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AN HISTORIC YEAR

Speech By

Manuel F. Cohen
Chairman
Securities and Exchange Commission

North American Securities Administrators
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Fellow securities administrators and distinguished guests, it is an honor and a pleasure to speak to you this afternoon.

The past year has been a most successful one for public investors in the United States. Important events have occurred in the areas of legislation, regulatory activities, and judicial decisions on both the Federal and state levels.

I

With the possible exception of the Report of the Special Study of the Securities Markets which was transmitted to the Congress a little more than a year ago, the most significant was enactment of the Securities Acts Amendments of 1964. Its passage is, in every sense, a tribute to the patience, the care, the diligence and the sheer heart of my predecessor William L. Cary, who, as you know, has retired for the moment to the quieter pace of the academic halls.

In the main, the Amendments eliminate the differences in reporting requirements between issuers of securities listed on the exchanges and the larger issuers whose securities are traded over the counter, allow the self-regulatory organizations and the Commission to raise standards for entry into the securities business, and strengthen the Commission in dealing with broker-dealers and their employees. This major piece of legislation was recommended by the Report of the Special Study and strongly supported in principle by representatives of the securities industry and by others affected by it. It also benefited from extensive and carefully conducted hearings by the Congress which permitted a thorough consideration of all of the issues involved.

The Amendments make too many changes for me to discuss them all here. I will mention a few which should be of interest to state officials. For a more complete discussion of the new provisions I refer you to the packet of releases which you should have received from us last week. One summarizes the Amendments Act and the others announce new rules and rule proposals, certain exemptions, and a revision of our broker-dealer registration form. You will receive additional packets from time to time.

The new legislation did not affect the philosophy or the basic structure of securities regulation in this country. No change was made, or suggested, in the concurrent jurisdiction exercised by Federal and state authorities over interstate offerings of securities and over broker-dealers and investment advisers who do business in more than one state. Indeed, the determination by the Congress not to accept our recommendation to eliminate the exemption from registration for

broker-dealers engaged only in an intrastate business reflects a decision not to affect the present balance. I should hasten to say that our proposal should not be viewed either as a step toward Federal preemption or as reflecting dissatisfaction with state regulation. On the contrary, we believe firmly that state regulation has made, and will continue to make, significant contributions to securities regulation and that there should not be any Federal preemption. Local officials provide surveillance that we could never match and, as Justice Brandeis pointed out, the states serve as laboratories for new ideas.

One of the most important effects of the new legislation will be a raising of the standards to be met by those entering the securities business. I am sure that our experience, and the data collected by the Special Study, support your own view that one of the greatest dangers to public investors is the inexperienced broker-dealer or salesman with no understanding of how the securities business operates or of the merchandise he is offering and little appreciation of his legal and ethical obligations to customers. Following the lead of some states which have long prescribed qualification standards for broker-dealers subject to their jurisdiction, the Amendments meet this problem by requiring the NASD to establish capital requirements and standards with respect to the training, experience, and other qualifications of their members, and of persons associated with them. The Commission is vested with similar power as to broker-dealers who are not members of a registered securities association and their associates.

The Amendments set a new pattern and authorize the Commission to prescribe generally, for non-members of self-regulatory organizations, a system of control similar to that now applicable only to members of such organizations. This feature of the legislation was added towards the end of the legislative process in lieu of our proposal for compulsory membership in a self-regulatory institution. It raises a number of interesting questions and possibilities. However, we were not in a position to implement these provisions immediately. We have established a special unit in our Division of Trading and Markets to gather more precise and fuller information as to the persons and firms affected and to consider the regulatory needs and problems which may be anticipated. This unit plans to work with the self-regulatory organizations and to consult with state officials.

Another major change has been made in the Commission's disciplinary power. Previously, neither the NASD nor we could proceed against an individual associated with a broker-dealer unless we proceeded against the firm. In some situations where violations were committed by an employee, despite effective supervision and strong efforts by management to detect and prevent violations, proceedings

against a firm were necessary. In a few cases, offending individuals may have gone unpunished, particularly where they severed their associations with the securities business. Perhaps of greater importance, a record was not made as a basis for possible debarment from the business in the future. The Exchange Act, like many state blue sky laws, now provides for proceedings directly against offending individuals, where that course is appropriate, without joining the entire firm. At the same time, however, the Amendments codify the Commission's earlier interpretation that failure of supervision provided a basis for sanction against the firm or supervisory personnel. In addition, the grounds on which the Commission may deny or revoke registration, if it finds it in the public interest to do so, have been expanded.

As I have already suggested, the Amendments require disclosures and periodic reporting by larger publicly-held issuers of securities traded over-the-counter comparable to that now afforded by the issuers of listed securities. This feature of the new law complements that concerned with the quality and integrity of those in the business. It will provide the means whereby the broker-dealer and his salesman may inform himself and his customer as to a larger number of investment opportunities. It should improve confidence in those issues and renew interest in the over-the-counter market. An additional benefit will be the assistance it may provide you in the examination and approval of offerings made within your state.

An interesting aspect of the new provisions concerning over-the-counter issuers of securities is that they give responsibilities for investor protection to several new groups of officials -- Federal bank regulatory authorities insofar as bank stocks are concerned and, with respect to stocks of insurance companies, the state insurance commissioners. I shall speak only as to the latter. Many responsibilities concerning periodic reports, proxy regulation, and insider trading are, in effect, delegated to the states individually and to the insurance commissioners operating collectively through the National Association of Insurance Commissioners. A few of you operate from the same general authority as does the insurance commissioner of your state. Most of you do not. I am sure, however, that your colleagues have already been in touch with you concerning this matter. In view of their expressed wish to assume new duties, and to assist them in a complete fulfillment of the legislative intention, we have offered to the National Association of Insurance Commissioners such assistance as may be required.

II

Although a good deal of our energy and attention during the past year were devoted to the legislative program, we, the self-regulatory institutions, and other groups have been busy considering and taking action upon other recommendations of the Special Study. You have already heard of some of these achievements. I shall refer to a few of the actions taken and currently under way.

A beginning has been made with "quotations" in the over-the-counter market. Our new Rule 15c2-7, which should be of assistance to you in your enforcement efforts, requires dealers entering "quotations" in a system such as the "sheets" of the National Quotation Bureau to disclose whether they are acting as correspondents, or under some other financial arrangement with other dealers, and the identity of the latter. This information is to be revealed in the published quotations by symbol, number or otherwise.

I should emphasize that this rule is but a beginning. The NASD and we have been studying carefully the recommendations of the Special Study and appropriate measures to implement them. Satisfactory solutions to meet the difficult problems involved must be found.

Another part of the Commission's implementation program involved our proxy rules. As a result of a much publicized case, the Study recommended that in the preparation of financial statements to be included in reports to stockholders, issuers follow accounting principles and practices which are generally consistent with those required for financial statements filed with the Commission. That recommendation was the basis for the recent amendment to Rule 14a-3 which is designed to improve the completeness and the accuracy of the information furnished stockholders.

Significant reforms have been effected by the self-regulatory organizations. The New York Stock Exchange has enunciated standards on the obligation of members to supervise their employees, and we understand that the NASD will soon submit rules in this area to its membership. Both the major exchanges and the NASD have adopted new rules and interpretations with respect to advertising and investment advice. The NASD has announced other proposals designed to meet recommendations of the Special Study and otherwise to meet felt needs. All of these organizations have expanded their staffs to improve surveillance of selling practices. The New York Stock Exchange and the American Stock Exchange have taken certain steps and are considering others designed to provide a better balance in representation as between floor members and those principally concerned with doing

business with the public. Regional exchanges have also augmented their staffs, stepped up their surveillance activities, and improved their testing procedures for registered representatives.

You are, I am sure, all aware of the changes effected by the major New York exchanges in floor trading. We are hopeful that under the new rules, floor trading will serve to provide added liquidity and depth to markets for securities in a manner which will serve the interests of the investing public.

I shall not attempt to detail other changes made by these institutions during the past year. I do wish to take this occasion, however, to acknowledge the excellent cooperation and assistance we have received from the self-regulatory organizations, and other groups representative of various aspects of the securities business, in the development and successful conclusion of our legislative program and in the implementation of other recommendations of the Special Study. During the past year we have strengthened our lines of communication with those who appear before us. In recent weeks we have taken steps to create additional liaison arrangements to the end that all segments of the securities business, and of industry generally, as well as their representatives, will have clear and open avenues for discussion, for petition and, if you will, for complaint.

As further evidence of the value of the discussions and assistance so made possible I am pleased to announce at this time a proposed resolution of many of the problems pointed to by the Special Study arising from the combination of responsibilities assumed by specialists in our major stock exchanges.

Today, in Washington, the Commission is publishing for comment a proposed new rule. This rule, known as 11b-1, deals with stock exchange specialists and was initially recommended by the Special Study Report. I can also announce that, at the last meeting of their Boards of Governors, the New York and American Stock Exchanges adopted about 15 changes in their rules governing the conduct of specialists. I would like to say a few words about these rules.

To understand what these new rules are all about I will attempt to state in the broadest terms who the specialist is, and what he does. Specialists are exchange members who act as brokers and dealers in a specific group of securities in which they are registered. As brokers, specialists mainly hold and execute limit orders which are away from the current market when they are forwarded to them by other brokers. As a dealer, the specialist uses his own capital to take positions in his specialty stocks. The Exchange Act and various exchange rules

limit specialist dealer transactions to those reasonably necessary to maintain a fair and orderly market. In this context a fair and orderly market is usually thought of as a market with price continuity.

While all this sounds fairly straightforward, there are complex and difficult problems just beneath the surface. Here are a few of them. How much capital should be required of exchange specialists? To what extent should the rules compel specialists to use their capital in market situations which involve substantial risks -- or to put it another way, to what extent should specialists be compelled to shoulder an affirmative obligation to assist in the maintenance of a fair and orderly market? To what extent should specialists be permitted to liquidate their own positions in a manner which may cause some market instability -- obviously specialists cannot be required to assume positions and hold them forever. How can it be assured that when a specialist deals as principal with an investor whose order was entrusted to him that the customer has received a fair price?

I will now try to describe, in terms as general as a statement of the problems permits, what answers the new regulatory program provides.

Rule 11b-1, the proposed new Commission rule, is composed of three major parts. The first part requires the exchanges to have adequate rules in certain areas. First, it is required that the exchanges have rules which impose an affirmative obligation on specialists to utilize their capital as dealers. This is the first time that a clear statement of such an affirmative obligation has been required, and the new rules of the New York and American Stock Exchanges so provide. Second, is a requirement that each exchange require its specialists to have adequate minimum capital; another is that each exchange provide effective and systematic methods of surveillance of specialist activities. In response to these requirements, one of the new rules adopted by the New York Stock Exchange triples present specialist capital requirements; another new rule adopted by the New York Stock Exchange and the American Stock Exchange will permit the utilization of specialist income data on a stock-by-stock basis for regulatory and surveillance purposes.

Finally, and also in the first part of the new Commission rule, is the requirement that the exchanges have rules on the brokerage responsibilities of specialists. Among the changes adopted by the two major exchanges are rules designed to assure that specialists' brokerage customers receive the best possible prices and that the specialist does not give himself preferential treatment.

The second part of Rule 11b-1 sets up procedures for Commission review of newly adopted rules of the exchanges regulating specialists. Under these procedures, the Commission can disapprove new exchange

rules if they are inadequate to achieve the purposes of the provisions contained in the first part of the rule or are inconsistent with the public interest or the protection of investors. The Commission, of course, retains the authority contained in Section 11 of the Exchange Act to adopt its own rules regulating the conduct of specialists if that becomes necessary.

The third part of Rule 11b-1 permits the Commission to commence proceedings directly against a specialist in certain cases where an exchange has failed to do so or its action has been inadequate.

The circumstances under which such a proceeding can be commenced are related to one of the problems I mentioned a few minutes ago -- the liquidation of positions by specialists. One of the problems noted by the Special Study was that in times of crises, for example the May 1962 market break, some specialists engaged in unwarranted liquidations of their positions which tended to disrupt rather than contribute to the orderliness of the market. Among the new rules adopted by the exchanges is a rule which makes it clear that a specialist's paramount duty is to assist in the maintenance of a fair and orderly market and that this duty continues even while the specialist engages in liquidating transactions. This is one of the duties that can be directly enforced under the third part of Rule 11b-1 if an exchange fails to take effective remedial action.

In these few minutes I have only attempted to cover the highlights of this new regulatory program.

One word of warning should be sounded. I will not pretend that either the Special Study or the new rules which implement its recommendations provide any ultimate solutions to these or other problems. We believe that the new rules represent a real advance and that because of them we will have a better specialist system. However, prices of securities will continue to go down as well as up -- it is not the specialist's job to interfere with major price changes.

This leads me to another point that I wanted to make about these new rules -- their background. If a better specialist system results from these rules it will be because a group of dedicated individuals on the staff of the Commission worked for almost a year with equally dedicated individuals at the exchanges, both members and staff. The package is the result of at least 20 different conferences with industry representatives -- some of which lasted a full day. Of course I would be less than candid if I did not say that occasionally -- I really mean occasionally -- the volume of the discussion may have been a bit on the

loud side -- but even this was in the context of discussion, not debate or harangue. At the end we worked out rules and policies which have received the approval of government and industry. This acceptance could not have been attained without a genuine desire to reach agreement and good will among all concerned.

Despite the fact that, in a formal sense, the Commission has power to impose rules in this area, it is doubtful that, on matters as subtle and complex as these, the Commission by itself could have promulgated a viable regulatory program without the working cooperation of the industry. Such cooperation, of the members, presidents and the staffs of the exchanges, was not wanting here. And on our side, I think we can point with pride to a willingness and ability to recognize and respond to the legitimate problems and concerns of the industry.

To return now to the main thread of my remarks, most of the recent discussions concerning our activities have revolved around the Amendments Act and implementation of the Special Study recommendations. And, as I have stated, we have spent considerable time and energy on these matters. We have, however, also been making progress in other areas. For example, although we have not yet come to a decision on certain of the matters referred to by the Wharton School Report and the Special Study as they relate to investment companies, we have taken an important step under the Investment Company Act of 1940. I refer to the Commission's recently published proposal to revise its annual report Form N-30A-1 (to be redesignated Form N-1R) for registered open-end and closed-end companies (other than small business investment companies).

There are at present some 731 investment companies registered with the Commission under the Investment Company Act, of which 365 are open-end and 207 are closed-end companies (including in the latter figure 74 small business investment companies). From the beginning of the Commission's inspection program in the fiscal year 1957 through fiscal 1963, the Commission's staff completed a total of 250 inspections of registered investment companies. In fiscal 1964, an additional 146 inspections were completed. On the basis of this latter figure and relating it solely to the so-called "active" investment companies among the 731 registered with the Commission under the Investment Company Act, we are currently operating under an inspection cycle of 4.28 years. We hope to improve this situation.

We recognize, however, that to place our inspection program on a three-year cycle, for example, would require additional personnel for the Commission and would entail other related expenses. It would also

take time and expense to train inspectors, many of whom must necessarily be new recruits, to achieve a high degree of proficiency. Moreover, while it is salutary to inspect periodically every investment company, however well managed it may be, there inevitably are certain investment companies which require prompter or closer scrutiny than others. At any rate, the Commission considered that the public interest and the protection of investors would be served by strengthening the annual report. The existing report form, I might point out, has not been revised in any material respect for about 10 years. Based on our experience since then, it was our view that a form should be devised which would, on the one hand, provide better disclosure to the investing public and, on the other, more effectively channel the Commission's energies in its inspection program. We thought that an improved form might also serve to focus attention of the registered investment companies and their management more sharply on the prohibitions and requirements of the Investment Company Act and, thus, provide a significant measure of self-regulation.

After some two years of drafting and redrafting by our staff, with the benefit of discussions and correspondence with committees representing the investment company industry and the accounting profession, the Commission published for comment, on August 4, 1964, a proposed revision of the annual report form. At the request of the Investment Company Institute we have extended the period for written comments to October 15th. We are hopeful that an amended form, whether as proposed or as modified in the light of further comments, may be adopted before the end of this year. I therefore urge that all comments be submitted as promptly as possible.

III

During this past year a number of decisions were announced by state and Federal courts which will have a very large impact on securities regulation. Probably the most important is the opinion of the United States Supreme Court in SEC v. Capital Gains Research Bureau, Inc. In interpreting the anti-fraud provision of the Federal Investment Advisers Act, the Court stated the provision was not to be construed according to technical common law doctrines of fraud, but rather "flexibly to effectuate its remedial purpose." Although the case involved an investment adviser, this forward-looking rule of interpretation will have meaning in the interpretation of all securities statutes, whether Federal or state. At least two other important decisions should be mentioned -- the one in J. I. Case Company v. Borak, and the other by a Baltimore City court in United Funds, Inc. v. Carter Products, Inc. In Borak, which involved a violation of the Commission's proxy rules, the Supreme Court for the first time considered

and applied the so-called implied civil remedy doctrine for a violation of a provision of the securities acts or rules issued under them. The Carter decision suggests that state courts, interpreting their own state statutory and case law in light of the purposes of securities regulation, will impose high standards of conduct on corporate managers and insiders. I think it fair to state that these and other decisions handed down during the past year reflect the fact that the courts are increasingly sensitive and sympathetic to the purposes of securities regulation.

IV

The year has been an important one on the state level as well. With effectiveness of the new Nevada statute, forty-nine states and Puerto Rico now have securities statutes. And this year Congress enacted a securities law for the District of Columbia. Thus, all major United States jurisdictions, except Delaware, have local securities regulation. The Puerto Rican law was modeled on the Uniform Securities Act, making nineteen American jurisdictions which have adopted the uniform act entirely or substantially. Continuing a most useful trend initiated by the state administrators, I understand that 40 states have now adopted the Uniform Consent to Service of Process and Corporate Resolution forms. This should relieve you of some detail and allow you to devote more of your time and energy to enforcement. The activities of the North American Securities Administrators and of the Midwest Securities Commissioners Association have contributed greatly to progress in this and other fields.

In addition to these statutory and administrative rule changes, state enforcement activity continued at the high level of recent years. The Commission's securities violation unit is now collecting data on this activity and the number of state actions is impressive. I am informed that for the year ended June 30, 1964, there were 233 cease and desist type orders and 75 other administrative actions; in addition, 117 criminal convictions and 29 injunctions were obtained by state administrators in securities matters. In my view and that of our enforcement people state blue sky regulation is a more vital field than ever before.

V

By this time I am sure you know why I feel that this has been an important year in securities regulation -- I believe an historic one. Passage of the Amendments Act by the Congress and the court decisions I referred to and others, have confirmed the basic merit of securities regulation. However, this should not be taken to mean that we can relax

our vigilance. The sharp growth of the public interest in securities and the corresponding development of the industry make it obvious that our task is still a major one, not only in the administration of existing law and the fuller development of standards under them, but in seeking solutions to new problems. Without attempting to recite all that are appearing on the horizon, a few of these problems are already clear: what protections are necessary in connection with retirement plans involving securities, particularly where the assets of such plans are commingled; how should automation be used in the industry; what problems flow from the tremendous growth of institutional investors, including investment companies; and what do all of these mean for the structure of the securities business and markets and traditional ways of doing business.

This is the point at which I would be expected to exhort you to greater and greater heights of cooperation in the resolution of these problems. However, I have decided to ask only that you continue the existing high level of cooperation between us.

We have always encouraged participation by our staff in regional and national meetings of state administrators to further closer relationships, encourage mutual understanding of common goals and problems, and, hopefully, to eliminate some duplication of effort. This has made possible reference of some enforcement problems to local enforcement authorities. We have also embarked on numerous joint investigations which have proved most successful and have resulted in considerable savings to you and to us. I wish also to thank the Canadian and Mexican securities authorities for the excellent cooperation we have had from them in securities matters which have crossed national boundaries.

Our securities violations service is a constant working example of the benefits resulting from cooperation. The Division of Trading and Markets has, for some years, acted as a central clearing house for the collection and dissemination of information as to administrative, civil and criminal actions by Federal, state and self-regulatory agencies. This information is published and distributed every three months in our SV Bulletin. More than 600 Federal and state agencies now receive this Bulletin. I need not recite for you the importance of this service in processing and reviewing registrations for the sale of securities and applications for broker-dealer and investment adviser registration.

We are now engaged in a further cooperative effort looking toward revision and improvement of our forms. Our staff is working with your committees and with the NASD to determine whether and the extent to which we can promulgate applications for broker-dealer and investment

adviser registration which may be adopted by all having jurisdiction over such matters. We have been encouraged to believe that a uniform application for investment adviser registration will be agreed upon within the next several months.

I am confident that this cooperation among us and with representatives of industry will continue and broaden in the natural course of events. My confidence is based on the success we have thus far achieved. The measure of that success was pointed out by President Johnson on the occasion of his signing of the Amendments Act last month. Despite the political climate at the present time, I think that you will agree that his words are essentially non-partisan. The President stated:

> "Capitalism in America is what it is today because of the initiative, the enterprise and the responsibility of our free system. But it is also what it is because of the course that we have chosen for this government to follow. We rejected the idea that the role of government is either coercion or control. On the contrary, the proper function of government is to meet its responsibilities wisely so that people may have confidence in their future, in their system and in themselves. . . . The people of this country and the people of the world have confidence in our system and in themselves because of that type of leadership.
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> . . . Less than a lifetime ago this country's confidence in the securities markets was very small. On July 31 this year the market value of stock listed on the New York Stock Exchange reached a new high of $465 billion in contrast to a value of $23 billion prior to the enactment of the first Federal Securities Law in 1933. . . . Investor confidence is due to many factors. High on the list is the factor of confidence in the common sense attitude taken in the administration of our laws by our government. . . . The law signed today should further strengthen the securities markets and public confidence in them. Industry and government have worked together in the writing of these laws. Industry and government will work together in making these measures succeed."

The President spoke about industry and government working together, but it is obvious that an important part of this total effort has been the cooperation among governmental officials, particularly Federal and state securities administrators which seems especially significant to me this year. As many of you know, all the world is looking to us for clues to solutions of problems elsewhere. In England, France, West Germany, Canada, several of the emerging nations, and elsewhere, studies are under way or have been proposed to determine the adequacy of existing controls over the securities markets. Indeed, in some of these countries the establishment of regulatory bodies similar to ours is being urged as national policy. And I am sure that most of you have seen reports of recent actions taken by existing institutions, such as the London Stock Exchange, to strengthen their controls very substantially.

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In closing, I wish to say a word on the future of our partnership as governmental officials regulating securities transactions and markets and those engaged in them. The movement for state blue sky laws began a little over fifty years ago and the SEC will shortly celebrate its 30th Anniversary. The goals of securities regulation have been encouraged by leaders of our major political parties on both the state and Federal level. They have been generally accepted by all groups in our society. Although not beyond criticism, we have worked steadily to increase the protection of the American investor and the integrity of our financial institutions. The securities industry has worked with us to achieve these goals. The past year indicates that this job is still going forward. In particular it shows that we have not lost our vigor as we have changed from new experiments to mature institutions. I look forward to the coming years with confidence.

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