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The Securities Exchange Act of 1934

American big business and its lawyers are familiar enough with integrated industry. A type of a completely integrated industry is one which digs its own raw material out of its own land, transports it by its own carriers, manufactures it through many stages into finished products, moves the products to its own selling depots, and disposes of the output through its own selling organization. The government in the Securities Act of 1933 and the Securities Exchange Act of 1934 is now giving business a taste of integrated regulation. So far as the federal jurisdiction can constitutionally extend, the government is now regulating the manufacture, that is, the issuance, of securities, wholesale and retail distribution of securities, and subsequent trade in securities. The venerable and once esteemed policy of laissez faire has received many assaults in all countries since the War, but scarcely ever has it sustained more comprehensive and conclusive repudiation than by the security legislation of the present Administration.

The Securities Exchange Act of 19341 consists of a new law and a rider. The Act itself establishes the federal regulation of stock exchanges. The rider amends the Securities Act of 1933.2

Amendments to Securities Act of 1933

I.

The Securities Act, known to its friends as the “Truth in Securities” Act or the “Let the Seller Beware” Act, required the registration of new securities with the Federal Trade Commission if the mails or any means of interstate communication were to be used in their sale. The essential feature of the Act is this registration of certain types of new securities with its consequent disclosures and the civil and penal provisions relating to misstatements and omissions. The right of registration does not depend upon the soundness of the enterprise represented by the securities. If the facts are honestly and accurately stated the stocks and bonds of a company proposing immediate interplanetary

communication may be registered. The Act, however, does contain an important supplement to state blue sky laws in its provision imposing criminal penalties for the use of the mails or other interstate communications to defraud in the sale of securities. With the exception of the latter stipulation, the Act has no application to securities issued and distributed prior to the passage of the law. The Securities Act has been the subject of so much written and oral discussion during the brief period in which it has been in effect that one may assume a familiarity not only with its general outline but with its details on the part of every person having even a remote connection with its operations.3


Much of the extreme exasperation with the law which is current in financial circles relates to the application of the law to particular critics themselves. The disclosures of salaries, bonuses and other advantages of insiders, which the Act requires, are exceedingly distasteful. The preparation of the detailed schedules is a burden and expense. The requirement that copies of contracts and indentures be included is particularly onerous and in many instances is of little utility. The statutory period of twenty days between the filing of the registration papers and their effective date, as well as numerous provisions relating to liabilities of underwriters, require basic changes in existing organizations for the distribution of securities. None of these objections is of much real significance in view of the larger aspects of the legislation. The passage of the Securities Act at a time when the security business was practically at a standstill, and when the experiences before and during the depression dictated in any event fundamental reform in investment banking, made it possible to comply with the Act with the minimum dislocation of vested interests.

The more thoughtful discussions of the Act, besides their function as mere expositions of its provisions, have concerned themselves chiefly with (1) comparisons between the Securities Act and the British Companies Act, emphasizing the much greater severity of the American law, (2) possibilities of unfairness of the law in respect to persons not primarily responsible for errors in documents filed for registration, and (3) the vagueness of numerous and important clauses in the Act.

Strenuous efforts looking to the amendment of the law were made from the moment of its passage. It was asserted that new financing for the larger industrial units was impracticable under the Act in its existing form. While many new securities were registered, especially in the brewery, distillery, and mining industries, it was pointed out that these were mostly small new corporations with relatively simple financial structures. On the other hand, there were few issues of railroad or municipal securities offered by investment bankers, though both of these are exempt from registration. Admitting that certain bankers and corporate executives were deterred from refunding operations, there is no conclusive evidence that new security issues would have appeared in important volume had the Securities Act been non-existent.

4 713 registration statements involving security issues amounting to $962,856,438 became effective in the fiscal year ending June 30, 1934. 216 of these involved reorganizations, the total issues amounting to $128,542,179. 775 statements involving security issues amounting to about $1,100,000,000 were registered up to July 31, 1934.

5 A few large corporations, including the American Water Works Company and Electric & United Aircraft & Transport, registered security issues in 1934.

6 The amount of railroad and municipal borrowings from the Reconstruction Finance Corporation is a suggestion of how little public market there was for any kind of new securities in 1933.
Much of the debate regarding amendment of the Securities Act ignored political and business realities that should have been recognized as decisive. A good many sponsors of the Act recalled the abuses of the boom period which terminated in 1929, and being convinced of the expert draftsmanship of the law were inclined to oppose even minor clarifying changes. They attributed especially to the lawyers opposing the law both uncanny subtlety and complete duplicity. If the counsel for any financial house made even the simplest proposal for a revision of a section in the law, certain persons were sure that the lawyer could phrase his language so adroitly as to kill the law's whole effectiveness. On the other hand, opponents of the measure not only exaggerated its adverse effect upon current financing operations but they seriously offered interpretations of the law which they themselves would be the first to reject as absurd if the interpretations were presented to them as judicial officers or by opposing counsel. The net result of much of the controversy was that opponents of the law ignored a widespread and even violent public and congressional opinion that would have demanded and enacted drastic security legislation if all of the academic and other experts concerned with the drafting and administration of the law had been removed to paradise. This public and political feeling was and is a reality and must be taken into account in any talk about modifying the law. At the same time business fears, even if groundless, and no one familiar with the law believes them wholly unfounded, are also a reality. They must be at least diminished if the Securities Act is not to have the effect of impeding the return of prosperity. Something has been done in this direction by the rider to the Securities Exchange Act.

II.

The 1934 amendments to the Securities Act transfer the administration of the Act to the Securities and Exchange Commission from the Federal Trade Commission without affecting anything done by the Federal Trade Commission or pending at the time of the transfer.\(^7\) No additional legislation is enacted relating to protective committees and reorganizations, but the new Commission is directed to make a study of this matter and report to Congress on or before January 3, 1936.\(^8\) The Securities and Exchange Commission has already created a special reorganization division in accordance with this direction.\(^9\) The larger number of the remaining amendments are formal changes proposed largely by the Federal Trade Commission itself and chiefly for the purpose of bringing about a greater consistency between various sec-

\(^8\) Ibid. § 78 jj.
\(^9\) Professor W. O. Douglas of Yale is Chief of the Reorganization Division.
tions. In section 2 the term "security" was broadened to include certificates of deposit for a security and fractionally undivided interests in oil, gas or other mineral rights as well as any guarantee of any of the forms of security defined in the Act. The provision regarding interests in oil and other mineral rights accords with the Commission's understanding of the original meaning of the section. The inclusion of "guarantee" in the definition of security is supplemented in section 2 (4) by eliminating a guarantor from the category of issuers. A guarantor no longer needs to sign the registration statement in respect to the security itself. Since a guarantee is a security the guarantee itself must be registered and the guarantor must furnish appropriate information about itself.

A further amendment in respect to issuers relieves from individual liability trustees of business trusts, trustees for protective committees and members of limited liability companies. The effect of this is to place the liability on the business entity though the active manager is still the issuer. The amendment is also in accordance with the Commission's opinion that since the trusts and committees are persons under the Act, they are the real issuers.

The definition of prospectus in section 2 (10) originally seemed to require a prospectus to be received by the prospective buyer prior to any other communication offering a security for sale. The amendment makes clear that the prospectus may accompany the communication and that the prospectus may be "given" as well as "sent." Of more significance is the substitution of "sent or given to," in place of "received by." The seller no longer has the absolute duty to see that the prospectus is received.

Section 3 relating to exempted securities and section 4 on exempted transactions are both amended by including among exempted securities, those exchanged for existing securities without the payment of a commission, securities exchanged in connection with reorganizations under court supervision or under a state banking or insurance commissioner's control, and securities sold entirely within a state, if issued by a domestic corporation. While these amendments add a few clauses to the substantial part of the original law, their principal significance is to attach the previous exemption to the security itself and not to the transaction in connection with which the security was issued. The law now expresses more clearly what was originally intended. The principal extension in the new section is the inclusion of state banking and insurance commissioners with courts. An important limitation on the exemption is found in the stipulation that the approval of the court or official must be given after a hearing on the fairness of the plan.
Section 10 b (1) relating to a prospectus more than thirteen months old is amended by changing the absolute requirement of the user to bring the information down to a date within a year of its use, to such a requirement only when the user has such information or can get it without unreasonable effort or expense.

Section 19 concerning special powers of the Commission now has a saving clause to the effect that no one complying with a regulation of the Commission before it has been rescinded or declared invalid by judicial or other authority will suffer any liability. This merely makes certain that persons who in good faith rely upon the Commissioner's orders will be adequately safeguarded.

The foregoing and several other minor alterations in the law obviously do little or nothing to meet the objections of those alarmed by the law's demands.

III.

Out of all the adverse criticisms of the Act those relating to the civil liabilities imposed by section 11 and section 15 taken in connection with the limitation of actions provisions in section 13 have been the most sincere and meritorious. The rider to the Securities Exchange Act made several substantial concessions on these points.

Section 11 of the original Act allowed anyone who acquired a security without knowledge of an untruth or material omission in the registration statement to sue, in rescission or for damages, every signer, every director or partner of the issuer, everyone named as about to become a director or partner, every expert responsible for any part of the registration statement and every underwriter. The plaintiff was not required to be the original purchaser nor to have seen or otherwise relied upon the registration. The liability of the issuer was absolute. Directors and others than experts might escape by timely resignation and notice, by showing lack of authority for their inclusion, or by showing reasonable investigation and reasonable grounds for belief in the statement or reasonable reliance on public documents, public reports, or reports of an expert. An expert's liability for the part of the statement for which he was responsible might be avoided by showing reasonable belief. The burden of proof in every situation was on...
the defendant. In determining what constituted reasonable investigation and reasonable belief, the standard was that required of a person occupying a fiduciary relationship. Suit might be brought in any state or federal court having jurisdiction over the defendant. The amount of recovery was limited to the offering price. Section 15 made liable under sections 11 and 12 all persons, individual and corporate, who controlled those made liable by the two sections. Section 13 fixed a two year limitation after the discovery of the untruth or omission for actions under section 11 and an absolute limitation of ten years after the security was offered to the public, irrespective of the date of discovery of errors and omissions.

Under the amended law if a person acquires a security after the issuer has made generally available a twelve months' earnings statement following the registration of the security, his right of recovery depends upon his assuming the burden of showing that he relied on the untruths in the registration statement or on the statement as registered with omissions. The amending clause adds that proof of reliance may be established without proof of the reading of the registration statement by the person suing. While this qualification diminishes the relief afforded by the amendment in respect to suits due to omissions, the shifting of the burden of proof seems of primary importance.

Greater lenity is shown to those liable under section 11 who rely on public records and reports of experts, by changing the requirements regarding reasonable belief from positive to negative terms. The defendant may show "he had no reasonable ground for belief and did not believe" statements based on such records or reports were untrue or that there was a material omission, or that statements in the registration statement did not fairly represent the public or expert’s report. The amendment at least makes clear that the director or banker does not have to make an investigation independent of that made by the expert.

The provision in section 11 establishing a standard of reasonable belief and investigation has been changed by the dropping of the expression "person occupying a fiduciary relationship" in favor of the phrase, "a prudent man in the management of his own property." There remains the same chance of the finding of different standards in different localities but presumably everywhere the conduct of the prudent man who acts for himself will be regarded more charitably than that of the trustee for widows and orphans.

The most important step toward the liberalization of the Act was leaving too many loopholes in the law a code of requirements which may legitimately be made of accountants and other experts can be developed which will afford them more guidance as to the liabilities they are accepting than is given them at present.
taken in the redrafting of the paragraph relating to damages. The stipulations regarding rescission are omitted. Damages are still *prima facie* the difference between the amount realized on the value of the security and the amount at which the security was offered to the public. One clarification here adopts the Commissioner's view that if a security is offered at $100, purchased by the plaintiff at $200 and sold by him at $50, his damages are $50 and not $100 as might have been contended under the original Act. The defendant under the amended law has the privilege, heretofore denied him, of reducing his liability to the extent that he can prove the alleged damages were not due to untruths or omissions in the registration statement but to other causes. The liability of an underwriter is absolutely restricted to the aggregate price at which the part of the security distributed by him was offered to the public, plus any special advantage accorded to him in connection with the offering. The underwriter may still be sued by any purchasers of the security whether or not their securities originated through him. The theoretical administrative complexities of this provision are considerable, but as a practical matter in most instances a local underwriter will doubtless be held responsible to the persons to whom his liability should extend.\(^1\)

The genuine fear that wealthy directors would be subjected to a multitude of suits by disgruntled speculators, who had no real cause of action, but who expected to be bought off for their nuisance value, has been met by a provision that in a suit under section 11 or any other part of the Act the court may require an undertaking from either side for the costs of the suit including reasonable attorney's fees. Even if such an undertaking is not required, the court in connection with a judgment may assess costs against either party, if the court believes the case of the loser to have been without merit, in an amount sufficient to reimburse the other litigant for the reasonable expenses incurred by him.

IV.

Whether or not these amendments go as far as investment bankers have a right to demand, they at least take away much of the force in the contention that the Securities Act is causing a paralysis in corporate financing. The Securities and Exchange Commission should give

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\(^1\) See Douglas and Bates, *Some Effects of the Securities Act upon Investment Banking* (1933) 1 *CHICAGO L. REV.* 233; Douglas and Bates, *Stock "Brokers" as Agents and Dealers* (1933) 43 *YALE L. J.* 46; Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 *YALE L. J.* 171. Professor Douglas has been perhaps the severest of the friendly critics of the Securities Act. Happily he is now in a position as a member of the organization administering the law to do something to correct its uncertainties and ameliorate its inequities.
sympathetic consideration to the problems of reducing or at least clarifying the responsibilities of accountants and other experts, and of simplifying the requirements for the filing of copies of documents in connection with registration statements. Under the British Companies Act it is sufficient if a corporation makes available certain documents referred to in the prospectus. Press statements report that the American Water Works Company recently filed a registration statement of 200 printed pages with 1600 additional pages of exhibits. In the reorganization of the United Aircraft and Transport Corporation, made necessary as a result of the ukase of the Postmaster General regarding mail contracts, four statements had to be filed, one by each of three corporations and an additional statement by a voting trust. Three months of labor was required in the preparation of the registration statements and prospectus. The documents submitted to the Federal Trade Commission by the applicants consist of two volumes for each company, each one being about one and one-half to two inches thick, on legal cap sheets. One volume is the original application and another the amendments. The whole amounts to forty or fifty pounds of ancient history, statistics and personal information.

The prospectus that was based on the registration statements is about 120 pages of closely printed matter. It includes in the schedule of reorganization expenses the following estimated items: registration fees, Federal Trade Commission, $4,238; printing of registration statements and prospectuses, $17,000; mailing notices and prospectuses to stockholders, $3,500. There is also $45,000 for accountants' fees and $50,000 for counsel fees, which would include an undisclosed proportion attributable to the necessity for registering. The reorganization had the approval of the shareholders in June, 1934. Registration of the new issues was effective August 31. The prospectus went to those who held the old securities, not to those who might purchase the new ones, and it gave the old stockholders little more pertinent information than was contained in the original letter describing the plan and the succeeding letter showing the allocation of earnings.

Congress, it seems, should recognize the justice of the demand that all suits under the Securities Act be brought in the federal courts. In the nature of things most suits will be so brought in any event. The repeal of the prohibition law again makes it possible for these courts promptly to take care of new business. Even if only the federal courts try cases under the Securities Act, it will require years before some of the unavoidable uncertainties of the law yield to authoritative in-

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12 Only the federal courts have jurisdiction of cases under the Securities Exchange Act. § 27.
pretation. If such problems as that of contribution among those several liable under the Securities Act may be passed upon by 48 state supreme courts in addition to the federal tribunals the reasonable administration of the law may be needlessly embarrassed. Nothing in the amendments heretofore adopted threatens the reforms intended by the law, nor would these reforms be imperiled by a simplification of the law's relation to the judiciary.

Securities Exchange Act of 1934

I.

Every recent depression has resulted in an investigation of stock exchanges and commodity exchanges. The country as a whole knew little about securities and not much about commodity speculation in 1907. The 1907 panic merely resulted in a New York investigation. The White Commission appointed by Governor Charles Evans Hughes in 1909 made an illuminating report about security and commodity speculation. Its conclusion was that state regulation of exchanges should not be attempted. Since by that time prosperity had appeared around its corner, the public accepted the Commission's opinion.

There was a mild depression in 1913 and the stock exchange was investigated, this time by Congress. Prosperity again returned and nothing was done. Another depression occurred in 1920 and another congressional inquiry was undertaken. This resulted in federal regulation of grain exchanges. The law was declared unconstitutional. Farm prices continued low—there was more investigation, a new regulatory law was passed, and this time sustained. Finally, we had the major depression beginning in 1929. Congress as usual investigated the stock exchange and since prosperity did not return promptly, we have at last the federal regulation of stock exchanges.

What one thinks of the Securities Exchange Act of 1934 depends


14 Report of Pujo Committee, Money Trust Investigation—Hearings before the House Committee on Banking and Currency on H. R. No. 429 and No. 504, 62d Cong. 3d Sess. (1913). See H. R. Rep. No. 1593. Mr. Samuel Untermyer was counsel for the Pujo Committee. See also Hearings before the Senate Committee on Banking and Currency on S. No. 3895, 63d Cong. 2d Sess. (1914). The Hughes report is also printed in this volume. The Senate committee had no counsel.

upon what he thinks about life in general. If he wants to abolish the
capitalistic state by next week, if he wishes the government to trans-
form the country into an American version of a dream of Theocritus,
or in the alternative a land where everyone not working for the gov-
ernment is living on his pension, and all are spending a generous
leisure in sport and listening to the radio, he will feel that government
regulation of stock exchanges has stopped far short of an ideal. He
may feel the same way if he wants horse-racing, lotteries, poker and
contract bridge to absorb all the gambling proclivities of our people.
On the opposite side he may believe that institutional and corporate
deficiencies can be remedied without government interference, that
governmental regulation of business generally means only added expense
to both business and government without profit to either, and that
where the business regulated is potentially profitable there is a con-
stant danger of corruption of the governmental agents with consequent
scandal and decrease in the already scanty respect for public authority.
A third viewpoint, which is presumably that of the sponsors of the
present measure, is that government, by the exercise of a conservative
control largely through the self-regulatory bodies of business itself,
can hold business to its own ethical standards and help business itself
to discipline its followers who are unfaithful to their own standards. 16
The Senate Committee on Banking and Currency found that imme-
diately prior to 1929 too much credit was absorbed in security specu-
lation, that manipulation and other unfair practices often made the
market prices of securities highly artificial, and that insiders of various
sorts had all kind of unfair advantages in respect to others interested
in corporate securities. To some extent these evils were beyond the
jurisdiction of stock exchanges, to some extent the exchanges were
impotent, to some extent they were indifferent. The Securities Exchange
Act attacks all these evils.

II.

The administration of the Act is divided between the Federal Re-
serve Board and the Securities and Exchange Commission. The Board
has most of the credit control, the Commission most of the regulation
of the practices of exchanges and their members. The Federal Reserve
Board has eight members. Two of these are the Secretary of the
Treasury and the Comptroller of the Currency. The rest, including
the one who must be an agricultural member, have ten year terms.
This might seem to assure a certain independence of the Administra-

16 See Berle and Means, The Modern Corporation and Private Property (1932); Dice, The Stock Market (1929); Ripley, Main Street and Wall Street (1927); Berle, Liability for Stock Manipulations (1931) 31 Col. L. Rev. 264.
tion in power and a consequent freedom from politics. In reality the combination of the presidential power of appointment and removal with the votes of the *ex officio* members seems more and more to make the Federal Reserve System an adjunct of the Treasury and dominated by Treasury policy. The Securities and Exchange Commission has five members, not more than three of whom can be brethren in the same political party. The latter provision is a comfort to liberal and lukewarm Republicans during a Democratic administration, and to tepid and conservative Democrats when the Republicans are distributing patronage.

III.

Everyone admits that vastly too much of the nation's credit resources went into stock speculation from 1927 to 1929. The original responsibility for this situation must be borne by the government itself, which for various reasons insisted upon a cheap money policy when prudence would have dictated a contraction of credit. The major excesses at the end of the speculative boom were due in considerable part to the use of corporate and other non-banking resources in the call loan market. To a very slight extent, if at all, was the mushroom growth in speculative credit due to scant margins on accounts with brokers. The Securities Exchange Act in sections 7 and 8 lays a basis for the control of credit in security transactions. Section 7 deals with margin requirements of brokers to customers; section 8 with loans to brokers and dealers. While the Federal Reserve Board is given authority to determine margin requirements, a standard is prescribed by the Act which in fact has been followed by the Board in the rules which take effect October 15, 1934. The legislative standard concerns only the initial extension of credit, that is, credit extended when a security is bought. The Board, however, may prescribe rules as to credit which may be subsequently maintained. The Board may also regulate the maintenance of a marginal account in general, including matters involving additional purchases, substitutions, withdrawals, arbitrage, transfers, under-margined accounts, short sales, and the like. The Board may also control the borrowing from banks for the purpose of security speculation.

The margin requirements suggested by the Act itself allow initial loans in alternatives, whichever is higher: 55 per cent of the current market price of the security or 100 per cent of the lowest price of the

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security during the preceding 36 calendar months (or for the present since July 1, 1933) but not more than 75 per cent of the current market price. These regulations might seem to impose an unfair clerical burden upon brokers, but statistical services have already developed tables for computing margin requirements. As soon as brokers' clerks have become familiar with the use of these market aids it will be relatively simple to determine the status of any customer's account in respect to the rules of the Federal Reserve Board. The margin requirements of the rules are not applicable until July 1, 1937, to accounts existing October 1, 1934. These old accounts are merely continued for liquidation. Certain securities such as United States, state and municipal bonds are exempted from provisions of the Act and certain provisions of the Act such as those involving loans by banks apply only to equity securities. Equity securities are generally stocks, although other securities may be brought within this classification. Credit may not be extended except on exempted securities and those registered upon a registered stock exchange though credit already extended on unlisted securities may be maintained under regulation of the Board.

In spite of the fact that the computations are not so formidable as first anticipated, that the regulations are flexible, and that the Board has shown no inclination to wreck the business of stock brokers, it may be questioned whether the attempt thus to control the details of the relations between brokers and customers is worth the agony it causes brokers and the amount of supervision it requires of the Board. The Board should have some reserve power to control the amount of credit allowed customers, but since it can regulate effectively in other ways the volume of speculation it would seem that so long as margin trading is permitted at all brokers under the general rules of the exchanges should be relieved from these detailed stipulations.

Section 8 authorizes the Federal Reserve Board to regulate loans made by banks and other lenders for speculative commitments in

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18 It seems obvious that this means that if a stock is selling at 80 and its lowest price the past three years is 60, a broker may lend $60 a share on the stock if registered either as listed or unlisted. Since the Federal Reserve Board's rules have been announced some question has been raised regarding the interpretation of these requirements. Mr. Meyer gives a number of helpful illustrations of the probable operation of section 7. Meyer, op. cit. supra note 15, at 51-54.

19 Securities and Exchange Act of 1934, § 3(12).

20 Ibid., § 3(11): "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security; or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."
securities. This power extends not only to loans to traders but also to borrowings by brokers and dealers. Brokers and dealers may borrow only from member banks, from other banks agreeing to conform to the law and regulations in respect to such borrowings, and from other brokers and dealers in accordance with rules of the Federal Reserve Board. Other borrowings by a broker are severely restricted. He may borrow from anyone for emergency needs, but subject to the Board's regulations. He may borrow from any source on exempted securities. What borrowings may be permitted on unregistered securities is uncertain. Since brokers cannot lend to customers on unregistered securities' borrowings on such securities can not be large. The Securities and Exchange Commission is given authority to promulgate rules relating to over-the-counter markets. Such rules when announced will have an important bearing on credit problems connected with unlisted securities.

If a customer has a credit balance with a broker this might be regarded as a borrowing. A bank's deposits are debts from the bank to the depositor but they are not regarded as borrowings within the meaning of statutes and rules limiting the amount a bank may borrow. It seems likewise that a customer's balance created in good faith with a broker should not be called a loan to the broker.

Loans to a broker which are not in connection with his ordinary business as dealer or broker are not forbidden. If a broker wants to borrow $10,000 from his mother to build a summer cottage on Martha's Vineyard, this is not a matter within the jurisdiction of the Federal Reserve Board.

The broker's aggregate indebtedness incurred in ordinary course of business may not exceed twenty times the net capital employed in the business. In computing net capital the broker must exclude fixed assets and the value of his exchange membership. Indebtedness includes customers' credit balances but excludes that secured by exempted securities. The Securities and Exchange Commission may restrict the indebtedness to a figure below the maximum stipulated in the law.

The hypothecation of a customer's securities may be regulated by the Commission. In no case may the broker commingle customers' securities for borrowing without the customers' written consent and in no case may securities of a customer be mingled with those of the broker himself or with those of someone not a customer. The lien
of the pledgee in any case must not be greater than the aggregate indebtedness of the customers in respect to the pledged securities. The chief change effected by the hypothecation provisions of the Act is the absolute prohibition against mingling customers' securities with the securities of others.

The Act forbids the broker to lend the customer's securities without the latter's consent. This as well as most of the hypothecation provisions is a mere re-enactment of existing law.

IV.

Sections 7 and 8, especially the latter, are the parts of the Act concerned with the larger aspects of credit and financial policy. Sections 9, 10, 11, 15 and 16 dealing with market practices, section 5 concerning the registration of exchanges, and section 12 concerning the registration of securities are the chief parts of the Act designed to raise and maintain standards of fair dealing on the exchanges.

It is a truism that the great majority of stock speculators lose money. Most of them will continue to pay high tuition for their financial education. Only the rare man can resist the psychological urge to follow the crowd. Those caught in the surges of popular buying enthusiasm will continue to err in the future as in the past. The difference should be that the shrewd, intelligent, well-poised speculator, who is not an insider, now has a much better chance. Admitting that most speculators have lost because of cupidity, ignorance and impatience, the possession of the opposite qualities was no guarantee of any better success. Artificial prices of securities were the rule rather than the exception. For speculative purposes the intrinsic merits of a stock were frequently irrelevant. The winners in the speculative movements obtained profits by strong-arm methods that had nothing to do with ability. The result was vast economic power, with all that implies in a democracy, in the hands of men whose ethical standards were substantially those of gangsters. If fairly carried on under restrictions that prevent its absorbing the energies of too many individuals and taking too much of the national credit resources, there is much to be said for stock speculation even as a form of gambling. Aside from the utility of speculative buying and selling in continuing a volume of transactions sufficient to make a real market, stock speculation is a

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25 This is statutory statement of a somewhat less specific standing rule of the New York Stock Exchange.

26 It is sometimes contended that if the exercise of judgment is involved, there is no gambling. If one wagers that around the corner a green car will appear before a cream-colored one, that is gambling. If he wagers that a given horse will cover a measured distance faster than another horse, that is an exercise of judgment.
competitor with poker in the development of the admirable human qualities of courage and patience. It trains one in the sound appraisal of his fellows. Unlike horse-racing and lotteries, the participants need not lose their whole stakes at once. Even the losers may retain some valuable assets. Speculation is the only form of gambling which requires its votaries to become educated men. A few years of unsuccessful trading in stocks may leave a man with no money but with a sound and extensive knowledge of applied economics, public finance, corporation finance, foreign trade, tariffs, banking, accounting, foreign languages, science, engineering, and imaginative writing. If the speculator is more fortunate and has large profits plus all this education, it means that economic power has come to the deserving. The great winner will be the magnificent spender, the patron of music, art, the drama, literature, and learning. The smaller winner will be the same in miniature. Both can furnish examples of gracious, generous living.

Section 5 makes it unlawful for any broker, dealer, or exchange to use the mails or any instrumentality of interstate commerce to employ the facility of any exchange in the United States unless the exchange is registered as a national securities exchange with the Securities and Exchange Commission or is exempted from such registration. The New York Stock Exchange and all of the other leading securities exchanges in the United States have already applied for and have been accorded registration. Section 30 makes it unlawful for brokers or dealers to use the facilities of exchanges not in the United States in evading the law.

Section 9 forbids any person by the use of the mails or any instrumentality of interstate commerce to employ the facilities of any national securities exchange to create artificial prices. Wash sales, matched orders, rigging the market, dissemination of information about

27 Cf. Holmes, J., in Board of Trade v. Christie Grain & Stock Co. (1905) 198 U. S. 236, 247: "Of course, in a modern market, contracts are not confined to sales for immediate delivery. People will endeavor to forecast the future, and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices, and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain." For a serious study of the economic effect of stock speculation by one of the severest critics of the present stock market machinery, see Flynn, Security Speculation: Its Economic Effects (1934). See also Danielian, The Stock Market and the Public (1933) 152 A. M. Econ. Rev. 496; Hawtry, Speculation in American and English Stock Markets (1934) 3 Am. Scholar 420.
market activity for the purpose of affecting the price of securities, and
the issuance of false and misleading statements regarding securities are
categorically prohibited. Pegging or stabilizing prices, puts, calls, straddles
and other options are unlawful except to the extent permitted by
the regulations of the Commission.

Section 9 imposes civil liability against violators of the prohibitions
of the section in favor of any bona fide investor or trader who buys a
security the market for which has been manipulated. All that the
plaintiff needs to show is that he bought or sold the security and that
the price of the security was influenced by the manipulation. Actions
to enforce such liability must be brought within one year after the
discovery of the facts constituting a violation and in any event within
three years after the violation. Contribution, as in cases of contract,
is permitted among those made liable under section 9.

Section 10 forbids short sales or stop loss orders of securities regis-
tered on a national security exchange except as such transactions are
allowed under the Commission’s regulations.\(^2\) Short sales or sales
against the box are forbidden to officers, directors, and ten per cent
stockholders. In addition section 10 contains a blanket provision for-
bidding any manipulative or deceptive devices in contravention of the
rules and regulations of the Commission. The resourceful and unscrup-
ulous traders who think up schemes not specifically condemned by sec-
tion 9 thus find themselves at best only one jump ahead of the Com-
mission.

V.

Some of the original drafts of the Securities Exchange Act proposed
to forbid brokers and particularly specialists to trade on their own
account. An exception was made of odd lot dealers. These proposals
were induced by disclosures of certain instances where brokers had
participated in pools to the disadvantage of their customers and of at
least one instance where a specialist had had an active part in the

\(^{2}\) Under section 16 every officer or director of a corporation and every holder
of ten per cent of any class of any registered equity security must file a statement
with the exchange and with the Securities and Exchange Commission. Any stock-
holder reaching the ten per cent class must file a report within ten days of becoming
such an owner. The obligation to report applies to beneficial ownership, irrespective
of the name in which the equity security is registered. If an officer, director or ten
per cent stockholder makes a profit from selling any equity security bought within
six months or from buying any equity security sold within six months, the profit
belongs to the corporation. If the corporation does not sue, any holder of any
security of the corporation may sue for the benefit of the corporation. Section 16
should accomplish a good deal in discouraging the use of confidential information
for the private advantage of insiders. See Dodd, *For Whom Are Corporate Man-
grers Trustees?* (1932) 45 Harv. L. Rev. 1145; Berle, *For Whom Corporate Man-
grers Are Trustees: A Note*, ibid. 1365.
direction of a pool in a stock in which he was specializing. The spon-
sors for these drastic provisions took little account of the harsh effect
the law in such form would have upon many upright members of the
stock exchange or of the possible consequence to the market of remov-
ing from trading privileges the floor traders and specialists.

About sixty members of the New York Stock Exchange engage in
trading exclusively for their own account on the floor of the Exchange.
The floor trader acts exclusively as principal and usually only with his
own capital. He has no customers and accepts no commission orders.
He buys and sells securities for his own account, assuming the entire
risk of profit and loss. He is not restricted to a fixed post nor to a
limited number of securities. In the course of the day's trading the
floor trader competes throughout the floor with specialists, other floor
traders, and brokers buying for the account of their customers, thus
contributing to the maintenance of a fair market in all the stocks in
which he deals. The general opinion seems to be that the floor trader
performs useful services in the maintenance of a continuous and liquid
market. If the trading on the exchange were limited to the execution
of commission house orders there would likely be occasions on which
the divergence between the bid and asked prices would be so extreme
as to result in wide fluctuations. The presence of the floor trader,
ready to buy and sell instantly for his own account and for small
profits, tends to prevent excessively sharp rises and declines.

The specialist is a member of the exchange who deals exclusively
in one or more stocks and is thus able to execute promptly all orders
entrusted to him. The operations on the floor of the exchange are so
active and varied that it is physically impossible for a broker who
directly represents a commission house personally to execute all trans-
actions committed to him. A specialist is primarily a broker's broker
who can instantly execute orders for the purchase or sale of specific
stocks. The specialist, however, is also a dealer. Under the rules of the
stock exchange as they have long existed the specialist with a market
order in his possession is barred from trading for his own account
until that order is filled. The business of the specialist is carefully
supervised and drastic penalties are imposed if, in connection with his
work as a specialist, he indulges in any practice inconsistent with just
and equitable principles of trade.

Whenever the specialist deals on his own account his trades, by the
rules of the New York Stock Exchange, are not binding except with
the consent and approval of the representative of the firm with whom
he deals. The original draft of the Securities Exchange Act proposed
to divide specialists into two categories, \emph{viz.}: dealer-specialist and broker-
specialist. The dealer-specialist was to be allowed to trade for his own account but not to accept commission orders, while the broker-specialist might execute orders for others, but could not trade on his own account. The specialists themselves argued strongly against this provision. The brokers have a large investment alone in their stock exchange seats. During periods of inactive trading it may be difficult for a specialist to obtain an adequate income merely from orders executed for others. Not only is the privilege of trading on his own account necessary to the livelihood of the specialist, but his own trades, just as the transactions of the floor traders, help to maintain a continuous market. The specialists also pointed out that over a long period of years the record of the specialists had been almost wholly free from allegations of misconduct. Congress ultimately withdrew from the extreme position of the original draft of the law and without forbidding specialists or other brokers to trade on their own account authorized the Commission either to regulate or wholly to prohibit trading by members on the floor of the exchange either for their own account or for discretionary accounts. The Commission was authorized to regulate trading by members off the floor but on the exchange in order to prevent such trading from becoming excessive. The Commission is further permitted to make special rules for arbitrage transactions, transactions in exempted securities, and transactions by odd lot brokers and specialists. Specialists are not permitted to execute discretionary orders.

A broker who is also a dealer may not carry on margin directly or indirectly a security which was part of a new issue in the distribution of which he participated as a member of a selling syndicate within six months. Likewise, a broker who is also a dealer may not make a purchase or sale for or with a customer unless he discloses to the customer in writing whether he is acting as a dealer for his own account or as a broker. The Commission is directed to study the feasibility of completely segregating the functions of dealers and brokers and report to Congress on or before July 3, 1936.

VI.

Sections 12 and 13 prescribe the procedure for registering securities to be traded in on national securities exchanges, the reports which must be filed when the security is registered and the periodical reports which must be filed thereafter. The corporation whose security is to be registered must set forth in its application relevant information about itself and its affiliates, including the articles of incorporation, by-laws, indentures, underwriting agreements, names of directors, officers, underwriters and stockholders holding more than ten per cent of any class
of the corporation's stock, their interests in the corporation's securities, their remuneration, and their contracts with the corporation as well as the remuneration of more than $20,000 a year to others than directors and officers. Besides balance sheets and profit and loss statements for three years, which the Commission in its discretion may require to be certified by independent public accountants, the Commission may demand other financial statements which it deems necessary for the protection of investors.

The exchange must first approve a security for listing and certify that fact to the Commission. Under section 19 the Commission may refuse registration, but if it does so, it must give notice and opportunity for hearing. The Commission's orders are subject to court review.

Securities listed when any exchange is registered may be provisionally registered until July 1, 1935, without furnishing the information outlined in the law. The issuers of such securities are not excused from furnishing periodical reports under section 13. By section 13 annual reports must be furnished to the exchange and the Commission by all corporations whose securities are listed. Quarterly reports and other documents to keep the information filed under section 12 reasonably current may also be required by the Commission.

One of the most significant powers of the Commission is that of prescribing the form of reports and the items and details of the balance sheet and earnings statements. The Commission may also stipulate methods for valuing assets and liabilities, determining depreciation, recurring and non-recurring income and investment and operating income, and preparing separate and consolidated financial statements. In the debates on the law there was much loose talk about the Commission's being given the power to regulate the internal management of corporations. The law stops far short of such power but the potential control over accounting practice is in reality formidable. The need for greater uniformity and clarity in corporate accounting has long been recognized. The Commission will doubtless be cautious in its prescriptions and will act only with expert counsel and after consultation with the parties concerned. One purpose of the Act is clearly to protect investors by giving them more current information in more understandable form. The Commission cannot satisfy this purpose unless ultimately it effects a noteworthy revision in the public financial statements of many corporations.

VII.

In addition to listed securities it has been the practice of exchanges to make up a second category of securities in which trading is per-
mitted although the securities are not registered. Besides these listed and unlisted securities traded in on the exchanges there are, from the standpoint of the investor, two other classes of securities. One group is bought and sold in the over-the-counter market. The other class consists of the securities of small corporations throughout the country which are bought and sold from time to time by local and other investors although no particular market is maintained in them. It is the present practice in respect to securities subject to trading on the over-the-counter market for some brokerage or investment house to announce itself as making a market for certain securities in which it is interested. It gathers lists of persons who are likely to wish to buy or sell these particular securities. The financial community understands that purchases and sales of certain unlisted stocks and bonds may most conveniently be made through certain houses. These houses also are generally ready to quote bid and asked prices. The Securities Exchange Act recognizes that if it applied only to trading on national exchanges in listed securities the over-the-counter market might offer an easy means of evading the law. The Act therefore contemplates that the Commission will ultimately regulate transactions on over-the-counter markets, require the registration of dealers and brokers making such a market, and the registration of securities. Congress recognized, however, that the complexity of actual and potential problems relating to unlisted and over-the-counter trading was too great to be solved by detailed statutory enactments and that in any event some time would be necessary before definite regulations could be formulated. The Act accordingly allows the Commission to continue until June 1, 1936, unlisted trading privileges to securities which had such privileges prior to March 1, 1934. The granting of such unlisted privileges is made only after application by the exchange itself. Such unlisted securities are then exempt from the registration and most of the reporting requirements of sections 12 and 13. If the security in question has not been registered on the exchange making the application for unlisted privileges to it, but has been accorded unlisted trading privileges on another exchange, the Commission may grant unlisted trading privileges to it until July 1, 1935. The Commission is also directed to make a study of trading in unlisted securities and to report with recommendations to Congress on or before January 3, 1936.

The regulation of over-the-counter markets is left entirely to the Commission. It is to be noted that the Commission only has authority where a real market is maintained for both the purchase and sale of any security except an exempted security, commercial paper, or unregistered security the market in which is predominantly intrastate and
which has not previously been listed or registered. The law thus discourages any attempt to avoid the application of its provisions by removing securities from stock exchange lists. The Act does not apply where a market for purchase and sale is not maintained, nor to incidental dealings by investment houses in securities in which they do not make a market, security sales by auctioneers, and purchases and sales by individuals who are neither brokers nor dealers.

VIII.

Reference has already been made to civil liabilities for manipulative market practices. A civil liability is also imposed for making a false or misleading statement in a document filed under the Act. Plaintiffs in such suits must have relied on the statement. This liability is less extensive than that in favor of persons suffering from manipulative market practices who may recover without showing any relationship between themselves and the person whom they are suing. Criminal penalties are also imposed for wilful violations of the Act. The maximum punishment is $10,000 fine or imprisonment for not more than two years, except that an exchange may suffer a maximum fine of $500,000.

All suits to enforce civil liability must be brought one year after the discovery of the facts and in any case within three years from the date when the violation occurred. The court, as in the amendment to the Securities Act, has the power to require either party to give bond for costs including attorney's fees and to impose costs including attorney's fees against either party. A contract made in violation of the Act is void against the guilty party. The Commission may enforce the Act by various steps supplementing the criminal penalties and civil liabilities. The Commission for cause may withdraw or suspend exchanges, exchange members and officers and securities. The Commission may also apply for injunctions or mandamus to prevent violations or to compel compliance. Jurisdiction over all criminal and civil suits under the Act is vested exclusively in the federal courts. Under the Securities Act the federal courts have jurisdiction over all criminal proceedings but have concurrent jurisdiction with the state and territorial courts in respect to civil suits. The Securities Act indeed goes so far as to prohibit the removing of a suit brought in a state court to a federal court.

30 Ibid., § 32.
31 Orders of the Commission, as distinguished from its rules and regulations, may be reviewed in the United States Circuit Courts of Appeals or the Court of Appeals of the District of Columbia. Ibid., § 25.
32 Ibid., § 21.
33 Securities Act of 1933, § 22.
The Act in its 34 sections contains a number of other administrative provisions, some of which are of considerable importance, but to which limitations of space prevent extended reference here.

IX.

The New York Stock Exchange, other stock exchanges, and most corporations whose securities are listed have accepted the new law and have taken steps to continue their activities in accordance with its provisions. Even if none of the larger exchanges challenges the constitutionality of the Act, it seems inevitable that in due course some disciplinary or other ruling either by the Federal Reserve Board or the Securities and Exchange Commission will be met by an allegation of the Act's unconstitutionality.

The draftsmen of the law recognized the prevailing skepticism about the constitutional warrant for federal regulation of stock exchanges. The stock exchange regulation bill was not introduced until after extensive investigation by Congress of the security markets. The inquiries conducted by the Senate Committee on Banking and Currency, while occasionally without dignity and frequently given publicity in such a way as to amount to extreme unfairness to the interests being investigated, set a new standard for thoroughness of preliminary preparation. This was especially true after Mr. Pecora became the Committee's counsel. In prior investigations, while the members of the congressional committees and their counsel actually knew of a good many abuses, notably in connection with manipulative practices, their information, however credible, was mostly their own personal knowledge or hearsay. So far as it could be established by direct testimony, the witnesses generally were obscure people with private grudges. The more eminent men of business were apt to assume a bland ignorance of all but the most ethical conduct. Short selling by officers and directors might have been alleged, but the great banker on the stand had never done such a thing nor, so far as he knew, had any of his friends. The investigation expired with the publication of huge and chaotically arranged volumes, which, however entertaining, nobody read. The matter ended with some congressional sharp-shooting, indignant editorials in the New Republic and the Nation, and editorial platitudes in most other journals of opinion. Mr. Pecora's method was to mobilize a squad of accountants and statisticians among whom the depression gave him a wide choice in expertness and experience, obtain access by persuasion, coercion and subpoena to the most secret records, discover the actual history of innumerable speculative movements, and then ask

34 Ferdinand Pecora, now a member of the Securities and Exchange Commission.
the participants in public for explanations which were dramatic enough to be news and which also became a part of public records. The net result was not only to make out a \textit{prima facie} case for regulation but at the same time to emphasize the national as distinguished from the local interest in the doings of the securities markets.

The Act opens with a recital of reasons why transactions upon securities exchanges and over-the-counter markets are affected with a national public interest.\textsuperscript{35} This recital mentions the volume of such transactions, asserts that many of them originate outside the states in which the exchanges are located and require the use of the mails and other instrumentalities of interstate commerce for their communication, that the issuers of securities are engaged in interstate commerce, and that the transactions involve the use of credit directly affecting the financing of trade, industry and transportation in interstate commerce and thus influence also the volume of interstate commerce. Mention is also made of the relation of quotations on the securities exchange and the use of credit in connection with security transactions, to federal taxation, the national banking system, and the Federal Reserve System. Finally, in a concluding paragraph the assertion is made that manipulation, excessive speculation, and unreasonable fluctuations of security prices adversely affect the general welfare.

The draftsmen of the Act obviously relied chiefly upon the commerce power as a basis for this marked extension of federal authority. The law is not a tax nor banking measure. The power of Congress in respect to banks is itself only an implied power.\textsuperscript{36} The limits of congressional control over the mails have never been clearly defined.\textsuperscript{37} Even if Congress has absolute power over the mails, if this were all, the scope of federal regulation of security markets would be narrowed materially. The general clauses in the preamble to the Constitution

\textsuperscript{35} Securities and Exchange Act of 1934, § 2.
\textsuperscript{36} McCulloch v. Maryland (1819) 4 Wheat. (17 U.S.) 315.
\textsuperscript{37} The congressional power over the mails seems broader than its authority over interstate commerce. No exclusion from the mails as a result of an act of Congress has thus far been held unconstitutional. The cases of exclusion, however, have uniformly involved matter which would commonly be regarded as evil. See \textit{Ex parte Jackson} (1877) 96 U.S. 727; \textit{In re Rapier} (1891) 143 U.S. 110; Champion v. Ames (1903) 188 U. S. 321 (exclusion of matter relating to lotteries); Public Clearing House v. Coyne (1904) 194 U. S. 497 (matter in furtherance of schemes to defraud); Milwaukee Pub. Co. v. Burleson (1921) 255 U. S. 407 (reasonable matter). The postal power, like other powers, is subject to the bill of rights. Congress through the postal power could not put limitations upon the freedom of the press. \textit{Ibid.} at 430; Burton v. United States (1906) 202 U. S. 344, 371. See also Cushman, \textit{National Police Power under the Postal Clause of the Constitution} (1920) 4 \textit{Minn. L. Rev.} 402; Pam, \textit{Powers of Regulation Vested in Congress} (1910) 24 \textit{Harv. L. Rev.} 77, 99; Rogers, \textit{The Extension of Federal Control Through the Regulation of the Mails} (1913) 27 \textit{Harv. L. Rev.} 27.
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have never been understood to transfer power from the states and the people to Congress.

In an earlier article I asserted that if Congress wished to regulate stock exchanges the Supreme Court in Board of Trade of the City of Chicago v. Olsen had indicated the drafting technique to be followed and that the constitutionality of the legislation would depend upon the implication to be drawn from the same case. While such a statement may be an undue simplification of the problem, it still seems to me essentially true. The dicta in several earlier decisions would indicate that Congress could not regulate stock exchanges. The earlier de-


The Hopkins case held that the rules of the unincorporated Kansas City Livestock Exchange establishing a fixed commission charge and forbidding certain dealings did not make the exchange a combination in restraint of trade. In this case the Court said: "The selling of an article at its destination, which has been sent from another State, while it may be regarded as an Interstate sale and one which the importer was entitled to make, yet the services of the individual employed at the place where the article is sold are not so connected with the subject sold as to make them a portion of Interstate commerce, and a combination in regard to the amount to be charged for such service is not, therefore, a combination in restraint of that trade or commerce." 171 U. S. at 590. The Court continued: "Members of the New York Stock Exchange buy and sell shares of stock of railroads and other corporations, and the property represented by such shares of stock is situated all over the country. Is a broker whose principal lives outside of New York State, and who sends him the shares of stock or the bonds of a corporation created and doing business in another State, for sale, engaged in Interstate commerce? If he is employed to purchase stock or bonds in a like corporation under the same circumstances, is he then engaged in the business of Interstate commerce? It may, perhaps, be answered that stocks or bonds are not commodities, and that dealers therein are not engaged in commerce. Whether it is an answer to the question need not be considered, for we will take the case of the New York Produce Exchange. Is a member of that body to whom a cargo of grain is consigned from a Western State to be sold engaged in interstate commerce when he performs the service of selling the article upon its arrival in New York and transmitting the proceeds of the sale less his commissions? Is a New Orleans cotton broker who is a member of the Cotton Exchange of that city, and who receives consignments of cotton from different States and sells them on "change in New Orleans and accounts to his consignors for the proceeds of such sales less his commission, engaged in interstate commerce? Is the character of the business altered in either case by the fact that the broker has advanced moneys to the owner of the article and taken a mortgage thereon as his security? We understand we are in these queries assuming substantially the same facts as those which are contained in the case before us, and if these defendants are engaged in interstate commerce because of their services in the sale of cattle which may come from other States, then the same must be said in regard to the members of the other exchanges above referred to. We think it would be an entirely novel view of the situation if all of the members of these different exchanges throughout the country were to be regarded as engaged in Interstate commerce,
cisions did not develop any clear principle nor to the extent that they
denied congressional authority did they show any unanimity of opinion.
The decision in the Olsen case was not unanimous, but with only two
dissents it at least represented a judicial attitude of greater significance
than an affirmance by necessity or a five to four decision. A second
point is that in fact the national interest in stock exchanges is now
much greater than when Hopkins v. United States was decided in
1898, or even Hatch v. Reardon in 1907. It is quite possible that
security trading on the great exchanges forty or even twenty years
ago did not affect interstate commerce sufficiently to afford a constitu-
tional warrant for federal regulation. That would not require the
same conclusion today with the great increase of corporate over private
ownership, the vast enlargement in the distribution of securities, and
in general the greater integration in the financial life of the nation.

The peculiar significance of the Olsen case lies in the fact that in
the earlier case of Hill v. Wallace the Supreme Court had declared
unconstitutional practically the same Future Trading Act as was before
because they sell things for their principals which come from States different from
the one in which the exchange is situated and the sale made." 171 U. S. at 597.


The Moore case decided that the New York Cotton Exchange could not be
compelled to deliver its quotations to another exchange. The Court rejected a con-
tention that the operations of the Exchange were in restraint of trade. The Court
said: "The New York Exchange is engaged in a local business. Transactions between
its members are purely local in their inception and in their execution. They consist
of agreements made on the spot for the purchase and sale of cotton for future
delivery, with a provision that such cotton must be represented by a warehouse
receipt issued by a licensed warehouse in the Port of New York and be deliverable
from such warehouse." 270 U. S. at 604.

Quaere, whether the implications from these quotations are not repudiated by
the holding in the Olsen case.

No such discussion would be complete without at least a reference to Paul v.
Virginia (1868) 8 Wall. (75 U.S.) 168, holding that insurance contracts are not sub-
jects of interstate commerce. The Court said: "The defect of the argument [that this
was interstate commerce] lies in the character of their business. Issuing a policy of
insurance is not a transaction of commerce. The policies are simple contracts of
indemnity against loss by fire, entered into between the corporations and the as-
sured, for a consideration paid by the latter. These contracts are not articles of
commerce in any proper meaning of the word. They are not subjects of trade and
barter offered in the market as something having an existence and value independent
of the parties to them. They are not commodities to be shipped or forwarded
from one State to another, and then put up for sale. They are like other personal
contracts between parties which are completed by their signature and the transfer
of the consideration. Such contracts are not interstate transactions, though the
parties may be domiciled in different states. The policies do not take effect . . .
until delivered . . . etc." 75 U. S. at 183. See also Hammer v. Dagenhart (1918)
247 U. S. 251 (child labor law based on commerce clause held unconstitutional).

41 Supra note 40.
42 Supra note 40.
43 (1922) 259 U. S. 44.
the Court in the Olsen case. The Court in Hill v. Wallace said the Act was on its face a device to regulate boards of trade and could not be sustained as an exercise of the taxing power. The Court refused to uphold the Act under the commerce power on the ground that Congress did not have the exercise of the commerce power in mind and that the Act "lacked appropriate limitations." Sales for future delivery "cannot come within the regulatory power of Congress as such, unless they are regarded by Congress, from the evidence before it, as directly interfering with interstate commerce so as to be an obstruction or a burden thereon." Congress thereupon continued its investigations of grain exchanges, recited its findings in the Grain Futures Act as assertions of the relation between grain trading and interstate commerce, and reenacted with slight modifications the Future Trading Act. When the Grain Futures Act, being challenged on the same grounds as its predecessor, came before the Court, the Court sustained it on the authority of Stafford v. Wallace. Chief Justice Taft in his opinion said:

"Whatever amounts to more or less constant practice, and threatens to obstruct or unduly to burden the freedom of interstate commerce, is within the regulatory power of Congress under the commerce clause, and it is primarily for Congress to consider and decide the fact of the danger and meet it. This court will certainly not substitute its judgment for that of Congress in such a matter unless the relation of the subject to interstate commerce and its effect upon it are clearly non-existent.'

"In the act we are considering, Congress has expressly declared that transactions and prices of grain in dealing in futures are susceptible to speculation, manipulation, and control which are detrimental to the producer and consumer and persons handling grain in interstate commerce, and render regulation imperative for the protection of such commerce and the national public interest therein.'

The factual differences between grain trading and security trading

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44 Ibid. at 69.
45 (1922) 258 U. S. 495. This decision upheld the federal regulation of terminal livestock markets.
46 262 U. S. at 37.
are considerable. Grain itself, much more obviously than the evidence of ownership in corporations or of credits, is a part of interstate commerce. Grain is grown chiefly in states where it is not consumed. There is an annual flow of grain across state lines. In the centers of the grain trade, especially Chicago, the relation between the actual movement of grain and trading in futures can be shown by expert testimony. In the Stafford case, upon which the Court relied in the Olsen decision, certain practices of commission merchants accelerated or diminished the volume of livestock passing through Chicago.

Trading on the New York Stock Exchange has no such direct effect on the interstate movement of commodities as do the operations on the Chicago Board of Trade or the activities of livestock commission firms connected with the Chicago stock yards. Stock trading operations, though they often result from and are followed by interstate communications, do not in themselves consist in the interstate movement of intelligence. Moreover, the exchanges themselves do not even transmit their quotations. So far as the New York Stock Exchange is concerned these are sold locally and disseminated by agencies having merely contractual relations with the Exchange.

The actual trading on a stock exchange is local. The practice of an exchange is to treat brokers as principals. The purchase or sale is a completed transaction in the state where the exchange is located. Where there is a stock clearing corporation as in New York the physical handling of certificates is thus centralized and its local character emphasized. Many types of transactions, for example, those of floor traders, originate and are consummated solely within the stock exchange building. The New York Stock Exchange requires corporations whose stocks are listed to establish New York transfer offices. The effect of this is that even if shares of stock are purchased or sold for out-of-the-state customers, the actual transfer of title is likely to take place in New York.

It is possible that some but not all of the activities of stock exchanges are subject to federal regulations. On the whole, however, it seems the various phenomena of stock exchange operations are so closely interrelated that if their principal functions are found to affect interstate commerce, the whole structure will come within federal control. Moreover, once the federal power is established Congress can exercise the widest discretion as to methods and instrumentalities.47

47 A thoughtful and judicial discussion of the federal power over stock exchanges, although from the standpoint of those inclined to oppose such regulations, is contained in a privately printed brochure, dated December 18, 1933, entitled “The Extent of Federal Power to Regulate Stock Exchanges and Stock Exchange Firms,” by Raoul E. Desvernine, Edward McGarvey and Jackson S. Hutto.
When one looks at the matter entirely unembarrassed by knowledge of prior court decisions or abstract conceptions of the nature of commerce the conclusion seems almost inevitable that stock exchanges are constitutionally subject to federal control. Commerce is business. Business is either local or interstate. Practically speaking, no one has any difficulty in distinguishing local from national enterprise. In this sense, the great stock exchanges, particularly the New York Stock Exchange, are not local. The New York Stock Exchange, as a group of brokers under a buttonwood tree, may have been local in 1792. It may have been almost local until the War. By 1929 it was a national and international institution.

Its members would have been offended had it been accorded any lesser dignity in the business world. Congress in the last analysis has merely accepted for purposes of regulation the popular and even the internal opinion about the great stock exchange, and in lesser degree about other stock exchanges. Whether any public advantage will come out of this control is another matter, not here considered. The public hope is that regulatory bodies with the highest expertness and integrity can be maintained, which by supplementing rather than supplanting the control now exercised by the governors of the exchanges, will hold the members of exchanges and those dealing through them to the highest practicable ethical standards without disorganizing the market to an extent which affects unfavorably its commercial utility. The stock exchanges are showing a patriotic tendency to give the Federal Reserve Board and the Securities and Exchange Commission an opportunity to demonstrate what the recent legislation is worth. Whether the Act in its present form represents a permanent addition to the Federal Code depends largely upon the way it works as administered by the government. Not until these workings have been demonstrated for a reasonable period will a real appraisal of the legislation be possible or appropriate.

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