CHAPTER IX

MARGINS AND MARKETS

The New York Stock Exchange sponsored a round table on business and finance at the 1936 session of the Institute of Public Affairs of the University of Virginia. Charles R. Gay, president of the Exchange, had spoken in strong defense of speculation and the rights of speculators. The following discussion is taken from Mr. Douglas' reply to Mr. Gay, delivered July 11, 1936.

Two years ago there was launched a long-needed program of Federal regulation of the securities markets. That program is still in its nascent stage. Its full development will be a matter of years. By its very nature it calls for gradual approach and tentative measures tested in the light of experience. We have to date attacked only segments of the problem. It is still too early to make adequate appraisal of some of the measures which have been adopted. But there are some current aspects of the problems which are arising in connection with the administration of the Securities Exchange Act of 1934 which I would like to mention briefly.

In the first place there is the problem of margins over which the Federal Reserve Board has jurisdiction. In this connection there have been some interesting developments. Following the decline in stock prices which occupied most of the month of April of this year, some people became apprehensive concerning the restriction of margin accounts which was caused by the combination of stiffer margin requirements and the stock-price decline.

Under Regulation T of the Federal Reserve Board concerning loans by brokers and dealers, there was prescribed, effective April 1, a maximum loan value for registered securities (other than exempted securities) of 45 per cent of current market value. Regulation U, covering direct loans by banks for the purpose of purchasing or carrying registered stocks, effective May 1, also prescribes a 45 per cent maximum loan value.

It is likely that speculators have been inclined to purchase stocks to the limit of lawful credit accommodations inasmuch as even that full amount is considerably smaller than they had been accustomed to carry with equal cash or collateral in preregulation days. Obviously, when margin accounts are filled to capacity even a small dip in stock prices will have the effect of restricting further purchases. Moreover, the accounts may remain thus restricted for some time, since a subsequent market rise may not include, to any worth-while extent, the poorer-grade issues that fall sharply.

In former times it was not unusual for some classes of speculators, intent on greater profits, to attempt to carry as much stock as their funds and collateral would permit. When a dip occurred in prices, these buyers, even as today, were in no position to make further purchases. Often it was only a matter of a small further decline that brought about a number of calls by brokers for additional margin. Thus, restriction of margin-account buying is not new, but restriction today does not mean enforced selling.

Contemporary stock buyers, as well as those of any previous period, might be grouped in two classes: those who cannot resist the temptation to overtrade and those who are wise enough to "restrict" their own accounts by purchasing no more than a very reasonable risk will permit. The second group would include true investors who confine their dealings to cash transactions. Every investor and every smart speculator sees the wisdom of self-restraint in stock-market matters. A cautious investor "restricts" himself to the amount of cash at his disposal.

The two main purposes of the margin sections of the Securities Exchange Act of 1934, prevention of the excessive use of credit in security transactions and limiting speculation, are to a substantial extent accomplished by Regulations T and U. Their existence is justified by the creation of greater safety for investors on the exchange and in the capital markets.

As of May 29, 1936, there were 418 reporting member firms of the New York Stock Exchange which carried margin accounts for customers. The number of these accounts totaled 205,884. It may be liberally estimated that these 205,884 accounts involved 200,000 persons, or less than two tenths of 1 per cent of the population of the country. It may also be estimated that these accounts represent the great bulk of margin trading through brokers in this country. During this year New York Stock Exchange brokers' loans have averaged about one billion dollars. From other data which we have it may be estimated that the brokers supply about one quarter of a billion dollars more money, making a total of about one and one quarter billion dollars of customers' debit balances owed to brokers. Taking the market value of New York Stock Exchange stocks alone, it appears that the ratio of the total debit balances of customers to the market value of these stocks is 2.51 per cent.

It can fairly be said that present margin regulations do not impose an undue burden upon security buyers. With $5,500 one may purchase securities valued at $10,000, a value about 82 per cent in excess of the funds available for the speculation. It is difficult to rationalize a more liberal credit extension, to find reasons why stock buyers should take greater risks.

Our national income in 1932 was less than forty billion dollars. In that year retail sales on the installment plan were estimated at three and one half billion dollars.

[FN 1] Thus, assuming forty billion dollars of funds were available, the three and one half billion representing installment sales bore a ratio of only 8 3/4 per cent to total national income. Thus it will be observed that the average man's general installment obligations amounted to only 8 3/4 per cent of his annual increment.

The buying of a car on the installment plan is the equivalent in many cases of money saved which might otherwise have been used in various ways. There is little difference between saving ten dollars a week for the purchase of furniture for the home and buying it on ten-dollar weekly installments. The purchase of securities on borrowed money is a different story. Money placed in securities represents savings. The purchase of securities on credit is an outright oversaving which may jeopardize true saving, since a price decline forces liquidation.

The popular view, however, is that we must make some allowance for American gambling proclivities. And it is said that Congress did this in writing Section 7 of the Securities Exchange Act, which deals with margin requirements for securities registered on national securities exchanges. However that may be, a thoughtful student of the subject cannot fail to be impressed with the necessity for examination of the hypotheses upon which margin trading is based. The ramifications of that subject have never been adequately studied. Constant and attentive consideration of the incidences of margin trading becomes essential for the immediate and long-range program of control of security speculation and security manipulation.

In the second place there is the problem of the "thin" market, which in some respects is closely related to the problem of margin trading. Blame for the relatively thin stock-exchange markets of recent months has been attributed by many to the Commission and to the Federal Reserve Board. And fears have been expressed that continuing regulation of this character will tend to accentuate this condition of "thinness." [FN 2]

We have had occasion to study this problem intensively in recent months, especially in connection with our study of the segregation of the functions of brokers and dealers. Recently we have submitted a preliminary report on that subject to Congress. [FN 3] In that report we recognized the grave risk of fundamental conflict of interest existing when one person acts both as broker and dealer; *i.e.,* when he acts as an agent or fiduciary for others on the one hand and as a trader for his own account on the other. As we pointed out in that report, this conflict may react to the disadvantage of the brokerage customers:

A broker who trades for his own account or is financially interested in the distribution or accumulation of securities may furnish his customers with investment advice inspired less by any consideration of their needs than by the exigencies of his own position. The securities, equities and credit balances of his customers may be endangered by the risks which he incurs in making excessive commitments for his own account. A complicating factor in these situations is that the average investor too frequently is unaware of the distinction between the broker and dealer relationships and hence takes no account of the possibility that the advice and service proffered by a broker may be affected with a powerful, independent interest at variance with his fiduciary obligation.

We also pointed out that the prevalence upon exchanges of a type of dealer activity which exerts undue influence on prices and incites public speculation, leads to disorderly markets and interferes with the effective fulfillment of the brokerage function.

That study and report were "preliminary in character." Rather than adopt a comprehensive program of immediate segregation of all brokers and dealers, we chose the course of an "evolutionary but direct approach" with the view of moving forward progressively toward a thorough solution of this aggravating problem. To that end we proposed, among other things, a "functional segregation of all members on the floor of the exchange with the exception of the specialist in the stocks in which he specializes." Under such a requirement, floor traders could not act as brokers and floor brokers and commission brokers could not, while on the floor, initiate orders for their own account or the account of their firms.

We also suggested further proposals for control of floor trading, for restriction of the activities of the specialist, for trading by members in stocks off the floor. These additional requirements move in the direction of an insistence upon a singleness of allegiance on the part of brokers acting in fiduciary capacities. We do not leave the problem with these admittedly partial solutions. We are committed to a continuing and increasingly intensive study of the whole problem with a view of moving progressively forward toward the objective of high standards of conduct in our security markets.

Admittedly such measures will have their effects on the quality of the securities markets. They may contribute to the "thinness" of such markets. But let us stop at this point to consider some of the aspects of this quality of thinness not from the point of view of brokers and dealers whose income may be affected but from the viewpoint of our national economy. Disregarding the proposed segregation rules which we have sponsored and looking solely at present rules and regulations, what condition do we find?

If rules and regulations under the 1934 Act have reduced the numbers of potential buyers and sellers of securities on the stock exchanges, or limited the extent of their trading, it should be remembered that they are those same rules which were devised to prevent manipulation and controlled prices, to prevent excessive use of credit in security speculation, to prevent excessive speculation itself, to remove the advantages formerly accruing to insiders, and to regulate the trading by members of the exchanges. Some contend that these rules and regulations have contributed to thinness in the markets. But it must be remembered that volume of trading usually dries up after a long upward trek in security prices is halted, even temporarily, by a swift decline. Thereafter, speculative activity is lethargic until primary causes are found for renewed upswing or further decline. In fairness, then, it cannot be contended that these natural causes be disregarded and full blame be attributed to Federal regulation. The normal lassitude of markets which follows speculative excesses cannot be overlooked.

Furthermore, what is this thing called "liquidity" and how important to our national economy is it? Liquidity means not only convertibility into money but also conversion into money within a reasonable period of time and at a price not out of line with that deemed appropriate for the particular commodity. The fact that a ready market may exist for a commodity does not necessarily mean that the commodity possesses liquidity, for the market price may be so out of line with current conceptions as not to provide a price within the limits which are deemed appropriate. Some are apt to think of the 1929 stock market as being the norm for liquidity. But what degree of liquidity was there, for example, in October, 1929, when stocks listed on the New York Stock Exchange lost over $15,000,000,000 of value? At that time it would seem that instead of liquidity we had evaporation.

Now if there were reason to sell a large block of stock in a short period of time and within a reasonable range of prices, one should not be surprised to find the problem more vexing now than in the summer of 1929. Yet compared with October, 1929, such a transaction would perhaps not be so difficult. On the other hand, it is self-evident that if in the average day's trading in regulated markets there are fewer buyers and fewer sellers, or if there are as many as in previous years but they are trading in smaller amounts of stock, the need of "thickness" of the market also has been reduced proportionately. It would also seem obvious that to the extent that these markets are freed from manipulation, the need for thickness in the market is likewise reduced proportionately.

As I have stated, the so-called "liquidity" and "continuity" of security markets during past periods of large volume of trading were, while they lasted, due in large part to excessive trading by professionals and insiders. Still worse, a substantial portion of the activity was provided by manipulative efforts of pools and by the overtrading of misguided individual speculators who bought securities, not because of merit or intrinsic worth, but because of the glamour of pool-made markets and whispered tips originating with the pool managers. Markets which are free from these influences and in which purchases are made after mature deliberation are more permanent markets, if not as liquid for the short term. When a pool advertised its wares by sudden market price movements in its stocks, the public buyer was drawn in at high prices. After a sharp decline, that buyer did not have the necessary funds to purchase similar shares at a reasonable price level. This means that, on a broad scale, more and more speculators and would-be investors were drawn into the maelstrom of a gambler's market at higher and higher prices. Obviously, many of these persons were automatically released from their holdings as prices declined sharply. The aftermath of the speculative orgy was low prices and low public participation. Thus the liquidity of the boom market paved the way for the illiquidity and lack of continuity of later markets.

Let us look into the short periods of liquidity associated with earlier bull markets. The same floor trader who was willing to buy stock at twelve o'clock on a certain day was a willing seller at two o'clock. The insider, who supported his favorite issue at attractive prices on a decline, generally let the purchased block of stock go on the first good rally. The manipulator who created fancy prices also caused sharp declines when he had completed his distribution and was taking a short position. The eighths and quarters of the floor traders and the larger profits of insiders and manipulators resulted principally from the fact that many "outsiders" paid more for their stocks or received less upon their sale than might otherwise have been the case. If we cannot countenance such abuses—and we should not—we cannot have the high degree of liquidity which was a concomitant of the extremely active markets of limited periods in the past, unless such liquidity is the result of public interest not artificially stimulated. Such liquidity and continuity were normal resultants of the manipulation and excessive speculation of those periods.

It has been stated that specialists' books in recent weeks have been very thin. That is to say, there are few buyers and sellers who have open orders to buy at prices below current prices or to sell above current prices. Perhaps specialists' books are always thin, when a long rise in the market has been followed by a sharp decline and speculative activity temporarily has been reduced because many brokers on the floor, who in busy days leave their orders with the specialists, attend themselves to their execution on quiet days. In the second place, as markets become less active, the true books of orders at or near the market, in the majority of fairly active stocks, are in the pockets of various floor brokers and in the minds of speculators and investors who will buy or sell without advance notice to the specialists. Markets are not as thin as the specialists' books would indicate.

What we ought to remember is that those who buy with sufficient capital, and not merely to take advantage of one-quarter- or one-half- or one-point movements, neither depend upon, nor are interested in, markets featured by the degree of liquidity for which our speculative and manipulative markets have been notorious. Markets of this sort, which were prevalent in the late 'twenties, ended in practically complete non-marketability. Investors' markets necessarily are different markets, but this does not mean that the investor fares worse. The most liquid markets are those made by manipulation, but the investor who remembers the experiences of 1929 and 1932 should certainly be aware of the fact that they are not made for his benefit.

Or to state the matter in another way: [FN 4]

The economic value of an exchange is popularly measured by the extent to which it possesses the quality of continuity and imparts liquidity to its securities. Respect for these attributes, particularly where stocks are involved, has become generally ingrained in the consciousness of investors and lenders. Investors and lenders are accustomed to regard current exchange quotations as accurately reflecting the realizable value of a security…Our economy as presently constituted not only holds these attributes in high esteem, but has attuned many of its institutions, such as our banking system, to them.

On the other hand, the experience of the past suggests that the creation of claims that demand liquidity can be carried to such lengths that the result is an unstable economy. Over-emphasis upon liquidity promotes artificiality in the economic structure, because it is based upon the assumption that the wealth represented by securities is and will continue to be readily convertible into money and at not too great a deviation from current quotations. Inasmuch as a belief in the continued existence of liquidity makes for lending capacity on securities, independent of what may be the purpose of the loan, it induces expansion in bank credit, and, as the past readily illustrates, undue expansion of bank credit has reverberations throughout the entire economic structure.

The total volume of credit extended upon securities may at any time be wholly disproportionate to the credit that lenders would extend directly to the corporations which issued these securities, even though the latter type of loan has a legal position ultimately superior to the loan made upon the securities. Such a result largely flows from the fact that the market imparts for the time liquidity to the securities held as collateral, though the ultimate security in both instances may be the earning power of the corporate assets. Again, the prominence of the quality of liquidity increases the inclination, already too prevalent, of buyers of securities to think in terms of the appreciation in the value of the security rather than its promise of continued and substantial earnings. This inclination impairs the value of the market as an accurate barometer of investment opportunities and thus tends to vitiate the judgments of even those buyers who do think in terms of underlying worth.

That activity as such is desirable because it promotes liquidity, and that speculative activity is an essential to the maintenance of liquidity are by no means established economic truths. Generally speaking, lack of balance in the market between investment inflow and outflow operates to bring about changes in price trends. When the outflow exceeds the inflow, prices fall; but if they fall below a certain point, the sacrifice which would be involved in the sale of a security may induce its holders to treat it as non-liquid rather than as liquid wealth. Consequently, speculative activity, which accentuates price trends, has its bearing upon such a phenomenon. Furthermore, if liquidity involves an appropriate balance between investment inflow and outflow, and a disturbance of that balance occurs, speculative activity that accentuates price trends tends to increase the lack of equilibrium already present, and, though convertibility into cash may be maintained, that accentuation brings about the type of artificial instability making for price declines and rises totally out of line with basic economic conditions, and destructive of a fundamental element of liquidity.

From this it is clear that our problem and concern are not with thin markets as such, but with that type of speculation which brings about artificial instability. Speaking generally it may be said that the interests of investors and speculators are basically divergent. By his very nature the investor has to buy when he has a surplus of funds or has to sell when he needs to realize on his invested funds. A speculator does not have either to buy or sell. He simply does it in the hope of making a profit. It was stated by the House Committee Report on the Securities Exchange Act of 1934:

There is plenty of room for legitimate speculation in the balancing of investment demand and supply in the shrewd prognostication of future trends and economic directions; but the accentuation of temporary fluctuations and the deliberate introduction of a mob psychology into the speculative markets by the fanfare of organized manipulation, menace the true functioning of the exchanges, upon which the economic well-being of the whole country depends.

On this basis there is room for speculation which furnishes a bridge between the investor-buyer and the investor-seller. But that bridge does not have to be so wide, and the multitude of speculators so large that the number of investors will be overwhelmed. As I have stated, such excessive speculative markets, with all their liquidity, have been fertile ground for abuse and actual fraud, for distorting the real prices, by divorcing them, through an intervening speculative enthusiasm or despondency, from their economic background. At times this caused wholesale distress, because everybody relied on liquid markets, and got themselves accustomed to thinking of liquidating, even wanted to liquidate at the same time, which, of course, is impossible. It is a fundamental weakness of the liquidity concept—and a reflection on the way we have been educated to react to it—that there are times when thousands of people want to buy for speculation, while there is only a small number of investor-sellers available, and, at other times, still greater numbers all wanting to liquidate at the same time, while those who would have been investors have been tuned up to the speculative state and, instead of being buyers themselves, for no good investment reason join the already too disproportionately large ranks of the sellers.

If we have recurring waves of ups and downs*; i.e.,* market swings, or cycles, to the extent that we have a large number of speculators that play such swings rather than take an investment position, the danger is that, if all are equally smart to catch the trend, stocks will shoot stratosphere high at one time and drop abysmally low at another.

In view of this it is obvious why we should not be as solicitous in permitting freedom of action on the part of the speculator as we are in safeguarding the interests of investors.

It is not uncommonly contended that the professional speculator should be left free and untrammeled and that, if that course were followed, the public speculator would be protected. There is, however, a fallacy in assuming that professional speculators protect the public speculators. This fallacy flows from the assumption that there is a certain definite amount of stock to be traded, say, a thousand shares. If three hundred of such shares are bought by professional speculators, there are only seven hundred shares left for the less wise public speculators, and hence they get to that extent less hurt than if all the thousand shares were bought by them. The truth of the matter is that trading has a totally different aspect. The professional speculator does not take off so much stock from the public speculator. Rather, the more he buys the more the public will buy. He sometimes generates movements in stock, and, because of the facilities of the ticker, the public joins him. It is not at all proven that increased speculation by professionals means decreased speculation by the public. It is likely that the opposite is true.

It is proven, however, that certain professional trading accentuates price trends. Thus our analysis of daily trading reports from members of the New York Stock and Curb Exchanges, gathered over a period of six months, showed that the floor trader traded against the trend only one third of the time, but traded with the trend two thirds of the time. However, when fluctuations in prices were small, floor trading was neither preponderantly with nor preponderantly against the trend. But when the market definitely moved in one direction or the other floor trading was with the trend 73.5 per cent of the time. We concluded that "floor trading on most of the days under review accentuated the trend of market prices."

To put the matter another way, if you let speculation alone and set up no controls over it, what starts as moderate speculation will feed on so-called injudicious speculation; the speculative excesses are quickened and the investment process is weakened. And finally, by depleting the ranks of investors in favor of those of speculators, speculation inevitably, sooner or later, destroys its own foundation and builds a debacle.

What is frequently forgotten is that the cost of speculation to the public is very high. There are as many, or more, transactions in the odd-lot market, for example, as in the round-lot nonprofessional market. The average purchases in the odd-lot market amount to about twenty shares, or less than $1,000 per transaction. The double taxes paid, the high minimum commissions, the differentials, are such that it may be estimated that a customer, starting with about $ 1,000, as a result of sixty-six trades, has contributed to the kitty $1,000. If he buys on a 50 per cent margin, thirty-three trades will result in the $1,000 going to the kitty. If he uses still smaller margin, and buys that much more stock, it means, of course, that the kitty will take the amount in fewer transactions. This assumption is, obviously, based on the fact that in his sixty-six trades he will buy and sell, on the average, at the same price; that is, that he has an average chance of neither losing nor winning. Whether he has such an average chance is still to be proven over a term of years. That so-called injudicious speculation is not only economically harmful but harmful to the individual has been long recognized by conservative brokerage houses, who have insisted upon margins higher than the stock exchange, and discouraged their customers from overtrading, and too rapid a turnover, even though it meant a loss of commissions.

All speculative theories agree that the fundamental basis of all markets is legitimate trading. In the grain market, for example, the basic idea is to distribute the crop to the processors; in the security market it is to give an opportunity to those who have accumulated funds to buy and, when they need cash, to sell. It is sometimes said that the speculator is actually a "middleman" between the original seller and the ultimate buyer. This is something simple and comprehensible; but, whether, in order to render this service, it is necessary to turn over the capitalization of some stocks several times in one year is far from proven. It is true that this furnishes "great liquidity," but, as I have stated, the greatest liquidity is always in artificial markets, made by pools and manipulators for as long as the making goes on. And, whether such markets are made by manipulators, or the liquidity results from spontaneous speculation, it usually ends in a condition where there are no markets, and neither speculators nor investors can sell. Rapid turnovers mean increased brokerage commissions. But from a broad, national point of view, there is little economic significance in whether the turnovers are high or low.

So in conclusion, let me say, first, that our primary concern is with the protection of investors. The objective is neither creation of "thin" markets nor "thick" markets, but with curbing of speculative excesses which are so dangerous to our national economy and with the injection into these market places of higher standards of fiduciary relationships. And let me say, secondly, that the appearance of thin markets is not of itself a matter to be decried. Nor is the fact that this may possibly be due in part to actions taken by the Securities and Exchange Commission and by the Board of Governors of the Federal Reserve System any proper condemnation or criticism of the propriety and necessity of the kind and degree of Federal regulation which has been imposed. Nor is the fact that insistence on higher fiduciary standards of conduct in the securities market by segregation of brokers and dealers may accentuate the quality of thinness any justified criticism of that ethical proposition. Thin markets may promote true liquidity, as well as the contrary. We need to forsake the blind faith in that kind of liquidity for which the markets of the late 'twenties were conspicuous and to examine *de novo* the validity of the hypotheses upon which that kind of liquidity is based. Until we approach the problem in that manner and from the viewpoint of our total national economy, rather than from the viewpoint of brokers and dealers bent on increasing their income, we will never reach a satisfactory solution of the problem of attuning the security exchange markets to the public interest.

[FN 1] Evans Clark, *Internal Debts of the United States*, p. 307.

[FN 2] The stock market is said to be "thin" when the ranks of potential buyers and sellers are thin; this reduces the speed with which a given amount of securities can be bought or sold at a specific price.

[FN 3] *Report on the Feasibility and Advisability of the Complete Segregation of the functions of Dealer and Broker (1936).*

[FN 4] *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker (1936)*, pp. 98-99.