"SOME ECONOMIC ASPECTS OF THE WORK OF THE TRADING AND EXCHANGE DIVISION; THE MARGIN REQUIREMENTS AND THE SHORT SELLING RULES PROMULGATED UNDER THE SECURITIES EXCHANGE ACT OF 1934."

ADDRESS

of

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My first job with the Commission was to watch the ticker. There were about a half a dozen of us engaged in the same work. It was the beginning of October, 1934, and with the exception of the directors and assistant directors, there was no Trading and Exchange Division.

Looking back, I question whether the directorate knew at that time what the Division was going to do. But one thing they were sure of and that was the ticker must be watched. So a big corner room was set aside for this purpose and the ticker services were installed -- news tickers, the New York Stock stock and bond tickers, the New York Curb ticker. Those who placed us there no doubt felt that by so doing they had their fingers on the financial pulse of the nation. By having us "ticker sleuths" they thought they could detect and thereby eliminate all manipulation.

The first time we saw a stock stick its nose above the general level, which was a few days after we had been assigned to our duties, we all rushed at it. The then Chairman of the Commission delegated a few of us to run up to New York to see what had caused this stir. We pushed around the New York Stock Exchange and a few of the offices of member firms, and in a short time ran across a name that had been notorious in the late 20's in stock market pool operation. We were sure, then, that we had uncovered a real jiggle, and we traced it further. As we came to the goal of our searches, it gradually dawned on us that no attempt to influence the price was involved, but that, on the contrary, a large banking group was seeking to accumulate a substantial investment position in this stock and that all the floor traders and tape watchers had jumped in, which in turn excited the little fellows, and this was what we had observed on the ticker.

This gave the Commission some idea of what it was in for and of how complicated its inspection, enforcement, and rule-making job was going to be, and that a few bright men in the ticker room weren't going to be able to do it for them.

It is generally acknowledged that the security markets play an important role in the economic scheme of things in the United States. For that reason, the Commission, which is vested with powers to regulate certain aspects of trading in these markets, must necessarily consider what effects its actions will have upon their functioning. So it is that the Trading and Exchange Division, which shoulders the burden of recommending changes and modifications in the exchange machinery pursuant to the Commission's regulatory powers, must necessarily consider the economic repercussions of its proposals.

In order to understand our problem more clearly, we might for a moment consider very sketchily the principal functions which security markets are said to play in the economic picture. Security markets are held to be important adjuncts to capital markets; that is to say, they are said to help the flow of the savings of individuals into existing industries and into new industries in the United States. It is claimed that their role is performed in two ways:

In the first place, the claim is made that the security market, by providing a place where all buyers and sellers may publicly register their opinions of the value of securities, permits the establishment of prices which are the synthesis of the maximum amount of knowledge. This price-fixing function is held to be of the first importance since it serves to sort the successful and economically justifiable industries from those whose prospects are poor, and it serves to separate the efficient companies in each industry from the less successful ones. Thus, good industries and good companies find it easy to raise new capital and to expand, while unsuccessful industries find the capital market barred to them because of the poor rating which the security market has given to their securities.

A second function which the security markets are said to perform is to provide liquidity to the investments of security holders. The existence of the security market, it is claimed, permits the holder to liquidate his commitments at the shortest possible notice at a price not greatly different from current market quotations. This factor is supposed to render capital investment more attractive and to permit the flow of capital into industry.

Any trading practice or any group's trading which the Commission is empowered to regulate by law generally is defended on the grounds that it helps either or both of these functions. It may be attacked, on the other hand, either on the grounds that it hinders these functions or because its cost to the public is too great by comparison with the contribution it makes to the security markets' functioning.

The Trading Division is faced with the difficult task of weighing the economic arguments for and the arguments against the continuance of the many practices of security traders which the Commission is required by law to regulate. While in most cases the balancing of these scales is extremely difficult, in some instances it presents little difficulty. The most vicious forms of manipulation, for example, are unequivocally barred by law and the Division simply carries out the law's mandate. Manipulation is forbidden, it should be noted, because it is a species of fraud. That is to say, the price-fixing machinery of the exchange, which is a principal reason for its existence, no longer reflects the honest opinions of buyers and sellers.

Although in this instance, little difficulty is encountered in deciding upon a course of action, in most cases the issues are not so clear. For example, since its inception the Commission has been faced with the job of regulating the segregation of broker and dealer functions on the Exchange floor. The fact that members may combine broker and dealer functions on the floor of the Exchange has been attacked for the reason that it gives certain advantages to members' trading which are not accorded to their customers; for example, that it permits members, through a knowledge of customers' orders, to trade more advantageously for their own account. The non-segregation of functions has been defended just as strongly on the grounds that the trading of members bridges the gaps between what might otherwise be the discontinuous price movements resulting from investors' occasional purchases and sales. Thus, it is held, the price-fixing machinery of the exchange is improved.

Short selling is another controversial subject with which the Trading Division has had much to do. Those who would permit unrestricted short selling have claimed that short sellers effect such sales during price rises and cover their positions during price declines, thus adding stability and liquidity to stock prices. But short selling has been attacked on the grounds that short sellers habitually follow exactly the opposite pattern of action; that they do not take short positions until prices have begun to decline and they do not cover their short positions until prices have commenced to rise, thus harming price liquidity and stability.

Despite these difficulties, the Trading Division has satisfied itself upon the desirability of certain moves, and, as a result, regulation has proceeded in many fields in which it has been deemed necessary.

Among the activities which we felt should be more carefully restrained was irresponsible short selling. The exchanges had had a rule for some time purporting to restrain so-called bear raiding but we had suspected that the rule was not as effective as it was represented to be. The rule simply prohibited the selling of a stock below the last sale price. We suspected, however, that in declining markets, if there was a substantial bid at a price at which a sale had just taken place, the floor traders would all hop on the bid and clean it up before the public could get its long stock off. In the latter part of 1937, when the market was declining very heavily, we got the New York Stock Exchange to give us detailed figures on short selling in important stock issues and, in analyzing, we found that our suspicions were confirmed. Thereupon, the Commission promulgated its first rule directly related to trading on exchanges. These were the short selling rules and prohibited the selling not only below the last sale price, but also at such price. This rule not only effectively prevented short selling in declining markets of the bear raiding type, but it has also removed from a declining market the competition which short sellers previously had offered to bona fide long sellers. It has preserved bids resting below the market for long sales.

This rule was pretty tight because as it worked out, when a sale of one lot of stock in the unit of trading is made at a price a short sale cannot be made except above that price. Exchange officials have consistently complained that the rule has not only operated to prevent short selling in declining markets, but in rising markets as well. The virtue of short selling as I previously pointed out is said to be the cushion that short positions provide when they are covered in a declining market. If it is true that short selling cannot be made in substantial amounts in a rising market, positions can't be accumulated and there is no cushion. As the Commission had promulgated its short selling rule on an experimental basis, it was decided that in line with its cooperative policy a revised rule which had been worked out in conference between exchange officials and the staff would be tried. As a matter of fact, the rule which was decided upon was one of those which the Commission had had under consideration in 1937. This new rule was promulgated recently, and we are going ahead with out studies of short selling by getting detailed statistics such as we have not had before. In fact, we hope to throw real light on the whole subject of short selling and to be able to say how important it is by figures which we will start to get on or about the first of May.

We, in conjunction with the exchanges, watch activities of short sellers in markets particularly during war scares and we are reasonably satisfied that both the original Commission rule and the present rule prevent bear raiding. Experience may prove the need for further revision of the rule and perhaps for a return of the original rule.

One of the aspects of the securities markets around which there has been much controversy is the so-called liquidity of the market. Although the term has never been satisfactorily defined by its proponents, it means anything from pure volume per se to a market condition able to absorb any amount of selling at a given moment, and, conversely, to supply any amount of buying at a given moment. Various measures of liquidity have been worked out statistically, such as the amount of fluctuation per unit of trading. But all measures have in common the fact that more "liquidity" is shown with greater volume. These measures indicate that liquidity on this basis has been declining in recent years. This may be partially explained by the increasing number of issues listed on the large exchanges but it has been hinted all along, and finally voiced in 1937 by Mr. Charles R. Gay, who was then president of the New York Stock Exchange, that this phenomena is directly attributable to regulations of the Commission. It may be granted that liquidity has its virtues. The question that puzzles us is at what cost shall we have it? We had liquidity in the 20's because we had pools and irresponsible professional speculators. Shall we have liquidity in 1939 on the same basis? Some proponents of relaxation of the anti-manipulative provisions of the Act make us suspect that their answer to this question would be yes; that they want liquidity at any price. But we are not ready to sacrifice public protection for market liquidity.

The greatest proponents of liquidity, of course, are the commission brokers, the traders and the speculators. Volume of trading is what interests all of these because even in a great bull market they will not make profits unless there is volume. Now we ask whether a bull market reflecting good times will not be just as satisfactory although the volume is less, and, conversely, whether a declining market will be worse simply because of reduced trading and speculating. In other words, it has not been established that liquidity is a market quality which is important to any but day-to-day traders; but it is the longer-term trends of the market upon which we are trying to direct emphasis rather than the day-to-day or minute-to-minute fluctuations.

If we define liquidity as something more than sheer volume, if we regard it as a quality which is characteristic of stable, non-erratic markets, the question arises as to who contributes to liquidity. The financial community claims that it is the professionals, the floor traders and their associates. But figures which we have been collecting and releasing weekly indicate that these fellows are almost always swimming with the tide; that is, when the market is going down, they are going out. That isn't a real contribution to this kind of liquidity. On the other hand, the little fellows, the odd-lot buyers and sellers seem to be the most important group dealing against the trend; they constantly buy on balance in declining markets and sell when the markets rise.

Another influence of the Exchange Act upon our economic life is to be found in the margin requirements prescribed pursuant to Section 7. In 1929 the volume of borrowings by members of the New York Stock Exchange alone exceeded $8,000,000,000. This was one of the situations which Congress felt called for remedial legislation. It was believed that this tremendous absorption of available funds into speculation deprived industry of needed funds and substantially increased the cost to industry of its financing. In other words, industry was put in the position of being compelled to compete with speculators in order to secure funds. To prevent the repetition of such a condition, Congress delegated to the Federal Reserve Board the right to prescribe margin requirements so as to prevent the excessive use of credit for the purpose of purchasing and carrying securities. The Federal Reserve Board issued Regulation T pursuant to this authority.

What the Regulation does is to limit the amount of credit that a broker may extend to his customer in a margin account to 60% of the market value of securities carried. It also imposes a requirement of 50% on short sales. Although the rules were promulgated by the Federal Reserve Board, their policing and enforcement is one of the functions of this Division. Enforcement is sought to be achieved by close cooperation with the regional offices who maintain a staff of margin inspectors to examine from time to time the books of firms subject to the Regulation.

Two jobs in which the Division is further interested which have decided economic aspects are the problem of smaller exchanges and foreign dealings. There are in all 20 registered national securities exchanges and 7 exempted exchanges. . Some of the smaller exchanges around the country have apparently been losing business, due partly to the economic growth of the country in the course of which local corporations, the issues of which fed the local exchanges, have grown to national importance. When this happens, the securities have a wider appeal and the stockholders want a national market. Therefore, applications are filed for registration on the larger exchanges and although the issue may continue to be listed on the local exchange, the primary market is transferred. It seems that the future of the smaller exchange is to act as a regional market place and to compensate for the issues which they lose by interesting local business to list securities which are dealt in over-the-counter. This, together with the extension of unlisted trading privileges, seems to be the future course for these exchanges.

The second matter is the impact and influence of European security owners and traders on our markets and the possible avenue which European markets provide for escape from our regulations. We have made several attempts, somewhat informally, to obtain reliable data on the importance of dealings in American securities on foreign exchanges but have been unsuccessful largely because it is not the custom in Europe to publicize records of transactions and also because Europeans are disinclined to make available information on their security dealings or those of their clients. It has been alleged that our regulations, such as the short selling rule and margin regulations, can easily be and frequently are evaded by persons in the United States routing their transactions through European brokers and dealers. Again, we have no reliable data or information to substantiate or deny this allegation, although we have sometimes challenged those who hold these views. We recently noticed an article in a magazine definitely maintaining that a substantial volume of business was being diverted from our markets to Europe. We wrote to the author of the article, telling him of our interest in the subject and asking him to make available to us the information which provided the basis of his conclusions. He had to confess that he, in fact, had none.

As you know, the Commission has recently appointed a European representative, Mr. Harold Neff, who has as his assistant Mr. C. R. McCutcheon of this Division, who will try to throw some light on these and related subjects. These matters are, of course, at present frequently discussed in the press and are of current importance.

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