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Summary of Remarks
by
Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System,
at the
Silver Anniversary Dinner
of the
Association of Customers' Brokers

Waldorf-Astoria Hotel,
New York City,

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The postwar period and especially the years since 1949 have been marked by a dramatic growth in stock values and stock trading. These developments have changed the character of the market and have increased the responsibilities of all participants in the securities industry. The value of all stock now outstanding is about five times what it was in 1949, and the market value of stocks listed on the New York Stock Exchange has risen even more sharply--reflecting new listings as well as price increases. The average number of shares traded daily on the New York Exchange last year was four times the daily volume in 1949, while the annual dollar volume of trading on all exchanges rose from \$11 to \$64 billion over the same period.

Meanwhile, an equally dramatic increase in the number of shareholders--from an estimated 6.5 million in 1952 to 17 million a decade later--has multiplied the number of individuals with a personal stake in the market. This development has brought new responsibilities both to the securities industry and to authorities charged with various aspects of stock market regulation. Attention in Congress is now being focused, for instance, on the need to provide investors with accurate information about stocks traded over-

the-counter as well as those listed on exchanges. The standards of integrity and competence required of salesmen in dealing with this enlarged public have also assumed added importance.

Stock market credit--the area in which the Federal Reserve Board has special responsibility--has shared fully in the over-all expansion since 1949, with the total of customer credit rising from \$1.2 to \$7.2 billion. Margin transactions at all times appear to have accounted for a significant share of total stock trading, and for as much as a third in periods of high activity. During each of four postwar periods when initial margin requirements were lowered to 50 per cent, credit expanded vigorously to levels well above the preceding highs.

In authorizing control over loans extended for purchasing or carrying listed stocks, Congress in 1934 directed the Board to prevent the excessive use of credit in the stock market. The Board's aim in administering this regulation--its only continuing selective control over credit--has always been to permit market participants as much flexibility as is consistent with the legislative directive. Over the years, the Board has recognized a number of special circumstances which have appeared to justify exceptional treatment. These special privileges provide an important element of flexibility in the regulation, but they should be used only within the context for which they are intended. The

whole principle of a regulation capable of allowing exceptions can be jeopardized if such privileges are exploited to defeat the primary purpose of margin requirements.

For example, the Board's margin regulations now require stock purchasers, as a general rule, to deposit a 70 per cent margin. Since holders of rights to subscribe to new stock offerings might be unable to exercise these rights if they had to provide the normal initial margin immediately, however, they are allowed to borrow up to 75 per cent of the market value of the new stock in a special subscription account. This accommodation is intended to be temporary, but some low-margined subscription accounts do in fact remain outstanding for long periods. When this is allowed, the over-all purpose of margin regulation is weakened and the accounts remain vulnerable to margin calls in the event of a market decline.

Another special privilege is that of same-day substitutions. The general rule requires that when a customer whose account is undermargined sells stock, 70 per cent of the proceeds must be retained to upgrade the margin status of his account. But investors may wish to alter the composition of their stock holdings from time to time, and a special exception within the regulation permits them to do so. Such substitutions may be made without penalty so long as both sales and purchases are carried out on the same day, but

this privilege also is subject to abuse. By various transactions involving registered and exempt bonds it is possible for customers to liquidate their stock positions rather than to make substitutions. Under these circumstances, the substitution rule gives the sellers a technical device for re-entering the market on preferential terms, or even for making outright withdrawals of cash exceeding those permitted under the general rule.

Another special privilege relates to the holding of credit balances in special accounts. This is intended to benefit customers who would otherwise have overmargined accounts, either because they have left sales proceeds on deposit with the broker or because the current loan value of their collateral is greater than the actual amount of their debt. These customers could make some additional purchases without putting up additional margin. If margin requirements were to be raised, however, any such purchasing power in the general account would simply be absorbed in meeting the higher requirements.

Brokers are allowed to protect this excess purchasing power against changes in margin requirements by taking it out of the general account and holding it as a credit balance in a special miscellaneous account. Dangers of misuse arise when credits to that account represent unrealized gains in the market value of collateral. Transfers of this sort occurred frequently last year

when margins were at 50 per cent and the market was rising sharply. Installation of automated equipment has permitted many brokers to price out collateral easily, so that balances held in many special miscellaneous accounts as unrestricted purchasing power reflect the highest loan value reached in a daily process of valuations. Top valuations based on peak prices for volatile issues are likely to be temporary; the irresponsible use of purchasing power derived from such values could seriously undermine the effectiveness of initial requirements in providing a buffer against maintenance margin calls in a declining market. Conversely, responsible advice by brokers can do much to limit the danger posed by unrestricted purchasing power based on temporary high valuations.

A final example of the key role customers' men can play in minimizing or aggravating regulatory problems concerns lenders other than brokers or banks. According to the regulation, brokers cannot arrange credit for their customers on terms more favorable than they themselves can offer--that is, from sources of credit not subject to margin requirements. In the past, it has appeared that the flow of stock market credit from such miscellaneous lenders was relatively minor. This, together with the administrative difficulty of identifying and policing the wide variety of potential lenders in this field, has seemed to justify their omission from

regulatory control. Scrupulous avoidance of any role--however indirect--in bringing together borrowers and unregulated lenders will help to minimize this regulatory gap.

In summary, controls over the use of credit in the stock market are most workable and least burdensome to all participants when they are sufficiently flexible to permit exceptions for special circumstances. Such reasonable regulation can be effective, however, only if it is observed with responsible integrity within the industry itself.