Charles Schwab

How One Company Beat Wall Street and Reinvented the Brokerage Industry

John Kador

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:
Kador, John.
Charles Schwab : how one company beat wall street and reinvented the brokerage industry / John Kador.
p. cm.
ISBN 0-471-22407-3 (hc : alk. paper)
1. Charles Schwab Corporation—History. 2. Stockbrokers—New York (State)—New York—History. 3. Schwab, Charles. I. Title.
HG4928.5 .K336 2002
332.6′2—dc21 2002010446

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To the men and women of the Schwab family
whose fierce loyalty to Chuck is surpassed
only by their commitment to the truth

First, they ignore you.
Then they laugh at you.
Then they fight you.
Then you win.

Mahatma Gandhi

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ACKNOWLEDGMENTS

It is a paradox that those who most deserve acknowledgment have the least need for it. I am literally indebted to more people than I can name. In the case of this book, a number of people who have been monumentally helpful have asked for no acknowledgment at all. To everyone who decided to help me with no other expectation than I would weave their individual experiences anonymously into the tapestry of this account, I offer my heartfelt thanks. I wish circumstances permitted you to be named individually.

I am also proud to acknowledge the following former Schwab employees who generously shared their stories, answered my incessant questions, and agreed to be quoted on the record: Ambre Abbott, Sheri Anderson, Rhet Andrews, Niel Armstrong, Mark Barmann, Dan Bass, Alison Bomar, Bruce Cardinal, Dennis Clark, Mark Collier, Barbara Daniels, Alan Diener, Ed Ferland, Roger Franklin, Jim Fuller, John Gambs, Bill Gillis, John Granholm, Marc Greendorfer, Robert Grosskopf, Genene Hamel, Ward Harris, Barbara Heinrich, Anne Hennegar, Christine Herbert, Sean Howard, Mark King, Bill Klipp, Ron Kloth, Ron Lay, Kathy Levinson, Jim Losi, Lisa Mak, Timothy McCarthy, Casey McClintock, Joseph McComb, Melinda Meahan, Madalyn Mitchell, Lauri Moss, Peter Moss, Dan Neumann, Phillip Parkerson, Bill Pearson, Earlene Perry, Chip Roame, Kevin Rogers, Robert Rosseau, Harvey Rowen, Bob Ruggieri, Tom Seip, Daniel

Sheehan, Jim Skinner, Larry Stupski, Tom Taggart, Robert Tantalo, Blodwen Tarter, Barry Uhl, Thomas Voltz, Kevin Wheeler, Jim Wiggett, Michelle Wolpe, Sherman Yee, Mansoor Zakaria. My thanks go, also, to the few former Schwab employees who asked that their only acknowledgment be the satisfaction of knowing they were a resource to the author.

I am indebted to a number of professionals who took time from their busy schedules to educate me about various aspects of the securities industry in which Schwab and its executives continue to play such a key part. I am pleased to acknowledge: Devanie Anderson, Tony Bianco, Moira Johnston Block, John Bowen, Daniel Burke, Tim Butler, Amy Butte, Mark Calvey, Dale Carlson, Benjamin Cole, Joe Cutcliffe, Harold Evensky, Jon Friedman, Jamie Dimon, Andrew Gluck, Warren Hellman, Ken Greenberg, Sam Jaffe, Sheldon Jacobs, Andrew Kahr, John Keefe, Lee Korins, Carolyn Leighton, Bob Levy, Dan Livingston, Leo Melamed, Scott MacKillop, John McGuinn, Mike McGreevy, Stephen McLin, Guy Moszkowski, Paul Merriman, Deborah Naish, Terry Pearce, Lori Perlstadt, Richard Repetto, Terry Savage, Pamela Sayad, Lewis Schiff, Amey Stone, Taylor McMaster, Lynn Upshaw, Alan Weber, Barry Young.

It is my pleasure to thank my agent, Susan Barry of the Swayne Agency, for helping me at every stage of this project, and Jeanne Glasser of John Wiley & Sons for providing a firm guiding hand.

Every writer, if he or she is lucky, gets the benefit of family members who provide more support than his or her desperate attempts at acknowledgement can repay. So it is in my case. I can only note here the patience and understanding demonstrated by my wife, Anna Beth Payne, my children, Daniel and Rachel, my brothers, Peter and Robert, and my parents Julius and Marianne, all of whom gave various chapters the benefit of their wisdom.

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Charles Schwab

INTRODUCTION

In the beginning when investors were at the mercy of stockbrokers, financial self-determination, like airplane travel, was reserved for the well-off. Then Charles Schwab beat Wall Street and reinvented the brokerage industry. Now Charles Schwab & Co., Inc. continues to liberate the world of personal finance and we are all, rich and poor, better off for it.

This book narrates the evolution of Charles Schwab & Co. from a pure discount brokerage through four wrenching upheavals. But while upheaval can be instructive and, when it happens to others, even entertaining, it is not the main focus of the story. The true subject is Schwab's organizational elasticity and how it is able to reinvent itself around a fixed set of core values. This value-based strategy has allowed Schwab to evolve within its industry. Many companies spout off about values. In reality, Schwab is one of a handful of companies that has actually capitalized on this approach.

Charles Schwab & Co. is the epitome of the anti-Enron company. In three decades, Schwab has emerged as one of the most inspired and inspiring financial services organizations in history. Thanks primarily to the values and leadership of its founder, Charles R. Schwab, the company has evolved a distinctive values-driven management mindset that encourages the company to put the interests of its customers first. This priority allows the company to question its most cherished assumptions and thereby avoid the arrogance that hardens the arteries of other companies that are occasionally kissed by success.

Like all values, Schwab's values are easy to list but are more difficult to honor in practice, and lately they have come to conflict with other values. Emerging as an alternative against the excesses of the traditional securities brokerage industry, Schwab developed a transcendent set of goals to which individual egos could be willingly subordinated. All Schwab employees sign on to the value of serving the average, individual investor by conformity to a few non-negotiable values:

SCHWAB'S TRANSCENDENT VALUES

Core Value	*Implication*
No conflict of interest	Schwab people will be paid salaries instead of sales commissions.
No advice	Schwab customers are sophisticated traders. Schwab will not recommend individual securities.
No sales	Schwab will not push individual products. It will avoid proprietary products. "Call us because no Schwab sales person will ever call you."
Customers first	Empowering. Working from the customer in, rather than existing processes out. Identify what customers want and only then determine if you can supply the requirement at a profit.

From the very beginning, Charles Schwab has put himself squarely in the bulls-eye of this journey. His name is on the building. His face adorns the ads. Customers may do business with any of the thousands of Schwab people around the world, but Chuck—please, not Charles—is their broker.

What is in the company's DNA that has allowed it to succeed in so many harsh environments? What permitted a discount brokerage to give up $9 million in fees to offer the No-Annual-Fee IRA just because it seemed right? What made it think success would derive from slashing prices by 60 percent to enter the uncertain world of electronic trading? What made it think the Web would be a friend and not a foe? The company pivots freely around a set of standards that emerge out of its values. Everything else can change, but these standards endure:

Create a Cause, Not a Business. "We are custodians of our customers' financial dreams." Think about that. When was the last time you saw a business take itself that seriously? It shows. Schwab people act as if they are curing cancer.

It's easier to find the courage to abandon the practices that have been making you rich when everyone shares a transcendent purpose. The values serve as a safety net for the high-wire act. Sharing a cause provides cover for anyone poised to discard a familiar but tattered business model for a lustrous but untested business proposition. Schwab welcomes questions elsewhere considered subversive: *Who are we serving by this decision? Will my skills and my relationships be as valuable in this new world as they were in the old? How much will I be asked to unlearn?*

These are genuine, heartfelt questions that can't be answered in advance. The courage to leave some of oneself behind and strike off for parts unknown comes not from some banal assurance that change is good but from a devotion to a wholly worthwhile cause.

The Power of Culture, Done Right. Lots of companies pay lip service to a culture of ethics and values. Schwab people actually live it, for they know that a corporate vision may come and go, but the values stay put. In a world that blurs the distinctions between customers and suppliers and competitors and partners, values are the only thing that defines where Schwab, the company, starts and where it ends. Everything else can recede—the products, the services, the industry itself—but an abiding culture can serve as the custodian of dreams for the team.

Welcome Upheaval. Everybody talks about the power of new ideas, until a new idea actually requires them to change their behavior. Then stability suddenly looks attractive. How on earth did Schwab find the chutzpah to migrate its business to the Web, knowing that the move would force it to cut by more than half the prices on its bread-and-butter service? By adhering to its culture of core values. People up and down the organization who agreed on little else agreed on the value of putting the customer first. How would your company react to a similar proposition? Typical is how Merrill Lynch confronted the same problem: It denied. And then after it denied, it debated. And after it debated, it fiddled at the margins of the problem until Schwab took over. How did Schwab avoid months, perhaps years, of savage debate? What can Schwab teach us about welcoming the specter of cannibalization?

Success Is a By-Product of Something More Important. Schwab executives understand that you don't aim at success. For success, like happiness, cannot be pursued; it must ensue, and it only does so as the unintended side effect of a company's commitment to a cause. Serving customers fairly and honorably is that cause. Products and services at Schwab are developed because customers indicate a need for them. Only then does the company try to figure out if it can deliver the product or service at a profit. Grant Tinker, former head of NBC, was asked how he planned to make the network number one. His answer applies to Schwab: "First we will be best, and then we will be first."

Schwab has made its share of mistakes, and this book documents many of them. But it would be a bigger mistake to regard these reports as an attack on the company's integrity. That remains remarkably constant. It's probably true that Schwab makes fewer mistakes than other companies of its size. The quick pace of its decision-making process, ironically, works to minimize the number of significant mistakes. When a company is guided by a simple set of well-known principles, it compresses the cycle for making decisions, recognizing mistakes, and correcting them. Paying steady attention to integrity is the force that guarantees consistent performance.

Yes, there is a moralistic streak about the company that some consider off-putting. To be sure, Schwab grew out of the founder's righteous indignation over the corruption and cynicism of the brokerage industry and its systematic swindling of the average investor. As a consequence, the story the company tells about itself is not just that it is more efficient than its competitors. No, Schwab people believe that Schwab is on a mission to provide investors with the most useful and ethical brokerage services in the world. It is not just better operationally, it is better morally. Schwab, in this estimation, represents virtue. The downside is that this attitude reinforces a toxic "us versus them" consciousness that takes its toll on employees at all levels of the organization.

Schwab is on a crusade. Schwab people are not just running a brokerage. They pursue virtue. It's a cause that grounds the effort in goodness. It provides a feeling of belonging, a sense of purpose, and a catalyst for action. People will work hard for money, but will give their lives for meaning. Henry James described the task of working for a cause in which you truly believe: "We work in the dark—and we do what we can—we give what we have. Our doubt is our passion and our passion is our task." So it is at Schwab. Even a big setback, and 2001–2002 represented a huge period of doubt for the company, can't dim the manifest personal pride that Schwab people, current and former employees alike, have in what they accomplished. This is their story.

Schwab has reinvented itself three times. It is currently in the midst of its fourth transformation. "Leveling the Playing Field," Part One of this book, describes the original version of the company and the men and women who helped build it.

Schwab version 1.0 was the pure discount brokerage made possible by the deregulation of brokerage commissions on May

1, 1975, a date known in the history of the securities industry as "May Day." Chapter 1, "May Day," describes the cynical and corrupt securities industry from which Schwab emerged. Then in 1975, when he was 38 years old, Chuck (as he prefers to be called) awoke one day to realize that May Day created the conditions to start a brokerage for people like himself: savvy traders who neither needed nor wanted advice. It would be a brokerage for the rest of us.

Chapter 2, "Opening Investment," looks at the life and career of Chuck Schwab, the founder of the company, and how his moral vision inspired the firm's moral authority. Chapter 3, "Building the Brand," considers the early struggles and triumphs of the company as it systematically constructed its reputation.

Schwab has always been a technology-driven company. Chapter 4, "Innovation," describes Schwab's commitment to an innovation meritocracy in which great ideas win out, no matter where they come from. Schwab is a rule-breaker. From day one it has trespassed on respected boundaries. Discount brokerages, everyone knew, were supposed to do away with frills like branches so they could offer lower commissions. So what did Schwab do? It built an international network of branches—430 at this writing. "Branchland," Chapter 5, examines the history and culture of Schwab's branch and call center facilities.

For most of its first decade in business, Schwab focused on executing transactions efficiently. Trading commissions comprised most of the company's revenues into the 1990s. This situation was less than desirable because the cyclicality of trading volumes made growth unpredictable. The company needed new sources of revenue. At the same time, the customers Schwab served were beginning to change. Thanks partly to Schwab's services, they were wealthier and their portfolios were becoming too complex for them to manage. They needed advice and they asked Schwab to provide it. Now Schwab's aversion to advice came into apparent conflict with its commitment to giving customers what they wanted. Chapter 6, "Advice and Advisors," tells how Schwab challenged one of its most deeply held beliefs and started creating advice offerings that were true to its values.

Schwab version 2.0 emerged in the 1980s as it transformed itself into an asset gatherer. As the business model shifted from transaction fees to the benefits of having millions and then billions of customer dollars under management, Schwab diversified its product offerings with mutual funds and institutional services. It became intentional in serving growing numbers of independent financial advisors. It launched radical products such as the instantly successful Mutual Fund OneSource program that persuaded mutual fund investors to hold their fund positions at Schwab.

Over the years, a number of accidents, catastrophes, and misfortunes have threatened to ruin Schwab. Some of these calamities were of its own making; others were acts of Nature. All created a crisis that by fortune or skill Schwab managed to navigate. In each case, the company emerged stronger, wiser, and more in charge of its destiny. Part Two of this book, "Profiles in Crisis," chronicles eight of these episodes. Chapter 7, "Forsaken IPO," recounts an ill-advised initial public offering that a not-ready-for-prime-time Schwab mounted and then quickly withdrew. Chapter 8, "Birthright," tells the story of how a company desperate for funds and legitimacy agreed to sell its birthright to the largest bank in California. A cultural mismatch from the beginning, Schwab nevertheless maintained its integrity as it struggled to reclaim its independence. The celebrations following its independence and a successful IPO were short-lived, however, because of the events described in Chapter 9, "Market Crash." On October 19, 1987, Black Monday, the stock market tumbled, creating havoc throughout the industry and testing Schwab's ability to weather the downturn.

Continuing Schwab's tales of woe, Chapter 10, "Margin Call," tells the incredible story of how Schwab allowed one Hong Kong customer to expose the company to over $120 million in liabilities. The fast action and intrigue that Schwab applied to recover most of the money it was owed saved the company. As a result, the company beefed up its risk management disciplines and made sure such a thing would never happen again. Chapter 11, "Earthquake," describes an act of nature, the San Francisco

Loma Prieta earthquake of October 17, 1989. Schwab people pulled together in ways large and small to protect the company, restart its computers, and to be ready to serve very nervous customers the next morning. The company's reputation for dependability was enshrined that day. While not strictly speaking a crisis, the Mutual Fund OneSource program described in Chapter 12 represented the company taking a huge gamble as it gave up an existing revenue stream in exchange for the uncertain rewards of giving more account control to the customer.

Chapter 13, "Heart Attack," tells the story of a company coming unglued at the very height of its success. Under the vision and leadership of Charles Schwab as implemented by president Lawrence Stupski, the company was poised to meet its loftiest growth objectives. Then on January 10, 1992, Larry Stupski, a leader revered by all, had a heart attack. He was 46 years old and considered indestructible. Stupski survived, but the company would never be the same. The company recalibrated its leadership. The consequences of that event reverberate throughout Schwab to this day.

Schwab version 3.0 illustrates Schwab's struggle to seamlessly integrate the Web-based services it developed in the mid-1990s with the established company. Chapter 14, "eSchwab," tells the story of how the company took an unprecedented leap into the unknown and became a Net company. By fits and starts, the company figured out how to use its Web offering to cannibalize the company's bread and butter services. This is the story of how accepting a little pain now is better than enduring a lot of pain later. It was nothing less than eating your own young and there was nothing painless about it. Here, Schwab's celebrated "Clicks and Mortar" strategy first took shape.

Part Three, "Custodian of Uneasy Dreams," considers the company under the leadership of co-CEO David Pottruck. Schwab in the current period faces formidable obstacles from both external competitors and internal contradictions.

Schwab version 4.0 makes the company look more than ever like the full-service brokerage firms it used to scorn. Chapter 15, "Balance of Power," examines how David Pottruck is an ideal leader for Schwab as it enters the twenty-first century. It also criticizes the co-CEO structure that the company has adopted since 1997. The chapter reports on how the company pursues affluent investors, including its 2000 acquisition of U.S. Trust. But with this newest reinvention, Schwab faces a huge risk to the franchise that has become so successful. Average investors feel abandoned. Employees feel betrayed by the increased focus on advice-giving and sales.

Every company demands its share of myth and legend, but for a company less than 30 years old, Schwab is off-the-scale in these departments. What is it about Schwab that encourages myth making? Trying to determine the literal truth of certain Schwab stories is pointless. Myths are things that never happened, but are always true. But if we don't search for ways to become aware of the myths that are unfolding in our lives, we run the risk of being controlled by them. Chapter 16, "Schwab Mythology," attempts to deconstruct the mythology of Schwab to discern the lessons they offer about work and passion.

The last chapter, "Unfinished Business," concludes by looking squarely at some areas where Schwab has underperformed. International markets, for instance. Why has Schwab failed so utterly to find any traction for its brand in overseas markets? The chapter scrutinizes some management practices that concern investors and analysts. Foremost among these is Schwab's succession policy. It doesn't seem to have one, and that worries everyone with a stake in the company's future. "There always comes a moment in time when a door opens and lets in the future," the novelist Graham Greene wrote. Such a door now confronts Schwab. The question is whose hand will turn the knob?

The brokerage industry faces a crisis of confidence. For investors, the brokerage industry is no longer a trusted partner. Investors are abandoning the financial markets, devastated by the revelations that daily rock the industry: two-faced stock analysts who tout company stocks to the public while trashing them in private; greedy executives who pad their own pockets; regulators who act more like lapdogs for corporate interests than watchdogs for the public interest; auditors who willfully or negligently allow it to happen and then hide behind their shredders. In its latest marketing campaign—"It has never been a better time for Charles Schwab"—the company acknowledges that it must face the dark side of an industry out of control. To its credit, under the moral authority of its founder, Schwab is taking strong leadership to restore the confidence of investors.

Chuck Schwab continues to revitalize what he finds inadequate. Let's go to him with notebook in hand. He remains our teacher.

Author's note, a word about names. To avoid the inevitable confusion that reigns when discussing any eponymous company, "Chuck," the name he prefers, refers to Charles R. Schwab the individual. "Schwab" and "Charles Schwab" refer to the company he founded.

PART ONE

Leveling the Playing Field

1 May Day

May 1, 1975

May Day—the day when fixed brokerage commissions were abolished—marked a crossroads for the U.S. securities industry and created the conditions for the birth of Charles Schwab & Co. Most brokerage firms responded to deregulation by cutting their commissions rates for institutional investors and raising them for the average investor. Schwab chose a different course.

Every story organizes the collision of random events into an opportunity for learning. So it has been from time immemorial. Every story points to a beginning before which there was chaos. "Once upon a time" the most memorable stories begin, demanding that the storyteller assign a marker to separate the now from then, the light from the dark. So it is with the Schwab story.

A number of dates will serve. Shall we start with 1937, the year not only of Chuck Schwab's birth, but a reasonable marker for the end of the worst of the Great Depression and the start of the economic expansion that created, after World War II, the prosperous middle class that would fuel the company that Schwab was to found?

Maybe a better date is 1963. It's the midpoint of the era we now call the Go-Go Years, a period when the stock market threw off the predictability of the 1950s and danced the Hullabaloo. For the first time, trading stocks became sexy and young brokers could grow facial hair and show their faces at the Cheetah and other discothèques. Advisory investment newsletters were the rage in those Go-Go Years, and, not to disappoint, Chuck launched *Investment Indicator.*

At its height, the newsletter had 3,000 subscribers, each paying $84 per year for the privilege. If you do the math, the newsletter kicked off maybe a quarter of a million dollars per year in gross revenues, which was not bad considering that the median annual household income in 1965 was $6,597. But not bad was not nearly good enough. Chuck realized you can't get rich selling advice through a subscription newsletter. Even then, perhaps, Chuck had a problem dispensing advice to others.

Chuck wanted to be a player. Motivated by the combined desire for professional respect and personal wealth, Chuck aspired to join the new breed of mutual fund portfolio managers. The superstars of this elite circle were consistently outperforming the market averages, racking up gains of 30–40 percent for their investors. Everybody loved them and Chuck wanted to be a superstar, too. That's why he created one of the first no-load mutual funds. He called the fund Investment Indicators and it soon became the largest mutual fund in California, with $20 million in assets. Alas, as we shall see in Chapter 2, Chuck's excellent adventure in mutual funds crashed and burned, as did much of what he took on in the early years.

In 1971, Chuck established First Commander Corporation, his first brokerage. From the start he had an inherent problem with the way the brokerage industry compensates its stockbrokers. Here are the facts he had to contend with: Stockbrokers are nothing more than salespeople. They are compensated based on commissions. Commissions are a benefit only to the brokers and their firms. It follows that commissions are a detriment to the customer. Brokers earn commissions only when they persuade a customer to make a trade. That would be bad enough but it gets worse. Customers think they can rely on brokers for advice. That's a clear conflict of interest. To aggravate the matter further, brokerage firms have a commission structure that rewards brokers for selling the riskiest investments. The riskier the investment, the higher the broker's commission, and the greater the incentive for the broker to adjust his advice. That's why Arthur Levitt, the former chairman of the Securities and Exchange Commission made these departing remarks: "Let's begin with the first step for a lot of investors: selecting a broker. The very first question that a person should ask his or her broker is, 'How do you get paid?'"

Chuck considered all the commissions, front-end loads, margin interest, markups, fees and other "impairments of capital" as conspiracies against the public. He swore eternal hostility to every form of swindle of investors. No wonder First Commander Corporation didn't make it. Being a traditional stockbroker required selling as well as giving advice, and Chuck was constitutionally averse to both. Chuck decided to regroup. He bought out his partners and tried his hand in a variety of deals, many of which were presented to him by his obliging uncle, William Schwab. Maybe the better date to start the story, then, is 1973, when Chuck renamed the company Charles Schwab & Co., Inc., and floundered around for a while, waiting for an opportunity to present itself.

That opportunity came on May 1, 1975, and on this date we can reliably pin the beginnings of the Schwab Story.

It's difficult from this vantage point to grasp the arrogance of Wall Street traders before May Day, the name assigned to the day when, after 183 years of price fixing, the New York Stock Exchange (NYSE) was forced to give up a system of fixed brokerage commissions.

How audacious. Here was an industry celebrating the purest expression of free market enterprise and competition in the world, but embracing for itself government-sanctioned regulation. Ever since it was founded in 1792, the public face of the NYSE extolled the virtues of competition and the American Dream, where any kid can grow up to be the chairman of the board or, lacking that, the president of the United States.

Now the industry acted as if the reformers had proposed Karl Marx as the president of the New York Stock Exchange. The most sober industry spokesmen warned that American free enterprise would all but collapse if competition were allowed to be the arbiter of trading commissions. SEC hearings were filled with testimony such as, "May Day is a great holiday in Russia. And Russia has said there is no need to fight democracy; it will burn itself out. Well, Commissioners, you have the candle and matches, and it will be a short fuse."

No group in the United States—with the possible exception of major league baseball—enjoyed such a privileged position to organize its members into an association with the power to maintain a marketplace for their exclusive use, to fix prices to be charged in the market, to restrict entry to that market, and to boycott competing markets.

Behind the apple-pie veneer of good old American free enterprise, the NYSE represented just another cynical conspiracy against the public. Except this cartel—for that's what it was—managed to thrive for 183 years, reaping untold riches on its beneficiaries. The group of New York brokers who secretly met in what must have been the original smoke-filled hotel room contrived a monopoly to fix commissions and to keep all the trading business for itself. For almost the entire history of the country, these essential terms remained unchanged. Commission rates went up, of course, but they were always nonnegotiable. Take it or leave it. But if you decided to leave it, you were confronted by Rule 390, the sweetest provision of all. Rule 390 dictated that all stocks listed on the New York Stock Exchange could be bought and sold only through a member firm.

At first, the government had neither the mechanism nor the will to do much about it. Thus the NYSE prospered, and its