The SEC: A Brief History Of Regulation

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As investors, particularly individual investors, we buy, sell and trade stocks with a certain sense of security. We know that if a corporation deceives us, we have an avenue through which to seek recompense - though maybe not always to our satisfaction.

It wasn't always the case that you could pursue some sort of justice. In fact, most of investing history is fraught with deceit, folly and enough "irrational exuberance" to deter even the most stalwart supporter of Adam Smith.

In this article, we'll look at how the West was won, or rather how the markets in the Western world became regulated.

Tutorial: Advanced Financial Statement Analysis

Blue Sky Laws Cause Sudden Storms

Throughout most of its history, the practice of investing has been kept among the wealthy, who could afford to buy into joint stock companies and purchase debt in the form of bank bonds. It was believed that these people could handle the risk because of their already considerable wealth base - be it land holdings, industry or patents. The level of fraud in the early financials was enough to scare off most of the casual investors.

As the importance of the stock market grew, it became a larger and larger part of the overall economy in the U.S., thus becoming a greater concern to the government. Investing was quickly becoming the national sport, as all classes of people began to enjoy higher disposable incomes and finding new places to put their money. In theory, these new investors were protected by the Blue Sky Laws (first enacted in Kansas in 1911). (For more on financial regulation, read *The Pitfalls Of Financial Regulation* and *Financial Regulators: Who They Are And What They Do*.)

These state laws were meant to protect investors from worthless securities issued by unscrupulous companies and pumped by promoters. They are basic disclosure laws that require a company to provide a prospectus in which the promoters (sellers/issuers) state how much interest they are getting and why (the Blue Sky Laws are still in effect today). Then, the investor is left to decide whether to buy.

Although this disclosure was helpful to investors, there were no laws to prevent issuers from selling a security with unfair terms as long as they "informed" potential investors about it. (To read more on this subject, see *Don't Forget To Read The Prospectus!* and the *Online Investment Scams Tutorial*.)

The Blue Sky Laws were weak in both terms and enforcement. Companies wanting to avoid full disclosure for one reason or another simply offered shares by mail to out-of-state investors. Even the validity of the in-state disclosures weren't thoroughly checked by the state regulators. By the 1920s, the economy was "roaring" along and people were desperate to get their hands on anything to do with the stock market. Many investors were using a new tool, margin, to multiply their returns. (Read more about margin in *Margin Trading* and *How Does Your Margin Grow?*)

Black Tuesday

With so many uninformed investors jumping into the market, the situation was ripe for high-level manipulation. Brokers, market makers, owners and even bankers began trading shares between themselves to drive prices higher and higher before unloading the shares on the ravenous public. The American public was amazingly resilient in their optimistic craze, but catching too many of these stock grenades eventually turned the market and, on October 29, 1929, the Great Depression made its dreaded debut with Black Tuesday. (To find out more, read *The Greatest Market Crashes and How Investors Often Cause The Market's Problems*.)

In the Wake of the Great Depression

If Black Tuesday had only affected the stock market and individual investors, the Great Depression may have only been the "Mild Depression". The reason Black Tuesday had the impact that it did was because banks had been playing the market with their clients' deposits; also because the U.S. was on the verge of becoming the world's biggest international creditor, the losses ravaged both domestic and world finances. The Federal Reserve stood clear and refused to lower the interest rates that were bankrupting margin trader after margin trader - institutional and individual - leaving the government to try and stop the bleeding through social programs and reform.

The actions of the Fed displeased the government, mostly because the stock bubble was encouraged by the increases the Fed made in the money supply leading up to the crash. As the fallout from the crash settled, the government decided that if it was going to be on the hook for stock market problems, it had better have more say in how things were being done.

Glass-Steagall and the Securities and Exchange Act

The year 1933 saw two important pieces of legislation pass through Congress; the Glass-Steagall Act was established to keep banks from tying themselves up in the stock market and prevent them from hanging themselves in the case of a crash. The Securities Act was intended to create a stronger version of the state Blue Sky Laws at the federal level. With the economy wasting away and people calling for blood, the government beefed up the original act the following year with the Securities and Exchange Act of 1934.

The SEC

The Securities and Exchange Act created the Securities and Exchange Commission (SEC), President Roosevelt's response to the original problem with the Blue Sky Laws, which he saw as a lack of enforcement. Investor confidence had been shattered by the crash, and several more acts were passed with the intention of rebuilding it. These included the Public Utility Holding Company Act (1935), the Trust Indenture Act (1939), the Investment Advisors Act (1940) and the Investment Company Act (1940). The enforcement of all of these acts was left to the SEC. (To learn more about the SEC, see *Policing The Securities Market: An Overview Of The SEC*.)

For the first chairman of the SEC, Roosevelt chose Joseph Kennedy. The powers that the various acts granted to the SEC were considerable. The SEC used these powers to change the way Wall Street operated. First, the SEC demanded more disclosure and set strict reporting schedules. All companies offering securities to the public had to register and regularly file with the SEC. The SEC also cleared the way for civil charges to be brought against companies and individuals found guilty of fraud and other security violations. Both of these innovations were well received by investors who were hesitantly returning to the market following WWII - the primary mover that restarted the economy.

The Return of the Investors

Better access to financials and a way to strike back against fraud became part and parcel of a more controversial change that limited extremely high-risk, high-return investments to investors who could prove to the SEC that they could handle a large loss. The SEC sets the standards for accredited investors, which is sometimes seen as a value judgment on the part of the SEC and, perhaps, a shift from "protecting investors from unsafe investments" to "protecting investors from themselves".

From Here On

The SEC has continued to make the market a safer place for individual investors, and it continues to learn from and adapt to the scandals and crises that occur despite its best efforts. One example of this is the Sarbanes-Oxley Act (2002). After Enron, Worldcom and Tyco International used slippery accounting that resulted in widespread damage to investor portfolios, the SEC was given the responsibility to prevent a repeat in the future. (For related reading, see *Cooking The Books 101*.)

Although the SEC has been an extremely important shield for protecting investors, there are fears that both its power and love of tighter regulations will eventually harm the market. The biggest challenge for the SEC, both now and in the future, is to find the balance between protecting investors from bad investments by making sure they have accurate information, and outright blocking investors from investing in areas that the SEC believes are bad.