REMARKS OF
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"THE REGULATORY ENVIRONMENT"

Before The
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ASSOCIATION OF STOCK EXCHANGE FIRMS

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At the Commission we have a broad disclaimer which is used by those authoring articles and which reads as follows:

> "The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission . . ."

In view of the fact that my remarks here today have not been considered by my colleagues on the Commission, I am adopting the disclaimer and I shall claim sole responsibility for anything which I shall say.

First, it seems appropriate that we revisit breifly the Securities Exchange Act of 1934 to indicate the relative statutory roles which Congress intended the exchanges to play in the regulatory pattern and also the role intended to be played by the Securities and Exchange Commission. The preamble says:

> "* * * transactions in securities as commonly conducted in securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, * * * and to impose requirements necessary to make such regulation and control reasonably complete and effective. * * *"

The Act sets up the procedures for self-regulation in the securities industry subject to oversight responsibilities placed in the SEC. I think it fortunate that the Congress gave clear recognition to the concept of self-regulation, for this form of regulation, if properly implemented, can best serve the needs of the brokerage community as well as the needs of the investing public.

We know one of the principal reasons self-regulation was put in our statutes was that it was believed the securities industry itself might be in a better position to evaluate and resolve its own problems in a changing environment than might be the case with direct and pervasive regulation by a government agency which necessarily could not be on the scene every business day.

In many important respects Congress placed the job of regulation in the public interest squarely with the industry. As members of the Exchange, you are in a real sense regulators, just as I am, and your responsibilities encompass the major activities in the industry and most of the issues which are of major concern at the present time. The job of self-regulation has been well described by Mr. Justice Stewart's comment in the Supreme Court decision in Silver v. New York Stock Exchange:

> "The purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry."

The privilege of self-regulation involving such a vital public interest was not granted without oversight and review. That oversight and review was lodged in the Commission and it was given the final responsibility and authority for carrying out the Congressional mandate for regulation of the securities industry. An early Chairman of the SEC envisioned the Commission's oversight role 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 for use but with the hope it would never have to be used."

The House Committee in 1934 in this same vein also observed:

> "Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped that the effect of the bill will be to give to the well-managed exchanges that power necessary to enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise."

Without the regulative oversight of the Commission, the Court in the anti-trust decision last week in the Thill case could not have said, as quoted in the press, "Judge Reynolds, in his opinion, indicated he believes the SEC is properly exercising its duties of supervision over the Big Board's commission structure and that the SEC's supervision was sufficient for control of the Exchange's practices."

While we share with you the responsibility of seeing to it that the vital national public interest is protected, if the concept of self-regulation is to work you must retain the initiative and the initial responsibility.

All of us are very familiar with all the trials and tribulations which were occasioned by the back-office problems of the industry and which extended over many, many months. I put this in the past tense because it is not only my hope but my belief that the worst is now over. However, I would be less than candid were I not to say that although we have apparently weathered that storm, the more I have learned about it since the worst days have been over, the more serious I consider it to have been. I know that the industry, the Exchange and the Commission learned a great deal from the experience and that today everyone is in far better condition not only to recognize the problems but to deal with them. I must say, however, that the risks which were involved in that experience were far too great to be permitted to happen a second time. The very fact that we skated so near the brink in that experience reaffirms my conviction that perhaps our number one project as regulators is to anticipate crises rather than merely to react to them. For example, figures developed by the Commission show that during the period leading up to the time of greatest back-office stress, the brokerage industry generally, and the New York Stock Exchange firms particularly, were hiring and training registered respresentatives at a far disproportionate rate to the hiring and training of the personnel needed to handle the increased sales generated by those well-trained and, for a time at least, well-rewarded registered representatives. Somewhere in the regulatory pattern a red flag such as this should have indicated the congestion which was bound to follow.

Although it has not received much attention, probably one of the most serious results of the back-office difficulties has been the irritation and disillusionment of the customer. While we attach importance to the improvement in the reduced number of fails, we at the Commission are now faced with the clean-up involved in the tremendous number of complaints of customers. I am sure all of you are sensitive to the impact of customer relations and investor confidence on the profitability of your individual firms, and on the strength of the securities markets. While I am reluctant to tell you that you have been and still may be driving customers away, you should know that the Commission is receiving complaints from the public in unprecedented numbers about the services rendered, or rather not rendered, to them by their brokers. A few years back, written complaints could be numbered in the 100's. In 1967, we received under 3,000 complaints, of which 67 percent were related to back-office problems. In 1968 the number of complaints grew to 3,500 and again the majority concerned the back-office log jam. In the first six months of 1969 we received over 6,000 complaints and the number is still running well over 1,100 per month. Ninety percent of those complaints relate to the back office.

Customers are complaining about delayed delivery of securities for periods ranging as high as 18 months or more; delayed delivery of funds; errors in statements of account which go uncorrected for months and which compound the original errors. Not the least, the complaints speak of discourtesies ranging from outright rudeness to simple delays in acknowledgment of complaints, or requests for information, and failure to keep the customer informed of developments in the solution of his problems. Obviously, the number of complaints received by the Commission constitute only a fraction of the total number of transactions taking place in the markets today. We know, however, that firms are receiving as many as 25 or 30 for every one that we receive, and that far more citizens simply suffer in silence. In spite of the improvement in July, 1969, 1 out of every 8.4 transactions was a fail.

In fairness, I hasten to admit that the Commission has also had a serious and annoying back-office problem and also due to increased volume. We have the additional problem that when your volume dropped we expected ours would follow, but such has not been the case.

In its fiscal year ended June 30, 1969, 4,706 registration statements were filed with the Commission covering offerings of approximately 87 billion dollars of securities. I repeat, 4,706 filings involving 87 billion dollars as compared with 2,906 in fiscal 1968 covering approximately 54 billion dollars of securities. The latest available figures indicate that the pace continues. In July and the first three weeks of August 553 registration statements were filed as compared with 505 filings in the comparable period of 1968. At present there are 1,717 pending registration statements in various stages of processing by the Commission's staff.

COMMISSION RATE STRUCTURE

Putting aside the SEC's back-office problems, the matters we are discussing substantially affect the profitability of the industry. Certainly none of us and particularly I, want it to be anything but profitable. Unless firms can operate at a profit the public cannot be well served. All of us know the industry generally has -- so to speak -- gone from feast to famine. Just when everyone got geared up for 15,000,000 share days we suddenly moved into 8,000,000 share days.

The rates of commission and other charges is the number one subject relating to future profitability of member firms and is a most important area in which exchanges are permitted to establish rules of practice with respect to their membership. By the same token, one of the most important statutory responsibilities of the Commission is to assure that these rates, if they are to be fixed, are reasonable to both the public and the industry. For more than a year now, the Commission has been engaged in a broad-based factual inquiry into the problems associated with the stock exchange commission rate structure. By any criteria, these problems include the most difficult issues facing the industry and the Commission, but their continuing complexity cannot delay their resolution. The Commission and the industry will have to make the hard decisions which are required. For my own benefit, it would be more than helpful if someone would give me an educated guess as to whether we should do our figuring on the basis of 15,000,000 or 8,000,000 shares.

The initial phase of the hearings disclosed that the levels of compensation for large volume orders under the then existing rate structure were excessive. This is demonstrated by the numerous arrangements and devices for sharing income with recipients who had no connection with the transaction. The extent to which brokers had been willing to negotiate with mutual fund managers for the sharing of commissions and the nature of the practices devised to distribute the commissions evidenced that the commission charge for large orders was a fixed minimum in name only. Following these disclosures, all exchanges adopted an interim rate schedule providing a volume discount, unique in 175 years of stock exchange history, in recognition of the available economies of scale. Moreover, they coupled this rate structure with a prohibition against so-called customer-directed give-ups.

The volume discount is credited with producing an annual saving of $150 million for investors who deal through institutions. What its other effects may have been is not yet clear but obviously the effects have been far-reaching when measured by firm's income, outgo, and resultant profit or lack of profit.

As the hearing progressed, I gather the conclusion was reached that it would be difficult, if not impossible, to develop a rational defense of the then existing commission rate structure and level. The New York Stock Exchange then announced that it had employed the services of an outside economic consultant to conduct a study and make recommendations respecting a new rate schedule more closely cost-related than the present one and in quotes more "rational."

The Department of Justice testified in these proceedings that standards for judging the reasonableness of any minimum rate structure cannot be devised and that the Commission should abolish the rules of the Exchange which provide for the fixed minimum commission.

As the hearings concluded the Exchange urged that the Commission await the results of the Exchange's study before resolving the basic question of whether there should be a minimum rate schedule. The Exchange has represented that the study will afford a basis for developing a fixed minimum commission rate which will achieve the desirable results of competition and do so without risking the adverse consequences to the securities markets it foresees from negotiated rates.

In his August 26 letter to the NYSE membership, which we saw in the press last week, the President of the NYSE indicated that based on preliminary data obtained thus far by the Exchange and its consulting firm, a revised commission rate structure may require, among other things, increased rates on small transactions by the small investor. This letter came very much as a surprise to the Commission and its staff and we have not yet had the benefit of seeing the data on which this suggestion is based.

In view of the representation to us that the study will not be completed until the end of the year we are, of course, curious as to the basis for this suggestion. Others must be too, for we have already received several inquiries from within and without the government.

New innovations designed to meet competition in the market have arisen which promise to bring some of the issues in the commission rate structure hearings to a head. Consider, for example, just four of the portents for change which have come to the front since the rate structure hearing began on July 1, 1968.

1. The development of automated trading information systems.

2. Action of one regional exchange permitting membership by publicly owned financial institutions which have no captive sales organization.

3. The action of a major institutional brokerage firm in resigning its exchange memberships to conduct its business in the third market.

4. The decision of another well-known exchange member institutional brokerage firm to seek the capital available from public ownership without obtaining the prior approval of the exchange.

Since these developments the New York Stock Exchange announced the acceleration of its commission rate study to present a new commission rate structure proposal by the end of 1969. Also it has announced that accompanying the Exchange's public ownership proposals would be proposals on the related matter of institutional membership and revealed that the Exchange has under study the possibility of granting access to institutions in some form of associate membership.

I am expressing no opinion at this time on the desirability of any of these developments or whether the changes they suggest are consistent with the standards in the Exchange Act. These and other developments in the industry will have an immediate and also a long-range impact on those employed in the securities markets and on their profitability. They will have a corresponding impact on those who have regulatory responsibilities. They illustrate that the problems associated with the commission rate structure before the Commission are dynamic -- not static. The decisions which are required -- and which will be made -- must resolve the needs of both the investing public and of the broker-dealer community.

The Commission has directed its staff to prepare analyses of the issues involved in the commission rate structure hearing. Because of the urgency of these issues decision of any one cannot be deferred until a decision is reached as to how all should be resolved.

AUTOMATED TRADING SYSTEMS

The development of market communication systems has been the subject of intense activity in the last several years. Improvements have been sought both in the block trading market and the over-the-counter market. In these two areas more than any other there has been a need for rapid collection and widespread dissemination of market information.

Existing communication facilities for small block and round-lot trading in listed securities appear adequate. A different story exists in the over-the-counter market where the marketability of unlisted securities is discernable only through day-old pink sheets or direct communication with numerous marketmakers. Likewise, purchasers and sellers of large blocks of listed or unlisted securities have had to depend on the initiative and ability of their broker to "shop around" to find market interest in particular blocks. The advances in electronic data processing have made it possible to develop systems responsible to the needs in both of these areas. Thus, the need for current over-the-counter quotations hopefully has been satisfied by NASDAQ, a computer system sponsored by the NASD to be operational in 1970. This system envisions three levels of service and will permit marketmakers to furnish current quotations for national broadcast to trading departments and also to furnish current representative quotations for use at the retail level.

Communication advancements have also proceeded apace in the large block trading area. We are all acquainted with Instinet, Autex and the New York Stock Exchange's BAS.

The proposed systems have taken a variety of forms. Some are private profit-making enterprises. Some are sponsored by quasi-public organizations. There are also variations as to who may subscribe, who may put information in the system, and who may receive information from the system. As a result of these variations, the Commission and its staff have been required to assess each individual system's potentials in terms of how it cuts across our statutory responsibilities. Since each system possesses the capability for widespread and instantaneous dissemination of market information, there appears to be a need for the Commission to establish some regulatory basis from which to protect the public from potential abuses such as fictitious quotations, fraud, market manipulation and the like.

Automated trading systems for block trading have also presented new and interesting regulatory problems. Part of our problem is that the technology which led to the development of these systems was not envisioned when the 1934 Act was passed. Rule 15c2-10 was proposed by the Commission on August 4, 1969, in response to the need for some regulatory control. That proposal provides that no broker or dealer may operate or participate in any automated trading information system unless a plan describing the system and detailing specific rules of operation designed to prevent abuse of the system and providing adequate record-keeping has been submitted, and declared effective by the Commission.

In the release announcing the proposal, the Commission invited comments both on the question relating to the appropriate regulatory status of the various automated trading information systems and on the regulatory pattern which would be established under the Rules.

Some basic regulatory controls seem mandated by our statutes. However, I doubt that anyone can now foresee all of the problems that this new technology will raise from a regulatory standpoint or what impact this new technology will have on the securities markets. To give an example, finding a customer for the other side of a block trade has been one of the services afforded by institutional brokers. To the extent that this is accomplished by automated systems, we cannot now guage what impact will occur on the profitability of broker-dealers who heretofore have not had the ability to find the other side and, by the same token, on the reportedly small number of brokers who have heretofore had that ability. We may also ponder whether automated systems which enable institutional customers to trade blocks without the services of a broker-dealer will substantially affect the income and profitability of the securities industry as presently constituted. Likewise, it is not clear what impact automated trading information systems will have on the choice of markets. Since finding the other side of a large block has been one of the services paid for by brokerage commissions, it is also difficult to tell what impact automated trading information systems will have on the level of commissions paid on large transactions. Changes have been taking place rapidly and it seems to me that on the subject of automation our work, and yours, has really only begun.

MUTUAL FUND LEGISLATION

Another area I would like to touch on for a few moments is the mutual fund bill. I am sure you are well aware of the long effort to deal with the problems raised by the spectacular growth of investment companies and particularly the mutual fund segment. Mutual fund assets have increased from $450 million when the Act was passed in 1940 to nearly $58 billion today. There are now about thirty funds, each of which holds more assets than the entire mutual fund industry in 1940. In fiscal 1967, 108 new investment companies were registered with the Commission. This figure was 167 for 1968, and in 1969 it was a record 222. There is every reason to expect that investment company growth will continue at an even more accelerated pace in the years to come.

In 1940, Congress anticipated that investment company growth might at some future time create problems and directed us to report on them when they raised important issues involving the public interest. In 1958, the Wharton School of Finance and Commerce was commissioned to conduct a study. Its report, published in 1962, as well as the Special Study of the Securities Markets, in 1963, called attention to some of the more important -- and pressing -- problems. In 1966, after an extensive staff study, the Commission reported to Congress, its own evaluation of the public policy questions raised by these studies and shortly thereafter submitted its legislative proposals.

In the two and a half years that have followed, the bill has seen a full, and sometimes repetitive, series of hearings and refinements. As Senator Sparkman pointed out during the floor debate last year, this has certainly been one of the most carefully studied pieces of legislation to come before the Congress in recent years. As it stands today each of the three major legislative proposals has been modified in certain respects.

First, the Commission's original proposals would have limited the sales load for investment company shares to five percent of the amount received and invested by the investment company. The bill would replace this provision with a grant of jurisdiction to the NASD similar to that which the NASD has in the over-the-counter market. It would be authorized to adopt rules designed to prevent "excessive sales loads" but allowing for "reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads" to be charged investors. The Commission would have oversight authority similar to that which it has generally over the NASD.

The second major area in which the Commission made recommendations was that of management fees. The Commission recommended that the Investment Company Act be changed to specify that management fees should be "reasonable" and to provide for court enforcement of this standard. Prior to this session of Congress, the Commission and its staff consulted with industry representatives from time to time and repeatedly expressed its willingness to attempt to work out provisions in this area which would be acceptable to the industry as well as the Commission. Following the 1969 Senate hearing, the Commission's staff and industry representatives resumed their discussion of this matter, and agreed on a substitute for the reasonableness standard. This substitute was originally suggested by Senator McIntyre and provides that the investment adviser has a fiduciary duty with respect to management fee compensation. This is the standard in the bill passed by the Senate, and in H.R. 11995 introduced in the House by Congressman Moss. The Commission believes the controversy over management fees has been resolved in a manner consistent with our original recommendation.

Third, the bill recently passed by the Senate and now in the House would not, as originally recommended by the Commission, abolish the front-end load. Instead, two alternative methods for employing the front-end load are provided. Under the first alternative, contractual plan sellers may continue to sell plans with the presently authorized front-end load, under which up to 50 percent of the first year's payments may be deducted for sales commissions. However, if an investor elects for any reason to redeem his underlying shares for cash during the first three years, he would also be entitled to receive a refund of the amount by which all sales charges paid exceeded 15 percent of the total payments made under the plan. In addition, contractual plan sellers could at their option elect a second alternative. Under this alternative, the bill specified a formula whereby the load could not exceed 20 percent of any payment nor average more than 16 percent over the first four years.

Of course, there are many other changes which would be made by the bill. In fact, there are over 40 other amendments which we believe are necessary. The solutions which have emerged and which are now before the Congress will provide important and needed protections for this Nation's five million mutual fund investors. Although I would not speculate on a definite date, I am optimistic that this Session of Congress will enact the first major revisions of the Investment Company Act since its passage in 1940.

RESTRICTED SECURITIES

There is one other current topic of concern in the investment company area I would like to discuss, and that is the ownership of restricted securities or "letter stock" by investment companies. The magnitude of these holdings can best be illustrated by a few figures from a staff survey of the annual reports filed with the Commission by registered open-end and closed-end investment companies which indicated that these companies owned better than four billion dollars worth of restricted common and convertible securities at the end of 1968.

Holdings of restricted securities pose a number of difficult problems for investment companies. Valuation of an investment company's portfolio affects the price that purchasers will pay for shares and, in the case of open-end companies, the amount shareholders will receive on redemption. Valuation can also have significant effect on a fund's apparent performance and management's compensation.

The open-end company ought to retain maximum flexibility in the choice of portfolio securities, which, on the basis of their relative investment merits, should be sold to meet redemptions. To the extent that the portfolio consists of restricted securities, this flexibility is reduced. While restricted securities remain restricted, they may not be publicly sold -- nor can they be distributed to redeeming shareholders as an in-kind redemption. While they may be sold privately, there may not be sufficient time to obtain the best price since the date of payment or satisfaction may not be postponed more than seven days after the tender of the company's redeemable securities for redemption. A private sale within that period may result in the investment company receiving less than its carrying value of the restricted securities. This would result in a preference in favor of the redeeming shareholders and a diminution of the net asset value per share of shareholders who have not redeemed. Therefore, instead of arranging a private sale of restricted securities, an open-end company that is faced with redemptions may decide to sell unrestricted securities which it would have otherwise retained on the basis of comparative investment merit.

At the present time, the staff is conducting an extensive evaluation of the restricted securities activities of registered investment companies and we hope that the study will illuminate their effects on corporations and investors. I wanted to mention this area and our concern with it since the Commission expects to make an announcement concerning this matter shortly.

Because of the prestigious escutcheon which you emblazon on your front door in gold leaf, you who are gathered here today should feel particularly privileged to actively participate in self-regulation. That sign "Member, New York Stock Exchange" conveys exactly what you intend it to convey -- that is, that your firm is a member in what has been for many generations the largest security trading mechanism in the world. Customers are attracted because they have faith and reliance not only in the integrity of that firm and its exchange, but also that the affairs of the customer will be well and expeditiously transacted. That expectation, and I emphasize this, should not be limited to transactions in securities listed on the Exchange, but to all transactions -- small or large -- executed in any market for any customer.

You as the professionals and I as an oversight regulator must never forget that we are involved not only with one of the most important but with one of the most basic and essential industries in the world. Without the securities industry and its markets, America could not have the economic, social or political system which it has achieved. Without it, the world would not have the progress and stability pioneered and produced by American corporate production and services, and research for future production and services. The reason the people not only of the United States but of the free world will surrender their savings for the slips of paper in which you deal is because they have confidence in the integrity of that slip of paper. They have confidence not only in the inherent value which it represents, but also they have confidence that they bought it at a fair price in a fair and efficient marketplace. Although there have been dark periods, that confidence has been earned by the New York Stock Exchange over a period of 175 years.

That confidence has, however, been greatly enhanced since those days in 1929, which some of us elder citizens vividly recall, and I am satisfied that at least some of the credit for that enhancement is due the pattern of regulation adopted by the Congress in 1934. I am satisfied that without that pattern of regulation there would not be the confidence in that slip of paper which is the product of your marketplace nor would there be the confidence in your marketplace as a fair and efficient place in which the investor does his marketing.

In conclusion, it seems that there has never been a time since the adoption of the Securities Act when so many decisions need to be made. Accompanying each of those decisions will be regulation -- more in some areas, less in others. When we think of the matters now before the regulators such as the changes in the basic structures and operations of the Exchange due to institutional trading and other factors, the complexities of commission rates, public ownership, electronic trading, anti-trust considerations, institutional membership, and the many others I am sure that you agree simply to enumerate them makes one wonder how and when all of them can be successfully resolved. It seems obvious that more fundamental changes will occur in the next two years than in the past twenty.

The end question which I ask not only you but myself is this: in the division of responsibility between the self-regulators whom you represent and the government which I represent, where should the lines be drawn? What is the proper role of the government as to the questions enumerated and the new ones just over the horizon? Should the government simply let matters evolve and have the decisions made by the industry, by economic and other forces, or should the government decide the questions and cause these things to happen or prevent their happening by actions of the Securities and Exchange Commission? Or, as a third alternative, should the government attempt, in conjunction with the self-regulators, to influence the course of events in those directions which seem the wisest?

It seems to me that the government's course should and must of necessity be determined at least in large measure by the willingness of the industry through self-regulation to accept the responsibilities and shoulder the burdens. I would assume that the course taken by the government will be in direct ratio to the willingness and ability of the self-regulators of the industry to do those things which must be done. It is my hope that you in the first instance and we in our oversight capacity may be successful in discharging our responsibilities. Between us, we should be able to plan ahead to accomplish those things which will improve the industry, better our markets, and better serve the investor.