THE POLITICAL ECONOMY OF THE SECURITIES ACT OF 1933

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ABSTRACT

The Securities Act of 1933 is typically described as a "full disclosure" statute, yet many of its detailed provisions forbid disclosure about pending offerings during specified periods or using specified media. These features provided governmental enforcement of retail selling restrictions that are widely used by managing underwriters but that became difficult to enforce contractually during the late 1920s. The net effect was to reduce competition among investment banks. In particular, the act protected separate wholesale and retail investment banks from competition by integrated firms.

I. INTRODUCTION

The Securities Act of 1933 is a severe testing ground for rent-seeking theories of economic regulation. The investment banking industry faced severe obstacles in the legislative arena in 1933. Its public image was at an all-time low. The new president had successfully used his inaugural address to assign public blame for the Depression to financiers and had campaigned on a promise to reduce their power and influence. The statute itself was drafted in haste and secrecy, and its principal draftsman, James Landis, was an academic reformer interested in establishing greater public control over finance.2

The Securities Act did, however, produce winners as well as losers

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2 For a careful overview of the political context and leading figures of the New Deal securities reforms, see Joel Seligman, The Transformation of Wall Street 1–100 (1982).

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within the investment banking industry. In tandem with other New Deal reforms, the statute curtailed competition among retail dealers that threatened the survival of the syndicate system of distribution (and its associated retail price maintenance) during the 1920s. One important consequence was to protect high-prestige wholesale investment banks, and the retail dealers who sold on their behalf, from competition by integrated wholesale/retail investment banks that gained market share in the late 1920s. Ironically, in the late 1940s, the Justice Department brought an unsuccessful antitrust case, United States v. Morgan, against 17 leading investment banks, charging a conspiracy to monopolize the underwriting business. The government relied, in part, on the defendants' success in competing for managing underwriting positions against less prominent investment banks.

The prior literature on the Securities Act is largely devoid of public choice analysis. The economic commentary looks for (and largely fails to find) evidence that the act improved investors' returns or the informativeness of prices. The dearth of public choice explanations is not, however, surprising. We have no systematic data on the value or profitability of investment banking firms prior to 1933, as they were mostly private partnerships engaged in a largely unregulated business. The act itself was adopted in great haste and by voice vote, generating none of the raw material (records of votes in committees and on the floor of Congress) that is often used to show the alignment of economic interests for and against legislation. The two most persuasive avenues of empirical testing are therefore unavailable. Henry Manne suggests that the major investment banks may have been helped, rather than hurt, by the Securities Act. He argues that the leading firms, who underwrote low-risk securities and kept a close eye on the companies whose securities they sponsored, had nothing to lose from a "full disclosure" policy and much to gain from driving out underwriters of high-risk securities. He acknowledges, however, the lack of supporting data.

5 Roberta Romano uses such evidence to construct a convincing public choice explanation of the regulation of the futures markets. See Roberta Romano, The Political Dynamics of Derivative Securities Regulation, 14 Yale J. on Reg. 279 (1997).
Prior commentators have also tended to look only at the statute’s broad design rather than its detailed features. Even Manne takes at face value that the “truth in securities” act is a disclosure statute. Less well understood is that the Securities Act is equally a secrecy statute. It forbids most public disclosure of pending offerings prior to the filing of a registration statement with the Securities and Exchange Commission (SEC).\(^7\) The statute also mandates a minimum delay of 20 days between the filing of the registration statement and the beginning of retail selling. While traditionally described as mere pieces of the technical apparatus of “full disclosure,” these provisions imposed important limitations on both retail and wholesale competition.

I try to show that these “technical” details can be best understood as means of eliminating several specific competitive techniques that low-status securities dealers used successfully against high-status dealers in the late 1920s and early 1930s. Given the limited quantitative information available, the analysis is principally qualitative. I do, however, attempt to bolster the argument with the available data on underwriters’ compensation and market share. These are not sufficient by themselves to carry the day, but they supplement the qualitative discussion of the statute and the competitive context in which it arose.

The paper proceeds as follows. Section II describes the changing conditions in the investment banking industry after World War I. Section III examines quantitative measures of the growth of competition during the 1920s, Section IV describes specific competitive tactics that new entrants to the business used to gain market share, and Section V discusses those features of the Securities Act and related New Deal innovations that addressed these tactics. Section VI returns to the quantitative evidence, arguing that the Securities Act increased concentration and underwriters’ profits. Section VII concludes.

II. STRUCTURAL CHANGE IN THE 1920s

The investment banking industry became substantially more competitive in the 1920s than previously. This section describes the investment banking industry prior to World War I and the changes that occurred during the 1920s.

\(^7\) As originally enacted, the statute forbade any solicitation in connection with an offering until the registration statement had become effective. The SEC, however, permitted limited solicitation using a preliminary or “red herring” prospectus. From 1933 until the SEC’s creation in 1934, the Federal Trade Commission was the administering agency.
A. Before World War I

The syndicate system of underwriting and selling new issues of securities evolved in the United States during the late nineteenth and early twentieth centuries. The distinguishing feature of the syndicate system was a coordinated selling effort. Under prior practice, investment bankers purchased newly issued securities as a group at a fixed price, then sold them individually at times, places, and prices of their choosing. Under the syndicate system, by contrast, the purchasers contractually agreed to sell the securities at a uniform price at such times and places as the syndicate manager specified. Advertising was also organized collectively.

A syndicate was formed by an "originating" or "issuing" investment banking house that performed the functions typical of a managing underwriter today—advising the company, investigating its business, and negotiating the type and terms of the security and the details of the offering. The other syndicate members delegated near-total managerial control to the originating house. I use the terms "originating," "managing," and "lead" underwriter interchangeably to refer to the investment bank that acted as the principal financial advisor to the issuing company.

Underwriters were compensated by purchasing at a discount. The syndicate purchased from the company at a negotiated price. Investors ultimately purchased at a fixed price set by the originating house in consultation with the company. The "gross spread," or difference between the price paid by investors and that received by the company, represented compensation to the underwriters for providing financial advice, bearing underwriting risk, and finding buyers and was shared among the investment banks and dealers participating in the offering on the basis of the roles they played. In the pre-1933 era, there might be several syndicates standing between the company and the ultimate investor, with each syndicate buying at a slightly smaller discount.

At the top of the pyramid, the managing underwriter received the largest compensation. The syndicate paid it a fee as compensation for managing the issue. Moreover, the managing underwriter, in consultation with the issuer, chose the other underwriters and distributors of the issue and determined the amount of their underwriting or sales commitments. The ability to dispense business was a valuable asset to an issuing house.

Prior to World War I, compared to what would follow, the system of

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9 See id. at 56–57.
distribution and the investment banking hierarchy were static. There was a clear separation between originating houses and distributing houses.\textsuperscript{11} The former were purely or predominantly wholesalers who negotiated directly with issuing companies and sold to other securities dealers and institutional investors.\textsuperscript{12} The originating firms formed the aristocracy of investment banking. Distributors participated in underwriting syndicates at an originator’s invitation and sold partly to smaller dealers and partly to investors. For large offerings, the prized position of originating banker would likely be held by one of a few large, New York–based “houses of issue,” the most prominent of which were J. P. Morgan & Co. and Kuhn, Loeb & Co.\textsuperscript{13} In the years just before the war, William A. Read & Co., which became Dillon, Read & Co. in 1921, joined this exclusive club.\textsuperscript{14} Other investment banks carved out competitive niches in selected industries—for example, N. W. Harris (later Harris, Forbes & Co.) and Chicago-based Halsey, Stuart & Co. in public utilities and Lehman Brothers and Goldman, Sachs & Co. in merchandising.

The dominance of the wholesale houses reflected structural features of the new-issue market. Institutions and wealthy investors were the principal purchasers; retail investors did not yet participate directly in the securities markets on a large scale.\textsuperscript{15} The United States was a net importer of investment capital from abroad, and underwriters relied in part on access to foreign investors. This tended to channel new issues through the principal financial center, New York, and to underwriters with strong international ties.

J. P. Morgan and Kuhn, Loeb had greater access to capital than did other investment bankers. Both were private banks (that is, privately held, unregulated commercial banks that did no business with the general public) that took deposits from their business customers, although their aggregate deposits were small relative to those of ordinary commercial banks. More important, each had extensive European connections and close relationships with large commercial banks. These relationships enabled them to borrow money and place large blocks of securities on short notice.\textsuperscript{16}

The distribution process was slow. Syndicate agreements often lasted for

\textsuperscript{14} See Morgan, 118 F. Supp. at 671–72.
\textsuperscript{15} See Edwards, supra note 13, at 228.
\textsuperscript{16} See id.
a year, and the process of distribution usually lasted several months. The new-issue market was dominated by bonds. Stock generally reached the market through private sales and insiders' sales through brokers into the secondary market.

B. From World War I to the Securities Act

The structure of the investment banking business as described above changed substantially after the war. The United States emerged from the war a creditor nation with "the largest stock and flow of broad-based savings in the world." Domestic borrowers no longer had to rely on foreign capital. They could also for the first time tap an army of small investors.

Increasing Reliance on "Retail" Selling. To finance the war effort, the United States Treasury sold securities on an unprecedented scale. The four Liberty Loans of 1917–18 and the Victory Loan of 1919 aggregated $21.5 billion. To put that number in context, the gross federal debt at the end of 1916 was $1.2 billion, and the total amount of corporate securities issued from 1907 through 1916 was $16.7 billion. To sell bonds on such a scale, the Treasury enlisted the country’s commercial and investment banks and brokerage houses in a nationwide sales drive. These institutions sold bonds in small denominations and solicited millions of individuals of modest means who had never before invested in securities. The Treasury estimated that the noninstitutional bond market prior to 1917 consisted of approximately 350,000 individuals. More than 21 million individuals, however, purchased Liberty Bonds. In the course of tapping this new market, many investment banks got their first taste of what could be accomplished with "high-pressure" selling efforts.

17 See Brief on General Points in Support of Defendants' Motion to Dismiss at 47, Morgan, 118 F. Supp. 621.
22 The Fourth Liberty Loan alone had 21 million subscribers. See Annual Report of the Secretary of the Treasury for 1918, H.R. Doc. No. 1451, 65th Cong., 3d Sess. 18 (1919). The First, and Second Liberty Loans had 4 and 9 million subscribers, respectively; see 1917 Annual Report, supra note 21, at 7, 10. The Treasury Annual Reports do not provide the number of subscribers for the Third Liberty Loan.
The Liberty Loan drives produced a generation of salesmen who were experienced at contacting hundreds or thousands of retail customers rapidly. After the war, these salesmen created a nationwide network of securities dealers who specialized in selling securities to individual investors. These retail dealers formed the bottom rung of the distributional ladder. They purchased new issues for resale and held inventories of securities traded in the secondary markets to meet the growing demand of middle-class households for investments. In many cases it is a stretch to call them “investment bankers” because they served exclusively a distributional function. Thus the term “securities dealer” was used as a broad category to include investment bankers and this new class of retail seller.

Retail selling was not limited to the bottom echelon of the securities industry, however. Three investment banks just below the top tier—Harris, Forbes & Co., Halsey, Stuart & Co., and the National City Company (the underwriting arm of the National City Bank)—developed large, nationwide retail sales forces. Halsey, Stuart installed an extensive private wire system to enable it to reach customers all around the country from its Chicago headquarters. It used newspaper (and later radio) advertising to reach retail customers and permitted smaller investors to buy securities on an installment plan modeled after the Liberty Loan installment payment plans.

The National City Company built a large retail sales force beginning during the war years. Under the leadership of Charles E. Mitchell, “the greatest bond salesman who ever lived,” the National City Company purchased several smaller investment dealers and opened branches around the country. National City was at the forefront of high-pressure salesmanship. As a contemporary described it, “Instead of waiting for investors to come, [Mitchell] took young men and women, gave them a course of training on the sale of securities, and sent them out to find the investors. Such methods, pursued with such vigor and on such a scale, were revolutionary.” Mitchell pioneered door-to-door securities sales and large bonuses for salesmen who successfully moved the bonds the company underwrote. By the end of the 1920s, the National City Company was “the largest agency in the world for distributing securities.”

23 See Morgan, 118 F. Supp. at 638.
24 See Caroso, supra note 19, at 260.
25 Id.
27 See id. at 87–88.
28 Seligman, supra note 2, at 24.
29 Id.
More Rapid Distribution. The growing importance of individual investors and the development of the retail securities dealer as an important class of financial intermediary altered the mechanics of distributing securities. A new layer was added underneath underwriting syndicates, known as a "selling group." The selling group consisted of securities dealers chosen by the originating house who purchased an allotment of underwritten securities at a discount and agreed to sell them to investors at a fixed price. Because they purchased only at the time of retail distribution, selling group members did not "underwrite" in any significant sense; in fact, they often committed to purchase securities only to the extent that they could find purchasers. Like the underwriters, the selling group delegated extensive authority to the originating house to control the terms of the distribution. Dealers sold in amounts, at times, at prices, and often in geographical territories specified by the originating house.

The new distribution techniques substantially increased the speed with which a new issue of securities could be sold even though issues were larger on average and many more potential buyers were solicited. More financial institutions were now involved in selling a new issue, and rather than wait for buyers to come, they actively sought them out. New issues could be sold in a matter of days.

Changing Mix of Securities. Investor demand for equity securities grew rapidly at the end of the 1920s. The prewar investment banking industry focused on corporate debt securities and, to a lesser extent, preferred stocks. After the war, investors were increasingly willing to take greater risks in pursuit of higher returns. Businesses responded by selling more equity into the public markets. Investors’ increasing tolerance for risk allowed start-up companies to raise capital in the public markets. This in turn created opportunities for smaller, regional investment banks to manage these riskier issues. By 1929, investment banks that had little track record as managing underwriters were originating issues of relatively unknown corporations.

III. Measuring the Growth of Competition

After the war, investment banks could succeed without spending years developing reputation and contacts, and accordingly many new firms entered the business. Established investment bankers soon complained that there were too many firms. By the late 1920s, they also complained of the

31 See Morgan, 118 F. Supp. at 642–43.
32 See id. at 644.
33 The increase in common stock issues, as a percentage of total new securities issues, is shown in Table 2.
TABLE 1
INVESTMENT BANKERS ASSOCIATION OF AMERICA DESCRIPTIONS OF MEMBERSHIP GROWTH

<table>
<thead>
<tr>
<th>Year</th>
<th>Quotation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1919</td>
<td>&quot;The Membership Committee has had before it the largest number of applications in any one year since our organization. . . . The organization of many new houses has occasioned some concern.&quot; (p. 20)</td>
</tr>
<tr>
<td>1920</td>
<td>&quot;It is the opinion of the Secretary that no other Membership Committee ever faced the number of applications as during the past year. New houses have sprung up everywhere, some headed by men of unquestioned ability as bond men; others organized by well meaning but unseasoned young men.&quot; (p. 23)</td>
</tr>
<tr>
<td>1921</td>
<td>&quot;The large increase in the number of applications filed has caused the Membership Committee considerable concern and has led to the question of limiting membership.&quot; (p. 32)</td>
</tr>
<tr>
<td>1924</td>
<td>&quot;The Membership Committee is to be congratulated upon the firm stand it has taken in the admission of houses. There has been no side-stepping of responsibility. For the year which closed August 31, 1924, thirty-nine houses were admitted to membership as against forty-five the year previous. Greater stringency caused the decrease.&quot; (p. 35)</td>
</tr>
<tr>
<td>1926</td>
<td>&quot;I think it is safe to say that with each succeeding year, membership in the Association has become more difficult to secure.&quot; (p. 85)</td>
</tr>
</tbody>
</table>

Source.—Proceedings of the Annual Convention of the Investment Bankers Association of America (various years).

decreasing profitability of their business. This section attempts to piece together the available information to provide qualitative and quantitative measures of the growth of competition in the industry during the 1920s.

A. Number and Capital of Investment Banks

In 1912, several investment banks founded a trade group, the Investment Bankers Association of America (IBAA). Growth in the IBAA’s membership and the organization’s response, documented in its annual reports, provide evidence of rapid entry into the investment banking business during the 1920s.

After World War I, the IBAA began rejecting many membership applications. In 1919, it formally limited consideration for membership to firms that had been in the business for at least 2 years. Table 1 collects quotations from reports of the IBAA’s secretary and membership committee. They express dismay about the postwar rate of entry into the investment banking business. These indications of concern wane, however, during the great boom in new securities issues beginning in the middle of the decade.

See Proceedings of the Ninth Annual Convention of the Investment Bankers Association of America 38 (1920) (hereafter "1920 Proceedings").
TABLE 2

THE INVESTMENT BANKING INDUSTRY AND THE NEW-ISSUE MARKET, 1912–40

<table>
<thead>
<tr>
<th>Year</th>
<th>New-Issue Volume ($Millions)</th>
<th>Common Stock Issues (% of Total)</th>
<th>Number of IBAA Member Firms</th>
<th>Aggregate Capital ($Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1912</td>
<td>2,254</td>
<td>257</td>
<td>263</td>
<td></td>
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<tr>
<td>1913</td>
<td>1,646</td>
<td>354</td>
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<td></td>
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<tr>
<td>1914</td>
<td>1,437</td>
<td>356</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1915</td>
<td>1,436</td>
<td>340</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1916</td>
<td>2,187</td>
<td>361</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1917</td>
<td>1,531</td>
<td>407</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1918</td>
<td>1,345</td>
<td>399</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1919</td>
<td>2,668</td>
<td>28.2</td>
<td>433</td>
<td></td>
</tr>
<tr>
<td>1920</td>
<td>2,788</td>
<td>19.9</td>
<td>485</td>
<td></td>
</tr>
<tr>
<td>1921</td>
<td>2,270</td>
<td>8.8</td>
<td>552</td>
<td></td>
</tr>
<tr>
<td>1922</td>
<td>2,949</td>
<td>9.8</td>
<td>586</td>
<td></td>
</tr>
<tr>
<td>1923</td>
<td>3,165</td>
<td>10.4</td>
<td>607</td>
<td></td>
</tr>
<tr>
<td>1924</td>
<td>3,521</td>
<td>14.7</td>
<td>617</td>
<td></td>
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<tr>
<td>1925</td>
<td>4,223</td>
<td>14.4</td>
<td>620</td>
<td></td>
</tr>
<tr>
<td>1926</td>
<td>2,574</td>
<td>14.8</td>
<td>662</td>
<td></td>
</tr>
<tr>
<td>1927</td>
<td>6,507</td>
<td>10.5</td>
<td>676</td>
<td></td>
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<tr>
<td>1928</td>
<td>6,930</td>
<td>30.2</td>
<td>690</td>
<td></td>
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<tr>
<td>1929</td>
<td>9,376</td>
<td>54.0</td>
<td>665</td>
<td></td>
</tr>
<tr>
<td>1930</td>
<td>4,957</td>
<td>22.3</td>
<td>626</td>
<td></td>
</tr>
<tr>
<td>1931</td>
<td>2,372</td>
<td>8.2</td>
<td>533</td>
<td></td>
</tr>
<tr>
<td>1932</td>
<td>644</td>
<td>2.0</td>
<td>427</td>
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<tr>
<td>1933</td>
<td>380</td>
<td>36.1</td>
<td>378</td>
<td></td>
</tr>
<tr>
<td>1934</td>
<td>397</td>
<td>6.3</td>
<td>495</td>
<td></td>
</tr>
<tr>
<td>1935</td>
<td>2,332</td>
<td>9.0</td>
<td>621</td>
<td></td>
</tr>
<tr>
<td>1936</td>
<td>4,572</td>
<td>5.9</td>
<td>751</td>
<td></td>
</tr>
<tr>
<td>1937</td>
<td>2,310</td>
<td>12.3</td>
<td>796</td>
<td></td>
</tr>
<tr>
<td>1938</td>
<td>2,155</td>
<td>1.2</td>
<td>754</td>
<td></td>
</tr>
<tr>
<td>1939</td>
<td>2,164</td>
<td>4.0</td>
<td>734</td>
<td></td>
</tr>
<tr>
<td>1940</td>
<td>2,677</td>
<td>4.0</td>
<td>691</td>
<td></td>
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</table>

Sources.—New-issue volume and common stock: U.S. Dep't of Commerce, Bureau of the Census, Historical Statistics of the United States (various years); IBAA membership: Proceedings of the Annual Convention of the Investment Bankers Association of America (various years); aggregate capital: Irwin Friend et al., Investment Banking and the New Issues Market (1967).

As a consequence of the IBAA's growing exclusivity after the war, the growth in IBAA membership must understate growth in the number of investment banking houses after 1919, perhaps substantially.

Table 2 provides estimates of the dollar volume of new domestic corporate securities issues, the number of IBAA members, and the aggregate capital of the investment banking industry for the period 1912–40. The fig-

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35 The market share figures provided later in this paper include foreign as well as domestic issues. The Federal Reserve Bulletin, my source for foreign issues in the United States, does not provide information going back to 1912, so foreign issues are omitted from Table 2.
tures are consistent with Ervin Miller’s conclusion that “securities firms increased sharply during the 1920s both in number and in assets.”36 During the first half of the 1920s, they also grew faster than the market for new issues. The size of the retail sales force also increased rapidly. According to census data, the number of stock and bond salesmen grew from 6,000 in 1910 to 11,000 in 1920 and 22,000 by 1930, a level that would not be reached again until the 1950s.37 Table 2 also shows the volume of common stock issues as a percentage of the total. Because high-prestige underwriters avoided common stock, its prevalence is also a measure of the penetration of low-prestige firms into the underwriting business.

B. Industry Profitability

Members of the IBAA complained in the late 1920s about the decreased profitability of the underwriting business.38 It appears that average spreads declined during the 1920s. In 1923, Arthur Dewing estimated that the gross spread for a typical bond issue was in the range of 5 percent of the sales price.39 By contrast, in 1940, Kenneth Haven gathered data on bond issues during 1926–29 and found that the average spread was approximately 3.0 percent.40 The director of the SEC’s Research Division, writing in 1937, also found an average spread of 3.0 percent on a sample of bond issues from 1927 to 1931.41 A separate study, also published in 1937, showed an average gross spread of 3.03 percent for 224 bond issues during the same period.42

The decline in spreads does not, of course, prove a decline in profitability because the industry’s costs were also changing during the 1920s. Some of the cost of underwriting a new issue—investigating the issuer's business, providing advice, and developing a sales pitch, for example—are fixed

36 See Friend et al., supra note 18, at 93.
37 See 1 Historical Statistics, supra note 20, at 142.
38 See, for example, Proceedings of the Sixteenth Annual Convention of the Investment Bankers Association of America 45 (1927) (hereafter “1927 Proceedings”) (address of IBAA president noting “diminishing margins of profit”); Proceedings of the Seventeenth Annual Convention of the Investment Bankers Association of America 8 (1928) (hereafter “1928 Proceedings”) (address of IBAA president arguing that a return to “the condition of wholesome competition enjoyed in former years” was necessary in order to “have happier conditions and better net profits”).
40 See T. Kenneth Haven, Investment Banking under the Securities and Exchange Commission 34 (1940).
costs that lead to economies of scale. As a result, gross spreads are typically smaller on a percentage basis for larger issues, and issue sizes were increasing in the 1920s.\textsuperscript{43} An SEC study found that the gross spread on bond issues of less than $5 million during the period 1925–29 was 5.2 percent, suggesting that much of the decline can be attributed to larger average transaction size.\textsuperscript{44} Moreover, because the distribution process was more rapid, the cost of financing the securities while in inventory (as well as the associated risk) was decreasing. Other costs, however, were likely increasing. The new selling methods were costlier than the old because they required larger sales forces. Short-term interest rates rose during this period, which would offset some of the decreased financing costs resulting from more rapid distribution.

Absent more information, we cannot determine quantitatively whether underwriting became less profitable in the late 1920s. The strongest available evidence is the bankers’ frequent complaints about excess capacity and declining profits. As one investment banker put it, “[T]he big problem is the diminishing ratio of profits caused by rapidly growing concerns.”\textsuperscript{45}

C. Concentration in the Underwriting Market

We can calculate market shares among managing underwriters starting in the mid-1920s. From 1925 through 1935 the National Statistical Service (NSS) published a periodical listing all new public offerings of securities grouped by managing underwriter.\textsuperscript{46} I used this information to compile a list of all offerings managed by “major” underwriting houses during that period. I define a “major” house as one that managed at least one public offering of at least $10,000,000 during the period (excluding securities of affiliates or mutual funds). By this definition, there are 105 major underwriting houses that managed 4,344 offerings during the period 1925–35, inclusive.

The NSS data end in 1935; however, additional data on market shares are available from the trial records of the Morgan litigation. Using SEC and investment bank records, the parties introduced into evidence data on market shares for a series of 3-year periods after the enactment of the Securities Act. There are two drawbacks to this data source. First, it aggregates market shares over 3-year periods rather than year by year. Second, it divides the

\textsuperscript{43} As to issue size, see Morgan, 118 F. Supp. at 642.

\textsuperscript{44} See Friend et al., supra note 18, at 408–9 (relying on SEC data).

\textsuperscript{45} See 1927 Proceedings, supra note 38, at 206.

TABLE 3
CONCENTRATION IN THE INVESTMENT BANKING INDUSTRY, 1925–40

<table>
<thead>
<tr>
<th>Year</th>
<th>% Concentration</th>
<th>Year</th>
<th>% Concentration</th>
</tr>
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<tbody>
<tr>
<td>1925</td>
<td>37.0</td>
<td>1933</td>
<td>14.6</td>
</tr>
<tr>
<td>1926</td>
<td>31.2</td>
<td>1934</td>
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<td>1928</td>
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<td>12.9</td>
<td>1937</td>
<td>50.4</td>
</tr>
<tr>
<td>1930</td>
<td>34.1</td>
<td>1938</td>
<td>54.1</td>
</tr>
<tr>
<td>1931</td>
<td>47.4</td>
<td>1939</td>
<td>46.3</td>
</tr>
<tr>
<td>1932</td>
<td>55.3</td>
<td>1940</td>
<td>53.1</td>
</tr>
</tbody>
</table>


Note.—Concentration is the aggregate dollar amount of new domestic and foreign corporate and foreign government securities managed by the five highest ranked investment banks, as a percentage of the total dollar volume of securities issues by domestic and foreign corporate and foreign government issuers.

dollar amount of an issue among all listed comanagers. By contrast, the NSS listings credit the entire amount to the “lead” manager. In order to make the two data sources comparable, I looked at all tombstone advertisements in the Wall Street Journal for the years 1936 through 1940 and identified the lead manager for comanaged offerings (the lead manager always appears in the upper left-hand position in a tombstone advertisement). I also looked at the raw data produced by the defendants in Morgan to produce a year-by-year breakdown of market shares for the same period.

Table 3 shows the aggregate market shares of the top five managing underwriters in each year from 1925 through 1940. On the basis of more limited evidence compiled during the Morgan litigation about pre-SEC offerings, it seems clear that the higher level of concentration in 1925 was typical of the period 1918–24. In the increasingly competitive market of the late 1920s, however, concentration fell steadily and substantially, from a high of 37.0 percent in 1925 to 12.9 percent in 1929.

IV. THE CRISIS OF THE SYNDICATE METHOD

As competition increased at the retail level, sellers began to seek an advantage over their rivals by violating those provisions of syndicate agreements that specified the timing and price of the distribution. The increased speed of distributions and the focus on retail selling during the 1920s made it difficult for managing underwriters to monitor and control the behavior of hundreds, or occasionally thousands, of securities dealers participating in
the sale of a new issue. By the late 1920s, investment bankers realized that the viability of the syndicate system was threatened.

Established bankers described the phenomenon as a decline in the professionalism of the investment banking business. Like lawyers or doctors today, many investment bankers of the 1920s viewed themselves as members of a learned profession, the standards of which were being eroded by new entrants who were mere salesmen. A measure of that concern is the creation, at the IBAA’s annual convention in the fall of 1926, of the Committee on Business Problems. The bulk of that committee’s first report, delivered at the 1927 convention, was prepared by its Subcommittee on Distribution and addressed changes in distribution methods.47

The subcommittee’s report noted two tactics in particular: “beating the gun,” or selling prior to the agreed-upon distribution period, and selling at discounted prices. The report also expressed concern about high-pressure selling efforts and competition from commercial banks. By the time the IBAA convened in 1933, Congress had addressed each of these four problems.

This section addresses these competitive issues one at a time. It then asks why managing underwriters wanted to uphold the syndicate system. Finally, it notes that the integrated investment banks that combined wholesaling with retailing did not face these problems to the same extent as the separate wholesale and retail firms and suggests that this provided the integrated firms with a competitive advantage.

A. Beating the Gun

In the late 1920s, a practice known as “beating the gun” became common. Under the normal underwriting practice, underwriting and selling syndicate agreements contained an undertaking not to sell securities until they were “released” by the managing underwriter through a telegram or telephone call. To beat the gun was to violate the syndicate agreement by taking orders from customers before the securities had been released for sale.

Beating the gun allowed one distributor to get a head start on the others in the competition for retail customers. It was, however, inconsistent with the premise of a syndicated selling effort—that each seller complied with contractual restraints on price, timing, and (sometimes) territory. Managing underwriters were sensitive to the complaints of retailers who complied with syndicate agreements and, in so doing, lost customers to others who had not complied.

In order to prevent the practice, originating houses tried to keep the tim-

ing and price of the issue secret until the last minute. This was not always possible, however, particularly for issues of large companies. These companies were closely followed by the financial press, and newspapers or investment magazines might print the details of a coming large issue of securities before the issuing house had formally released the information to the syndicates.\textsuperscript{48} Thus selling group members were able to take orders from customers with reasonable confidence that they would be able to provide the security at the time and price quoted, even though they were contractually obligated to wait.

The rise of this "unfair trade practice"\textsuperscript{49} caused great consternation; one commentator described investment bankers as "preoccupied" with beating the gun.\textsuperscript{50} The Committee on Business Problems declared that its aim "has been to establish the principle of 'Fairness of Competition' so that all who are associated in the public offering of an issue of securities should compete on an equitable basis with respect to the time of such offering."\textsuperscript{51} The only realistic punishment available, however, was for the managing underwriter to cut the offending dealer out of future deals. A managing underwriter would not want to take such a drastic step unless it was certain that the offender really had cheated. Being sure was easier said than done. Dealers might complain to originating houses about other dealers, but they were generally unwilling to give specifics. A dealer would learn about an infraction when he called a customer on the offering date only to learn that the customer had already agreed to purchase from a rival. The complaining dealer, however, was unwilling to give the customer's name to the originating house for fear that the resulting inquiry would offend the customer and lead to the loss of business.\textsuperscript{52}

The IBA\textsuperscript{A} Subcommittee on Distribution concluded that the root of the problem was excessive preoffering publicity.\textsuperscript{53} Even scrupulous dealers could not avoid beating the gun when both their salesmen and customers could get the details of a pending offering in the morning newspapers. Either the salesmen would find it irresistible to call on customers prior to the offering date or customers would contact the salesmen. The chairman of the subcommittee spoke approvingly of issuing houses that kept a tight lid on

\textsuperscript{48} See 1928 Proceedings, \textit{supra} note 38, at 183–84.

\textsuperscript{49} See George E. Bates, The Waiting Period under the Securities Act, 15 Harv. Bus. Rev. 203, 212 (January 1937); see also Gourrich, \textit{supra} note 41, at 44, 65 (describing the practice as "unfair competition").

\textsuperscript{50} See Bates, \textit{supra} note 49, at 212.

\textsuperscript{51} See Proceedings of the Eighteenth Annual Convention of the Investment Bankers Association of America 170 (1929).

\textsuperscript{52} See 1927 Proceedings, \textit{supra} note 38, at 240.

\textsuperscript{53} See 1928 Proceedings, \textit{supra} note 38, at 174.
information about the timing and price of offerings but recognized that this "ideal condition" was difficult to achieve. Speaking of the large houses of issue, he noted, "They are doing all they can to get the information to every one of you men at the same time, and what they want is someone to tell them a practical way, someone to also try and keep publicity out of the paper." On the rare occasions when this "ideal condition" was achieved, it led to a different problem—selling group members had to decide how large an allotment to request in a matter of hours. This increased the likelihood of expensive mistakes. The issuing houses wanted to be able to give the details of an upcoming offering to potential selling group members a few days in advance but, nevertheless, be confident that the dealers so contacted would not take orders until the commencement of the offering.

B. Discounting

The practice of cutting prices gave rise to even more passionate debate within the IBAA. As described above, underwriters were compensated for their services by purchasing at a price below the fixed offering price. The discount was shared between the house that underwrote a security and the house that sold it. The latter's share was called a "selling concession." The seller could, in turn, "reallow" a specified portion of the selling concession to other securities dealers who purchased from them for resale to their customers. Thus, for example, in a bond underwriting the gross spread might be $20 per $1,000 bond, of which $10 would be retained by the underwriter and $10 would go as a selling concession to a distributor, who could realow up to $2.50 to any other securities dealer.

Because there was no universally accepted definition of "securities dealer," underwriters and selling group members who wished to compete on the basis of price without blatantly violating their syndicate agreement developed the practice of granting a realowance to any customer able to negotiate for it. First all financial institutions, such as banks and trust companies, came to expect a discount. By the late 1920s, some dealers were offering concessions to all institutional investors as well as to lawyers and other professionals. The vice president of the IBAA complained at its 1927 convention about "the big giving of concessions which has grown to such an extent now that it is practically a reduction in price to everybody except the few unfortunates" who failed to bargain for it.

54 See id. at 184.
55 Id. at 186.
56 See 1927 Proceedings, supra note 38, at 195.
57 Id. at 236.
Like beating the gun, price-cutting was viewed by most members of the
association as an unethical practice, but one that was extremely difficult to
stop. "Our greatest evil is price-cutting," in the opinion of one member.58
Two solutions were proposed. The first was simply to ban all reallo-
warances, so that any securities dealer who was not a member of the selling
group would have to buy at the same price as the public. The other proposal
was for the IBAA's regional groups to draw up lists of "recognized" secu-
rity dealers and ban granting a discount to anyone who was not on such a
list.

C. Salesmanship

I have already discussed the development of new retail sales tech-
niques—newspaper and radio advertising, door-to-door selling, installment
plans, and so on. Established investment bankers were aghast at the lengths
to which their more aggressive competitors would go to solicit potential
buyers. As the number of securities dealers grew and those dealers hired
more and more salesmen, investors had many sellers to choose from. As
one observer noted, "[T]he business is sadly overcrowded and too many
salesmen are calling on each customer and prospect. . . . No man who isn't
a professional bond buyer needs to have more than four or five bond sales-
men calling on him regularly. Most of them have either forty or, finally and
in disgust, not any."59 Thus beating the gun and discounting were important
new tactics in the battle to convince an investor to buy a new issue through
dealer X rather than dealer Y.

D. Competition from Commercial Banks

The Treasury relied heavily on commercial banks to sell Liberty Bonds.60
Accordingly, after the war, many commercial banks created bond depart-
ments or securities affiliates to engage in securities underwriting and deal-
ing using the skills they had acquired in the Liberty Bond drives. From
1922 to 1929, the number of commercial banks engaged in the distribution

58 Id. at 206.
59 Wall Street at Close Range: II—The Bond Salesman's Problems, World's Work, January
1931, at 98.
60 Approximately 56 percent and 53 percent, respectively, of subscriptions for the First
and Second Liberty Loans were received through national banks. See 1917 Annual Report,
supra note 21, at 548–49. See also Peach, supra note 30, at 31–32 (containing more detailed
data on bank sales of Liberty Bonds and noting, "Practically all national banks became fa-
miliar with the technique of distributing securities during the War").
of new issues of securities, through either a separate securities affiliate or a bond department, grew from 277 to 591.\textsuperscript{61}

The entry of a commercial bank posed a greater competitive threat than the entry of a new investment bank because of the greater capital the former could devote to underwriting if it chose. Rather than lend funds for short periods to investment banking syndicates, banks began to devote those funds to direct competition. Because they combined substantial capital and large sales staffs, commercial banks were particularly apt to integrate origination and retail distribution.

\textit{E. Why the Syndicate System?}

Why did the IBAA’s members care so deeply about retaining the syndicate system rather than allowing securities dealers to compete on the basis of price? The industrial organization and finance literature both provide a possible explanation.

Fixed-price syndication is a form of resale price maintenance. As in other contexts, issuers and managing underwriters may choose resale price maintenance in order to induce dealers to offer product-specific services.\textsuperscript{62} This is consistent with the behavior of managing underwriters, who urged distributors to become familiar with the issuer and the security in order to be able to recommend securities that were suitable for their customers. It is also worth noting that resale price maintenance is typically observed in highly concentrated markets in which manufacturers have market power.\textsuperscript{63} The syndicate system thrived during the early part of the century to the mid-1920s, a period in which a small number of managing underwriters dominated the business. It broke down during the late 1920s, during a large drop in concentration in the market for managing underwriters. It has survived from 1933 until the present, along with a high level of concentration.

A second possibility is that the syndicate system provides an efficient solution to the informational asymmetry problems that arise in public offerings, particularly initial public offerings. Issuers are better informed than investors about their own business, but investors in the aggregate are better informed than issuers about systematic factors that influence the price at which a new security will sell.\textsuperscript{64} Investment banks solve the asymmetry problems by certifying issuer quality to investors and by seeking informa-

\textsuperscript{61} See id. at 83.

\textsuperscript{62} See Lester G. Telser, Why Should Manufacturers Want Fair Trade? 3 J. Law & Econ. 86 (1960).

\textsuperscript{63} See id. at 88.

\textsuperscript{64} See Lawrence M. Benveniste & Paul A. Spindt, How Investment Bankers Determine the Offer Price and Allocation of New Issues, 24 J. Fin. Econ. 343 (1989).
tion from investors about their likely demand prior to actual sale. In order to prompt investors to make accurate disclosures, managing underwriters underprice and allocate new issues disproportionately to regular clients who disclose positive information. Retail dealers may have played the role of repeat players in the 1920s just as institutional investors do today.

Either explanation would account for managing underwriters’ determination to maintain the syndicate system. As the 1920s progressed, however, they found it increasingly costly to do so by contract. Investment banks consequently had two alternatives. The first was integration. Firms that combined the wholesale and retail functions could exercise greater control over selling efforts. A second alternative was for a regulator to enforce compliance with the syndicate system. The latter, as we will see, is what the Securities Act accomplished.

The syndicate system may have been an efficient contractual arrangement given the enforcement costs characteristic of the period from roughly 1900 to the mid-1920s, but given the higher enforcement costs of the late 1920s, it could survive only with a subsidy (in the form of governmental enforcement). It is possible that the subsidy enhances welfare—that is, the benefits to issuers and investors of more efficient distribution outweigh the cost of the subsidy. The likelihood seems small, however, inasmuch as investment banks successfully used vertical integration as an alternative to government enforcement, as discussed in the next section. More important, the marginal benefits of the syndicate method would have to be implausibly great to outweigh the compliance costs associated with the Act’s “gun-jumping” prohibitions and the “fair practice” rules of the National Association of Securities Dealers, Inc. (NASD), discussed below. One may conclude that retail price maintenance is unobjectionable but stop short of concluding that it should be subsidized.

F. The Challenge of Integrated Firms

An alternative to resale price maintenance is integration. Investment banks that had retail outlets all over the country, such as Harris, Forbes, Halsey, Stuart, and National City, did not have to rely on regional securities dealers to the same extent as the wholesale investment banks. They could control their own firm’s retail sales effort. Compared to wholesale-only underwriters, the integrated firms could also have a higher degree of confidence in the information they received about retail demand, as much of it came from their own retail outlets.

The integrated firms were therefore able to seek origination business that would earlier have gone as a matter of course to the high-prestige wholesale firms. In 1927, an integrated firm entered the ranks of the top three for the
first time, as National City displaced Dillon, Read, which fell to number four. In 1928, Harris, Forbes, National City and Halsey, Stuart ranked first, second and fourth, respectively. In 1929, Harris, Forbes was again the top underwriter, and of the three highest prestige wholesale firms, only Dillon, Read made it into the top five.

During the years 1925 and 1926, the three top wholesale firms, J. P. Morgan, Kuhn, Loeb, and Dillon, Read, managed approximately $2.5 billion of securities offerings, double that of the top three integrated firms, Harris, Forbes, Halsey, Stuart, and National City. In 1927 the gap narrowed, with the wholesalers managing $1.5 billion and the integrated firms $1.2 billion. During 1928 and 1929, the integrated firms turned the tables, managing $1.9 billion to the wholesalers’ $1.2 billion. This was an unprecedented challenge to the wholesale firms’ decades-long dominance of the new-issue market.

V. THE REGULATORY SOLUTIONS

Leading investment banks and their trade group, the IBAA, were experienced lobbyists that had successfully influenced the content of state securities, or “blue sky,” laws in the 1910s and 1920s. The IBAA supported federal disclosure regulation as a means of improving the ethics of the investment banking industry. Industry members supported the proposed Securities Act, although they complained about its liability provisions for underwriters. After a successful lobbying campaign, those provisions were amended in 1934 to reduce underwriters’ liabilities.

The wholesale investment banks had additional reason to favor federal intervention as their position was eroded by integrated firms. The top wholesale banks were among the nation’s most politically well connected businesses. J. P. Morgan and Dillon, Read, in particular, had numerous partners who split time between finance and government service. John W. Davis, Morgan’s lawyer, enjoyed remarkable access to the Senate Banking Committee, even attending several executive sessions to argue against public disclosure of some of his client’s financial and business information. Partners of the wholesale firms testified in favor of disclosure regulation at the brief House and Senate hearings on the proposed Securities Act, decrying the decline in the “ethics” of their business. As public choice theorists have noted, even legislators who believe themselves to be pursuing the pub-

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67 See Senate Banking and Currency Committee, 73d Cong., Minutes for May 23, 26, 30, and 31 and June 5, 1933 (housed at the National Archives).
lic good will be influenced by interest groups when the latter are important sources of information about the "problems" of the industry to be regulated. 68

The Securities Act and other New Deal financial reforms addressed the specific competitive concerns outlined above. They had, in broad terms, three effects. They provided the government's aid in enforcing the syndicate system by outlawing beating the gun and discounting. They slowed down the distribution process and divided it into distinct wholesale and retail phases. Finally, they removed commercial banks as competitors for underwriting business. The consequence was to neutralize the competitive advantages of integrated firms and return to a system in which wholesale banks originated new issues and sold them through stand-alone distributors. This section shows how the technical details of the Securities Act achieved those results.

A. Beating the Gun

The Securities Act achieved precisely what the IBAA's Committee on Business Problems wanted to achieve but could not—it made it possible for a lead underwriter to provide distributing houses with detailed information about a pending issue secure in the knowledge that the latter could not agree to sell securities until the official offering date. The act also assured the absence of retail solicitation prior to the offering date by suppressing preoffering publicity.

The Securities Act requires that a registration statement be filed and become effective before any person may sell the securities; until a 1954 amendment, the term "sell" included any solicitation efforts. 69 Thus it was illegal to mount a publicity campaign prior to the date of effectiveness. The lead underwriter could control the timing of effectiveness, because a registration statement for a fixed-price underwriting could not become effective until it contained the pricing information. Thus the typical practice was to file a registration statement omitting price information, wait the statutorily prescribed 20 days, and near the end of that period file an amendment containing the pricing information. So long as the SEC consented to this amendment, the registration statement would become effective on the twentieth day after the original filing.


69 The statute was amended in 1954 to permit oral solicitation and distribution of preliminary prospectuses during the waiting period. See Securities Act § 5(b), (c), 15 U.S.C. § 77e(b), (c); for a discussion of the background, see 1 Louis Loss & Joel Seligman, Securities Regulation 394–420 (3d ed. 1989).
Before the registration statement was filed, all public discussion of the issue was banned. Securities lawyers today still counsel their clients against any premature public statements relating to the offering—to make such a statement is to "jump the gun," although I doubt many securities lawyers know that the phrase antedates the Securities Act.

The statute also directly attacked newspaper and radio advertisements by defining each as a "prospectus" that, with limited exceptions, could not be published prior to effectiveness. The prohibition on newspaper publicity was broad enough to cover a story printed after interviewing a company officer about the pending offering. No longer would detailed information about pending offerings appear in the morning papers prior to the offering date, stimulating customers to call their brokers.

Of course, regulatory restrictions often generate countermoves. In a 1936 bond offering, Halsey, Stuart proposed to distribute a "preliminary" version of the prospectus during the 20-day waiting period notwithstanding the prohibition on "selling" prior to effectiveness. The SEC decided to permit it subject to the inclusion of a legend in red type, noting that the registration statement was not yet effective, and thus the "red herring" prospectus was born.\(^\text{70}\) Protests soon appeared that investment banks were once again "beating the gun" by soliciting customers during the waiting period.\(^\text{71}\) An important difference from pre-1933 practice, however, was that the managing underwriter maintained complete control of the timing of sales through its control of effectiveness. The Securities Act kept securities from being sold until the managing underwriter was ready.

**B. Discounting**

The Securities Act made it illegal to grant undisclosed discounts. It required that the registration statement disclose the public offering price of the securities and any deviation from that price by any distributor "to any person or classes of persons, other than the underwriters, naming them and specifying the class."\(^\text{72}\) A separate early New Deal reform, however, went much further and enabled the IBAA to achieve its long-standing goal of limiting discounts to recognized securities dealers.

President Roosevelt signed the National Industrial Recovery Act (NIRA) into law only a few weeks after the Securities Act. The NIRA permitted self-regulatory industry groups to adopt codes of fair practice enforceable

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\(^\text{70}\) See Halsey Develops New Form of Summary, Wall St. J., May 25, 1936, at 1, col. 5; see also New Issue Bulletins May Be Circulated in 20-Day Period, Wall St. J., May 25, 1936, at 3, col. 3.

\(^\text{71}\) See Bates, supra note 49, at 73–74.

by the federal courts. As the only national trade association for the investment banking industry, the IBAA immediately created an Investment Bankers Code Committee and prepared a "Code of Fair Competition for Investment Bankers" and a set of Fair Practice Amendments (collectively the "Code") that were approved by Executive Order of the president in March 1934.73

The code prohibited discounting. It declared that "[n]o participant in a selling syndicate or member of a selling group shall . . . offer the securities being distributed by such syndicate or group at any price below [the] public offering price."74 Further provisions declared that a syndicate member could not grant any selling concession or commission to any person other than an investment banker who was registered with the relevant Regional Code Committee and therefore entitled to display the Blue Eagle of the National Recovery Administration (NRA).75 Many of the additional rules relating to selling syndicates were designed to close all loopholes that might permit a discount to anyone not meeting the code's definition of "investment banker."

The Supreme Court declared the NIRA unconstitutional in May 1935, but with the assistance of the SEC, the investment banking industry continued "voluntary compliance" with the code.76 That the code was successful in ending widespread discounting is attested to by the complaint of a Firemen's Insurance Company executive in 1937 that dealers ceased giving his company discounts during the NRA period and never resumed.77

In only a few years the antidiscounting rule was again a formal regulatory requirement. With the SEC's blessing, the Investment Bankers Code Committee reorganized itself into the Investment Bankers Conference, a self-regulatory organization for securities dealers, in 1936. The conference and the SEC worked with Congress to craft an amendment to the Securities Exchange Act of 1934 authorizing the formation of a self-regulatory organization for securities dealers. Their goal was to "continue the principles of self-regulation under government supervision first tried under the NRA."78

74 Id., art. V, § 4(a).
75 See id., art. V, § 4(b); art. IX, § 7; art. X, §§ 1–3.
76 See Carosso, supra note 19, at 389. See also Investment Bankers Organize, Bus. Week, October 12, 1935, at 23, 24 (noting that SEC Chairman James Landis "recommended that the work and ideas of the former code committee, as well as the personnel, be perpetuated in a voluntary group").
78 See Carosso, supra note 19, at 390.
The amendment, known as the Maloney Act, was enacted in 1938. The Investment Bankers Conference then reorganized itself into the NASD. While larger, more prestigious investment banks favored the Maloney Act and the Code of Fair Practice, smaller dealers opposed them. This is understandable, as smaller dealers were more likely to need to offer discounts to compete for business.

The Maloney Act explicitly permitted antidiscourting rules. The NASD created a set of “Rules of Fair Practice” modeled on the code. Those rules included (and still include) a ban on discounting as well as a prohibition on giving selling concessions to any person not engaged in the investment banking or securities business.

C. Separation of Wholesaling and Retailing

The Securities Act’s prohibition on solicitation prior to filing and the mandatory “waiting period” between filing and effectiveness create separate wholesale and retail phases of a public offering. Before filing a registration statement, an issuer may freely communicate with potential underwriters and those underwriters may freely communicate with one another. All potential syndicate members, however, are cut off from information about retail demand during this period.

These provisions protected separate wholesale and retail securities dealers from competition by integrated firms. Integrated firms, as described above, had two important competitive advantages. They were able to substitute ownership for contract as a way of controlling the timing and price of retail selling activity, and they had superior access to information about retail demand. The act provided regulatory enforcement in place of contract, making it possible once again for a combination of wholesale and retail firms to engage in fixed-price underwriting as effectively as integrated firms. The act also made it easier to gather information about institutional demand than about retail demand. During the waiting period, underwriters may solicit indications of interest using oral communications and roadshows. They may not, however, engage in mass marketing such as newspaper, radio, or television advertising. This assures that solicitation during the waiting period is aimed at institutional investors.

Kenneth Haven’s 1940 study of the impact of the SEC on investment banking claimed that the distribution of new issues after the Securities Act resembled English practice, under which the initial round of purchasers was

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70 See id. at 388–92.
largely institutional and the underwriters engaged in minimal retail solicitation.\textsuperscript{82} This was precisely the pattern that the wholesalers advocated beginning in the mid 1920s. Wholesale firms had long-established contacts with institutional investors that gave them an advantage in gathering information about institutional demand. The integrated firms had an advantage in gathering information about retail demand. The Securities Act's restrictions on retail solicitation ensured that pricing decisions would be made principally on the basis of information about institutional demand. This played directly into the hands of the wholesale houses.

\textbf{D. Competition from Banks}

I will mention only briefly the issue of competition from banks, which was not addressed by the Securities Act. The Banking Act of 1933 contained provisions popularly known as the Glass-Steagall Act that separated commercial from investment banking. Jonathan Macey argues that Glass-Steagall was an important victory for the investment banking industry because it removed commercial banks as competitors.\textsuperscript{83} William Shughart argues that the Banking Act represented a straightforward division of markets between the investment and commercial banking industries that benefited both.\textsuperscript{84}

Glass-Steagall did not dramatically reduce the number of underwriters competing for business. Most of the large bank securities affiliates were spun off from their commercial bank parents, or alternatively their top officers left to form new investment banks. The separation of commercial and investment banking did, however, contribute to the dramatic decline in the capital devoted to securities underwriting in the 1930s. The successors to the bank affiliates' underwriting businesses did not have ready access to loans and capital contributions from a parent bank. The Banking Act therefore removed the principal competitive advantage of the bank securities affiliates. The commercial banks gained something as well, because the private bankers were forced to abandon their deposit banking and stick to securities underwriting (as did Kuhn, Loeb) or split themselves into a commercial bank and a separate investment bank (as did J. P. Morgan).

Interestingly, until the final days before the Banking Act's passage, Glass's bill did not apply to private banks, meaning that J. P. Morgan and Kuhn, Loeb would have been unaffected, while the National City Bank and

\textsuperscript{82} See Haven, \textit{supra} note 40, at 60.


the Chase Manhattan Bank would have had to jettison their securities affiliates. The latter two were integrated firms, and both National City and Harris, Forbes (which Chase Manhattan acquired in 1931) had surpassed J. P. Morgan and Kuhn, Loeb during the late 1920s. The chairman of Chase Manhattan Bank, however, prevailed upon President Roosevelt to extend the ban on underwriting to private banks over Glass’s protest.\(^{85}\)

VI. **Measures of the Impact of the Securities Act**

That the Securities Act helped save the syndicate system is clear from the fact that the practices that had threatened syndication during the late 1920s were explicitly outlawed and did not recur. As discussed above, however, it is possible that the syndicate system was an efficient form of organization, and one could therefore argue that the act was benign. This makes it particularly important to look at the limited evidence we have on the act’s impact on underwriters. I return to the available information on market shares and spreads and argue that the evidence suggests that the act decreased competition in managing underwriting to the detriment of issuers and investors.

**A. Concentration**

Returning to Table 3, we see that the share of the top five underwriters was above 50 percent in all but one of the years after 1933. My result is consistent with the Temporary National Economic Committee’s estimate of 53 percent as the share of the top five managing underwriters for the period 1934–39.\(^{86}\) This is not, however, sufficient to show that the Securities Act increased concentration. Concentration increased during the period 1930–32, prior to the act. An alternative explanation consistent with the data is that concentration fell during a period of increasing new-issue volume and greater use of equity (1927–29) and rose again when new-issue volume and common stock issuance declined during the Depression. Ervin Miller finds that concentration generally decreases in periods of increasing underwriting volume and that concentration among managing underwriters is substantially higher in bonds than in stock.\(^{87}\)

To test whether the Securities Act had a marginal effect, I estimate the following ordinary least-squares regression:


\(^{86}\) See Friend et al., supra note 18, at 148.

\(^{87}\) See id. at 152–64.
TABLE 4
REGRESSION: THE SECURITIES ACT AND CONCENTRATION

<table>
<thead>
<tr>
<th>Variable</th>
<th>Estimated Coefficient</th>
<th>t-Statistic</th>
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<tr>
<td>STOCK</td>
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<td>VOLRT</td>
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<td>.129</td>
</tr>
<tr>
<td>SECACT</td>
<td>12.1</td>
<td>3.03</td>
<td>.011</td>
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NOTE.—The dependent variable is concentration in managing underwriting for the years 1925–40 (reported in Table 3). Predictor variables are (1) common stock issues as a percent of total new-issue volume (STOCK), (2) the rate of change of new-issue volume (VOLRT), and (3) a dummy variable that takes the value of one for years 1934–40 and zero for all prior years (SECACT). $R^2 = 0.87, N = 16.$

\[
CON_t = \alpha + \beta_1STOCK_t + \beta_2 \ln \frac{VOL_t}{VOL_{t-1}} + \beta_3SECACT_t + \epsilon_t, \quad (1)
\]

where $CON_t$ is concentration (the aggregate market share of the top five managing underwriters) in year $t$, $STOCK$ is the percentage of new securities issues consisting of common stock, $VOL$ is new-issue volume, and $SECACT$ is a dummy variable that takes the value of one for the years 1934–40, after passage of the Securities Act, and zero before.

The results are presented in Table 4. All the estimated coefficients are of the expected sign—an increase in the rate of growth in new-issue volume or in the relative prevalence of common stock is associated with lower concentration. The estimated coefficient on the Securities Act dummy is positive and significant. It is, of course, important to keep in mind that with only 16 annual observations, the results are suggestive but not definitive. They are, however, consistent with the qualitative evidence that the act reduced competition in the market for managing underwriters. I estimated alternative specifications substituting gross national product and the number of IBAA members for new-issue volume, as well as one including all three as predictors. In each case the estimated coefficients and significance levels on $STOCK$ and $SECACT$, as well as the $R^2$ of the regression, were very close to those reported in Table 4.\textsuperscript{88}

A few other pieces of information support the analysis. First, the traditionally dominant wholesale underwriters, after losing considerable ground to integrated firms during the late 1920s, returned to the top of the hierarchy

\textsuperscript{88} I also estimated the regression equation nine times, each time changing the year in which the dummy variable switched from zero to one, starting at 1930 and ending at 1939. The specification reported in Table 4, which included the $SECACT$ dummy, produced the highest $R^2$ and the lowest $p$-value on the dummy variable. This provides some additional comfort that something special occurred in 1933.
after 1933. The average aggregate market share of J. P. Morgan, Kuhn, Loeb, and Dillon, Read from 1925 through 1933 is 16.1 percent, and from 1934 through 1940 (substituting Morgan Stanley & Co. for J. P. Morgan) it is 31.1 percent. On the basis of a t-test for equal means, the difference is statistically significant \( p = .008 \).

Morgan Stanley’s competitive position is particularly noteworthy. J. P. Morgan elected to remain a commercial bank and ceased underwriting from early 1933 until a group of its partners left to form Morgan Stanley & Co. in September 1935. Operating for 4 months in 1935, Morgan Stanley nevertheless ranked third in managing underwriting for that year and returned to the top spot in 1936. In the 6-year period 1935–40, Morgan Stanley managed approximately $3 billion of offerings, nearly double that of its nearest competitor (Kuhn, Loeb) and more than J. P. Morgan’s total for the boom years 1925–30. By contrast, National City spun off its underwriting arm, but it never regained prominence. Halsey, Stuart returned to its original niche in public utility underwriting. The newly created First Boston Corporation acquired the top officers and goodwill, but not the retail selling outlets, of Chase Harris Forbes.

A final avenue of inquiry is to compare investment banks that survived after 1933 with those that did not. Manne, who suggests such a comparison, also notes that it is problematic because it is difficult to distinguish the effects of the Depression from those of the Securities Act.\(^8^9\) To attempt to disentangle the two as much as possible, I limit the analysis to a subset of my list of “major” investment banks consisting of those that survived the Depression. I define a firm as having “survived” the Depression if it is listed as an existing firm in the IBAA’s 1933 annual report, is not a commercial bank (which could not underwrite after 1933 because of the Glass-Steagall Act), and engaged in some underwriting business in either 1932 or 1933. The latter is a stringent test because the new-issue market was extremely thin in those 2 years. By this definition, 54 of the 105 major managing underwriters survived the Depression.

Of those 54 firms, 36 managed at least one offering during the period 1934–40, and 18 did not. We can therefore divide the subsample into firms that survived the Depression but not the Securities Act and those that survived both. As Table 5 shows, there are interesting differences between the two groups. Only 28 percent of the firms that returned to managing underwriting in 1934–40 are based outside New York City, compared to 61 percent of those that did no further managing business. The firms that managed new issues after the Securities Act were more established, as measured by

\(^{89}\) See Manne, supra note 6, at 36.
the average number of issues they had managed prior to the Securities Act as well as the average number of large issues (more than $10 million in proceeds). Each of the differences is statistically significant. The result is consistent with the qualitative evidence suggesting that the Securities Act was disproportionately beneficial to large, established, New York–based investment banks.

B. Profitability

The Securities Act did not stop the decline in spreads. Four separate studies of investment banking compensation before and after the Securities Act find that spreads decreased after enactment.\(^{90}\) Haven’s data, which are the most complete, show that the average spread on bond issues decreased from 3.0 percent in 1926–29 to 2.2 percent in 1933–37.\(^{91}\)

Once again, the decline does not tell us directly what we would like to know, which is industry profitability. Unlike the 1926–29 period, however, we can make an educated guess about the direction of the change. Virtually all components of underwriters’ costs must have been lower in 1933–37 than in 1926–29. Issue size continued to increase. Short-term interest rates fell substantially, as did salaries and the number of employees. The only increased costs were the additional accounting, legal, and printing fees gen-

\(^{90}\) See Friend et al., supra note 18, at 408–9; Haven, supra note 40; Gourrich, supra note 41; Miller, supra note 42.

\(^{91}\) See Haven, supra note 40, at 20, 34.
erated by the Securities Act itself. Issuers paid most of these costs directly, however, so they had no direct impact on underwriting spreads.

Fortunately, we can estimate the most important component of underwriters' costs, which is the cost of retail selling. Recall that selling group members do not underwrite. They perform only a retail distribution function, for which they receive a selling concession paid out of the underwriting spread. Miller's study of bond issues for 1927–31 found that concessions to selling group members averaged 1.65 percent of the proceeds of the issue, or 55 percent of the gross spread. I calculated the compensation paid to selling group members for all bond offerings underwritten by J. P. Morgan & Co. during the period 1927–31, using data produced by that firm during the stock exchange hearings of 1932–34.\(^{92}\) The result was 57 percent of the gross spread, closely in line with Miller's data. Both Miller and Haven find for sample periods after the Securities Act that about 44 percent of the gross spread, on average—or about 1 percent of the total proceeds, assuming a gross spread of 2.2 percent—was paid to selling group members. Thus the largest single component of the underwriters' costs declined by 40 percent.

These estimates suggest that net of retail selling costs, underwriting compensation declined by about 11 percent from 1926–29 to 1933–37. Controlling for average issue size (which tends to decrease the spread and which increased after 1933) and average riskiness of the security (which tends to increase the spread and which decreased after 1933), the decline was smaller still. Given the substantially larger declines in the general price, wage, and short-term interest rate levels, it is very likely that underwriters' profits increased after the Securities Act.

VII. CONCLUSION

The Securities Act pursued socially useful goals. In particular, its disclosure requirements forced the promoters of corporations undertaking initial public offerings to disclose their financial stake in the new corporation, thus combating an abuse that had persisted in both England and the United States since the mid-1800s.\(^{93}\) Its starting point for solving the problem was the same as that developed in the Companies Act in England—mandatory disclosure of promoters' and underwriters' fees and stakes in a company.

The statute did more than this, however. It prohibited contact with potential retail buyers in advance of an offering, making it difficult for one re-

\(^{92}\) See Pecora Hearings, pt. 1, supra note 12, at 228–39.

tailer to poach another's customer. In tandem with the NIRA and the Maloney Act, it enabled the IBAA to prohibit and monitor the use of price discounts in connection with public offerings. It also effectively divided offerings into wholesale and retail periods. These features helped leading wholesale and retail firms enforce restrictions on retail competition that were central to the syndicate system of underwriting, thus protecting their market against incursions from integrated firms. None of these things was necessary in order to achieve the simple goal of requiring full disclosure. They benefited investment banks, particularly high-prestige investment banks, and likely raised costs to issuers and investors.

The Securities Act accordingly provides a useful cautionary tale about the efficacy of economic regulation. The act is generally regarded as one of the greatest success stories of the New Deal. Unlike many regulatory statutes, it has been largely untouched by claims that it raises entry barriers or enforces cartel agreements among members of the regulated industry. Yet a closer look at the statute, in light of the competitive conditions in the underwriting market in the 1920s, shows that even the Securities Act was a likely source of rents for the firms it subjected to regulation.