

CORPORATE FINANCE AND THE CHANGING STOCK MARKET

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Introduction

Much has been said and written about the changing structure of the U.S. equities market. The pros and cons of dealer versus auction markets have been examined in great detail, and a variety of evolutionary approaches to combining the two have been suggested [16, 31] in addition to a number of more radical proposals (see, for example, [5]). The primary focus has been on alternative structural changes for the brokers and dealers who dominate the market's operation. Highly sophisticated analyses of economies of scale in brokerage have been introduced, and the tools of industrial organization have been similarly applied to the examination of dealer services [11, 32]. An important secondary focus has been on the implications of structural changes for buyers and sellers of common stocks [31], and in particular the influence a particular change might have on transactions costs.

In contrast, discussions of the implications of the changing stock market for corporate issuers and for corporate financial policy have been loose and highly speculative. Much of the rhetoric has combined the interests of those seeking to maintain the status quo with gross confusions of cause and effect. In addi-

tion, factors having little or no relation to the structural issues have been cited in an attempt to influence public policy in favor of those who oppose reform. To some degree, this situation has resulted from a failure of corporate officers to assume an active role in the debate or even to understand the issues in question. An objective examination shows that a restructured stock market should have no serious negative impacts and could lead to a reduction in the complexity of corporate financial policy.

The Functions of a Securities Market

It is useful to begin by discussing the appropriate functions of a securities market. In this connection it is relevant to first consider the functions that are not appropriate because much recent speculation about the problems of the U.S. stock market is based on misconception and because some indirect observations may thereby be provided about the appropriate functions.

A popular misconception is that the stock market is not currently functioning well because price-earnings ratios have recently reached historically low

levels. (One may recall that a few years ago it was argued that the market was not functioning well because multiples had reached all time highs.) While it may be frustrating for investors and issuers alike to see multiples at levels which appear to be "irrational," it should be remembered that it is not the function of the market mechanism alone to determine the "appropriate" price of corporate capital. The high volatility of price-earnings ratios over relatively short periods is also vexing, but the prevention of price changes, *per se*, is not the function of the market either. Also frustrating is the simultaneous appearance of stocks with widely divergent price-earnings ratios, a concern reflected by recent discussion about the problems of the so-called "two-tiered" market [14]. Nevertheless, it is not a function of a securities market to prevent widely different price-earnings ratios from materializing.

While misconceptions related to price behavior have been, perhaps, the most prevalent, two more subtle ones have played a particularly prominent role in recent debate. William McChesney Martin's controversial 1971 report to the New York Stock Exchange espoused the notions that the market should encourage a high volume of transactions and should foster more participation by individual investors when it concluded that "the number of shareholders and the volume of trading may more than double in the next ten years if the character of the market is oriented in favor of the public" [15, p.26]. It is questionable whether either of these developments would necessarily be good since the function of a securities market is not primarily to influence the way the public chooses to invest or to encourage more volume, *per se*. Rather, it is to encourage the development of a market structure that is responsive to changing trading needs and desires.

What, then, are the functions of an appropriately structured stock market? Stated in the broadest terms, its overriding function is to aid in the allocation of capital. Misallocation will adversely affect an economy's growth rate, and the nature of its expansion will fail to reflect the desires of future consumers. In the final analysis, of course, decisions concerning the allocation of capital manifest themselves as supply and demand conditions in the markets for real capital goods. There must be a mechanism, in short, for collecting, saving and channeling it to the system's investors.

Simply put, allocational efficiency depends upon a market's external and internal efficiency. External efficiency is concerned with a market's ability to establish prices that fully reflect all available information; internal efficiency refers to its ability to pro-

vide transactions services to buyers and sellers at the lowest prices possible.

In recent years much has been written about external efficiency under the general heading of "capital market efficiency" [8]. More often than not, it has been argued that external efficiency is synonymous with allocational efficiency, which is not necessarily true. If the price of transactions services greatly exceeds the costs of providing them, capital may not be allocated efficiently even if the characteristics of external efficiency are present [30].

Because the U.S. stock market is considered to be externally efficient, recent debate has focused primarily on seeking ways to improve the market's internal efficiency, particularly in relation to institutional trading [8]. To be internally efficient, a market must have adequate facilities for accommodating the temporary excess supply and demand situations that occur even with a stable underlying equilibrium situation. Such facilities are made possible by people (or organizations), such as market makers or dealers, who stand ready to make trades with investors who desire immediate transactions. They perform the function of smoothing out temporary imbalances in the flow of orders by trading for their own accounts, earning for themselves a "jobber's turn" on the spread between the bid and the ask price—a turn comparable to that earned by retailers in very good markets.

Like any other transactions cost, that associated with purchasing the services of market makers permits the existence of small price dependencies that would not exist in a perfect market. Moreover, because orders for immediate execution tend to be cleared at either the bid or ask price, this cost encourages the development of reversals or negative serial dependencies—i.e., the tendency of negative price changes to follow positive price changes and vice versa in a sequence of transactions. Although these dependencies are an indication that real markets are not perfect, they need not be regarded as a sign of market inefficiencies unless they exceed the level at which rank and file investors can make systematic profits by exploiting them.

It is important to remember that an internally efficient market exists to provide marketability, not liquidity. A particular asset has marketability when traders can take or dispose of reasonably good-sized positions at prices relatively close to the underlying equilibrium price. Virtually all liquid assets are highly marketable, but not all marketable assets are liquid. For example, a speculative common stock may possess rather good marketability characteristics in the sense that its market is resilient, but it may also experience rather wide price fluctuations.

Stock Market Structure: Past and Present

Virtually all empirical studies of U.S. stock market behavior confirm that its prices react quickly and usually accurately to new information. Its "efficiency problems," therefore, are related to transactional characteristics, and, more specifically, to the need to find an organizational structure that can provide appropriate marketability in the face of changing trading conditions, chiefly the growth of institutional trading.

For some time in the United States, virtually all common stocks have traded either in continuous auction or negotiated (over-the-counter) markets. The principal components of the former are a centralization of brokerage activities and a provision of dealer services to smooth out temporary imbalances in the inflow of buy and sell orders. In the stock exchanges, which utilize this format, these components are combined and handled by the specialists (non-competing market makers) who perform the dual function of broker and dealer. These central brokers hold and execute public orders which are forwarded to them and, as dealers, trade for their own accounts when offsetting orders are not present. In providing the latter service, they make it possible for traders who wish to submit market orders to be serviced without appreciable delays.

By contrast, the negotiated market has neither centralized brokerage nor the guaranteed provision of dealer services to smooth out temporary imbalances in the order inflow. The market does have dealers who trade for their own accounts and provide marketability for traders who seek immediate sales; however, because of the comparative absence of formal constraints, the strength of a negotiated market is subject to considerable variation over time. If a large number of firms are actively providing firm bid and ask quotations for "reasonably" sized orders, buyers and sellers have little difficulty in either taking or disposing of their positions. On the other hand, if firms are backing away from the market, by widening their bid and ask spreads, reducing their willingness to take positions, or both, investors find it difficult to do business on reasonable terms. Indeed, when firms back away, as is sometimes the case when extreme uncertainty exists, investors are faced with a situation in which orders either are refused outright or are accepted only on the basis that they will be transacted if and when offsetting orders appear. Of course, when this happens, trading takes place between investors with intermediaries acting only as brokers.

To perform their pivotal role effectively, special-

ists must iron out temporary disparities between the inflows of buy and sell orders by buying and selling for their own accounts. Moreover, as organized in the New York and American Stock Exchange, they must do so without attempting to solicit orders when trading volume is inadequate. In other words, in contrast to the over-the-counter dealers who actively seek out orders to adjust inventory positions, the specialists must rely on price adjustments or other changes in market conditions to induce a flow of orders that will offset their positions. When there is a relatively steady, well-balanced inflow of buy and sell orders, a specialist can meet the obligations of the job with relative ease because the risks and costs associated with taking positions are manageable and provide an opportunity to earn an excellent return on capital. Estimates of net returns earned by NYSE specialist units on their average invested capital range from 54.58% per stock per year for units with high inventory activity to 89.76% for the units with lower activity [24, pp. 1915 & 1925].

When the inflow of orders becomes particularly unsteady or unbalanced, however, the specialist's task becomes considerably more demanding and risky. Over a decade ago, the SEC's *Special Study of the Securities Market* reported that specialists find it both difficult and unprofitable to make markets in very inactive stocks [23, p. 87]. Similar problems result when the total quantity of shares bought and sold is relatively sizable but the distribution of orders varies greatly over time, as with stocks that are traded by institutions in large blocks. For this reason, the *Special Study* also reports that "blocks of shares are often too large to be readily and promptly absorbed through the routine procedures of the continuous auction market" [23, p. 128].

The problems posed for the auction process by thin markets are fairly well understood; the exchanges attempt to deal with them by systematically excluding issues with insufficient trading volume. However, problems posed by the increasing volume of block trading resulting from growth in the number of institutional investors have not been dealt with adequately. Moreover, there appears to be a limit to what can be done to deal with the problems. The history of the corporate bond market and the government securities market, and the development of the Third Market—a negotiated market for listed securities, in which NYSE members do not participate—suggests that in the presence of institutional block trading a negotiated market often can have significant advantages over the auction system. The only real source of marketability for an institutional seller is ready buyers. Yet, the specialists who are

forbidden to solicit orders and lack sales organization comparable to those of the Third Market firms, are not in touch with potential buyers. However, in the absence of a competitive dealer organization in the NYSE, it is not altogether clear that the specialists would supply marketability services in sufficient depth and at reasonable prices [24, pp. 1849-61].

The growth of the institutions and the concomitant decline in the relative importance of individual investors have created virtually insurmountable problems for the traditional continuous auction market. When most trades were for one or a few round lots, there was little question that economies were inherent in the auction method of market making. However, in the age of block trades, these economies are questionable. The *Institutional Investor Study* [24] concerning specialists' difficulty in dealing with blocks indicates that their participation is a rapidly decreasing function of the size of blocks and is irregular even for relatively smaller ones [24, pp. 1634-5].

Future Market Structure

It has been suggested that an evolutionary approach to meeting the needs of institutional investors is likely to prevail [29, 31]. Such an approach will probably rely on refining the Third market; linking it to the Fourth Market, i.e., the market in which institutions deal directly with each other without the use of broker-dealers; developing an interface between the Third and Fourth Market and a retail auction market; and increasing the degree of competition at all market levels. In a highly refined version of this approach, Mendelson [16] suggests that the Third and Fourth markets could be linked to each other and to a more competitive retail auction market through a computer network, the Automated Trading System, which does *not* use the computer as a market maker, *per se*, nor discourage market making by retail or block traders. Instead, it uses the computer to maintain the retail book, perform a myriad of recordkeeping chores, provide to all market makers equal access to the marketplace, and supply a composite tape. Block traders are able to communicate with each other and with institutions and are linked to the retail market. Thus, any trade arranged in the block market guarantees that a limit order at a price better than the block trading price would be accommodated as part of the block transaction. Institutions are able to communicate with each other in a refined Fourth Market as well as with the block houses. They, too, are linked with the retail market, so any trade between institutions

is the effect of cleaning up the retail book. In contrast, retail market makers and brokers cannot communicate directly with the Third and Fourth Markets, but they have full knowledge of the retail books, which are operated on a competitive auction basis.

Regardless of whether or not this system gains followers, its essential features will probably be a part of whatever system emerges. With the exception of the *Martin Report* [15], which has been criticized for its anticompetitive flavor, virtually all of the important analyses of the past few years [24, 26, 25] suggest a move in this direction. As Mendelson noted in comparing his market structure proposals with those of the SEC, "The basic difference is more in the distance travelled than in the direction taken, . . ."

The structure likely to emerge will be more internally efficient than today's market, thus having transactions costs that reflect the costs of providing exchange and marketability services more closely than do present brokerage commissions and spreads. Both spreads and commissions should decline relative to what they would be in an unreformed market [7]. It remains to be seen, however, whether they would decline for all types of investors and transactions.

Brokerage commissions are now set partly by competition and partly by regulation. For transactions involving \$300,000 or more, commission rates are subject to negotiation between a broker and client. Smaller transactions continue to be subject to fixed minimum commissions set by the major stock exchanges and approved by the SEC, which has indicated its intention to subject all commission rates to competitive rate settings no later than May 1975. Whether or not this schedule is met, the trend toward competitive rate setting seems to be firmly established, and discussions of fixed commissions now tend to focus more on when they will end.

Refining and linking the Third and Fourth markets with a retail-auction market is quite compatible with and almost certainly leads to competitive rate setting. Virtually no significant barriers to entry exist at any of its various levels, and service prices at all levels must be competitive to obtain business.

When brokerage commissions are competitively established, they will more closely reflect the underlying costs of servicing tenders. To our knowledge, the nature of the marginal costs of brokerage services for orders of different sizes has not yet been empirically established but under existing structures, they tend to decrease up to a certain order size and then remain reasonably stable over the remaining range [13, p. 812]. Thus, it appears that institutional

investors might obtain even lower brokerage costs under a system of competitive commission rates; as a consequence, individuals who channel their savings through financial intermediaries would probably benefit directly from such rates. They could also benefit indirectly if competitively determined brokerage commission rates helped to eliminate some of the incentive for churning institutional portfolios.

To the extent that the existing fixed minimum commission structure exceeds the current costs of servicing small orders, competitively determined commissions would almost certainly be to the advantage of individual traders, who manage their own accounts, and they might be benefited even if this were not the case. Current costs of servicing orders of all sizes are based on the existing structure of the brokerage industry. Under competition, it is likely that structural changes making it possible for all traders to pay lower commissions would occur. While this would not necessarily be the case, it is a mistake to attempt making definitive inferences based on brokerage cost structures produced by the market structure of the past and the present rather than the future.

The important point is that in an era of competitive rate setting, brokerage commissions would reflect costs, and this is as it should be. Those who support existing fixed commission schedules because they involve the subsidization of individual investors at the expense of institutions are, in our judgment, in error. There is no compelling reason to encourage direct participation in the market by subsidizing small transactions at the expense of individuals who chose to participate in the equities market through financial intermediation.

While brokerage commissions appear on a broker's statement and are the visible aspect of transactions costs, spreads between bid and ask prices are also a part of costs, and the impact of structural changes on them should be considered. Recent studies show spreads narrowing as competition increases [29]. To make profitable trades in a competitive environment, dealers try to set bid and ask prices inside the quotes of competitors; when all competing dealers do so, an overall narrowing of spreads results.

Competition for the specialists in market making for exchange-listed securities is now quite limited. They are given some competition by incoming limit orders—i.e., buy (sell) orders of traders that specify maximum (minimum) prices—and by the market-making activities of the regional exchanges and the Third Market dealers, the last two of which provide some competition for institutional business. However, in the future competition will probably be keen at all levels. For example, in the retail market

there will be almost no barriers to entry by dealers who were willing to “stand on their markets” and abide by the rules governing trading. Retail market makers will find it necessary to quote competitive spreads that are narrower than those prevailing now. Moreover, to the extent that a larger, more competitive dealership structure can spread the risks associated with positioning, the resilience of the stock market will be enhanced, thus accommodating different trading needs of small and large investors.

Currently institutional orders have the effect of making wider spreads on large transactions than on small ones. As a result, these orders tend to produce temporary reductions (price reversals) in the prices of securities which average slightly more than 1% and are partly dissipated before the end of the trading day. Such reductions have been identified as “an increase in transaction costs to the institutional seller—necessary to mitigate a short term supply-demand imbalance” [11, p. 818]. It has been alleged that these reversals are to some extent the result of current inadequacies in the auction market and lack of competition and division of labor among specialists in offsetting short vs. long term imbalances in any given stock price. In addition, the failure to provide adequate linkages between the retail and wholesale (block) markets is said to have caused block traders to demand price concessions larger than might otherwise be necessary. To the extent that these arguments are valid, the type of structure discussed above might improve the situation. For example, linking the Third Market with the retail market will give block traders added ability to liquidate part of their positions and thus reduce the risks associated with block positioning and, presumably, the cost of being a block trader. Nevertheless, price reversals associated with blocks will not be eliminated completely. Large demands for marketability services will require a penalty for quick executions.

Corporate Decision Making in a More Efficient Market

In perfect markets, prices adjust to new information instantaneously and without bias, and equilibrium rates of return on securities holding impound the differences in the riskiness of various financial claims. In real markets, however, the costs of generating and processing information and making transactions will always act as frictions, with the result that the equilibrating processes will continue to contain lags and the prices of assets will be slightly different from those in a world of zero

transactions costs. Nevertheless, if an imperfect market possesses both internal and external efficiency, prices will generally reflect all available significant information regarding risk and return. These prices will embody differences in the marketability and exchange costs of various financial claims, and movement toward equilibrium will be reasonably rapid and unbiased. Such a market will be devoid of both windfall returns resulting from the exploitation of time lags in the information disseminating process and monopoly returns to those who provide broker and dealer services to investors.

General Asset Management Decisions

In spite of limited knowledge about the formation of investor expectations, the processes by which returns are generated, and the theory of valuation in a multiperiod context, there is considerable empirical support for the single period capital asset pricing model. The empirical analysis of Fama and MacBeth [9] indicates, for example, that investors tend to hold efficient portfolios and that on the average the expected return of a given stock over time $E(R_i)$ is a linear function of its nondiversifiable risk β —that is, the portion of a stock's risk which is accounted for by variations in the return of the market index $E(R_m)$. Algebraically, $E(R_i) = (1-\beta)R_f + \beta E(R_m)$, where R_f is the one period risk free rate of return. If $(1+R_i)$ is expressed as $(P_{i,t+1} + D_{i,t+1})/P_{i,t}$, then the price of the firm's common stock at period t , $P_{i,t}$, can be expressed as the discounted sum of its expected future price, $P_{i,t+1}$, and dividend, $D_{i,t+1}$. That is, $P_{i,t} = [E(P_{i,t+1}) + E(D_{i,t+1})]/(1+\Phi)$, where the discount rate Φ is equal to $(1-\beta)R_f + \beta E(R_m)$. In other words, in a stock market where investors hold efficient portfolios, and prices reflect available information within the limitations of transaction and information costs, the market's discount rate applied to the cash flows of various risky assets is approximated by the sum of the risk-free interest rate and a risk premium that is a function of the systematic risk of the asset. (Articles by Rubinstein in the March 1973 issue of the *Journal of Finance* [22] and Weston in the Spring 1973 issue of *Financial Management* [34] provide good illustrations of this method.)

The important implication of this equilibrium relationship for investment decisions is that a firm seeking to maximize the value of its shares should only accept capital investment projects for which the net present value of cash flows discounted at the particular rate applicable to a given project, is greater than zero. Otherwise, the price of its stock will decline in order to bring its expected return back

into equilibrium with the systematic risk, β , of the firm. This relationship requires that financial managers not only estimate the cash flows associated with a project, but also the relationship of these flows with both the overall market and the rate of return on the "market portfolio." Since all the information about a given project is contained in its systematic risk, β , the relationship between its cash flows and the aggregate level of economic activity requires explicit consideration. Major new projects about which meaningful historical data are lacking demand relatively sophisticated methods of estimating the conditional distributions of the cash flows for all subjectively relevant states of economic activity, as well as the marginal probability distributions of economic activity over time [27].

In a stock market becoming increasingly efficient in an internal sense, firms able to develop methods to provide consistently accurate forecasts of these variables will have their values capitalized in its securities prices. More importantly, improved internal efficiency will enable investors to react to increasingly smaller changes in a firm's probable future profitability. However, in relation to a given level of a stock's price, price changes resulting from the capture of such information will be rather small.

Mergers

Among the most important asset decision problems are those concerned with mergers and acquisitions. Other things being equal, profit maximizing firms should prefer internal expansion to mergers if the marginal costs of expanding or adding flexibility are lower than the cost of acquiring them through purchase [6]. When coupled with investors' behavior, as envisioned in the capital asset pricing model, this implies that mergers for diversification purposes will result in an increase in shareholders wealth positions only if they create real technological economies or managerial synergies. Investors usually cannot achieve the same results merely by making appropriate shifts in the portfolios of financial assets. The prudence of mergers and acquisitions becomes the subject of intensified scrutiny as the stock market's internal efficiency improves; for the more efficient the market is in providing transactions services, the easier it is for investors to eliminate unsystematic risk—that unique to a firm or industry—by holding efficient portfolios of financial assets.

The development of governmental policies, as advocated by some, designed to make non-horizontal mergers and acquisitions more difficult are of questionable value at the present time, and as the market becomes more operationally efficient, their desirability

will become even more doubtful. In such a market, shares of firms that consistently make poor investment decisions will quickly decline in value, which in turn will encourage improvement of decision making processes to avoid a takeover. A governmental policy designed to prevent mergers and acquisitions would work effectively against the improvement of resource allocation, which, is after all, the primary reason for seeking greater capital market efficiency.

Liquidity Management

Determination of an appropriate level of liquidity for the firm is another important function of financial management. Inadequate liquidity may force a firm to default on its maturing liabilities and create technical insolvency, while excessive liquidity tends to reduce the expected return to shareholders. Within the framework of the capital asset pricing model, liquidity management should be analyzed in terms of its impact on systematic risk, the only firm-specific, nondiversifiable risk. To the extent that returns on cash balances and other short term marketable securities have relatively low correlations with the overall return on the market index, substantial current asset holdings might be expected to reduce a firm's systematic risk. However, that existing empirical evidence has failed to find such correlations is demonstrated in the work of Kettler and Sholes [2, p. 669,] and in the article by Logue and Merville in the Summer 1972 issue of *Financial Management* [13, p. 40].

As a practical matter, much of what firms currently do in regard to liquidity management is determined by the various rules of thumb established by banks and other lending institutions, many of which have virtually no basis in theory and even less practical justification. At best, they represent curious anachronisms from an age when corporate financial management in general was dominated by questionable conventional wisdom [4, pp. 18–26]. Fortunately, the stock market now provides important feedback to corporations and their money market creditors. There is considerable evidence that indications of inadequate liquidity, as well as tendencies toward technical insolvency and bankruptcy, are reflected in the prices of common stocks [1, 33]. Improvements in the internal efficiency of the market may help free companies from strict adherence to various traditional standards of liquidity [12] by making it possible to impound this type of information even more quickly and fully. Firms would then gain substantial added flexibility in managing short term assets without adversely affecting their credit standing with lenders.

Capital Structure and Dividend Policy

The financing mix problem of determination of the sources of funds which comprise a firm's capital structure can be translated into two somewhat interdependent decisions: (1) debt vs. equity financing and (2) reinvestment vs. dividend payout. A firm's cost of capital was traditionally viewed as being dependent on the differential costs of debt and equity and the extent of leverage employed [28]. In their seminal article, however, Modigliani and Miller (M & M) [19] argued that in perfect securities markets, financing mix should not influence cost of capital, that is, the value of a firm should be invariant with respect to financing mix. Of course, after recognizing the imperfection associated with the different tax rates applied to cost of equity and the explicit costs of debt and preferred stocks, M & M later demonstrated that with permanent debt in the capital structure, the value of a firm should be increased by the capitalized value of tax savings on corporate indebtedness [20]. This does not imply, however, that firms should substitute debt for equity without limit: as leverage is increased, the cost of debt capital tends to rise. Fisher's [10] findings on risk premiums indicate that a 1% increase in the debt-equity ratio of a firm is associated with the increase in debt interest cost of 0.2% on the average. Moreover, as Rubinstein [22, p. 178] has demonstrated, for any given level of operating risk, non-diversifiable risk, β , of a levered firm increases in direct proportion to the debt-equity ratio and necessitates an increase in the required rate of return on common stock.

In a stock market in which investors can substitute "homemade" leverage for debt in corporate capital structures at reasonably similar costs, the virtues of an "optimal" capital structure, i.e., a specific mix of debt and equity capital which maximizes the market value of a firm, become extremely suspect. For all practical purposes, it is appropriate to consider the relationship between the cost of capital and a firm's capital structure as a horizontal function throughout most of the relevant range of debt-equity mixes [28, p. 117]. Consequently, capital investment projects should be evaluated at the market determined marginal costs of capital, which within broad limits should be independent of the financing mix.

Due to the work of Miller and Modigliani [18], it is generally agreed that in perfect capital markets variations in dividend payout rates should not influence the value of shares nor significantly affect policies regarding investment decision making. However, two sources of imperfection in real securities

markets, the taxing of dividends and capital gains at different rates and transaction costs associated with liquidating and reinvesting gains, must be considered.

If investors hold efficient portfolios, as the evidence tends to indicate, the advantage of being taxed at capital gains rates should result in a preference for retention and reinvestment of corporate earnings over dividend income. Thus, after-tax returns will be larger and transaction costs to reinvest dividends will be avoided. As long as retained earnings are invested at rates in excess of the cost of capital, even those stockholders who need a steady income stream should be benefited more by a policy of retention. Equivalent portions of their appreciated stocks can be sold with only capital gains taxes incurred. The lower rates for capital gains should more than compensate for the problems created by the indivisibility of shares and the brokerage and marketability costs that may be incurred in liquidating positions.

To the extent that improved internal efficiency of the stock market reduces transactions costs, it should be even easier for firms to pursue a rational dividend policy which regards them as a form of payment to be made only when earnings cannot be profitably reinvested.

The Listing Decision

In regard to listing on a stock exchange, a restructured stock market could have very significant implications. Until the rapid growth of institutional investors, the question of whether or not to list stock on a major exchange was analyzed primarily in terms of the firm's ability to meet listing requirements. A few firms that were able to meet these requirements chose not to have their stocks listed, but the vast majority were eager to do so because of the belief that it would provide shareholders with improved marketability. The growth of institutions and improvements in computers and telecommunications technology, however, have resulted in conflicting arguments concerning the merits of listing. Even if companies elect to list their stock, some institutional transactions will probably take place in the over-the-counter market. In addition, movement from the over-the-counter market to an exchange means giving up competition among a number of over-the-counter market makers in favor of a single specialist. Understandably, these arguments have caused a growing number of firms not to list. With maturation of the type of structure described earlier, however, virtually all stocks with enough trading activity will be "listed" on the competitive auction

market for rank and file investors. Firms will not be faced with a "listing" decision; they will simply find that dealers are willing to make a market in their stocks and have entered quotes in the retail auction market. Similarly, firms will discover that institutional transactions, to which retail customers will be provided equal access, are taking place in the Third and Fourth Markets. Simply put, the restructured stock market will relieve corporations of the listing decision and give them added confidence in the degree to which all buyers and sellers can trade on equitable terms.

New Equity Capital

There are those who believe that a stock market structured to more effectively meet the trading needs of institutional investors will have adverse consequences for corporations. Some even predict that such a market will make it virtually impossible for small or new firms to obtain much needed equity capital. Currently stock prices are at historically low levels in relation to corporate earnings, and it is costly for all firms to float new equity issues. However, when companies return to the marketplace, if it has been restructured to provide for greater internal efficiency, there is little reason to believe that firms will find a hostile environment. It was recently noted [21, p. 65] that institutionalization of the bond market and the concomitant displacement of the continuous auction market by the dealer market proved more efficient and resulted in lower distribution costs for new bond issues. However, expanded regulation of financial intermediaries with regard to their holdings of common stocks could make it somewhat more difficult for a parallel development to take place in the stock market. Strict limits on the percentage of ownership of the shares of a given corporation, for example, could make it more difficult to place large blocks of the stock of smaller companies directly with institutions and would seem to be of questionable merit [3].

A Concluding Comment

Because of a variety of general economic trends, particularly double digit inflation, the capital markets are currently in a state of disarray. Those opposed to reforming the structure of these markets or to upholding past reforms are seizing upon contemporary events as a possible basis for obtaining their objectives. A prime example of this is the argument that a restructured stock market would

have grave consequences for the conduct of corporate financial management, a fear which both economic

and the history of the bond market suggest is unfounded.

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