

ADDRESS OF
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To The
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When I received your invitation to come and tell you something about the work of the Securities and Exchange Commission, I could not help thinking back to the days when I was a student here. They were particularly hectic for me because I had a job during the summer that required me to work seven days a week and the hours were quite long. As a result of my labors, I accumulated a little nest egg and upon the advice of my employer, I purchased stock known as United Founders. I believe that I had enough money at that time to buy five shares, and it was selling for \$33 per share. This issue had a rather spectacular career, and when it reached \$66 and I had doubled my money, I sold and then wondered what to do with the cash proceeds. I had enough money for the first half semester tuition, but I had to make sure about the money for the second half. I got to thinking about a good safe investment and finally a spark was illuminated. Why not invest in the electrical industry since they had no competition, the rates were favorable, and it certainly had a future. As a result, I bought a utility at the highest point it ever attained and within a month came the crash of 1929. I was not only wiped out -- I was desiccated.

It is a rather curious circumstance that with this youthful and rather traumatic experience as a wizard of finance that I should now address you some years later as a Commissioner of the Securities and Exchange Commission. Now, what happened? Without going into any great detail, the facts are that this nation went on an economic binge and suffered from a prolonged hangover. Our sense of values underwent considerable revision; a mirage of prosperity which had obscured our social thinking vanished; and the people began to think in terms of human rather than property rights. During my student days there occurred a political, a social, and an economic revolution. The Commission was a product of these revolutionary forces.

We Americans have no genius for preventive justice. One of the most striking phenomenon of the American political system is reform by way of scandal. And so, out of the market crash of 1929 and the ensuing depression came securities legislation. Congressional investigations into the causes of the crash uncovered incredible examples of manipulation of stock market prices, disregard of fiduciary obligation, and down-right fraud.

The first law enacted, the Securities Act of 1933, dealt with securities sales. It required, briefly, that complete and accurate information be furnished any person being offered a security. The legislation followed the English system which has been in operation for over one hundred years and provides for full disclosure as contrasted with the various future "blue-sky" laws which attempt to go into the merits of a particular issue. The second law enacted, the Securities Exchange Act of 1934, regulated among other things the stock exchanges and transactions on those exchanges. It is the stock exchanges that I would like to discuss in more detail with you this morning.

The operation of an exchange today is necessarily complicated, but it should not be mysterious. The exchanges themselves are anxious to educate the public about their activities. In essence, the stock exchange is just a place where buyers and sellers of stocks may get together to transact business. If you have an opportunity and have not already gone to the Stock Exchange and the Curb Exchange in New York, do so by all means. The exchanges are nothing more than an open area in a building that contains various posts. Particular stocks are traded at each post and some posts may have as many as fifty stocks traded at it -- each post being numbered. There are stock exchange employees stationed at each post to take from the specialist sales and purchases and the name of the stock, which is in code, and the price at which it was sold and purchased. This is transmitted to a room upstairs where this information is typed on a ticker tape which is then flashed across a screen on the floor and simultaneously impulsed to thousands of

other stations throughout the United States. Because of the multitude of transactions and the number of exchange members consisting of traders, brokers, dealers and their clerks, there are several people on the floor at one time while the trading is in progress. There is a large board that signals telephone calls and a horn honks and there is a flash covering the number that is pulsating making another type of noise, all of which adds to the general confusion which apparently exists to the untrained eye. In another part of the exchange, securities which have been bought and sold are exchanged through a clearing house which operates very efficiently and closes transactions three days following the sale. There is a proposal to extend this period to four days. The exchanges themselves have nothing to sell, although some Mid-Westerners seem to feel that livestock are bought and sold on the "stock exchange."

All exchanges are now indoors. At one time, however, they met in the open air. The New York Stock Exchange first met under a buttonwood tree at 68 Wall Street. The New York Curb Exchange originated as a hysterical-looking group of brokers who met each day in William Street in downtown Manhattan. As late as 1920 their activities were described as follows:

"In the street a jostling mass of human beings, fantastically garbed, wearing many-colored caps like jockeys or pantaloons, their heads thrown back, their arms extended high as if in prayer to some heathen deity, their fingers working with frantic symbols, their voices crying in agonized frenzy, and at a hundred windows in the great buildings on either side of the street little groups of men and women gesticulated back as wildly to the mob below."

Moving indoors, the exchanges acquired more respectability. But, they also increased their influence upon our national economy and their opportunities for good and evil. The credit mechanism of the nation became inextricably linked with the exchanges,

and industry, trade and millions of plain people like you and me became dependent upon their proper functioning. It is estimated that today four out of five securities transactions, apart from government bond sales, take place on stock exchanges.

When a purchase is made on the New York Stock Exchange, which handles about eighty-five per cent of all exchange business, the report of that purchase is flashed within minutes to the ticker services located in thousands of offices throughout the country. In these offices thousands keep a close watch over the trends. Business prospects, money for expansion, inventory purchases, financial policies may all depend upon the market trend.

Prior to the enactment of the Securities Exchange Act these trends were sometimes artificially induced. The exposure of the extent and effect of manipulative practices upon the organized exchanges was one of the most important accomplishments of the legislative investigation into stock market abuses which led to the Securities Exchange Act. Various methods, singly or in combination, were used to manipulate prices.

Most commonly, three or more people would get together and form what was called a "pool." They would agree to engage in concerted action to raise the price of a particular security by making purchases and sales in such quantity it would attract members of the public, who would invest in the company. Then, after stock had been accumulated and the price pushed up, the pool stock would be quietly unloaded and the public left with the inflated securities. As an added fillip to this procedure, the pool would sometimes sell short after it had finished disposing of all the pool stock, covering when the price went down to its normal level. In that way the public would suffer coming and going.

An example of the way this works is as follows. A broker gets an order from one of the public to either buy or sell a certain stock. He approaches the trading post to talk to the specialist to find out about what the market is without indicating whether

he has a buy or sell order. The floor trader whose sole function is to buy or sell to his own account, and not for others, follows the broker to the post. In concert with others, and from whatever information he maintains, at the closing minutes of the trading all the electrical stocks are hit with offers to buy at prices above the current number. The result is that when trading ceases for the day, the headlines of all the financial papers of the country are to the effect that the electricals closed strong. The result is that the interest is whetted in all electricals. Now, the scene shifts to Kansas City or California and this information, due to the lag in time, is noticed by a station out there. He calls his broker and says, "What is this about the electricals being strong?" Now, the broker does not live who says, "I don't know", because if he does not sell the order, he knows that the customer is going to some other broker and the other broker is going to give him the inside information. Therefore, he usually tells his customer, "Well, they say--". Thereafter, the customer decides that it might be a good idea to buy some electricals to get in on the rise and places an order which will be on the post when the market opens. Duplicate this process several times, and it can easily be seen how the trader will make a profit on this kind of transaction. During 1929 over 100 stocks listed on the New York Stock Exchange were subjected to one or more such operations. The returns were fantastic. One pool, in a seven day period, bought and sold almost 1,500,000 shares of Radio Corporation, at a gross profit of over \$5,500,000. The net profit, distributed to the members of the pool was almost \$5,000,000.

The tools used by the pool were wash sales, matched orders, tipster sheets and rumors. The wash sale is a transaction in which the same person is both buyer and seller. The matched order is a prearranged transaction between two members of a pool. By these devices the pool could show great activity in the security and could force the price to a desired level without incurring any real obligation.

The tipster sheet assumed various forms. Although the nature and extent of a pool's operations were shrouded in complete secrecy, the participants used brokerage house market letters, investment advisory services, trade papers, and newspaper publicity to attract and excite the public towards a security. But they were clever. The market letter never advised the purchase of the stock. It simply used statistics and favorable comparisons. And as any student of psychology knows, a person who thinks he had independently reached an important decision is much more likely to insist upon implementing it. The newspaper writers and trade paper publishers were often given a participation in the pool profits for their assistance in building up interest in the stock. One member of Congress produced documentary proof that one of the pools spent almost \$300,000 upon newspaper people to obtain the publication of articles about a security.

The first English case of manipulation is perhaps the classic one. It was decided in England in 1814, and involved false rumors concerning the Napoleonic Wars. Each rumor of victory for the Allies raised stocks. Each rumor of defeat depressed their prices. One day in late February, 1814, a man dressed in military uniform arrived in Winchester from Dover, scattering gold among the postillions. He let it be known, after questioning, that Napoleon had been killed and the Allies were in Paris. Shortly afterwards, two other men dressed as French loyalist officers arrived with similar tidings, and then disappeared.

Of course, the market rose with the news and fortunes were made by persons holding the proper securities. Upon investigation by the Stock Exchange, however, it was discovered that the whole procedure had been an elaborate play, designed just to raise the prices of stocks so that a young naval officer and his friends could extract large profits. The naval officer and his confederates were tried and convicted of a conspiracy to raise the price of Government securities. Their defense, that the Government was not harmed, was rejected. That case established in Great Britain the concept of a free and open market.

As early as 1907 there was considerable agitation in this country to outlaw manipulative practices by legislation. In that year President Theodore Roosevelt sent a special message to the Congress urging the regulation of stock market speculation. But it was not until the administration of another Roosevelt that a bill was finally passed providing for any degree of control over the exchanges.

Insofar as manipulation is concerned, the Securities Exchange Act specifically makes illegal wash sales, matched orders or any other device designed to create a false or misleading appearance of active trading in a security. It likewise makes it a criminal offense for any person, either alone or in concert with others, to raise or depress the price of a security for the purpose of inducing the purchase or sale of the security by the public. The staff of the Commission is constantly alert to detect any unusual activity or any unusual market movements. At the first sign of such activity it institutes an investigation.

The Act also makes it unlawful to circulate rumors or reports concerning market operations designed to raise or depress prices. In order to increase the effectiveness of these prohibitions against manipulation, violators are not only subject to criminal and injunctive action initiated by the Commission, but they are civilly liable in damages to any person who purchases or sells a security at a price which was affected by the violation. The claim for damages which might be made if one of the old manipulative practices were undertaken staggers the imagination. A few thousand dollars worth of transactions might result in judgments aggregating millions of dollars.

The Congress also took steady aim in the Securities Exchange Act at short selling. Short selling is a device whereby a person sells stock which he does not own, anticipating that the price will decline so that he may purchase it at a lower price to complete his contract. The actual mechanics of a short sale work

like this:

An order is given to a broker to sell a stock short. This order is transmitted in the usual fashion to the floor of the exchange, executed, and recorded just like any other order to sell. The purchaser is unaware that he is buying from a person who does not yet own the stock. By the rules of the exchange, in the ordinary case, the seller must make delivery within three days. Since he has no shares to deliver, his broker arranges to borrow some stock for him and delivery is made with the borrowed stock. When, subsequently, the short seller decides the time is ripe, he orders his broker to cover the short sale by buying the stock in the open market and delivering it to the lender.

There is considerable difference of opinion upon whether short selling serves any economic function. The feeling of many persons is best expressed by a bit of doggerel credited to one of the nineteenth century financial robber barons which went like this:

He that sells what isn't his'n
Must buy it back or go to prison.

Implicit in this is the recognition that there is something immoral in selling something which must be borrowed. England, France, Germany and Holland all at one time or another banned this practice. In this country various states also attempted, during the nineteenth century, to prohibit short sales. But each country and each state ultimately repealed their prohibitions.

The proponents of short selling contend that this practice stabilizes the market. The short sellers form the only group of people in the market who must buy, and in a crisis this force forms a cushion against complete deterioration of security prices. The opponents of the practice have compared this to knocking a man down and then placing a cushion under him to keep him from being uncomfortable. They contend that short sellers accentuate every market trend, for they sell when the market is going down and cover when it goes up.

In enacting the Securities Exchange Act, Congress found it impossible to discover where the truth lay between these conflicting views. Accordingly, it simply gave the Commission authority to prescribe suitable rules and regulations to govern short selling.

The Commission, after studying the erratic price movements of the market in 1937, came to the conclusion that certain types of short selling, at least, were destructive of market stability. It, therefore, adopted detailed rules designed to eliminate such types. Briefly, these rules provide that short sales may be made only at prices above preceding sales of the security. This prevents short sales when the market is moving downward, and permits short sales to act as a brake upon a speculative rise.

There are, of course, numerous exceptions. The Commission has recognized, for instance, that the odd lot dealer must sell short occasionally. As you may know, an odd lot dealer is a person who buys and sells less than a round lot, which is usually 100 shares, exacting a small profit for the service. When his total of odd lots equals a round lot he usually executes the round lot transaction on the exchange. These dealers do not, however, wish to speculate. Accordingly, it is their practice to execute the round lot transaction as soon as their accumulation of odd lots approximates the round lot. Thus, they may have purchased only 91 shares of stock when they decide the market movements require them to dispose of these shares. Since a round lot, 100 shares, must be sold, the odd lot dealer may be temporarily short 9 shares. No one has suggested that short selling restrictions should hamper him in the carrying out of his legitimate function.

Other exemptions from the short selling restrictions are also provided for in arbitrage transactions (i.e. simultaneous purchases and sales on different exchanges) and where the seller owns the security and intends to make delivery "as soon as is possible without undue inconvenience and expense."

These rules seem to have taken the caffeine out of the short sale. The Commission found, when it investigated the stock market break of September 3, 1946, that short sales amounted to no more than 1.5 per cent of all sales that day. So small a percentage could hardly have had much influence upon the market. Prior to the short selling rules it was estimated that the short interest on some days accounted for as high as 30 per cent.

I do not wish to imply that the Securities Exchange Act and the Commission have found the answers to all of the problems of stock exchange regulation. Like any industry which is not static, each change in the temper of the times brings with it its own problems. Today the exchanges and the Commission seem to have a mutually satisfactory relationship. Both cooperate in the solution of the problems as they arise.

But it was not ever thus. The exchanges fought the adoption of the Securities Exchange Act and for a short time after its passage continued to act as a private body responsible only to its members rather than a public institution with responsibilities to every investor.

Again it was a scandal and an investigation of that scandal which brought in its wake necessary reform. Probably no member of the New York Stock Exchange enjoyed greater prominence and prestige during the 1930's than Richard Whitney. From 1919 until he was suspended in 1938, he was a member of its governing committee. From 1930 to 1935 he was President of the Exchange. Ironically, he had even been, for a number of years, a member of and Chairman of the Committee on Business Conduct.

Beginning in 1926, however, Richard Whitney had misappropriated the securities of customers, including those of his father-in-law, and trust funds entrusted to his care so that by 1938 his accounts showed almost \$500,000 illegally pledged as collateral for personal or firm loans. For three and one-half years prior to 1938, the firm had been insolvent, but it continued to

do business, jeopardizing each dollar given it by a customer. In the last year he worked out over 100 loans totaling \$27,000,000 -- in order to escape detection. Though other members of the exchange were aware of this, they maintained an "unwritten code of silence." Ironically, it was a groundless rumor that led to the discovery of the embezzlements. On the day the firm was finally declared insolvent and suspended from the exchange, its deficit was over \$2,500,000, and, in addition, Richard Whitney had a personal deficit of over \$3,000,000.

The investigation into this failure revealed that Richard Whitney, like many lesser and less sophisticated speculators, had been guilty of guessing wrong about the market movements. As his personal speculations failed, he was driven, more and more, to the misappropriation of clients' funds. Ultimately, he was indicted, and convicted of grand larceny. It is a familiar, sordid tale. But the prominence of Richard Whitney and the scale of operations made this one different.

Prior to the Whitney investigation, the Commission had recommended a reorganization of the Exchange to better reflect its public nature. The Exchange had responded by appointing a committee to study the problem. The committee had recognized the validity of the Commission's recommendations and had drawn up a plan for a modern administrative organization. But, before any action could be taken, the Whitney scandal broke. After that it was a foregone conclusion that the reorganization would take place.

Under this plan, which is in effect today, the New York Stock Exchange has a paid non-member president, executive staffs to carry out functions formerly conducted by exchange members sitting as committee members, direct representation of the public on the board of governors, and increased representation on the board of governors of exchange firms doing business with the public. A similar administrative structure governs the other large national securities exchanges,

All this was accomplished without resort to the compulsory processes provided in the Act. In fact, in the entire history of the Commission there is only one instance in which the Commission has been compelled to resort to formal proceedings to force a stock exchange to adopt a necessary rule. This is a tribute to the public spirit of the exchanges.

The one dispute related to the practices of "multiple trading." As you know, many securities listed on the New York Stock Exchange are also traded on nineteen other regional exchanges. The constitution of the New York Stock Exchange subjects to suspension or expulsion any member who "deals publicly outside the Exchange in securities dealt in on the Exchange." Under this provision, the Exchange in 1940 barred its members from trading on other exchanges in stock listed on the New York Stock Exchange, except when executing brokerage transactions. The Commission thereupon instituted public proceedings which resulted in an order compelling the constitutional provision to be amended to permit multiple trading.

In the remaining minutes I should like to discuss with you some of the current problems facing the Commission. One of these, to which we give the jaw-breaking title "Limitation and Segregation of Functions of Exchange Members," is as old as the Act itself. It deals with the question whether any person should be permitted to combine the functions of a broker and a dealer. A broker acts as an agent in a transaction and receives, as compensation, a commission. A dealer buys and sells for himself, either to other brokers or to his customers, just like any merchant who has any other commodity to sell. His compensation is the profit he realizes from the difference between the sales price and his purchase price. Of course, no person is permitted to act as both a broker and a dealer in the same transaction. He may not sell from his own inventory to a customer he is representing as a broker. Obviously, that would place an undue strain upon his responsibility, as a broker, to buy at the best price possible.

However, even if he is not a broker and dealer in the same transaction he may be placed in a position of conflicting loyalties. Thus, a broker who trades for himself may furnish his customers with investment advice inspired less by considerations of their needs, than by the exigencies of his own position. Or, he may buy for himself instead of for his customer at low levels. Or, his customer's credit balances may be endangered by risks he incurs as a dealer. A complicating factor is that the average investor is too infrequently aware of the distinction between the broker and dealer.

As a method of safeguarding the investor from dangers of this type, complete segregation of function has been suggested. Persons acting as brokers would under this proposal be prohibited from acting as dealers. Similarly, dealers could not act as brokers. Opponents of the plan point out that such a proposal would seriously disrupt the country's financial machinery, since a great majority of all the persons in the securities business in the United States combine the two functions. The Commission in 1936 decided against the segregation of these functions.

Another aspect of the same problem is the dilemma posed by the specialist who acts both for his own account and as an agent for others. Legend has it that the first specialist was a member of the New York Stock Exchange who broke his leg. Since his mobility was restricted, he took up a position at the spot where one of the most active stocks, Western Union, was traded. He soon became so expert other brokers asked him to handle orders for them. At any rate, ambulatory incapacity is no longer a prerequisite to being a specialist.

Every stock dealt in on the New York Stock Exchange has at least one specialist; stocks which enjoy considerable trading activity have as many as six competing specialists; and some specialists handle as many as 50 stocks.

It is the role of the specialist to prevent wide spreads in bid and asked prices and to maintain a continuity market in the stock. He stands at his post all day, meeting all comers, and being ready with a bidding or an asking price at all times. Both for their own account and for others, specialists transact a substantial percentage of all the business done on the floor of the exchange.

As a broker, the specialist is usually entrusted with those orders which are not market orders; that is, orders to buy or sell at the current price. He keeps a record of these orders, which underlie every market, and thus is in an excellent position to judge the technical position of the market. He can tell whether a comparatively mild selling spree will set in motion a series of other selling orders, which he is instructed to execute only if the market declines to a certain level or, vice-versa, whether a mild upsurge will set in motion other orders which will continue or stop the upward trend.

Before the passage of the Securities Exchange Act, the specialist was a valuable member of any pool engaged in manipulative activity. Since 1934, however, the Commission has found little evidence of such activity. The chief complaint against the specialist today is that he possesses "unfair" opportunities for profit from trading as a dealer, and he should therefore be restricted to a brokerage function.

The Commission, believing that the specialist renders a useful service, has taken no action in this respect. But it has recommended rules to the exchanges, all of which have been adopted, under which the specialist is subject to strict supervision. He must be registered as a specialist with the exchange; he must engage in only such activity as is necessary to the maintenance of a fair and orderly market; and he may not disclose the record of his orders to other persons.

Such studies as we have made since the adoption of these rules have indicated that they are sufficient to protect the public.

But these and other problems are continuously reexamined by the Commission with each new development in the securities markets. The vision of those in control of the exchanges must be kept equal to the inventive genius of those who would promote the abuses that Congress has outlawed. Our philosophy is quite simple. We seek only to enforce honesty in security dealing, to prevent abuses before they occur whenever possible, and to punish overreaching by persons who ignore their fiduciary responsibilities.

There are other problems in connection with stock exchanges. The problem of the traders who roam around the floor buying and selling for their own account and competing for stock on both ends with brokers who are handling the business of the public, is a very real one. At the present time, theoretically at least, if a broker and a trader get to the post at the same time with the same price on the buy side, the broker is allegedly entitled to the stock. No one knows how this actually works. There is a custom of flipping a coin to see who gets it. It is on the sell side that the problem becomes much more acute, and there are those who hint broadly that the traders will always get rid of their stock before a broker can sell it on behalf of the public. However, the Stock Exchange is more and more aware of its role as a public institution and much is being done to overcome the "private club" theory. The Stock Exchange has hired public relations counsel and an advertising agency to sell its place in our economy and the service that it renders to the public. Previously, the activities of the exchange could be observed through a catwalk through a hole in the floor, but at the present time, a new room has been added where the public is catered to and movies are shown on one phase or another of the stock exchange activities. It is hoped that this trend will continue and that the stock exchanges and the trading in securities will all be as open as a goldfish bowl, because it is my considered opinion that when this happens, the public will really have the confidence in the stock exchange and the trading in securities as a public institution.