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SECURITIES MARKETS 1929-1959 AND THE S.E.C.

Address of

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Two weeks ago the Securities and Exchange Commission celebrated its twenty-fifth birthday. On July 2, 1934, the original five Commissioners held their first meeting here in Washington and elected Honorable Joseph P. Kennedy as their Chairman. It was their privilege to chart the early courses of an entirely new venture by the Federal Government in the economic activities of our country. I do not intend to try to review the experiences and activities of the Commission or to attempt to evaluate the Commission's work under the Federal securities laws during the past quarter century. Such material has been and will be adequately covered on other occasions. I intend rather to concern myself principally with two questions which I have been asked on several occasions in recent weeks, first, whether the legislation now on the books is adequate to prevent a serious collapse in the market, and second, what can the Commission do to avert such a contingency.

The fact that such questions can be asked is enough to raise doubt whether the public and even the press have not come to take this Commission for something which we are not and to expect accomplishments of us which we cannot perform and were never intended to perform. To begin with, I think I should remind you that the Commission cannot, and I doubt whether anyone else can, regulate or control the powerful, fundamental forces which operate to cause major market movements. We have in this country what is essentially a price economy. One of the distinguishing characteristics of such a system is the inevitability of price fluctuations, based in large measure on the freedom thereunder of the citizen to do or not to do things which may cause commodity and security prices to move up or down.

Indeed, it is often helpful to recall that the price level at which a security sells is not reflective of any intrinsic values. There is no value in the piece of paper representing your share of stock, nor in the share itself except insofar as it is an aliquot portion of a going and profitable business. There is a self-evident value in a bushel of wheat, a ton of steel or a bale of cotton. However, the value of a share of stock of a corporation dealing in or producing or using one of these commodities fluctuates, not with the value of the commodity, but with the profitable use to which the corporation can put its assets or the value it can realize upon

their sale. It is substantially true that the stock market reflects the economy, but it is not necessarily true that every price movement reflects a considered judgment based on sound economics.

On the other hand, while it is perfectly obvious that we cannot and do not possess a magic wand which will prevent gyrations in the stock market averages, it is equally clear that, under the Securities Acts, when the market averages do advance or retreat, they do so free of the sinister influences which, in an earlier day, caused distress and tragedy in countless thousands of homes and business establishments.

Many of you here today can recall vividly the period through which we passed twenty-five to thirty years ago. Others of you, however, may be of another generation and may not remember the time when there was no S.E.C. It is sometimes difficult to convey to those who did not live through these times a vivid picture of the financial practices which caused the Securities Laws to be passed, and effectively to describe the differences between the securities markets then and as they have developed in the intervening period. Every new Commissioner and every staff man must, of necessity, be a practicing student of financial history and one of his most important tasks is to evaluate the modern scene in terms of the situation as it existed in the twenties and as it has evolved in the twenty-five years of our being. If today I can convey to you just a little of this perspective, perhaps you who are members of the National Press Club will find it easier to explain and describe to the public the nature and significance of some of today's kaleidoscopic financial events.

It is doubtless quite natural for an observer to remark that the Dow-Jones Industrial average has recently reached over 660 as compared with 386 in 1929; that the activity in brokerage offices and the statistics from the exchanges suggest that the man in the street is again coming into the market in large numbers and at high prices; that there seems to be a speculative fever in the air; that the prices of certain glamour stocks would hardly suggest a bargain sale and he may be pardoned if he wonders whether this is 1929 all over again.

The economists are quite capable of drawing their own conclusions as to whether or to what extent our economy and the activity in today's stock market are but lengthened shadows of that distant time. Opinions can differ as to what factors operate to cause price collapses and whether prices and volume are causes or effects of activity or stagnation. These are matters of endless debate, and I don't propose to join the argument. The matters I am about to mention are not open to debate; they are hard, existing,

continuing, effective facts and conditions. You may place your own valuation on them, but you cannot ignore them. You are privileged to believe that not enough has been done, but you cannot deny what has been done.

First, let me point out that the securities industry, comprising the stock exchanges, the underwriting houses, the brokers and dealers and the other elements of the capital market is now a disciplined industry. This discipline is in some measure imposed by law but, what is more important, a very great deal of it is self-imposed. Because of this fact, it is more effective and pervasive than it might otherwise be.

Prior to 1934, many of the operations in the exchange markets could hardly be described as being in the public interest. No one could be sure that prices in these markets bore any relation to values or reflected the impersonal forces of supply and demand or, what was more serious, that the exchange rules were designed to produce any such results. In fact, it is now clear that many highly artificial forces were at work. For example, during 1929 the prices of over 100 stocks on the New York Stock Exchange were subjected to manipulation by massive pool operations. In the classic situation, the operators of such a pool would arrange for a source of supply of a security, usually through options, and then by concerted group action create activity and interest in the stock in order to unload the syndicate holdings at a profit upon the public which had been attracted by the activity. Floor traders and specialists roamed freely and without supervision on the floors of the exchanges and participated without restriction in pool operations. Bear raiders periodically barraged the market with short sales in order to accentuate price declines. Listing requirements were minimal and the data given in listing applications were indifferently investigated. Administration of the exchanges was lax; their rules apparently ignored or even contemplated the existence of manipulative activities.

In the intervening years, the exchanges have developed a sense of public responsibility; they have adopted rules restricting the activities of floor traders and specialists; listing requirements have been made more rigid and periodic certified financial reports have been required; excessive trading by members has been restricted; rules adopted by the Commission have taken the sting out of short selling. Under the Exchange Act, manipulative pool operations are prohibited, as are wash sales, the dissemination of false or misleading information and other devices for rigging the market.

The major exchanges at least have demonstrated that they are conscious that they are institutions vested with a public interest. They are obviously acutely aware of the danger to which they would be subject if the public were to suffer serious loss due to improper functioning of the exchanges as institutions or due to improper conduct by exchange members. They understand that the destruction of confidence of investors in the integrity of the securities markets which would follow such a contingency would be disastrous to our national economy and to the financial community of which they are a part, and have specified procedures and adopted rules to guard against abuses. I do not mean to say that the exchanges and the S.E.C. do not still have their differences of opinion or that the Commission does not continue to exercise close surveillance over the markets or that there is any atmosphere of complacency in the relations of the S.E.C. to the industry. I think the exchanges would hasten to cite book and page to the contrary. What I want to emphasize is that the wholesome respect of the exchanges for the power vested in the S.E.C. by the Securities Acts has resulted in a self-discipline far more rigid than that which I think the original draftsmen ever contemplated.

In the over-the-counter market, the National Association of Securities Dealers has become a powerful force for the establishment and maintenance of standards of good business conduct. Membership in this organization carries with it very valuable privileges in the over-the-counter market and in the underwriting business. It exercises a discipline over its members which is no empty gesture. Members may be, and are fined for misconduct or expelled or suspended for cause, and are subject to rules adopted to promote fair competition and to protect the public from unfair practices. I am willing to concede that the activities of this organization may be said to serve an enlightened self-interest, and that here again, the S.E.C. does not always see eye to eye with the trade in all details nor have we hesitated or will we hesitate in the future to take appropriate action if the occasion appears to demand it. The fact remains that the existence and self-discipline of this industry group have been and will unquestionably continue to be potent forces leading to the prevention and elimination of practices which were in some measure, at least, responsible for the underlying weakness of the pre-S.E.C. market.

In the second place, as you know, the bull market of the twenties involved the use of large volumes of credit to finance speculative activities. Call money rates in 1929 were as high as 20 per cent and credit poured into the stock market from all over the country. Brokers' loans rose from $1.9 billion in 1922 to a peak of $8.5 billion in October, 1929. Industrial

corporations even found it profitable to issue securities in order to raise funds destined to be thrown into the call market. The machinery for supplying credit for securities transactions, in which process banks supplied funds to brokers, brokers carried their customers and gave back their customers' collateral to the banks, was driven at a dizzying clip by the mirage of quick, easy and riskless wealth. Speculators ignored the fact that the yield of the securities purchased on margin was far less than the interest on their debit balances with their brokers. There were no limits save the prudence of the broker, which was sometimes debatable, to the amount of margin that was required of a speculator. The expectations of capital gains overshadowed the present economics of the transaction. Drawn into the market by the vision of pie in the sky, margin customers assumed positions to protect which they had insufficient liquid resources. The impact of a relatively small decline in prices under these circumstances was disastrous. Sales on margin calls depressed prices, causing more calls and more selling pressure. It was not a pretty sight, nor was there any control over it under the then existing exchange practices.

Under the Securities Exchange Act of 1934, this machinery for creating stock market credit is subject to strict regulation through margin requirements established by the Federal Reserve Board. Ever since the adoption of the Act and at the present time, cash requirements so established largely prevent the use of credit to support a speculative orgy. Brokers' loans at present in a far larger market run to about $3 billion. There is no longer any serious danger that a surge of cumulative margin calls will force liquidations and accelerate declines. Speculation must now be largely financed through cash rather than credit, and if the customer does not have substantial cash in his jeans, he cannot join in the party.

In the third place, there was a time when an underwriter about to offer a new issue for sale to the public could get and issue a statement of financial condition of the issuing company only if and when the management chose to release one. There was a time when the press could find out about a company and its operations only what the company chose to divulge. The affairs of corporate management such as their ownership of securities, their compensation and transactions between management and their companies and affiliates were withheld from stockholder or public scrutiny. In those literally dark ages, information supplied by an underwriter or an issuer was not susceptible of any reasonable verification simply because no one could be compelled to tell the whole truth. Furthermore, when a new issue of securities was to be sold, it broke on the market

with an instantaneous force. No time was allowed for investors, analysts or salesmen to study what little financial data might be released. There was intense pressure to sell the securities at once.

In today's market and under the Securities Acts, no significant industrial, commercial or utility financing can take place until all important aspects of the company and of the proposed transactions are laid open to leisurely public scrutiny. All but a few important publicly held corporations are required promptly to file with the exchanges or with the Commission or both, and thereby to make available to the public press, a report of every major business event which will materially affect its balance sheet. One interesting result of these provisions is that your financial editors are given a voice of authority and a tone of conviction such as they had never previously possessed.

There is no way to measure the direct and indirect effect of the various provisions of the Securities Acts which do not attempt to regulate the mechanics of the financial markets but rather direct that the truth, and all of it, be told to investors and to the public. We know that many a deal has died aborning or has been hastily snatched back and reformed solely because its proponents came to realize that they were going to have to submit the full and true story to public scrutiny and analysis, and this they were unwilling to do. We know that many an issue was eventually realistically priced only because the story which the law requires to be told would have made it impossible to sell the issue at an inflated price.

Overcapitalization, watered stock, weird capital structures, bewildering securities rights, the use of corporate funds for improper and noncorporate purposes, abuse of corporate powers, practically all the sins in the corporate decalogue can still be committed under the Securities Acts, if the sinner is willing to stand in the market place and loudly and publicly announce that he is about to commit them. The fact is that few sinners are willing so to do, and the necessity for disclosure normally prevents the abuse.

In this process, the presence and functions of the press are a potent factor. It is not merely the requirements imposed by law for the filing of a document with the Commission in Washington or with the exchanges which accomplishes this financial dry cleaning. It is the fact that all this information is openly available to the public press, the knowledge that the press will comment, criticize and discuss the corporate facts of life so displayed, and that the wider audience thus

reached will be advised of the advent of sin, which in many cases gives real meaning to the legislative scheme. There is little doubt but that the press has thus been made a real and cogent instrument of corporate reform, and has accomplished a real public service to businessmen and to the public investor.

From another point of view, however, such voluntary reform as may thus be effected is only a side effect of the disclosure process. The primary purpose of the Securities Act, after all, is to place it within the power of both the seller and the buyer of securities to know what they are doing. A single issuer or an occasional issue may now and then successfully deceive the securities industry and the public, but it is highly improbable, if not impossible, that a whole industry can today flim-flam the country as, for example, did the electric and gas utility industry a few decades ago. Nor is it now possible, against this background, for manipulative pool operations to be carried on in the old, grand manner.

As a fourth consideration, let me remind you that there was a day when an issuing company could and as likely as not did bring out a new issue without subjecting its books to the audit of an independent accountant, and also when, even though management did condescend to employ an accountant, the issuer was under no obligation to follow his recommendations. You may read the results in the reports of the various investigations as the result of which the Securities Acts were passed. In many instances, the financial statements upon the basis of which the public was asked to advance its savings were replete with concealment, double talk and downright falsification, and when management deigned to publish earnings statements and annual reports, it was a fair bet that the truth was not in them.

Things are quite different today. The Securities Acts now require the production of adequate financial statements and insist that these statements be certified by an independent public accountant. This, more than any other single influence, probably has revoluntionized business accounting and reporting. These provisions gave the accountants an essential voice and authority in corporate matters. The American Institute of Certified Public Accountants has accepted the responsibility thus thrust upon it and has introduced and enforced high-minded concepts of independence, proper accounting practices and sound accounting principles. The issuer can no longer safely ignore the advice and recommendations of the accountant. No longer can he forthwith discharge the honest accountant and consult another

in the hope that some fundamental problem can be avoided by different accounting treatment. Sound accounting principles have been evolved by the profession and accepted as standards which must be followed by its members. These procedures and policies have produced a quality of financial reporting and a sense of public responsibility not exceeded anywhere in the world, and have made it improbable that economic reverses will result in uncovering any substantial inherent weakness in corporate finances.

As another consideration to be taken into account in seeking the answers to the questions which have been put to me, let me point out that there are other disciplines now operative in the financial market, which are of major significance though largely unknown to the public generally. Important among such vehicles are some of the trade organizations. Contrary to the general impression, these groups were not formed, and do not exist for the sole purpose of holding periodic conventions, the expenses of which are deductible items on corporate earnings statements. I have found them to be surprisingly sincere organizations of skilled technicians who are deeply interested in pooling their experience and knowledge. Some of the principal groups with which we are in continual contact are the American Society of Corporate Secretaries, the Controllers Institute of America, the National Federation of Financial Analyst Societies, the American Management Association, the Investment Bankers Association and the National Association of Investment Companies.

This aspect of the work of these organizations has a deep significance, although it does not produce the stuff of which headlines are made.

Here, as elsewhere in our relations with the people who operate under our jurisdiction, our points of view may and often do differ, but also here, as elsewhere, there has generally been an informed and reasonable attempt to adjust industry practices and standards so that they may be consistent with the interests of investors and the public. With the blessing of the S.E.C., there has, throughout the years, been a vast improvement in corporate reports to stockholders, in stockholder relations, in the quality of the proxy material submitted to security holders, in the honesty of the sales literature used by investment companies, in sound accounting practices, in clear exposition of corporate policy and in the creation of an atmosphere conducive to warm investor reception of American securities as investments and American industrial corporations as sound economic

institutions. The open discussions in forums sponsored by organizations such as I have mentioned are the very antithesis of the organized deception and deceit which at one time accompanied the fantastic operations of the securities markets.

The sixth facet of the modern market to which I would like to call your attention hinges on the existing persuasive deterrents to violations of the Securities Laws. Their presence in the statutes, and the activities of the Commission and of the courts in applying them, have for many years served to impose upon the deliberate wrongdoer and the irresponsible adventurer some important sanctions in case of misconduct. The result has been to take out of the present market a number of morally or financially unreliable operators in securities and to expose to severe penalties those who may be tempted to make hay in any kind of a disorganized market.

The Securities Act contains civil liability provisions which place personal responsibility on management for acts which individuals at one time might have safely assumed would have been concealed behind the corporate shield. The statutes permit civil actions in such cases, which are not defeated by jurisdictional limitations of the State courts. Sellers of securities are now exposed to actions unknown or most difficult to maintain under the common law. The touter has not the freedom he once had to practice his art. When the insider gains some secret information and seeks to take personal advantage of it by purchase or sale of his corporation's securities, he must disclose the transaction. Confession thus made is under some conditions an invitation for a stockholder to bring suit to recover any profit for the benefit of the corporation.

All the Securities Acts provide for criminal liabilities which have been resorted to on many an occasion to incarcerate the fraud and the cheat.

But more effective, I suppose, than any of these sanctions is the power given to the Commission to investigate, to publicize, and to comment upon actions and practices in various types of administrative proceedings. The powers which we have to suspend the right to sell an issue of securities, to revoke the right of a broker-dealer to engage in business, to suspend or revoke the registration of a security on an exchange, to suspend trading in a listed security, to apply for an injunction against prohibited conduct, all these powers place in the hands of the Federal Government a strict control which never before existed. As I

have pointed out, however, in the last analysis these are residual powers and remedies. The informal disciplines which I have described and which reflect an intelligent self-control often render direct government intervention unnecessary.

Finally, as must be obvious to you by now, since our statutes rely so heavily upon disclosure and publicity, the various media of publicity play an essential part in the preservation of orderly, sensible markets. In a very special sense, the press has a responsibility to avoid becoming the unwitting tool of those who, by tip and rumor or by untimely publicity, hope to use its columns for their own profit and advantage at the expense of an uninformed or misled public. The S.E.C. is anxious to avail itself of every means by which it can educate the investing public in the dangers of indiscriminating investment, whether in the market or outside, and it has gone to some length in this respect in the past. It has recently completed negotiations under the auspices of The Advertising Council as the result of which material will be made available for use by TV stations this Fall. We have great hopes for the success of this program.

In comparing the pre-S.E.C. market with the present one, I hope I do not appear to consider, with Candide, that all is for the best in the best of all possible worlds. We have our multitude of difficulties and problems. Nor are the Securities Acts examples of flawless legislation. In fact, we are currently engaged in a program contemplating extensive amendments to them. Nor can we always be sure that every security transaction is effected without any deceit and after full and frank disclosure. In the very nature of things, only a sort of rough justice can eventuate even under all the safeguards I have described. Nevertheless, it is clear that the situation today is essentially different from that of twenty-five years ago, and what was true then is by no means necessarily true now.

You will notice that I have made no reference to any power which we or any other person or agency might exercise to prevent a citizen from using his own judgment as to how and when he may convert his cash or other property into securities, or vice versa. Nor have I made any reference to any power to advise a citizen that he must or should do one or the other or that one security is better or worse than the next one. I would expect that a suggestion that we be authorized to exercise in this manner some sort of a paternalistic oversight would rouse a violent opposition, to which I would be hard put to advance any reasonable defense. Yet, implicit in the questions to which I referred

and which have been put to me is the suggestion that we either have, or in some way should be seeking the power to exercise some control over the judgment of the American investor as to how he should manage his property or that we should be able to circumscribe his freedom to exercise that judgment.

In the ordinary course of our daily work, we observe the market action of a large number of securities. The timing and nature of some price movements may suggest the desirability of an informal inquiry designed to determine why and what influences are at work tc produce such an action. For this reason, we keep an eye on price movements in individual issues and we try to determine whether some manipulative scheme is in process which would interfere with a free market. If evidence of manipulation is found, we take action as rapidly as possible. But supposing we find, as we very frequently do, that buy or sell orders have come into a fluctuating market from brokerage firms all over the country which orders are unrelated to each other and are obviously no part of any deep laid scheme concocted by anyone. Shall we then quarrel with the public appetite? Should we have the power to meddle with the free choice of the investor?

If a great segment of our populace becomes convinced that the only way to protect itself from the hazards of tomorrow's price level and the diminishing value of the dollar is to bid up prices so that the premium paid for the fancied protection begins to look like very expensive insurance, are we to say the collective judgment of those so spending their own money is wrong? And if the sentiment changes and the pressures come the other way, should there then be a greater duty to interfere?

Congress has, in the Securities Acts, given some important emergency powers to the S.E.C. The Commission may temporarily suspend trading in a specific security and it may, with the consent of the President, suspend all trading on any or all exchanges. Similarly, if the holders of the securities of an investment company suddenly decide to liquidate in dangerous numbers, the company may ask our permission to suspend payments for the protection of its security holders. In short, we do have some very limited emergency powers which are available in the face of a stock market panic. Whether we can or should be able to attempt to prevent a decline, even a serious decline, in market prices is another and, to my mind, a very doubtful question.

Before concluding, I think I should tell you what the Commission found out in a study which it made of the market break of September 3, 1946. This was the last occasion offering data for a serious study of this nature, and covered a day during which stock prices on the New York Stock Exchange had their sharpest decline in nine years. Our conclusions are not very comforting to believers in the "devil" theory of market breaks, the theory that every such phenomenon is caused by some evil and malignant force or by some dastardly group of market operators weaving their nefarious schemes in the back room. On the contrary, we found no evidence that the overall market activity resulted from planned or concerted action by any group or groups of persons or that the activities of any of the participants in that market evidenced anything more than the interplay of opinions as to when to buy and when to sell. Short sales were an insignificant factor. No consistent pattern of trading was found among exchange members: some member groups were sellers on balance, others were buyers. Finally, we were unable to find any evidence of any sort of manipulative activity in that day's market.

I respectfully submit that Congress quite properly refused, in 1933 and 1934, to give to the S.E.C. any paternalistic functions. I have my own personal ideas as to some of the values on the present market. I have already publicly expressed myself as to the sanity of amateurs who take speculative risks in the market with money they cannot afford to lose. They might just as well put up their money at Laurel or Las Vegas. I cannot visualize any legislation which would protect the American investor against a falling market, nor can I conjure up any reason why, or any mechanism by means of which Congress should try to build a ratchet into stock market prices which will prevent their decline. Prices have gone up, they have gone down in the last twenty-five years. In the presence of a free market, there is every indication that they will go up and down in years to come. However, for the reasons I have given, I am inclined to doubt that, in the absence of international catastrophe, we will see a repetition of the market of the early thirties.

Of course, I could be wrong.