when information became available about OTC companies, that market exploded in size. Nasdaq, the electronic quotation system established in 1971 by Gordon Macklin, then president of the NASD, has enabled the OTC market to challenge the supremacy of the NYSE.

"The tone is set at the top," William Donaldson [the present SEC chairman and a former chairman of the NYSE] said. "You must have an internal code of ethics that goes beyond the letter of the law to also encompass the spirit of the law. Does that concept exist in all companies? No."

The end of fixed commission rates, by reducing transaction costs, gave an even greater stimulus to the markets. For years, Wall Street bitterly opposed efforts by the SEC and the Justice Department to abolish fixed rates, which only goes to show that the financial community sometimes needs Washington to do for it what is in its own best interests.

In 1970, Robert Haack, a former Milwaukee broker who was president of the NYSE, had the courage and foresight to declare publicly that, if the NYSE wanted to remain competitive, it should allow its members to negotiate the commission rates they charged their customers. But Haack was ahead of his time. He lacked the support of a large portion of the membership and, as a result, his reward for being right was that he became the invisible man of Wall Street. He kept his job as president until his five-year contract with the Exchange ended, but his influence at the Exchange completely disappeared.[32]

It took the joint efforts of Congress and the SEC to forbid the fixing of rates,

Quarterly Quote

"The corporate-governance movement in America has become a mighty current. It can't be stopped — not by politicians or pawns of politicians, not by arrogant CEOs who plow all the money in the world to try to push us out of the way, not even by powerful lobbies such as the U.S. Chamber of Commerce or the Business Roundtable that spend millions each year fighting to maintain cozy board rooms. They are playing a losing hand because I believe 'right is might' and right will prevail in the end."

Sean Harrigan, Former President of the $177.8-billion California Public Employees Retirement System

which took effect on May 1, 1975. Largely as a result of this change, the average daily volume of trading on the NYSE, which was 18 million shares in 1975, has increased almost 100 times, to about 1.4 billion shares today.

In 1964, Cary was succeeded as chairman by Manuel Cohen, a graduate of my present employer, Brooklyn Law School, and the only staff member of the SEC ever to rise through the ranks without interruption to become a member of the Commission and then its chairman. He was a professional regulator in the best sense. He knew the rules as no other person did, and he made sure the rules kept up with developments in the markets. Manny Cohen's tenure saw a wave of mergers and acquisitions, and he was instrumental in getting Congress to enact the Williams Act, which regulates tender offers and corporate repurchases of stock.

John Kenneth Galbraith once observed that regulatory bodies, like the people who comprise them, have a life cycle. In youth they are vigorous, aggressive, evangelistic, and even intolerant. Later they mellow, and in old age — after a matter of ten or fifteen years — they become, with some exceptions, either an arm of the industry they are regulating or they become senile.[33] The SEC is clearly an exception to this rule. Although it had a long sleep in the 1940s and '50s, and while the efforts of state regulators such as Eliot Spitzer were sometimes necessary to awaken it from occasional siestas, the SEC's reputation as an effective government agency is well deserved. Many of those who served on the Commission or its staff, including myself, are proud to consider their years there as a top experience of their careers.

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a happy, healthy

and peaceful 2005.