ADDRESS

by

WILLIAM O. DOUGLAS

Commissioner, Securities and Exchange Commission

At the

NEW YORK STOCK EXCHANGE INSTITUTE

Thursday, November 12, 1936 - 8:45 a.m.

Customers' Men

Since this is a little university in Wall Street, I wish to speak to you in terms of education. I have no concern over the lack of any adequate opportunity which this institution will afford you to obtain necessary training and equipment for your professional work. I believe that you will be introduced to many of the mysteries of Wall Street. I believe your studies in economics, accounting and finance will stand you in good stead and give you a broader perspective on your vocation. I believe you will be well trained to master the complicated financial machinery of which this spot is the physical center. I believe you will receive instruction designed to draw the line for you between legitimate and illegitimate; honorable and dishonorable business. I have no worry on the quality of your instruction. My only worry is what will happen to you as you move forward in your business.

I am particularly happy to discuss with you some of these problems, because you are and represent youth. Youth has both ambition and idealism---an ambition to conquer; an idealism to make the homely virtues living realities. Youth is anxious to preserve the best from the past and to discard the worst. Youth is eager to repair the damage of those who preceded them and to build constructively and permanently. Youth is open-minded and forward-looking, not oppressed by prejudices engendered by habit, routine, and convention. Youth is the generating force whereby we move forward towards a fuller and better national life.

Hence, I welcome this opportunity to lay before you some constructive ideas for your consideration---ideas which relate to the business into which you are fast being integrated. One of the most difficult jobs is to view objectively one's own activity and conduct. This is likewise true of one's vocation or business. But I feel it will be worth your attempt if you undertake to do so.

In this connection, youth faces perplexing problems. There always have been and always will be subtle and subversive influences at work to corrupt the high functions which business, finance, and the other professions perform. For this reason one of the chief problems of youth is an ethical one. Friends, associates, environment, indeed time alone, work for this corruption. When I speak of corruption I do not mean gross extravagances in the form of larcency and the like. I refer to the practice of gentlemen teaching youth gentlemanly ways of redistributing the wealth of their clients so that they may get an inordinate share of it in extravagant ways. I mean the youth of the ideal of freedom of opportunity and private initiative to warrant or excuse exploitation. I mean the application of pressure from employers that these high virtues be exercised solely to the end that their earnings will increase. I include temptation to ape the activities of clever market operators so that acquisition of material wealth may be easy, effortless, and immediate. I refer to the urge to keep the customers' portfolios well churned so that by the quick inflow of commissions one may the sooner join the elite of high finance.

Some of your elders say that the thing that was wrong with 1929 was that they were too commission hungry. But human nature has not changed. I see no reason to believe that youth cannot develop as ravenous an appetite. There will be inducements to do so, for the pressure to move onward and upward, according to cash-register standards will be almost irresistible. Hence, that which will at times appear to you, either by example or by precedent, as the end of the rainbow will be a carnation in your lapel and the comfortable club life of your city. These are not matters which should depress youth and make it jaundiced and bitter. Rather they constitute a challenge to youth to make constructive conquests and to capitalize opportunities missed by their elders.

Your profession has no particular claim to distinction in this respect. The same elements appear as a corroding influence in other professions. Our educational system has been too virile in production of men immunized from a sense or feeling of social responsibility; trained in the art of plunder in gentlemanly ways; imbued with the false ideal that the American way means exploitation. There has been too little emphasis on the principle that the basic essential of an education is the ability to think -- to think in terms of human values, to think in terms of social responsibility, to think in terms of what the cumulative effect of your daily activities is in terms of your clients' welfare and of your character. This need, while not peculiar to your profession, is especially accentuated there because in final analysis yours is a profession affected with a public interest.

I can perhaps sharpen and make more specific some of the matters which cause this worry and concern, if I restrict my comments to one vocation which at least some of you will enter and which doubtless holds out bright prospects and hopes, especially as we move forward on the road of prosperity. This is the vocation of the customers' man.

I suppose you would say that a customers' man is not a salesman but an order clerk who transmits customers' orders, who makes sure that the orders are executed, and who reports the execution of the orders to his customers. You might say that although he contacts customers and solicits business for his employer, he does not have an inventory of securities to sell. When a customer makes a purchase through his firm, the firm does not (or certainly should not) sell the security which the customer buys. But, in spite of all this, the customers' man is a salesman, though he has nothing to sell but himself, his services, and his counsel.

The function of providing a mechanism whereby buyers and sellers can be brought together is an important function to perform. Its importance is not restricted to the securities field. If you have mice and I have a mousetrap, the one who supplies the ready machinery whereby we may come together is performing an important function, at least judged from the viewpoint both of those who do not like mice and of those who desire to sell mouse traps.

Securities exchanges similarly serve high functions in providing the mechanism whereby buyers and sellers can readily come together. One of the problems raised by the institution of customers' men is the basic question of how far these markets should go towards providing salesmanship as distinguished from a market where purchases and sales can be effected. Salesmanship like its brother, advertising, may be an indispensable ingredient of our system of business organization. Salesmanship in the field of securities, however, has given rise to such a host of abuses that the most conservative safeguards are necessary. Finance has used salesmanship as a short cut to profits. Salesmen have not been able to forego those profits by telling customers not to buy this or that because it is not economically justified. Salesmen have been told and have believed that their task is to sell customers whatever they want, and, if necessary, make them want what the salesmen have, at any price which the traffic will bear. Those who have selling organizations on their hands would not take the larger view, as that is against their financial interests. These selling organizations clamor for salable securities. They like merchandise which is stylish and which has a popular demand, even though such merchandise usually reflects an exploited situation. Hunger for commissions thus becomes at times the sole arbiter of the process of capital distribution and preservation, When that happens, the securities business has become not a legitimate enterprise conducted for a profit but a business engaged in exploitation.

This type of salesmanship which I have described has no necessary relationship to the business of securities exchanges. These could be conducted without it and it could be conducted without them. And I do not wish to attribute to the exchanges, as such, the evils and abuses which such salesmanship has engendered. But it is important to consider the impetus to excesses which is provided when salesmanship of the type supplied by the customers' man is added to exchange trading. There is then added a stimulating factor. The glamorous limelight of exchange trading is sufficient in and of itself to attract the moths of speculation and investment. Customers' men may make that light seem brighter and more attractive than is warranted.

History teaches that the interest of customers' men frequently lies in encouraging customers to buy and sell not only often but promiscuously and indiscriminately; to be satisfied with small profits or to accept small losses; and to make the daily pace and direction of the stock market their measurement of value. Customers' men, being in constant contact with tickers and news, are frequently influenced by short-term considerations, rumors, inside dope and the like, and disseminate this influence among their customers and prospects. Furthermore, they have not only distributed other people's rumors; they have manufactured and distributed their own. Customers' men frequently have been primarily interested in generating trading by speculators, since their compensation is dependent, indirectly at least, upon the volume of business transacted through them. At times their activities reach the proportions of high pressure salesmen whose frantic telephoning and whose conduct are more compatible with the boiler room than with customers' rooms of member firms. Accordingly, they become an influence which stimulates speculation and encourages active and in-and-out trading.

Perhaps the tendency to such speculative activity has been accentuated by the nature of customers' men since, as I have said, they are primarily engaged in the solicitation of commission business in securities. In a sense they are order clerks who see to the interests of their customers in transmitting orders, in making sure that the orders have been properly executed, and in reporting the execution of orders to the customers. By their constant observation of the market, of news and of tickers, they also keep their customers apprised of price trends of securities in which they cause their customers to be interested and of new developments affecting those securities. But it should be remembered that as to counsel or advice rendered by customers' men, they are not, for the most part, trained statisticians or economists. Their experience with securities has been largely gained in the street or financial district. At times their contacts in the financial district and elsewhere give them insight into the merits of certain securities. Yet even though they may make, at times, studies of corporation reports and statistical data, the advice or counsel which they are generally prepared to offer is neither that of the statistician nor that of the professional investment counsel. Thus it is that there is a growing belief that customers'-men are of no use to bona fide investors; that persons who desire to invest money have ample facilities among the many sound and reliable institutions and member firms of securities exchanges without the necessity of the intervention of an additional agency like the customers' man.

These facts emphasize one of the dangers of attaching such a person to our already complicated and impersonal market machinery. It tends to separate by one further degree *values* from *things*. It tends to accentuate the dominant characteristic of securities exchanges as inanimate objects — impersonalized to such a degree that human and social values disappear and economic facts become blurred and indistinct.

This separation of *values* from *things* is one of the most conspicuous danger points in our entire system. The progressive movement from barter, tokens and coins to paper money and securities has enabled finance to treat business as mere conglomerations of stocks, bonds, notes, debentures. Finance has not neglected the opportunity thus afforded. Through complicated financial structures, holding companies, collateral trusts, tribute in the form of hidden charges, and the like, it has created a system which at times makes almost impossible any intelligent determination of the relation between *values* represented by the securities and the *things* which securities represent. Or if the determination of such relationship is possible, the tendency is to treat the facts of transportation, manufacture, wholesaling, retailing, as secondary rather than primary. The weather vane of business becomes not the profit and loss account and the balance sheet, but the gyrations of these pieces of paper as revealed on the ticker. Under such influences, the ticker cannot become the pulse of business. Under such influences, the ticker cannot follow business — the tendency is the false illusion of business following the ticker. In other words, economic facts disappear from the picture or become blurred and indistinct. The fact that people who have saved are involved, and that their future and security are at stake is also forgotten. The social and human values disappear. When that transpires, the market becomes a place for games rather than orderly investment and liquidation processes. The consequence is, as I have stated, an inanimate and impersonalized market devoid of human or social values and irresponsive for periods to economic facts. Tragedy in the form of social disintegration is the end result.

Customers' men, to the extent that they stimulate trading by their solicitation methods, accentuate this tendency. They add an artificial element to the market processes. They breed excitement and feverish interest. In their small way, they add to the churning of portfolios which in terms of basic economic functions has no significance. It is important only as measured in terms of cash-register standards. The activities of customers' men can have no other effect, so long as they parade themselves as understanding and knowing markets, market trends, and securities values, when in fact they do not have such understanding and knowledge.

These facts make abundantly clear that the whole institution of customers' men is at least of unestablished value. They stress anew the question of whether or not such a stimulating influence has any proper place in our sensitive and delicate market mechanism. They challenge you who are moving forward towards that profession to produce living evidence that the economic, human and social values involved in the exchange process not only will not be sacrificed, but, in fact, will be enhanced by virtue of your activity. If you do not produce that evidence, society or your exchange may feel that your function performs such a distinct disservice to investors as to justify a change in the system.

But if, and so long as, this vocation continues there are certain practices which need be eschewed, lest you further corrupt it and lest it corrupt you. In this brief paper I cannot mention all of them. A few will suffice for illustration. The first relates to the fiduciary position of customers' men. He who holds himself out as rendering this investment counsel and this service to customers should be held to high fiduciary standards of conduct. If he who gives this advice and encourages and stimulates his customer's purchases and sales, has a self-interest in the transaction over and above his salary or regular compensation, his customer is apt to receive not unbiased and disinterested advice but advice discolored by the self-interest which such purchases and sales will serve. The presence of this self-interest will deprive the customer of the benefit of disinterested and impartial advice, the very thing which presumably the customer thinks he is getting. The courts of law have refused to admit that the average individual could stand the stress and strain of such dual interests. When the issue is resolved in final analysis, it means that the counsel given will be likely to follow the bias and self-interest of the agent rather than the best interests of the customer. In any given case the factors in motivation are too subtle and tenuous to result in anything but guesses. But human experience teaches that a man cannot serve well two or more masters. In terms of customers' men, this fundamental principle of fiduciary relationship should mean at least two things.

(1) First and foremost customers' men should have no interest, directly or indirectly in any security for themselves, except that which they have acquired for bona fide investment purposes. To many this will appear to be not only a mistake in business judgment but also a meticulous and unnecessary stretching of these ethical and legal rules. To be sure, such standard of conduct outruns the rule of law. But as a working rule of thumb, it is essential if the market place is to be rid of some of the subtle influences of biased and discolored advice by those who purport to be objective advisers. The question is not simply one of preventing specific transactions wherein the customers' man or his firm has a special

adverse interest, transactions which should be beyond the pale; it is broader than that. It entails also avoidance of a situation whereby the customers' man, influenced consciously or otherwise, by his own glowing prospects in particular speculative transactions and impressed by his own infallible judgment, proceeds to advise his customers to follow in his footsteps. Meticulous regard for these standards should be had by reliable and competent persons purporting to render investment counsel. Needless to say, this would entail prohibition of margin accounts for customers' men, directly, or indirectly through their wives, fathers, brothers, etc. In such cases, there are further reasons: Not only will judgment be warped and biased; fair-weather customers' men will be so concerned with their own margin accounts that their clients' interests will suffer, especially in times of market reactions.

(2) Customers' men should be prohibited from having any interest in an operation designed to distribute securities. Great abuses have occurred in the past by reason of the presence of such an interest. The practice of paying customers' men, directly or indirectly, for the placement of securities with their customers has not been abolished. Reputable firms will shun and avoid this practice. Eager and ambitious (and hungry) customers' men will be tempted by it. The temptation will always be present. Operators engaged in a secondary distribution will be vitally concerned with the task of putting the securities away in permanent hands. If they can work through the good offices of the customers' man and reach such purchasers, their operations will be made easier. Accordingly, they will attempt to buy the customers' man for a consideration. The end result is that for that consideration the customers' man is giving not disinterested advice but advice corrupted and biased -- irreconcilable with his fiduciary status. His corruption violates legal and ethical standards of conduct of ancient origin. He then becomes not a useful or permissible cog in the financial system but a corroding influence. He may be able to survive the fair weather of the markets. But the day of accounting comes sooner or later if he departs from the standard of giving advice on any basis other than his own free belief in the merits of the security.

In the second place, the extravagances of the customers' men in connection with margin trading and discretionary accounts, weaken the case and challenge the justification for their existence.

Justifiable criticism of customers' men has been directed to their tendency to encourage over-trading by their customers. Frequently they have had no regard for margin regulations and they have permitted their customers to load up their accounts beyond the point of conservatism. Some customers' men have encouraged customers who have a limited or restricted account to make new commitments which they cannot afford and which they must liquidate within the limit of the three business days allowed by Regulation T. Thus the spirit, if not the letter, of such regulations has been violated. This malpractice is not, to be sure, traceable entirely to the door of the customers' man but is one for which his employer should receive equal, if not greater, blame. The problem, as you know, has been recognized by your Exchange in its rather recent ruling that no member shall permit a customer "to make a practice" of effecting transactions requiring a margin and then either defer the furnishing of a margin beyond the time when such transactions would ordinarily be settled or cleared, or of meeting such demand for margin by the liquidation of the same or other commitments in his account. But the problem from the point of view of the customers' man is not only to see that there is no such regular practice but to prevent all other transgressions. As to the prevention of such excesses, the customers' man stands in a peculiarly strategic position and is recalcitrant in the performance of his obligations if he neglects to insist on meticulous fulfillment of such rules.

More important, however, are the abuses which have arisen in the past as a result of the employment of discretionary powers by customers' men. After your Exchange had adopted a rule according to which customers might delegate discretionary powers only to partners, it was known that such powers were in turn delegated by partners to customers' men; so that the spirit, if not the letter, of the rule was violated. That rule has, as you know, been altered by the Exchange so that no discretionary accounts may be handled either by partners or by customers' men without the consent of the Committee on Customers' men. But there appears to be valid consideration for a rule which would effectively prohibit customers' men from employment of any discretionary trading power. The interests of customers' men in general and those of their customers would be well served by such a prohibition.

The dangers of any other course are self-evident. Compensation of a customers' man will always be dependent indirectly, if not directly, on the commissions he brings the firm. If he has a discretionary account, the temptation will always be almost irresistible to keep that account well churned for the sake of commissions. Discretion, in other words, will tend to disappear. The daily or weekly record of the customers' man can be bolstered by a few transactions in the discretionary account. The guiding principle will tend to be the record of the customers' man in terms of commissions rather than his record in terms of sound and conservative judgment in the interests of his client. Here again motivation is a complex thing. Cause and effect will not always be easy to determine. But human experience (the record of the past) teaches us that an employee in such a position will tend to sacrifice the client's interest for his own record of achievement in terms of commissions.

In sum, if the institution of customers' men is to survive, it must have meticulous regard for the standards of conduct governing fiduciaries. It cannot survive if it ostensibly serves the customers but actually serves the employees and employers. It must redefine its functions. It must forsake the idea of salesmanship and concentrate on investment service. If the institution desires to survive, let customers' men become serious students of corporations; let them be in a position intelligently to advise clients on reorganization plans; let them qualify to render counsel to those solicited in proxy campaigns; let them be competent to advise on mergers, consolidations, recapitalizations and the like; let them lose their consuming interest in intermediate price movements; let them desist from calling their customers unless requested or except in serious emergencies; let them become studiously concerned with the fundamentals of business and of finance. The only social vindication of that institution is to be found in such a course. Whether or not such a program of achievement can be attained will be in issue. Perhaps it is impossible of realization. Perhaps the fact that the customers' men are not paid by the clients but by the firms, from which the pressure to produce business will be strong, will provide an irreconcilable factor.

But as I stated earlier, the institution of customers' men has at present an unestablished value. In the past it has served as a method of churning portfolios, of creating frenzy and excitement, of manufacturing and distributing rumors and tips — in short, of serving as a fair-weather device to make the market a gaming place. Whether it can be made a valuable investment service adjunct to organized exchanges rests in the hands of your generation. It will not and should not survive if the corruption of which I earlier spoke intrudes.