NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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HOLD FOR RELEASE: 1:30 P.M., EDT, Tuesday, March 12, 1974

CONFIDENCE AND LIQUIDITY

An Address By

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Securities and Exchange Commission

March 12, 1974

PBW Membership Conference
Bellevue Stratford Hotel
Philadelphia, Pennsylvania

Ever since I became Chairman and, I am sure, even before that, the securities industry has been sending the folks back in Washington a message that these are not particularly pleasant times for the industry. There is some justification for that view. The markets are down, and have been for some time, and changes and, even more, threats of changes, both in the nature of our markets and the rules under which you must operate, are occurring at a frightful rate -- so much so, in fact, that many of your number, who these days primarily are concerned about staying afloat and, hopefully, turning a profit -- as you rightfully should be -- would like to put aside considerations of the nature of these changes and their meaning, until a later time, when calm reflection may prevail. We at the Commission, like you, keep waiting for that time.

The Commission is fully aware of the situation, and we have become increasingly concerned not only with the present and future structure of our markets, but also with the financial health and profitability of the securities industry and the morale of its members as we work toward the future. It is hard enough to struggle across rough terrain without its becoming a slough of dispondency because of uncertainty about where you are headed and whether it is all worthwhile.

Conferences such as this one, therefore, serve an important purpose. At the least, they provide the comfort of learning that you do not suffer and worry alone. At best, they provide a clearer glimpse of where we are headed and why and how we expect to get there. At this conference, you have been worrying with experts.

The liquidity crisis, which one your panels discussed earlier today, is a prime example of a current problem cutting into profitability for broker-dealers, threatening the vitality of our classic auction markets in their efficient role of value determination and facing portfolio managers with disturbing prospects. There are, however, probably two crises; one is the decline of the individual investor as a direct participant in our stock markets -- which produces one sort of undesired effects and suggests one sort of remedies -- and the other is the problem of the disposition of large blocks, with different effects and solutions.

These two liquidity crises are perhaps not totally unrelated, but they are discrete enough to permit separate discussion. This afternoon I would like to say a few words about the individual direct investor. Where has he gone? How can we get him back?

It sometimes seems that the individual investor was really only a creature of someone's perverse imagination and that, if he existed at all, he now is, at the least, an endangered and perhaps extinct species, a quaint relic of a less complex era. The nation's exchanges and securities markets, once dominated by this little understood species, have since become the province of a more powerful and knowledgeable creature -- the institutional investor -- whose interests many seem to think are antipodal to firstnamed.

Many believe that the lack of a steady stream of small orders from individual investors, combined with the strains imposed on the securities markets by the trading habits of institutions, have brought us to a liquidity crisis of major proportions. The reasons underlying this turn of affairs, as you might expect, are extremely complex, and in many instances very subtle. I would like to provide some perspective as to this phenomenon -- at least the perspective of some of us in Washington, to analyze some of the reasons for its existence; and to recount certain steps the Commission has taken, or proposes to take, in an effort to contribute to the goal of providing a healthy, fair and efficient environment for the individual, as well as the institutional, investor.

While it is true that the nation's trading markets for stocks listed on the New York Stock Exchange are dominated by institutions, individuals still own the greater proportion of outstanding equity securities. For example, while the proportion of institutional volume was increasing dramatically during the decade from 1958 to 1968, total individual equity holdings remained relatively constant, amounting to 71.7 percent in 1958, and 71.8 percent in 1968, decreasing somewhat to 62.9 percent at the end of 1972. Individuals on the whole apparently tend to purchase securities for long-term investment, while institutions tend to look for market "plays" and trends, showing no great reluctance to sell out a position when a perceived short-term has run its course.

In addition, a large proportion of the reversal that has seen the proportionate institutional share of market activity increase from 30 to 70 percent of equity volume probably is attributable to the switch to equities by pension funds, insurance companies and other institutions, and by more aggressive institutional trading strategies and, thus, to some degree, reflects new volume rather than declining volume on the part of individual investors.

Moreover, it is not easy to determine the number of individuals who have become disillusioned with traditional direct equity investments as opposed to those who have simply found investment alternatives which appear more attractive at the present time. Over the course of the last few years, for example, there has been a revolutionary proliferation of new investment vehicles competing for individual investors dollars. Among these are tax-sheltered securities (such as oil and gas drilling participations and cattle breeding programs), numerous real estate investment programs (some of which involve tax-shelter characteristics, such as the offering of citrus or macadamia nut groves, and some of which do not, such as the offering of Real Estate Investment Trusts) and option contracts, a market for which has been revitalized by the Chicago Board of Trade Options Exchange. Brokerage firms, following this trend, have set up departments to specialize in real estate and tax sheltered securities and in options, as well as their distant relative, the commodities future contracts.

Additionally, over the last year and a half, the government and corporate bond market has offered an extremely attractive alternative to equity investments. Some short-term instruments, such as commercial paper, exceeded a 10 percent return at times during 1973, while governments exceeded 8 percent. While these short term instruments are mostly the province of the institutional and larger investor, these rates are barometers of the debt market. Thus, the average return on new utility issues rose from slightly over 7 percent at the end of 1972 to 8 percent at the end of 1973, and the overall average rate for corporate bonds was 8.05 percent at the end of 1973. Even savings accounts became more competitive with adjustments to the interest ceiling which savings and loans and banks may offer customers.

It obviously is difficult, therefore, to quantify the precise incidence of individual investor disillusionment with the equity markets. Nevertheless, it is safe to presume, I suppose, that individual investors have not exactly been bursting with confidence in the traditional corporate equity trading markets over the last few years; at least, that is the conclusion many knowledgeable financial writers and professional participants in the brokerage industry have reached. The reasons for this disenchantment, which are numerous, include:

concern over the solvency of brokerage firms;

concern about the vulnerability of brokerage firms to paper work problems;

concern that institutions get all the good research, best prices and "inside information"; and, of course,

concern, generally, about the direction of the economy, most recently with the energy crisis and inflation.

Instilling individuals with confidence in our markets will be difficult, but there are grounds for a certain amount of optimism over the next few years. Let me discuss briefly some of the courses upon which we have embarked.

As you are aware, the cash and securities customers leave with their brokers are far safer today than ever before. The use of that cash is now highly restricted, while the use of those securities has been limited to certain areas by our free credit balance rule, Rule 15c3-3. Furthermore, funds and securities left with brokers are guaranteed against loss, within certain limits, by a government-sponsored corporation, "SIPC" -- the Securities Investor Protection Corporation. Surprisingly, however, a report to New York Stock Exchange members, compiled by Market Facts-New York, Inc., entitled Marketing Securities to the Small Investor, found that small investors have "virtually no awareness" of SIPC. Interviews compiled in this study were made in 1971 and 1972, shortly after the creation of SIPC, and it may be that a study prepared today might show different results. Clearly, the incidence of awareness must be increased.

We have also been engaged in tightening the net capital standards for all broker-dealers to increase the quality of a broker's capital position as well as to increase the entry standards for new firms. And the surveillance capability of the self-regulatory organizations and the Commission over the financial and operational positions of broker-dealers has increased greatly since the late 60's. As a result, it is far less likely now than it was in the past that a brokerage firm will overextend itself or will risk its customer's funds or securities; and, if a firm does work itself into difficulty, its customers will have the protection of SIPC.

This is not to say that SIPC has worked perfectly. There have been some complaints and criticism, especially arising from the Weis Securities liquidation. Very likely, improvements should be made and I am confident they will be. Chairman Hugh Owens of SIPC has a task force at work right now studying the SIPC experience to date and preparing recommendations.

At the same time, the industry's back-office and operational capabilities have improved greatly since the disastrous years of 1968-70. Brokerage firms have invested much money in acquiring new and modern capacity -- giving them today, on the whole, excess capacity for current volume and new cost problems. As you know, the back office jam -- along with the transfer and clearance jams -- was perhaps the chief regulatory problem of the late sixties and it alone was probably responsible for the disenchantment of numerous investors, as our complaint file over those years amply evidences. While significant strides already have been made to ensure that the paperwork crisis will not recur, the recent signing by major stock exchanges and the NASD of a memorandum of understanding to make the development of a national system for clearing and settling securities transactions possible, and the subsequent work of the committee thus created under the chairmanship of Robert Gardiner, is a significant and important step forward.

Concurrently, we have been working on proposals to implement facets of the planned central market system for listed securities. We believe such a central market system will help renew investor confidence in our markets for several reasons:

First, brokers will be able to offer their smaller customers execution capabilities that are comparable to those offered to large institutions by major institutional houses. Traders for institutional houses "shop" the market for the best execution of their institutional customer orders, a timely and expensive process which, up until now, has not been considered economically justifiable for smaller orders. The composite quotation system we have outlined will provide brokers with the capacity to determine, instantaneously, where the best market for the execution of a customer's order is, even though that order may only be for 100 or 200 shares.

Second, our central market system envisions that greater marketmaking capability will exist to absorb any temporary imbalances between supply and demand produced by institutional desires to purchase or, especially, to sell securities in a hurry. The temporary market vicissitudes caused by such institutional block trades are believed to increase caution and wariness on the part of small investors.

Third, we anticipate that, once a central market system comes into being, investors that have left limit orders with a specialist or market maker will be able to participate and receive the benefit of any discounts and premiums which result from a proposed block transaction.

Fourth, by providing access to broker-dealers that are not currently exchange members, or that are members of regional exchanges to the major flow of orders, it is hoped that these broker-dealers will be encouraged to compete more effectively for customer business in primary market securities.

As many of you probably noted, the Commission took two steps last week to bring the central market system closer to reality. On Friday, we sent a letter of comment to the NASD and exchange sponsors of a plan for a composite transaction reporting system--the so-called composite tape. It is our expectation that our differences have been worked out, so that a positive response will be forthcoming and the participating agencies can begin preparation for the pilot project. Earlier last week, we published amendments to our short-sale rules for public comment, amendments which we believe will be necessary to accommodate the commingling of reports on the composite tape of transactions in the same securities in different markets.

The competitive rate experiment, beginning on April 1st of this year, also should help restore small investor participation in our markets. Brokerage firms have discouraged small orders, simply because those orders have entailed more expense than revenue. Particularly with respect to those individuals that desire a full range of brokerage services, with the advent of our experiment in limited price competition firms will be able to charge higher prices. This, hopefully, will make smaller customers more welcome at those firms that have discouraged such business in the past.

At the same time, brokers will be able to "unbundle" their services, so that small investors, or small traders, will be able to seek out reduced charges for execution. Those wanting ancillary services may be charged separately for them. We expect that this price competition on small orders will take many forms, including, on an individual firm basis, something akin to the PBW's proposal of a round-trip discount. These two aspects of the commission rate experiment could encourage small investors to return to the trading markets in significant numbers.

The efforts of the Commission and the self-regulatory agencies do not, however, stand alone; Congress has been quite active in the securities area. Two pieces of pending legislation may have an important effect, if adopted, on the confidence of individual investors and their desire to increase their participation in our securities markets.

It has become almost axiomatic to note that many individual investors believe the dominant institutional traders hold all the "trump" cards, insuring their success in the markets at the expense of smaller investors. This belief is, at least in part, predicated upon the secrecy that shrouds much institutional investment activity. To counteract this problem, and to insure that our markets are more open, we have advocated the passage of legislation requiring some disclosure by institutions of certain shareholdings and trading transactions. The adoption of this legislation would give smaller investors at least a periodic peek at the hands held by the institutions.

Congress is also considering a proposal to amend the tax laws to provide a graduated, long-term capital gains tax; this tax would decrease as the holding period of a security increases. This provision also would liberalize the provisions for deductibility of long-term capital losses against ordinary income. The purpose of the tax changes would be to increase the liquidity and mobility of capital by reducing the tax bite on positions held for a long time and to cushion market losses.

At the Commission, we certainly do not underestimate the problem of investor confidence in the markets. The major policy initiatives I have described certainly should dispel any notion of complacency on our part. Investor confidence has proven to be a tough problem; one that proves its tenacity by fighting back. But, in the past, we've gone several rounds with problems equally as tough, and we appear to be on the road to the solution of many of these.

When the first cable between England and India was completed, George Bernard Shaw reportedly remarked: "That's fine. But what are they going to SAY?" No one has ever accused the Commission and the securities industry of wanting in things to say to each other. In fact, at times, the dialogue has even been strident. But we have demonstrated that difficult problems can be resolved once we develop a common focus. And we have developed such a focus on the problem of market confidence and liquidity. Together, our efforts give us reason to expect that individual investors will return to our markets to find a more welcome and suitable environment.