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Review of Wall Street: Security Risk by Hurd Baruch

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BOOK REVIEW

Wall Street: Security Risk. HURD BARUCH. Washington: Acropolis Books Ltd. 1971. Pp. iv, 356. $8.95.

Fashions in books follow fashions in life. And a fashion with the perennial endurance of the quest for wealth brings each year a fertile harvest to swell the bookseller's inventory.

Books about the stock market, appearing and receding in dull succession, rank high among popular non-fiction works in terms of the number of titles published. These books, which usually combine basic information with more or less "helpful" hints and investment techniques, seem to sell when taken as a group. But seldom does a factual book about America's second-most sought after value achieve or deserve distinction.

The Money Game by "Adam Smith" (later revealed to be George J. W. Goodman) combined the dual virtues of exposé and alluring subject matter to propel itself to best-seller success. The insightful and somewhat discomfiting revelations of *Wall Street: Security Risk* perhaps aim to provide similarly potent promotional stuff. The two books are, however, quite different in their approach. The author of *The Money Game* was, despite his candor and consequent attempt at anonymity, a securities industry insider. His presentation of the foibles and human frailties of the brokerage community was permeated with a boys-will-be-boys attitude of sympathetic understanding. Not so with Hurd Baruch, whose authorship of *Wall Street: Security Risk* evidences the predictable ritualized quasi-hostility of a professional regulator. His years on the staff of the Securities and Exchange Commission (where he has risen to the level of Special Counsel in the Division of Trading and Markets) have obviously left Mr. Baruch with not only an intimate knowledge of the securities industry but with a somewhat special perspective as well.

It is this perspective that brings life to what amounts to a 300-plus page essay on the capitalization practices of brokerage firms and the dry complex of laws, rules and regulations pertaining thereto. With a sort of subtle drama, and an eye to the comprehension problems of the non-lawyer reader, Mr. Baruch builds an unsettling and at times astonishing picture of the inefficient and anti-competitive house that American capitalism built.

That house is of course the New York Stock Exchange, the Exchange itself and the relatively limited number of influential firms which together control its policy and furnish its personality. Unfor-

tunate though it may be that the dominant factor in the securities business is a monopolistic cartel, the situation becomes preposterous when, as a matter of federal policy, the cartel is expected to regulate itself in the public interest. Such, at least, is the conclusion of Mr. Baruch.

An impressive, sometimes ponderous, array of evidence is produced in support of the conclusion that self-regulation has amounted to no-regulation, except to the extent that regulation serves the purposes of the securities industry giants. Such a conclusion is not especially surprising; what is more surprising is that anyone ever really believed that self-regulation could work in the first place. To perceive why self-regulation was made a key component of federal securities policy and to appreciate the specific short-comings of self-regulation, an understanding must first be had of the conditions in the securities business which give rise to a need for any special regulation at all.

Brokerage houses are custodians of huge amounts of their customers' property. Cash customers leave freely withdrawable money and securities with their brokers, for greater or lesser periods of time, largely for convenience. Customers who receive credit from brokerage houses also leave money and securities on deposit, though credit customers are not free to withdraw until repayment of credits extended. The brokerage firms neither pay nor, in the case of cash customers, render any special services for the use of this property. Nor are the firms subject to extensive regulation (as are, for example, insurance companies and banks) tending to assure *safe* use of their customers' property.

To be sure, however, customers' cash and securities are used by their brokers. In fact, such property constitutes a major component in the financial structure of New York Stock Exchange member firms. Experience has shown that withdrawals by customers are ordinarily offset by other customers' deposits. There is thus no reason for securities firms to keep sufficient cash and securities on hand to meet all obligations to all of their customers. Indeed, it would be wasteful for a firm to do so when the bulk of such funds could be at work in the firm's business—making money for its owners.

Customers' securities, left with the firm, provide an even more important source of financing than does customers' cash. Most commonly, brokers turn customers' securities into cash by pledging them as collateral for bank loans. This method, despite its simplicity and utility, has the disadvantage of being relatively inefficient: banks do

not like to lend more than 75 per cent of the market value of the securities pledged. By lending customers' securities to another broker (on which a 100 per cent deposit is required), or by delivering them in settlement of sales by customers (or sales by the firm itself), the entire market value of the customers' securities can be converted to cash.

The securities industry justifies this cashing in on the ground that it is necessary in order to finance customers' margin (*i.e.* credit) transactions. This justification is only partial at best. Not only is cash realized far in excess of margin financing needs, but as an everyday occurrence customers' fully paid for securities somehow seem to get accidently (and unlawfully) pledged. If and when disaster strikes, these fully paid customer-owned securities can be redeemed by their owners—but only by paying for them again.

All of which might be highly academic if the securities industry (or even the giants of the securities industry) were built upon the solid rocks of hard capital which the public is led to believe underlie Wall Street.[1] Unfortunately, however, disasters do strike, as in 1969 and 1970 when over one hundred New York Stock Exchange member firms became basket cases ripe for the receivers. Losses to customers of these firms have so far been measured only in terms of inconvenience, frozen accounts and unrequested transfers of accounts from broker to broker. But this comparatively happy fact derives more from the enlightened benevolence of the New York Stock Exchange than from any built-in protection to which customers were entitled as such. For when a brokerage firm fails, all who have supplied it with financing, including its customers, stand to lose.[2] Moreover, when hard times are coming, the suppliers of a firm's equity financing, who are normally the first to know, seem to find ways to get their money out while the getting is still possible.

To protect the customers stranded by this wave of insolvent firms, the New York Stock Exchange came to the rescue pitching in

[1] Mr. Baruch's implications notwithstanding, no question of basic propriety is raised by the broker's use of customer-owned property. The securities industry must compete with alternative economic investments for capital resources by implying a competitive rate of return. The availability for use in the firm's business of property in customers' accounts is a factor affecting that rate of return. Specific charges for services are another factor. Assuming that it is easy to enter the securities business (Mr. Baruch notes that a brokerage firm requires less capital than a franchise hamburger stand), one must conclude that it works out in the long run so that the securities business is not immorally profitable at the customer's expense once risk and other relevant factors have been taken into consideration. The customer benefits through lower charges for specific services.

[2] Of course in highly prosperous times only the owners stand directly to gain.

not only the entirety of its "Special Trust Fund" but throwing in its savings for a new building as well. Even this magnanimous gesture was inadequate, however, and talk of "technicalities" gained currency as the Exchange looked for ways to avoid responsibilities to the customers of destitutes among its least powerful members.[3] Mr. Baruch implies that only congressional intervention caused a change of heart on the part of the Exchange which ultimately came to the aid of the customers in question—as a price for passage of the Securities Investor Protection Act of 1970.

Interestingly, the securities industry initially opposed the enactment of legislation to provide for insurance of brokerage accounts similar to that offered by the Federal Deposit Insurance Corporation for bank depositers. Perhaps it was fear of accompanying reforms which prompted opposition to such patently beneficial legislation. In any event, industry pressures left their mark on the final Securities Investor Protection Act: insurance of customers' accounts is limited to at most $50,000 whereas obligations of bankrupt firms to *other brokers* may be covered 100 per cent. Intense industry interest in dominating the Securities Investor Protection Corporation resulted in an ambiguous compromise which offers no assurance of public control over the disbursement of taxpayers' money.

Despite the securities industry's opposition to any substitution of outside regulation in place of self-regulation, the inherent weakness of self-regulation became incontrovertably apparent during the 1969-70 debacle of failures. The pressures on brokers' "back-office" clerical personnel created by the upsurge in trading volume in the late sixties resulted in the much talked about "breakdown" which played a large part in a number of brokerage house failures. The value of securities undelivered by their settlement dates grew to billions of dollars. One prestigious house had lost track of $700 million of securities and still attempted to do business as usual. That this firm was able to do so is cited by Mr. Baruch as evidence of how the securities industry "abdicated its self-regulatory responsibilities."

In these difficult circumstances, self-regulation proved to be a system of imposing only token or ineffective sanctions and controls on violators; the Exchange seemed to be powerless to do much more against influential industry members. Indeed, during the speculative rush of the late 1960's, when accounts and new offices were opened

[3] Strictly speaking, *ex*-members.

with abandon in the face of mounting paperwork difficulties, the Exchange took no effective action, despite prompting and prodding by the Securities and Exchange Commission.

Perhaps the special pressures generated out of trying times may explain (but never justify) the failure of self-regulation to adhere strictly to existing standards. But what can be said when the self-regulator's *prescriptions* of rules, adopted for all time and uninfluenced by the standard-bending passions of the worst of financial bad times, are in reality mere illusions of regulation?

As a striking example of such non-regulatory rules, Mr. Baruch cites the so-called "net capital rule" which has been used by the New York Stock Exchange in order to exempt its members from the more stringent and far less loop-hole ridden net capital rule of the Securities and Exchange Commission. Both the Commission's net capital rule and that of the Exchange are supposed to protect investors by requiring, as a condition of doing business, that the brokerage firm owners' investment, excluding illiquid assets, bear a fixed ratio (20:1) to the firm's aggregate indebtedness. Nonetheless, differences in the details of the two rules permit a considerable "protection gap." For example, under the Exchange's net capital rule, owners of firms can pull money out while the firm already has too little capital to comply with the net capital rule. The observance of the Exchange's rule has matched the laxity of the rule itself. At least one firm was counting among its *liquid* assets the anticipated tax refunds to be paid at year-end in respect of losses sustained to date.

The sum of the New York Stock Exchange's regulatory record during the collapses of 1969-70 was not very good, Mr. Baruch would have us conclude. The Exchange either did not have the power (or competance) or the will to set effective standards, discover violations of those standards and punish the violators.

One might inquire as to the whereabouts of the Exchange Commission at such a crucial time. If the troubles were so virulent, violations so rampant and dangerous, and the public interest so jeopardized, why *was* the SEC content to stay for the most part behind the scenes ineffectivually pushing on strings? Mr. Baruch admits that the Commission was aware of the problems and mindful of some possible solutions. Moreover, the Commission was not legally powerless, at least where firms having severe business difficulties might, at very least, be guilty of fraud in the sale of securities.

Mr. Baruch's explanations for SEC inaction tend to be weak and

suggest that *nobody* knew precisely how to make the best out of a very bad time for the securities business. Other than attempting to "run with" firms having difficulties (as the New York Stock Exchange apparently did), about the only alternative would have been to close them down. Whether this solution to the difficulties of 1969-1970 would have been preferable—or better for the customers of the firms concerned—is highly questionable. Can the New York Stock Exchange's way of doing things be so bad when, after all is said and done, the Exchange picks up the tab where it has not quite succeeded?

Focusing on its results rather than on its procedures, the New York Stock Exchange has done a pretty fair job of protecting investors from monetary loss, especially considering that it is a "private club controlled by a small clique of firms." Parallels to the Exchange's record of willingness to sacrifice cash are hard to find in the business world. This is not, however, to say that a few adjustments adjustmentsmight not be helpful. Mr. Baruch feels that specific action is needed in the related areas of customer protection, "back office" operational systems, price competition in brokerage services, and increased governmental oversight.

Customer protection reforms would include a requirement of more effective segregation from the broker's own property of customers' property entrusted to the broker. Deep inside, Mr. Baruch seems disposed to accomplish this segregation by legally requiring separation of the "broker" (agent's) function of securities firms from their "dealer" (principal's) functions. Sensing that such a radical proposal will not be immediately embraced, alternative (and somewhat less drastic) surgery is also proposed, analogizing to commodities market practices and suggesting stiff requirements for escrowed reserves. A realistic net capital rule and improved record-keeping and monitoring procedures are also components in Mr. Baruch's customer protection plan.

While implementing the segregation proposals will deprive securities firms of a significant source of financing, Mr. Baruch seems convinced that the industry as a whole will not be put underwater as a consequence. Difficulties may result for shaky firms, but these are precisely the firms which, under present regulations, cause the greatest customer protection problems. Other firms may replace the lost financing by publicly offering their own equity securities, thereby allowing investors to share in not only the risks but also the profits of capitalizing the securities industry.

As the panacea for "back-office" operational problems, Mr. Baruch advocates a certificateless society in which the stock certificate would be replaced by computer memories and non-negotiable "confirmations of ownership." This, together with price competition on brokerage commissions, would lead to an industry-wide shakedown through which (according to Mr. Baruch) only a small number of powerful oligopolists would survive. And such a result, supposedly, would be optimal from the investor's point of view.

On the question of increased governmental oversight, Mr. Baruch notes (a) the inevitable inability of self-regulation to assure investor protection and (b) the fine record of the Securities and Exchange Commission, together with the fact the Commission needs more money and independence. Unwilling to call for the outright abandonment of self-regulation, he calls instead for "coordinate regulation" with the government supreme, leaving only a supplementary role to the self-regulators. Making the Commission the czar of the industry would no doubt result in more efficient regulation than the present anarchy of give and take. Whether it would result in "better" regulation is another question.

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