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OUR CHANGING CAPITAL MARKETS

An Address By

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One social disability suffered by SEC personnel and securities lawyers generally is that we tend to be conversational bores. I don't really know whether we are much worse than other people engaged in complicated pursuits that are equipped with their own occult lexicon and folklore and an endless stream of insoluable problems that are easy to make intellectually complicated. I only know that we are bad enough.

It is also true that in any such complicated field, you can easily become so absorbed in fascinating technical problems that you lose sight of where you are heading and even whether the problems are worth solving. For this occasion, knowing that you are not all professional technicians with respect to our federal securities laws, I propose to do the best I can to raise my head above the morass of specific matters with which we are concerned and look ahead a bit to where we are trying to go and consider why this might be of interest to concerned citizens.

Let me first go back a bit and consider where I think we have been and why I think it has been a pretty good trip.

The SEC was born of pain and sorrow 40 years ago, at the depth of the Great Depression, as one of the first and, as it turned out, more durable products of the New Deal. In the words of Variety's famous headline, Wall Street laid an egg in 1929 and, to mix up the metaphors a bit, there was still blood all over the street. Congressional committee hearings naturally ensued and by 1933, with the new administration of President Roosevelt, it was certain that there was going to be Federal securities legislation. It was arguable then, as it is now, whether the crash caused the depression or whether the underlying forces that caused the depression also caused the crash as the first symptom. While one might reason that, if the crash was simply the effect of problems with the economy, attention should be directed to the economy and not the stock market, in fact too many suspicions had been aroused and too much evidence collected of inequities in the processes for the distribution and trading in corporate securities. Quite apart from other measures aimed at restoring a healthy economy -- most of which were ineffective or unconstitutional or both -- it was inevitable that our securities markets would receive some drastic legislative attenion. What resulted was

at the same time more conservative and more enduring than some of the more direct attacks on the economy during that period.

Although the story has been told before in treatises on the subject, it is still worth recalling what happened at that time and what might have happened. It all began shortly after President Roosevelt had been inaugurated in March of 1933 and delivered his State of the Union message calling for legislation requiring truth in securities. The first legislative approach was to attack the process of the distribution of securities by companies through underwriters to the public. This seemed the more fundamental problem, and, anyway, Congressional studies of the more complex subject of market regulation were still in progress. The Securities Act of 1933 was the result.

Even today it is helpful to remember the alternatives facing the draftsmen and Congressional sponsors, bearing in mind that no legislation at all was not one of the alternatives. The most obvious approach was that already embodied in the more stringent state blue sky laws, namely, that the Federal government, through a suitable agency (originally the Federal

Trade Commission, which had been in existence since 1916), should determine whether a security should even be permitted to be offered to investors and prohibit its offering if it did not meet the requirements of a fair, just and equitable standard as conceived and applied by the government agency.

Another approach was that of the capital issues committee created rather late in World War I. Under this approach, the Federal government agency would have the authority and responsibility to determine whether a proposed offering was in the best interests of the U.S. economy as a whole. That is to say, under this proposal the government agency would decide which companies in which industries at what time could have access to our securities markets, not as much in terms of the immediate protection of investors but in terms of what companies were most in need of capital in accordance with some plan for the economy.

Finally, there was the full disclosure approach. The basic proposition here was that investors should be left free to decide whether a particular offering of securities was attractive to them, provided only that the offeree investors were in possession of all material facts. The assumption was that the channeling of capital into its most productive uses

could most efficiently be accomplished through the decisions of a multitude of investors properly informed. This would be preferable to, and more efficient than, having a permanent agency decide on who was entitled to new capital. For the system to work best, the Federal government also ought not to intrude itself into the question of what was fair, just and equitable to a particular investor, provided he was fully informed.

Needless to say, drawing upon the English Companies Act and Brandeis's reverence for the therapeutic effects of sunshine, the draftsmen of 1933 settled upon full disclosure rather than regulation as the governing principle.

When it turned its attention to market regulation the following year, 1934, Congress again settled upon fair and equitable markets as the ideal. No effort was made to govern or even influence market prices, as long as the market was not rigged in favor of professionals and insiders.

The philosophy thus adopted has not gone unchallenged. I'm sure that when the first statutory prospectus was made public in 1933, someone observed that it was completely unreadable by, and hence uninformative to, the ordinary

investor. The comment continues to be made and we continue to worry about it. But we retain faith in the proposition that the individual investor is benefited from the public availability of relevant and material information even if he does not read it himself or cannot understand it, and even though we continue to seek devices to produce more readable materials.

Some of the challenges cut more deeply than merely deploring the unreadable prospectus and question the practical utility of a full disclosure system, sometimes based upon doubts about the theoretical validity of fundamental analysis as a basis for investment decision, and question our allegedly exaggerated concern for equity in the market place.

Sometimes this criticism reminds me of a story that used to be told by Professor Prosser, a famous teacher and writer on the law of torts. He told of going up to a lighthouse on the shore of Puget Sound and finding an old Indian chief standing there studying the situation. It was an impressive structure in a dramatic setting, and to make conversation, Professor Prosser said, "Isn't that magnificent!" The Indian thought a few minutes and replied, "It looks fine,

but it's no good. The bright light flashes and the loud bell clanges, but the fog comes in just the same." So, the criticism goes, we flashed the lights of full disclosure and rang the bells of fairness in the market place and the market went down anyway, just as though we hadn't been there. All we have done is construct a more expensive way for people to lose their shirts while the lawyers and the paper industry get richer.

It seems curious that such doubts are expressed at home at the same time that the strengths of our system are being increasingly appreciated abroad. For some years now, the SEC has carried on a thriving export trade, helping other countries understand our system and adapt it to their domestic needs. For years we have worked with the Japanese, and more recently with several Latin American countries. We are currently participating in a working group of the Organization for Economic Cooperation and Development to develop principles to govern a reasonably uniform full disclosure system for the countries of Western Europe and Japan. Two of our staff have recently returned from Kuwait, which is concerned about its local securities market. Before

its recent defeat, the Conservative Government in the United Kingdom had proposed legislation to curb trading on material inside information, imposing criminal penalties that seem to us quite severe, possibly because under their legal system they cannot expect the privately-brought class action to accomplish enforcement. Not long ago, France created its Commission on the Operation of the Bourse, giving it some powers similar to those held by the SEC.

Foreigners have become converts to the benefits of full disclosure and fairness as the basic qualities of strong and free capital markets. Our legal and regulatory apparatus, in fundamental outline, is coming to be the pattern for the free world. It is appropriate to question how well we really think it has worked.

If we examine honestly the goals and aspirations of national policy as embodied in the SEC and the laws it administers in relation to actual experience, we must admit that we have not achieved complete success. We have caused the production of enormous quantities of information about companies and their securities, but we know that we still are not always getting the right information where it is needed in a form in which it can be used. The ideal of placing all investors on a parity

with respect to material information is probably not within the grasp of human attainment, but we can surely do better. When we have discovered instances of the unfair misuse of information before it is generally available to investors, we have brought enforcement actions, but we know that there remains the suspicion among individual investors that they are at a disadvantage relative to the professionally managed institutional investors in terms of the information available and the time when it is available.

We know that our securities markets do not always operate equitably. We still encounter instances of manipulation. But, more important than that, we know that they do not always operate efficiently to absorb large orders without shattering effects on market prices. Perhaps even more serious than the reality is the fear that we know some individuals have that the value of their investments is at the hazard of drastic market fluctuations unrelated to any fundamental change in values, whether or not caused by improper market activity by others.

Most serious of all, we know that our system still sometimes fails to produce timely and accurate information of gross fraud and mismanagement. Even assuming, as we do, that American

industry on the whole is honestly managed with no intent to deceive the public, we must recognize some distressing instances of gross departures from this norm. For all of our laws and regulations and enforcement efforts, American investors have lost some staggering sums through fraud and other dishonest and illegal behavior.

We cannot claim to ourselves or to other peoples studying our system that we have achieved perfection in full disclosure and fair and efficient markets. The question is, is there a better policy to pursue? It is refreshing and comforting to me that, while we tend to emphasize the instances of our failure, foreign observers emphasize the fact that these failures were detected, exposed and punished. Where these examples of failure may shake our faith, they give others comfort.

It is my opinion, in this regard, that the foreign observers are right and the domestic doubters are wrong. Given the fact that we must continue to improve our carrying out of these policies, full disclosure and fair and efficient markets are the goals to be sought rather than resort to other forms of governmental control over our capital markets or the abandonment of controls. The legal and regulatory apparatus constructed over the past 40 years has stood the test of time. Even though we have fallen short of perfection, we have constructed a remarkably strong and stable system able

to weather some fierce storms. The threats to our system of capital formation do not, in my judgment, lie in our regulatory philosophy and efforts, but in other developments.

There are two basic problems that it seems to me we face in the forseeable future. The primary purpose of our capital markets is to raise capital, but trading markets are essential for this purpose and especially for equity capital. There is a substantial market for debt securities that is somewhat indifferent to subsequent market price. But, especially under our tax policy penalizing cash dividends, the willingness of investors to put cash into new offerings of common stock is heavily dependent upon their expectations with respect to the future market value of the stock. The present state of the stock market is such as to seriously impede the ability of companies to raise capital by selling stock. For some period of time one can observe this state of affairs with relative equanimity, especially if one does not own any stocks directly and is not worried about one's retirement funds and so on. There must come a time, however, when this state of affairs becomes an economic and even a social problem of critical magnitude.

American industry needs capital, including enormous sums of equity capital, to meet the economic requirements of the coming decade. This is needed not to satisfy the greed and

materialistic ambitions of corporate managers, but to maintain employment and prevent social upheaval from severe shortages of goods and services we have come to rely upon. This capital will not be supplied voluntarily unless investors see the hope of reasonable gain in supplying it. The difficulties here lie in the causes of inflation, high interest rates and other sources of loss of optimism in the future value of common stocks, and I have no solutions to suggest within the competence of the SEC. I only urge the support of any measures proposed that offer improvement in the prices of common stocks.

The other problem is different but related and somewhat closer to the SEC's turf. It is also more technical. This is our ability to maintain competitive and liquid capital markets, and it relates both to the characteristics of investors and the securities industry that serves investors.

On the investor side, it has often been observed that more and more holdings of and trading in corporate shares are accounted for by so-called institutional investors, meaning pension funds, mutual funds, university endowment funds and other professionally managed funds that typically buy, sell and hold relatively large blocks of stock. In the aggregate, these funds

have been growing both absolutely and relative to the direct investments of individuals. Their trading accounted for something over 70 percent of the volume on the New York Stock Exchange last year, and there is no reason to expect it to decline.

There is a tendency to treat these institutional investors as bad guys in our capital markets as well as our corporate life.

Since they have, often, large sums to invest, they tend to hold large chunks of stock. Some corporate managers, after once being flattered by their interest, have learned to dread them because of their willingness to accept takeover bids at prices over the market and the propensity of some of them to support troublesome public interest proposals at shareholder meetings. From a market point of view, they are a problem in liquidity. If they wish to sell, it may be difficult for the market to absorb their shares without depressing, if temporary, effects upon the market price. It tends to be uneconomic if not contrary to proper investment policy for institutional investors to purchase new offerings of smaller companies. To the extent that institutional investors have soaked up cash that otherwise might have been available for direct investment by individuals, they may have reduced the sources of equity capital for such companies.

It seems useless to deplore the growth of institutional investors. Each presumably serves a useful purpose for its beneficiaries, and there is every reason to expect them to increase in size and number. One cannot hope, for example, that pension funds or innumerable endowment funds get smaller. Apart from any concerns that may develop about concentrations of economic power, the challenge for our capital markets is to provide these monsters with adequate liquidity and to encourage them to greater diversification in some instances.

Adequate liquidity for institutional investors depends in large measure on adequate capital in broker-dealers. Here we face another problem of growing dimensions. Primarily because of fallen prices and low volume on our stock markets, profitability of securities firms has shrunk, and so has capital and their ability to raise capital. At the same time these firms are facing competition and threats of more competition from banks, insurance companies and other institutions. We are participating in programs to make the securities industry more competitive and more efficient, but it remains to be seen whether these measures can succeed without substantial improvements in the markets themselves. Any significant decline in an independent

securities industry and resultant domination by other financial institutions would cause a drastic change in our capital formation facilities.

To sum it up, I think the SEC over its 40 years has seen great progress in providing full disclosure to investors about publicly-held corporations and in providing fair and equitable markets for their securities. I think this progress, which is the envy of the free world, has contributed substantially to economic growth and social stability. We are still far short of perfection, and these policies should be pursued even more diligently and effectively.

At the same time, we must recognize new problems facing our capital markets. The one problem that overshadows all others is the low prices of our corporate stocks. If this situation continues, we face severe economic difficulties. In addition, we must work toward measures that will preserve liquid and efficient markets where institutional investors predominate and that will preserve a healthy and competitive securities industry.