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THE SECURITIES MARKETS

Address of

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before the

THE ECONOMIC CLUB OF CHICAGO

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It is a great pleasure for me to be here tonight to address The Economic Club of Chicago at its 28th annual meeting. As a Chicagoan, I take particular pleasure in returning from Washington for this occasion.

The many citizens of Chicago and of Illinois serving in the Government would make you proud if you were as aware as I am - because I see something of them - of the fine job they are doing. I will not take time to mention any individual, except to say that our Republican Senator Everett M. Dirksen is one of the real sources of inspiration and strength to those of us in the present national Administration.

I am here to speak to you members of The Economic Club on the subject "The Securities Markets".

A principle of the Federal securities laws which the Securities and Exchange Commission administers is full and fair disclosure -- disclosure of the facts pertaining to the proposed investment. In keeping with this principle, let me make full and fair disclosure to you economists now.

First, I am not an economist. Although I played in a minor key on economic courses in college, particularly a never-to-be-forgotten course in senior year in money and banking, my professional training developed in law.

Second, the Securities and Exchange Commission, of which I have been a member for two years and at which I have been designated by the President as Chairman to succeed Ralph H. Demmler, is not an economic agency. Our function is the regulation of the securities markets according to legal standards laid down by the Congress in a series of laws enacted in the thirties. The agencies of the Federal Government whose impact is economic -- so far as the securities markets are concerned -- are the Treasury and the Federal Reserve System, not the Securities and Exchange Commission.

Third, and let me make this most emphatic, I am here to discuss the securities markets as an institution in our free economic society. These markets make it possible for owners of securities to sell them and of would-be investors to buy them. This in turn makes possible a market in which companies can issue and sell new securities, and thus meet their capital needs. Nothing that I say tonight has anything to do with past, present or future prices, or price levels of securities.

After these three disclaimers, I think it is most appropriate for me to speak, and for you members of The Economic Club to listen, if you will, about the securities markets.

The proper functioning of the securities markets is indispensable to a healthy and sound economy in America. Our Commission as a regulatory agency is in a position to observe how the securities markets function and whether they are fairly conducted. Sometimes a market that is generally functioning well, that is generally fairly conducted, develops soft spots at which sharp dealing and improper or illegal practices show up. I will make a few observations at the end of this talk on some influences in the marketing of certain types of securities that are unhealthy and should be corrected.

The attention of the American people was recently directed to the stock market by the study made by the Committee on Banking and Currency of the United States Senate. I'm sure most of you followed the news accounts of the daily parade of witnesses at the hearings which lasted for several weeks, from March 3 to 23. Those who testified before the Senate Banking Committee were recognized leaders in Government, business, economics and labor, or were "elder statesmen". They gave a great deal of interesting testimony about how the securities markets operate, their relationship to the Government and the public, and their relationship to the national economy.

Also, thousands of individuals, bankers, brokers, dealers, stock exchanges and others received questionnaires from the Senate Banking Committee, and supplied answers, on the subject of recent and not so recent rises in the market prices of stocks. Thus, an enormous amount of expert opinion was gathered into the hands of the Committee. This is presently under study by the Committee and by the Committee's professional staff. Further hearings on one phase of the study -- proxy contests for control of listed corporations -- have been scheduled for the last week of this month of May and, of course, more hearings may be held after that if the Committee so decides. What ultimately will result from the study, no one not connected with the Senate Banking Committee, least of all I, could possibly say.

In addition to the testimony of the witnesses taken at the hearing (which comprises a document of over 1,000 pages), there has also been released by the Senate Banking Committee a very interesting staff report entitled "Factors Affecting the Stock Market". Information for this report was supplied to a major extent by the Securities and Exchange Commission, the Federal Reserve System and the New York and American Stock Exchanges. Some of the basic data which I will be giving you in the next few minutes is based upon information supplied by these government agencies and securities exchanges. Incidentally, two of our Commission's top staff people, a lawyer and a financial analyst, were loaned to the Senate Committee to help with the work.

What are the factors affecting the stock market today and why are they important to the economy?

First, and of course obviously to you who are interested in economics and so who cannot help but be aware of it, in the 16 months between September 1953 and January 1955, common stock prices had a sharp and rapid rise. A characteristic of this rise in stock prices was that the increase in common stock values was unusually persistent and did not suffer the recurring setbacks which took place during the other extended advances that have occurred since 1915.

A result of this was that dividend yields on industrial stocks declined from an average of 5½% in 1953 to 4-2/3% in 1954 and were only moderately above 4% in January 1955. However, the differential between industrial common stock yields and yields on triple A corporate bonds was still more than 100 basis points and this was in marked contrast to the relationship of industrial stock yields and high grade corporate bond yields in the twenties and thirties.

Another interesting relationship is that the 1953-54 rise of stock prices was not confined to the United States. It also took place in other countries. For example, between September 1953 and December 1954 the percentage increase in industrial stock prices was 54% in the United States, 44% in the United Kingdom, 38% in Canada, 85% in France, 50% in the Netherlands, and 25% in Switzerland.

During the same period there developed a considerable increase in the volume of trading activity. For example, the number of reported shares traded on The New York Stock Exchange totaled 573 million in 1954, the largest annual volume, during any sustained period of rising prices except the late twenties. Daily volume increased from about one million shares in July 1953 to 2.2 million in the mid-1954, and then went on up to between 3.2 and 3.5 million shares in the closing months of 1954 and January 1955.

At this point, I would like to remind you of my earlier warning that I am not an economist nor is the Securities and Exchange Commission an economic agency. But in 1952 the people of America elected a president and a party who believed that national prosperity was not dependent upon war, but that a sound and expanding economy could support the sinews of a strong national defense and yet avoid the tragic erosion of the people's savings in monetary inflation. The President has often expressed his abiding belief in the importance of the individual and of individual initiative.

These propositions are rather simple to state but much more difficult to achieve. At any event, in the past two years the awful drain of lives and resources in Korea has been ended, our defenses have been placed on a sustained long range basis of strength, and a continuous effort made to ease the world's war tensions. Government expenditures have been brought under control. The purchasing power of the dollar has been stable, and a sound and flexible monetary policy pursued. In early 1953, the inflationary trend was halted. The readjustment incident to controlling expenditures and halting inflation was accomplished by the fourth quarter of 1954, when the reduction of business inventories and the decline in Federal expenditures leveled off. The gross national product rate recovered from $355.8 billion in the first three quarters of 1954 to $362 billion in the fourth 1954 quarter, and moved on up to $370 billion in the first quarter of 1955. It seems, if I may venture an opinion, that it is possible to have peace, full employment and a high standard of living for the people of America, all at the same time. This is one of the great accomplishments of the past two years.

Can there be any wonder, then, that the people of America responded by showing confidence in the economy?

At the hearings before the Senate Banking Committee, this was well brought out by Secretary of the Treasury Humphrey, who said to the Committee:

> "There is just one word of caution that I want to leave with you. Confidence or lack of it has more to do with conduct of investors, businessmen, and the great mass of the people generally than any single thing. If there is confidence in the future, in the stability of the economy, and in the maintenance of jobs, the American people continue to buy the things they need and the things they want.

"Most American families are in position today to buy more than the bare necessities of life. When they have confidence, they buy things they do not absolutely need, but they buy things that they want. If they lose confidence, they postpone or cancel those purchases. Businessmen either move forward with plant expansion, with the creation of new jobs, or they are cautious and restrained based on confidence. And investors are perhaps more sensitive than any in governing their conduct on the confidence that they have or that they lack. . . . .

"The feeling of confidence in the future has been strong and has moved up on a broad front for the past several months. Business activity has been expanding. And this month that we are in today may well be one of the highest months of activity we have ever had in our history. We are on sound economic grounds based on sound principles. There is no reason why we should not go forward unless confidence is injured or destroyed."

The confidence of the American investor in the economy, therefore, is of extreme importance. For on that confidence depends the willingness of the people to channel their savings into productive investment, and the willingness of management to commit to capital outlays the enormous amounts needed to serve our people's requirements. For example, industry's capital expenditures for plant and equipment in 1953 were $28.3 billion, in 1954 were $26.8 billion, and are estimated for 1955 at $27.1 billion. The second quarter of 1955 is expected to show the upturn in the rate of plant and equipment expenditures following the decline which began late in 1953.

During the post war period through 1954, corporations invested $172 billion in new plants and equipment and increased their net working capital by $44 billion. Almost three fourths of the funds needed for this $216 billion of capital expansion were provided from internal sources, that is, depreciation, accruals and retained earnings.

The managers of American corporations would not think of reinvesting these enormous sums, obtained both from the capital markets and generated internally, did they not have confidence in the continued soundness, expansion and growth of our economic system.

Another economic factor undoubtedly at work is the use of bank credit in the securities markets. The mechanics of stock market credit and the control which the Federal Reserve System has over this are important. The Securities Exchange Act grants to the Board of Governors of the Federal Reserve System power to fix margin requirements, and after a period of two years at 50%, the Board raised the margin requirement to 60% in January 1955 and in April to 70%. Also, the volume of credit which at any time may be available through the banking system is affected by actions taken by the Federal Reserve System in the areas of discount operations, open market operations and changes in reserve requirements.

Another factor undoubtedly at work is the impact of taxes on the market - corporate taxes, excess profits taxes (which expired in 1953) and individual income taxes (including the somewhat more favorable tax treatment since 1954 accorded income from dividends), and the capital gains tax. Two particular problems in this area are worth thinking about, though no solutions are in sight. First, that the structure of the Federal corporate income tax tends to encourage use of borrowed funds rather than equity capital has been strongly asserted by some people. Whether this is so or not, the maintenance of a strong equity position by American industry in my opinion is important. In a recent interview, Dr. Arthur F. Burns, Chairman of the Council of Economic Advisers, stated that he thought "our growth will rest on a sounder foundation if equity capital accounts for a larger part of the private investment than has been the case in recent years". Second, some people and organizations have argued that there is a "lock-in effect" brought about by the capital gains tax. Whether this is true or not, I don't know. Let me emphasize again, I mention these as being questions or problems about which people are thinking.

Another factor affecting the stock market about which less is probably known than should be is the impact of institutional investment in stocks. Eliminating inter-corporate holdings, the total market value of outstanding stock of all American business corporations at the end of 1954 was about $268 billion, of which over $150 billion were listed, that is traded on the exchanges. Of this total, it is estimated that individuals held 73%, or $196.4 billion. Institutions held an estimated $66.5 billion or 25% of the total.

The New York Stock Exchange estimates that at the end of 1954 7.5 million individuals owned shares of publicly held companies. This figure is about a million more individuals than a 1952 estimate made by

The Brookings Institution. It is also significant that during the past 14 years there appears to have been a pronounced upward trend of common stock buying by institutions. These include life insurance companies (legal investment laws having been liberalized), banks acting as fiduciaries, both open-end and closed-end investment companies, and pension funds. Statistics developed by the Trading and Exchanges Division of our Commission show the net purchase of common stock by institutional investors as running between $1.2 billion and $1.5 billion in each of the past three years.

Another factor perhaps at work in the market is the extent to which speculation by the public has increased. Various statistical data supplied by the New York Stock Exchange indicate considerable and increasing public participation in the market.

Now, how does all of this fit in to the economic conditions existing and which we must expect and hope for in the years ahead? What are the conditions we must look for?

Let us think for a moment of what The Economic Report of the President to the Congress of January 1955 calls "the growth potentials of our economy". This report contains two prophetic paragraphs about the future:

> "The American economy has created new jobs and produced marvels of abundance in the past. It should be able to do so in equal or even greater degree in the future. Our population is rapidly increasing, educational levels are rising, work skills are improving, incomes are widely distributed, consumers are eager to improve their living standards, businessmen are actively engaged in starting new enterprises and expanding old ones, the tools of industry are multiplying and improving, research and technology are constantly opening up new opportunities, and our public policies generally encourage enterprise and innovation. With so many favorable factors, a continuation of rapid economic growth may reasonably be expected.
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> "An arithmetical calculation, based on a number of technical assumptions, the most important being that the average annual gains in productivity that we have had in recent times will occur in the future, shows that our country can within a decade increase its production from a current annual level

of about 360 billion dollars to 500 billion or more, with the figures expressed in dollars of the same buying power. Of course, the record of the past sets no limit to our future achievements. Nor should we permit arithmetical projections to obscure the basic fact that an economy succeeds only as people succeed. Our economic future depends on the full use of the great treasure house of intelligence, skill, energy, and confidence of the American people."

The enormous amounts of money, saved by the American people, which are invested in the brick, mortar, machine tools, equipment and research of American corporations would not be invested were it not for the underlying confidence of the American people in the political, economic and social system which we have developed under our representative form of Government. That means confidence in American management, in our labor organizations, in our Governmental institutions, in the laws and in the people themselves. The continued confidence of the people in the future of America and in our free institutions is of vital and basic importance to the economy. The rising standard of living, the rising rate of population, the increase in the gross national product, the increase in the number and productivity of our working people expected over the years ahead can be provided for so long as the confidence of the American public in its privately owned capitalistic system is maintained.

This in turn requires the proper functioning of the capital markets It is the function of the Securities and Exchange Commission to administer laws which are designed to assure to the American investing public certain basic legal protections. The Securities Act, for example, requires that fair disclosure of pertinent financial facts be made to prospective investors by corporations selling new issues of securities in interstate commerce to the public. The Securities Act contains civil and criminal liabilities for misrepresentation and fraud.

The Exchange Act, under which the Securities and Exchange Commission has jurisdiction over corporations whose shares are listed on national securities exchanges, over the exchanges themselves and over brokers and dealers, also gives the Commission power to regulate for the protection of investors. For example, annual and certain interim financial reports are required to be filed and made public by listed companies. This requirement has led to the development of the enormous reservoir of financial information, available in the statistical services, about the companies whose shares are listed. Listed companies must also meet certain disclosure rules in connection with the solicitation of proxies to vote at meetings of their shareholders. Profits by corporate "insiders" in certain short-swing trading transactions are under severe legal restrictions. The conduct of market activities is under the Commission's constant surveillance. Pools, manipulation and rigging of stock prices in the markets have been substantially eliminated.

Also, the securities laws adopt as the policy of the Congress the philosophy that industry self-regulation to the extent possible and feasible should be encouraged. Most of the stock exchanges have rules of conduct and actively supervise their members. The National Association of Securities Dealers, Inc., representing the over-the-counter dealers, is also a fine example of a self-regulating industry organization operating under a statutory mandate. Thus the American investor should be entitled to have confidence that the capital markets through the medium of which he invests his savings are run with certain basic standards of decency and good business conduct.

However, this is not to say that the enterprises coming to the capital market to attract investors' money are all good or all sound or that the means of attracting the money are fair. The soundness of the enterprise - or lack of it - is the responsibility of business, not of Government, so long as the pertinent financial facts are fairly disclosed.

Here I want to sound a warning note. I believe that the integrity and reputation of American business can be tarnished by certain activities of a few types of enterprises in marketing their securities.

There is now a national public interest in the mining of uranium. There is a risk that the activities of some of those engaged in the sale of uranium issues may give the uranium mining industry generally a black eye. Our Commission is presently engaged in a study of how the money raised in some of these small uranium issues is being spent. Many people who bought domestic and Canadian uranium issues have not been given a fair chance. For example, many of these uranium common stocks sold to the public have inferior positions in the corporate structure to options and warrants given the promoters. Thus, if the venture is successful, the promoters will be enriched at the expense of the public stockholders.

Most of these issues are set up on a "best efforts" basis, and there is no assurance there will be enough money raised to explore or drill. Often claims are exaggerated. Puffed-up and alluring advertising appears in the newspapers and over the air waves.

It would be a shame for American business and for the American capital markets to forfeit investors' confidence because of activities of the kind I've just described. For it is my belief that great source of hope for the well being of all our people is the continued growth of our free enterprise system. Let me illustrate this, and close, by quoting a few sentences from the remarks the President made at the annual meeting of the United States Chamber of Commerce on May 2 - "Commerce, its free propagation and progress in this country, has brought today the great organization -- this great institution that we call modern America. We still believe that, in the aggregate, the initiative of the individual, his aspirations and his hope of bettering himself and his family -- his ambitions -- if directed equally toward the common good as toward his own betterment, will produce the greatest good for all of us".

Thank you for this opportunity to discuss the securities markets.