

The Babson Staff Letter



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The New York Stock Exchange: Evolution Through Revolution—Part 1

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Introduction

The venerable New York Stock Exchange (NYSE) and its celebrated trading floors are in for some significant change. For starters, this quintessential symbol of capitalism will soon likely merge with a former rival electronic-trading market and in the process become publicly traded like the very stocks swapped through the Exchange's storied open-outcry auctions.

Regarded as the premier equity market in the world, the NYSE currently represents nearly 2,800 listed companies with a combined market value of approximately \$20 trillion. Its next largest competitor has a combined market value of only \$3.5 trillion. By fostering capital creation, better corporate governance,

technological innovation, and investor participation, the NYSE helped build the most sophisticated and respected financial market in the world.

Now the sort of competition the NYSE helped capital markets harness has itself come to the business of trading stocks, particularly with the ascendancy of electronic forums over human interaction. With the NYSE poised to begin a new chapter in its long history, we thought it an appropriate time to look at its development and the changes affecting how the financial markets operate. In part one of this two-part Staff Letter, we begin with a look back at the NYSE's humble beginnings.

Beginnings—New Government, A New Market

Wall Street itself—the symbol of the broader U.S. investment community—traces its name back to **1653**. Settlers of Dutch descent, who constantly feared attacks by the British and Indians, constructed a 12-foot stockade wall for defense. The wall was torn down in **1685** and a new street built stretching between the banks of the East and Hudson Rivers. This simple road would later become known as Wall Street.

In the **mid-1750s**, before the introduction of a formal exchange, merchants and brokers gathered in lower Manhattan to auction off a wide variety of commodities including wheat, tobacco, cotton, sugar, and sometimes slaves.

Then in **1790**, the Federal government refinanced all Federal and state Revolutionary War debt, issuing \$80 million in bonds, which became the first major publicly traded securities. Thus were born the U.S. capital markets. The first actively traded stocks, the Bank of New York and the Bank of the United States, were issued the following year. Unfortunately, following an extremely successful debut, these stocks collapsed in

1792 along with the market, following manipulation by a U.S. Treasury official.

In the wake of this crisis, in May 1792, the first organized stock exchange in New York was created (one year after the country's first exchange was formed in Philadelphia). Under a buttonwood tree in Castle Garden (now called Battery Park), John Sutton, Benjamin Jay, and 22 other New York City stockbrokers and merchants signed the Buttonwood Agreement. This pact formed the rules, regulations, and fees for the first organized stock market in New York, including the significant prohibition that the signers not participate in any other auctions of securities.

The first listed company on the NYSE was the Bank of New York, which remains there today over two centuries later. Stocks of banks and insurance companies dominated the market in the early part of the 18th century. These financial institutions in turn provided much of the capital for the country's nascent transportation and manufacturing industries.

Shortly after the War of **1812**, commercial activity in the U.S. increased and the securities market in New York began to grow. On March 8, **1817**, the organization behind the Buttonwood Agreement drafted a constitution and named itself the New York Stock & Exchange Board (NYSEB) and moved to 40 Wall Street. New members paid an initiation fee of \$25 and membership became known as holding a “seat” on the Exchange.

During these years, stocks were traded in a “call market,” where the president of the NYSEB read a list of stocks and brokers traded each security in turn. There were two trading sessions each day, one in the morning and another in the afternoon.

Much like today, advancements in technology furthered the progress of the Exchange. In **1844**, Samuel Morse invented the telegraph, which broadened market participation and facilitated communication with brokers and investors outside of New York. In the Exchange’s first move to improve corporate governance, it strengthened its listing standards in the **mid-1850s** by requiring companies to provide complete statements of capital resources and shares outstanding. Increased oversight would continue to be a fundamental responsibility for the Exchange throughout its history.

August 24, **1857**, marked the first major U.S. stock market crash. A major financial institution failed (as a result of embezzlement!), and worsening economic conditions after the end of the Crimean War and speculation in railroads and real estate contributed to a market panic. Prices dropped eight to ten percent in a single day, and the market bottomed down 45% from the beginning of that year.

The Specialist is Born—Growth and Evolution Follow

In **1872**, the Exchange migrated toward a continuous trading market and away from the existing call market. Stocks were assigned to designated areas on the trading floor and brokers dealing in those names remained at those locations. This was the advent of the NYSE specialist, a position that remains the cornerstone of the NYSE’s open outcry auction market.

To this day specialists manage the two-way auction market in the specific securities they have been assigned. They use human judgment and insight to best bring together buyers and sellers of securities and to keep trading orderly. Specialist firms are solely in the business of trading listed securities.

The Exchange set the commission paid to members who executed trades for other members at \$2 per one

In **1863**, the New York Stock & Exchange Board voted to change its name to the New York Stock Exchange, and two years later it moved to the corner of Wall and Broad Streets, its present address.

Throughout the 1860s, key technological developments helped drive the evolution of the NYSE: the transatlantic telegraph cable in **1866**, which opened the door for arbitrage trading between the London and New York stock markets; and stock tickers, which allowed stock quotes to be continuously relayed from the NYSE’s trading floor to brokerage houses throughout the country.

The Exchange took further steps to increase the stability of its marketplace by requiring all NYSE-listed companies to register all outstanding shares at a bank or other appropriate agency. Meanwhile, for the first time in its history, in **1868** the Exchange permitted members to sell their seats. (At the time seats had traded as high as \$7,500. Their low point was \$2,750, in 1871, their subsequent high price was \$2,650,000 in 1999.)

On September 25, **1869**, gold speculation resulted in the next crash on Wall Street. A syndicate of New York bankers attempted to corner the gold market prior to the U.S. government reinstating the gold standard after the Civil War. Gold prices jumped nearly 12% in one day to \$162½ per ounce as the market panicked.

In response, the government began releasing four million dollars of gold into the market, but the action was misinterpreted to be four million ounces of gold. Gold prices plummeted nearly 20% in fifteen minutes to \$133 per ounce. Stock prices fell, and many investors and brokerage houses were wiped out.

hundred shares. The term “two-dollar broker” still refers to this type of business.

In September **1873**, only four short years after the gold speculation crash, Wall Street experienced another crushing blow. The major depression afflicting Great Britain spread to the U.S. Jay Cooke & Company, a preeminent investment bank, failed and a ripple effect occurred across the country. The NYSE closed for 10 days. The collapse of Jay Cooke & Company was tied directly to the country’s speculation in railroad stocks. In the aftermath, nearly one-quarter of the country’s 364 railroads failed, unemployment rose to 14%, and the U.S. was thrown into a financial crisis.

By the late 1870s, continued advancements and industrialization pushed the U.S. back to prosperity, and the

NYSE thrived as investors regained confidence in the U.S. equity markets. The Exchange worked to integrate other advances in technology, such as the introduction in **1878** of telephones on the floor of the Exchange. December 15, **1886** marked the first day the Exchange traded over one million shares. Continuing to build on the demand from investors, the NYSE purchased a controlling interest in Commercial Telegram Company in **1890** and renamed it the New York Quotation Company (NYQC). The NYQC stock ticker tape machine became the exclusive device for printing stock prices on Wall Street.

Advances continued throughout the balance of the 1890s. The Exchange created another subsidiary, the New York Stock Exchange Clearing House, designed to centralize and improve the transfer of securities between brokers. It encouraged listed companies to publish annual financial statements for their shareholders. (This became a requirement in 1899.) In **1896**, Dow Jones published its first industrial average (DJIA), which consisted of 12 stocks with an index value of \$40.94. (Notably, only one of the original 12 stocks, General Electric, remains in the index today.) Less than three months later the DJIA reached its lowest close ever (\$28.66).

A New Century—New Challenges and Opportunities

The beginning of the 20th century marked a number of significant firsts for the country and the NYSE. On April 30, **1901**, over three million shares traded hands. With the continued growth in trading activity, the Exchange required more room. In **1903**, the Exchange moved to a significantly larger trading floor, space that is still in use today. With the ever-increasing public interest in the stock market, the DJIA closed over the \$100 mark for the first time on January 12, **1906**.

Come **1914**, the world was plunged into the ultimate instability of world war with the assassination of Austrian Archduke Ferdinand. But even before the ensuing hostilities commenced, the world's financial markets panicked and many exchanges around the world closed to stem any selloff.

The NYSE shut down for four and a half months starting in July, 1914 (after the DJIA had already lost nearly 11% in value). When the DJIA began pricing again, on December 14, 1914, it further dropped

more than 20% to close at \$56.76. Despite the Exchange's closure during this period, a few stockbrokers and speculators continued to trade in an open-air black market.

For the next two years, American investors continued to buy stocks despite the reluctance of foreign investors. This activity pushed the DJIA to a new high of \$110.15, up 107% from its low. In a dramatic change in practice, the Exchange began quoting and trading equities in dollars per share and discontinued pricing as a percent of par value.

In **1917**, the U.S. entered the war and its economy was enlisted in the effort. President Wilson effectively nationalized much of American industry, which boosted growth in the process. By war's end the next year, the U.S. emerged a world power with a flourishing economy and expanding capital markets. Moreover, the world now looked toward Wall Street as its financial center, a position long held by London. Over the next 10 years more than 1,700 foreign issues would be offered publicly in the U.S.

A Golden Era, A Capital Crisis

The early **1920s** marked the start of the historic bull market that ran through 1929. The market soared almost uninterrupted for nearly eight years, with the DJIA reaching a record high in September at \$381.20, an increase of nearly 500% from its low in 1921.

Throughout the 1920s the NYSE made many changes and improvements, including the formation of the Stock Clearing Corp., which provided a central clearing and delivery system for securities traded between members, banks, and trust companies. Meanwhile, the Exchange's formation of the Fraud Bureau, its tightening of listing rules, and its creation of regulations governing proxy

solicitation helped increase investor confidence and improve market stability.

On June 12, **1928** one-day volume topped five million shares for the first time. In **1929** the Exchange introduced a central quotation system and new larger trading posts, which enabled the dissemination of real-time bid-ask price quotations via phone.

The significant enhancements and improvements of the NYSE and the U.S. capital markets could not have prepared anyone for the catastrophe that would soon rock the financial world in late 1929. Rapid U.S. expansion and rampant speculation in the stock market drove

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stock prices to new record highs, peaking on September 3, 1929.

After drifting lower, on October 24, 1929 (“Black Thursday”), the stock market sold off dramatically on record volume of almost 13 million shares. After appearing to stabilize the next day, the market went into full collapse on “Black Monday,” with the DJIA closing nearly 14% lower. The final blow came the next day: October 29, 1929.

An unprecedented 16.4 million shares traded on that “Black Tuesday” and the Dow dropped nearly 12%. Ticker tapes used to disseminate information from the exchange floor were overwhelmed and ran over two hours behind, further fueling investor panic. By the end of the day, 880 issues were worthless, a total estimated loss of over \$8 billion. Some ruined brokers and investors jumped from their office windows. The NYSE would not see a comparable volume day for another 39 years.

The Stock Market Crash of 1929 only signaled the start of the Great Depression. For the next three years stock

prices would continue to fall with the DJIA hitting a low of \$41.22 on July 8, 1932, a total decline of over 89% from its high. The U.S. financial markets were decimated; European investors withdrew capital and Americans turned away from the financial institutions they blamed for the Crash.

Fallout from the Crash and the ensuing Depression fundamentally changed the way the U.S. manages its economy and resulted in the basic financial and regulatory structure of the country today. Meanwhile, the searing influence of the Crash on investors’ psyches and their willingness to invest in stocks would take decades to overcome.

In part two of this Letter, which will appear later this summer, we will look at the modern era of the NYSE and U.S. capital markets, major developments in the second half of twentieth century, plus how competitive pressures, evolving regulation, and technological change are reshaping the capital markets’ landscape today.

Note: Main sources of historical information include the New York Stock Exchange, Dow Jones & Co., and Wikipedia.com.

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