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SECURITIES INDUSTRY OPERATIONAL RESPONSIBILITIES FOLLOWING THE OCTOBER MARKET BREAK -- WITH AN ADDENDUM ON PROPOSED GLASS-STEAGALL REPEAL

REMARKS TO
THE SECURITIES INDUSTRY ASSOCIATION
Boca Raton, Florida

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DECEMBER 2, 1987

SECURITIES INDUSTRY OPERATIONAL RESPONSIBILITIES FOLLOWING THE OCTOBER MARKET BREAK -- WITH AN ADDENDUM ON PROPOSED GLASS-STEAGALL REPEAL

It is a pleasure and a privilege to appear before you today. The events of the last few months have been difficult for all of us. They have tested our endurance, drawn on our resources, and challenged our optimism. Although I am pleased that our market systems showed strength through the recent October market break, I am concerned about the impact that the break may have on public confidence in the securities market. Today I want to explore some of the ramifications of recent events, offer to you some suggestions for improving public confidence in broker-dealer operations and customer sales practices, and explore my concern that proposed repeal of the Glass-Steagall Act may have the effect of permitting banks to engage in securities activities without requiring them to conform to the securities laws designed to protect investors and maintain fair and orderly securities markets.

The October Market Break

To place the October market events into context, it is important to note that, as recently as August 12, 1982, the Dow Jones Industrial Average was at 776. Approximately 5 years later, on August 25, 1987, it reached 2736, almost a fourfold increase. Even after the record 508 point decline on October 19, the Dow remained at 1738, almost 1000 points above its August 1982 figure. Those facts indicate that our securities markets must be examined in their historical context, with market strength evaluated on a comparative basis.

Market strength during the October decline should also be evaluated using other factors. Most importantly, all of the major U.S. broker-dealers remained in sound financial condition throughout the market break, a credit to their strong capital positions and successful risk management. Moreover, despite a tidal wave of volume, including two consecutive 600 million share days, uncompared trades remained under control. And, thanks to the extraordinary back office efforts of the securities industry, clearance and settlement systems functioned relatively well.

This is not to deny that the events of the market break raise concerns about the adequacy of the industry's structure, capacity, and capitalization. As you know, the staff of the Securities and Exchange Commission has commenced a study of the market break. There has been substantial progress in the study and we expect to issue a preliminary staff report in January. This is the same timetable that has been set for the separate Brady Task Force report, an effort with which the Commission is cooperating.

The Commission's study will cover a variety of issues, including:

- the role of futures-related index arbitrage and portfolio insurance in the market downturn;
- the adequacy of dealer capital during times of high volatility and volume;
- operational capacities with respect to order execution, order routing, clearance, and settlement;
- the treatment of retail securities customers during the crisis;
- the effect of foreign market trading and market movements on our markets during this time; and
- the response of the mutual fund industry to the market break, including the ability of mutual funds to respond to redemption requests during the week of October 19.

With regard to the role of futures-related trading in October, we will be addressing several important questions, including:

First, to what extent did index-related trading contribute to the market decline? Although our preliminary information is that index-related trading occurred in significant amounts on October 16, 19, and 20, we are not yet ready to comment regarding the extent to which such trading contributed to the market decline.

Second, how have institutional portfolio strategies been affected by the ability to use stock index futures and options to adjust stock positions more quickly and more cheaply than by trading stocks? More specifically, did institutions increase their stock positions to the point that they were more likely to make selling decisions as the market moved downward?

Third, does the ability to take the equivalent of a very large stock position through futures and options with relatively lower initial deposits result in unacceptable levels of speculative activity in the markets? In other words, should higher margin requirements be imposed on derivative index products?

While we must consider ways to prevent or limit extreme market effects of derivative index products, I am well aware that when we consider possible remedial measures it is important to avoid stifling innovation. Automation and new products are both a product of and an important contributor to an innovative environment unheard of only a few years ago. Innovative products, such as index futures and options, are valuable tools in our modern markets, and restricting use of such products may merely result in substitution by efficient replacements in other markets. In conducting our study, I believe that an important focus should be on improving the capacity of our markets to handle the effects that flow from innovation, automation, and product development.

With regard to market capacity, we should focus particularly on making more dealer capital available in times of extreme volatility. Well-capitalized specialists and market makers are important to healthy markets. We should strive to see that a severe downturn will not imperil the financial viability of critical portions of our specialist and market making community. In light of the concerns raised by the events of the week of October 19, capital and liquidity questions will certainly be a major part of our study.

Improvement of Broker-Dealer Operations and Customer Sales Practices

Any review of the conduct of the securities industry should emphasize that responsibility for market supervision is shared by the self-regulatory organizations and the securities firms, as well as by the Commission. The concept of self-regulation is a cornerstone of the structure for oversight of our securities markets, and if that concept is to have continued viability a review of necessary adjustments in light of the events of the market break should be undertaken by the securities industry with investor confidence as a primary goal.

Self-regulation in the securities industry is premised on the concept that securities firms hold themselves to higher standards than are required by law: standards of high commercial honor, and just and equitable principles of trade. These standards reflect a tradition of striving for high goals, not settling for just the letter of the law. I believe that this tradition must be maintained so that the honesty and integrity of the securities industry is made manifest to investors and to the public at large.

Let me underline my strongly held belief that, despite some glaring exceptions, the securities industry is deeply committed to fair and honest securities markets and to maintaining the highest professional standards in dealings with the investing public. Nevertheless, I urge you to respond to the concerns of the public both by increasing your diligence with regard to professional standards and by increasing the visibility of your efforts.

In evaluating the recent market events, we should not overlook that for a significant period the securities industry has experienced unparallelled prosperity. Let me give you some approximations showing the recent tremendous growth in the industry. Sales in U.S. securities markets rose from about $540 million in 1980 to a projected $2.5 billion in 1987. During the period 1980 to 1986 NASD membership more than doubled, from 3,000 in 1980 to 6,600 in 1986; branch offices rose from 7,500 to 18,000; and the number of registered representatives also doubled, from 200,000 to 400,000. In this period the number of investment companies also increased from 1,500 to 2,500, and the number of investment advisers increased from 4,600 to 11,100.

Despite this recent period of growth and prosperity, the securities industry today seems to be fearing market uncertainty and lower profits. A natural response to these conditions is to cut costs, and some securities firms have begun taking steps to reduce staff and dispose of low margin operations. As you wrestle with the difficult management choices forced upon you by recent events, I urge you not to sacrifice the future by extremes of cost-cutting zeal, and in particular, I urge you to examine the need for attention to several areas:

1. the quality of service provided to retail customers;
2. the adequacy of clearance, settlement, and order routing systems;
3. the effectiveness of existing supervisory and compliance functions to guard against abusive sales practices; and
4. the sufficiency of procedures to inhibit insider trading.

These are also areas that the Commission is scrutinizing either as part of its study of the market break or as part of its ongoing examination and enforcement programs.

The importance of the first area of concern, the quality of service provided to retail investors, has been heightened in light of the events of the market break. The concept of an account representative carries with it a notion of loyalty and service to retail customers. If public confidence is to be bolstered, retail customers need to be reassured that their brokers are faithfully representing their interests. We have heard from large numbers of investors who complained that during the market break they could not reach their brokers to place orders, or that brokers delayed in notifying them whether their trades had been executed. The clear perception of many investors was that securities firms served their institutional customers at the expense of retail investors. Additionally, it appears that some in-house systems for routing retail orders for execution simply broke down under the stress of unforeseen volume. Order routing systems that became clogged should be revamped to prevent such problems when they are subject to similar strains in the future.

We also have received many complaints from investors who experienced immediate margin calls or whose positions were liquidated without receiving any notification. Although securities firms' rights regarding margin accounts are set forth in customer agreements, many investors claimed that their registered representatives had not sufficiently explained how a margin account operates.

The second area of concern, the adequacy of clearance and settlement, was also brought to the forefront by the market break, and is currently under examination by the Commission staff. We have experienced a week when the average daily volume on the New York Stock Exchange was over 400 million shares, and there is no guarantee that such volume will not return to the market. During those high volume days in October, comparison, clearing, and settling departments came under extreme stress, forcing the securities markets to close early to allow these departments to catch up with the pace of trading. The Commission's study of the October market break will examine the quality of order execution and routing for smaller orders, as well as the functioning of clearance and settlement systems.

The NASD's recent proposed rule change concerning mandatory participation in its small order execution system and automated access to market makers is a positive development. I hope, however, that the firms will add to the SEC study and the NASD action by initiating changes in this area. In light of October events it is important that they initiate operational enhancements so that they will be prepared to meet the demands of the next volume surge. It is also critical that firms resist the temptation to cut back office costs merely because back offices do not produce revenue.

The third area of concern involves those functions that guard the integrity of the industry, particularly supervisory, compliance, and audit functions. Although these areas are not profit centers either, now more than ever, they too must be maintained and strengthened. The industry must not take actions, even in an effort to reduce costs, that would jeopardize these functions.

In recent months, the need for individual securities firms and the securities industry as a whole to preserve standards of integrity has become particularly acute. The events of October, coupled with the recent insider trading scandals, appear to have cast a shadow on the public perception of the industry's commitment to the small investor. Complaints to the Commission regarding securities firms have doubled following the events of the past months. In this crucial time it is important for the public to know that the industry is committed to maintaining high ethical standards and to protecting the public from securities law violators.

To achieve investor confidence and reduce abusive sales practices, firms must be particularly sensitive to their supervisory and compliance responsibilities. The securities firm is the first line of defense against dishonest or illegal conduct by the securities professionals it employs. I cannot emphasize too strongly that supervision cannot simply be delegated to your legal and compliance staffs. There must be an ongoing commitment by each of the senior managers of the firm. Until compliance receives the same kind of attention as your profit centers, you will continue to face the likelihood of breakdowns that can lead to undesirable publicity, with incalculable losses in customer confidence.

Firm supervisory systems depend on the presence of knowledgeable, trustworthy supervisors watching over the activities of securities firm employees in the home office and in the field. They require safeguards to avoid predictable and recurring problems, and defined procedures to ensure that securities activities are carried out under the eye of qualified supervisors. They also require regular audits of all securities activities to assess the effectiveness of established procedures and to detect instances of illegal or dishonest activity. While these procedures may be costly to maintain, they increase customer confidence and reduce costs resulting from customer arbitrations and SRO and SEC disciplinary actions.

The front line in any supervisory program is the branch manager. In an uncertain market, branch managers will be facing economic pressures that create a strong temptation to overlook problems with their registered representatives, particularly top producers of revenues. Securities firms must remain attuned to these pressures. They must train and supervise branch managers as well as give special attention to complaints against top producers.

Speaking of top producers, careful selection of employees is also an important supervisory function. Care must be taken both in the hiring of sales personnel, and in providing them with supervision appropriate to their background. A particularly noteworthy problem is that of the dishonest, but high-producing registered representative who roams from firm to firm. If you hire an account executive who has a record of customer complaints, you must realize that you are accepting the obligation to develop and maintain special supervision of that person.

The fourth area of concern, insider trading, is another in which your continued efforts to supervise and control securities personnel are essential. The insider trading scandals of recent years have struck a severe blow to the reputation of the securities industry. The image of suitcases of money being traded for secret information has disturbed the public, eroding confidence in the securities markets. Since it is difficult to prevent insider trading or tipping by securities firm employees, imposition of strict procedures to safeguard inside information is essential.

Senior management of securities firms in particular should assume responsibility for preventing the misuse of confidential information. Procedures to prevent insider trading should be put in place and applied with the full backing of the executive office. These procedures may involve "Chinese Walls" to restrict access to and disclosure of material nonpublic information, use of restricted lists to prevent firm and employee trading in certain securities about which the firm has inside information, and the use of watch lists to monitor trading in such securities. The Commission has recognized that specific policies and procedures can vary from firm to firm. What is crucial is that the procedures be adequately designed to prevent the misuse of material nonpublic information in the firm's possession, and that these procedures be consistently and firmly enforced.

Properly implemented, these procedures are not only a valuable safeguard against any appearance of impropriety, they are also a crucial part of any defense to a legal action. The Commission's proposed insider trading legislation, transmitted to Congress in November, provides firms with a specific affirmative defense to an insider trading action if the person making the investment decision on behalf of the firm did not know and was not influenced by the information and the firm had implemented procedures designed to prevent that person from coming into possession of the information.

In order to be effective your protections against insider trading should provide that some person or office is consistently made aware of all communications that occur "over the Wall." Moreover, there must be sufficient documentation so that your internal auditors, the SEC, and SROs can evaluate the effectiveness of your system. And, just as with sales practice supervision, maintaining effective Chinese Wall protection requires continuing commitment by senior executives. Nothing less will serve to persuade the public that the industry is determined to prevent illegal and unfair insider trading by securities professionals.

SRO and Commission Enforcement Programs

I have emphasized the importance of vigilant supervision by securities firms as the first line of defense against unethical and illegal conduct. A few words should also be said about the second and third lines of defense. All of you know that the self-regulatory organizations bear significant responsibility for inspecting securities firms. When these inspections reveal inadequate supervision or controls, the SROs work with the firms to correct the problems. Because of the large size of the securities industry, the Commission has relied heavily upon the SROs' inspection and enforcement functions in the past. It will continue to do so in the future.

The SROs have been especially effective in enforcing the net capital requirements applicable to their members. The SROs must now expand their focus with respect to deterring sales practice abuses. The Commission will encourage the SROs to place a high priority on demanding high standards of conduct by all levels of the securities industry, and especially by sales personnel. The Commission also will encourage the SROs to take an active interest in seeing that firms have effective supervisory arrangements in place, and to apply their just and equitable principles of trade zealously in order to discipline sharp and abusive sales practices. Vigorous enforcement by the SROs is a necessary complement to the renewed efforts by securities firms to prevent dishonest conduct by their personnel, and is essential to increasing public confidence in the securities markets.

The Commission, too, has a key role to play in this process. I believe that the Commission must strongly assert itself in the area of sales practice abuses, by ensuring that the SROs perform their regulatory functions, by bringing enforcement actions of its own, and by working with the state securities commissions. In particular, the Commission can make an important contribution to the reduction of sales practice abuses by encouraging securities firms to establish sound supervisory procedures and to apply these procedures effectively. If firms fail to do so, they should be disciplined in a manner that will encourage immediate improvements.

It is highly important that the securities industry retain public confidence. Maintenance of public faith requires a commitment by the entire securities industry to live up to high standards of integrity. It also requires vigorous enforcement activity by the self-regulatory organizations, and consistent and effective oversight and enforcement by the Securities and Exchange Commission.

Proposed Repeal of Glass-Steagall

As a final topic, I would like to address an issue that I know is of utmost concern to many of you. Tomorrow, I will testify before the Senate Banking Committee on the present legislative proposals to repeal or reform the Glass-Steagall Act. In addition, the House Subcommittee on Telecommunications and Finance has asked the Commission to submit a report on the effects of Glass-Steagall reform or repeal. The Commission's views on this matter are important because, as the federal agency responsible for the protection of investors and the maintenance of fair and orderly securities markets, it has a crucial interest in the proper regulation of the securities activities of all participants in our capital markets, including depository institutions.

In preparation for my testimony, I have met with proponents and opponents of Glass-Steagall repeal. I have spoken with other federal regulators of our financial institutions, with members of Congress, with representatives of the banking community, and with representatives of the securities industry. Indeed, a group of your leaders met with me in Washington to discuss the SIA's views on Glass-Steagall reform.

In essence, proponents of repeal argue that allowing banks to engage in all securities activities would improve the safety and soundness of the banking system by allowing banks to diversify their business, to increase their capital, and to be more profitable. They also argue that bank entry into securities activities will benefit consumers through increased competition, and that the relaxation or repeal of Glass-Steagall is necessary to make U.S. banks competitive with those abroad. Opponents argue that repeal will increase the level of risk in the banking system, result in unacceptable concentrations of economic power, and unfairly favor banks.

The Commission's perspective on these issues, however, is different from that of either the proponents or the opponents of repeal. The Commission must be concerned with issues of investor protection and fair and orderly capital markets. Because of these concerns, it is the Commission's position that banks should be allowed to engage in the securities business only if their securities activities are subject to Securities and Exchange Commission regulation -- regulation that has as its primary goals the protection of investors and the maintenance of fair and orderly markets. The Commission cannot support Glass-Steagall repeal unless these objectives are obtained.

Specifically, the Commission cannot support Glass-Steagall repeal unless banks are required to conduct both new and existing securities activities in separate securities affiliates subject to Commission regulation. To this end, the Commission continues its strong support for the proposed Bank Broker-Dealer Act, which would require that banks engaging in broker-dealer activities do so through separate affiliates subject to Commission regulation. In the Commission's view, the specific activities that must be placed in securities affiliates include the following:

- publicly-advertised brokerage activities;
- brokerage services provided to advised accounts for which transaction-related compensation is received;
- corporate securities dealing or underwriting, including private placements;
- municipal revenue bond underwriting and dealing;
- underwriting of unit investment trusts; and
- distribution of investment company shares.

Another area of great concern is that of conflicts of interest. If the Glass-Steagall Act is repealed, Congress should consider safeguards to address the unique conflicts of interest that would be created, particularly those arising from bank underwriting and bank investment company activities.

Disclosure policies are also important. If a rational financial system is to be established as part of Glass-Steagall reform, then the Bush Task Group recommendations to consolidate in the Commission the administration and enforcement of the securities registration and reporting requirements for all publicly-owned banks and thrifts should be adopted. The Commission continues its strong support for the Task Group recommendations and will urge that their adoption be part of any Glass-Steagall legislative package.

Conclusion

There are many facets to the Commission's responsibility for the protection of investors and the maintenance of fair and orderly securities markets. I have reviewed with you today our plans to study the October market break, our suggestions for improving broker-dealer operations and sales practices, and our concerns regarding regulation of bank securities activities should the Glass-Steagall Act be repealed. In these areas and in many others I believe the Commission and the industry should work cooperatively to promote the industry's good health and thereby to improve our nation's capital markets.