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SELF-REGULATION IN THE SECURITIES INDUSTRY

Speech by

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I.

Self-regulation is a concept more widely cited and relied upon in the securities industry than in any other specifically subject to regulation by federal agencies. Indeed, it has the imprimatur of statute, in the 1934 Act's provisions relating to exchanges as well as the more elaborate effort at regulating the over-the-counter market through the Maloney amendment. This is as it should be: we are dealing with business practices -- the spectrum of ways in which day-to-day financial transactions are being conducted -- and with evolving standards. No one, including even the most hardened bureaucrat, would conceive that the government can or should prescribe a fully detailed pattern of doing business fairly.

Self-regulation is a phrase that calls for definition. Some think it means total autonomy. My effort today is to convey some impression of what self-regulation means to the Securities and Exchange Commission, and how it can flourish. I should like to suggest that it means autonomy somewhat in the same relative sense as the SEC is said to be autonomous. We are called an independent regulatory agency. But anyone who thinks we are completely independent has not been long in Washington. We are subject to oversight, by the Congress. And that is as it should be! I am always mindful of the experience of another

bureaucrat from a university who recently appeared before a Congressional Committee. After he had expounded the law, the Chairman said, "That's a very good lecture, professor, but remember, down here the class gives the marks." Furthermore, our budget and legislation must pass through the Chief Executive via the Bureau of the Budget. And, finally, on occasion we are reminded that our decisions are subject to judicial review.

I do not say there is a precise parallel with the SEC. But I do say that in an industry dealing with securities, with the complexities which they pose and with liquidity second only to bank deposits, some oversight is called for. Quite properly, the profit-motive is at the root of our economic system. But given this motive, regulation of the industry in the interest of the public cannot be left exclusively to the practitioners, public-spirited though they be. That was settled in principle some twenty-eight years ago and has been proven by experience. Of course, the public participant should not be arbitrary or oppressive. As I said a year ago, we have tried to be responsible both in action taken and the way in which our special study is being conducted, and we have tried to keep our promises made here.

II.

Furthermore, we believe that oversight need not and should not stifle initiative for self-regulation. Although the need for outside regulation may be accepted by an industry, the leaders within it should nevertheless have the freedom to suggest and effectuate improvements in standards without discouragement. This is true for the exchanges and the NASD on the one hand, and for this Commission on the other. I firmly believe that any institution -- private or public -- can be run honestly and tirelessly and yet at the same time it can die. Rigor mortis will set in if all of us do not re-examine ourselves -- find out where the industry has been moving, and accordingly how we should redefine our responsibilities.

III.

In recognizing the need for oversight, we hold no brief for empire building. The Commission has expanded by a third since early 1961 when I came. This much was imperative: no one had time to think beyond *ad hoc* problems and see where we were going. The registration backlog was at an all-time high. We had some notion that all such problems could be cleared up by a fresh mind and we brought in a businessman experienced in reorganizing companies. The answer came back that the problem was manpower. Expansion thus was called for to meet existing problems. At this time I feel our internal job is consolidation and improvement. We are not interested in growth

as such. As evidence of our desire not to enlarge, we have recently had an ironic difference with the NASD before a House Committee. During the past two years the SEC has been faced with a real regulatory problem in the District of Columbia. We greatly accelerated our enforcement activities, but vigorous enforcement can never be a substitute for high standards. We therefore recommended adoption of a strong Blue Sky Law for the District of Columbia administered by local government as preferable to expanding SEC jurisdiction. Wallace Fulton, on the other hand, favored broadening our powers to meet the special problems of the District of Columbia. We appreciate the vote of confidence, but we feel our responsibilities are national. And we do not believe our activities should supersede local regulation, nor I might say self-regulation.

IV.

Our attitude toward self-regulation has been demonstrated concretely this year in connection with the American Stock Exchange. It seems to me in poor taste to exhume the problems explicitly set forth in our report and well known in the financial community. These problems are now being resolved. If the SEC worried about its "image", it might have brought immediate proceedings and publicly forced through a reorganization plan. Then we might have been hailed as "vigorous" (a politically attractive label). But we do believe in the principle of

self-regulation, and we mean what we say. As an understatement encouragement was indeed necessary. Here was a dramatic example of the need for oversight. But once the situation was fully appreciated by the American Stock Exchange community, responsible members assumed leadership and reorganized the Exchange. They have taken an interest in it, reframed its constitution, abolished the committee system, strengthened staff responsibility, and elected an able president.

On this general subject, I should like to attempt one generalization about achieving effective self-regulation through membership organizations in the securities industry. It appears safe to conclude that success depends in substantial part on the adequacy and ability of the professional staff and the amount of responsibility vested in them. This in turn rests upon the wisdom and vision of the Board of Governors. But the staff provides a continuity and objectivity which is needed to raise standards in the industry. I appreciate the philosophy of the NASD that the members should regulate their fellow members, but as the scope of self-regulation enlarges, it will become increasingly arduous without an effective staff.

V.

Keith Funston has framed his attitude toward self-regulation in a somewhat different light. Who, he asks, can best set operating standards and determine the most effective level of service to the public?

The securities industry? Or the government? He did not answer that rhetorical question, but I doubt if we need be more explicit with this distinguished audience. I can appreciate the basis for his point of view. After all, he is the head of the New York Stock Exchange, and has been emphasizing the lifting of standards in the industry. The Exchange, for example, has enacted rules that stock may not be listed unless it be voting stock, or unless the shareholders have the right to vote on acquisitions. It has required interim financial reports and has regulated the qualifications and conduct of its members. In general these rules demonstrate the dynamic element of self-regulation of which Mr. Funston may well be proud.

At the same time, I do not think his question calls for an answer of one or the other: the securities industry or the government. It seems to deny the need for oversight or public participation at all. I cannot agree that any exchange or any other institution including the SEC has achieved perfection. Certainly, I shall not attempt to justify every action we have ever taken. We make mistakes, but are doing the best we can. Thus I take the position that Commission participation is not only required under the statute, but also healthful. Inter-action is stimulating. Every member of the New York Stock Exchange will concede that the Exchange, though a public institution, still seems to have certain

characteristics of a private club, a very good club, I might say. Without prejudging the facts, it seems to me that periodically the role and performance of its members -- whether floor traders, odd-lot houses or specialists -- or the rate structure -- should be re-examined. I can assure you that we recognize most of these problems are in the grey area -- without black or white solutions. The public is intimately involved, and any institution having public responsibilities but operating as a private association benefits by oversight.

Philosophical limits upon unchecked self-regulation are suggested by consideration of anti-trust principles. One purpose of the Sherman Act is to prevent private groups acting in concert from exercising their power to the detriment of competitors and the public interest. Now the Exchange says there must be either exemption from anti-trust or erosion of self-regulation. If the Exchange wants absolution, can it be achieved without some other form of governmental participation -- i.e., the SEC? In legal circles today there is much talk of primary jurisdiction -- for example, the Federal Power Commission versus the Department of Justice as to pipe lines, the Civil Aeronautics Board versus the Department of Justice as to airline mergers. In the securities industry the Exchange tends to sponsor a maximum freedom from both. Whether or not the anti-trust laws apply, some government oversight is warranted, indeed necessary, to insure that action in the name of self-regulation is neither discriminatory nor capricious.

In sum, I do not agree that the Commission should have to resign itself to a vestigial role in dealing with an exchange and its members. I feel we must become directly involved, as we have in major disciplinary proceedings involving exchange members, where important questions of principle are at stake. I have in mind cases involving improper credit devices, or even Cady, Roberts & Co. of which some of you may have heard, and which the New York Stock Exchange has sought to interpret responsibly. I further believe that general rules and practices should be scrutinized by the Commission. There is some health and vitality in inter-action, just as Congress forces the Commission to keep alert.

At the same time, I foresee no major expansion of the SEC -- which must still focus on broad-scale problems of self-regulation -- on policy rather than day-to-day administration.

VI.

The preceding discussion turns us logically to the NASD. Here a self-regulatory institution was deliberately created and its functions were concretely spelled out in the Maloney Act. Recently the NASD has demonstrated its initiative in developing policies as to unconscionable underwriting compensation and -- we hope -- suitability,

i. e., what is suitable for the customer. As the NASD moves ahead and raises standards, the SEC should encourage this initiative. I cannot yet outline the conclusions of our special study, but I can go so far as to say that in the over-the-counter market self-regulation has much room for growth. The opportunity is there. The industry should accept it, and finance it with adequate budget.

For example, the wholesale quotation system is of basic importance to the operations of the over-the-counter market. At present, this system is a privately owned enterprise. By immense good fortune it is under the direction of a person having a high sense of integrity. But what if subsequently one of less scruples and responsiblity were to assume control of the system? Many responsible people in the securities industry believe the quotation system is clearly affected with a public interest. What steps in the long run could be taken that would ensure responsible management or control over its operations?

Again, we now find that many of you who opposed reporting requirements for a broader spectrum of companies as recently as 1957 believe the time has come when the public needs more information about stocks not listed on the exchanges but traded over-the-counter. If this is a logical development, there is still the problem of how such information (once public) can become more widely available to

broker-dealers and their customers, and more closely tied to the selling process. (We have recently had an example of essential information available in our periodic reports totally unused by the advisory services .)

Finally, some industry regulatory agency, presumably the NASD, must assume a more active and vigorous role in connection with the retailing aspects of the over-the-counter market, including selling literature and market letters.

For the NASD and any association with which it may share duties, I can see an expanding role for self-regulation. The Commission is reluctant to assume the primary responsibility and detailed supervision over an area which requires more regulatory attention than it has had thus far. Thus I anticipate substantial growth on the part of the exchanges and the NASD. Those members who are budget conscious should bear this in mind. Do not begrudge the funds to increase self-regulation. Governmental action is called for when there is a void, but the SEC is sincerely anxious that any vacuum be filled by industry policing.

Finally in this connection may I say that government officials -- outside the SEC -- Congressional and otherwise, have asked us whether our fees should be raised to make the Commission self-sustaining. Our own suggestion was that heavier charges might be deferred. We believed a much greater financial burden will be placed upon you

as self-regulators, and that you should be in a posture to tolerate it.

VII.

Turning now to the Investment Company Institute, we come to an industry in which self-regulation has been generally rejected thus far. This point was highlighted by my colleague, Commissioner Whitney, before the Institute last spring. In one area which we discussed concretely with the Institute and its Chairman, the paradox is that the SEC is in favor of less governmental intrusion and industry prefers more. All of us -- the I.C.I. and the Commission -- seem agreed upon the principle that more inspection of investment companies is called for. With our limited personnel to date, we have had roughly a 12 year cycle. This is inadequate, indeed absurd. The industry believes we should perform the inspection, if necessary financing ourselves in a self-sustaining way akin to national bank examinations. Since this would require a statute, one can see future delays while inspections continue to lag. We suggested that the Institute take the initiative. It, or some association connected with it, could retain independent certified public accounting firms to carry out a major role in the inspection program. They would thus be independent of the particular investment company, and of this Commission as well. Their work, duly certified, could then be submitted to the SEC. Thus the fundamental responsibility would fall upon the Institute and its agents,

and Commission personnel need not be measurably increased. I can understand how the industry would quibble over the content and scope of the inspection, but cannot fathom the reason for rejecting the idea in principle. We need only go back to 1933 to recall that a large staff of government personnel was suggested to audit companies seeking to register their securities. Happily, the alternative of thrusting the burden upon the independent C.P.A. was adopted. Accountants, conservative like all of us professional people, might hesitate to accept this innovation as to investment companies which might broaden their auditing responsibilities. But looking back to the thirties they can appreciate the enormous stimulus for raising standards which resulted.

Perhaps the problem in the Investment Company Institute is that there is little common ground among its members. This is a point frequently made by its officers. As we said upon publication of the Wharton School Report, we have no preconceptions about this industry. Perhaps in order for some measure of self-regulation to develop, the members must recognize their many diverse facets:

Are the problems of load and no-load funds the same?

Are the problems of funds with management companies the same as those few which have no management contracts?

Are the interests of the management company members of the institute the same as those of the fund members?

Are the problems of closed-end and open-end funds alike? The industry itself seems to recognize distinctions, as evidenced by the formation of the Association of Closed-End Investment Companies.

VIII.

In conclusion, what is self-regulation and what are the prospects for it? It does not exclude participation by the Commission with the industry associations. You need suggestions, and so do we. As my predecessor on the Commission, now Mr. Justice Douglas, said in 1938: ".... The point where self-determination should cease and direct regulation by government should commence must usually be determined not by arbitrary action but by neatly balanced judgment and discretion on both sides." Our participation should not reduce your initiative any more than Congress' oversight should stifle ours. As we see it, the opportunity for self-regulation is abundant: both for the exchanges and the NASD. As I said earlier, this Commission is in no mood to expand, to seek growth for growth's sake. Government steps in to fill an evident public need; we urge you, indeed entreat you, to acknowledge this need and fulfill it yourselves.

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