

"1949 AND THE SECURITIES BUSINESS"

A TALK

by

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before the

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When I say to you that I am very happy to be here this afternoon and talk to you, the Stock Brokers' Associates of Chicago, I am giving voice to a very sincere sentiment and expression of my own personal feelings.

Since the inception of corporate shares and the chartering by the various kingdoms and commonwealths of divided enterprise, there has necessarily had to be a trading or a bartering in such shares or securities. The institution of the stock exchange, as we know it today, is a result of great evolutionary changes. The very word "stock exchange" has a tendency to electrify the thoughts of the individual. There has been, and still remains, a great deal of romance in the very concept of stock trading. I, personally, have always regarded the mechanism of a stock exchange, i. e., the free market for the buying and selling of securities, as a great instrumentality in our economic system. An instrumentality, if you please, that must be guarded carefully that it not be the object of public scandal and public ridicule so as to deter its intended purpose.

You, as a group, represent Chicago. You are all interested in the securities business. You represent a very vibrant part of Chicago's citizenry, and I am most happy to be here to talk to you about a few of the problems the securities business faces in 1949. They are your problems and they are the Commission's problems as well.

You are undoubtedly familiar with my personal background, being that of a business man and investment banker for many years. It was my pleasure for several years to be a member of the Detroit Stock Exchange. All this happened, of course, prior to my appointment to the Securities and Exchange Commission. I truly believe that I should have and do have an understanding of your problems; and, speaking for the other members of the Commission - while their backgrounds may be different - they too have an appreciation of your present day market difficulties.

For reasons which even our most expert observers cannot fathom, the investment industry today is not sharing the nation's unprecedented prosperity. Its participation in the national income has declined from 3/4's of 1% in 1929 to only 1/10 of 1% in 1947. In 1929 the investment industry earned 644 million dollars; in 1947, less than a third of that amount \$(198 million). At the same time, the number of people engaged in the investment business has diminished by fifty per cent.

The Baltimore Stock Exchange has recently announced its merger with the Philadelphia Stock Exchange. There have been rumors of plans being discussed in the midwest for further consolidation of operations. This represents a contraction of facilities undoubtedly made necessary by a diminished volume of business.

Over twenty years ago, on November 23, 1928, I am told the Chicago Stock Exchange experienced its first half million share day. The following year there were days when volume of trading exceeded a million shares, and a seat on this Exchange sold for well over \$100,000. I can recall when a seat on the Detroit Exchange sold at almost such a figure. Today a million shares is an active day on the Big Board. The volume of activity on the New York Stock Exchange is a weather vane for the whole industry, and everyone connected with the securities business is concerned about its present condition.

We happen to be living through a period in which the investment habits of the nation are changing. The prosperity and possibly the survival of the investment industry will depend upon how well it senses the direction of this change, and how it adjusts to it.

You are the link between what is known as the "issuer" and the customer. No one is as close to the picture as you. I don't have to remind you that the selling of securities seems to grow more difficult each day. In that connection, one of the members of the staff reminded me that learning the

securities business is like Mark Twain learning the pilot's trade in "Life on the Mississippi." You will recall that Mark Twain writes that he had to learn the river all the way down, and then he found it looked altogether different coming back up. It was different by night and by day. It looked different in the fall than in the summer, and in the spring the torrents washed banks away and formed new channels and he had to learn it all over again. And so it goes.

For one thing, the character of the securities you sell has been changing. Security trading has progressed through wild-cat banks, the railroad days of Gould and Fisk, the fabulous mining ventures, the era of the "coal oil Johnnies," the local legerdemain of the street railway financing, the public utility holding company expansion of the 20's, and the Bolivian and Peruvian 8's of the same period.

Today you trade in what has become a pretty highgrade list of industrial and utility securities, whether they be listed or over-the-counter.

Then again, your customers are changing. The changing income pattern in our nation means that more people have more money, and fewer have lots of money. Our high standard of living means that more and more people have a little left over for savings. It is these savings which are needed to finance enterprise in this country. The staggering sums required to maintain the largest industrial plant in the world have become too great for a relative handful of people to supply. The billions upon billions of dollars required each year can be found only in the mass savings of all the people.

The investment industry is awakening to this revolutionary change in its market. About a year ago in a talk in New York, I was able to document this transition with facts and figures. There has been a definite income shift in this country. In their search for security, over a third of the people's savings goes to the insurance institutions, to be reinvested in

securities. But there still remains a pool of individual savings available for investment which far exceeds any demand of the capital markets. Only a fraction of this vast potential supply is today being tapped by our investment banking channels. Last year only one and a half billion dollars were invested in new security issues out of liquid savings of individuals totalling over 8 billion dollars. We also find that the rate of direct investment in securities has not been keeping up with the rate of savings. To me this indicates just one thing - those who sell securities are not approaching the people who have the savings.

Increasingly, one hears that brokers must learn to understand and tap this strange new mass market. J. A. Livingston, a prominent financial writer, recently chided the industry for not applying its analytical talents, used so skillfully in appraising the corporation securities it sells, to discovering and analyzing this new market for securities. A survey recently by the Federal Reserve Board showed that most people in this country do not even know what common stock is. A surprisingly high percentage of those who indicated familiarity with common stock disapproved of it as a form of investment. Still fewer people know how to go about placing a simple buy order. There was a time when a brokerage house boasted about its prominent customers. Today, the tendency is to point to the number of shop foreman, small shop keepers, and housewives in the accounts. If we expect these people to take an interest in the market and invest their savings in it, perhaps we had better begin by letting them know what the market is. It's, I suppose, a merchandising job. The public must be taught the ABC's of investing. It is not an easy job. But the prospective rewards are large and there is opportunity to perform a service to our economic system by providing industry with the capital it needs.

Introducing these new people to security investment will require aggressive selling techniques. But this should not call for high-pressure selling. Salesmen have a high responsibility to deal fairly with these people. If they do not, this new market is likely to be destroyed.

Salesmen of necessity should be well informed. The rapid growth of the statistical department is proof that the investor today seeks more information. The market letters produced by these departments are helpful. Unfortunately, they occasionally are not as accurate or complete as they might be.

I came across a particularly shocking one recently, prepared by a well-known eastern house. It purported to be an analysis of the second preferred stock of American & Foreign Power, a subsidiary of Electric Bond & Share. The story this market letter told was alarmingly incomplete. There was no mention, for example, of the proceedings in which the company is involved under the Public Utility Holding Company Act. There was not even a hint that a plan of reorganization had been formulated which drastically affected the rights of this particular stock. Such omissions are inexcusable. Worse still, from your point of view, they hurt, rather than help, the security salesman who tries to use them. Inevitably they boomerang.

Even if the market letter were a perfect selling document, it is not a substitute for informed selling. It is equally important that each salesman be his own statistical department. The securities laws do not prevent effective selling. They are a bar only to carelessness and misrepresentation. The salesman should be able to supply information and to express a well-founded opinion if necessary. In this connection, I know from my own experience that there are security salesmen who make it their business to inform themselves fully about the security they are selling. But there are others, and we all know them, who are satisfied to take a quick look at the market letter, listen to a couple of rumors, and grab for the telephone.

Of course, things have grown so complicated that it isn't enough for you to know just particular company situations. You are expected to be something of an accountant, tax specialist and lawyer. You must be an expert on government fiscal policy, appreciate fully the significance of the changing value of the dollar, know all about contract renegotiation, Regulation T, and be able to appraise things like "refundable Federal Taxes on income of prior years arising from the carry-back of operating loss." And of course you must be up to the minute on the general political and economic outlook. These are only some of the ingredients that today go into servicing an account. Is it any wonder that the name "customers' man" has been found inadequate? From time to time the industry has searched for a new title to designate this keyman in the shop. One large eastern house recently came up with the term "account executives;" which I thought at first was another case of "if you can't raise their pay, either raise their title or make them a partner." But on further reflection, I rather agree with that thinking.

There have been many suggestions for broadening market interest. Stock splits are generally accepted as a way to increase market activity. This method has been followed by a fairly steady number of large corporations in recent years. Some years ago in Detroit it was observed that the big investors were fast disappearing and that more and more equities were showing up in trust funds and estates where trading, as you know, is reduced to almost nil. Investment dealers therefore encouraged the low priced stock, and that has become fairly standard among the motors which make up a large part of the Detroit market.

The extent to which lower priced stocks increase market activity depends in some measure on commission rates. This, of course, brings up the whole question of fees and commissions.

I had the staff check for me some of the early history of fees and commission rates. Here is an interesting item which they turned up. It is the agreement made in 1792 between the various members of what then constituted the New York Stock Exchange: -

"We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one quarter percent Commission on the Specie value, and that we will give a preference to each other in our Negotiations. In testimony whereof we have set our hands this 17th day of May, at New York, 1792."

From this you can see that even back in those days the keen competition in this industry required that the members be bound to an agreement setting a minimum rate. The 1/4 of one per cent rate lasted for many years - until 1856. For a brief period during the Civil War a brisk market made it possible to lower the rate to 1/8 of one per cent.

The per share basis and the sliding scale type of rate did not appear until just before the First War. This scale became more complex with each revision. In 1947 the new rates were adopted, based mainly on the money value of the transaction rather than on the number of shares involved. In a sense, this was a return to the original concept of "one quarter percent ... on the specie value." However, this simple basis is combined with a sliding scale having numerous categories. As everyone knows, it is perhaps the most complicated schedule ever adopted.

It is too early to say how the new rates will eventually work out, particularly as they might affect the volume of market trading. Higher rates do not necessarily bring greater revenue. Where people buy for investment, the commission is usually an insignificant part of the cost. But widespread trading - and that is the bread and butter of this business - is discouraged by high commissions, which eat up principal.

The S. E. C., as you know, does not set commission rates, although under the Act it is empowered to order a modification if "necessary or appropriate for the protection of investors or to insure fair dealings in securities on the exchange or to insure fair administration of the exchange." So far, the Commission has never used that power. As a matter of practice, when an exchange is considering a change in commission rates, it will usually bring its proposals down in advance for informal discussion. These discussions may produce some modifications before final adoption. When they are adopted, they are the rule of the exchange, to be enforced by the exchange. They are not the rule of the S. E. C.

I am conscious of the fact that this audience is composed of people who each day are confronted in some manner with regulations promulgated by the Securities and Exchange Commission. One of the things which seems to raise a general query in the minds of those engaged in the business is this one, which is so often put to me . . . "Why do you send inspectors in to check the various brokerage houses?" "Can't you get sufficient information from the reports which you require?" "Why does this work have to be duplicated by the NASD?" . . . and so forth.

May I make this one observation? After having served two years on the S. E. C., and having come daily in intimate contact with not only the other Commissioners but the directors and staff members of the various divisions, I am satisfied that they have only one, sincere purpose - and that is to be constructively helpful.

On the other hand, after many years in the investment and security business, I know for a fact that security dealers possess as high a degree of honesty and integrity as any other professional or industrial group in this country. The average security dealer, and salesman, and customer's man, has the genuine interest of his customer at heart. But there are exceptions.

And these exceptions, generally by virtue of publicity given to their acts, go a long way toward creating a suspicious attitude on the part of the public. For this reason, it is imperative and for the good of all that periodic inspections be made and the dishonest fringe discovered and eliminated. Let me give you an example of the kind of thing such inspections may turn up -- situations which, incidentally, would never show up in the periodic reports. It demonstrates that the best intentioned house may not be able to protect itself against certain types of fraud. This story not only involves a customer's man but several individuals, two or three on the outside. I am referring to the fraud against the Keystone Custodian Funds recently uncovered by the Commission.

It all began with two routine investigations - a broker-dealer inspection and what we call a flying quiz into a suspected manipulation.

As you know, the S. E. C. maintains constant surveillance over the market and whenever unusual activity in a security is noted for which there is no explanation, an immediate check is made. In this particular case a normally quiet stock on the New York Stock Exchange suddenly jumped from 5 to 7. One of our investigators was assigned to look into the trading.

At about the same time another investigator was inspecting the books of a brokerage house which we shall call A. In checking customer blotters he came across a technical violation of Regulation T in which stock had been purchased for an account and resold at a profit the same day but no money had been paid by the customer to cover the purchase the stock. He found several similar instances in that and in another account. In each case, the stock had been purchased from or sold to a second brokerage firm - B & Co.- which becomes the central firm in the picture. The investigator learned that both accounts had been introduced to broker A by a customer's man of B & Co. and that he had also supplied the orders.

Meanwhile, the manipulation investigation revealed that this same customer's man had effected substantial purchases of the stock in question for numerous accounts in several different brokerage houses, that the stock had been resold almost immediately from all of these accounts, and that the purchaser was Keystone Custodian Funds, a registered investment company. The Keystone purchases had been executed on the exchange by other brokers. Inquiry at B & Co. revealed the coincidence that this same customer's man serviced their Keystone account.

The plot started to thicken. Two frauds were suggested at this point:

First, the transactions uncovered by the manipulation quiz suggested that the customer's man had advance information about Keystone's proposed transactions in time for him to act thereon.

Second, the broker-dealer inspection served to indicate that a fraud was being perpetrated on customers of B & Co.

The two lines of inquiry were tied together when further investigation revealed that in each of the in-and-out transactions, Keystone was the ultimate purchaser.

At this point Keystone was asked for the details of each purchase and sale made by it over the past year. A comparison of the transactions in the questioned accounts indicated that they had been used exclusively for in-and-out trading invariably at a profit in securities contemporaneously bought or sold by Keystone. It was also possible to uncover several other accounts of this same type with other brokerage houses and to associate them with the customer's man.

Now the pattern was clear - but who was supplying the customer's man with his information? A study of the time slips, giving the exact time each order was placed with the broker for execution, and the time of execution, showed that the leak was at the Keystone end; and other lines of inquiry -

cancelled checks, toll slips, etc., finally pointed to one man - a trader for keystone.

When confronted, he confessed. His confession was so broad as to clearly involve the customer's man and also another brokerage firm.

It will be a while before all the transactions are unravelled. The profits of the fraud are estimated at about \$300,000, of which commissions and expenses constitute almost \$200,000. The Keystone Custodian Funds and its management are, of course, in no way implicated.

Broker-dealer supervision by the S. E. C. is only one phase of the work assigned to that body. The S. E. C. administers seven different statutes. It is a busy place, and may I assure you that the intent and desire of those connected with it is to be helpful in every manner possible to people engaged in the legitimate distribution of investment securities. I have always personally conceived of the S. E. C. as an affirmative, positive force rather than a restrictive, policing one. As I see it, it is the function of the S. E. C. to guide the financial practices of America's business corporations and those who deal in their securities. Its object is to maintain, so far as humanly possible, public confidence in our business institutions and in the integrity of our financial markets. Its purpose is to facilitate the application of the nation's savings to the sustenance and growth of our economic life.

It has been a pleasure to appear before you here this afternoon and express to you a few of the thoughts in which you might have some interest.