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Remarks of Wm. McC. Martin, Jr.,
Chairman, Board of Governors of the Federal Reserve System,

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Symposium Observance of
175th Anniversary of New York Stock Exchange

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This is a happy occasion for me, a homecoming warmed both by memories and by the presence of many new friends and old. Thank you for letting me join with you in this anniversary celebration.

Although it bears the name of a city, the New York Stock Exchange is, in reality, a national public institution, one almost as old as the Republic to whose development it has contributed so much over a century and three quarters.

I like to recall that when the Exchange was founded by twenty-four brokers on May 17, 1792, only three years had elapsed since General George Washington had become the first President of the United States by taking his oath of office on a balcony overlooking Wall Street. It is unlikely that this marketplace could have endured over so long a span had it not served the country well.

I like also to recall, from the days of my association with the Exchange, a basic "guideline" for the operation of the Exchange laid down not by the Government but by a committee formed by the Exchange itself from the members of its own community. It was called the "Conway Committee" and the keynote of its report was sounded in these seven words: "The public interest is the paramount consideration." That rule is as applicable now as it was then: the public interest must always be the paramount consideration for the Stock Exchange.

As these recollections attest, anniversaries often are occasions for looking backward. When an individual is being honored, there may be nowhere else to look. By the time a man is ready to celebrate his achievements, the celebration is likely to be what artists call a retrospective exhibit--one that sums up a life's work. Institutions, on the other hand, continue adding to their years and achievements so long as they continue to fill an important public need. The problems and opportunities of the past are always less vital than those of the future.

It is, therefore, appropriate that the New York Stock Exchange has chosen to celebrate its 175th anniversary with a theme looking toward the future, and my remarks--in keeping with that theme--will be directed broadly to the part capital markets are expected to play in bringing about economic advance:

Let me say, at the outset, that in terms of our economic potential I am a confirmed optimist. The ingredients for growth and the technological advances already looming on the horizon foreshadow opportunities beyond imagination. Along the road, however, are many obstacles. Currently we are struggling with a world-wide shortage of investable capital. And this gap can only be closed by the discipline of capital formation through the saving and investment process in which the New York Stock Exchange has an important role.

Exchanges provide continuous ready markets for securities that constitute an important proportion of the assets of many individuals and businesses. Individuals, to make purchases of goods

or services, or to meet changing circumstances, frequently have to sell or borrow on their securities to obtain the necessary cash. Furthermore, businessmen often sell their securities or pledge them as a basis for loans to obtain working capital. Sales or borrowing transactions of these kinds would be far more difficult without market centers, where investors, traders, brokers, and dealers, are brought together. Sales of new security issues by business corporations would also be more difficult if buyers did not know they could later dispose of such assets readily.

Properly functioning financial markets are vital to the attainment of a high standard of living and steady growth of employment opportunities. A major distinction between highly developed, industrial economies and those of the less developed countries is the lack in the latter of effective capital markets for mobilizing the savings of their people. We could not today have our American system of mass production, distribution, and consumption if it were not possible for business enterprises to assemble large aggregates of capital through the securities markets by pulling together the scattered savings of individuals.

The American public has demonstrated a high capability and willingness to save. During the past five years, the public's holdings of financial assets have increased on the average by about \$55 billion a year. But savings do not automatically become available for long-term capital investment: it takes capital markets to mobilize savings and transform them into modern factories and stores, new homes for American families, and the roads, schools, hospitals and other facilities constructed by local, state, and federal governments.

If, however, our capital markets constituted nothing but a meeting place for individual suppliers and users of funds, many participants would never realize their opportunities--at least not on the scale attained in recent years. The success of the American economy in making use of its large and growing pool of savings to finance fixed investment of all kinds has rested on the ability of institutional investors to intermediate between savers and users of funds. They must first attract large savings flows through tailoring their own securities to fit the needs of many savers, and then pass these savings on to users on terms suitable to the needs of the latter.

The process of intermediation is not new. Institutions have been providing these services for many years. Insurance companies and retirement funds have afforded assurances that specific savings goals will be met on a contractual basis. Thrift institutions and the savings departments of commercial banks have offered a current return combined with safety and liquidity. Investment companies have provided savers who want to participate in the securities markets with shares in diversified, professionally managed portfolios. What is new is the absolute and relative growth of these institutions since World War II and the dominant position many of them now hold as direct suppliers of funds in most new issue markets.

The greater importance of institutional investors has altered the character of various capital markets significantly since World War II. Marketing practices, financing techniques, even

market instruments have been increasingly shaped to fit the preferences of these institutions. And the rise of institutions as direct market participants has in turn changed, and in some respects diminished, the traditional market role of middlemen--underwriters, brokers and dealers.

Changes have been particularly evident in the market most directly concerned with financing long-term business investment--that for corporate bonds. Certainly this is no longer a retail market in the customary sense of the word. The principal suppliers of funds are now insurance companies, corporate pension funds and, more recently, the retirement systems operated on behalf of state and local government employees. All these are concerned with finding long-term investment outlets for a large annual inflow of funds. Their financial obligations are predictable and do not--or are not expected to--require the liquidation of existing assets. Whereas individuals are reluctant to tie up funds for long periods unless the assets they acquire are marketable, institutions with contractual obligations and predictable inflows usually have little need for a secondary market. Accordingly, for most debt issues, secondary markets are now thin and in some cases virtually nonexistent.

Underwriting practices also reflect the character of the market's dominant customers. In a retail market where large bond issues must be distributed to a great number of individuals or small institutions, underwriting syndicates must make a massive sales effort to market bonds in small denominations. But where large institutional investors are the principal takers, potential customers are readily canvassed and are likely to subscribe for large blocks.

I think it can also be said that an institutional market tends to broaden the range of companies which are eligible for long-term financing. To succeed in distributing a public bond issue "at retail," it is important to an issuing company to be known nationally and to have a balance sheet about which no one is likely to raise questions. Sophisticated institutional investors, on the other hand, are prepared to evaluate the special circumstances of less well known companies. In fact, in many instances, corporate borrowers and institutional lenders choose to by-pass altogether the conventional process of a public offering, arranging to extend the credit singly or as a group through a private placement. And although the share of corporate bonds that are privately placed varies rather widely according to market conditions, in general it amounts to more than half of the total.

We can all agree that each of these innovations increases the corporate bond market's flexibility, its efficiency, or its capacity for serving particular borrowers and lenders. But we must also recognize that these changes have made that market less suitable for individual investors. And if they have not significantly diminished the importance of the financial middleman, they have sharply changed the nature of his role.

Fortunately, the situation is not altogether parallel in markets for stocks. There, institutions and individuals have many similar needs. Both, for instance, are dependent on the existence of an effective mechanism for secondary trading. Without it, current owners would have no opportunity either to liquidate holdings for cash or to exercise their investment judgment.

At one time it was expected that institutional investors would tend to treat stocks much as they did other assets, accumulating relatively permanent holdings in selected issues and varying the composition of their portfolios through the use of savings inflows. But this does not seem to be the case. Institutional holders are expanding their "turnover" activity and, as such transactions increase, their needs for an active and efficient secondary market are at least as strong as those of individuals-- though the size of their transactions makes this service more difficult to provide.

The importance of secondary markets is greatly increased by the corporate practice of building equity primarily through the reinvestment of retained earnings. If profits are re-invested rather than paid out in dividends, shareholders are not given an explicit choice whether to withdraw their share of earnings or to increase their commitments. But if share values rise to reflect the results of reinvestment by corporations in their business, the option of their shareholders can be restored by the possibility of sales in an active secondary market.

Meanwhile, these same markets provide new investors, whether institutions or individuals, with their only substantial avenue of shareownership in most large established corporations. The new-issue market which operates over-the-counter remains of strategic importance to smaller, newer or more rapidly growing corporations. But precisely because such issues retain the traditional character of venture capital, the markets that serve these issuers must remain adapted to distributing small issues to individual risk-takers.

In short, the problems posed for the stock markets by institutional investment do not stem from a basic conflict of interest between two incompatible classes of customers. They are technical problems of how to maintain a market mechanism that can accommodate the large transactions and volume business of big institutions while continuing to serve the retail needs of individual investors. I realize that you in the securities industry, both on and off the organized exchanges, are already working to develop procedures to cope with these problems.

But, in the meantime, some institutional investors are creating a new problem which poses a potentially more serious risk to the future well-being of stock markets. Increasingly, managers of mutual funds, and portfolio and pension fund administrators, are measuring their success in terms of relatively short-term market performance. In effect, they set a target on a growth stock, attain that target, unload, and then seek other opportunities for quick capital gains.

Given the large buying power of their institutions, there is an obvious risk that speculative in-and-out trading of this type may virtually corner the market in individual stocks. And in any event, activity of this kind tends to create undesirably volatile price fluctuations. I find this trend disquieting.

However laudable the intent may be, it seems to me that practices of this nature contain poisonous qualities reminiscent in some respects of the old pool operations of the 1920's. I suggest

that the Stock Exchange, as it celebrates its 175th anniversary, watch these activities carefully and make certain that this new cult of short-run market performance does not once again result in a tarnishing of Stock Exchange wares.

The specific responsibilities of the securities industry to those who use its market place may be covered rather well by what used to be called the pursuit of long-run, enlightened self-interest. Customers must be dealt with honestly. They must have access to impartial and informed advice. They must not suffer as a result of inside trading or massive institutional speculation. Abuses of investor confidence by a few, for short-run gain, reflect badly and, in the long run, disastrously upon the entire industry. It is the responsibility of the Exchanges and other market organizations to have proper rules and requirements and to see that these standards are scrupulously observed.

Stock market customers also need full and accurate information about the companies whose securities they decide to buy or sell. Prior to the establishment of the Securities and Exchange Commission, the New York Stock Exchange, through its Stock List Committee, pioneered and led the way in this area. Now the S. E. C. also has a responsibility for making sure that information is available on companies whose stocks are listed on the organized exchanges and on an additional group of large companies whose shares are actively traded over-the-counter. For certain widely held bank stocks that are traded over-the-counter, parallel responsibility rests with the supervisory bank authorities.

In addition, the Board of Governors of the Federal Reserve System has the duty to set margin requirements which will prevent the use of credit in the stock market from becoming excessive. Here, too, we have the responsibility of adapting to change; as, for example, we are seeking to do in our recent request to Congress to extend margin requirements to actively traded stocks in over-the-counter markets. Similarly, we must be alert to changes in credit practices regarding such things as financing of convertible debentures and the use of credit obtained from unregulated lenders.

The question is often asked how stock market credit can be "excessive" when the ratio of loan to market value is more conservative than that generally accepted for most other types of credit. I think in this connection, it is only necessary to remind ourselves of one characteristic of stock market credit. When stock prices are changing rapidly, a little credit can often go a very long way to accentuate that price movement, either up or down. On the up side, pyramiding can occur because loan values increase as holdings rise in price, and added credit can then be used to make new purchases which tend to drive prices up further. The potential of credit for bringing this about has probably increased in recent years. As automated record-keeping has been adopted more widely throughout the brokerage industry, the top market values reached in each customer's account are instantly recorded and made the basis for further purchasing power.

Even more destabilizing to the market, however, is the effect that thinly margined credit can exert when prices drop sharply enough to trigger margin calls. If these calls have to be met through sales that depress market prices still more, a chain reaction of additional margin calls, touching off further forced sales and further declines, can be very difficult to arrest. If stock market history has taught us anything, it is that reasonable restraint on margin transactions is a moderate price to pay for limiting the repercussions of an excessive use of credit on market movements. This is especially true because such movements are likely to have a disproportionate psychological impact on business expectations and on the economy at large.

I might add here that while those of us who are usually concerned with the broader aspects of monetary policy think of margin requirements as a selective control, they are actually rather general. A requirement that is quite acceptable for most stocks in a given market may be inadequate to prevent the use of credit from playing a highly destabilizing role in markets for certain selected issues. Only industry participants can identify such speculative situations on a day-to-day basis, and it is gratifying that the Exchanges themselves in the fall of 1965 and the spring of 1966 took some responsibility for controlling these situations.

In increasing numbers, the American public has been demonstrating its desire to buy and own shares so as to participate in the increasing productive power of an expanding economy and in the accompanying increase in value that stocks on the whole have

registered over the years. Whatever the merits of stock prices as a barometer of short-run business fluctuations, there can be no question that in the long-run they reflect confidence in the future of the American economy.

Whether the high potentials of our economy are realized over the long-run will depend on the entire range of private decisions and public policies that will determine, on the one hand, whether incentives are adequate to encourage continuing economic growth and, on the other, whether we can avoid the excesses of unsustainable booms.

The specific goal of the country's overall economic policy is noninflationary growth at the maximum rate. I think we have learned quite a lot over the years on how to accomplish this, even if we have not always distinguished ourselves in applying our knowledge. It may be true that we have shown more talent for forcing the bloom of prosperity than for prolonging its life. And it is certainly true that, however much we may have advanced in handling the economics of adversity, we have not yet wholly mastered the economics of prosperity--though master it we must if we are to achieve our goals, including the elimination of poverty and the elevation of living standards for all.

If the government provides an appropriate combination of monetary and fiscal encouragements and restraints, and if our citizens in general give their support to these policies and continue to act in enlightened self-interest, we can maximize our chances of maintaining prosperity in the years ahead.

We are blessed to be living in a free society where the responsibility of government, as I understand it, is not to order the lives of people but to provide a climate of opportunity that will encourage them to apply their energy, enterprise and ingenuity to improving the lot of themselves, their families, and their communities, and thus to promote the welfare of the country as a whole.

This country is a republic, a constitutional democracy, in which the general welfare is expressed in political procedures, forms, and institutions. At the center of our way of life is the market place, tying together individual freedom and material progress. While concepts may be modified and should be from time to time, as they have been, our basic thinking continues to recognize the strength we derive from private property, free competitive enterprise, and the wage and profit motive, operating in the market through the price mechanism. The Federal Reserve Act, the Securities Acts, and the Employment Act of 1946 were framed with this heritage in mind.

As we stand on the threshold of the 176th year of the New York Stock Exchange, let us all look to the future with courage, faith, and confidence in the system that has made this country great.