

# On efficiency and regulation of the securities industry

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An outsider reading the literature on SEC regulation is struck by the contrast between the amount of space devoted to the unresolved problems created by industry practices and the paucity of material dealing with problems created by SEC practices. Even more striking, after 30 years of regulation, is the absence of discussion of the rationale for continuing present regulations or a review of the achievements or deficiencies of past regulations. While there is considerable discussion of current proposals to extend SEC regulation into new areas, little attention is paid to the problems that would be reduced if existing regulations were changed or eliminated. One of the few attempts to present some evidence of the effects of SEC regulation on the industry,<sup>1</sup> produced a reaction that seems excessive, to an outsider, considering the tentative nature of the evidence presented. Indeed, a major point of the respondents<sup>2</sup> seems to be that no assessment of the SEC's achievements or deficiencies is required. It is sufficient, for them, that the law and the SEC have eliminated some of the practices that previously existed.

Furthermore, I am struck by the relative absence of economic analysis and the relative importance of equity in the more common arguments for regulation.<sup>3</sup> None of

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\*I am indebted to Karl Brunner and to my colleagues Richard Roll and Michael Thomson for helpful discussions. Roll, in particular, forced me to reconsider some parts of my argument and pointed me toward new evidence. I have not asked them to share responsibility for any remaining errors or misinterpretations.

<sup>1</sup>George J. Stigler, "Public Regulation of the Securities Market," *Journal of Business* (April, 1964), pp. 117--42.

<sup>2</sup>Irwin Friend and Edward S. Herman, "The SEC Through a Glass Darkly," *Journal of Business* (October, 1964), pp. 382--405; Sidney Robbins and Walter Werner, "Professor Stigler Revisited," *Journal of Business* (October, 1964), pp. 406--13; and Irwin Friend and Edward S. Herman, *Journal of Business* (January, 1965), pp. 106--10.

<sup>3</sup>This is the conclusion reached by Professor Friend. Cf. Irwin Friend, "Broad Implications of the SEC Special Study," *Journal of Finance* (May, 1966), p. 332. After presenting this paper to the Conference, I had the benefit of reading an, as yet, unpublished analysis of the monopoly power of New

the three most common economic arguments for regulation -- economies of scale, restrictions on output, or externalities -- is made with great force, although elements of each of these appear to be present.<sup>4</sup> The industry is generally regarded as having an important role in the allocation of resources over time, so the presence of monopolistic practices, of monopoly, or of important externalities, though not decisive, would strengthen the case that is now made for regulation. I will consider some of these issues in later sections, although I do not deal with them extensively.

Another argument for regulation is that the industry, though not monopolized, does not allocate resources efficiently. Economic efficiency is said to be increased by regulations requiring firms to release additional more accurate information. While there are several variants of this argument, most of them have a common core that consists of a denial of one of the most fundamental propositions in economics -- that value and price are identical. It is alleged that because the public is myopic or easily misled, the prices of speculative securities, such as common stocks, are often based on whim, fancy or "psychological" rather than "economic" attributes. J.M. Keynes, for example, compared the securities markets to a casino, while others have spoken similar or harsher words about the market for new issues in the early sixties or the market for "computer" stocks in 1967. One finds frequent statements to the effect that prices bear little relation to the "worth" or "true value" of a stock measured by the future earning power of the corporation. Some versions of this line of argument are no more than assertions of the stated conclusion.

Underlying some of the more meaningful criticisms of the securities markets is the view that, where the market prices of common stocks do not reflect the future earning power of corporations, resources are likely to be misallocated. The reason is that some corporations are able to sell stock and use the proceeds to acquire

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York Stock Exchange member firms by Robert Doede: *The Monopoly Power of the New York Stock Exchange*, (unpublished doctoral dissertation) University of Chicago 1967.

<sup>4</sup>Two of these arguments were raised in the papers presented to the Conference. Irwin Friend argues, in part, that the existence of monopoly justifies SEC regulations. I fail to see his point. How does the existence of monopoly in 1933--34 justify the continuation in 1968 of the regulations introduced in the earlier years? Why has the SEC failed to eliminate the monopoly power of the NYSE member firms?

resources on favorable terms while others with similar earning power, will be required to pay higher prices to acquire resources. This line of reasoning has a long history. Moreover, on one interpretation of recent research on stock market prices, there is support for this view. I will discuss this argument in more detail in the next section.

In addition to these broad issues about the intertemporal allocation of resources, questions are raised frequently about the efficiency of the over-the-counter markets and the exchanges as markets in which individuals adjust or acquire portfolios. Recent criticisms have emphasized the differences -- or lack of differences -- in fees, commissions or charges paid by various participants. New regulations have been proposed or introduced by the exchanges and the SEC. Some of the new regulations affect the relative positions of different types of members of the exchanges such as the floor trader, the specialist, and the broker-dealer. Others affect the relations between the retailer of mutual funds, the wholesaler of mutual funds, and the broker-dealers who make portfolio transactions for the funds. The latter are, primarily, members of the principal exchanges. Below, I discuss some of the new regulations or proposed regulations and some of their effects. Also, I consider some of the problems created by SEC practices and suggest some alternative procedures that, I believe, are more efficient means of accomplishing desired ends.

### **The efficiency of the securities markets**

Students of the securities markets like to distinguish two types of market efficiency which I shall call contemporary and intertemporal efficiency.<sup>5</sup> The securities traded on the markets are mainly outstanding rights to corporate earnings and property. New issues are small in relation to outstanding issues and in relation to purchases or sales of outstanding issues. It is suggested that as a result, the securities markets may be efficient in distributing existing shares from buyer to seller yet have little influence on the flow of newly issued securities and on allocation of resources among firms and

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<sup>5</sup>Friend, "Broad Implications...", *op. cit.*, uses the terms "operational" and "allocational" to refer to these separable problems. There is an extended discussion of the various types of efficiency and the role of the securities markets in achieving efficiency in W.J. Baumol, *The Stock Market and Economic Efficiency*, The Moorhouse I.X. Millar Lecture Series 36 (New York: Fordham University Press, 1965).

over time. Standard economic theory implies -- and evidence suggests -- that if the price of an existing asset rises in response to a change in demand for the asset, production of the asset (or close substitutes for the asset) increases and newly produced supplies of the asset are offered on the market. In the securities market, however, new production, i.e., offers of new issues of particular securities, may not appear in a decade or even a generation. An important link between contemporary and intertemporal efficiency is said to be broken by the failure of firms to take advantage of temporary, or longer-lasting, changes in the price of securities.

Those who offer the above defense of regulation do not argue that regulation improves the intertemporal allocation of resources directly, and for this reason, I believe their argument is both incomplete and overstated. In any case, the issues raised are broader than the scope of this paper for much the same reason, viz. regulation has not been defended as a means of correcting deficiencies in intertemporal allocation that result from the failure of firms to sell securities or from their failure to use current or recent share prices when computing the cost of capital and deciding on their capital budgets. My examination of the literature suggests, instead, that those who claim that regulation improves the intertemporal allocation of resources rely on an entirely different and opposing argument.

Regulation is said (by its defenders) to improve the intertemporal allocation of resources indirectly, by improving the contemporary allocation in two main ways. First, investors have available more information, and more accurate information, when choosing new issues. Regulation has increased the amount of information on new (and outstanding) issues, and has shifted to stockholders part of the increased cost of providing the information and of enforcing uniform minimum standards of disclosure. Better information permits purchasers of new issues to improve estimates of future earnings and thus determine the price they are willing to pay for shares. Regulation imposes penalties for misstatement that are perhaps more rapidly or more readily enforced than common law fraud rules. The result is said to be a reduction in uncertainty and an improved contemporary allocation of resources.

To the extent that (1) investors make better-informed judgments when selecting

new issues and (2) firms whose future earnings would have been overestimated are deterred from issuing and (3) these benefits exceed the cost of obtaining them, intertemporal resource allocation is improved. The arguments for an improvement rest on some unstated propositions about (1) the comparative advantage of government in collecting and providing information and (2) the presumption that, without intervention, the securities markets would not generate the information desired by securities purchasers at comparable or lower cost. These arguments deserve more consideration than they have received. We know very little about the size and distribution of the costs and benefits of regulations requiring firms and households to report information to government agencies. If society gains from using private and public resources to disclose information and enforce disclosure rules, it may be possible to increase the gain by choosing methods that are more efficient than coercion. Since very little is known about the costs and benefits of present or prospective arrangements, the usual plea for research is in order.<sup>6</sup>

The second argument relating regulation to contemporary and intertemporal resource allocation is that firms use current, recent, or average market prices of their securities when computing the rate of return to be used as a cut-off for new investment. Regulation is said to improve the intertemporal allocation by improving the contemporary allocation. In this case, regulation is said to improve resource allocation by eliminating some of the "least desirable" features of the market process -- large, frequent and sudden changes in price -- sometimes called "speculative excesses."

Prices are important pieces of information for decision-making. By preventing large, frequent, or sudden changes in the price of outstanding securities, regulation improves the quality of the information provided by stock prices and thus increases the social value provided by the existence of a securities market. I regard this argument, whether true or false, as the main economic argument for regulation of the securities

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<sup>6</sup>I have found a few studies that begin to treat the problem. Henry G. Manne, *Insider Trading and the Stock Market* (New York: The Free Press, 1966) raises and discusses a number of questions about the right to buy and sell information and the costs and benefits of alternative arrangements. Stigler, *op. cit.*, and Friend and Herman, *op. cit.*, discuss the value of present regulations requiring disclosure at the time new securities are sold.

markets.

Recent research on stock price changes bears directly on this point. A number of studies using different techniques, have reached similar conclusions about the character of the information provided by changes in stock prices.<sup>7</sup> Stock prices have been found to change as if they were governed by an entirely random process, so current price changes give no information that investors can use to improve their predictions of price changes. Today's price changes are, in the main, independent of price changes in earlier or later periods.

These findings are subject to two conflicting interpretations. On one interpretation, stock price changes are unrelated to economic variables such as present and anticipated corporate earnings and dividends. Instead, stock prices are very much like the numbers that appear on a roulette wheel in a gambling casino, as Keynes suggested.<sup>8</sup> By preventing some of the large movements generated by shifts in the opinions of short-term professional traders, regulation serves the useful purpose of improving the quality of information. Resource allocation is improved by regulation, albeit indirectly, if this interpretation is correct.

The second interpretation is that market participants are alert to changes in economic variables. Information affecting the value of a firm is processed quickly, so that past prices fully discount expected future earnings and dividends. On this interpretation, the stock markets are extremely efficient devices for processing information, and regulation is at best a nuisance and perhaps a more serious threat to the efficiency of the securities markets. A recent study by Stigler<sup>9</sup> shows that relatively large percentage deviations from the equilibrium price can be generated, daily, by

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<sup>7</sup>See, for example, M.D. Godfrey, C.W.J. Granger, and O. Morgenstern, "The Random-Walk Hypothesis of Stock Market Behavior," *Kyklos*, XVII, 1 (1964), pp. 1-30, and Eugene Fama, "The Behavior of Stock Market Prices," *Journal of Business* (January, 1965), pp. 34--105.

<sup>8</sup>J.M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936), p. 159. In the preceding and following pages Keynes considers and rejects the argument that long-term holders would seek to profit from -- and thus correct -- the movements in short-term price changes caused by the activities of professional short-term traders.

<sup>9</sup>Stigler, *op. cit.*, pp. 126--32.

random changes in demand, under trading rules similar to those in effect on the New York Stock Exchange. This evidence suggests that observed price fluctuations cannot be used as evidence of destabilizing speculation since most price changes are in a range no larger than the range to be expected under the rules and practices in effect on the New York Stock Exchange.

The conclusion that stock price changes are best described as the result of a random process, the so-called random walk hypothesis, has stimulated a relatively large amount of research designed to test the alternative hypothesis that price changes are not entirely random. Several different methods have been used in attempts to demonstrate that past information on trading volume or prices can be used to generate predictions of future price changes that are more accurate than those generated by chance.<sup>10</sup> However, as several of the investigators recognize, the finding that price changes are not entirely random is of limited value for discriminating between the alternative hypotheses, unless it can be shown that some individuals could have profited from the information. Generally, the studies do not compare the value of the information to the cost of acquiring and exploiting it. It is entirely possible that the exchanges are extremely efficient and that individuals exploit available information up to the point at which profits are maximized. If so, the unexploited information is not worth the cost of acquisition, and the finding of a departure from the random walk is uninteresting.

A recent study by Shelton<sup>11</sup> reports on the experience of approximately twenty thousand individuals who are presumed, on entirely reasonable assumptions, to allocate time and money to detailed, careful examination of data on earnings,

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<sup>10</sup>R.A. Levy, "Relative Strength as a Criterion for Investment Selection," *Journal of Finance* (December, 1967), pp. 595-610; H. Theil and C.T. Leenders, "Tomorrow on the Amsterdam Stock Exchange," *Journal of Business* (July, 1965), pp. 277-84; Eugene Fama, "Tomorrow on the New York Stock Exchange," *Journal of Business* (July, 1965), pp. 285-99; Charles Ying, "Stock Market Prices and Volume of Sales," *Econometrica* (July, 1966), pp. 676-85. A number of other studies have examined the extent to which mutual funds and other professional investors are able to secure better than average returns. These studies are discussed in the following section.

<sup>11</sup>J.P. Shelton, "The Value Line Contest: A Test of the Predictability of Stock-Price Changes," *Journal of Business* (July, 1967) pp. 251-69.

expected earnings, dividends, managements, prices, and other variables that, in economic theory, affect the value of the firm. Each of the individuals in Shelton's study chose 25 securities (from a pre-selected list of 350) and "held" the securities for six months. On the average, the individuals earned a return on their chosen portfolios that was significantly higher than the return on randomly selected portfolios drawn from the same universe. These findings suggest that there is a positive return to information and, thus, the findings discriminate sharply between the two alternatives with which we are concerned. Individuals who purchase reliable information are able to forecast stock price changes more accurately than could be expected if chance or the whim of speculators determined price changes. Since there is a positive gross return to information, changes in market prices must incorporate new information. On the other hand, Shelton's findings do not clearly reject the random-walk. The reason is that Shelton's sample does not permit him to compare the marginal cost of acquiring information and selecting non-random portfolios to the gain in revenues from doing so. We do not know whether individuals realized a net gain after allowing for the opportunity cost of time and the cost of other resources devoted to portfolio selection.

There are, moreover, two additional types of evidence that suggest that the exchanges correctly process information about the value of the firm. One comes from studies of the effect on the share prices of debtor and creditor firms caused by unanticipated changes in the general price level.<sup>12</sup> The fact that over time net debtors gain and net creditors lose during periods of inflation, as these studies suggest, is inconsistent with the interpretation of share prices as solely the result of Keynes' casino-roulette process. However, the effects on share prices of inflation, particularly unanticipated inflation, are primarily long-term effects, while regulation of trading practices on the stock exchanges is designed to reduce the size and frequency of the short-term price changes that are alleged to result from the activities of professional traders.

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<sup>12</sup>R.A. Kessel, "Inflation Caused Wealth Redistribution," *American Economic Review* (March, 1956), and L. DeAlessi, "The Redistribution of Wealth by Inflation: An Empirical Test with United Kingdom Data," *Southern Economic Journal* (October, 1963), pp. 113-27.

Another, more recent, source of evidence is a study designed specifically to test the proposition that share prices correctly reflect new information.<sup>13</sup> The findings of this study discriminate between the alternative interpretations of the evidence that share price changes are random. The authors examine virtually all of the "splits" among listed shares on the New York Stock Exchange during a quarter century. They show, first, that shares split most often after they rose in price relative to a representative index of share prices. Second, they show that purchasers anticipated, correctly, that dividends on the shares that split would rise relative to dividends on shares in the index. Third, the authors show that in the months following the split, changes in the prices of split shares, as a group, did not differ from the changes in price experienced by shares that did not split. The superior performance of the group of shares that split ended at the time of the split. Finally, the authors divide the shares that had splits into those that increased dividend payments (relative to all shares) following the split and those that did not. The fact that the entire group did no better, following the splits, than the index is accounted for by the divergent performances of those that raised and those that did not raise (relative) dividends. Again, the share prices correctly reflected both types of change in (relative) dividends. In fact, there is some evidence in the data that, on the average, the market correctly anticipated which companies would raise (relative) dividends.<sup>14</sup>

I conclude that the available evidence supports the interpretation that share prices contain reliable information about expected earnings, dividends, and other factors affecting the value of individual firms. Given the evidence that supports the random-walk hypothesis, I conclude, also, that the exchanges -- and particularly the large organized exchanges -- process information quickly and efficiently. Today's price changes have incorporated most or all of the available information about future

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<sup>13</sup>E. Fama, L. Fisher, M. Jensen, and R. Roll, "The Adjustment of Stock Prices to New Information," University of Chicago, January, 1967 (unpublished).

<sup>14</sup>The evidence is in Table 2 of the paper by Fama, *et al.*, cited in the previous footnote. Stocks that raised (relative) dividends following a stock split rose in price relative to those that did not raise dividends in each of the ten months prior to the date of the split.

values of traded shares. Not much information remains that can be exploited profitably.

These conclusions do not imply that there is no need for regulation, although they suggest that it is difficult to improve on the efficiency of the exchanges as a place for processing information. Nonetheless, even though society values the efficiency of the present system, Congress may disapprove of the way in which the exchanges distribute the returns to participants in the process. Regulation may be designed to change the organization or operation of the exchanges so as to alter the distribution of income resulting from the market process. I will discuss the organization of the most important part of the industry before considering some recent, proposed changes in regulation.

### **Regulating the New York Stock Exchange**

The New York Stock Exchange (NYSE) is by far the oldest and largest of the exchanges. Organized in 1792, the NYSE has had a dominant position in the securities industry for more than a century. On almost any measure of relative size, the position of dominance continues. More importantly, trading on the NYSE is concentrated. A few broker-dealer firms carry out most of the transactions and earn most of the income. While only 20 percent of the firms with three or more representatives are affiliated with the NYSE, these firms earned 75 percent of the gross income earned by all firms in the industry.<sup>15</sup> The dominant position of NYSE firms is, in part, a consequence of regulation.

Affiliation with the NYSE is a valuable right that is reflected in the price paid for membership. Judging from newspaper quotations the price of a seat has approximately doubled in recent years. Some indication of the comparative value of membership is given by the data in the Special Study showing the average gross income of member and nonmember firms for the year ending March, 1962. Members of the

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<sup>15</sup>The earnings include earnings from underwriting new securities, but the proportion of earnings that come from underwriting is not significantly higher for NYSE member firms than for nonmembers. Data are from *Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, 88th Congress, 1st Session (1963), House Doc. No. 95, Pt. 1, pp. 18 and 35. Hereafter, I will refer to the report as the Special Study.

NYSE had, on the average, gross income of \$3.6 million; members of other exchanges had average gross incomes of \$5,000,000; and firms that were not members of any exchange earned an average of only \$216,000.<sup>16</sup> Needless to say, these differences in average gross income are not necessarily reflected fully in the differences in net income. Firms with the largest gross income have more branch offices and more salesmen, hence more expenses and more payments for the use of capital and labor. As gross income rises, payments for labor and capital may rise more than proportionally.

Growth in trading volume on the NYSE has been accompanied by a growth in the size of broker-dealer firms, with relatively little growth in the number of member firms and an actual decline in the number of members. The Special Study shows that during the postwar years 1945-1962, a period during which the number of broker-dealer firms registered with SEC increased by 40 percent (an increase of 1,600 firms), the number of NYSE member firms increased only 15 percent (an increase of 86 firms).<sup>17</sup>

The difference in growth rates is explained readily. The NYSE uses a number of devices to restrict the number of members. Tests, fees, blackballs, investigations of character and income, and asset requirements are used to reduce both applications and membership. The total number of seats on the exchange is controlled by the governors of the Exchange, who also control the number of allied members, i.e., the number of people eligible to be general partners or stockholders of member firms. Although allied members do not have seats on the exchange, they must meet most of the membership standards and are subject to the same investigation. The number of allied members has grown much more than the number of members holding seats, again suggesting that the NYSE prefers growth in the size of broker-dealer member

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<sup>16</sup>Special Study, Pt. 1, p. 31.

<sup>17</sup>*Ibid.*, pp. 36-37.

firms rather than growth in the number of member firms.<sup>18</sup>

Although data are not readily available on the earnings and position of member firms in the 1920s or early 1930s, the report of the Pecora investigation suggests that cartel practices were not unknown in the industry before the SEC was established.<sup>19</sup> It appears, therefore, that the SEC and the 1934 Act have changed (or countenanced changes) in the types of restrictive practices used to increase profits of NYSE member firms but have not eliminated these practices. This allegation, if correct, would not be surprising. Our broad experience with regulation suggests that communities of interest develop between the regulators and the regulated. Initially, the regulators eliminate many of the cartel-like practices that have developed in the industry, so the initial effect of regulation is often beneficial to many members of the public. Later, the regulators become increasingly concerned with the industry's problems, and regulation becomes a means of restricting entry, reducing efficiency and protecting the industry from competition. The railroad and banking industries are examples that come readily to mind.

Economic theory implies that, where costs of entry are relatively low, restrictive trade practices will be eliminated when barriers to entry are removed. Nonetheless, not one of the SEC's principal current recommendations affecting stock exchange practices proposes to remove barriers to membership on the NYSE or to remove or meliorate their anti-competitive effect.

Of course, it may be argued, the SEC does not have authority to increase the number of firms that are permitted to become members of the NYSE. This power has been left in the hands of the members of the exchange, particularly the Governors. Such argument is irrelevant. The SEC is seeking to change the laws and rules under which the NYSE and other exchanges operate, and it has not asked Congress for any new authority to remove barriers to entry. On the contrary, the Special Study endorses

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<sup>18</sup> This paragraph is based on the material in *ibid.*, pp. 75--79. The authors of the Special Study apparently favor these restrictions on entry and believe (p. 79) that they furnish "protection of the public."

<sup>19</sup> *Stock Exchange Practices*, Hearings before the Senate Committee on Banking and Currency, 1933-34.

restrictions on entry, as I noted above, and does not discriminate in its endorsement between restrictions that take the form of tests of competence and those which take the form of blackballing or membership fees. Significantly, the SEC does not seek to change commission rates by removing barriers to entry, a surprising position in view of Chairman Cohen's statement that:

Almost every regulatory problem we have concerning the securities markets is related in some way to the level or structure of rates prescribed by the minimum commission rules of the New York Stock Exchange.<sup>20</sup>

In the past, commission rates have been set by the member firms. One of the principal recommendations<sup>21</sup> of the Special Study affecting the commission structure on the exchanges concerns the odd-lot differential paid by the public.<sup>22</sup> The Special Study notes that the 1951 fee charges were negotiated between the odd-lot dealers and the brokerage firms that transact with the public. The Special Study also notes the lack of price competition in the odd-lot business and charges that the odd-lot firms on the NYSE are able to pressure other exchanges to maintain an odd-lot differential no lower than the differential charged on the NYSE.

Still, the Special Study does not recommend freer entry and competition as a means of reducing fees and charges. The main recommendations are (1) for reductions in the brokers' cost of carrying out odd-lot transactions, and (2) that responsibility for regulating the odd-lot differential be given to the NYSE, i.e., to the Board of Governors. But in the absence of competition, there is no reason to believe that cost reductions lead to equivalent price reductions. In general, proposals for increased technical efficiency in a monopolized industry are of uncertain value to

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<sup>20</sup>The quotation is from a speech to the Investment Bankers Association and is reported in Amyas Ames, "Comment," *Journal of Finance* (May, 1966), p. 341.

<sup>21</sup>I am not familiar with the legal details of present and proposed regulations, and I have not examined most of the current proposals for changes made as a result of the Special Study. My choice of "principal recommendations" relies on the choices made in David K. Eiteman, "The SEC Special Study and the Exchange Markets," *Journal of Finance* (May, 1966), pp. 311-23. Below, I discuss principal recommendations affecting mutual funds. Some of these, e.g., proposals to ban "give-ups," have importance for the members of the NYSE and overlap the material covered in this section.

<sup>22</sup>Special Study, Pt. 2, pp. 171-202, discusses odd-lot transactions.

consumers, since it is not clear that where monopolists are able to reduce costs they will reduce price rather than increase the return to monopoly position.

The second proposal was accepted by the NYSE, and determining the size of the odd-lot differential became a responsibility of the exchange. In this case, some slight price reductions were offered. The differential was reduced on stocks priced between \$40 and \$55. The public benefitted from the reduction in the differential and lost because of the transfer of additional rate-making power to the NYSE. I have no way of measuring the net effect of the two changes. However, I find it puzzling that the SEC increased, rather than reduced, the power of the NYSE to set fees and charges for service in light of Chairman Cohen's complaint about the NYSE commission rules.

The low-level of the analysis used to justify some of the proposed regulations is illustrated by the arguments in the Special Study leading to the conclusion that the floor trader was in an advantageous position to profit from price changes. The extent of the advantage is suggested by the claim that a floor trader could profit from buying and reselling round lots of a \$25 stock if the price rose by eight cents. The source of the alleged advantage is that the floor trader is present on the floor of the exchange. He is, therefore, in a position to receive information quickly and does not have to pay the "floor brokerage fee." A member of the NYSE trading off the floor is charged a floor brokerage fee, so his out-of-pocket cost for buying and reselling in 1962 was eight cents higher. The beakeven point for the public was said to be sixty-eight cents at the time.<sup>23</sup> A variety of other complaints against the floor trader were made, but not established; the main complaint appears to be that the floor trader (often) took advantage of his position to engage in "destabilizing speculation."

The first set of charges against the floor trader makes no allowance for the opportunity cost of the floor trader's time. One of the most elementary principles of economics requires that comparisons of cost include some allowance for the income the floor trader would earn if he did not spend his time on the floor. An additional cost that is not included in the computation is the opportunity cost of the investment in a

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<sup>23</sup>Eiteman, *op. cit.*, p. 312.

seat on the Exchange. The alleged cost advantage of the floor trader appears to be based solely on the out of pocket costs of trading and, as a result, is meaningless.

After further study by consultants, the NYSE eliminated all floor traders and introduced a new category, the "registered trader" and a new set of rules to limit his activities. It is difficult not to conclude that both the SEC and the Exchange overlooked every opportunity to let competition and unrestricted entry eliminate any profit from monopoly position accruing to floor traders. Instead, they agreed upon new regulations which increased the authority of the Governors of the NYSE and the number of reports required of members. Similar solutions were imposed to meet the criticisms made of the market specialists by the authors of the Special Study.

One final issue concerns the purpose of the new rules limiting the activities of specialists and registered traders when prices of particular shares are changing rapidly. The ostensible purpose of these rules is to protect the public against the effects of "speculation" by market professionals. I have very little knowledge about the extent to which the public attempts to profit from the small daily changes in stock prices caused by the activities of market professionals, or the amount they lost (or perhaps gained) under the old rules. Friend and Herman claim that small investors have annual portfolio turnover rates of 5 to 10 percent, substantially less than the average turnover rates on the NYSE during the comparable period.<sup>24</sup> The evidence cited in the previous section suggests that small, daily changes are difficult to forecast and the evidence in the following section suggests that professional speculators do not, on average, earn returns that are significantly higher than those obtainable by chance. Therefore, if specialists and traders on the floor of the Exchange profit from their position, the profit is more likely to be a return to monopoly position than the result of successful forecasting. If so, elimination of barriers to entry, as suggested above, would seem to resolve the problem by reducing monopoly power. Why has the SEC failed to reduce the monopoly power of the NYSE?

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<sup>24</sup> Friend and Herman, "Professor Stigler on Securities..." *op. cit.*, p. 108; Special Study, Pt. 1, p. 36.

## Regulating the mutual funds

Research has added substantially to our knowledge of the practices and performance of the mutual funds industry in recent years. The Wharton School Study<sup>25</sup> was the first of a series of studies sponsored by the government and concerned with appropriate policy toward the industry. Academic interest was initially motivated by the desire to test a theory of portfolio selection -- the Markowitz theory<sup>26</sup> -- against the performance of professional investors and later by the desire to use the experience of professional investors as evidence in support of the random-walk hypothesis.<sup>27</sup> The studies use different methods, so the similarity of the findings permits relatively firm conclusions to be reached. The conclusions provide a useful background for the discussion of regulation.

One main conclusion is that purchasers of mutual funds obtain a return that is no better than the return that could be obtained if the funds chose portfolios by random selection, or chance. At best, professional management has had a small effect on the mean return earned. Since trading and management fees increase costs, several of the studies show that, on the average, professional management reduces net return.

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<sup>25</sup>Irwin Friend, F.E. Brown, E.S. Herman, and Douglas Vickers, *A Study of Mutual Funds* (Washington: Government Printing Office 1962).

<sup>26</sup>Harry Markowitz, *Portfolio Selection, Efficient Diversification of Investments* (New York: John Wiley and sons, 1959).

<sup>27</sup>Donald Farrar, *The Investment Decision Under Uncertainty* (Englewood Cliffs, N.J.: Prentice-Hall, 1962); William F. Sharpe, "Risk Aversion in the Stock Market: Some Empirical Evidence," *Journal of Finance* (September, 1965), pp. 416-22; William F. Sharpe, "Mutual Fund Performance," *Journal of Business* (January, 1966), pp. 119-38; Irwin Friend and Douglas Vickers, "Portfolio Selection and Investment Performance," *Journal of Finance* (September, 1965), pp. 391-415; Ira Horowitz, "The 'Reward-to-Variability' Ratio and Mutual Fund Performance," *Journal of Business* (October, 1966), pp. 465-68; John Lintner, "Security Prices, Risk, and Maximal Gains from Diversification," *Journal of Finance* (December, 1965), pp. 587-615; Michael Jensen, "The Performance of Mutual Funds in the Period 1945-64," University of Rochester, January, 1968 (unpublished).

One important difference between the two types of tests is that tests of the Markowitz hypothesis require an assumption about the relation between observed (ex post) measures of risk and the subjective (ex ante) risks accepted by the funds. Sharpe, *op. cit.*, and Horowitz, *op. cit.*, offer evidence suggesting that the funds are able to anticipate the risks they undertake with reasonable accuracy. Studies seeking to test the random-walk hypothesis do not make prior assumptions about risk, since they compare the returns earned by the funds to the returns that would be earned if the funds used random selection.

This conclusion applies to the industry as a whole. Individual portfolio managers may consistently earn higher returns than either a broad-based index of share prices or a randomly selected portfolio.

The second main conclusion that emerges from the studies is that mutual funds are an important -- and apparently an efficient -- device that permits individuals to reduce the risk of holding equities. Mutual funds do this by combining securities with returns that are not perfectly correlated and selling the resulting portfolios. Recent studies by Sharpe and Lintner suggest that mutual funds come reasonably close to providing portfolios that appear to be efficient in the Markowitz sense, which is to say the funds provide the highest mean return consistent with the given measure of risk.<sup>28</sup>

Taken together, the studies indicate that mutual funds provide a useful service to investors and that the value of the service would be increased if the cost of operating the funds could be reduced. The studies also suggest that operating costs can be reduced without hampering average performance if mutual funds reduce the volume of trading and perhaps also the amount paid for the services of investment advisors, the so-called management fee. Although some funds may receive excellent advice, academic researchers have failed to discover any significant relation between performance and the management fees paid to advisers and administrators. In view of the findings on the efficiency of the exchanges in processing information, the result is not unexpected.<sup>29</sup>

One of the SEC's three main recommendations for a change in industry practices concerns the management fee.<sup>30</sup> The SEC would apply the rule of reason

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<sup>28</sup> Sharpe, "Mutual Fund Performance," *op. cit.*; Lintner, *op. cit.*; Markowitz, *op. cit.*

<sup>29</sup> The evidence is not wholly unambiguous. The difference may be small and hard to isolate or may be hidden by differences in accounting practice.

<sup>30</sup> The recommendations are contained in SEC, *Public Policy Implications of Investment Company Growth*, (Washington: Government Printing Office, 1966). I have selected as of principal interest three of the four recommendations that are discussed in R. Mundheim, ed., "The University of Pennsylvania Law School Conference on Mutual Funds," *University of Pennsylvania Law Review* (March, 1967), pp. 659-854. The entire issue is devoted to the proceedings of a conference at which proposed regulations were discussed. I have omitted one of the issues discussed at the conference, the size of mutual fund

and in effect bring about a reduction in the management fee through the courts. The main legal argument for the change in procedure appears to rest on the claim that it is difficult in practice to get the funds to choose outside (or unaffiliated) directors who are independent of the management. The principal economic argument for the change has been stated above.

It is not clear that this rate-making authority is required. I believe that if several of the prevailing anti-competitive practices are eliminated, funds will be forced to become more efficient and seek means of reducing expenses, including management fees. Moreover, it might be useful to increase competition by permitting load funds that are organized for profit by stockholders.<sup>31</sup>

A second important proposed change is a reduction in the maximum sales charge, known as the "front-end load." The proposal calls for a reduction in this charge from 9.3 percent to 5 percent of the asset value. The maximum fees are important to the funds because there is a retail price maintenance clause -- Section 22(d) -- that requires all retailers of a particular mutual fund to sell shares at the same price. The issues here seem relatively clear. Representatives of the industry and of the SEC seem to agree that neither the industry nor the SEC favors competition.<sup>32</sup> I

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transactions, because there does not appear to be much of an issue and because my proposed solutions to other problems are applicable to this problem -- if it is a problem. Hereafter, I will refer to this document as Pennsylvania Law School Conference.

<sup>31</sup> One result of the failure to organize the industry competitively is that fees become the means by which the management increases its income at the expense of the owners. Nichols found that similar practices were common among mutual savings banks. See Alfred Nichols, "Stock versus Mutual Savings and Loan Associations: Some Evidence of Differences in Behavior," *American Economic Review* (May, 1967), pp. 337-46. For a more general treatment of the effect of private versus collective or mutual forms of ownership, see Harold Demsetz, "Toward a Theory of Property Rights," *American Economic Review* (May, 1967), pp. 347-60.

<sup>32</sup> See Pennsylvania Law School Conference, pp. 788 and 837-38. The SEC's arguments in favor of retail price maintenance and against competitive pricing are reported to be that repeal would:

- (1) favor companies with "captive" sales forces (i.e., more fully integrated companies),
- (2) hurt broker-dealers that are primarily engaged in retailing mutual fund shares, and
- (3) be of little benefit to the public because there are no-load funds available.

The first two statements argue that segments of the industry should be protected at the expense of the public. The third argument avoids the relevant issues. An identical argument could be used (a) to show that there is no reason to have front-end-load funds or (b) to defend any restrictive practice that the

believe that one of the worst features of commission-type regulation -- cooperation between the regulators and the regulated at the expense of the public -- is at work. This problem can be resolved, readily, by repealing old regulations rather than imposing new ones.

The third problem on which I shall comment, the "give-up" is also a result of anti-competitive practices that can be eliminated by removing rather than increasing regulation. Members of the New York Stock Exchange (and other exchanges) agree not to engage in price competition. Fees and charges are set by the exchanges, and rebates or discounts for volume are not permitted. The underwriters of mutual funds, also are prevented from engaging in price competition. They are not permitted to offer retailers of funds a bonus (or higher commission) to reward them for services to the fund, for example promoting sales of the fund. The underwriters, retailers and brokers have developed a relatively elaborate system to increase the compensation of the firms that market the fund, the retailers of funds, and to reduce the brokerage fees received by the larger NYSE member firms that carry out portfolio transactions for the fund. In effect, the stock exchange member firms give up a part of the fees received for making portfolio purchases or sales to the brokers who retail the funds. The division is made in proportion to the sales of the fund generated by the retailer. The SEC desires to eliminate this practice and to introduce discounts for volume purchases. Among their stated reasons for desiring to eliminate the "give-up" is the desire to eliminate purchases and sales of securities instituted solely to increase the commissions paid to brokers who act as retailers of the funds.

Again there is a simple, straightforward solution to the problem, and it is the same as the previous one. Mutual funds, or their officers, like everyone else, should be allowed to purchase seats on the NYSE and on other exchanges. The funds would then be able to carry out their own portfolio changes, either by having a representative on the floor or by using the services of a registered trader. I cannot find any argument in the various studies against this proposition. Some funds have been able to acquire

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Commission and the industry desire.

seats on regional exchanges by roundabout methods.<sup>33</sup> It seems likely that once membership in the exchanges is opened, give-ups and other similar practices would disappear. In the preceding section I have suggested some other advantages to the public that are likely to occur if the exchanges -- particularly the NYSE -- eliminate barriers to entry.

### **Conclusion**

To a casual observer -- an outsider -- regulation by independent commission appears to follow a rather regular pattern. In the beginning, the regulator eliminates some of the more vicious, restrictive practices that were used to justify regulation of the industry. Later, new restrictive practices develop after negotiation between the regulators and the regulated. Generally, the new regulations restrict entry, establish standards, and raise the level of education, income, or wealth required for admission to the industry. The restrictions on entry, though different from those prevailing in the earlier, unregulated period, are no less restrictive and perhaps harder to change, since the new restrictions, unlike the old, are sanctioned by law and regulation. Periodically, additional regulations are introduced to eliminate "undesirable" practices that have arisen despite -- or perhaps because of -- previous regulations. In time, the regulators and the regulated become indistinguishable. The industry helps to draft new regulations. And the trade associations help to convince the more reluctant members to accept most of the new regulations by pointing to the more stringent regulations that might have been imposed. The regulated become the regulators -- or the agents of the regulators.

Very little of what I have read about the SEC and the securities industry while preparing this paper falls far from the general description of regulation that I have just given. Yet, as a student of recent banking history, I know that occasionally this pattern is broken. Limited -- but nevertheless increased -- entry was permitted in banking a few years ago. New ideas were encouraged, and the industry embarked on a period

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<sup>33</sup>Pennsylvania Law School Conference, p. 832.

of profitable expansion and increased service.

There is no evidence that the approach that has been successful in -- and for -- the banking industry has had much effect on the SEC or the securities industry. I have tried, therefore, to suggest some ways in which competition in the securities industry might be increased, rather than further reduced. I believe that there are other areas in which SEC regulations could be removed and replaced by procedures designed to encourage rather than restrict competition.<sup>34</sup> If the securities markets serve individuals and society as efficiently as recent research suggests, perhaps the time has come to examine the efficiency with which SEC regulations promote the public interest.

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<sup>34</sup>One of these is my "law of the conservation of regulation." This law would require the SEC (and similar organizations) to name one regulation that they are willing to remove for each new regulation proposed. It is a weak start -- but a start -- toward removing regulations, particularly old regulations that are enforced often sporadically, arbitrarily and at the whim of the enforcement agency.