CAPITAL MARKETS AT THE CROSSROADS

An Address By
Ray Garrett, Jr., Chairman
Securities and Exchange Commission

January 22, 1975

Economic Club Of New York
New York, N. Y.

Some of you, surely, have memories that go back long enough to recall that Congress did not create the Securities and Exchange Commission out of love and charity toward the securities industry. At least since Wall Street had laid its famous egg, in the fall of 1929, until the Commission opened for business in July of 1934, the securities industry had been under extensive, continuous and rather hostile scrutiny.

In fact, when Joseph P. Kennedy was appointed to the first Commission, and became its first Chairman, in contemplating the Securities Exchange Act of 1934 that he was to administer, he is reported to have observed that, if that act had been in effect ten years earlier, he would not have become a millionaire. Whether or not that was true, the new laws and the new Commission were obviously meant to make some changes in the operation of our capital markets, and they did. Indeed, they are still making them.

We are today completing what many in the industry regard as the most dramatic change in the 40 years since our creation — the abolition of fixed commission rates for transactions on our national securities exchanges. Congress is, of course, contemplating the same move, and the United States Supreme Court has accepted a case raising the issue of the application of the antitrust laws to fixed rates under the present statute — the question being whether fixed rates constitute an illegal conspiracy in restraint of trade, despite the provision in the Securities Exchange Act giving us authority to review and compel changes in stock exchange rules, including those respecting the fixing of rates.

While this whole matter is highly contentious, as is the related matter of the establishment of a central market system, the program is not conceived of as punitive — certainly not by the Commission and, I am confident, not by the Congress. Of course, you can readily find persons in the securities industry who will say that, if we are unfixing rates as a friendly gesture, the industry doesn't need any enemies.

Nevertheless, we would take such an important step only based upon reasonable confidence that the ultimate effect would be to improve and strengthen our capital markets.

And this is an issue, I should add, that has been explored at great length on many occasions, in many forums, including our most recent hearings that

concluded shortly before Christmas. So that the question today is not whether, but by whom, how and when.

I am sure that many of you are not concerned with this matter on a day-to-day basis. Largely for that reason, I had not planned to talk much beyond what I have already said about unfixed rates, but I subsequently learned that Wall Street's fabled intelligence and communications network had spread the word that I would announce tonight the Commission's conclusions on whether exchange commission rates should come unfixed.

Until these reports filtered down to Washington, it had not occurred to me and my colleagues to relate this occasion to that decision. We had, in fact, rather hoped to have the decision made and announced before now. This not having prove to be the case, we have indulged our reluctance to embarrass the network. I must say, however, that I am a bit concerned with the apparent eagerness with which many securities industry leaders and members present here tonight have accepted the idea that I should announce our conclusions after this enjoyable dinner. It is not likely to be good for the digestion. It might have been better to get a good night's rest and tackle this issue in the morning. I hope that I can count on the street's well-developed propensity for discounting expected bad news to maintain emotional equilibrium in all quarters.

In any event, it is clear that this is not the time or the place to attempt a detailed description of our conclusions and the reasons therefor. We will, in

the next few days, officially publish a release setting forth our detailed views. But, if there is any suspense left, I should state officially that the Commission has decided to adopt its proposed Rule 19b-3, requiring unfixed commission rates on exchanges, with certain modifications, some substantive and of interest, others not.

The rule we shortly will publish, requires all exchanges to cease fixing the commission rates their members must charge the public no later than May 1, 1975, the date we originally proposed 18 months ago. Under our rule, the exchanges cannot fix such rates after May 1, 1975, and if rules to that effect are still extant on and after that date, their members may not comply with them. So much is pretty simple.

The rule we have adopted also requires so-called intra-member rates — the rates members must charge each other — to come unfixed one year later — May 1, 1976. The delay in the unfixing of intra-member rates will insure that everyone has time to plan for this event, and will spread the task of adjusting to change over a longer period of time.

Another rule we had proposed — Rule 10b-22, dealing with brokers' agreements to fix rates — has not been adopted.

What is the significance of our action?

— For one thing, it means that, for the first time in almost 200 years, the rates of commission that brokers charge to public customers on exchange securities transaction will not be determined by exchange rules. Market forces will operate to set these prices; and there may be variances from firm to firm.

— It means that brokers can be more free and imaginative in pricing their services to the public.

— It means that recent dramatic shifts in the structure of our markets can, and will, be reflected in the commissions exchange members may charge.

— It means that, if economic and market conditions so require, member firms can raise or lower their rates immediately, without the need for clearance, approval or acquiescence by at one, except, of course, the investing public.

— It also means that the Commission may be sued. We would rather not be sued, but we are not fearful of the result.

The fact that we have determined to adopt Rule 19b-3, however, does not mean that we are insensitive to the concerns that were raised during our hearings. In our best judgment, unfixing commission rates at this time and in these circumstances is the right thing to do; but we have a continuing responsibility to oversee the fairness and efficiency of our markets. We intend to establish effective procedures to monitor the effect of our rule so that we can make any changes, within our present authority, promptly to

prevent unfairness or market disruptions. Given our reporting requirement powers under existing law, this should not prove difficult. However, any measures we may take to preserve the auction market or protect against other disruptions should be taken on actual evidence rather than fears and forecasts. We intend to be in a position to act quickly if action is required.

In unfixing rates, we recognize that the fears that some have expressed include a fear that we are moving into a realm of direct intervention in the rules governing the functioning of our capital markets. To a certain extent, I suppose, we are. We do, after all, have rather direct regulatory authority over most of the participants in that process, and we do have a mandate to preserve the fairness and efficiency of the securities markets.

But, for American industry at large, Congress chose, and has continued to choose, to rely on the relatively free operation of the markets, where investors are fully informed, as nearly as may be, and the markets are operated fairly and honestly. We have no express authority to approve or disapprove offerings of securities as good or bad for the economy as a whole, or for the issuing company, or for the investor, and we have never questioned that it should be otherwise. Indeed, any representation to the contrary is a criminal offense. Similarly, our official concern for prices in the trading markets is limited to whether they are improperly influenced by manipulative or deceptive activities

The markets' performance in the last few years, and the recent celebration of our fortieth birthday, naturally raise questions about the efficacy of this arrangement. There are plenty of doubters around. The system did not impede, and hopefully facilitated , the unprecedented raising of capital by American industry during the roughly twenty-five years following World War II. It may well be, in fact I think it is, the case, that it was the disclosure and market regulatory apparatus established by the Commission that encouraged, not to say lured, so many individuals during those years to return to the stock- markets, and in such a big way. Sometimes this rests heavily on our conscience, because the system did not prevent the disappearance of equally unprecedented sums in market values in the past five years.

To some modern economists, our laws and rules and activities had nothing to do with any of this, except to make it all more expensive for the benefit of lawyers, accountants, financial printers and bureaucrats. Not only, in their view, is fundamental information about companies irrelevant to the market place, but we-haven't even done a very good job about enforcing disclosure and fairness — witness the examples of massive management malfeasance in recent years that have come to our notice and public notice only too late.

I find these observations a bit depressing. While we may be approaching a period when a government job will, in itself, be something to treasure — unless Congress acts effectively to adopt a comprehensive and

effective economic program, such as the one outlined by President Ford last week — none of us presently at the Commission is so hungry as to view with equanimity the awful possibility that it is all a monstrous charade.

Even more depressing is the criticism from the shorn lambs to whom we have been quite unable to temper the cold wind of lost savings and shattered expectations of economic security if not great wealth. Some of them let me have it in rather strong terms. If they accept the fact that we never promised them a profit or even preservation of principal — a message that does seem to have gotten around pretty well — then they accuse us of being pussycats when it comes to seeking out and imposing righteous retribution on those malefactors who are responsible for it all.

Last Christmas, for example, I received, a rather elegant Christmas card with a pastoral scene, and the manufacturer's little imprint indicating that this was a card from its "Holiday Elegance Collection." Opposite the printed greeting wishing me "all the happiness of the Christmas Season," was a typewritten message that read as follows:

> "According to my morning paper, President Ford is being pressured to remove all Nixon appointees — Saxbe goes to India as far away as they can get him: You are a Nixon appointee — I am suggesting Bangledesh — any closer would be a continuing 'Catastrophe' for the Investing Public. START PACKING YOUR BAG. It won't be long."

The sender preferred to remain anonymous, but I pointed out to my colleague from Cleveland, Commissioner Sommer, that the post-mark was Ohio.

As to the first criticism — that fundamental information about companies is irrelevant to the marketplace — I simply cannot agree. Despite all of the computer models and random walks, I cannot accept the irrelevancy of fundamental analysis. But even if these critics should be correct to some degree, and fundamental analysis is not so important as we have traditionally regarded it, disclosure and fairness perform an important function beyond the purveying of data to analysts.

At this time of deep concern and even suspicion in so many quarters regarding the management of American business, it seems more important than ever that investors be confident that they are getting the real facts about publicly-held companies. It seems to me unthinkable that we should abolish or even curtail our system for the flow of corporate information regardless of how well an investor might do with a dart board. The realities lie in the other direction.

But how about the little fellow that got wiped out, or investors in the aggregate, who have lost well over $500 bill in market value since 1972? Has the system been adequate for them? Obviously, it depends upon what was expected of the system. Here, I think the record is adequate, if not more.

There seems to be sufficient realization that investors knew what they were buying and that the government never promised anyone a rose garden, so that we have no riots and little screaming for tighter controls or government ownership. The strongest felt pressure, from where I sit, is for more effective enforcement of the laws we now have.

I don't mean to discount the widespread disappointment and disillusion with our stock markets or the memories that we all share of having once more got caught up in a make-believe frenzy when we ignored all the lessons of the past and imagined that we had repealed the law of gravity. But should the Commission in its administration of the federal securities laws have prevented, or at least tempered, the boom as well as the bust?

Looking back, I do not see how it could have done so without giving the Commission more control than a good man would want or a bad man should have. While our system provides ready machinery for effective control over access to our capital markets and the terms thereof, in this context we strongly favor adhering to the disclosure philosophy of 40 years ago, realizing that this means bad experiences as well as good. Such is the price of freedom.

Concluding, as I do, that experience does not require any radical alteration of our securities laws relating to public offerings and market prices, however, does not mean that I view the future with any complacency.

We are attempting to usher in major revisions in the method and manner in which securities business is solicited and conducted. With the cooperation of the securities industry, we have made important strides toward a central market system that we think will be fairer to all investors. Congress is also active in that direction. But the best marketplace in the world, which is what we already have, is worth little if investors refuse to participate.

The decline in equity values is now well recognized to have reached critical proportions, affecting not only individuals, but everyone from pension funds and foundations to corporations unable or unwilling to sell new shares to increase the borrowing base and permit the construction of new facilities. The decline is a world-wide phenomenon, and, in part due to this and its effect on the value of foreign investments, we are faced, among other things, with the possibility of balance sheet insolvencies of a sort that we have been happily free of for many years. And the realization that the Commission's responsibilities under Chapter X of the Bankruptcy Act will likely keep us busy whatever happens is no source of joy.

If this trend develops according to the worst fears, some emergency relief might be necessary in the direction of making government funds available for equity investment in companies of critical importance to our economy. This idea was espoused by Felix Rohatyn in the New York Times some weeks ago, and part of the subsequent disagreement no doubt sprang from the unfortunate and inaccurate reference to a "RFC."

I had a private reason for criticizing Mr. Rohatyn's proposal. He would make the Chairman of the SEC an ex-officio member of the governing board. Otherwise, I think the proposal should be seriously considered. At the least, the problem it would seek to solve must be fully recognized.

More recently, one well-run, nuclear pioneer utility, long regarded as innovative and profitable, found its financial position so tenuous that it called upon the government to purchase a $200 million issue of its nonvoting, junior preferred stock. The company was not singling itself out — it recommended the same course with respect to other stockholder-owned utilities.

This may seem unthinkable to us now, and certainly is a vast departure from prior general practice, but it falls far short of what others have suggested. What led to this suggestion was the common difficulty experienced by this company in financing further necessary expansion.

We at the Commission have observed for years the increasing leverage of American companies and the erosion of the equity cushion. The effect of this is to make our companies more vulnerable to hard times than would otherwise be the case. Naturally, the problem is exacerbated by the heavy resort to short-term borrowings more recently.

Parenthetically, in the face of this and of the projected capital needs for the coming years, we have observed with some curiosity the distribution of cash by companies for the repurchase of their own shares. Using information

collected by the New York Stock Exchange for listed companies, we estimate that, over the last six years, an aggregate of between $10 and $15 billion in cash has been paid out by companies for the repurchase of their common stock.

I am well acquainted with the simple arithmetic employed to demonstrate that repurchases are the best investment of excess cash, even where no market maintenance or other quasi-manipulative interest is present, and many of the reacquired shares were no doubt reissued for options or purchase plans, and I certainly do not intend to be critical of any particular management that come to the good faith conclusion that this was the best thing to do. Still, taken altogether, it doesn't help the case for heroic government measures to assist industry in raising new equity capital.

Perhaps what would help long-range are measures that would take the emphasis off growth as the only way to profit from investments in stocks, relying as it does not only upon ever increasing earnings per share but also on a constant, if not increasing, price-earnings ratio. The alternative would to make even common stocks attractive on a yield basis.

Obviously, a major problem is taxes. The securities industry and others have expressed strong interest in amelioration of the capital gains tax as it applies to securities, and many proposals have been advanced, all claiming to be fairer and stimulating more trading volume, especially, and mostly initially, I should imagine, by those presently "locked in" to low-basis stock.

As we all know, low-basis stock is not so low-basis today as it was yesterday. These measures might help trading volume and would surely be more equitable for investors, but if one is concerned with the capital structure and liquidity of companies, something else should be considered.

We at the Commission, while recognizing our lack of authority, responsibility and expertise on matters of federal tax policy, would nevertheless urge that attention also be given to the possibility of eliminating the bias in favor of debt financing and low-payouts on stock, by making corporate dividends deductible to the corporation. Last fall, President Ford suggested this with respect to dividends on new preferred stock issues meeting certain requirements, seeking mostly, we understand, to help the difficult financing problems of our public utilities. We hope that serious attention will be given to doing the same across the board.

It would not be good form for a Chairman of the SEC to intrude any further into tax policy and try, among other things, to devise means to compensate for the apparent revenue loss. Perhaps it isn't good form to go as far as I have already. But all signs indicate that, some reexamination of the sources of capital for American companies is very much needed. This may present an opportunity to place the taxation of corporations on a basis that encourages companies to maintain a strong equity base while being fairer to successive generations of shareholders. Among other things, it could also redress an unfavorable discrepancy in regard to foreign corporations and their tax burdens.

Withdrawing, now, from this brief, nonprofessional excursion into economic and tax policy, I should add that, notwithstanding the fact that the Commission was not created solely to provide joy either to broker-dealers or to the management of publicly-owned companies, we, and the laws we administer, were conceived of as contributing to the strength of our capital markets. To paraphrase an old sergeant of mine, we may not be good to them, but we are supposed to be good for them.

This does not lead me to expect daily plaudits from those within the reach of our writ. Human nature can be strained only so far. And I am mindful of the advice of Mark Twain to the effect that, if you see someone coming to you intent upon doing you good, you should run as fast as possible in the other direction. While this is doubtless a healthy response to the intermeddling functionary in general I'm on the other side now, and I believe that our present system and what we propose within that system, are good for our capital markets and those involved with them. But the problems run much deeper than the quality of our market system. We will watch with great concern the efforts of the Administration and the Congress to adopt economic measures to cope with these problems and stand ready to furnish information and views where we can be helpful.