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RISK TAKING AND CAPITAL FORMATION

An Address by
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NOTE: This is the final draft of Commissioner Thomas' remarks. Although this draft may be quoted, the Commissioner might have made minor revisions during her oral presentation.

Taking substantial, calculated risks to accomplish worthwhile goals has been the unique genius of the American people. Risk takers, adventurers and entrepreneurs alike, discovered and explored America. Vigorous pioneers, willing to forsake the comforts of familiar ways in search of a better life, accounted for much of our westward expansion. Traditionally, it has been risk taking -- the willingness of the American people to explore new ground, to try new products, and to risk total failure in pursuit of tremendous success -- which has been the key to our nation's progress and the heart of its greatness.

Today America must once again draw upon this frontier spirit to confront many of our recurring problems. Inflation continues to erode our faith in a prosperous future. Foreign competition, often subsidized by foreign governments, threatens some of our basic industries. Secure energy resources still remain to be developed. These are only a few of the enormous problems of the eighties. Yet, despite their enormity, despite their apparent tenacity, I believe that the ingenuity of the American people -- the spirit of the West -- will enable us to resolve these complex problems.

Although I can offer no panacea, new capital formation will be a key element in any solution. And encouragement of new capital formation requires a shift away from the official discouragement of risk taking which has -- however unintentionally -- resulted from much of the government regulation in recent years.

In contrast, acknowledgement that risk is often the engine of economic growth can have important public policy implications. Risk is as much an opportunity to succeed as it is to fail, and should be understood as such even in the regulation of the securities industry. In particular, we must consider new ways to assist American business and industry to raise the capital necessary for growth. For certainly increased capital formation will be a significant part of the answer to some of our nation's most pressing problems.

I. Risk Taking and the Western Spirit

The Western spirit to which I refer can be defined as the courage to proceed toward a worthwhile goal despite uncertainty. The American settlers, who suffered numerous and continual hardships developing the New World, shared this spirit. On average, about 15% of those who set sail for the new land never lived to see the shore, and over half of the Massachusetts Bay Colony settlers died during the first year.

After colonies and trade had been established on the western side of the Atlantic, a new generation of adventurous Americans again turned toward the West in search of new beginnings and a better life. New land, new trade and new products, in particular the lure of gold and silver, awaited those who were prepared to risk all. However, although some prospered, many others died along the trail. Nevertheless, with the scattered individual successes came great prosperity for the entire nation.

Although we all recognize that "rugged individualism" has been a key element in our growth and prosperity, government too has played its own significant role. Government can encourage, rather than discourage, risk taking in the quest for rewards. From the decision of Queen Isabella to finance Columbus' exploration, to the enactment of the Homestead Act, government has tried to foster and encourage an environment which engenders, rather than endangers, growth and investment.

Today one has to question whether our government has continued its policy of encouraging innovation and investment. We have to question whether government has let a fear of failure choke our country's innovative spirit, whether its attempt to prevent the failures which often accompany risk has blocked progress. We must question whether it has inhibited the creative energies that have fueled our society. Has the proper balance been struck between the concepts of risk and regulation? Has paternalism replaced pragmatism?

Although government must protect the many from the fraudulent devices of a corrupt few, it must take care not to destroy the ingenuity and entrepreneurial spirit which it initially sought to encourage. Government cannot protect entrepreneurs from their own folly; government cannot shield investors from loss. Risk is inherent in economic activity. We cannot sterilize risk from our economy without killing the economy.

Sterilized and free from all risk, and hermetically sealed by paternalistic regulation, the American spirit would be put on the dusty shelf of history with others that either became too timid or too fat to take the risks necessary to grow and prosper.

Today, more than ever, government must avoid a paternalistic role. We must provide instead a framework that encourages people to overcome fear, to experiment with the new and the untried. I am a new Commissioner, and a newcomer to government, but as a corporate lawyer I have long been concerned by overregulation. We at the Securities and Exchange Commission must help foster the kind of environment which will encourage people to accept, rather than avoid, the opportunity to take a risk in search of reward.

With this background and perspective, three areas of governmental, regulatory and societal risk-taking can be brought into sharper focus.

First, at the Commission, we should explore new ways to simplify our disclosure requirements, recognizing that individual risk-taking continues to be the key to the investment process. Second, we should continue our efforts to reduce the burden of overregulation, while not simply providing another layer of regulation in the name of deregulation. Third, we must acknowledge the increasing internationalization of our capital markets and seek both informal and institutional mechanisms to facilitate the free flow of capital, at the same time remaining sensitive to the needs and interests of our domestic economy.

II. Risk-Taking and Disclosure

The federal securities laws are predicated on full disclosure. As Justice Brandeis stated, "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants"

Although disclosure is generally the best method to prevent fraud and deceit, often the level of required disclosure is in direct proportion to the risk involved in a particular transaction. Some feel that the intent is not to inform the investor of risk, but rather to protect the regulator from criticism in the event of failure of the venture.

In my judgment, our responsibility is not to prevent investors from high risk investments. Our responsibility is to ensure that all of the risks are adequately disclosed. Investors can then make an informed decision as to whether they wish to take the attendant risks. Once all of the material information has been disclosed in an understandable fashion, our duties as regulators ought to be perceived to be discharged. Rules designed to regulate the type or merit of permissible investments are not in the best interests of either individual investors or the economy as a whole.

In short, under the federal securities laws, the entrepreneurial spirit was intended to remain very much alive.

It is not enough, however, that the federal securities laws are disclosure oriented and not deterrent in intent; they also must be administered in a neutral and unbiased fashion. This point can

perhaps best be exemplified by stealing a page from history. The early colonies were begun with the formation of publicly-held, chartered trading companies, companies organized for profit with shareholders throughout England.

The first two companies, London and Plymouth, were organized in 1606. Unfortunately for their stockholders, these early companies proved to be dismal failures and folded in 1624 and 1635, respectively. However, fortunately for our nation, this history of failure did not deter other vital investors. The Massachusetts Bay Colony was chartered in 1629, and its history has been told too often to need recounting here.

Given this history, how would we, as modern day disclosure experts, have required the prospectuses for these publicly-held trading companies to have been drafted? Certainly, we would have required disclosure -- in bold-face type -- of the uncertainty of life in the new world, the harshness of the northern climate and the rockiness of the land, and we might have required disclosure of the fact that few direct economic rewards could be expected; that there were no proven reserves of milk and honey.

Having required these disclosures (obviously with a bit more detail so the investor could understand the gravity of the warning), is there much more to say? Of course, there was other

information which could have been disclosed. For example, we could have required disclosure of the specifications of the ships, a soil analysis of the colony's farm land, a description of the market for tobacco and corn, or the risks of use of tobacco, or the benefits of polyunsaturates in corn oil. And what about those beads and trinkets for the Indians -- were they questionable foreign payments?

I believe, however, that once our historical investors were told, in frank and forthright terms, of the risk of failure and the uncertainty of reward, the minute detail merely diverts attention from the central issue. Indeed, I am quite concerned that an overly-detailed disclosure document, although completely fair and accurate, can, in fact, obscure effective disclosure. We often confuse investors with long descriptions of the trees without ever showing them the forest.

III. More Effective Prospectuses

Accordingly, a rethinking of our disclosure requirements may now be appropriate. The premise of the federal securities laws is that each individual investor should have the opportunity to make his or her own evaluation of the potential risks and possible rewards of an investment. It is incumbent on the Commission, therefore, to ensure that disclosure documents are as understandable to investors as possible. Yet, especially in high-risk offerings, there is a great temptation on the part of the Commission to demand a volume of information -- some would say,

a degree of mystery -- which makes these documents unreadable and incomprehensible to the public. Many of the Commission's well-meaning disclosure requirements have turned out not to be in the interest of the average investor, but, at best, are meaningful only to certain securities professionals.

For my part, I believe that our disclosure documents should be purged of information which public investors do not find useful. There should be a separation of the most germane -- and the most readily understandable -- information from the larger body of materials which may be less informative to the general investing public.

In this vein, I would encourage the Commission to continue to rethink its disclosure requirements with an eye to producing, as a first priority, an understandable document. We should consider, for example, requiring issuers to prepare and to furnish to investors a short-form prospectus -- a document limited to the most salient investment information. The Commission's current practice of requiring a summary of the prospectus at the front of the document is well-meaning but inadequate. I suspect that, once the summary is bound together with the full prospectus, the entire two inches of printed information looks so foreboding that many investors never read even the three or four page summary at the front. If it is too heavy to carry home in a person's briefcase, it probably never gets opened.

Instead, I believe we should risk an experiment with a requirement that two separate documents be distributed to investors. One would consist of the traditional disclosure material, pared down as much as possible but still useful to professional analysts who, in large measure, determine the public market, and useful to others who care to consider all the intricacies of the issuer. The second document would be a short-form -- unforbidding -- prospectus in large type and in as few words as possible. The short form would provide only the most relevant information and a broad warning about the risks of the venture.

To ensure that the utility of such a short-form prospectus would not be undermined by boilerplate-producing attorneys and underwriters, I would suggest that it should be subject to some sort of prescribed length limitation. If the Supreme Court can decide cases of the gravest constitutional consequence on the basis of arguments limited, by rule, to 50 pages, I would hope that we can find some way to require the key elements of an investment decision to be written in fewer than ten pages.

IV. Deregulation

Turning next to the issue of deregulation, it is important to note that the Commission already has done a fair amount to alleviate the burdens its regulations impose on business. We have broadened the small issuer exemptions from '33 Act registration (the basic securities registration requirement),

simplifying their use and increasing the maximum dollar amount of securities an issuer can offer to the public without registration. For registered public companies, we are integrating the '33 Act and '34 Act periodic disclosure requirements, and introducing a system of continuous registration. We have made it easier to resell privately-placed securities, and alleviated the plight of inadvertent investment companies.

As a Commissioner, I support these deregulatory initiatives. Indeed, I support going even farther than we have, and I expect that, over the next few years, we will do so.

Nevertheless, there are some real risks associated with deregulation. Each of the many rules of the Commission no doubt was imposed in response to some real problem. When the time comes to remove or amend a given rule, it may be impossible to know precisely the extent to which that old evil still lurks in the shadows. But the time has come to have the courage to take the risk.

Unfortunately, it appears that Congress is not yet ready to take the risk involved in real regulatory reform. As you may know, Congress has been considering for several months a variety of measures to reform the federal regulatory establishment. As a general matter, I support legislative deregulation.

However, Congress' approach to regulatory reform apparently is to add to the work of the agencies a welter of new procedures which are somehow supposed to make the agencies more sensitive to the cost that their rules impose on business. For example, the Regulatory Reform Act now pending in Congress would require that all rule-

making, regulatory or deregulatory, be accompanied by a statement of the data and methodology upon which the agency is relying, a memorandum of law describing the agency's authority to issue the rule, and an explanation of how the agency's factual conclusions are substantially supported in the public record. If the rule is deemed to be a "major" rule, the agency also would have to prepare a detailed cost-benefit analysis, as well as a discussion of alternative approaches.

As I have written and said before, I believe these measures are misdirected. They strike me as attempts to add more regulation in the name of deregulation. Added procedures involving production of memoranda and other documents do not automatically produce added sensitivity. They simply produce more bureaucratic paper-shuffling and more expensive government.

In addition, Congress is attempting through the Regulatory Reform Act to reform all of the agencies in a single sweep. The problem is that there are significant theoretical and practical differences among the various agencies which seriously limit the viability of this approach.

I have already noted, for example, that the SEC has had for several years a vigorous program of deregulation and reform. Other agencies have found deregulation to be more difficult within their current statutory mandates.

Yet, the Regulatory Reform Act will apply equally to all agencies. It will add a great deal of cost and complexity to

the work of agencies, like the SEC, that are already engaged in deregulation. All rulemakers, even when they are working to alleviate the burdens of existing regulation, will have to jump through the new procedural hoops that Congress is creating in the name of reform. In that sense, the Regulatory Reform Act will be counterproductive.

How should Congress be approaching regulatory reform? It ought to risk an examination of each of the agencies individually and rethink whether their mandates are still valid and whether they currently reflect an appropriate balance of conflicting societal goals.

V. Internationalization of the Capital Markets

A final area of risk-taking does not depend on whether deregulation continues or whether government officials will risk new approaches to old problems. The evolving international market for securities will be thrust upon us irrespective of our wishes. Events are overtaking our system of regulation. Like it or not, we now have a fairly substantial international securities market, but no uniformity or consistency in regulating that market. The outreach of the securities laws of various developed nations creates confusing and conflicting overlap in some cases, and wide gaps in proper regulation in other cases. The IOS/Vesco fiasco provides many examples of each. Furthermore, the regulatory systems of different nations are guided by different philosophies of regulation and corporate disclosure.

These philosophical differences result in barriers to a sensible, emerging, world securities market.

Although many specific, technical proposals have been advanced, I believe that for the long term we will need both informal and institutional responses to this emerging field. At an informal level, we need greater coordination among the concerned nations. We must develop communication between international regulatory officials to respond better to transnational securities fraud. Such efforts can reduce duplicative investigations and unnecessary regulations so that one nation can defer to the expertise or interests of another nation.

Informal communication, however, cannot resolve structural barriers to the development of a world securities market. Institutional efforts are needed, both here and abroad, to accommodate foreign corporations seeking to raise capital in our markets under our disclosure system, and our corporations seeking to raise capital in other nations' markets. For example, accommodations may be necessary for corporations whose financial statements are in compliance with the home country's accounting conventions, but not with ours. Flexibility may be needed regarding our segment reporting requirements which foreign companies view as an anathema. While these types of accommodations may sound straightforward, their drafting, implementation and acceptance will be a difficult process. Even though I strongly believe that the free flow of capital

and the internationalization of the securities markets is to our nation's long-term benefit, we must be careful that, in our efforts to accommodate foreign concerns, we do not place domestic corporations at a competitive disadvantage.

VI. Conclusion

In all of these areas, as individuals and as a society, we must not allow risk to deter us from embracing the future. We can ensure that understandable and useful information is provided to public investors -- while not insulating them from reasonable risk-taking. We can select government officials who are willing to risk deregulation. We can ensure that the international marketplace remains fair and open.

In the final analysis, America's ability to prosper depends on our personal strength and our willingness and freedom to make decisions in an uncertain environment. America must continue to rely on her pioneer spirit of individual risk-taking, and government should encourage it. We must return to the optimism on which our country was built, remembering that only with risk can come the real promise of reward. Risk-taking was the foundation of our historic economic development and will be the basis for our future economic recovery. Rejecting the cautious safety of paternalism, I look forward to participating in the Commission's efforts to facilitate economic revitalization. For only through capital formation, driven by the risk-reward incentives, can we help to keep our country great.