



STUART BANNER

SPECULATION

A HISTORY OF THE FINE LINE

BETWEEN GAMBLING AND INVESTING

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Introduction

"WHEN AS A YOUNG and unknown man I started to be successful I was referred to as a gambler," the banker Ernest Cassel once said. "My operations increased in scope. Then I was a speculator. The sphere of my activities continued to expand and presently I was known as a banker. Actually I had been doing the same thing all the time."¹

Cassel was retelling an old joke, but behind it lurked a dilemma that has troubled the legal system for a long time, a problem that is the subject of this book. For centuries there has been a consensus that *investment* is very useful and ought to be encouraged. There has also been a near consensus, one that has weakened recently but is still substantial, that *gambling* is dangerous and ought to be at least discouraged and maybe even prohibited. But what about *speculation*? Speculation lies somewhere between investment and gambling. It has attributes of both. Should speculation be legal? Should it be illegal? Should some kinds be legal and other kinds illegal? Which kinds? Throughout American history (and the history of other places too, but this book is just about the United States), speculation has presented a puzzle to the legal system. To figure out how to treat speculation, we have always needed to distinguish between two kinds of risky commerce: a good kind the law should promote and a bad kind the law should deter. We have always needed to draw a line between investment and gambling. This book is a history of our efforts to draw this line.

¹ The quotation was attributed to Cassel by Bernard Baruch. Carter Field, *Bernard Baruch: Park Bench Statesman* (New York: McGraw-Hill, 1944), 76–77.

The same sort of moralizing can be found among many judges of the period. Oat options sold on the Chicago Board of Trade "are essentially nothing but bets upon the price of oats," insisted one of the city's federal judges, "and as it is obvious that the effect of such transactions is to beget wild speculations, to derange prices, to make prices artificially high or low, as the interests, strength and skill of the manipulators shall dictate, thereby tending to destroy healthy business and unsettle legitimate commerce, there can be no doubt of the injurious tendency of such contracts, and that they should be held void as against public policy." In the District of Columbia, a court refused to enforce a promissory note signed by General George Custer just a few months before he was killed at the Battle of Little Bighorn. Custer had been speculating on the New York Stock Exchange, and the promissory note had paid for futures transactions in which neither Custer nor his counterparties had ever transferred any stock. The court held that these transactions were illegal, and that Custer's note was accordingly void. "All observers agree that the inevitable effect of such dealings is to encourage wild speculations; to derange prices to the detriment of the community; to discourage the disposition to engage in steady business or labor, where the gains though sure, are too slow to satisfy the thirst for gaming when once aroused; and to fill the cities with the bankrupt victims of such disasters as any 'Black Friday' may develop," declared Justice Alexander Burton Hagner. "The extent of this form of speculation now rife in our country is unprecedented." Such transactions were "immoral and illegal," sniffed the Nebraska Supreme Court. "Betting on a game of faro, brag, or poker, cannot be more hazardous, dangerous or uncertain," agreed the Georgia Supreme Court. "Indeed, it may be said that these animals are tame, gentle and submissive, compared to this monster. The law has caged them, and driven them to their dens; they have been outlawed, while this ferocious beast has been allowed to stalk about in open mid-day, with gilded signs and flaming advertisements, to lure the unhappy victim to its embrace of death and destruction."²³ In state

23 *Ex parte Young*, 30 F. Cas. 828, 832-33 (N.D. Ill. 1874); *Justh v. Holliday*, 13 D.C. 346, 348-49 (1883); *Rudolf v. Winters*, 7 Neb. 125, 130 (1878); *Cunningham v. National Bank of Augusta*, 71 Ga. 400, 403 (1883).

after state, judges clearly took great satisfaction in adopting a rule that promised to limit practices they viewed as grave dangers.

This judicial attitude was almost certainly reflective of wider public opinion. There does not appear to have been any significant effort, in any state, to enact a statute to undo what the judges had done and allow transactions in which neither party had the intent to deliver. The prevailing view seems rather to have been that of the *Bankers' Magazine*, which declared that "in this evil time, when no power seems able to stay the spirit of speculation, it is cheerful to note how strongly and uniformly the Courts have set their faces against sustaining speculative transactions." In summarizing the decided cases, a pair of lawyers approvingly remarked of the line the judges had drawn, a "distinction between *gambling* with a commodity, and dealing there in by way of *legitimate speculation*."²⁴

Occasional judges went so far as to declare that *all* options were illegal wagers. The transaction "called an 'option sale,'" averred Judge Thomas Gantt of St. Louis, was in fact "a wager respecting the rise and fall in the market of mess pork." Missouri law did not prohibit options, he acknowledged, but "it is altogether inadmissible to infer that everything is moral which the penal law does not forbid." Gambling was illegal and options were a form of gambling. A commentator agreed that "options" were lawful so long as the only choice open to the seller was the precise time of delivery, but that options were illegal where the seller had the option not to deliver the goods at all. But this was an extreme view. As the New York lawyer John Dos Passos (the novelist's father) explained, "options frequently represent real transactions." Where the owner of stock desired to sell if the price rose high enough, or to buy more if the price dropped low enough, it would be possible to wait for the market to change and act accordingly, but one could achieve the same result with more certainty simply by entering into option contracts to buy or sell stock at the appropriate prices. In such a case, Dos Passos observed, the stock owner was not wagering; he was

24 "Speculation and the Abuse of Trusts," *Bankers' Magazine and Statistical Register* 38 (1884): 653; Lewis H. Bisbee and John C. Simonds, *The Board of Trade and Produce Exchange* (Chicago: Callaghan & Co., 1884), 287.

genuinely committing to buy or sell stock if prices moved in a certain way.²⁵ A rule classifying all options as wagers was simply too broad.

Most judges accordingly drew a more accommodating line between permissible speculation and impermissible gambling. In one Pennsylvania case, for instance, the lawyer for one party argued that “all purchases of stocks, with a view to re-sell and make profit on their rise, or contracts to furnish stocks on time, should be declared gambling transactions and illegal.” This argument, the court observed, “would make a great inroad into what has, for an indefinite period been regarded as a legitimate business.” The true distinction, the court concluded, “is between a real transaction, where stock is actually bought and purchased and delivered, and a transaction in which that is not contemplated at all, and where the parties agree, from the beginning, that the stock is not to be delivered, but that they are to settle their mutual wagers upon the price of stock by paying the difference between the sales at the different times.” A real transaction, involving the actual purchase of something, could be as speculative as the parties desired without thereby becoming illegal. “It is the business of all people who engage in trade to speculate,” the court concluded; “all trade is based upon speculation, and no contracts are obnoxious to legal objection merely because they are speculations.” But if the supposed buyer and seller never intended any delivery of stock, the transaction would be an unlawful wager.²⁶

Court opinions of the 1870s are replete with lengthy discussions of this issue. Nearly all of them drew the same distinction, between speculative real transactions (which were lawful) and mere wagers on prices (which were not). “We must not confound gambling, whether it be in corporation stocks or merchandise, with what is commonly termed speculation,” the Pennsylvania Supreme Court explained in

25 *Waterman v. Buckland*, 1 Mo. App. 45, 46–48 (1876); C.H.W., note appended to *Sawyer v. Taggart*, *American Law Register* 27 (1879): 229–30; John R. Dos Passos, *A Treatise on the Law of Stock-Brokers and Stock-Exchanges* (New York: Harper & Brothers, 1882), 445–46.

26 *Smith v. Bouvier*, 70 Pa. 325, 331, 328 (1872) (the latter two quotations are from the jury charge of the trial judge, which was approved by the Pennsylvania Supreme Court).

1872. "Merchants speculate upon the future prices of that in which they deal, and buy and sell accordingly. . . . But when ventures are made upon the turn of prices alone, with no bona fide intent to deal in the article, but merely to risk the difference between the rise and fall of the price at a given time, the case is changed." "The law does not undertake to prevent speculation," agreed a federal judge in Wisconsin. "The truth is, men are speculative creatures as certainly as they are eating and sleeping ones. And, although it is undoubtedly true that much harm comes to the community from over-speculation, it is more than doubtful if the world would be better off without speculators; or, if it would be, that the law can do much in the way of abolishing them." The important thing was not whether a contract was speculative, or whether it included an option. What was important was whether the contract was for a real sale. As New York's highest court concluded, if "there is no intention on the one side to sell or deliver the property, or on the other to buy or take it, but merely that the difference should be paid according to the fluctuation in market values, the contract would be a wager."²⁷

By the 1880s, the intent-to-deliver rule was firmly established in American law. "The generally accepted doctrine in this country," the US Supreme Court declared in 1884, was that "a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and if, under guise of such a contract, the real intent be merely to speculate in the rise and fall of prices, and the goods are not to be delivered, but one party is to pay the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void."²⁸ Over the preceding three decades, case by case, state by state, judges had crafted a new limitation on speculative transactions.

As a doctrinal matter, the judges were reconciling two developments that pulled in opposite directions—on one side, the rise of a blanket common-law disapproval of gambling; on the other, the growth

27 *Kirkpatrick & Lyons v. Bonsall*, 72 Pa. 155, 158 (1872); *Clarke v. Foss*, 5 F. Cas. 955, 960 (W.D. Wisc. 1878); *Bigelow v. Benedict*, 70 N.Y. 202, 206 (1877).

28 *Irwin v. Williar*, 110 U.S. 499, 508–9 (1884).

of organized futures and options trading, which facilitated forms of speculative trading that looked an awful lot like gambling. As a policy matter, the judges were drawing a line between two kinds of risky transactions—on one side, those they considered customary and useful, and on the other, those they deemed novel and dangerous. “Two conflicting tendencies exist” in the court opinions on the subject, observed the prolific legal writer Francis Wharton. One was “laissez faire,” the view that “business should be left free” as much as possible. The other “starts from an ethical or police basis,” Wharton noted, according to which certain contracts were immoral by their nature and deserved censure even if businesspeople found them useful.²⁹ The intent-to-deliver rule was the judges’ way of mediating between these two goals.

But why exactly did judges consider transactions more dangerous when parties intended to settle their contracts through the payment of differences? What was it about the intended delivery of an item that made judges more willing to classify transactions in that item as acceptable business practice? The answers to these questions shed some light on why the rule was adopted so quickly and with so little recorded dissent.

In the summer of 1880, a man named Melchert in Davenport, Iowa, sold fifteen thousand bushels of rye on the Chicago Board of Trade, to be delivered any time in September, at prices ranging from 65½ to 68½ cents per bushel. When September came, rye was at 80 cents per bushel and rising. Melchert frantically telegraphed his broker, Erick Gerstenberg, to “cover immediately”—that is, to limit his losses by buying fifteen thousand bushels of rye at the current market price, before rye became even more expensive. But the direct telegraph line between Davenport and Chicago was not working. The telegraph company had to reroute the telegram through Omaha and St. Louis, which added a few hours to the time it took for Gerstenberg to receive it. In those few hours, rye jumped from 80 cents to 85 cents per bushel. Because of the faulty telegraph line, Melchert had lost an additional \$750. He sued the telegraph company to get it back. One of the telegraph company’s

29 Francis Wharton, note appended to *Melchert v. American Union Telegraph Co.*, 11 F. 193, 201, 203 (C.C.D. Iowa 1882).

defenses was that Melchert had not in fact lost anything, because his rye contracts were unenforceable wagers. Melchert did not have to buy any rye, the telegraph company argued, because neither he nor his counter-parties ever intended that any rye would be transferred between them. They were merely betting on rye prices.³⁰

The law was clear by 1880: if no one involved in these contracts contemplated the delivery of any rye, the contracts were unenforceable, and Melchert would lose his suit against the telegraph company. Judge James Love accordingly focused his attention on what was in Melchert's mind when he entered into the contracts. Did Melchert actually own any rye in the summer, when he agreed to sell fifteen thousand bushels of it? No, he hadn't owned any rye whatsoever. When Melchert instructed Gerstenberg to "cover immediately," was it likely that Melchert actually meant for Gerstenberg to go out and purchase fifteen thousand bushels of physical rye? To purchase fifteen thousand bushels of rye at 80 cents per bushel would have cost \$12,000, but Melchert did not send any money to Gerstenberg, and it was not likely that Gerstenberg would have lent so much money to Melchert. In fact, Gerstenberg did not buy any physical rye. Rather, he entered into a contract to purchase fifteen thousand bushels of rye from a firm called A. M. Wright & Co., which turned out to be the very same firm to which Melchert had sold the fifteen thousand bushels back in the summer. And did A. M. Wright & Co. actually own any rye? No. Like Melchert himself, the firm owned no rye at all. Melchert's "purchase" from A. M. Wright served merely to cancel out his "sale" to A. M. Wright from two months before. Neither side ever had any rye, and neither ever intended to deliver rye to the other.³¹

These facts prompted Judge Love to consider why such an arrangement should be illegal, when the very same transactions would have been lawful had Melchert and A. M. Wright simply intended to transfer ownership of some real rye. The answer, Love suggested, was that requiring the intent to transfer property was a way of limiting speculation to those who could best afford it. Someone who actually owned fifteen

30 *Melchert v. American Union Telegraph Co.*, 11 F. 193 (C.C.D. Iowa 1882).

31 *Id.* at 197-99.

of his own, should undertake to sell and deliver wheat in Chicago.” Nevertheless, Danforth concluded, “we cannot assume that anyone has violated the law and been guilty of immoral and corrupting practices in his business transactions, without proof, even though he may ask it himself”—and here Danforth likely revealed the true reason for the decision—“for the purpose of being relieved from the obligation of a losing contract.” In choosing whether to place the loss on Berry, who had stiffed his broker, or Rumsey, who had done nothing wrong, it was hard not to sympathize with Rumsey, even if that meant squinting a bit to find an intent to deliver wheat.³⁸

Of course, the difficulty of discerning intent also allowed judges the same leeway to invalidate transactions when their instincts pointed in that direction. A few years after the Maine court held Nicholas Berry to his contracts, an Illinois court considered the seemingly similar case of a young Chicago office clerk named McCurdy, who got in over his head speculating at the board of trade. The Illinois court showed considerable sympathy for McCurdy, who the court described as “a young man . . . who was not, and never had been, engaged in buying or selling wheat, corn, pork, lard, or other like commodities” until a three-month binge at the board of trade left him owing his brokers \$840, nearly a year’s salary. The court held that his brokers must have known that McCurdy had no intent to deliver or accept any commodities. “It matters not how nicely the forms adopted may be adjusted to legal requirements,” the court lectured, “if the transaction, when stripped of its covering, discloses what is in substance a bet or wager on the future price of grain.” The brokers thus could not collect on the debt.³⁹

In cases like these, which presented common fact settings, courts could plausibly impute to the parties either the intent to deliver or the intent to gamble on prices. One suspects that the outcome often turned on the judges’ sympathies for the particular parties before them, or—as in Ira Foote’s two cases discussed at the beginning of this chapter—on the judges’ unarticulated policy views as to the value of speculation more broadly.

38 *Id.* at 573.

39 *Beveridge v. Hewitt*, 8 Ill. App. 467, 479, 482 (1881).

THE WICKEDNESS OF THE CHICAGO BOARD OF TRADE

Despite the difficulty of applying the intent-to-deliver rule, it was well entrenched as a matter of common law by the late 1870s. In later years, many states enacted statutes codifying the rule. Some of these laws strengthened the rule by invalidating contracts even where only one party had no intent to deliver. A few states restricted speculation even more. The first was Illinois, which in 1874 banned the sale of options. California's constitution of 1879 prohibited stock futures. Georgia prohibited short sales. Arkansas and Mississippi enacted statutes banning all futures.⁴⁰ To get a sense of the political forces motivating these provisions, it is worth taking a close look at the two that were the most significant, the Illinois statute barring options (significant because options were staple fare at the Chicago Board of Trade) and the California constitution's ban on stock futures (likewise for the San Francisco Mining Exchange). Both were enacted in response to local concerns, but both were early appearances of issues that would become nationally salient in later years.

The Illinois statute was enacted during a period of agrarian discontent with the intermediaries between the farmer and the consumer—primarily railroads and grain warehouses, which farmers believed charged far too much. During this period, farmers in several states, including Illinois, successfully lobbied for state regulation of railroad and warehouse prices. Dealers were intermediaries in the grain trade as well, and they too were viewed with suspicion by many farmers. “We often hear the Boards of Trade, or what is known as dealing on ‘Change,’ denounced as a system inimical to the interests of farmers,” declared M. L. Dunlap at the 1873 convention of the Illinois State Farmers’ Association. Dunlap, a farmer from Savoy, in the central part of the state, was expressing the common view among farmers that trading in futures and options, especially short selling, had the effect of depressing commodity prices. Dunlap himself was skeptical about this. Nevertheless, he contended, “trading in options is no doubt a species of gambling highly reprehensible, and with which the farmer has nothing

40 T. Henry Dewey, *Legislation Against Speculation and Gambling in the Forms of Trade* (New York: Baker, Voorhis & Co., 1905), 15–50.

to do." As Dunlap saw it, "it is a practice that should not be permitted among a class of men whose integrity is a large part of their capital."⁴¹

In 1874, when the Illinois legislature convened to revise the state's statutes, agrarian pressure produced a bill to prohibit contracts for the sale of any commodity that the seller did not own and actually have in his possession at the time of the contract. This was the same rule first suggested in the United States by Joseph Story thirty-five years earlier, when it had been roundly rejected. The proposal was directly targeted at short selling on the Chicago Board of Trade, the single most vivid circumstance in which a trader necessarily contracted to sell something he did not yet own.

The bill was promptly criticized, for the same reason that Story's proposal had been criticized—it banned good transactions, as well as bad. "So far as such a law could be made to prevent wild speculations, 'scalping' options and their resultant 'corners,' it would prove beneficial," the *Chicago Tribune* argued, "but, unfortunately, the law is so sweeping." Farmers could not survive without making contracts to sell grain before the harvest, the *Tribune* pointed out. "With such a law in operation, it would require an amount of capital to transact business which would simply be unattainable, and the farmers would soon find themselves ruined." And the law would yield even more absurd results in other industries. A meat packer could not contract to deliver meat in advance. An opera manager could not sell tickets in advance, because the singers were not yet in the theater. A newspaper could not sell a year's subscription, because the publisher did not yet possess the entire year's news. "Such a law," the *Tribune* lamented, "would put a complete embargo on all business."⁴²

The bill was especially unpopular at the board of trade. Many of the contracts made at the board were for large quantities, like a thousand hogs or ten thousand bushels of grain. The board's president wondered how sellers could fit so many hogs or so much grain into their offices to satisfy the "possession" requirement. The broker John Bensley thought

41 Lurie, *The Chicago Board of Trade*, 52–56; *Proceedings of the Illinois Farmers' State Convention, Held at Bloomington, Ills., Jan. 15 & 16, 1873* (Chicago: Inter-Ocean Print, 1873), 22–23.

42 *Chicago Daily Tribune*, 15 Jan. 1874, 4.