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PHILOSOPHIZING ABOUT SELF-REGULATION IN A DEREGULATORY ENVIRONMENT

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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I. Introduction

"Deregulation," with its many connotations and colorations, has been a focus for at least the past two Administrations. Congress, the Executive branch, and independent agencies have all moved, to a greater or lesser degree, to rescind, simplify, or at least rethink existing regulations. In many instances, heavily regulated and therefore sheltered industries -- including banking and securities -- have been freed from regulatory constraints and competition and marketplace discipline has been enhanced. The Commission has been a participant in this effort and has taken various deregulatory steps during the past few years. All of you are familiar with such matters as reducing paperwork, shortening prospectuses, and, through Rule 415, reducing certain regulatory burdens to be met before selling securities to the public. A general theme has been a shifting of governmental functions to the private sector or simply deference to the workings and discipline of the marketplace.

At the same time, in other areas the Commission has increased regulation. The Commission has imposed strict rules governing stock transfer agents and imposed additional requirements upon foreign issuers, both those trading in the over-the-counter market and those listed on exchanges. In light of activities well-known to all, we are also considering whether the Commission should take a modest step and assert jurisdiction over banks by requiring them to register as broker-dealers under the Exchange Act, or at least to register a subsidiary.

The beginning of the year 1984, with all its Orwellian symbolism, prompts me to reflect upon the inextricably intertwined issues of regulation, deregulation and self-regulation, particularly upon the potential impact of deregulation upon the concept of self-regulation. You will note that my comments today are essentially devoid of legal authority for anything, and instead represent merely one Commissioner's reflections on matters political and philosophical.

II. Why Do We Have Regulation?

So let's begin today's philosophizing with a little history.

First question: why do we have such an extensive scheme of federal regulation for the broker-dealer industry? The answer: What George Orwell did for the year 1984, the Wall Street Crash did for the year 1929 -- they made them both unforgettable. You know the history well. From 1923 to 1929, prestigious investment banking houses sold Americans $6.3 billion in foreign bonds, at undisclosed commissions of up to 14%. By 1931, these bonds were utterly worthless. In the first eight years of the 1920's, prices on the NYSE doubled. In the eighteen months between March 1928 and October 1929, the value of the same shares doubled again. Between October 1929 and July 1932, these same stocks declined in value by 83 percent. Blue chip stocks, including General Electric and U.S. Steel, lost more than 90% of their value.

As the market declined, the stock exchanges -- essentially the only regulators at the time -- seemed either unable or unwilling to step in and police even the most brazen forms of manipulation, self-dealing and overreaching. "Bear raids" and massive "short sale" schemes flourished. The head of the New York Stock Exchange was even financing his personal speculations by embezzling from the NYSE Gratuity Trust Fund, another trust account, and the New York Yacht Club. When caught, he showed no remorse whatsoever. Of course, at the commencement of the Pecora Hearings in 1933, he had proclaimed, "The New York Stock Exchange is a perfect institution."

The excesses of brokers were not the only causes of the Crash and the Depression, of course, and some would debate whether they were the cause at all. And I hope that today's New York Stock Exchange and Mil Batten and John Phelan will not think I am lumping them together with the Exchange of the 1930's and Mr. Whitney or that I am suggesting that times have not changed. They certainly have, and most significantly. But the securities industry's perceived excesses became a symbol -- in a sense a focus of moral outrage on the part of people who felt they had been swindled. Before the federal securities laws, there were virtually no restrictions on entry into the brokerage business or effective regulation thereafter. It seems strange today to remember that a federal regulatory presence in an industry which occupied a significant, fiduciary position, at the time was even thought unconstitutional by many respected legal scholars. Such a federal presence today seems logical and natural, and few dispute its necessity.

III. Why Do We Have Self-Regulation?

The Securities Exchange Act of 1934, and with it the intrusion of a federal presence into the securities industry, however, nonetheless embraced the concept of self-regulation. The Securities and Exchange Commission was designed, in part, to see that self-regulation by the exchanges continued but become more effective. In oft-repeated words, William O. Douglas characterized the relationship between federal regulation and self-regulation of the securities industry, at least in the ideal world, as "letting the exchanges take the leadership with government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready to use but with the hope that it would never have to be used." At this point, I pause to emphasize that the relationship between SRO's and the Commission today is largely characterized by good will, mutual respect, and a spirit of cooperation, and all that is highly constructive.

But it nonetheless is sometimes enlightening and perhaps entertaining to remember how things were originally between the regulator and the self-regulator. The author John Brooks, in the eminently readable book Once In Golconda, tells the tale of the first visit of the five commissioners to the floor of the NYSE in July, 1934.

> "The Securities Exchange Act began functioning on July 1, and a few days later the cops arrived bodily on Wall Street's corner when the five new commissioners came for their first visit to the Stock Exchange. A tight-lipped Dick Whitney led them on a formal tour of inspection, having first taken the precaution of surrounding the floor with guards to restrain any brokers who might seek to do the visitors physical harm. The brokers stared coldly at the commissioners; trading came almost to a standstill; and in this atmosphere of suppressed hostility the new era dawned."

That's the way self-regulation started. At any rate, Section 6 of the Exchange Act required national securities exchanges -- the natural body for oversight in the listed securities' environment -- to register with the Commission. For those of you who are interested in arcane bits of history, the form for such registration has somewhat of a symbolic designation. It's called Form 1, and it still exists today, although I don't think I know many securities lawyers who have ever read it. As a matter of fact, if you say "Form 1" to most securities lawyers, you're likely to be corrected and asked politely if you really don't mean Form S-1. There was, of course, no logical body to act as a comparable over-the-counter

self-regulator. So in 1938 Congress was presented with a choice -- expand the Commission's powers and staff, or encourage the creation of an effective over-the-counter self-regulator. The Maloney Act in 1938 reflected Congress' judgment that self-regulation was conceptually valid and that an over-the-counter self-regulator would avoid the need for an expanded Commission. All that resulted in the NASD. The favorable Congressional attitude toward self-regulation was reaffirmed with the 1975 Amendments and in 1983, when Congress eliminated the SECO program and required SECO broker-dealers to join the NASD.

The virtues and advantages of self-regulation are obvious and have been much touted over the years by the industry and the Commission. By virtue of expertise and close proximity to the industry, an SRO is in a better position to conduct effective surveillance and to discipline those who engage in improper trading activities. An SRO can also set ethical standards and standards of commercial conduct and honor, which might be inappropriate for the federal government, or beyond the Commission's legal authority. An SRO, because of its close relationship with the industry, can be a leader in developing new trading processes and new products. All of that sounds much like "apple pie and motherhood," but those are the arguments, with much validity. But in all of this glow and spirit of self-congratulation, Douglas' characterization of the ideal relationship and the necessary tension between federal regulation and self-regulation must not be forgotten. Any forgetfulness carries with it much destructive potential. More on that in a moment.

IV. Why Do We Have Deregulation?

As much as anything, deregulation is a combined political-legal-social phenomenon. It has a broad impact on numerous agencies, programs and laws, with little discrimination among those agencies, programs and laws. In that respect, many perceive the 1980's to be a radically new era from a regulatory standpoint, perhaps just as radical as the 1930's were compared to the 1920's, albeit in a different direction. History will tell us if that is so.

But the fact is that current themes of deregulation and increased competition in the securities industry predate the current Administration. For example, the 1975 Securities Act amendments were designed to eliminate "unnecessary regulatory restraints" and to remove "barriers to competition" but to allow the industry, not the government, to chart its course. The Commission's efforts to implement the 1975 legislation have involved much deference to industry initiative. Other so-called deregulatory initiatives,

such as integrated disclosure and shelf registration, also have their roots in past years. The elimination of fixed Commission rates and May-Day is another early times deregulatory development. I therefore think it's a mistake to view this Commission's attitudes as radically different from past Commissions.

If all of this has been going on in past years, what does 1980's style deregulation really mean? And what does it have to do with self-regulation? Well, first of all, deregulation is a political fact of life, growing out of the popular frustrations with a complex federal bureaucracy perceived as unresponsive and heavy-handed. As every regulator knows, or should know, however, regulation cannot survive unless the long-term benefits of the regulation, whether characterized in terms of competition, market efficiency, investor protection or other high-standing and laudable goals, outweigh the burdens or costs, however measured. But it seems to me that deregulation must and will be evaluated the same way. With each deregulatory initiative, the effect when the federal presence is removed or lessened must likewise be considered. If not, it seems to me that the practical and political consequence of "over-deregulation" (if there is such a word) is the same as of over-regulation. Neither will last over the long-haul. And, of course, even though regulations may change or be rescinded, the Commission continues to have statutory responsibilities -- full disclosure and investor protection -- and so do the SRO's. Therefore, I would suggest that anyone who equates deregulation with no regulation or with lessened self-regulation may be looking at matters through a defective lens.

VI. The Future of Self-Regulation

With these loosely connected thoughts about history, philosophy and politics, let's try now to focus our thoughts on a specific issue -- the future of self-regulation in today's deregulatory environment. Is self-regulation viable for the long run? Is it stronger? Is it in danger? And does deregulation carry with it the potential for setting the stage for overregulation -- including the unwinding of self-regulation -- when the political pendulum swings, perhaps even moderately.

First, I think it's healthy self-examination to acknowledge that self-regulation in the securities industry has not always been without shortcomings. After all, it was self-regulation that gave us such things as fixed commissions and a baroque system of reciprocal commission practices for years. Perhaps many can remember the late 1960's with all those marvelous commission-sharing arrangements like customer directed give-ups, three-way tickets, four-way tickets,

mirror trades, Aunt Minnie's, and Blind Charley's. Likewise, restrictions on corporate membership and public and foreign ownership of member firms on exchanges hardly stand as shining accomplishments of self-regulation. The same could be said about the back-office crisis and net capital problems of the late 1960's, and a few other things. At the same time, it's only fair to acknowledge that these events are past, and I hear no SRO lobbying to return to that era.

But that's not to say that in some areas questions cannot be asked today about SRO's, and therefore the Commission's oversight of SRO's. From time to time, for example, we are all beat on a bit about progress toward developing something grandly called a national market system, collectively being accused of being dilatory, anti-competitive, parochial, and a few other choice adjectives. I might say that in defense I can come up with a few choice adjectives describing that legislative effort called the 1975 Amendments, but that's a topic for another day.

In some areas of enforcement, such as sales practices and the disciplining of member firms, some would argue that SRO's are not as active or tough as they could or should be. In fact, the Commission has been engaged in discussions with the SRO's, principally the New York Stock Exchange and National Association of Securities Dealers, about a greater SRO presence in the sales practice area. Some arguments against increased SRO involvement in this area are not totally without logic. We are told that an SRO lacks the subpoena and enforcement power given to a governmental authority. That is technically correct. We are also told that SRO's are in a most delicate position when they attempt to intervene in a matter between a member firm and its customers. That point also may have some validity, and the fact is that it is not always easy for an SRO to take the initiative in policing and disciplining its members. Among other things, the industry which supports the SRO may be composed of various constituencies, and the industry is not always capable of unanimous agreement about the detailed workings of SRO's. I suggest, however, that in the area of sales practices, the time may be ripe for greater SRO responsibility and intervention.

Another matter with implications for self-regulation, I believe, is found in Section 15 of the Exchange Act, the so-called "failure to supervise" provisions. Some may view §15 of the Exchange Act as nothing more than an enforcement statute, imposing statutory liability on brokers and dealers. But I suggest that Section 15 is a subtle and effective self-regulatory mechanism as well. It does not define or design specific procedures which firms must implement and enforce to prevent violations. Firms are given free reign, and the firm's internal self-regulatory scheme is the first line of defense. If it is not effective, the governmental presence comes into play in the form of a proceeding, frequently against the firm.

Such actions invariably are controversial and greatly resented by brokerage firms. They also are frequently defended with the argument that the firm didn't do it; that it was just an individual acting on a personal lark. That may be a valid defense in some cases, but it seems to be raised in virtually every case. I find it contradictory to hear elements of the securities industry wax eloquent about self-regulation and self-policing on one hand and then, when problems, perhaps even systemic, occur within a firm, and the Commission acts, the Commission is labelled as heavy-handed and overregulatory. I suggest that self-regulation means that those regulated must start at home. That means within the firm.

I have characterized self-regulation of the securities industry as a valued privilege, and that it is. Yet I cannot pass up the opportunity to observe that in some segments of the securities industry feelings about self-regulation are ambivalent. Last February, the Commission announced that it was considering proposing rules relating to the use of private entities to perform routine examinations of investment companies. Three alternative systems were suggested, including creating one or more self-regulatory organizations. Little support for any of the alternatives has been been forthcoming. Many have expressed fears about costs and concerns about increased and redundant regulation. Some raise considerable doubt whether the Investment Company Act authorizes the Commission to designate an SRO by rulemaking, without statutory provisions such as Sections 19 and 15A of the Securities Exchange Act. If deregulation means increased self-regulation, then most commentators seem to dislike deregulation and prefer regulation.

Perhaps my thoughts about an investment company SRO are a bit far afield from the issue of deregulation's impact upon self-regulation. So let me try to share with you a few personal conclusions.

1. An active regulatory presence in the securities industry is a permanent fixture, whether solely governmental or involving a mixture of government and the private sector. The existing scheme of self-regulation and federal oversight is simply too ingrained in our society and popularly accepted to go away. The statutory goals of the securities acts are as valid as they were 50 years ago, and an era of proclaimed deregulation has not changed that.

2. Deregulation can be fairly viewed as having a goal of reducing the role of government and the cost to the taxpayers at large. One appropriate way to do this is to shift costs and burden to the private sector and improve the efficiency of remaining federal regulation. In other words, deregulation may involve a greater reliance on self-regulation but not necessarily involve a lessening of overall regulation.

3. If deregulation -- at least as I have characterized it -- is to succeed, those responsible for self-regulation will have to assume a progressively greater burden. They also will have to prove that self-regulation is more effective or more efficient than direct governmental regulation. That is a serious challenge not easily met, and lip service to self-regulation doesn't "pull the wagon up the hill."

4. Effective self-regulation, and I emphasize that it must be effective to endure as a concept, can occur only if we all constantly engage in the process of balancing the risk of over-regulating against the risk of abdication of responsibility. It is a thin tightwire upon which we all stand.

5. Under no circumstances can deregulation mean an abdication of statutory responsibilities, because the long-term result will be more regulation. The statutory mandate for investor protection has not been lessened or altered. The concept of investor protection is not outdated.

6. And finally, we can expect 1984 and 1985 to be a time of renewed Congressional interest in the concept of self-regulation and its quality and efficacy. In that process, and if it's not in 1984 and 1985, it will be at some point in the foreseeable future, all of us will be called to account. I'm not sure that's a bad thing. Self-regulation is a fragile privilege, not an irrevocable license. Those of us who support the concept and want it to work must pay the price and bear the discomfort of doing so now. As lawyers frequently say, we better build the record.

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