SAFEGUARDING THE NATION'S CAPITAL

Address delivered by
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Gentlemen:

I appreciate very much the privilege of your invitation to appear before your Association here today, and it is with genuine pleasure that I respond to it. This is not the first time that I have been the guest of the bankers and business men of Milwaukee, and I assure you I trust that it will not be the last. So rapidly is capital accumulating in this wonderful central district of the Great Lakes basin and the Mississippi Valley, that there is a constantly growing community of interest between investors and financial institutions here and in New York. Not the least important economic problem of our own times is therefore the question of safeguarding the capital of the nation. It goes without saying that this is a large subject, if one defines capital in the broadest terms, as any form of accumulated wealth whatever. On my part, however, I only wish to speak of capital as represented by liquid and negotiable securities in the form of bonds or shares. Inasmuch as the securities listed today on the New York Stock Exchange possess an aggregate market value of approximately one hundred billion dollars, the question of safeguarding capital only in the form of securities is a sufficiently great and complicated topic.

II

The tremendous increase of the American security investing public during recent years has been very generally recognized. The day was when a bondholder was popularly considered to be a quite unusual and exceptional sort of person because of the relatively limited class of Americans who regularly purchased or held bonds. But this condition of affairs was ended, I trust forever, by the popularization of security investments during the great Liberty Loan campaigns and the subsequent period of prosperity. America is therefore in a fair way to become the greatest security investing nation in the world, and this very important development in our economic and social life is already having its effects practically throughout the whole world of American business and American finance. One such effect is to increase the interest and knowledge which American investors everywhere have for the leading American security market on the New York Stock Exchange. As long as this market possessed little practical contact with the average man, it was apt to excite a peculiar suspicion. But in a day like the present, when thousands of people are frequently employing the services of the New York securities market, much of the lack of understanding concerning it which formerly prevailed, has already vanished. On its part, the New York Stock Exchange has made unusual efforts to spread through the country a more general knowledge of its methods of organization and operation. These efforts have not consisted in endeavoring to sing its own praises on all possible occasions, but to make available all possible information concerning itself, and to invite criticism from all quarters, in the hope of improving and perfecting its services. The New York Stock Exchange has coupled this effort to make itself more genuinely understood with definite, and on occasions, drastic action designed to protect the security investing public on whose business the market basically depends. The New York Stock Exchange has not for many years, as a matter of fact, been a merely local institution. Ever since the adaptation of electricity to the practical tasks of speedy communication, the New York securities market has been a national institution in its services and in its scope of business. But in these days when in so many directions and upon such a tremendous scale, capitalism has begun to share its benefits more widely than ever before throughout all parts of this country and with all classes of our population, its status as a national institution has of course grown in proportion.

Naturally, the more our security investing public grows, the larger becomes the task of endeavoring to safeguard the processes of security investing. Many separate agencies have today been enlisted in driving from the investment field the security swindlers who are always so anxious to prey upon it. Our Federal Post Office Department, for example, has been doing, often unnoticed, a magnificent work in excluding from the mails the insidious and fallacious advertisements of fraudulent security dealers. American business men themselves have been equally active, particularly in the creation of Better Business Bureau organizations in many of the leading American cities. These Better Business Bureaus, organized for the specific purpose of combating fraud directly and actively, have made a great record for themselves in purifying the national arteries of commerce and finance. But my mission to you here today is to tell you about some of the work along this very line which the New York Stock Exchange has undertaken in recent years, and its experiences with it.

III

Before undertaking to discuss the part which the New York Stock Exchange has striven to play in safeguarding public security investments, I should first perhaps explain briefly something concerning the powers and limitations of the Stock Exchange itself. There seems to be considerable confusion from time to time in the public mind on this score. While one set of critics may be denouncing the Stock Exchange for not taking action in some matter, another group may at the same time be complaining of the Stock Exchange's "tyrannous and high-handed actions."

The New York Stock Exchange is a voluntary association of 1,100 members, many of whom reside and have their places of business entirely outside of New York City. The purpose of this association, to paraphrase briefly its own constitution, is to provide Exchange rooms and other facilities for the convenient transaction of their business by its members, to maintain high standards of commercial honor and integrity among its members, and to promote and inculcate just and equitable principles of trade and business. The Stock Exchange itself is not in business, and its operations are not undertaken for profit. Over a century of experience in conducting the affairs of the Exchange has led to the formulation of a considerable body of rules and regulations with which the business of Stock Exchange members must conform. But I would point out that the powers of the Exchange naturally apply only to its own membership, and not to the public at large. Over its own membership it is true the Exchange possesses very great and very complete power. It can discipline, suspend, or even expel members of the Exchange who in its judgment have broken the spirit as well as the letter of fair dealing. But the New York Stock Exchange does not possess, nor does it seek to possess, any official or governmental status. It therefore has no power over the public at large, and cannot reasonably be called upon to attempt to exercise any such power. Inasmuch as the basis of all the business of the New York Stock Exchange consists in the buying and selling of securities listed upon it by the American public, the interests of the Stock Exchange are bound to be identical with those of our investing public.

The safeguards which the New York Stock Exchange endeavors to throw about the processes of public security investment are many and important. In the first place, it thoroughly investigates the records of candidates for Stock Exchange membership. Such candidates, in addition to being able to purchase a membership on the Exchange and to provide sufficient capital for engaging in the business, must be formally elected to membership by the Exchange's Committee on Admissions. Entirely apart from the amount of money any candidate may be able to command, he will not be elected a member of the New York Stock Exchange if his own business career has been tainted with unfair dealings in any form.

The same scrutiny is exerted in respect to the securities which can be bought and sold upon the Exchange. When application is made for the listing of any stock or bond there, the applying company or government must make a full and fair statement concerning the factors upon which the value of the securities depends. Naturally the Stock Exchange cannot attempt to play the prophet in regard to securities which it lists, nor does it officially guarantee its listings in any way. But it does see to it that adequate information concerning the securities is made available to the whole public which is thereby enabled to determine concerning the value of the securities with all the relevant facts at hand. In the long campaign for fuller and more frank corporate publicity, the New York Stock Exchange has consistently been a leader for the last fifty years.

An elaborate machinery in the Exchange has long been set up to enforce its regulations concerning fair dealings, not only between Exchange members, but also between any Exchange member and the general public. In addition, the Exchange carefully supervises the distribution of its ticket quotations, in order to prevent undesirable persons from employing Stock Exchange quotations to dupe and swindle the nation's security buyers. Finally, in the field of fraudulent security selling, even though such activity lies entirely beyond the immediate scope of the Stock Exchange's business, the Exchange has nevertheless repeatedly called public attention to the dangers of the swindling evil, and has for several years been conducting a campaign to eliminate security swindling as a factor in our business life. Apart from cooperating on all possible occasions with our Federal government, the Security Commissions or Commissioners of our States, and local legal authorities throughout the country, the Stock Exchange was primarily responsible for the financing of the Better Business Bureau of New York, whose splendid work in combating security frauds has benefited not merely New York itself, but the entire country as well.

IV

One of the most controversial aspects of the New York stock market in recent months has consisted in the so-called brokers' loans. It is well known that these loans have increased very largely during the past year, and the fear has frequently been expressed that they were becoming entirely too large. The difficulty in discussing the size of brokers' loans consists in the lack of any dependable yardstick by which to measure them. Naturally, common sense would indicate that the more rapidly such loans grow, the more likelihood there is that they may soon become too large. But the size of brokers' loans is after all bound to be a relative question. It is a well-known fact that the United States has become the greatest financial creditor nation of the world. The immediate effect of this vastly important development has naturally been a very great expansion in the banking and security business recently. Just as unusual exports of American steel would greatly expand our steel industry, or unusually large exports of grain would greatly expand our agricultural industry, so the recent enormous exports of American capital have necessitated a huge expansion in this country throughout the banking and security business. We have been seeing an unparalleled volume of new security issues created and offered to our investing public in recent years, and likewise unparalleled amounts of American capital constantly invading our security markets seeking investment. The whole scale of the security business in this country has in consequence experienced an enormous expansion in practically all its branches. Brokers' loans have thus risen along with turnover on all the stock exchanges in America, and the new security offerings made in every financial center of the country. The fact that this movement has continued year after year should clearly distinguish the period which we have recently seen, from the old-fashioned short-lived bull market in securities. As long as further American capital continues to be generated in this country, and continues to seek security investment in our market, I do not for one see anything fundamentally unsound in the increasing size of American financial statistics, nor in the growth of the ordinary financial facilities which America, as a creditor nation, should obviously possess to be able permanently to handle the business.

It is of course a very great fallacy to think that brokers' loans are purely unproductive, and are made only to finance speculation. Such a view, common though it may be, is most superficial and short-sighted. It is a well-known fact that most new securities are at first difficult to sell to outright investors, because they are not seasoned. It therefore becomes necessary in practice to hold a part of many new security issues in the market floating supply, until longer experience can induce security investors to put their money in the issues. Brokers' loans in consequence represent just this floating supply of securities for the whole New York market. The collateral to these loans are securities in the process of distribution. To argue that brokers' loans are unnecessary or are unproductive, therefore, amounts to arguing that the whole security business of the country is unproductive. Actually America has been very wise in creating facilities for the ready financing of large and unseasoned security issues. We talk today of American industrial prosperity being based on mass production. We also realize that mass production demands tremendous initial outlays of capital and large corporate units, but we sometimes fail to remember that financing all this makes large loans on security collateral inevitable. To wipe out brokers' loans, or violently and arbitrarily to reduce them, would thus inevitably slow up American industry itself, if not fatally to halt its continued progress.

I would also mention, in connection with this subject of brokers' loans, a peculiar internal development in American finance during recent years which has tended considerably to increase them. I refer to the present-day tendency of American companies to obtain their working capital from securities and the security loan market rather than from commercial loans at the banks. The recent wealth of funds available in this country for security investment, and perhaps the memory of difficulties experienced with commercial loans during the financial contraction of 1920-1921, have induced many American companies to sell new bond and stock issues, accumulate large cash surpluses, and thus render unnecessary borrowing at the banks on open account or with commercial paper. When such cash surpluses are not employed in their business, the companies will lend them in the call loan market. Undoubtedly this is one reason why commercial loans have not in recent years expanded to the same extent that loans on securities have. Novel as this method of corporate financing really is in this country on its present scale, it is yet too early to assert that it is less safe and sound than former methods were. But it has imposed on brokers' loans the task of financing not only the fixed capital needs, but also the working capital needs, of innumerable American business corporations.

A final consideration lies in the fact that brokers' loans in practice act as a sort of buffer to commercial loans. When credit deflation becomes necessary, it is always brokers' loans that are deflated first. Thus these loans represent a surplus which can be employed for other purposes, should the occasion arise. The events of 1919-1921 clearly showed the truth of this assertion. The peak of the call loan market was reached in November, 1919, after which these loans were rapidly deflated. By the late fall of 1920, over half a billion dollars had been squeezed out of brokers' loans, but meanwhile the total volume of loans by all American banks had risen very greatly, thus indicating that the credit obtained be deflating brokers' loans in Wall Street was being used to lend to farmers, merchants and manufacturers all over the United States. Furthermore, after 1921 many corporations were enabled to retire frozen commercial loans at their banks by floating new company securities in Wall Street. But these new security flotations, being unseasoned, had to depend on the market for brokers' loans in large measure to carry them until they could be distributed to permanent security investors. In this way, the security collateral loan market in Wall Street represents a surplus market which in the past has shown its ability to act as a buffer for commercial loans in times of deflation and in particular instances to liquefy frozen commercial loans. Our brokers' loan account today is large mainly because our surplus of capital in America is large. We should have, I feel, few fears that our banking authorities will allow brokers' loans to absorb an undue amount of the credit of our national banking establishments.

V

No discussion of the securities market can be accurate or complete without clearly distinguishing between capital and credit. I do not wish to enter into the labyrinth of difficult economic questions to which the scientific establishment of such definitions inevitably leads. As working definitions, we may say that credit is a kind of temporary and conditional capital. The brokers' loans which have been so much discussed recently are really for the most part extensions of credit by lending financial institutions. I do not need to remind this audience of bankers that sometimes a financial institution can lend too much credit and thereby get itself into an embarrassing position. For this reason, we are all bound to feel a certain apprehension concerning any business at all which is carried on largely with the use of bank credit. Just as new extensions of credit may foster an expansion in business, so a contraction of credit may curtail business. If this were the whole truth concerning the stock market today, or for that matter at any other active period of its history, the question of brokers' loans might well assume a quite alarming aspect. But we must not look at the stock market solely and merely from an angle of credit, for the question of capital even more fundamentally influences its constant development and expansion. I have already alluded to the fact that the general wave of commercial and industrial prosperity in this country has led to the accumulation of unprecedented amounts of capital. This capital may be destroyed through unwisdom or waste, but it is not subject to expansion or contraction on the same basis that bank credit is, and it has been the continual stream of this fresh American capital into our securities markets that has been fundamentally responsible not only for their expansion in scope, but also for the enhancement in the prices of their securities. Investors from all over the country, both large and small, have been continually purchasing securities outright and locking them up in their strong boxes for permanent investment. Large outright purchasing of American securities for long-term holders has also come into the New York market from the recently rehabilitated investing classes of European countries. So important has this factor proved itself in recent years that, as I see it, the major concern of the Stock Exchange today really lies in the question of how far its facilities are adequate in handling this continual flow of investment funds. The question of credit, as far as the Stock Exchange is concerned, is one for the banking institutions which are experienced managers of credit problems.

If we are to obtain a clear notion of how this factor of surplus capital has been affecting our security markets recently, we must for purposes of contrast consider a moment the very different conditions in this respect which existed in this country practically from its foundation down until quite recent times. For over a century, the United States was, with scarcely an important interruption, always a debtor country. We were larger consumers of capital than producers of it. The upbuilding of the United States, including the construction of our enormous railway systems and our huge industrial facilities, consistently called for more capital than the American people were able to save. For this reason, in the Wall Street securities markets, down until a few years ago, securities were always more abundant than capital, and in fact the foreign stock exchanges of London, Amsterdam and other European centers had been largely depended upon for the ready marketing of American stocks and bonds.

In recent years this situation has been suddenly reversed, and we have found ourselves in the possession of sufficient capital not only to finance all our own business undertakings, but also to make large foreign investments. This new situation is still only imperfectly realized and understood, even by our financial leaders. We still have the psychology of a debtor country, and the experiences of a century have tended to make our financial machinery and financial facilities essentially those of a debtor nation. Thus it comes about that our current surplus of capital has proved both mystifying and embarrassing to us. But it may well be that we must accustom ourselves, because of our new creditor status, to a situation where capital is more abundant than good investments. Indeed, the constantly falling yield of the best American investment securities would seem to indicate that such a situation is already at hand.

So unusual is this abundance of capital in this country, that we have not all as yet realized on the one hand the great potentialities for good which it conveys, and on the other hand the peculiar dangers with which it is attended. From the borrowers' standpoint it might seem that cheap capital was unquestionably a good thing, and undoubtedly an abundance of capital is one of the greatest stimulants to industrial production and commercial distribution. But this is by no means the whole story. Literally millions of people in this country are investors, and by reason of steady investments during their active years of life, they are striving to create for themselves a competence in old age. This practice of small-scale thrift is of enormous social and economic importance, and any interference with it is highly undesirable. Naturally it is much easier for the small investor to accumulate a competence for himself when the yields on standard securities are high than it is when these yields are low. If the yields on conservatively invested capital, through the accumulation of a national surplus of capital, become unusually low over a long period, it will operate profoundly to discourage private thrift and investment. For this reason cheap capital, as I say, is not an unmixed blessing, and what we really need today is stability of security yields at reasonable levels.

It was the realization of this obvious and yet frequently overlooked fact that led the New York Stock Exchange this spring to list the two great British government sterling bond issues, which together aggregate in their outstanding amounts approximately twelve billion dollars. By this step these securities, which are generally thought to be the best foreign securities in existence, have been placed at the ready disposal of investors all over the United States through the market on the New York Stock Exchange. It was felt that thereby a genuine service was being performed for the American investor, and at the same time a new stabilizing factor was being introduced into international commerce and finance. For today it is a well-known fact that trade balances between nations are being settled to a greater extent by the purchase and sale of securities than by gold shipments or shiftings of short-term credit. More and more we are approaching the time when the yields on long-term investments will rise and fall together all over the world, and the introduction in our markets of British internal government bond issues should facilitate the readier stabilization of security prices and yields, not only inside the United States, but also between the United States and foreign countries.

VI

A final word of explanation is perhaps necessary in regard to the attitude of the Stock Exchange toward price movements in securities which are dealt in upon it. The Stock Exchange makes every effort to establish and maintain free and open markets for its listed securities—markets in which the power of public buying and selling is readily and immediately felt, and in which all purchasers and sellers are accorded the same even-handed justice. But it is obviously not the province of the Stock Exchange to concern itself with movements in security prices as such. Public opinion must in the long run be depended upon to regulate the levels at which security prices stand at any particular time, and the Stock Exchange fulfills all its proper functions by maintaining a market where the forces of supply and demand originating with the investing public can meet and mutually satisfy themselves.

After its century of experience in the business of maintaining the leading security market of this country, the New York Stock Exchange is firmly of the belief that unusual price movements in securities, or waves of security speculation, have a way of adjusting themselves without the intervention either of the Stock Exchange or other artificial regulation. This attitude toward price making and speculation in securities represents a faith in democracy and the common sense of the average man translated into financial terms. In the long run it has, throughout history, proved the basis of all the great markets of the world, whether in securities or commodities. There is all the less reason for apprehension in these matters today, because of the existence of the Federal Reserve system.

As for the Stock Exchange itself, while it properly restricts its functions within the scope of its abilities for practical performance, at the same time these functions are sufficiently important and difficult to necessitate continual vigilance and continual effort on its part.

Under freedom the New York Stock Exchange has over the past century been able to foster and develop thrift and security investment not merely in its own locality but all over the United States. It provides not only those indispensable financial facilities for marketing securities which have been so widely availed of by American business and even by the American government itself, but also fundamental and time-tested safeguards in security dealings so vitally needed by the steadily increasing class of public security buyers throughout the nation.

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