NEWS

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THE U.S. EXPERIENCE -- FEDERAL REGULATION WITH COOPERATION

An Address by
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It is a great pleasure for me to participate in this conference on "The City and Self-Regulation" with such distinguished members of the securities industry.

I recognize that today you are examining the role of private securities organizations in the regulation of the conduct of their members, as well as examining other methods of regulation. Accordingly, I have been asked to describe the United States experience with the regulation of our securities industry.

As most of you already know, we in America have fashioned a system that differs significantly from the British system, which is altogether appropriate. We in the United States, despite our acknowledged origins, are in fact very different from the British. Our traditions are different, our personalities are different. It could credibly be argued, although of course not by me, that the American cowboy still rides on Wall Street while the English gentleman still inhabits the City, and cowboys require different regulations than do gentlemen.

This point was brought home to me quite clearly about a year ago when I was describing our laws against trading on inside information to a group of British executives and the press. I was saying that we at the SEC were supporting increased sanctions against insider trading, because our current sanctions are quite inadequate to

remedy the situation. At present our remedies are limited to obtaining disgorgement of the ill-gotten gains and requiring the wrongdoer to submit to an injunction, which is merely a promise not to do it again. I said to my audience that I believed then, and still do, that in America the threat of a treble damage assessment is necessary to deter those who would trade on inside information. At that point one man in the audience interrupted me to say "but Commissioner Thomas, why do you need all that--the real punishment is inflicted when the sordid story is told and the fellow's name gets in the paper unfavorably." Not so in the U.S. -- in my country that fellow would say -- "Just be sure you spell my name right."

As a result of this difference in attitude -- perhaps overstated in my story -- we in the U.S. have opted to allocate by statute the responsibility for regulation of the securities industry to the public sector. But in turn the public sector has delegated a portion of its authority to the private sector. In contrast, as I understand your system, the private sector exercises regulatory authority over the securities industry on a somewhat voluntary basis.

Now to describe the American mix of legislated governmental and delegated private sector regulation:

Under our system the federal government, primarily through the Securities and Exchange Commission, in conjunction with private industry groups that we also call self-regulatory organizations, or "SROs," regulates the conduct of securities exchanges, brokers and dealers, transfer agents, clearing agencies, and securities information processors. This cooperative system has, we believe, proved to be quite effective in protecting American investors and providing a responsive regulatory environment for our securities industry.

Although we characterize the relationship between the SEC and the SROs as cooperative, that does not mean that the industry and the government fulfill the same function or that they enjoy the same authority. Rather, as I mentioned earlier, the authority of our self-regulatory organizations is specifically delegated to them by the SEC, and they are subject at all times to SEC oversight.

Prior to the 1920s, our federal government was not so involved in securities regulation. Then, the primary regulation came from the stock exchanges and the rules they applied to their members. The exchanges were voluntary, unincorporated associations, and were regarded by many, including themselves, as private business clubs, entitled to establish their own rules for the admission,

expulsion and discipline of members without federal or judicial interference.

This situation was quite satisfactory until the great stock market crash of 1929. At that time, widespread public concern and outcry provoked a massive Congressional investigation into the workings of the stock market and the stock exchanges. The investigation revealed numerous outrageous frauds and manipulations in connection with the initial public offerings of securities and trading practices in the secondary market. Congress was shocked into the realization that stock exchange rules were completely inadequate. In response to growing public clamor, Congress, after much debate, declared that federal regulation of the stock markets was both necessary and desirable, and as a result enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.

The federal Securities Act of 1933 primarily regulates public offerings of securities by issuers and underwriters. The principal objective of the Act is to provide investors with sufficient, accurate information to enable them to evaluate for themselves the merits of securities being offered for sale. This is achieved by requiring that an issuer, before its securities are offered to the public, file with the SEC a registration statement containing a prospectus. The prospectus, which sets

forth detailed financial and operational information about the issuer and the securities to be sold, is required to be made available to each prospective purchaser prior to the time an investment decision is to be made. The Securities Act is also designed to prevent fraud and misrepresentation in connection with the sale of securities by subjecting issuers, underwriters and other participants in the distribution process to civil liability for fraudulent statements made in connection with a sale.

It is important to note that the Securities Act, known as the "'33 Act," is not designed to give the SEC the power or duty to pass upon the merits of an offering. Many states, however, have exercised parallel jurisdiction and do purport to pass upon the merits of individual offerings within their state. In 1934 Congress enacted the Securities Exchange Act which established the Securities and Exchange Commission and provided rules for comprehensive regulation of the trading of securities in the secondary markets. An issuer wishing to have its securities traded on a national securities exchange or in the over-the-counter market must generally file a registration statement similar to that required by the Securities Act of 1933. In addition, updated financial and other information must be filed periodically with

the SEC on various reporting forms and made available to the investing public. Additional disclosure requirements apply to proxy solicitations as well as to tender offers. The Exchange Act also provides a comprehensive scheme for the regulation of broker-dealers. Such regulation includes registration with the SEC, compliance with SEC bookkeeping and reporting rules, stringent financial responsibility requirements, and required adherence to a complex pattern of specialized anti-fraud provisions.

Under the Exchange Act, Congress also required that the SEC delegate certain of its regulatory functions to the stock exchanges and to the other self-regulatory organizations, such as the National Association of Securities Dealers, called the NASD. These delegated responsiblities include rulemaking, the establishment of listing requirements, and the inspection and disciplining of members.

This system of cooperative regulation worked relatively well for more than three decades. In the late 1960s, however, you may remember that the pressures produced by an unprecedented trading volume revealed numerous deficiencies in the industry's administrative, or "back-office," facilities, and a major crisis in the U.S. securities markets ensued. Recordkeeping and accounting controls were regularly breaking down, and

firms were losing physical control of millions of dollars worth of securities. Many firms failed or nearly failed under circumstances that indicated that there were lurking on Wall Street numerous operational problems that cooperative regulation had not successfully addressed.

At the same time, the SEC brought several major fraud actions against securities professionals, pointing to the fact that in some quarters improper and unethical trading and selling practices were being followed.

In response to these events, the 1975 amendments to the securities laws were enacted, making extensive changes in the Exchange Act and increasing the amount and scope of the SEC's authority. For example, the 1975 amendments gave the Commission authority over clearing agencies and transfer agents and expanded the SEC's traditional oversight authority. Although the 1975 Amendments provided some much-needed patching for the chinks that had begun to show in our regulatory armor, there was no attempt made at that time, on either Capitol Hill or at the SEC, to abandon the cooperative concept.

Cooperative Regulation Today

Today, under the Exchange Act, the SEC has jurisdiction over the various self-regulatory organizations, which include ten national securities exchanges, one registered national securities association (the National

Association of Securities Dealers), the Municipal Securities Rulemaking Board and ten registered clearing agencies.

The SROs perform a variety of functions. The exchanges and the NASD operate, as well as regulate, market facilities, write administrative, practice, recordkeeping, antifraud, and other types of rules governing the conduct of their members, inspect member firms for violations of those rules as well as violations of the federal securities laws and rules, and discipline their members for violations. Clearing agencies provide comparison, clearance and settlement functions for their participants. The Municipal Securities Rulemaking Board writes rules applicable to transactions in municipal securities. The SEC oversees all of the SROs' activities and, in addition, engages in direct regulation and enforcement activity with respect to SRO members.

It is a somewhat confusing system even to those of us who operate it. To you, the identity and function of the players and the rules governing their movement must be as obscure as a game of cricket is to my American-trained eyes.

In order to give you a better understanding of our system, let me briefly highlight the two main aspects of the SROs' functions -- inspections and discipline.

Inspections

The SEC relies heavily on the exchanges and the NASD to inspect their member firms to ensure compliance with the federal securities regulations and SRO rules. Both the exchanges and the NASD have substantive written examination programs designed to ensure the competence of their members. Every self-regulatory organization and its members must make and keep various records and reports for prescribed periods of time, and the SROs are expected to conduct periodic inspections with respect thereto.

Discipline

SROs are also required to bring appropriate disciplinary actions against members. Disciplinary hearings are usually held before a panel of members or participants.

The Exchange Act provides a number of procedural requirements for hearings, including specific written charges, notice, opportunity to defend, a record, and a statement of reasons for any sanctions. SROs are required to give the Commission notice of final disciplinary actions, and these actions are subject to review by the Commission on its own motion or upon application by the aggrieved person. The Commission may set aside or reduce (but not increase) the sanction, or

it may remand the case to the SRO. Any aggrieved person may appeal the SEC's decision directly to the federal courts.

Assessment of Self-Regulation

I believe that self-regulation subject to SEC oversight has, with certain exceptions, generally worked well for the American securities industry. In some ways, it operates more efficiently than direct federal regulation because it is free from some of the formalities and procedural requirements of governmental action. It also provides a mechanism for industry professionals who know and understand how the business works to establish appropriate rules and to discipline violators. Self-regulation also tends to promote the education of industry members and to allow a wide diversity of representation. Our hope is that this results in enhanced cooperation and increased respect for regulation.

In addition, self-regulation performs a service which would be extraordinarily cumbersome for our federal government to perform. Currently, some 9,000 public companies are registered with the SEC, and perhaps twice that number of broker-dealers, investment advisers, investment companies, and other securities industry participants are subject to our jurisdiction. Our direct responsibilities for registration, reporting, legal

interpretation, enforcement and oversight are considerable. If they were coupled with direct responsibility for the matters primarily administered by the self-regulatory organizations, we would face a herculean task. At our present staffing levels, we simply could not do it all. Thus, self-regulation has permitted the SEC to focus on major issues and generally to avoid many of the detailed regulatory responsibilities for the securities industry. In fact, in the face of our government's current movement towards deregulation, the self-regulatory organizations are even more critical and must now assume more responsibility towards ensuring the integrity of their members and of the market place.

At the same time, I am certainly aware that self-regulation has disadvantages. It cannot be denied that there is a tendency for individuals, in any industry, to use their collective power to advance their own interests. It is always possible that the industry will not be diligent in policing itself, or that it will develop policies that are anti-competitive or discriminatory. Self-regulation can be used to avoid any regulation. Friendships can be leveraged to suppress investigations or to avoid remedying violations. Powerful members of an SRO can use their positions to disadvantage less powerful members. Accordingly,

ongoing Commission oversight is essential to assure compliance with the Federal securities laws with respect to matters such as SRO rulemaking, membership policies, and disciplinary functions and to prevent anti-competitive and other problems inherent in self-regulation.

Future of Self-Regulation in the Securities Industry

As I look to the future, I believe that self-regulation will continue to play a major role in the regulation of our securities industry. The SEC already has placed increased emphasis on self-regulation. For example, it has deferred significant enhancement of its direct market surveillance capabilities, and instead is working closely with the SROs in an attempt to achieve an SRO-administered intermarket surveillance program.

In the rapidly changing markets of the future, however, I also see many challenges that will arise. For example, as a result of the recent expansion by securities firms into nonsecurities activities, and the entry of other financial institutions into the securities business, regulation by industry classification will become increasingly difficult as industry lines continue to blur. Questions will arise such as how an SRO should regulate the financial integrity of

members involved in more than one industry, with financial exposure in each area, and whether it is appropriate for standards, such as sales practice rules, to vary on the basis of product.

A related issue will be whether more reliance can be placed on self-regulation for other financial institutions such as banks, insurance companies, savings and loan associations, and investment companies. In the United States, self-regulation has not played as important a role in the regulation of other financial institutions as it has in the securities industry. The expansion of self-regulation into those areas raises issues as to whether new SROs should be formed and, if so, what activities they would perform.

This is a picture of the United States experience with regulation of securities on a cooperative basis between the federal government and self-regulatory organizations. Historically, the level of governmental regulation has risen in response to major disturbances in the securities markets. But the federal legislation that resulted has consistently incorporated the involvement of professional organizations in the regulation of the conduct of their constituencies. These self-regulatory organizations have disciplined and educated their constituencies effectively in cooperation with, and subject to, the oversight of the SEC. The duties and allocation

of responsibilities have been modified over the years in response to changes in the securities marketplace.

This cooperation between the federal government and the securities industry has resulted in an effective and practical form of regulation in the United States. We believe it has fostered an investor confidence that has created a favorable climate for the formation of capital and trading in the United States.

However, although this system has worked successfully in the United States, I am not suggesting that our regulatory framework should be adopted here in England. I am seeking to describe our system, rather than to export it. I believe that each country should regulate or not regulate its domestic securities markets as it chooses.

In addition, I recognize and admire Britain's distinguished and effective tradition of self-regulation. There are clear differences between Britain and the U.S., even if not all on Wall Street are cowboys and not all in the City are gentlemen. The history and habits of the British securities markets are different, as is its geographic centralization. Accordingly, while describing our peculiar mix of legislated federal regulation and delegated self-regulation, I congratulate you on the tradition of self-regulation that you have inherited. It seems to work. Perhaps there are still gentlemen in the City -- and now even ladies, I trust.