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AMERICAN CAPITAL MARKETS: ROSES OR THORNS IN THEIR FUTURE?

An Address By

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Securities and Exchange Commission

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One of the pleasures of appointment to a job in Washington is the experience of coming home, even if only for a night. That pleasure is sometimes diluted with chagrin. You come back imagining that perhaps your old friends and comrades will discern new wisdom and insights in the glint of your eye, but you realize that, if anything, exposure to Washington has been more confusing than clarifying. And you wish that you could impart some nugget of "inside information" that would let everyone know that you are indeed in the inner circle, but alas, most of what you know of national affairs is what you read in Time or Newsweek or The Washington Post or The Wall Street Journal. And you would like to brag of triumphs that clearly bear your mark, but those, if they exist at all, are obscure and buried in the legalisms of governmental bureaucratese and are little susceptible of dramatic interpretation.

Still the adventure in Washington does do one thing: it substitutes one set of worries for another and I guess what I am about tonight is to worry a little out loud with you concerning something that worries the Commission of which I am a part and which perhaps worries you , too. That worry is the state of your capital markets.

This worry afflicts all of us in different ways. The institutions represented here worry about the decline in the values of their portfolios and the dangers to the yield from them so vital to the continuation of their very existence; the Plain Dealer reported last week that one local institution has seen its endownment funds shrink from $83 million to $72 million in a year and

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the "total performance" drop 11%. The businessmen here worry about the cost of the money they borrow and the harsh penalties of strengthening their equity position given the state of the market. Those who are individual investors have watched their investments shrink drastically in value and wonder whether they will ever again know the feeling of security about their investments they felt only a couple of years ago. And all of us, as citizens and consumers, worry about whether our economy, and for that matter, the world's economy, can indefinitely tolerate the stresses and shocks that are being daily inflicted upon it. If they can't, then our standard of living, steadily raised through almost two hundred years of national existence, may be jeopardized for us and for our children and theirs after them. And mixed up with all this is the survival of our political system. Responsible critics, like Robert L. Heilbroner, raise dire questions whether, given the population explosion throughout the world, the environmental hazards, and increasing demands on the earth's resources, our system of liberal – that's with a small "l" – democracy can deal adequately.

Our economy has been the envy of the world largely as the consequence of our ability to harvest the savings of individuals and channel them into productive enterprise. In some cases this harvesting has been direct: you and me investing in the equities of new as well as established enterprises. In other cases we as individuals have done this indirectly: we deposit money in banks which then lend it to entrepreneurs, or we invest in mutual funds which, though their activities are principally in the secondary markets, nonetheless provide an essential part of the mechanism which permits the raising of new money for new investments, or money accumulates for our benefit in pension funds which then invest.

No one doubts that the demands for capital in the near and long term are going to be prodigious. At the base is the need for capital to permit the continuing updating of our industrial machine, more urgent than ever as competition in the world market becomes increasingly intense, with more countries desperately trying to expand their share of the earth's treasures to provide for their nationals higher standards of living, if for no other reason than to abate the unrests that are multiplying throughout the world, especially in Africa and other under-developed

areas. Add to these needs the costs of complying with public expectations for cleaning up the environment and raising the standards of safety. On top of this are the additional demands to accomplish "Project Independence" with respect to energy. Little wonder that the New York Stock Exchange foresees in the next dozen years a possible capital shortfall of 640 billion dollars.

We are confronted with this challenge at a time when the state of our securities markets is the worst we have known in more than a generation, when all of our hopes and expectations have been obsoleted, when our confident expectations of endless advances of the Dow Jones have been shown to be horribly ill-founded, when pressures which have been hammering at the institutional structures of the capital markets have reached an irresistible intensity.

The other night I saw "That's Entertainment" and it was a relaxing experience. The typical MGM musical was a happy thing – simple, rhythmic, symbolic in a way of what in retrospect seems to have been a less perplexing, more manageable era, though my own recollection is that the period spanned by that particular art form had its problems, too. It was a time when no one challenged the supremacy of the New York Stock Exchange as the nation's securities marketplace, when the assumption was that anyone with a decent little company could find money, when the bulk of activity in the securities markets consisted of lots of people like you and me trying to find some means of providing profitable uses for our accumulations looking toward educating our children, providing for our retirement, finding fodder for bragging to our friends of our skill in the market.

But underneath this euphoria some very basic things were happening. We adopted a social policy that it was good for employers to provide for the comfortable retirement of their employees, and we expressed this social policy in a tax policy that gave pension and profit sharing plans favorable tax treatment. Since then we have witnessed the vast accumulation of money in the hands of pension trusts, which have grown from $73 billion in 1965 to $130 billion in 1973, with the rate of accumulation probably due to accelerate as a consequence of the Pension Reform Act of 1974. Aggressive merchandising teamed with the need of many for

professional money management and investment companies grew explosively from 47 billion in 1965 to 80 billion in 1972. The generosity of Americans and their dedication to educate, channeled and enhanced by groups like this one, brought gift giving to educational institutions to new levels, swelling endowment funds from 11.7 billion in 1965 to 14.5 billion in 1973.

In short and in summary, larger and larger amounts of money available for investment came under the control of professional managers. Overall I would have to argue this has been good. It has, though one would have to look beyond present conditions to sustain this thesis, resulted in overall sounder investment judgments than if the decision making process for that amount of money had remained dispersed throughout the population.

With this fundamental change in the whereabouts of investment capital came manifold consequences in the markets where securities were traded. These professional managers traded not one or two hundred shares at a time, but often tens and hundreds of thousands of shares at a time. This had the potential of adding immensely to the volatility of markets, with sharp runs down when an institution unloaded a big block, and sharp runs up when they accumulated a position, though it must be said that most managers conducted their trading in ways that sought to avoid these consequences. Where once half a million shares traded on the floor of the New York Stock Exchange in a security in a day might reflect a thousand or two thousand investment decisions, it might now reflect a hundred or less. Despite the mechanisms that were created to deal with this phenomenon we can still occasionally see the consequences of this institutional activity in the price movements of a particular security, though our economists and statisticians tell us that viewing the market as a whole, and prescinding from the price action of a particular security, the presence of increased institutional activity has not on the average significantly aggravated the volatility of stock prices.

To the everlasting credit of the securities industry, it responded to the needs and desires of this newly burgeoning type of investor and provided the techniques and the capital and the skill necessary to satisfy his needs. So called “block traders” developed who were willing to commit their capital to buy substantial amounts of stock from institutions with the hope that they

might be able to resell it at a fractional increase over the price they paid, rather than simply act as agents. "Third market" firms did the same sort of thing but outside the formalities of the exchange structure. More and more of the business was done away from the floor of the New York Exchange, which only a short time before had been so impregnable to competition. In the second quarter of 1974 about 7.7% of the total value of transactions in New York Stock Exchange listed securities was accomplished off the floor of the Exchange, almost three times the percentage eight years before.

These professionals, in control of millions of dollars of commission business to pass out, began to examine what they got in exchange for all this money they paid to execute their transactions and reached some farreaching conclusions. They recognized, among other things, that the commission typically paid included a whole bundle of services: it included the cost of actually carrying the order onto the floor of the exchange and having it done – executed is the technical term – there; it included the cost of transferring the stock certificates evidencing the ownership of the security and transmitting to the seller his funds; it included something called "research" which might mean much or little. Most of all, they realized that for transactions done on the exchanges – the commission was fixed by the rules of the exchanges and they had no opportunity to bargain for a lower price. Maybe they didn't need the services of salesman; maybe they didn't want what the firm called "research"; maybe – usually the truth – they didn't want the executing firm to keep custody of their certificates. Regardless, they paid the same price as the person who benefited from the entire bundle of services. The situation was like a restaurant that sold meals only table d'hote: you paid for the soup even if you detested soup and for the dessert even if it would kill you.

Not surprisingly institutions began to look for – and found – ways of breaking out of this bind, ways that generally were not available to individual investors. Among other things, they began hammering on the doors of the New York and other exchanges and demanded that they be permitted access on the floor of the exchange so they could transact their business without the intervention of a costly middleman. And there emerged dealers outside the exchange community

who would deal with them at costs under those charged by exchange members – the so-called "third market".

Coming at the same time as all this was the increasing movement of these institutional investors into equity securities. In the twenties no respectable money manager would have been caught dead with more than a smattering of equity securities in his portfolio. Any prudent trustee knew that it was graven in stone that he was obliged to protect the integrity of the fund he managed for someone else and that in equity investments lay surcharges, lawsuits, public didsain and unending shame. All that began to change. The Ford Foundation in 1965 publicly chided educational institutions for excessive caution and urged that they "get with it" by putting more of their portfolios into equities (ironically the present sad state of the market has depleted the values in the Ford Foundation portfolio to such an extent that they have been reported as severely curtailing their grants). There began the process of what is called by some the "equitization" of portfolios, the increase in the portion of portfolios represented by equities, a dramatic shift that resulted in the total volume of transactions on exchanges increasing as well as the proportion of total volume represented by institutions.

Further distorting activity in the markets was the advent of the so-called "performance cult", the obsessive desire, often imposed by corporate managers and beneficiaries seeking maximum total yield, i.e. dividends plus increase in market value, to outperform accepted criteria, such as the famous nine percent standard established by a University of Chicago study. In an effort to meet these demands money managers traded more and more often, looking for increased performance through short term profits (and remember, many of these institutional investors didn't have to worry about the tax consequences of short term trading since they were tax free), with the result that the turnover of institutional assets went from a previous norm of about 12 to 13 percent to over thirty percent. This, of course, was reflected in the volume of activity on the exchanges and in the over the counter market and contributed to the surge in prices that accompanied the increase in volume.

And further complicating all this, of course, was the tremendous expansion of techniques and systems for communication and for the storage and the manipulation of data. In the unending quest to find ways of utilizing this new technology to lower costs and supplant bodies, it became evident to many that the way in which the old Exchange floor was organized was indeed obsolete. It reflected a time when the most sophisticated communications techniques consisted of telephones and messengers and the best way of getting an order for a brokerage house to the floor of the Exchange was to phone it to the edge of the Exchange floor and have it walked by the broker to the post where the stock was traded. Communications and data processing set the stage for eliminating the distances -- geographical and others -- between exchange specialists and other dealers and giving investors the advantages of real competition among them.

Thus we have pressure from institutions for commission rates commensurate with the value of the services they receive, leading possibly to sharply lower income for the securities industry; increasing presence of the institutions in the equity market with resulting needs for capital to handle their needs and new mechanisms to avoid undue volatility resulting from big investment decisions; the explosive increase in our ability to communicate and handle data. All of these in the best of times would have created irresistible pressures on the old methods of doing business in the securities markets.

But these pressures, a long time building, reached their apex not in the best of times, but in what many consider the worst of times: today.

During the last two or three years all categories of investors, ranging from the most conservative to the wildest speculators, have had their fingers burned and have witnesses deteriorations in value once thought impossible. The Dow Jones average, down about 40%, really tells only part of the picture. Other stock indices, more representative, have declined anywhere from 50% to 70% and many individuals and many institutional portfolios have experienced depreciations that are as great or greater than that. The securities industry is suffering severe financial losses – New York Stock Exchange firms lost over $100 million in the

first eight months of this year – and substantial amounts of capital are being withdrawn from it – over 15% of the total amount in 1973 along, with more going this year. Old and proud names are disappearing from the business – DuPont, Shearson Hammill, G. H. Walker – and many who have for years enjoyed comfortable livings find themselves with sharply reduced standards of living and, even worse, in some cases without jobs.

Aggravating efforts to solve these horrendous problems and shape a securities industry and markets demanded by economic forces is the fact that many in the securities industry have adopted as their goal return to the way things were from about 1969 to 1973 when all levels of security activity were high, oh so high, money flowed as it had hardly ever flowed before, and the only problem, albeit one that almost killed the industry, was the so-called "paper crunch" during which securities firms were unable to effect transfers of securities, millions of dollars of stock certificates piled up in the back offices of firms, and innumerable errors plagued customers. Putting aside that as a monetary aberration, many suggest that the halcyon days of the recent past must somehow or other be made to return.

And they were halcyon days. During the period from 1960 to 1965, the average trading on the New York Stock Exchange was over 4.5 million shares a day; as recently as 1965 a New York Stock Exchange study had suggested that by 1975 the level of activity on the Exchange would have risen to 10 million shares a day. When the activity was hitting 20 million shares regularly, caustic sneers at the convervatism of the New York Exchange projections were commonplace, and it was nearly universally believed that they had been obsoleted. As a consequence of this frenzy of activity, in the belief that it heralded a new, higher and happier plateau of activity, the securities industry geared up. New faces and new firms appeared regularly, most of them with fairly lavish offices and expensive computer facilities. The staid old wire houses tripped over each other opening new branches to serve this marvelous, ebullient new world.

But as we know some terrible things happened on the way into Paradise. High interest rates tumbled stock prices, volume dipped to levels barely over half of what they had previously

been, individual investors suddenly became very income conscious and sought out the highest return available in the money market and generally forgot the phone numbers of their brokers. Still it has been generally felt in the securities industry that once the problems of inflation and high interest rates come under control, the world will go back to where it was and the rudely interrupted ascent to 25 and 30 million share days will once more commence. And the word many in the industry have given to Congress and their regulators has simply been: leave things the way they were, because if you bring about change now you make a bad situation worse, and given time these problems can be worked out within the same old context of exchange floors, monopolistic specialists, fixed commissions and all the other paraphernalia of the old way.

I think that is wishful thinking and more than that, I would suggest that it is dangerous thinking for the country, as well as for the securities industry. In short, there is no going back: too many things have changed, some forever, others if not forever, at least for a period of time that is significant from the standpoint of investment decisions.

Thus we are brought to our present posture: the market at the lowest levels in 12 years, the volume on the stock exchanges and in the over-the-counter market at levels insufficient to sustain the industry as it is now organized, a near total dryup of underwriting activity which means that precious few companies can tap the equity market for needed expansion and improvement (ad concomitantly with that has been a dangerously high reliance upon debt), a securities industry foundering in a sea of red ink, all of this accompanied by ever increasing demands for investment capital and dire predictions that we may confront substantially reduced standards of living -- or even worse -- unless we overcome the problem.

This would be a good place to end and leave it to others with perhaps better crystal balls to suggest what the outcome of all of this is going to be. I’m going to put prudence behind and suggest some of the things I see on the horizon as a consequence of all these events. And more than that, like the General who in the face of attack on all fronts said the situation was ideal for advance, I suggest the future is bright with challenge and opportunity.

First of all, the source of so much distortion in our market places, the near two hundred year old system of fixed commissions for transactions on exchanges, is going to disappear and if I had to guess when it will disappear, I would suggest that the Securities and Exchange Commission will stick with its May 1, 1975 deadline, although I caution that we are commencing on November 19 extensive hearings which probably will extend over a month or more to provide everyone an opportunity to give us their best arguments as to why this is a dangerous or disastrous course. With this reform many of the collateral problems will cease to exist: no longer will institutions years for membership on exchanges and all the game playing in an effort to recapture some of those commissions by institutional customers will cease. What this will mean to the level of commissions is, frankly, anyone's guess. My guess is that perhaps individual customers of brokerage houses may pay a little bit more, although not significantly so, and probably institutions will pay a little bit less, although I would not expect that the levels of commissions for them will fall to unprofitable levels. This, combined with the forces already at work, will probably result in a continuing contraction of the securities industry, with fewer firms in business, fewer registered representatives, and perhaps somewhat less capital available for firms in the business. But the rewards for the firms that survive – the most efficient, made so by the necessities of competition, stripped of excess costs by the present vicissitudes – will be abundant, as they have been for the strong and the fit in other price competitive industries.

Will contraction, as many people predict, cripple the capacity of the securities industry to do what it has done so well in the past, namely, be an efficient and an effective conduit through which financings for a variety of worthy enterprises, including small local firms, reach the market? I seriously doubt it. If there is a need for the service of brining small companies to the public, then there will be or develop organizations that can do the job at a profit; if there is no such need, then why should there be a capacity? Beyond that, the plain fact is that this country would be better off if a lot of the highly speculative, poorly managed, ill-conceived enterprises that were brought public during the late 60's and the early 70's had never been able to tap the public well for financing, and I would hope that when there is again an upswing of interest in

new equity issues, underwriters will exercise a good deal more judgment and prudence, self-control and self-restraint, and deny the public the questionable benefit of investing in companies that are not proper vehicles for public investment.

Probably institutions are going to have to assume a greater role in the early financing of meritorious enterprises. This may entail some adjustment of the standards by which the propriety of their conduct is judged and it may well be that some sort of tax stimulus will have to be applied. Much of the institutional money in this country is locked up in pools that enjoy special tax treatment: the income of pension funds is tax free, with contributions to them deductible by employers; the income of educational endowment funds are tax free; mutual funds enjoy the avoidance of taxation at the fund level for dividends passed through to shareholders. It may well be that legislation will at some point be required to assure that some portion, of pools of capital enjoying tax benefits be committed to smaller, more speculative enterprises. At one time Senator Lloyd Bentsen proposed that 1% of managed funds be freed from the "prudent man rule" so that they could be invested in a somewhat more aggressive fashion. Be all that as it may, however, I think the problem of capital for small enterprises can be solved through tax and other legislation. I am told, I might note, by a number of people in the industry that there are substantial funds available in venture capital companies which have yet to be tapped.

The role of the institutions in the market is now declining. It is being commonly said that the amount of trading on the New York Stock Exchange by institutions has risen to 70%. There are indications that that figure is obsolete and that once more the figure is edging back down closer to the halfway mark, as the equitization process has been completed and perhaps reversed and the "performance cult" has slipped into oblivion. It seems to me that out of the lessons of the last few years institutions will be hesitant for a long time to renew the aggressive investment tactics that resulted in totally distorted turnover rates. As a result of their sad experience with the so-called "vestal virgins" or "favored fifty", combined with increased public agitation that they respond more affirmatively to the needs of a larger number and variety of enterprises, they will probably spread their affections more widely, with the result that portfolios will be more

diversified and many companies which in the past have lacked their interest will suddenly find themselves acceptable. Already there is evidence that portfolio managers are seeking more actively investment opportunities beyond those which have traditionally appealed to them.

Will the small investor return to the market place? This is a big question. It took many years after the 1929-1933 debacle for individual investors to recover from the wounds they suffered during that period and it may well be that it will be some time before they can erase from memory the huskstering, the bland slogans, the excessively high expectations that resulted in such monumental losses for them. He has newly found that there is much to be said for investments that throw off cash yields and seem less vulnerable to sharp, unexplained fluctuations in value. Furthermore, he is relying more and more upon accumulations in pension and profit sharing plans to provide him with the security that previously he provided for himself with a stock portfolio. This is not to say that many of those now on the sidelines aren't ever going to come back, or are not going to come back even in the near term; as soon as it appears that once there is money to be made in equities many individual investors will float back into the action complete with new coats of wool. But they may leave behind on the sidelines for a much longer time many of their former confreres.

Very often when the notion is expressed that the individual must somehow or other be induced to come back to back to the market place, the thought seems to be less one of providing him with opportunity and more that his presence is necessary to provide that illusory dimension of the market called "liquidity." Dr. William C. Greenough, the head of the College Retirement Equities Fund, has said:

> "…it is inconceivable to use as a strong reason for bringing the public back to the market the idea that this public should provide institutions with 'liquidity.' Certainly, it ought to be the other way around. Institutional investors should not expect to 'use' individuals for their own purposes of liquidity. Rather, they have to consider how they can help make the stock markets more appealing to individuals as a broad approach to strengthening our capital formation."

We should want the individual investor back in the market place, not for the benefits others may gain at his expense, but rather because the market historically, with the exception of aberrations such as we know now, has generally been a good means for people to invest their surplus funds, provide for their security and the education of their children, enhance their standard of living, while at the same time providing American business with its needed capital. I think of perhaps more importance than whether the individual comes back into the market place is the question, once he is there, what will be done to protect him against the ravages he has suffered in the past? The Commission places great importance on this and we are presently planning a combined legislative and regulatory program designed to assure that those who advise him are more competent, have greater integrity and are better able to give him sound professional advice. Furthermore, the shakeout in the industry has resulted in the demise of many marginal operators who should have never been in the industry in the first place. We are hopeful that stronger regulation will keep this kind of person out. Hopefully, when the individual investor returns, his experiences and the experiences of those who were his professional advisers have been such that we may avoid, at least for a reasonable period of time (my faith in human nature is not deep enough believe that the events of the last few years will never be repeated), the speculative excesses of the past and stocks will be priced at more conservative and hopefully more stable prices. It may well be that companies will have to adjust their thinking about what their stocks should sell at in the market. Executives who found multiples of 30 to a 100 quite comfortable will have to be content with price earnings ratios of 10 to 15, not unduly conservative when you examine the long run of history.

In short, I think the small investor will come back, hesitantly, with some reluctance, cautiously and probably not inclined, at least for the moment, to as much activity as he engaged in in the past, but hopefully he will return with sharpened judgments and better instincts. His caution combined with reduced institutional investor activity will probably deny us the soaring volumes of trading activity for some time to come and the securities industry will have to adjust to this.

What does all this portend for the ability of this country to meet its capital needs over the next decade? Involved in that answer, of course, are so many other factors that I have not dealt with and which cannot really be measured with precision. Among those factors are government tax and fiscal policy, what the Arabs do with their newly augmented wealth, the extent to which affluence and growth become secondary considerations to environment, developments abroad, the state of the world economy. Uncertain as all those elements seem, I have a suspicion that they will not be destructive of our hopes and that after the distortion that we are presently experiencing has abated, after the mood and confidence of the country begin to ascend, we will once again have flourishing the great capital raising and capital allocating mechanism that we have known in the past. I think when all the changes that are in the wind are accomplished and the adjustments to them made, we will have a securities industry that will be better able to perform its historic function: it will be stronger, more responsive to the needs of its customers, more efficiently run.

I am sure that much of this has seemed to you dry and technical -- and I apologize. Immersed as we are at the Commission in these financial problems of the country, most of one's ruminations begin and end with them, largely, I say in justification, because so much of the future economic strength of this country depends upon what happens to our capital markets, how they are run, who runs them, how they are organized, how well they function. With those problems we are deeply concerned and hopefully dealing imaginatively.

Most of the time people are hardly aware of what is happening in the capital markets until a time of crisis. A time of crisis can be an occasion for throwing up hands and despairing; on the other hand, it can be a magnificent opportunity for imaginative reform and restructuring. That is the task we are about and we are hopeful that all of you and the institutions that you represent, business and educational, will be the beneficiaries of our efforts.