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The Emergence of the London Stock Exchange as a Self-Policing Club

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Abstract
In the early stock market in London there were substantial risks of non-payment and fraud. (Mortimer, 1801) According to Hobbesian theory, we would expect stock markets to develop only after government has implemented rules and regulations to eliminate these problems. The historical account, however, provides evidence that solutions to these problems did not come from the state. This article outlines the emergence of the London Stock Exchange, which was created by eighteenth century brokers who transformed coffeehouses into private clubs that created and enforced rules. Rather than relying on public regulation to enforce contracts and reduce fraud, brokers consciously found a way to solve their dilemmas by forming a self-policing club.

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I. Introduction

It is commonly held that government is needed to enforce contracts in financial markets. According to Hobbesian theory, without external enforcement, the incentives to cheat would prevail and welfare-enhancing trades would not take place (Glaeser et al., 2001; Buchanan, 1975; Tullock 1972, 1974).

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While it is certainly true that rules can improve contractual performance, a major option that is often ignored is the possibility of privately-generated rules. Upon examining the historical record we can see that, by and large, rules governing financial trading developed independently from the state. The focus of this paper is the evolution of the London Stock Exchange (Silber, 1981; Carlton, 1984; Fischel and Grossman, 1984; Macey and Kanda, 1990; Chambers and Carter, 1990; Mahoney, 1997; Banner, 1998; Macey and O'Hara, 1999).[1] Rather than having public origins, the London Stock Exchange emerged when eighteenth-century brokers transformed coffeehouses into private clubs to form a system of self-regulation.

Beyond merely providing buyers and sellers a location to meet, one of the most important functions of a stock exchange is fostering an orderly atmosphere where traders follow a common set of rules. Exchange members must constantly seek ways to attract business and one way to improve business is by providing assurances against fraud (Banner, 1998, p.132). By cooperating and forming a club for the joint provision and consumption of rule enforcement, stockbrokers enhance the value of their enterprise (Buchanan, 1965). This stands against the idea that stock exchanges would fail to organize properly without direction from the state (Frye, 2000).

There are many advantages of market regulation over government regulation. First and foremost, when the private sector has the ability to experiment, brokers can try different regulations to see which ones are most successful. It is choice that allows groups of freely associating individuals to discover new ways of governing their conduct. As Hayek wrote, "the value of freedom consists mainly in the opportunity it provides for the growth of the undesigned, and the beneficial functioning of a free society rests largely on the existence of such freely grown institutions" (Hayek, 1978, p.61). If private

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[1] For book-length histories of the London Stock Exchange see Wincott (1946), Morgan and Thomas (1969), Jenkins (1973), and Michie (1999).

clubs, such as stock exchanges, have the choice to pick their self-regulations they can attempt to discover what ones are beneficial. This contrasts with the position that rules need to imposed from the top down from the state. Hayek explained it well:

> There is an advantage in obedience to such rules not being coerced, not only because coercion as such is bad, but because it is, in fact, often desirable that rules should be observed only in most instances… It is this flexibility of voluntary rules which in the field of morals makes gradual evolution and spontaneous growth possible, which allows further experience to lead to modifications and improvements. Such an evolution is only possible with rules which are neither coercive or deliberately imposed—… Unlike any deliberately imposed coercive rules, which can be changed only discontinuously and for all at the same time, rules of this kind allow for gradual and experimental change. The existence of individuals and groups simultaneously observing partially different rules provide the opportunity for selection of the more effective ones (Hayek, 1978, p.62–63).

If brokers have the ability to choose they can continuously adopt new ways of self-policing.[2] While it may be the case the regulation of a stock market is necessary there is no reason to conclude that it must be done by the state.

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[2] This is not to say at every given instant people will break their bargains, insisting that the old rules no longer apply; they will, however, have to capability of adopting new arrangements and procedures for future contracts (Benson 1990, 1993; Stringham, 1999).

The Emergence of Stock Exchanges

Stock exchanges were not suddenly invented. No governor declared the establishment of the London Stock Exchange; rather it evolved over time (Smith, 1929, p.206; Wincott, 1946, p.1). Joint stock companies had first come into being in the sixteenth century and it was not for some time before there were enough tradable stocks to warrant the specialized occupation of stockbrokers (Kindleberger, 1984, p.196).[3] At first ownership of stocks was not widespread, and sales were conducted on a small scale directly between buyers and sellers, with trades typically consisting of one owner divesting his shares to another owner or someone else on the restricted list of eligible buyers (Jenkins, 1973). Liberalization of the banking sector at the end of the seventeenth century increased the ability for companies to borrow funds, which led to an increase in the quantity of joint stock companies from fifteen to a hundred and fifty in a matter of six years (Jenkins, 1973). The earliest evidence of stockbrokers in England appears in the late seventeenth century, and in 1692 the trade was important enough for the weekly periodical *Collection for Improvement of Husbandry and Trade* to begin publishing stock prices for eight companies (Houghton, 1727; Neal, 1987, p.99).

Initially brokers dealt in stocks as a side business, but eventually people began specializing in stockbrokerage (Jenkins, 1973).[4] They traded at the Royal Exchange, which housed other merchants such as grocers, druggists, and clothiers (Wincott, 1947, p.7). As the number of stockbrokers grew it became evident they were not entirely welcome at the Royal Exchange, and in 1696 the government passed an act

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[3] The Amsterdam Bourse of the seventeenth century is considered the first stock market (Allen and Gale, 1994, p.13). This paper focuses on the growth of stock trading in London, which eventually became the more developed market.

[4] Jenkins points out, "they were by no means necessarily stock-brokers. They could deal in anything they liked—stockes, gold, haberdashy, fish, bread, carpentry, spectacles, even bows and arrows" (1973, p.19–20).

"To Restrain the Number and the Practice of Brokers and Stockjobbers."[5] This act was to regulate and license brokers but they were able to avoid it merely by leaving the Royal Exchange and setting up business elsewhere in the city (Reed, 1975, p.5; Morgan and Thomas, 1969, p22–24). With the exception of dealings in foreign issues, most brokers left the Royal Exchange in 1698.[6]

The Use of Coffeehouses

Since there was no area designated as a stock exchange, trading took place in informal quarters, largely in the various coffeehouses between Cornhill and Lombard streets (Jenkins 1973; Wincott, 1946). Eighteenth century writer Thomas Mortimer wrote the "usual rendezvous of Stock-jobbers" was "Jonathan's Coffee-house, in Exchange-Alley" (Mortimer, 1801). The coffeehouses accommodated various brokers, some of whom even had offices there (Jenkins, 1973, p.40). One broker put out the following advertisement in 1695 in *Collection for Improvement of Husbandry and Trade*, "John Castaing at Jonathan's Coffee House on Exchange, buys and sells all Blank an Benefit Tickets; and all other Stocks and Shares" (reprinted in Mirowski, 1981, p.564). Brokers would go to the same coffeehouses every day to conduct their business.[7] One who

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[5] Lest it be thought that the atmosphere was completely laissez faire, there were quite a few restrictions on the market (Banner, 1998), but from a modern economics viewpoint we can tell that most of them were not advancing the market.

[6] Some trading took place on the streets and alleys, but as of 1700, London city officials did not allow such congregating in an effort to keep the streets clear (Morgan and Thomas, 1969; Wincott, 1947).

[7] The English coffeehouses were different from most modern American coffee shops, serving bottled beer, wines, spirits, sandwiches, biscuits, and cheese in addition to coffee (Jenkins, 1973, p.41; Morgan and Thomas, 1969, p.67). Various coffeehouses provided their customers with a meeting place that appealed to different types of people: writers and critics went to Will's, philosophers went to the Grecian, White's Chocolate House

had been successful in his dealings was described by his peers as "the leader and oracle of Jonathan's Coffee House" (Morgan and Thomas, 1969, p.46).

Since this was what might be considered a more complicated market, and it was common to make bargains that were settled quarterly, there were many things that could go wrong (Mortimer, 1801; Dickson, 1967). One problem was deliberate fraud. John Houghton wrote in his periodical in 1692, "Without a doubt, if those trades were better known, 'twoud be a great advantage to the kingdom; only I must caution beginners to be very wary, for there are many cunning artists among them" (Houghton, 1727, p.5). Another problem was unintentional default. Since many weeks could pass before trade came to completion, brokers ran the risk of if their trading counterparts not being able to pay on settlement day. Mortimer stated, "problems arise if the person making the trade does not have the ability (cash) to settle, for in many cases a broker and his customer had no money" (Mortimer, 1801, p.53–54).

The first response to this problem is we see defaulters being shunned and banned from the Jonathan's. If a broker did not follow through with his bargains, he was labeled a lame duck. In 1761 Thomas Mortimer's described a lame duck as "A name given in 'Change Alley to those who refuse to fulfil their engagements…There are some at almost every rescounter. The punishment for nonpayment is banishment from Jonathan's but they can still act as brokers at the offices" (reprinted in Morgan and Thomas, 1969, p.61). They did not physically punish bad brokers but merely turned them away from the coffeehouse; being expelled from meant a significant loss of business for a broker (Jenkins, 1973).

Despite being banished defaulters would later come back to the coffeehouses, which would pose a problem for those who were unaware they were dealing with someone with a bad track record. As a solution they decided to write the names of

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attracted gamblers, and Lloyd's Coffee House, which later became Lloyd's of London, specialized in shipping and marine insurance (Jenkins, 1973, p.41; Raynes, 1948, p.110).

defaulters on a blackboard as a warning to others not to deal with them (Morgan and Thomas, 1969) This form of boycott acted as form of non-coercive enforcement against those who were unreliable (Caplan and Stringham, 2001).[8]

Forming an Exclusive Club

While shunning functioned to a degree, eventually some brokers decided that coffeehouses open to the public left more to be desired. Brokers felt the need to become more exclusive to avoid having to deal with, in the words of one historian, "riff-raff" (Jenkins, 1973). During this time period different groups experimented with different settings to trade stocks or other securities. In 1765 the Bank of England built a Rotunda where trading took place, but this did not prove to be successful. An 1824 book described the trading there as of a "less respectable description" (reprinted in Mitchie, 1999, p.44) Brokers were noisy and were generally considered with disrepute. These settings were too chaotic to conduct business, so a better solution was needed (Jenkins, 1973; Morgan and Thomas, 1969).[9]

It is not surprising that hoards of traders, including dishonest ones, would attempt to conduct business in the same few places. With the potential gains high, cheaters could theoretically dissipate the rest of the traders' profits. Eventually one group of brokers devised a strategy to eliminate some of the disarray. In 1761 Thomas Mortimer wrote, "The gentlemen at this very period of time…have taken it into their heads that some of the fraternity are not so good as themselves…and have entered into an association to exclude them from J-----'s coffee-house" (reprinted in Smith, 1929, p.215). In 1762 one hundred and fifty brokers formed a club and contracted with Jonathan's

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8 Caplan and Stringham (2001) discusses boycotts as an enforcement mechanism.

9 We can imagine if such an arrangement was successful, trading might take place in establishments such as the London Stock Rotunda and the New York Stock Rotunda.

Coffeehouse to use it exclusively. Each member would pay eight pounds per year to rent out the Coffeehouse (Morgan and Thomas, 1969). By transforming Jonathan's into a private club they would be able to exclude nonmembers and expel those who were unruly. Historians refer to the founders of the club as the 'more substantial' (Morgan and Thomas, 1969, p.68) and the 'better sort' (Jenkins, 1973, p.45) of brokers. If only reputable brokers were allowed in the club, there would be a lot less potential for bad dealings.

Unfortunately for the new venture an ejected broker brought suit against the newly formed club, and the government interfered with their plans by declaring that Jonathan's Coffeehouse did not have the right to exclude outsiders (Morgan and Thomas, 1969; Jenkins, 1973). This put a damper on using coffeehouses as a private exchanges, so as an alternative strategy in 1773 brokers organized to purchase a building for their own use. This new building was known as New Jonathan's and was open to anyone so long as they paid the daily admission fee, which covered expenses such as rent (Wincott, 1946). In 1773 the *Gentlemen's Magazine* reported, "New Jonathan's came to the resolution that instead of its being called New Jonathan's, it should be called The Stock Exchange, which is to be wrote over the door" (reprinted in Jenkins, 1973, p.45). Although it was known as the Stock Exchange, it must be noted that it is different from modern notions of a Stock Exchange. In 1801 Thomas Mortimer stated, "Brokers assemble at a very large coffeehouse, called the Stock-Exchange" (Mortimer, 1801, p.150). This coffeehouse/stock exchange had no formal membership and was run by two committees, one representing the coffeehouse owners and another representing the customers (Morgan and Thomas, 1969; Jenkins, 1973).

Still there was no formal membership, and anyone could enter upon paying the daily entrance fee. The fee might have been enough to keep out some vagrants, but after a few years it became evident that it did not suffice. The price of admission was low enough that untrustworthy brokers were still present, causing problems for both investors and brokers (Wincott, 1946). Brokers wanted to have an even more exclusive club, and in 1801 they decided to require that entrants be subscribed members (Morgan and Thomas, 1969). They posted the following:

> The Proprietors of the Stock Exchange, at the solicitation of a very considerable number of the Gentlemen frequenting it, and with the unanimous concurrence of the Committee appointed for General Purposes, who were requested to assist them in forming such regulations as may be deemed necessary, have resolved unanimously, that after 27 February next this House shall finally be shut as a Stock Exchange, and opened as a Subscription Room on Tuesday 3 March at ten guineas per Annum ending 1 March in each succeeding year. All person desirous of becoming subscribers are requested to signify the same in writing to E. Whitfor, Secretary to the joint committees on or before 31 inst. In order to their being balloted for by the said committees (reprinted in Mitchie, 1999, p.35).

Brokers were required to follow a set of rules in order to be a member of the Subscription Room. They stated in 1801 that it "being desirous that the Stock Subscription Room should acquire and preserve the most respectable character and considering that for such purpose it is indisputably necessary to prevent the practice of every disorderly action" they would levy fines on rule breakers "to be paid to the Secretary of the Committee for general Purposes and by them applied to charitable uses" (reprinted in Morgan and Thomas, 1969, p.69).[10] This new enforcement mechanism would inhibit misconduct by keeping club members under control.

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[10] It is interesting to note that the fines were donated to charity rather than used a means of enriching those levying the fines. For an

As with all new ventures there were some wrinkles in this new Stock Subscription Room, and it would take some reorganization before problems were ironed it. Many of the frequenters did not want to see the changes and were generally uncooperative. One member was fined but refused to pay, contending that he should not have to go along with the new rules (Morgan and Thomas, 1969).[11] In the following months the Stock Subscription Room disintegrated, leaving those who desired a stricter more exclusive club with no choice but to go off and start a new exchange. With much preparations and an offer to old exchange brokers to become members, they raised funds by issuing four hundred shares at £50 each, of which each person could own up to four shares, and constructed the new building over the next year (Morgan and Thomas, 1969; Reed, 1975).

Challenges and Competition

The new Stock Exchange at Capel Court could now enact rules that had been unanimously agreed upon by it members, but not surprisingly the excluded brokers were unhappy with their position.[12] In 1810 some petitioned the government to undermine the Stock Exchange by forcing it open to the public. The proposed bill stated:

> There is at this time no open Public Market for the sale and purchase of the Public Stocks, Funds, Government and other securities; and that they place wherein the chief part of this business hath been hitherto and is now transacted, is a private room from which the

account of the rise of criminal law as a means of enriching the government, see Benson (1990, 1994).

11 Interestingly one David Ricardo was a member at this time, but he eventually resigned (Jenkins, 1973 p.51).

12 Around this time the Bank of England considered building a new public exchange – it decided against it (Morgan and Thomas, 1969).

> public is excluded; and it would be of great convenience and advantage to His Majesty's subjects if a public open market were established in a suitable situation for the purchase and sale of the said Stocks, Funds and Securities (reprinted in Morgan and Thomas, 1969, p.72).

If the government interfered with this private arrangement, the untrustworthy brokers could have achieved forced access into the new location.

Fortunately for the Exchange the government did not demand public access as it had in the case with Jonathan's Coffeehouse. A member declared that the 1810 bill was "under the specious pretext of creating an open Stock Market within the City of London," but that it truly was, "to shelter convicted defaulters and afford new facilities to the criminal designs of notorious and unprincipled gamblers." With its establishment the Stock Exchange would be "open to honourable men and closed shut for ever to notorious cheats" (reprinted in Morgan and Thomas, 1969, p.72). The London Stock Exchange was now able to enact and enforce rules internal to its members; anyone who was not a member was barred from the premises (Johnstone, 1814).

The fact that membership is costly and exchanges can expel brokers has led some to call this exclusivity an example of cartel behavior (Demsetx, 1969; Welles, 1975). Could it be that such cooperation between brokers was simply a form of collusion (Cowen, 1992; Cowen and Sutter, 1999)?[13] While the ability to enforce rules does allow brokers to punish non-cooperators, it does not enable them to enforce any rule they wish. As Mahoney points out:

> An exchange's attempts to charge a monopoly price for its members' services will harm only

[13] Cowen and Sutter (1999) claim that cooperation between competitors is a recipe for collusion.

> the members if the exchange faces sufficient competition from other markets. Other exchanges will capture trading volume by offering lower transaction costs and investors will be no worse off by virtue of a foolish attempt to charge a monopoly price in a competitive market. If stock markets face sufficient competition, then, restrictive rules will survive only to the extent they are efficient (Mahoney, 1997, p.1447).[14]

Rules that enhance the value of the product, such as assurances against fraud, will be self-enforcing, and as long as there are no legal barriers to entry, rules that are collusive will break down (Telser 1980; Caplan and Stringham, 2001).[15] If Exchange rules were simply collusive, customers would gladly seek brokers who did not follow the rules and charged less for the same service. This competition would make the cartel dissolve. On the other hand, if the rules were actually providing assurances against fraud, there would be little incentive for customers to actively seek out brokers who did not abide by Exchange rules.[16]

At the time, the London Stock Exchange members faced competition from a number of sources, making the market quite contestable. Those who wished to operate outside of the

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[14] Mahoney (1997, p.1482) adds, "Restrictive exchange rules may appear more benign when viewed as a means of preventing free riding and appropriation by non-members."

[15] Collusive rules will face pressure both from outside competition and from within the exchange. As Mahoney (1997, p.1491) writes, "The fact that different exchange members have different preferences regarding restrictive rules reduces the danger of a stable brokers' cartel."

[16] This is not to say that customers would only use brokers who were members of the Exchange. Brokers who established enough trusting relationships would be in less need of Exchange rules, and bargain hunters who were willing to take their chances with a bucket shop could do so.

Stock Exchange's rules could conduct business at private offices, the Royal Exchange, the Bank of England, other regional exchanges, or in foreign exchanges such as the Amsterdam Bourse (Mortimer 1801; Kregel, 1995; Morgan and Thomas, 1969; Michie, 1985; Neal, 1987; Stringham, 2001). This competition kept a check on the Stock Exchange that prevented it from enacting rules that are highly inefficient. In some cases rules were too onerous but were struck down because of the threat of losing business to nonmembers (Morgan and Thomas, 1969). These outsiders were considered an "annoyance," which is hardly surprising since they were in direct competition. To attract business the London Stock Exchange advertised in the press, publicizing that nonmembers were not "under the control of the Committee" (reprinted in Morgan and Thomas, 1969, p.141) serving as an indication that members of the London Stock Exchange were more dependable.

For many years the London Stock Exchange had no formal constitution, and it was not until 1812 that they issued their first rulebook (Mirowski, 1981; Morgan and Thomas, 1969). The need to attract business not legal rules made the exchange act in a judicious manner (Boot et al., 1993).[17] It was in the interest of the exchange to have a good reputation otherwise it would lose business. In 1877 even the government declared that the Stock Exchange's rules "had been salutary to the interests of the public" and that the Exchange acted "uprightly, honestly, and with a desire to do justice." It concluded by saying that their private rules were "capable of affording relief and exercising restraint far more prompt and often satisfactory than any within the read of the courts of law" (reprinted in Wincott, 1946, p.27). The club has an incentive to make sure the

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[17] Boot et al. (1993, p.1178) write, "Since a discretionary guarantee of a highly reputed guarantor can be more valuable than an enforceable guarantee of a less reputable guarantor, prices of discretionary guarantees need not be less than those for enforceable guarantees." On the importance of incentives rather than legal rules, see Hasnas (1995a, 1995b) and Klein (1997).

exchange is operating properly and so will enact and enforce rules as efficiently as they know how. A disinterested court or regulator on the other hand would have little incentive and even less knowledge to be able to enforce the rules of a stock exchange (Stringham, 1999).

Conclusion

Although there may good reason to worry that in a complicated stock market there are greater chances of fraud, it seems clear that there was no missing market in this realm. Rather than relying on public regulation to enforce contracts, brokers consciously found a way to solve this dilemma by creating and enforcing a system of private rules. Since it was their goal to promote trade, the interest of the members was aligned with the interest of its customers. It was their ability to experiment and their need to attract business that allowed for the discovery of better ways of organizing and self-regulating.

Under laissez faire, firms and clubs, such the London Stock Exchange, can choose to organize in any way they wish, and those that find successful ways of operating will flourish.[18] Since the London Stock Exchange did not have a legal monopoly it needed to make sure that its existence was beneficial. Dennis Carlton writes, "It is useful to view exchanges as competing (or potentially competing) with each other. As in other markets, competition is a substitute for regulation. The more competition there is, the more likely it is that exchanges themselves will promulgate rules and regulations that benefit and protect consumers in much the same ways as competition in other markets protects consumers" (Carlton, 1984, p.259) When exchanges are free to organize without government regulation, it allows for the discovery process of the market to operate. In their quest for more profits brokers will have the incentive to discover better ways of self-policing. The evolution of the London Stock

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[18] Other stock exchanges such as those in America evolved with quite different structures (Michie, 1986).

Exchange provides evidence that beneficial regulations can be created through the market.

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