

# COMMENTARY

## BUBBLE LAWS

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### TABLE OF CONTENTS

I. THE CYCLE OF FINANCIAL REGULATION.....79

II. THE 2002 CRASH .....83

III. THE 1929 CRASH .....90

IV. THE SOUTH SEA BUBBLE .....94

IV. CONCLUSION .....97

After a generation of unprecedented prosperity, investors awoke to the discovery that securities prices could not rise forever and that some corporate executives were greedy. The result was the Sarbanes-Oxley Act of 2002, which created new federal monitoring devices and penalties.<sup>1</sup> Professor Hamilton’s and other commentary on the recent corporate frauds point to the market excesses of the recent boom and to what the government should do to make sure that such things do not happen again.<sup>2</sup> I take the somewhat different view that the recent frauds are only the latest turn in a centuries-old cycle of capital market booms

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1. For a discussion of the Act and its causes and likely effects, see Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002).

2. See Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1 (2003).

followed by busts and regulation.<sup>3</sup> This brief Commentary will sketch the pattern and indicate some causes and effects, leaving deeper analysis for another day.

A boom encourages unwarranted trust in markets, leading to the speculative frenzy of a bubble and then to the inevitable bust. The bust, in turn, leads first to the disclosure of fraud and then to the mirror image of the bubble—a kind of speculative frenzy in regulation. A political context combining long-standing interest group pressures with panic and populism virtually ensures against a careful balancing of the costs and benefits of regulation. Regulators are more likely to react to past market mistakes than to prevent future mistakes. Even worse, post-bust regulators are likely to ignore the benefits of market flexibility and, therefore, to impede the risk-taking and innovation that will bring the next boom.

Part I describes the boom-bubble-bust-regulate cycle from both political and normative perspectives. Part II discusses the most recent episode—a boom focusing on the seemingly unlimited potential of new markets, followed by a bust that dissipates investors' gains, and a new law bolstering federal securities regulation of fraud and corporate monitoring. Part III moves the story back seventy years to the 1929 crash. This period, much like the 2002 episode, was also a story of unbounded optimism followed by a crash and the enactment of the first major federal securities regulation. Part IV moves back another two hundred years to the South Sea Bubble and the

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3. The point that securities regulation tends to follow crashes has been made before. See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997) (“[M]ost of the major instances of new securities regulation in the past three hundred years of English and American history have come right after crashes.”); Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 1 (2002) (observing that “every dramatic change in the structure of our securities laws has been provoked by a perceived failure in the capital markets that stimulated a regulatory response”); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 743 & n.11 (2000) (noting the “crash-then-law” cycle of securities regulation). Professor Banner argues that securities regulation results from popular distrust of securities markets, which during booms is “kept in check by the simple fact that too many people have been making too much money.” Banner, 75 WASH. U. L.Q. at 851. This argument draws from Professor Banner’s broader theory about how popular culture views securities markets. See generally STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860* (1998) [hereinafter BANNER, *POLITICAL ROOTS*]. By contrast, my theory focuses on interest groups, which provide a political explanation that Professor Banner misses. Cf. Paul G. Mahoney, *The Pernicious Art of Securities Regulation*, 66 U. CHI. L. REV. 1373, 1374–75 (1999) (commenting on Professor Banner’s analysis). Additionally, unlike Professor Banner, I also discuss the normative implications of the crash origins of securities regulation.

Bubble Act. This time the boom stemmed from the opportunities opened by trade with the new world, refinancing of the national debt, and the availability of new financial instruments. The regulation focused on the joint stock company structure of the firms that lured investors into the boom and resulting bust. In each case, regulation was passed without due consideration either to the benefits or costs of regulation, and it likely constrained the market's recovery from the crash.

#### I. THE CYCLE OF FINANCIAL REGULATION

This Part discusses the boom-bubble-bust-regulate cycle of financial market regulation from political and normative perspectives. The political story focuses on shifting interest group equilibriums. There is much money at stake in capital markets, and potential for political rent-seeking. Those who might gain from additional regulation include the regulators themselves, established firms that are best equipped to comply with stricter regulation, and reformers whose prominence rises with political acceptance of their theories.

In normal and boom times, new regulation would not help any distinct group enough to motivate the group to push for it. Regulated entities therefore have enough clout to defeat significant increases in liability or regulation. Those who might shift the balance, such as consumers or investors, do not see a need for new regulation while they are riding a rising market.

Crashes destabilize this interest group equilibrium in several ways. First, the more marginal firms, start-ups, and others that profited from the boom and opposed regulation that might thwart it, are now financially too weak to have much political clout. Second, pro-regulatory forces can enlist new supporters by arguing that regulation would restore "investor confidence"—code for more buyers and therefore higher prices. Third, reformers can draw on populism and envy of the rich,<sup>4</sup> which abates only as long as the rich generate significant wealth for the rest of us.

From a normative standpoint, regulation during market crashes is likely to be flawed because the post-bust political environment disables full evaluation of the benefits and costs of regulation. On the benefit side, regulation can do little to prevent

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4. See generally HELMUT SCHOECK, *ENVY: A THEORY OF SOCIAL BEHAVIOR* (Michael Glenny & Betty Ross trans., 1969); Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

the kind of fraud that flourishes when bubbles disable investor skepticism.

In normal times, when defrauders normally must present a veneer of plausibility, large frauds succeed only when they are extraordinarily ambitious. For example, the Equity Funding fraud of the early 1970s<sup>5</sup> and F. Donald Coster's McKesson & Robbins scam of the 1920s and 1930s<sup>6</sup> depended on the defrauders' ability to fool even normally skeptical auditors by fabricating fundamental aspects of the business—life insurance policies (Equity Funding) and inventories (Coster).

Booms begin when economic conditions produce optimism about expected returns.<sup>7</sup> For example, peace diverts cash from the government to the general economy, financial innovations reduce the transaction costs of investing, and new products or services promise extraordinary profits. Bubbles occur when this optimism outstrips reality. Market participants are then ready to accept even fraud that previously would have seemed implausible. Walter Bagehot has said:

The good times . . . of high price almost always engender much fraud. All people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity.<sup>8</sup>

Similarly, Professor Galbraith observes that embezzlement rises in good times because “people are relaxed, trusting, and money is plentiful.”<sup>9</sup> “Speculation on a large scale requires a pervasive sense of confidence and optimism and conviction that ordinary people were meant to be rich. . . . [A] feeling of trust is essential for a boom.”<sup>10</sup>

The prevailing mood's invitation to fraud is exacerbated by new business methods that seemingly make previous metrics obsolete. Skeptics are denounced as backward defenders of the

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5. See *Dirks v. SEC*, 463 U.S. 646, 665–67 (1983).

6. See Cynthia Crossen, *A '30s Business Genius Fooled Bankers, Peers and Price Waterhouse*, WALL ST. J., Nov. 6, 2002, at B1.

7. See generally WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 122–59 (1892).

8. *Id.* at 158.

9. See JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929 133* (50th anniversary ed., 1979).

10. *Id.* at 169–70; see also CHARLES MACKAY, *EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS* 88 (L.C. Page & Co. 1932) (1852) (noting that “[i]n times of great commercial prosperity there has been a tendency [for] over-speculation”).

“old economy.” Accordingly, the market has a harder time distinguishing the fraudulent from the credible.

Judgment biases increase the exuberance that drives booms. Investors may, for example, be overconfident in their own skills, be too optimistic, be led by a “conservatism” bias to discount evidence contrary to a prevailing trend, cling to prior beliefs, “anchor” estimates in some arbitrary value, or over-weigh more salient and recent, or “available,” evidence.<sup>11</sup> Executives also are susceptible to overconfidence, particularly those who have the highest self-esteem and who may also be the most successful.<sup>12</sup>

Insiders’ incentives to defraud may depend on whether the business is on the way up or down. Insiders may commit fraud on the way up because they share in the general mood of credulity. When the business turns down, insiders have an incentive to cover up their fraud in order to protect their wealth and freedom. At this point, insiders can no longer be effectively disciplined by their firms or the employment market.<sup>13</sup> Indeed, the consequences of discovery may be so severe that rational insiders may be induced to cover up even with little chance that the cover-up will be successful. This calculus may be reinforced by a psychological tendency to prefer risk when choosing whether to take a present loss or take a chance on avoidance of loss.<sup>14</sup>

Busts and ensuing regulation happen when the forces that drove the boom and bubble shift into reverse. During a bust, market risks are salient in the media, skepticism replaces

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11. For useful summaries of these and other investor judgment errors, see Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance* (Sept. 2002) (manuscript at 11–21), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=327880](http://papers.ssrn.com/paper.taf?abstract_id=327880) (last visited Mar. 11, 2003); Nicholas Barberis et al., *A Model of Investor Sentiment*, 49 J. FIN. ECON. 307 (1998), available at <http://gsbwww.uchicago.edu/fac/nicholas.barberis/research/sent.pdf> (last visited Mar. 14, 2003).

12. Donald C. Langevoort, *The Organizational Psychology of Hyper-competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. (forthcoming 2002) (manuscript at 8).

13. For discussions of the effect of the final period problem on insiders’ incentives to commit wrongdoing, see Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 702–03 (describing how a manager is more likely to commit fraud if his future employment is uncertain due to adverse business conditions); Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 696–702 (1999) (discussing how highly paid corporate managers, initially motivated to further shareholder interests in order to protect their “reputational stigma,” lack this motivation toward the ends of their careers).

14. Barberis & Thaler, *supra* note 11, at 15–19; Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 118–19 (1996). For an application to the attorney-client context, see Richard W. Painter, *Lawyers’ Rules, Auditors’ Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1413–14 (2000).

optimism, and a conservative bias and availability heuristic work in the opposite direction.<sup>15</sup> The context of crash-induced regulation has implications for its cost-effectiveness. First, to the extent that the crash itself bursts the bubble of investor overconfidence, regulation is unnecessary to correct the past bubble. Thus, Professor Galbraith says: “[A] speculative outbreak has a greater or less immunizing effect. The ensuing collapse automatically destroys the very mood speculation requires. It follows that an outbreak of speculation provides a reasonable assurance that another outbreak will not immediately occur.”<sup>16</sup>

Second, to the extent that judgment biases cause investors to ignore warning signs in booms, regulation may do little to prevent the next bubble. Professor Galbraith observes:

With time and the dimming of memory, the immunity wears off.

. . . .

[T]he chance for recurrence of a speculative orgy remains good. No one can doubt that the American people remain susceptible to the speculative mood—to the conviction that enterprise can be attended by unlimited rewards in which they, individually, were meant to share. . . .

. . . [D]uring any future boom some newly rediscovered virtuosity of the free enterprise system will be cited.<sup>17</sup>

Third, because the frauds of the next boom are unlikely to resemble those of the previous one, regulations imposed that are designed to deal with such frauds will not prevent future schemes. This problem is compounded by the fact that the crash environment is unlikely to be conducive to careful discovery of causes and cures. Public attention may be focused more on punishing the guilty than on preventing future harms.

Fourth, and perhaps most importantly, lawmakers regulating in a crash are likely to ignore or minimize regulatory costs. The salience of the crash may obscure the real gains—not only of investors from the beginning of the boom, but of consumers and producers from innovations that significantly reduced prices or increased productivity.<sup>18</sup> The crash also may

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15. Refer to note 45 *infra* (discussing the availability heuristic).

16. See GALBRAITH, *supra* note 9, at 171.

17. *Id.* at 171, 189–90.

18. See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 318 n.127 (2000) (noting that “[r]egulators also may suffer from cognitive biases, imposing higher levels of securities regulation when markets drop in value, to protect investors, while ignoring the benefits to investors when the market

cause voters and regulators to forget the factors that caused the boom, including a willingness to take risks and to innovate. Accordingly, they may be willing to impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success. This, in turn, may delay the next boom.

## II. THE 2002 CRASH

The recent boom and bubble probably began in the mid-1990s, as people started seeing limitless potential in the Internet and in the deregulation of telecommunications and other markets. In retrospect, the bubble started losing air in March 2000, when the NASDAQ index peaked above 5000.<sup>19</sup> The fraud aspect of the boom-bust cycle became evident on October 16, 2001, when Enron Corporation disclosed its first major accounting write-down.<sup>20</sup> The fraud disclosures and plummeting markets in the summer of 2002 led quickly to the passage of the Sarbanes-Oxley Act.<sup>21</sup> The following discussion shows how the boom, bust, and regulatory phases of the cycle fit the above pattern.

Three basic elements fueled the recent stock market boom. First, there were favorable economic conditions, including the sharp increase of available investment capital from broader participation in the market.<sup>22</sup> The baby boom generation was investing for retirement, capital flowed from less successful European and Asian capital markets,<sup>23</sup> and the National Association of Securities Dealers Automated Quotation (NASDAQ) system attracted listings of more marginal

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increases in value”).

19. See Carol Emert, “*The Bubble Is Gone*”—NASDAQ Hits 5-Year Low, S.F. CHRON., July 2, 2002, at A1 (reporting that on July 1, 2002, the NASDAQ fell to 1,404.80, the lowest point since June 10, 1997, after reaching a peak of 5,048.62 on March 10, 2000).

20. Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (Oct. 16, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QEarningsLtr.html> (last visited Feb. 28, 2003) [hereinafter Enron Press Release] (reporting \$1.01 billion in non-recurring charges for the third quarter of 2001).

21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

22. Steven Pearlstein, *In Euphoria, Key Players Looked Away*, WASH. POST, Nov. 10, 2002, at A1.

23. *Id.*

securities.<sup>24</sup> In the background were low rates of inflation, interest, and unemployment, and an extended period of peace.<sup>25</sup>

Second, new technology, particularly the Internet, promised to increase profits exponentially.<sup>26</sup> At the height of the boom, upstart America Online (“AOL”) could use its lofty stock essentially to acquire old media king Time Warner.<sup>27</sup> Enron in particular rode heightened expectations, beginning with energy markets that reduced the utility companies’ need to own generating plants, then applying similar techniques in other markets.<sup>28</sup> New companies were hyped at various stages by enthusiastic venture capitalists,<sup>29</sup> investment bankers,<sup>30</sup> and analysts,<sup>31</sup> all with their own interests at stake in the boom.

Third, the transaction costs of investing declined. Mutual funds proliferated, and stocks could be traded at declining commission rates. The new mechanics of investing brought together all of the elements of the boom—people invested both on and in the Internet, while declining transaction fees stopped subsidizing securities research, converting analysts into salesmen.<sup>32</sup>

These elements of the stock market boom also provided the conditions of a bubble that became detached from inherent values and susceptible to a crash. Because history did not indicate how high stock prices could go in new or reconfigured markets, investors thought prices would rise indefinitely. Thus, as Enron moved from energy to other industries, the market was willing to accept a \$90-per-share value in August 2000 that could be justified only on the basis of some heroic assumptions, such as that Enron would “earn a return on equity of 25% forever, grow

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24. NASDAQ delivered computer quotations for companies with only \$8 million in public capitalization, 400 shareholders, and no pre-tax income, as compared with \$60 million, 2000 shareholders, and \$2.5 million for the NYSE. See Paul Farhi, *Nasdaq “Casino” Had Few Safeguards: Zarb Says Markets Did All They Could*, WASH. POST, Nov. 11, 2002, at A1. Rather than tightly regulating its listed firms, NASDAQ relied on consumer education. *Id.*

25. *Id.*

26. Pearlstein, *supra* note 22.

27. *AOL Buys Time Warner for \$166 Billion in Stock Merger; Would Be World’s Biggest*, CHI. TRIB., Jan. 10, 2000, at 1.

28. See generally William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1288–99 (2002) (analyzing the Enron business model).

29. See, e.g., Ariana Eunjung Cha, “Johnny Appleseed” for a Risky Field: Doerr’s Ambition Costly to Investors, WASH. POST, Nov. 13, 2002, at A1.

30. See, e.g., Jonathan Krim, *Banks Go from Powerhouses to Pariahs*, WASH. POST, Nov. 14, 2002, at A1.

31. See, e.g., Paula Span & Ben White, *The Market Scholars’ Star Turn: A Blurring of the Lines Produced Troubling Conflicts*, WASH. POST, Nov. 15, 2002, at A1.

32. *Id.*

revenues to \$700 billion in ten years, and grow revenues by 10% per year (twice the historical rate of growth for [U.S.] public firms) thereafter.”<sup>33</sup> Moreover, the capital markets did not question the risks presented by almost \$21 billion in liabilities of a bewildering variety of “unconsolidated equity affiliates” that Enron disclosed in its 2000 annual report,<sup>34</sup> or optimistic accounting numbers at Enron and other firms. Corporate executives, too, were inclined to believe in their firms’ limitless prospects, particularly when exploding stock valuations reinforced these beliefs, and invested their firms’ cash accordingly, further inflating the bubble.

These conditions were conducive to fraud. Investors who had gotten used to swallowing tall tales about expected earnings lost their healthy skepticism. At the same time, executives awash in capital had more to spend on themselves. Moreover, executives whose pay and tenure were tied to their firms’ financial success had reasons to start fudging accounting numbers when the real numbers turned down. These executives may have so accepted the assumptions underlying their business plans that they could persuade themselves that the market would turn back up before their deception became apparent. Having begun to defraud, executives also had strong incentives to continue in order to escape discovery. The fraud was exacerbated by the monitoring failures of outside directors, auditors, lawyers, other executives, investment bankers, and securities analysts who were also caught up in the boom and prevailing optimism, and whose ties to booming firms caused distracting conflicts of interest.<sup>35</sup>

Stories about major frauds began in earnest with Enron’s October 16, 2001 disclosure that it took a half-billion-dollar after-tax charge against earnings and a \$1.2 billion reduction of shareholders’ equity related to transactions with special purpose entities the company had created for the purpose of keeping debts off its balance sheet.<sup>36</sup> The Enron disclosure may have been particularly alarming because of Enron’s size and emblematic

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33. Paul M. Healy & Krishna Palepu, *Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron*, J. ECON. PERSP. (forthcoming 2003) (manuscript at 24), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=325440](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=325440) (last visited Feb. 28, 2003).

34. ENRON CORP., 2000 ANNUAL REPORT 42 (2001), available at [www.enron.com/corp/investors/annuals/2000/](http://www.enron.com/corp/investors/annuals/2000/) (last visited Mar. 2, 2003).

35. These multiple failures are detailed in the report of an Enron board committee following the fraud in that company. WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002), available at 2002 WL 198018; see also Ribstein, *supra* note 1, at 7.

36. See Enron Press Release, *supra* note 20.

status in the new economy, and also because the NASDAQ slide and the September 11, 2001 attacks had already shaken market confidence. The culminating event seems to have been WorldCom's disclosure on June 25, 2002, that it misstated \$3.8 billion in fees the company paid to use transmission networks as capital expenditures.<sup>37</sup> The Dow Jones Industrial Average ("Dow") dropped precipitously the following month on record volume.<sup>38</sup> Securities prices now seemed to reflect fraud risk.

These events seemingly made it imperative to regulate the markets to drive stock prices back up.<sup>39</sup> Moves to regulate that began in the fall of 2001 appeared to languish in early 2002—until the summer stock market decline and the WorldCom disclosure put reform on the front burner. This quickly led to the enactment of the Sarbanes-Oxley Act of 2002, signed on July 30, 2002.<sup>40</sup> President George W. Bush, who embraced the bill as the

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37. See Jared Sandberg et al., *WorldCom Admits \$3.8 Billion Error in Its Accounting: Firm Ousts Financial Chief and Struggles for Survival; SEC Probe Likely to Widen*, WALL ST. J., June 26, 2002, at A1. The tally has since risen to over \$9 billion. Deborah Solomon & Jared Sandberg, *WorldCom's False Profits Climb: Telecom Firm's Latest Tally May Exceed \$9 Billion; SEC Files More Charges*, WALL ST. J., Nov. 6, 2002, at A3.

38. See Adam Shell, *Record Trading, Point Swings Mark Dow's Crazy Summer*, USA TODAY, Sept. 3, 2002, at 4B (reporting that over the summer of 2002, the Dow fell 1,440.76 points, or 14.3%, which included a drop of 390.23 points, the Dow's seventh worst point decline ever, on July 19, 2002, and that the average daily trading volume in June, July, and August of 2002 was 1.6 billion shares (up from 1.1 billion shares in the summer of 2001)).

39. In fact, neither the September 11, 2001 attacks, the Enron disclosures, nor even WorldCom can be blamed for the market's final downfall. The Dow reached its highest monthly close at the end of August 2000 (11,192). Prices then trended down on the Dow until September 2001, when they closed at 8567. Prices rebounded to 10,088 by the end of September 2001 and remained at about that level through May 2002 (10,104). The Dow declined 20% in July 2002, closing that month at 8264. It rebounded to close at 8919 at the end of August, but then sank again in September to 7997. Prices rose sharply in October and November 2002, to return to September 2001 levels. See Dow Jones Indexes, *Dow Jones Averages: Historical Index*, at <http://www.djindexes.com/jsp/industrialAverages.jsp> (last visited Mar. 14, 2003) [hereinafter *Dow Historical Index*].

The NASDAQ had lost most of its value well before these events, and both markets rose after these dates. After peaking at 5048 on March 10, 2000, it declined to 2577 by the end of the year and to 1669 on September 10, 2001. Because the NASDAQ was at 1695 when markets reopened on September 17, 2001, it was not affected by September 11, at least in the short term. The NASDAQ rose to 1989 by the end of 2001, but fell to 1475 on June 25, 2002, and to 1109 by October 8, 2002. It had risen to the 1400-range by December. See NASDAQ, *Market Data (2002)*, available at [http://www.marketdata.nasdaq.com/mr\\_module\\_menu.asp](http://www.marketdata.nasdaq.com/mr_module_menu.asp) (last visited Mar. 14, 2003).

40. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.). Title VIII of the Act is the Corporate and Criminal Fraud Accountability Act of 2002. *Id.* §§ 801–807, 116 Stat. at 800–04 (to be codified at 11 U.S.C. § 523; 18 U.S.C. §§ 1341, 1348, 1501, 1514A, 1519–1520; 28 U.S.C. §§ 994, 1658). Title IX of the Act is the White Collar Crime Penalty Enhancements Act of 2002. *Id.* §§ 901–906, 116 Stat. at 804–06 (to be codified at 18 U.S.C. §§ 1341, 1343, 1349–1350; 28 U.S.C. § 994; 29 U.S.C. § 1311). Title XI of the Act is the Corporate Fraud and

momentum gathered, described the law as “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”<sup>41</sup>

The Act reflects efforts by three specific groups. First, there are the academic reformers who, since the 1930s, have called for increased federal regulation of corporate governance.<sup>42</sup> Second, trial lawyers have sought repeal or rollback of the restrictions on securities class remedies and lawsuits in the Private Securities Litigation Reform Act of 1995 (PSLRA), which, among other things, tightened pleading requirements and modified joint and several liability.<sup>43</sup> Third, transactional lawyers stood to gain from the increased need for legal advice regarding significant new disclosure and other requirements and increased liability. Consistent with this theory, in the summer of 2002, an American Bar Association task force recommended dealing not only with lawyers but with corporate governance generally, including increasing director independence.<sup>44</sup> These groups could achieve

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Accountability Act of 2002. *Id.* §§ 1101–1107, 116 Stat. at 807–10 (to be codified at 15 U.S.C. §§ 77h-1, 78a, 78ff, 78u-3; 18 U.S.C. §§ 1512–1513; 28 U.S.C. § 994). For a discussion and analysis of the Act, see generally Hamilton, *supra* note 2, and Ribstein, *supra* note 1.

41. Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 WEEKLY COMP. PRES. DOC. 1284 (July 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020730-1.html> (last visited Mar. 15, 2003).

42. Prominent reformers have included Professors Adolf Berle, Gardiner Means, William Cary, and John Coffee. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988).

43. See Ribstein, *supra* note 1, at 33–34 (summarizing important provisions of the PSLRA).

44. See JAMES CHEEK, III ET AL., *PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 13–23 (2002)*, available at <http://www.abanet.org/buslaw/newsletter/0002/materials/preliminaryreport.pdf> (last visited Mar. 2, 2003). To be sure, transactional lawyers may have ended up losing from the new regulation of lawyers under section 307 of Sarbanes-Oxley. This seems clearer now that the SEC has proposed rules under section 307 which, among other things, require lawyers to report corporate wrongdoing to the SEC under some circumstances, creating a possible conflict with state confidentiality requirements. See *Implementation of Standards of Professional Conduct for Attorneys*, 68 Fed. Reg. 6324–29 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205.3(d)), available at <http://www.sec.gov/rules/proposed/33-8150.htm> (last visited Feb. 28, 2003). But this provision was added to the law relatively late in the legislative process. Proponents of more lawyer regulation were looking to the SEC as recently as the spring of 2002. See American Bar Association, *ABA Presidential Task Force on Corporate Responsibility*, at [http://www.abanet.org/buslaw/corporateresponsibility/responsibility\\_relatedmat.html](http://www.abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html) (last visited Dec. 20, 2002) (listing correspondence and related materials on attorney responsibility). Until the enactment, lawyers may have hoped that any additional burden imposed on them would be significantly outweighed by the increased demand for legal work.

some success after the crash, as public anxiety about the economy and the market combined with populist sentiments, all stirred by daily news media stories about rich defrauders. The public focused on fraud as closely as it had on the market's rise.<sup>45</sup>

The atmosphere of stock market panic, political maneuvering, sensational news stories, and the consequent rush to the adoption of Sarbanes-Oxley, led to some questionable cures for corporate fraud.<sup>46</sup> For example, the Act seeks to make auditors better watchdogs by setting up the new Public Company Accounting Oversight Board (PCAOB) and outlawing distracting conflicts of interest.<sup>47</sup> But increasing auditor independence may reduce their access to information as well as their expertise, ability, and incentives. Also, separating audit and non-audit services may move auditing to smaller, less reputable, and more judgment-proof firms. More fundamentally, these fixes do not get to the basic question of what auditors practicably can do to prevent fraud. Similarly, the Act's new duties,<sup>48</sup> liabilities,<sup>49</sup> and penalties for corporate executives,<sup>50</sup> including executive certification requirements,<sup>51</sup> are unlikely to counteract the strong incentives for fraud operating in the bubble context discussed above. At the same time, increasing the penalty and advancing

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45. The public's focus on a problem highlighted by daily repetition in the media is an example of the "availability heuristic" with "cascade effects." For an application of these theories to safety and health regulation, see generally Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059 (2000).

46. See Ribstein, *supra* note 1, at 18-47 (discussing these and other defects of the Sarbanes-Oxley Act).

47. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101(a), 206, 116 Stat. 745, 750, 774-75 (2002) (to be codified at 15 U.S.C. §§ 78j-1, 7211).

48. See, e.g., *id.* § 302(a), 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241) (requiring that corporate executives certify the truthfulness and accuracy of information in the company's periodic reports and attest to the adequacy of internal controls); *id.* § 403(a), 116 Stat. at 788 (to be codified at 15 U.S.C. § 78p) (requiring that directors and officers disclose the amount of their equitable ownership in the company).

49. See, e.g., *id.* § 303, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7242) (imposing potential civil liability on officers and directors for improperly influencing, misleading, or manipulating any public accountant engaged in an audit of the company's financial statements); *id.* § 304, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243) (requiring that the chief executive officer (CEO) and the chief financial officer (CFO) return to the company any bonuses or profits from the sale of company stock during the past year if the company must prepare an accounting restatement because of misconduct in relation to financial reporting requirements).

50. See, e.g., *id.* § 807, 116 Stat. at 804 (to be codified at 18 U.S.C. § 1348) (setting forth criminal penalties for securities fraud); *id.* § 906, 116 Stat. at 806 (to be codified at 18 U.S.C. § 1350) (establishing potential criminal penalties, in the form of either substantial fines or imprisonment, stemming from corporate officers' failure to certify financial reports).

51. See *id.* § 302, 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241).

the time at which executives have committed themselves to a misstatement may induce cover-ups during stock market busts.

By regulating in a panic, Congress also ignored potential market solutions to corporate fraud. Nothing prevents firms from demonstrating their honesty by, among other things, maintaining a high level of disclosure, voluntarily having executives certify accuracy, and hiring only independent audit-only firms. Auditing firms can signal their independence by clearly separating non-audit services, and securities analysts or their employers can provide assurances of the analysts' independence from the sell side of the business.<sup>52</sup>

Most importantly, the crash context of the legislation made it likely that Congress would ignore regulation's risk to socially valuable free markets and deter the risk-taking and innovation that can create the next boom. First, increasing executives' obligations regarding certifying financial reports and requiring them to reimburse compensation in the wake of an earnings restatement will tend to discourage risk-averse executives from engaging in profitable business activities that produce earnings surprises. Second, increased regulation and liability may make it harder for riskier firms to attract good executives, lawyers, and accountants. These people might prefer to work for firms that are less likely to report earnings surprises or for closely held firms that are not subject to securities market regulation. Third, executives, who must stake their personal wealth and reputations on the quality of their firm's reporting and monitoring, may insist that the firm's disclosures be so hedged or conservative as to be of little guidance, or such executives may want to spend more on disclosure and monitoring than shareholders would prefer. Again, these costs will be highest for the riskiest, and therefore the most innovative, firms. Indeed, fraud regulation is more likely to constrain risk-averse executives, who tend to obey the law, than those executives prone to committing fraud.

One might discount the importance of discouraging booms by arguing that the last one was illusory. But even a cursory look at share prices indicates that this is not the case. The Dow, near 9000 in late December 2002,<sup>53</sup> may be down more than 20% from

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52. For example, Citigroup has moved to split its research and brokerage units from the parent corporation and has placed the research unit under credible management. See Kate Kelly & Randall Smith, *Outsider Aims to Restore Citigroup's Luster—Weill Bets Krawcheck Will Help Allay Fears of Conflicts of Interest*, WALL ST. J., Oct. 31, 2002, at C1.

53. The Dow's closes varied between 8303.78 and 8627.40 from December 16 to 31, 2002. See *Dow Historical Index*, *supra* note 39.

its peak in January 2000,<sup>54</sup> but it is up 1000% since its close near 900 at the end of 1981,<sup>55</sup> as compared with the gain of about 20% from 1961 to 1981,<sup>56</sup> without adjusting for inflation. This indicates that a substantial amount of real value survived the collapse of the bubble. Moreover, even if firms have competed away the profits that drove stock market valuations, technological and financial innovations have increased consumers' purchasing power and workers' earning power.<sup>57</sup>

### III. THE 1929 CRASH

The recent burst of a stock market bubble and the accompanying regulation bear striking similarities to past boom-bubble-bust-regulate cycles. This Part discusses the 1929 crash and some of its regulatory aftermath. Like the Internet-induced bubble of the late 1990s, the boom of the 1920s was hailed (by President Coolidge) as a "new era."<sup>58</sup> During the 1920s, in a manner similar to recent history, promoters capitalized on investors' beliefs in unlimited horizons,<sup>59</sup> fed by abundant post-war capital, low interest rates,<sup>60</sup> and the proliferation of investment trusts.<sup>61</sup>

As in the recent past, the boom of the 1920s led to a bubble. Stock prices increased from 106 in May 1924 to 245 at the end of 1927, 331 at the end of 1928, and 449 in August 1929.<sup>62</sup> Economist Irving Fisher famously stated in autumn 1929 that "[s]tock prices have reached what looks like a permanently high plateau."<sup>63</sup>

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54. The Dow's close peaked at 11,722.98 on January 14, 2000. *See id.*

55. The Dow closed at 875.00 on December 31, 1981, and its closes varied between 868.25 and 875.95 from December 15 to 31, 1981. *See id.*

56. The Dow closed at 723.09 on December 26, 1961, and it closed at 873.38 on December 24, 1981. *See id.*

57. *See* Pearlstein, *supra* note 22 (noting that the economy's rate of productivity has grown by 1.5% per year since 1995, or about a trillion dollars per year in higher living standards, and is reflected in higher pay for workers and in cheaper goods and services).

58. *See* JOHN BROOKS, *ONCE IN GOLCONDA: A TRUE DRAMA OF WALL STREET 1920-1938*, at 89-90 (1969) ("On November 17, 1927, [President Coolidge] said that America was 'entering upon a new era of prosperity.'").

59. *See* GALBRAITH, *supra* note 9, at 46 (observing that new companies were formed, notably in radio and aviation, that never had more than a prospect).

60. *See* BROOKS, *supra* note 58, at 92-94 (noting efforts of the Federal Reserve Bank, led by Benjamin Strong, to maintain low interest rates, which led to leveraging of firms' and individuals' investments, because of Strong's incentive to help England stem the outflow of gold).

61. *See* GALBRAITH, *supra* note 9, at 49-50 (commenting that investment trusts increased approximately elevenfold during the years 1927 to 1929).

62. *See id.* at 7-9, 17, 66 (reporting the *New York Times* averages of twenty-five industrial stocks).

63. *See id.* at 70 (quoting Economist Irving Fisher).

Again, as in the current boom and bust, executives as well as shareholders were overconfident. As Professor Galbraith has noted regarding management of the investment trusts:

If one has been a financial genius, faith in one's genius does not dissolve at once. To the battered but unbowed genius, support of the stock of one's own company still seemed a bold, imaginative, and effective course. . . . So to the extent that their cash resources allowed, the managements of the trusts chose faster, though equally certain death. They bought their own worthless stock. . . . [M]en succeeded on a large scale in swindling themselves.<sup>64</sup>

On October 29, 1929, stocks lost forty-three points, a year's gain, on unprecedented volume.<sup>65</sup> As in the recent bust, the collapse exposed frauds. As Professor Galbraith reports: "Within a few days [after the crash], something close to universal trust turned into something akin to universal suspicion. Audits were ordered. . . . [T]he collapse in stock values made irredeemable the position of the employee who had embezzled to play the market. . . . [R]eports of defaulting employees were a daily occurrence."<sup>66</sup> The blame, as now, was placed partly on those who were supposed to be watchdogs but were found to have conflicts of interest, including banks that sold stock<sup>67</sup> and newspaper reporters who got cash for stories.<sup>68</sup>

There were also the populist scapegoats, including Albert H. Wiggin of Chase National Bank who, like Andrew Fastow,<sup>69</sup> had personal holding companies (special purpose entities), some named for his children.<sup>70</sup> Chase financed Wiggin's short sales of its own stock.<sup>71</sup> Wiggin got himself voted a life salary of \$100,000.<sup>72</sup> Charles E. Mitchell of National City Bank was indicted for tax fraud after he was found to be getting over a million dollars a year in 1928 and 1929 from a special fund designated by the bank's officers.<sup>73</sup> Richard Whitney of the NYSE,

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64. *Id.* at 125.

65. *See id.* at 111–12.

66. *Id.* at 133–34.

67. *See id.* at 71 (stating that many bankers "abandoned their historic role as the guardians of the nation's fiscal pessimism and enjoyed a brief respite of optimism").

68. *See id.* at 72–73 (reporting that by 1929, numerous journalists were "demanding cold cash for the news favorable to the market").

69. Andrew Fastow, former CFO of Enron, was charged with corporate wrongdoing in a seventy-eight-count indictment in 2002. *See, e.g.,* Kurt Eichenwald, *Enron Probe Broadens to Include Hard Assets*, CHI. TRIB., Dec. 26, 2002, at 14.

70. GALBRAITH, *supra* note 9, at 147–48.

71. *Id.* at 149.

72. *Id.* at 150.

73. *See id.* at 152–53.

who had made himself a symbol of the boom, became a target in the bust.<sup>74</sup>

The post-1929 political environment meshed with the long-standing aims of some interest groups. New Deal Democrats sought to bolster their legislative agenda.<sup>75</sup> The significant role of the academic reformer James Landis in drafting the 1933 Act parallels the support of modern academic reformers for increased federalization of corporate law.<sup>76</sup>

The initial post-crash legislation, the Securities Act of 1933,<sup>77</sup> served the securities industry's more specific objectives. Professor Henry Manne has argued that the Act helped the largest investment banking firms, whose relatively low-risk clients had the least to lose from full disclosure and who therefore would gain from regulation of underwriters of higher-risk firms.<sup>78</sup> Paul Mahoney argues more elaborately that the 1933 Act, together with other New Deal legislation, protected separate wholesale and retail investment banks from potentially ruinous competition.<sup>79</sup> The Act's anti-gun-jumping provisions, which slowed the solicitation and sales process under the guise of ensuring that buyers were well-informed, had the more important effect of reducing integrated wholesale-retailers' advantage over separate firms.<sup>80</sup> Competitive pressure on non-integrated firms was further reduced by the Glass-Steagall Act, which separated commercial and investment banks, and the National Association of Securities Dealers created the *Rules of Fair Practice* as a result of the Maloney Act, which banned

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74. See *id.* at 156–60 (chronicling Whitney's appearances as a witness before Senate committees and his subsequent arrests).

75. *Id.* at 164.

76. Refer to note 42 *supra* and accompanying text (discussing the goals of the academic reformers).

77. 15 U.S.C. §§ 77a–77aa (2000).

78. See Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY 21, 33–36 (Henry G. Manne & Ezra Solomon eds., 1974).

79. See generally Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1 (2001) [hereinafter Mahoney, *Political Economy*]. Professor Mahoney traces the concerns held by the non-integrated investment bankers through the late 1920s about increased market competition that threatened the viability of their selling syndicates. *Id.* at 3–11. In 1927, the bankers' trade group complained about gun-jumping and competition from commercial banks, which it claimed were impairing the ethics of investment banking. *Id.* at 14–18. The trade group later testified in favor of federal law at the congressional hearings on the Act. *Id.* at 20. Professor Mahoney demonstrates that the non-integrated firms' profits rose during the 1933 to 1937 period compared to the free competition period from 1926 to 1929. *Id.* at 30.

80. *Id.* at 21–22.

discounting and prohibited selling concessions to persons not engaged in the investment banking or securities business.<sup>81</sup>

Although the Securities Act of 1933 was enacted years after the crash and seemingly with more deliberation than Sarbanes-Oxley, similar questions about the benefits and costs of regulation arise in this context. Regarding benefits, there is an initial question about the cause of the crash. By the end of April 1930, the Dow had returned to its late 1928 price of 286,<sup>82</sup> but two years later, it reached 60<sup>83</sup> and did not recover to the 300s until April 1954.<sup>84</sup> This price history indicates that it was a decline in real valuations in the Depression, and not just the bursting of a bubble, that killed the 1929 market. One study shows that markets were overvalued by about 30% in the summer of 1929<sup>85</sup>—significant, but not enough to render the boom a mirage.

The more important question for present purposes is the extent to which the 1933 Act addressed any structural market problems and thereby reduced the chance of a recurrence. Several studies find little or no effect of the securities laws disclosure requirements.<sup>86</sup> Event studies show that the 1933 Act did not affect securities returns, indicating that the Act did not cause disclosure of valuable new information, as returns would have risen if firms disclosed more negative information after the Act.<sup>87</sup>

On the other hand, the 1933 Act had the sort of regulatory *cost* highlighted in this Commentary—discouraging risky ventures—as indicated by evidence that the *variance* of returns fell after the 1933 Act.<sup>88</sup> Although this fall could indicate that the

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81. *Id.* at 23–26.

82. Compare Dow Jones Indexes, *Dow Data: 1930–1939*, at <http://www.djindexes.com/jsp/avgDecades.jsp?decade=1930> (last visited Feb. 28, 2003) [hereinafter *Dow Data: 1930–1939*], with Dow Jones Indexes, *Dow Data: 1920–1929*, at <http://www.djindexes.com/jsp/avgDecades.jsp?decade=1920> (last visited Feb. 28, 2003).

83. See *Dow Data: 1930–1939*, *supra* note 82.

84. See Dow Jones Indexes, *Dow Data: 1950–1959*, at <http://www.djindexes.com/jsp/avgDecades.jsp?decade=1950> (last visited Feb. 28, 2003).

85. J. Bradford De Long & Andrei Shleifer, *The Stock Market Bubble of 1929: Evidence from Closed-end Mutual Funds*, 51 J. ECON. HIST. 675, 677 (1991).

86. See George J. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (Henry G. Manne ed., 1969). See generally Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613 (1981); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

87. See Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 465–86 (2001).

88. See Jarrell, *supra* note 86, at 613–15.

market had higher-quality information after the Act,<sup>89</sup> such a conclusion seems inconsistent with the evidence on securities returns discussed immediately above.<sup>90</sup> The decrease in variance indicates that the Act decreased capital allocated to riskier ventures. This could be because the Act's liability provisions caused underwriters to shift to lower-risk offerings,<sup>91</sup> because conservative accounting standards caused higher-risk firms that rely more heavily on projections and appraisals to privately sell their stock,<sup>92</sup> or because the Act reduced the role of regional integrated retailers that had specialized in higher-risk offerings.<sup>93</sup> Moreover, even if the positive or negative effects of the securities laws were unclear, the laws impeded the evolution of state law and securities exchange disclosure standards that might have resulted in more efficient rules.<sup>94</sup>

In short, lawmakers rushing to regulate following the 1929 crash focused on the supposed defects of markets while failing realistically to assess the costs and benefits of regulation. Accordingly, they reduced the opportunities of precisely the sort of innovative firms that were needed to fuel the next boom. Although there were many reasons why it took a generation for the market to return to the levels of the 1920s, the securities laws are more likely to have delayed than to have advanced the recovery.

#### IV. THE SOUTH SEA BUBBLE

Two hundred years before the 1929 crash there was the South Sea Bubble, which offers lessons for modern regulation similar to those of the crash. The South Sea Bubble resulted most directly from the South Sea Company's scheme to refinance government debt from the Spanish War and pursue business opportunities in South America.<sup>95</sup> Like the booms discussed

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89. Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1374-80 (1999).

90. See Romano, *supra* note 87, at 477-84.

91. See Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 791 (1988).

92. See Romano, *supra* note 87, at 481.

93. See Mahoney, *Political Economy*, *supra* note 79, at 1-2.

94. See Romano, *supra* note 87, at 483-85 (discussing studies indicating defects in disclosure standards and in SEC review under the securities laws).

95. Several commentators have discussed the historical accounts of the bubble and its causes and consequences. See, e.g., BAGEHOT, *supra* note 7, at 127-29; BANNER, *POLITICAL ROOTS*, *supra* note 3, at 41-87; RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844*, at 60-81 (2000); see also LARRY NEAL, *THE RISE OF FINANCIAL CAPITALISM: INTERNATIONAL CAPITAL MARKETS IN THE AGE OF REASON*, 52-55, 91-111 (1990) (detailing the South Sea Company's financing

above, the Bubble happened in an atmosphere of increased availability of investment funds and financial innovations that had reduced friction in the capital markets. The economy was flush with cash following the Spanish War, which ended in 1713.<sup>96</sup> The government owed Spanish War debt at interest rates that were 2% to 4% higher than during peacetime.<sup>97</sup> In February 1720, the South Sea Company proposed to assume all national debt not held by the Bank of England or the East India Company.<sup>98</sup> Current debt-holders would get transferable shares in a joint stock company and longer terms in return for lower interest rates.<sup>99</sup>

Share prices soared because increased investment capital chased relatively few investment opportunities.<sup>100</sup> Entrepreneurs offered increasingly speculative schemes, such as “a company for carrying on an undertaking of great advantage, but nobody to know what it is.”<sup>101</sup> Charles Mackay notes that “[m]en were no longer satisfied with the slow but sure profits of cautious industry. The hope of boundless wealth for the morrow made them heedless and extravagant for to-day.”<sup>102</sup>

Reacting to concerns about excessive speculation, on June 11, 1720, Parliament passed what is now known as the Bubble Act,<sup>103</sup> “[a]n act for better securing certain powers and privileges intended to be granted by his Majesty by two charters for assurance of ships and merchandizes at sea, and for lending money upon bottomry; and for restraining several extravagant and unwarrantable practices therein mentioned.”<sup>104</sup> Among other things (including the regulation of marine insurance companies), the Act provided that:

[A]ll . . . publick undertakings . . . presuming to act as a corporate body . . . raising . . . transferable stock . . . transferring . . . shares in such stock . . . without legal authority, . . . and all acting . . . under any charter . . . for raising a capital stock . . . not intended . . . by such charter . . .

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that led to the Bubble's burst); Henry N. Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes*, 6 INT'L REV. L. & ECON. 169, 171–73 (1986). For an early history, see MACKAY, *supra* note 10, at 46–88.

96. NEAL, *supra* note 95, at 90–97.

97. HARRIS, *supra* note 95, at 62.

98. See NEAL, *supra* note 95, at 97.

99. See HARRIS, *supra* note 95, at 62–63.

100. See NEAL, *supra* note 95, at 90–97.

101. MACKAY, *supra* note 10, at 54–56 (emphasis omitted).

102. *Id.* at 71.

103. 6 Geo. 1, ch. 18 (1720).

104. *Id.*

and all acting . . . under any obsolete charter . . . for ever be deemed to be illegal and void . . . .<sup>105</sup>

The South Sea Bubble and Act were similar to the other regulatory cycles discussed above in that the regulation was a reaction to a speculative frenzy and populist antipathy to entrepreneurs. The main difference is that regulation did not result from the crash, but rather may have caused it by suddenly cutting off entry of the firms that had driven the speculation. Interest groups favoring the regulation included the South Sea Company's backers, who were concerned about competition for capital by the non-chartered joint stock, or "bubble," companies that imitated the South Sea Company's financial structure.<sup>106</sup>

As in previous cycles, these interest groups took advantage of background concerns about speculation and populist antipathy to the speculators and entrepreneurs who were getting rich off of the Bubble, to push their agenda. As Mackay says:

Nobody blamed the credulity and avarice of the people—the degrading lust of gain, which had swallowed up every nobler quality in the national character, or the infatuation which had made the multitude run their heads with such frantic eagerness into the net held out for them by scheming projectors. These things were never mentioned. The people were a simple, honest, hard-working people, ruined by a gang of robbers, who were to be hanged, drawn, and quartered without mercy.

This was the almost unanimous feeling of the country.<sup>107</sup>

One reformer said that the entrepreneurs should be "tied in like manner in sacks, and thrown into the Thames."<sup>108</sup> "Resolutions were passed to the effect that the calamity was mainly owing to the vile arts of stock-jobbers . . . ."<sup>109</sup>

As in 2002 and 1929, the Bubble Act was a panicked reaction to perceived market imperfections that may have had long-term costs. Although the effects of the Bubble Act are not clear, it arguably impeded the evolution and spread of the joint stock company structure for more than a century following its enactment.<sup>110</sup>

105. *Id.*

106. *See* Butler, *supra* note 95, at 172–73 (arguing that the key group was Parliament, which was concerned about the value of its chartering business); *see also* HARRIS, *supra* note 95, at 64–79 (stating that the key proponent of the Act was the South Sea Company itself, particularly regarding the exemption for subscriptions of the South Sea Company).

107. MACKAY, *supra* note 10, at 72.

108. *Id.* at 73 (quotation marks omitted).

109. *Id.*

110. *See* Butler, *supra* note 95, at 173–76. Professor Banner argues that the Act had

## IV. CONCLUSION

Securities regulation is often enacted following the market crashes that conclude speculative bubbles. These “bubble laws,” in other words, are the soapy film that remains when the bubble bursts. This atmosphere is not conducive to thoughtful policymaking. Indeed, this panic regulation is more likely to dampen entrepreneurial activity by taxing the most innovative firms than it is effectively to deter fraud.

What, then, should be done about over-hyping, inadequate disclosure, and flimsy capital structures that lead to bubbles and crashes? One answer is to protect property rights in information, thereby ensuring that market participants have adequate incentives to dig out and piece together the information that firms prefer to keep hidden. This may entail not more regulation, but *deregulation* of financial markets, including eliminating or reducing rules deterring insider trading, takeovers, and analyst research.<sup>111</sup>

Another alternative is investor education. Ordinary investors should be investing in balanced portfolios through index mutual funds rather than betting on individual stocks. If they must try to beat the market, they should rely on fund managers and other advisors rather than their own imperfect judgment and stale information. They certainly should not be actively trading, or worse yet day-trading, buying on margin, or voluntarily sinking all of their retirement funds into their employers' stock.<sup>112</sup> Perhaps the worst harm caused by crash-induced regulation is that it conveys precisely the opposite message—that lawmakers can somehow make the markets safe from fraud and protect investors from themselves.

In short, recognizing the tendency to over-regulate following crashes might lead to more careful and nuanced responses to market problems. Until then, such regulation has an analogy in the story about the ventriloquist who was recounting what happened when he made some wisecracks his audience did not like. Referring to his heavily bandaged arm he said: “If you think this is bad, you should see the dummy.”

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little effect because it punished what was already illegal and gave rise to very few prosecutions. BANNER, POLITICAL ROOTS, *supra* note 3, at 78–79. But the Act may have effectively deterred speculative enterprises that would have triggered prosecutions. *Id.* at 79.

111. See Ribstein, *supra* note 1, at 47–61.

112. See Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 883 (2000) (noting that government intervention “has led many investors to believe that [the Federal Reserve] can and would prevent a stock market crash”); Langevoort, *supra* note 12 (manuscript at 6–7); Lynn A. Stout, *Are Stock Markets Costly Casinos?: Disagreement, Market Failure and Securities Regulation*, 81 VA. L. REV. 611, 667–82 (1995) (discussing the social costs of stock market trading).