Investing in Reform and Gambling on Change

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The hardest thing in the world is to figure out what you are doing wrong when nothing is going right. That is the way it has been for most of us in the securities industry this year. The second half of 1973 has been particularly rough — especially for those of us who make markets and therefore have large inventories at risk.

Once we turn the corner — if we have our wits about us — we will use those good times to understand these bad times.

Two assignments come to mind. The first is of particular interest to those directly in the securities industry; and the second for those like yourselves who have extensive dealings with the securities industry.

In the first category are what I call the structural problems. I think we have reached a broad consensus in the securities industry that we must invest money and brains in the new communications technologies because we can only make real money on big volume. The best way to attract volume is to lower costs. It is just that simple. The computer, properly used, holds more promise for reducing costs than any proposed legislation or regulation.

The second category is of direct interest to the National Investors Relations Institute. Groups like yours must work with the securities industry to seek out new markets. McDonald's didn't invent a new hamburger. What it did invent was a new marketing technique. The same holds true for the Street. We need to examine those marketing techniques which will radically broaden the base of stock ownership in the United States.

What I would like to do today is to discuss with you recent developments in the move toward a Central Market, meaning a Consolidated Transactions Tape, a Combined Quotation Service, and a National Clearing System; and then go on to explore some new marketing techniques such as monthly investment plans operated by commercial banks and stock options patterned after parimutuel tickets.

Structural Changes

Over the past several years the Securities and Exchange Commission and both houses of Congress have done first-rate jobs of studying the securities industry, writing excellent reports of their findings and proposing new legislation which would strengthen the SEC and set the stage for a nationwide Central Market which would be much more competitive and much more accessible.

Regrettably, the New York Stock Exchange and the Securities Industry Association view these proposals for change as a threat to their existence. They have dug in to oppose H.R.5050, the so-called Moss Bill, and S.2519, the so-called Williams Bill. No one can dismiss their opposition lightly because they have considerable clout. Last spring and again last month the Stock Exchange has let it be known that the price of its support for any new legislation is elimination of the Third Market. Of course, the issue is put more diplomatically in their public statements: in the name of "equal regulation" and "preserving the auction process," the Stock Exchange petitions the Congress to require that all transactions in listed stocks take place only on registered exchanges.

Neither the SEC, the Justice Department nor the staffs of the two Congressional subcommittees considering the legislation have any sympathy for such a rank boycott. They recognize, as I hope you do, that this country is too big and diverse to have one of anything — one airline, one computer company, one exchange or one political party. The historical thrust of the American experience has been to keep the power spread around. Those who have studied the securities industry recognize that the Third Market and the Regional Exchanges are the only check and balance to the economic domination of the New York Stock Exchange.

Needless to say, Weeden is right smack in the middle of the fight. The Stock Exchange is confident that over the years it can absorb the Regional Exchanges one by one or drive them out of the business. Not so with the Third Market. Even though the Third Market does but 7½% of the business done by the Stock Exchange, we present a challenge that scares them.

The source of that fear which in turn magnifies their fear of any and all competition is that over 30% of Weeden's business in stocks is done with members of the New York Stock Exchange. That is a fantastic commentary, to my way of thinking, on just how good or bad is the system which the Exchange wants to legislate for the entire country.

Bear in mind Weeden doesn't deal exclusively in big blocks of stock. Our average trade is in the 400-500 share category, the same as on the Exchange. Our prime customers are banks, insurance companies, pension trusts, member firms and non-member firms all across the country. All of these customers are professionals who know precisely what best execution means. They know what the real costs are. Our advantage lies not in our dealing in secret or in being less regulated. We welcome all the publicity we can get and are pleased to accept any and all appropriate regulation. Our competitive advantage, if that is what we have, is in making better markets and having lower costs.

I know how we are doing in the market, but I am less certain of how we are doing in the Halls of Congress. I wish I knew more about the political process – at least enough to be able to predict the outcome of the pending legislation. But for all the hours spent in Washington this past year, I haven't got a clue whether there will be any legislation this session, let alone what it will be.

Legislation or no legislation, I know we are heading toward a more efficient Central Market and that the best way to get there is to open up the market, not fence it off. Better markets require more market makers willing to risk more capital. The only way to increase that market maker participation is to eliminate the barriers which keep us from exposing our inventories to all available inquiry. Nobody wants to take on a big block of stock unless he has a reasonable chance of exposing it to all interested buyers. Those of you who are concerned about the depth and liquidity of the market in your company's stock should cease damning your institutional stockholders and focus instead on stock exchange rules which keep brokers and market makers all over the country from getting together.

The broker you hire, for whatever reason, must be free to go wherever he has to go to get best execution. The broker's loyalty to his client must exceed his loyalty to his Club. And if you don't want or need a broker because you are a professional, you should be free to deal direct in any or all of those markets or go direct to another professional – by telephone, pony express, or Instinet.

Third, the industry has to be able to clear transactions much more quickly. Far too many dollars are lost moving mountains of paper from market to market. What the banks have done for the clearing of checks, we must do for the clearing of stocks. That means a National Clearing System, based on continuous net settlements in regional centers where the transactions take place, without wasteful routing to New York. So long as all orders get maximum exposure, so long as all transactions get maximum disclosure, and so long as clearance is local, continuous and net, I am confident more competition will do a better job than more regulation in bringing about the Central Market. That is why it is so important that we have your support in moving ahead with the Consolidated Tape, the Combined Quotation Service and the National Clearing System.

The depth of my disagreement with those proposing more controls is profound. Competition and innovation are more important to this over-structured industry than any proposed new legislation or regulation. To preserve its present privileged status, the Stock Exchange foolishly blocks innovation and reform, even at the risk of alienating its customers, large and small.

The contribution of the Third Market has been and will continue to be our willingness to stand independent of the Establishment, to refuse to fix rates with the Club, or to join in boycotts of others.

Marketing Techniques

New marketing techniques should be of prime interest to the National Investors Relations Institute. One development about which you are undoubtedly aware is the opinion letter by the U. S. Comptroller of the Currency back in February 1973 finding nothing wrong with a proposal by Security Pacific National Bank to offer a monthly automatic stock investment plan to depositors and the public.

Eight months later we have nearly 30 banks, including most prominently the Chase Bank, offering similar plans.

The theory upon which the plans are based is that the banks are neither dealing in nor recommending stocks, but only accommodating customers. So viewed, many feel that the plans do not conflict with the Glass-Steagall Banking Act of 1933 which prohibits the banks from acting as dealers in corporate securities.

Whether or not the plans conform to the purpose of Glass-Steagall is, however, of far less importance to me, a non-lawyer, than the positive effect that someone is out there trying to attract business which the Street has never been able to service effectively.

Clearly the banks have a special capability for handling customers investing small amounts each month. I doubt if anyone else can duplicate the data processing capability already possessed by the banks.

Moreover, banks enjoy a natural advantage growing out of the sense of confidence which exists between the depositor and his bank. Regrettably, no such relationship exists between the public and the securities industry. I applaud Merrill Lynch for its new program of offering up to $300,000 of insurance to its customers on securities transactions. But the leadership on the Street ought not kid itself that the public looks upon it the way it looks upon the banking community.

I am all in favor of the established policy of our government which says that banks ought not be permitted to expand horizontally by acquiring competing banks. I would suppose, however, that an implicit part of that policy must be a willingness by the regulators to let banks expand into new fields, especially where the banks have efficiencies which would lead to lower costs for all involved. That monthly bank statement which each of us already receives, constitutes an existing efficiency upon which to build whole new industries. A Christmas Club type program for purchasing securities through banks may well work. If it does, independent of the competition it may offer the Street, it should be supported to the extent that broader public ownership of stocks is achieved.

Many explanations have been offered to explain the flight of the little guy. from Wall Street. They range from battle fatigue to excessive commissions to institutional domination. Probably there is a grain of truth in each of them. My own analysis would add that the mechanics of dealing with a stock broker on a small transaction are much too complicated.

As best I can tell, the only public customers left are willful business executives who trade a lot, and relaxed housewives with time to kill. Leadership in the industry insists that personalized service is necessary in order to sell stocks. I question that dogma. If discount houses are appropriate to sell the products that your company makes, why isn't the same concept appropriate for selling your company's stock.

The SEC also seems wedded to the dogma of personalized service. It tries to burden the relationship between broker and customer with vague concepts of "suitability." Undoubtedly there is an obligation for an investment adviser to pick stocks suitable to his customers' needs. Undoubtedly it is inappropriate for a bucket shop to sell junk to widows and orphans. But when the customer initiates the call, I question whether the same rule should or realistically can be applied. Besides, how can you pick suitable stocks without knowing an awful lot about your customer; and how can you take the time to know your customer for $20 worth of commissions on a small transaction handled exclusively by telephone.

For most of us, what we want and are unable to get is a suitable clerk who will quickly, honestly and cheaply handle that small order we want executed.

Wall Street should scrap all the pious palaver and red tape. We are running a business, not a religious movement. Let the little guy pick what he wants, just as he does at the supermarket. Can you imagine the girl at the check-out stand at the supermarket telling you you must not buy all that rich food you have in the shopping cart because she notices you are overweight! What is the rationale by which the Government says the stocks we buy are inherently more dangerous and therefore require more regulation than the food we eat or the cigarettes we continue to smoke. Quite bluntly, both the Stock Exchange and the Commission should stop treating the public like so many incompetents to be protected against their own improvidence. That condescending attitude is utterly inappropriate in theory and in fact. The "public" they are trying to protect is your wife and mine. The odds are they are brighter than the regulators.

When I read about the fantastic success of off-track betting, I sometimes wonder whether there is a relationship or at least an analogy between the flight from Wall Street and the rush to legalized gambling.

You and I know that reasonable men may differ over which takes more skill — picking a winner in the 5th race at Belmont or a listed stock which will double in six months. Honesty ought to compel us to admit that there is a hell of a lot of luck involved in both.

That being so, perhaps the real difference between the track and the market is not in the odds, but in the convenience. Off-track betting has made it easy and almost respectable to play the ponies. By contrast, it gets ever more complicated and expensive to play the market. The average brokerage firm makes it abundantly clear that the little guy is not welcome.

Look at the figures. OTB handles more than 500,000 bets each day. The New York Stock Exchange handles at most 50,000 transactions each day. That 10-to-1 ratio bespeaks some-thing about efficiency and the lack thereof. The Street should shed that kind of pretentiousness which surrounds its dealings with the carriage trade, which may have worked when it was the only game in town. We need to broaden our base economically, socially and geographically. If there happen to be more gamblers than investors in our society, so be it. Our job is to figure out how to appeal to investors and gamblers. There is nothing new or offensive about such an approach. Why do you think brokers publicly display the stock ticker tape in street level offices — to whet the betting instinct. I have no qualms in saying I would prefer to have people gamble on stocks rather than horses.

Have you ever looked at an OTB ticket? If you will read it carefully you will notice that the ticket is printed by the American Bank Note Company, probably the same company that prints your stock certificates. OTB is the little guy's stock market.

When I look at the fantastic increase in option business on the one hand, and in OTB betting on the other hand, I think there may be a relationship worth exploring. I would like to see our industry sponsor a feasibility study of stock options patterned as closely as possible to parimutuel tickets — that is, stock options of relatively short term, possibly as short as 30 days, priced as cheaply as possible and sold through numerous outlets. If you and I are really sincere that we want broader public ownership, we should have an idea of what demand would be for a 30-day bet on 10 shares of a $20 stock at the market at a cost of, say, $25.

The range of possibilities on what I call OTB type stock options is greater than one might think. Look at the enormous success of the Chicago Board Options Exchange. Now consider options not written by some third party, but by the company whose stock is to be subject to the option. That's right, your own company.

Harebrained as that last proposal might seem, I find nothing inherently wrong in reputable companies formalizing a procedure by which their production employees and the public at large are permitted to gamble on the future price of their stock, in small units, in much the same way their senior executives do, in large units, via phantom stock option and similar plans. As a director of National Semiconductor who watched that stock go from 23 to 83 in two months, I am persuaded we must do some fresh thinking on how we get more employees involved in stock purchase plans. Clearly the conventional plans are too complicated and poorly marketed.

Take Fortune's 500 companies or even the 50 so-called Religion Stocks. Those major companies provide so much of our employment and influence so much our economic well-being. They are clearly preferred by institutional investors. If there is a two-tier market, and I think there is and will continue to be, I say the little guy ought to be able to play it in small units along with the big boys who deal in blocks.

For those interested in investor relations, I tell you I am always surprised when I question employees of major companies and find out how little they know about their company's sales and earnings, let alone the stock price. Not so with the executives who are in there betting on the results. Think about all the interest and excitement in pro football. Perhaps the simple lesson of OTB is that our gambling instincts are stronger than our investing instincts. Maybe the slogan should be "Bet on America" rather than "Invest in America."

Second, by thinking about new uses for OTB type options, there is the inviting prospect of sopping up some of the discretionary dollars presently going into silly short term pleasures. Surely there must be some moral pluses to a $25 bet for 30 days on an increase in the price of Xerox compared to a bet on the Billie Jean King – Bobby Riggs match or the weekly office football pool! One thing is certain about stock options. The option bettor has gotten some play for his money with absolute protection on the downside. He cannot lose more than his original $25 bet.

Conclusion

Summing up, there are some structural changes we need to make. All center around using the computer to increase volume by cutting costs. A Consolidated Tape, a Combined Quotation Service and a National Clearing System — the three building blocks of the Central Market. Those are the structural changes which I am confident will take place — with or without new legislation.

With those changes should come increased competition and in response to that competition, some innovation.

You and I know that we need to get some hustle, some excitement, back into the Street. Sure, nobody wakes up in the morning, throws off his security blanket and mutters a prayer in praise of competition. Competition means change and change is disquieting. But no one has invented a better goad to enterprise.

Back in the Sixties, the Street had some very good years. While all that money was rolling in we got to taking ourselves pretty seriously. When things turned sour in the Seventies, the first reaction was to race down to Washington to seek subsidies and special exemptions from the Government.

This time around I hope it is clear to most of you that surcharges, fixed rates and boycotts only narrow and deaden the market. The privilege of protection by regulation is a bad tradeoff. Government always takes more than it gives.

This time, as the money starts coming in again, let's have the good sense to invest in reform and gamble on change.