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THE FUNCTIONS OF THE STOCK EXCHANGE

by

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It is one of the paradoxes of modern life that so many of its institutions are misunderstood almost in proportion to their real usefulness to society. Undoubtedly this is the case with stock exchanges. Many people see in the stock market only its momentary speculative surface, and never look beneath this restless froth and foam into the great economic tides which flow through it. To such a short-sighted view, stock exchanges take on the appearance of mere gambling casinos, where reckless wagers may be placed upon the meaningless fluctuations of prices. It seems needless to remark that if this were really the truth, the sooner all stock exchanges were abolished the better.

The confusion concerning the nature and functions of security markets is always greatest during depressions, when the shrinkage of earning power in industry inevitably impairs credit and depresses security and commodity prices. Investors and speculators alike experience severe losses, and very humanly wish to find a scapegoat for what in many cases are their own errors of judgment. One cannot easily attack the abstract law of supply and demand. It is always far easier to assail the stock exchanges. Such current waves of fallacious opinion should not be taken too seriously. After all, short of a complete revolution in our whole economic system, we will always need stock exchanges, and with the return of normal business and its reflection in rising security prices, agitation against them speedily disappears. It is, however, unfortunate that such prejudices should gain currency at times of real financial strain, when every effort should be made to restore sound conditions, instead of being wasted in combatting foolish economic fallacies and false panaceas. Correct diagnosis must always remain the first necessary step in effecting genuine cures.

Stock exchanges have evolved gradually during the course of several centuries, and to understand their present-day functions it is necessary to consider their past history. As their name implies, they are organizations by means of which money can be exchanged for securities, or securities for money. Until the seventeenth century there were no real stock exchanges in our sense of the term, because there were no bond or share issues. But when government financing came to be done by the creation of national debts and the issuance of government bonds, rather than by the private financial operations of the sovereign ruler, security investment began and there at once developed a need for a market where this new form of property could readily be priced, purchased and sold. Similarly, as long as business enterprise remained a small-scale affair, business firms needed little capital and rarely organized as stock companies; hence, there were no company bonds or shares and no need of a market for them. But with the coming of the industrial revolution, steam power was for the first time harnessed to transportation and industrial production, business enterprises came to need extensive capital, stock companies were in consequence rapidly formed, and the frequent issue of corporate securities began. The new company bonds and shares thus created in turn needed a market where they could easily be bought and sold. These same conditions have arisen in all modern countries, earlier in some and later in others. But everywhere the effect was the same - the imperative need of a regular and dependable market for both government and company securities.

The form which such security markets ultimately assumed has also been roughly alike in all modern countries, and has followed a very similar course of natural evolution. The earliest security markets, both here and in Europe, sprang up in the already existing markets for wholesale materials and merchandise. In London, the first stockbrokers gathered in the Royal Exchange, which had been erected primarily as a facility for merchants. In New York the original stockbrokers appeared in the mercantile auctions held on the wharves at the foot of Wall Street, and in the adjacent coffehouses frequented by merchants. As the volume of security transactions increased, however, a second stage of evolution occurred, in which the stockbrokers and security dealers organized separate markets in the streets. In London, they thronged in Exchange Alley, in Paris in the Rue Quincampoix, and in New York in lower Wall Street under the traditional buttonwood tree. The New York Stock Exchange met as a curb market in this way from 1792 to 1817, and in our own times the New York Curb Exchange held its meetings in lower Broad Street until it went under a roof in 1921.

Stock Exchange discipline and self-regulation are based squarely upon the power to expel, suspend or fine its members. Everywhere experience has shown that it is impossible in practice to regulate and control a market in the city streets, because brokers who employ improper tactics cannot be expelled, and dealings in improper security issues cannot be prevented. Accordingly, in every important financial center, the early curb markets have gradually moved indoors, adopted regulations for the business of their members, and enforced these rules by their power to deny admittance to such members as broke their rules. Upon this solid basis, elaborate but enforceable codes of conduct for stock exchange members have everywhere evolved.

This imposition of order and discipline upon the stock market, brought about by the organization of stock exchanges, constitutes one of their most important functions, and any comprehensive description of its many ramifications would make a fair-sized volume by itself. A particularly comprehensive code of rules has been gradually built up by the New York Stock Exchange, with which securities applying for admission to dealings on the Exchange floor must comply; the listing requirements of the New York Stock Exchange are the most intensive and searching in the world, in their insistence upon compulsory publicity and other features designed to inform and protect the investing public. Admission to membership in the Stock Exchange is not merely a matter of purchasing a "seat," for the applicant must be formally elected, and if his record is in any way questionable, he will not be admitted. The methods which Stock Exchange members and their firms employ in their business are also subject to comprehensive and at the same time detailed regulations of the Stock Exchange Constitution and Rules. The Governing Committee of the Exchange can prescribe severe penalties for actions by its members which could scarcely be successfully prosecuted in a public court of law. It is no exaggeration to state the members of the New York Stock Exchange are more completely regulated respecting their business conduct, than any class of business men in this country, and perhaps in any country. Naturally this self-discipline to which Stock Exchange members have voted to subject themselves, is of vast benefit to the security investing public, and could be maintained in no other way. It results not only in efficient and standardized practice in the security business, but also in what the Exchange Constitution terms "high standards of commercial honor and integrity" and "just and equitable principles of trade." It constitutes not so much a mere list of specific police regulations as a carefully wrought code of broad ethical principles which give consideration to the spirit as well as to the letter of the law.

From the economic standpoint, the basic function of stock exchanges consists in rendering securities more readily negotiable than they otherwise could be. How necessary this service is, should be obvious to anyone who will reflect what thrift and investment really involve. The fundamental reason why we short-sighted human beings are nevertheless willing to deny ourselves the enjoyment of present wants and satisfactions in order to save our money and invest it in securities, is because we all desire a reserve of funds to fall back on in emergencies. But if the securities in which savings are invested in this way cannot be readily sold whenever their owner wishes, one of the most important advantages of thrift has been nullified. By organizing the security market, by maintaining elaborate wire systems to all parts of the country and likewise an almost instantaneous ticker system for dispatching and printing current quotations, the New York Stock Exchange is able to attract bids and offers for its listed issues from all parts of the nation and even from beyond its borders. Without this organization and these facilities which it maintains, the actual negotiability of listed securities would prove as uncertain and undependable as that for issues not admitted to the exchanges but dealt in "over-the-counter."

Always highly important, this factor of negotiability has been of vital significance during the most trying periods of the depression. At times when no other form of property was in fact readily salable, security holders could always avail themselves of the security market to obtain cash. The task of thus holding the Stock Exchange open and keeping it functioning has not always been an easy one, yet curiously enough the Stock Exchange authorities have sometimes been bitterly assailed by short-signted persons at the very time when the free and open securities market which they were maintaining under great difficulties, stood almost alone in the path of a wholesale moratorium of credit.

Another function of the Stock Exchange which is frequently misunderstood, has to do with the prices established on its floor. Sometimes, when the trend of security prices does not please particular groups or individuals, they are apt to take the Stock Exchange itself to task for it. This is thoroughly illogical, for the Stock Exchange itself neither buys nor sells securities, and does not fix prices. The actual function of the Stock Exchange consists in maintaining a free and open market under strict rules and with convenient facilities, in which everyone can readily buy and sell. Prices in the stock market in consequence reflect the forces of supply and demand arising from the buying and selling orders of the whole public. During and since the war, the disastrous results of many attempts artifically and arbitrarily to peg prices of various commodities should make any real student of economics realize the necessity and utility of free and open markets like the Stock Exchange.

Another important function of the Stock Exchange less seldom appreciated is the stimulus which its ready marketing machinery affords to the flow of new capital into industry. The stock market is not simply a passive meeting place where supply and demand come together - it is a dynamic mechanism whereby securities can be seasoned and gradually distributed to investors. In many cases an entirely new security issue will fail to attract conservative investors, who like to see a long and well-tested record of earning power behind the securities they purchase. The existence of an organized security market enables just this desired "seasoning" process to be carried on, and thus for new securities to pass gradually into investors' strongboxes. New issues can in turn be underwritted because there is this under-tow of absorption of the older issues by investors. Upon these processes, the financing of large-scale industry and trade in turn depends.

With these and other equally basic functions of the stock market few have any quarrel. The principal point of criticism of the Stock Exchange is that its facilities are so commonly employed for "speculation". Yet a closer analysis of "speculation" itself will readily reveal the fact that it cannot be abolished, because it is needed to sustain risks inevitable and inherent in security ownership. If the stock market was available only to investors, it could not function continuously and therefore could not render securities truly and surely negotiable. What is more new securities could be issued only with the greatest difficulty, since ordinarily it is the speculator who absorbs so large a part of them until they become "seasoned" and made attractive to investors. Economists have in fact long compared the economic function of speculation with that of insurance, because both provide methods for the absorption of risk. In the security market, the investor can avoid or shift his risks only because of the presence and activities of the speculator. The investor can purchase "seasoned" issues because the speculator has been willing to hold them until they were "seasoned." When his securities begin to show deterioration, the investor can sell them largely because the speculator will take them off his hands, with the risks they entail. If these risks of ownership could not be shifted in this way to speculators at the will of the investor, the latter would be forced to absorb them himself, and investment would of necessity become speculative itself.

After the great fluctuations in security prices which haveoccurred all over the world in the last decade, it is natural that everyone should be anxious to see greater price stability in the stock market, and many superficially plausible schemes for artificially "stabilizing" the security market have been proposed. One trouble with such plans is, that they fail to penetrate to the real bed rock of the situation. The only way to stabilize security prices is to stabilize industrial earning power. As long as earning power fluctuates, the prices of securities which depend upon it are bound to fluctuate. Artificial stabilization schemes for the stock market, granted that they were really workable, could only succeed in manipulating security prices in order to have them tell falsehoods concerning the security values which they should truthfully reflect. Any such perversions of security prices, no matter how worthy the motives of those causing them would entail the danger of creating such a disparity between prices and values that sooner or later it could be corrected only by unusually violent and sudden price fluctuations.

If at times the Stock Exchange authorities may appear somewhat slow to take up with "happy thought" remedies, it must be remembered that the collective experience of the institution covers 140 years, during which it has been necessary to face almost every known sort of economic crisis and depression. Out of the crucible of frequently bitter experience has come the time-tested rules and principles which today are its common law and are embodied in its Consitution. The terrific test of the Stock Exchange facilities and rules imposed upon it at different times during the past three years has already led to new and sounder methods of operation and administration, as experience has pointed the way.