Evolution of Financial Services Regulation in the United States
1790 to Present

By Duane Thompson, AIFA®

Wealth managers may be surprised to learn that one of the first emerging markets in the world was a fledgling new country called the United States. At the time of its founding in 1789, the new nation's growth prospects, and even its survival, were uncertain. The 13 states of the new republic were dominated by an agrarian economy with little in the way of pooled capital and overseen by a radical new form of representative government. Nonetheless, trading in stocks and bonds was a nascent industry in two eastern-seaboard cities, Philadelphia and New York.

Philadelphia is the birthplace of the first formal U.S. stock exchange, founded in 1790 (Terrell 2010). In 1792, two dozen stockbrokers gathered beneath a buttonwood tree at 68 Wall Street in New York City and agreed to establish rules for trading stocks and bonds. This became known as the Buttonwood Agreement, and it launched the New York Stock Exchange (NYSE Euronext 2012).

The history of financial services regulation is a fascinating tale punctuated by sporadic legislative initiatives that were, in turn, stoked by financial panics, along with the rapid 19th-century transformation from an agrarian to industrial economy, and finally, by late 20th-century debates about functional regulation. These conditions have shaped the system governing today’s U.S. financial intermediaries, which, imperfect as it may seem, serves as a regulatory model for the rest of the world.

Common Law Fiduciary Duties

One could make a case that the initial framework of financial regulation was imported to the American colonies via English common law, which underlies the fiduciary duties of trustees. After George Washington in 1759 married Martha Custis, one of the wealthiest widows in the colonies, he was appointed as the legal guardian for her two children. This became a “weighty and time-consuming task that required Washington to satisfy the court with annual reports on his fiduciary actions” (Chernow 2010, 100).

Indeed, fiduciary conduct for financial intermediaries entrusted with the property of others was the hallmark of early standards of conduct in the United States. It remains so today. The traditional duty of loyalty that guided Washington’s fiduciary activities was enhanced by the 1830 ruling in Harvard College v. Amory (26 Mass. 446) that established a common law duty of care and eventually the prudent man rule (Bines and Thel 1978, xxix). This groundbreaking standard for prudent investment would eventually form an underpinning for embracing, albeit along a bumpy road through the courts, modern portfolio theory as postulated in Harry Markowitz’s seminal 1952 article on portfolio selection (Bines and Thel 1978, xxviii).†

Much later, these investment principles would be reflected in the drafting of the Employee Retirement Income Security Act of 1974 (ERISA) and state trust statutes, which incorporate a general duty to reduce risk through portfolio diversification. Trustees under previous case law were required to carefully guard the paper value of principal at all costs (Bines and Thel 1978, xxviii).

Bank Charter Disputes, and a Civil War, Shape Banking Regulation

Federal regulation dominates the financial services industry (minus the insurance sector), but banking regulation is fragmented under the “dual banking system” (Office of the Comptroller of the Currency [OCC] 2003, 1). Banking regulation in the republic’s early years was marked by political controversy. It was not so much the regulation of banks that was the subject of contention, as it is today, but rather government involvement in the granting of bank charters.

Early 19th-century economic growth in the country was punctuated by a series of financial panics, which occurred with almost surprising regularity roughly every 20 years. Until the early 20th century, however, Congress and the states did not react by imposing comprehensive regulation over the banking system. Instead, the granting of bank charters was the primary focus of political debate by Congress and state legislatures.

The two national banks of the United States, essentially operating as quasi-private central banks with multiple branch office locations, were issued charters in 1791 and 1816, each for 20 years, and the Treasury Department was granted authority to make inspections (OCC 2003, 4). State legislatures also granted a limited number of local banking franchises, often...
resulting in political favoritism and corruption (Bodenhorn 2004, 1). The “Free Banking Era” of 1838–1862 permitted bank start-ups without legislative approval, although substantial numbers of banks failed during the next 15 years (Bodenhorn 2004, 26).

The 19th-century transition from an agrarian to an industrial economy was marked by financial crises in 1819, 1837, 1857, 1873, 1893, and 1907, each sending shock waves through the economy. Economists continue to debate the origins of these panics, but they often began with classic economic cycles that peaked with heated speculation in land or railroad stocks and crashed with bank failures and the tightening of credit. At the onset of the Civil War, however, the Lincoln administration’s more pressing problem was financing an immense war effort. The solution was for Congress to adopt a uniform currency in 1863 and establish the first national banking regulator, the Office of the Comptroller of the Currency (OCC 2003, 6–7).

After the Civil War, another series of financial shocks culminated in the Panic of 1907, in which J. P. Morgan famously locked a number of bankers in a room until they determined which banks would receive financial support (Frydman et al. undated, 14). A congressional investigation of the causes of the crisis ultimately led to establishment of the Federal Reserve in 1913.

Over the years the OCC developed fiduciary powers to grant banks, upon application, the authority to provide trust services, including asset management and investment advice (OCC 2002). Banks remain exempt today from registration requirements under the Investment Advisers Act of 1940, though credit unions do not.

Development of Insurance, Accounting, and Securities Regulation

A decade before the OCC was established by Congress, other financial regulation began taking shape, beginning with the insurance industry and the appointment in 1851 of the first state insurance regulator (New Hampshire Insurance Department 2012). In 1869 the U.S. Supreme Court confirmed state primacy in insurance regulation in Paull v. Virginia (75 U.S. 168), in which the court determined that the issuance of an insurance policy was not interstate commerce. By the 1870s, insurance companies were widely regulated by the states, leading to the creation of the National Association of Insurance Commissioners (NAIC) in 1871 (National Association of Insurance Commissioners 2012). Though the court eventually reversed its position on federal regulation in United States v. South-Eastern Underwriters Association (322 U.S. 533, 1944), the insurance industry remains largely state-regulated by rules that protect policy holders by assuring the solvency of insurance companies.

Accounting also played a major role in financial services regulation. With the advent of railroads and other large companies in the late 19th century, the complexities of bookkeeping became more demanding. The forerunner of today’s Association of Independent Certified Public Accountants (AICPA) was founded in 1887; it pressed for legal restrictions in the use of the CPA title, leading to the first regulation of accountants in 1896 (Association of Independent Certified Public Accountants 2012). In 1896 New York became the first state to enact an accountancy statute, and by 1911 nearly half the states had passed accountancy laws (Barfitt 2007, 38–40). Passage of the 16th Amendment to the Constitution, authorizing a federal income tax, spurred further growth of the profession. Finally, during the Great Depression the Securities and Exchange Commission (SEC) relied in part on auditing standards developed by the AICPA for financial statements of publicly traded companies.

States got into the act of regulating the offer and sale of securities in 1911 when the Kansas legislature passed the first “Blue Sky Law,” which took its name from the speculative schemes that a judge of the era said were worth no more than so many feet of blue sky (North American Securities Administrators Association 2012). The North American Securities Administrators Association, a counterpart to the NAIC, was organized in 1919. By the time Congress began to enact federal securities laws in the 1930s, state regulation was firmly entrenched, leading to a dual system of regulation.

The Great Depression and Emergence of Modern Financial Services Regulation

The stock market crash of 1929 resulted in a severe, worldwide depression lasting more than a decade and led Congress to enact a series of financial services laws that remain largely intact. The Dow Jones Industrial Average, between its peak in 1929 and its low in 1932, 1933, and 1938, peaked with heated speculation in land and railroad stocks and crashed with bank failures and the tightening of credit. At the onset of the Civil War, however, the Lincoln administration’s more pressing problem was financing an immense war effort. The solution was for Congress to adopt a uniform currency in 1863 and establish the first national banking regulator, the Office of the Comptroller of the Currency (OCC 2003, 6–7).

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point in 1932, dropped more than 80 percent (Fink 2008, 16). This stock-market free-fall, along with high unemployment and widespread bank failure, propelled Congress to act decisively.

The Banking Act of 1933, also known as the Glass-Steagall Act, created the Federal Deposit Insurance Corporation (FDIC) but also prohibited cross-ownership of investment banks. The FDIC is perhaps best known for insuring the safety of bank deposits in member banks. However, it also oversees state-chartered bank trust departments, setting guidelines that rely in part on common law fiduciary duties and state trust law (Bines and Thel 1978, 71).

In 1934 Congress passed the Federal Credit Union Act, allowing for the establishment of nonprofit, cooperative credit unions. Like banks, credit unions are regulated on the federal and state level, and like the FDIC, also provide insurance for individual deposits up to $250,000 (National Credit Union Administration (NCUA) 2012).

The seminal laws regulating securities markets on the federal level were enacted by Congress between 1933 and 1940. The Securities and Exchange Act of 1934 created the SEC and set into motion regulation of securities transactions on the secondary market. In 1938, that law was amended to permit self-regulation of the brokerage industry. This led to the creation of several self-regulatory organizations (SROs), including the National Association of Securities Dealers (NASD). In 2007 the NASD merged with the New York Stock Exchange, another SRO, to become the Financial Industry Regulatory Authority (FINRA).

Regulation of Investment Advisors
In the mid-1930s Congress began investigating abuses widely reported in the press concerning the offer and sale of shares in mutual funds; as well as reported fraudulent activities of “investment tipsters.” The resulting report led to the final two major securities laws passed in the Great Depression, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. At the time, mutual funds and the investment advisory profession were relatively new; the first mutual funds were organized in 1924 (Fink 2008, 10–11) and the investment counselor industry emerged shortly after World War I (SEC 1939, 3).

According to congressional testimony by SEC staff in 1940, the elusive investment tipsters, ironically, were nowhere to be found. However, the staff report identified 394 investment counselors, the predecessors of today’s wealth managers, who were engaged in the legitimate business of advising clients on money matters. “The function of these counselors, also interchangeably referred to as investment advisors, was “to render to clients, on a personal basis, competent, unbiased, and continuous advice regarding the sound management of their investments” (SEC 1939, 23).

Two decades later, in the landmark 1963 U.S. Supreme Court decision SEC v. Capital Gains Research Bureau (375 U.S., 180) the court clarified that advisors so registered were required to act in a fiduciary capacity, with an affirmative duty of “utmost good faith and full and fair disclosure of material facts” (184–185).

In response to the rapid growth of financial planners and independent investment advisors during the 1980s and 1990s that strained SEC resources, Congress in 1996 divided oversight between the SEC and the states based on the amount of assets under management. Until then, state regulation varied considerably, without uniform client de minimis exemptions, net capital requirements, or waivers from investment advisor exams. These changes were included in the final law.

Late 20th-Century Convergence of Financial Services
The history of the regulation of investment advice across the financial services industry remains largely unwritten. Just as economists continue to debate the origins of the Great Depression, the question of how advice-givers should be regulated—under more opaque sales regulation or a fiduciary standard—will be debated for many years to come.

Various factors can be identified as contributing to the convergence of
financial advisory services, beginning with deregulation of fixed brokerage commissions in 1975. This led to the creation of discount broker–dealers and a commensurate increase in fee-based income for independent advisors and dually registered broker–dealers. New Internet trading technologies in the late ‘90s placed additional pressure on commission income in the brokerage houses. Finally, repeal of Glass-Steagall in 1999, which permitted cross-ownership of banks, brokerage, and insurance companies, allowed cross-selling of a variety of services under one roof.

Other developments include the imposition of insurance counselor laws in more than 30 states where fees are charged for advice, though no clear basis for these laws has been identified, nor were these laws intended to regulate financial planners (Wilkerson 2008, 52–54). Moreover, hybrid investment products or services have resulted in shared jurisdictions, such as regulation of variable annuity products by state insurance departments and the SEC, and investment advice to 401(k) plan participants regulated by the U.S. Department of Labor and the SEC. While the growth of broad-based wealth management services has accelerated in recent years, the regulatory framework remains largely unchanged since the Great Depression. As a result, financial intermediaries providing comprehensive advisory services usually are subject to multiple licensing requirements as agents of a broker–dealer, investment advisor, bank, or insurance company. Reform efforts to level the playing field in terms of applying fiduciary or suitability standards to intermediaries, or narrow exemptions from registration, have led to industry groups fighting vigorously to maintain or change the status quo. (See article on the fiduciary debate in this issue, “The Shape of Things to Come under a Uniform Fiduciary Standard for Brokers and Advisors,” pages 14–18.)

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, designed after the 2008 crisis to address systemic risk in the financial system, also served as a catalyst for changes in regulation of wealth managers, including application of a fiduciary standard to broker–dealers, as well as the potential creation of an SRO for investment advisors. These issues had festered for many years but rarely were brought to the attention of Congress.

Although the progress of current rulemakings under Dodd-Frank reform is reported almost daily in the trade and national media, the changes are but a shadow of the original framework created by Congress during the Great Depression. In the 1930s, Congress passed seven major statutes, which also resulted in three major agencies created to regulate financial services—the SEC, the FDIC, and the NCUA—as well as the NASD. Recall that these actions followed an 80-percent drop in the stock market, an unemployment rate of 25 percent, and failure of nearly one-half of all banks.

After the financial crisis of 2008, from which the country still is recovering, Congress had no need to create new financial regulators from scratch, nor was there the same political pressure to make drastic changes. In the Great Recession, the market dropped about 50 percent, unemployment reached 9 percent, and only a tiny percentage of banks failed. One new agency was created, the Consumer Financial Protection Bureau, and one was dismantled, the Office of Thrift Supervision. Instead, new requirements under Dodd-Frank expanded the authority of existing agencies to close regulatory gaps and established cooperative oversight to identify systemic risk.

While financial reform is ongoing and the scope of regulation continues to be widely debated, the next chapter will take many years to complete.

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Endnotes
1 See, e.g., King v. Talbot, 40 N.Y. 76 (1869) and In re Dickinson, 152 Mass. 184, 24 N.E. 99 (1890).
3 The term “mutual funds” is used here to reference investment trusts, and open- and closed-end mutual funds.
5 The seven were the Securities Act of 1933, the Banking Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

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