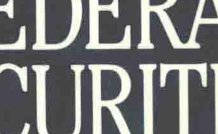
James Burk

VALUES IN THE MARKETPLACE

THE AMERICAN STOCK MARKET UNDER FEDERAL SECURITIES LAW



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STUDIES ON NORTH AMERICA

Vol. 2

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Values in the Marketplace

The American Stock Market Under Federal Securities Law

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Walter de Gruyter · Berlin · New York 1988

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Library of Congress Cataloging in Publication Data

Burk, James, 1948 –
Values in the marketplace.

(De Gruyter studies on North America ; 2)
Bibliography: p.
1. Stock-exchange – Law and legislation – United States.
2. Securities – United States. 3. Stock-exchange – United States.
I. Title. II. Series.
KF1070.B87 1988 346.731092 88-23759
ISBN 0 89925-487-X (U.S.) 347.30692

Deutsche Bibliothek Cataloging in Publication Data

Burk, James:
Values in the marketplace : the American stock market under fed. securities law / James Burk. – Berlin ; New York : de Gruyter, 1988
(De Gruyter studies on North America ; 2)
ISBN 3-11-011714-2
NE: GT

 – Typesetting: Arthur Collignon, Berlin. – Printing: Gerike GmbH, Berlin. – Binding: Dieter Mikolai, Berlin. – Cover Design: Hans-Bernd Lindemann, Berlin. – Printed in Germany.

Acknowledgements

Even small books, as this one, require material resources to complete. I am grateful to the National Science Foundation for awarding a doctoral dissertation grant in 1980 which enabled me to begin collecting data for the study reported on here. McGill University and Texas A&M University supplied additional funds permitting me to gather more data and to present preliminary reports of my findings at numerous conferences. I am grateful for their support as well. For material aid of another kind, but no less valued, I thank Jaime Vinas for his help in preparing the index and Connie Alexander, Lori Cheatham, and Melonie Hopkins, who typed, in a hurry and without complaint, the tables and appendices which appear at the end of the book.

Other kinds of support have been important for me as well. My children, Jacqualine and Theodore, grew to maturity listening patiently to their father's stories about the stock market – not the usual children's fare. Their good will (and that of their mother) has been a blessing on this work.

I am indebted also to those who read the manuscript in its several versions in whole or in part. Here I name only those who read the work in its entirety (some more than once) and who tried by various means to improve what I had to say: Benigno Aguirre, Connie Arnold, Patricia Burk, Ernest Q. Campbell, Ben Crouch, Carl-Ludwig Holtfrerich, Morris Janowitz, Edward O. Laumann, Donald N. McCloskey, Michael Schudson, Richard Sylla and Mayer Zald. To this list I must add my good colleagues at Texas A&M University whose strong support of my research has made writing this book a pleasant task.

I owe special debts to Edward Laumann, who first encouraged me to undertake this project, to Edward Shils, whose seminar on traditions led me to think seriously about various beliefs concerning stock prices, and to Morris Janowitz, who introduced me to the problems of social control and the methods of institutional analysis. I am indebted also to Bianka Ralle for her prompt, professional (and always helpful) work as editor.

Chapter Two, on "The Origins of Federal Securities Regulation," is a revised version of an article published earlier in *Social Forces* 63, 2 (June, 1985): 1010 – 1029. It appears here with their permission.

There is, finally, another, whose name I need not mention, but without whom this book would never have been completed: whatever good this book might do is done for him.

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Introduction

Chapter 1

Markets, Moral Order, and Regulation

Stock market averages are broadcast every day over the television and radio, and detailed information about stock trading activity is published in our daily press. This is not done only for the wealthy. Whether we own stock or not, we attend to the movement of stock prices, feeling good about ourselves and our society when stock prices rise – unless they rise too suddenly – and worrying about our well-being and the well-being of our society when stock prices fall – especially when they fall suddenly and far and over long periods of time. Why should we do so?

The stock market of course is an important economic institution which facilitates the raising of capital funds for business and permits the rapid transfer and dispersion of corporate ownership. But our fascination with its daily work is not narrowly economic. It is more profound than that. The stock market occupies a unique place in American culture. It stands as a symbol which in condensed form signifies our common life within a market-based, capitalist economic organization and within the moral culture which supports and sustains that organization.

We are in many respects positive in our attitude toward the market and what we think it represents. Its strength and capacity to generate wealth (so it seems) out of nothing is our strength as well. The material prosperity of our society we believe depends on the institutions of private ownership and aggressive trade in "free" markets, both of which are pillars of the stock market. And we elevate to the role of "hero" those who are able to master the uncertainties of trading to create huge fortunes for themselves.

Still we are not only positive toward the market. We are rather ambivalent about a style of life which appears at best to be amoral, in which individuals are guided (again, so it seems) only by the norms of acquisitiveness and are willing to utilize any means to increase their wealth even if it results in doing harm to others. And we castigate those who we think try unfairly to advance themselves by selling worthless securities, by spreading false rumors, by trading on "insider" information or by any other similar means. We quickly judge these acts to be morally reprehensible and condemn them in a way that we cannot so easily do to our entire way of life. Perhaps the occasional ferocity with which we attack "high finance" and "Wall Street" is, in part at least, a way of purging our uneasiness about the goodness of that way of life.

Sociologists know that markets are a source of moral controversy in modern society. Many of the longest traditions in the discipline and, to be inclusive, in all of social science have as one purpose to figure out what difference it makes to base so much of our social life on the mode of association which flourishes in markets. Not the least important questions which have been raised by these traditions ask: How might we resolve our ambivalence toward the market? What is the relation between markets and moral order? And if they are somehow opposed to one another, is there any way by regulation we might be able to enjoy the material benefits which markets bring without sacrificing a morally satisfying way of life?

These are the questions which animate this study of the stock market. They are too broadly put perhaps to expect a final answer to them here. Yet some progress with them might be made. The aim of this study is to trace the effects of federal securities regulation on the moral order of the stock market and on the market's subsequent institutional development. The argument shall be that our ambivalence toward the stock market cannot be resolved by regulation. Regulation may lead to a substantial modification of the market's moral order. As we shall see, beliefs about how one ought to trade stocks and who ought to be allowed to trade stocks underwent important changes as a consequence of federal securities law, and these changes altered substantially the organization of the market. But they did not, in the end, clearly strengthen the market's capacity for social control. This argument is not a call for deregulation. Effective market regulation is a necessary "guarantor of trust" that encourages us to face the contradictions and uncertainties of a market-based society.[1] Nevertheless, it is no sure technique to fix the operation of the market according to plan.

The place of the stock market in American society has been dynamic, changing and adapting to the growth and development of the larger societal order of which it is a part. It entered this century as a series of local, private markets which actively involved a relatively small number of individuals trading for their own account. But it was rapidly expanded through the first third of the century into a national mass market for the securities of industrial corporations. Shareownership became very widespread to include nearly ten

1 Susan P. Shapiro, *Wayward Capitalists* (New Haven: Yale University Press, 1984), pp. 190 – 192.

percent of the population by 1930 a proportion not very far from what it is today.[2]

Throughout most of this period the market was unregulated by any government and so it approximated the ideals, and displayed the difficulties, of a laissez-faire economic organization. During the thirties, the attitude of laissez-faire was replaced by a more proactive regulatory approach which made the stock market an object of federal securities control. In part because of federal regulation, over the middle third of the century individual investors were replaced in importance by the dramatic rise of institutional investors who entered the stock market for the first time. That transformation precipitated a crisis which nearly caused the market (in the form we know it) to collapse in the late 1960s, a crisis the causes of which are not yet entirely resolved. Since then, changes in the market have been shaped and are still being shaped by the pressures of an internationalizing economic organization. Of course, our economy and especially our capital markets have never been hermetically sealed within national boundaries. But, relatively speaking, they were more dominated by a domestic orientation before the 1970s than they can now afford to be. Adapting to this fact is the primary challenge for the stock market in the last third of this century.

This book focuses on the events of the second third of the century, of the period after laissez-faire and before internationalization, which extends, roughly, from the 1930s through the 1970s. It is a critical period sociologically. Its beginning was characterized by the emergence of a political outlook in which social progress and welfare were believed to derive rather more from rational planning and control than from the inevitable forces of progress "at work" in history.[3] Large-scale industrial and urban development, immigration, and the challenge to religious sensibilities posed by science were among the forces which forged this outlook. They defined what was modern and were recognized to be the basis of prosperous society. Yet they were also recognized as forces which were (at least potentially) powerfully corrosive of social stability. They made it difficult to form and to maintain a moral consensus able to regulate the exercise of private power and the pursuit of private

2 N. R. Danielian, "Ownership of Securities in the United States," *The Securities Markets*, ed. Alfred Bernheim and Margaret G. Schneider (New York: Twentieth Century Fund, 1935), pp. 35 – 62, 723 – 737. In 1985, the New York Stock Exchange estimated that 20.2 % of the population owned stock; but as recently as 1980 only 13.5 % of the population were supposed to do so. See Table B.1.

3 See Edward Purcell's *The Crisis of Democratic Theory* (Lexington, Ky.: University Press of Kentucky, 1973) and Michael S. Schudson, *Discovering the News* (New York: Basic Books, 1978), pp. 121 – 134.

interests. If nothing else, then the experience of world war and economic depression finally taught the poverty of that simple faith in laissez-faire which believed history would automatically work out for the best. To achieve human welfare, social control would have to be actively asserted, guided in democratic society by the reason of experts accountable to the people through the agencies of government. It was in this context that the initial attempt was made to reconstruct the normative order of the market by means of federal securities control.

In the fifty years since then, we have entered a new period of doubt, of self-doubt. The efficacy of human beings to control social organization through the reason of experts has been challenged in theory and experience. Students of complex organization over the last forty years have been busy pointing out that rationality is bounded and that organization is an emergent product of internal negotiations and compromises undertaken in confrontation with "environments" which are characteristically uncertain. In this conception, the efficiency of bureaucracy is no matter to take for granted.[4] And in practice, the burgeoning of governmental regulations in the period following the Second World War, especially since the late 1960s, did not lead to any obvious improvement either in economic development or in the quality of life. Government regulation, it began to be argued, more often hindered than helped to promote public welfare. As a consequence, there was through the 1970s and early 1980s a notable movement toward deregulation, beginning dramatically with the end of the draft in 1973 and extending from there more directly into the economic realms of finance, transportation, communication, and elsewhere.[5]

It is within this context that we shall examine the origins of federal securities regulation and trace its long-term effects for market organization. Doing so will involve us in, what Anthony Giddens has called, "the analysis of strategic conduct."[6] It is a mode of analysis informed by two assumptions. First, it takes seriously that market participants act purposively in the pursuit of their own interests, but that they do so on the basis of limited knowledge. Second, it assumes that the stock market is a complex institution the parts of which are imperfectly integrated. Limited integration, of course, implies limited consensus which hinders system-wide efforts at social control. In com-

4 Terry M. Moe, "The New Economics of Organization," *American Journal of Political Science*, 28 (1984), 739–777.

5 Robert B. Horwitz, "Understanding Deregulation," *Theory and Society*, 15 (1986), 139–174.

6 Anthony Giddens, *The Constitution of Society* (Berkeley and Los Angeles: University of California Press, 1986), pp. 288–293.

bination, these two assumptions lead us to consider the unintended consequences of the action of market participants for the stock market's institutional development. Adopting this analytical strategy will, I hope, shed light on the process by which we actually construct a moral order in markets. If so, it may be of some use to us as we think about the prospects for market regulation in the future. If that hope is to be realized, however, we have first to locate this general analytical strategy within the traditional theoretical debate about markets, moral order, and regulation.

Markets and Moral Order

Markets are social institutions characterized ideal-typically by what Michael Oakeshott calls a transactional mode of association.[7] In this mode of association, two or more actors are related solely by a desire to satisfy their own wants. The association, in principle, is not permanent but terminates when either actor obtains the satisfaction which was sought or concludes that the satisfaction desired cannot be obtained through continuing the relationship. It may involve cooperation, as actors join forces to construct a more efficient means for achieving their end, but this in no way alters the character of the relationship. It is intermittent association driven by each actor's pursuit of his or her own interests. Sociologists are familiar with Talcott Parsons's description of this kind of purposive social action as understood, in his terms, by utilitarian social theory. It is atomistic, with individuals calculating about means and ends, but with no necessarily common orientation to a collective purpose which organizes the whole "system of action."[8] His is an important image to keep in mind because it conveys precisely what Oakeshott and we think about markets in pure form: They are amoral institutions in which actors gather and exchange with one another (that is to say they exercise power over one another) in a solipsistic pursuit of their advantage.

Of course no market is like this. When we say that markets are social institutions, what we mean, in part, is that they, like all social institutions, are constituted by a moral order. The term "moral order" (or what in this study shall be an equivalent term, "normative order") refers to the conditions

7 Michael Oakeshott, "The Rule of Law," *On History and Other Essays* (Totowa, N. J.: Barnes & Noble, 1983), pp. 121 – 125.

8 Talcott Parsons, *The Structure of Social Action* (Glencoe, I11.: Free Press, 1968, orig. 1937), pp. 51 – 60.

of action which specify how people ought to behave. I include within this order both cultural elements (i. e., beliefs about what one ought to do and how one ought to do it) as well as social structures of authority organized to establish, maintain, or change institutional rules (or norms) to express and support these beliefs.[9] The moral order of a market, then, establishes rules about how one ought to trade, who is allowed to trade, what are acceptable terms of trade, etc. and it includes some kind of structural apparatus charged with the duty of enforcing market rules. That all markets are constituted by a moral order of this kind is no news to sociologists. It has been an important contention within the discipline since Emile Durkheim formulated his theory of the noncontractual bases of contract. But how this moral order is (or ought to be) established is a matter of serious contention within the social sciences and a serious policy question.

One argument we have to consider, perhaps the best known one, is the view I will call the neoclassical economic perspective. This perspective has its roots in the economic theory of Adam Smith and the private property theory of John Locke. Its essential claim is that markets create their own moral order, that moral order emerges naturally from transactions of exchange among market participants. If that is true, then markets truly are self-regulating, as this view also holds. But I wish to put this last claim on one side until we treat regulation per se. Now it is crucial to understand how markets are supposed to create their own moral order.

Two different arguments are offered. First, because people participate in markets to satisfy some want or desire, they will be attentive to the wants and desires of others; they will search for some way to supply another's wants in order to have their own desires met. The idea is simple, yet important. It is the motor driving the notion of "market discipline." Only to think of oneself in markets is, by this account, to risk that no one will wish to trade with you. While there may be short-term rewards to dishonest, avaricious, or other exploitative or entirely self-regarding behaviors, in time people will learn they can get a better deal by trading with someone else; the rewards to vice will necessarily dry up. Competitiveness, in short, is supposed to be a builder of "good" character. It may be genuinely "good" character or crafted

9 The term "moral order" is not very commonly used by sociologists today, though it is a perfectly good term. The term "normative order" is perhaps more common. I take my meaning for the term from Robert Cooley Angell who in his book on *Free Society and Moral Crisis* (Ann Arbor: University of Michigan Press, 1965), p. 16 refers in slogan form to moral order as "how oughtness is organized." See also Robert Wuthnow, *Meaning and Moral Order* (Berkeley and Los Angeles: University of California Press, 1987).

for display, as Erving Goffman would suspect, to advance one's self-interest. In either case, it is the apparent "good" character of market participants on which exchange depends and which establishes the market's moral order. Notice that the moral order which is created is a minimal one in this specific sense: It includes beliefs about how one ought to behave in markets (beliefs which are internalized). But it provides for no more elaborate enforcement machinery than is provided by the cumulative consequences of trading as measured (say) by profit.[10]

The second argument depends on a comparative analysis and runs, briefly, as follows. The market supplies a kind of social organization in which people can cooperate with one another to achieve desired goals, and so the market is better than the proverbial state of nature in which there is no cooperation among individuals. And the market is superior to alternative kinds of social organization, which usually rely on hierarchical or coercive controls, because it respects important civil and political rights and the liberties of individuals. As a result the social order which markets create are morally preferable to other social orders.[11]

Of the two arguments, it is the first which holds the greatest interest for us. While the second has a formidable intellectual machinery behind it, it addresses a different issue than we have before us. Its essential claim is that markets create a social order which is good and, therefore, that markets create a moral – i. e., a good social – order. We are not concerned, however, with all of society and the broad question how to create a good social order, important though that question is. Our concern is about the relative autonomy of particular market institutions within society to establish and maintain beliefs about how market participants ought to behave. It is to that concern which the first argument speaks, although not entirely persuasively.

10 The argument is based on the famous passage in Adam Smith's *The Wealth of Nations*, ed. Edwin Cannan (Chicago: University of Chicago Press, 1976), Bk. I, ch. II about the origin of the division of labor. A recent statement of it with the aim of making a moral defense of the market is made by Thomas Wilson, "Sympathy and Self-Interest," *The Market and the State*, ed. Thomas Wilson and Andrew S. Skinner (Oxford: Clarendon Press, 1976), pp. 73 – 99. A more general sociological variant of the argument can be found, I believe, in the emergent norm theory of Ralph Turner and Lewis Killian, *Collective Behavior*, 2nd ed. (Englewood Cliffs, N. J.: Prentice-Hall, 1972), pp. 21 – 25.

11 Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974) and F. A. Hayek, *Law, Legislation, and Liberty*, 3 vols. (Chicago: University of Chicago Press, 1973 – 1979). Criticisms of this argument are nicely summarized by Allen Buchanan, *Ethics, Efficiency, and the Market* (Totowa, N. J.: Rowman & Allanheld, 1985), pp. 64 – 81.

Even before discussing the alternative perspective, we can notice certain weaknesses in the neoclassicist position. It assumes that markets are relatively simple institutions in which the same norms of trading will be shared and observed by all market participants. Empirically, we know that is not true. Wayne Baker's network analysis of trading crowds in a modern options market supplies convincing evidence that these crowds are not all alike but are socially structured in ways that substantially affect with whom and how one trades (as measured by price behavior).[12] And it ignores, as Oliver Williamson has pointed out, that economic actors may not only seek their self-interest, but they may do so opportunistically, seeking it with "guile" and dissembling to realize "transactional advantages."[13] That such strategies might have long-term payoffs, as Williamson suggests they can, is an important departure from the idea that markets create their own moral order thought of as a positive good.

Opposed to the neoclassical perspective is the view I will call the structuralist perspective. This perspective has its roots in sociology, especially in the theory of Max Weber. Its essential claim is that markets do not and cannot create their own moral order; whatever moral order markets exhibit is derived from the moral order of the larger society in which the market is found. As Mark Granovetter has recently put it, institutions, even market institutions, "are so constrained by ongoing social relations that to construe them as independent is a grievous misunderstanding."[14] People organize politically and deploy group power to modify the operation of markets to obtain goals (e.g., through affirmative action or "buy American" programs) not obviously contemplated by any particular exchange relation. Their doing so helps to explain fundamental differences in the workings of various national economies.[15] The influence of government to shape the moral order of markets is more extensive, in other words, than suggested by the more or less neutral role it plays upholding contracts and punishing the use of force and fraud in markets.[16] It is the critical authority charged with the duty of establishing and maintaining the moral rules which market participants must follow.

12 Wayne E. Baker, "The Social Structure of a National Securities Market," *American Journal of Sociology*, 89 (January, 1984), 775 – 811.

13 Oliver Williamson, *Markets and Hierarchies* (New York: Free Press, 1975), p. 255.

14 Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology*, 91 (November, 1985) 482.

15 John Zysman, *Governments, Markets, and Growth* (Ithaca, N.Y.: Cornell University Press, 1983).

16 Amitai Etzioni, "Encapsulated Competition," *Journal of Post-Keynesian Economics*, 7 (Spring, 1985), 296 – 300.