

REMARKS OF

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Some Comments on Federal-State Regulation
of the Securities Markets

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Introduction

It is indeed a pleasure to be here today and participate in your fine program.

When securities markets are unsettled, there is sometimes a confusion as to the effectiveness of the markets and the economic forces which affect them. In recent months we have been reminded -- sometimes forcefully -- that prices in free markets can decline as well as advance. It can be fairly said, however, that no country has ever developed a better market system for trading and investing in securities than that which has been developed in this country. We are justifiably proud of the regulatory standards which have been developed on the federal and state levels for the regulation and supervision of our securities markets. Moreover, we all are looking for areas where improvements can be made. As a result of these efforts, investors, both large and small, can invest in our markets with the assurance that market forces rather than manipulative forces are determining the day-to-day prices which they pay and receive for their securities. It is vital to our economic growth and development that our securities markets continue to operate fairly and free of artificial restraints.

Recent Developments

The task of discharging our respective regulatory responsibilities is perhaps more difficult today than any time since the early Thirties. This is due largely to the tremendous growth experienced in all phases of our securities markets during the past decade. Many of the problems confronting the securities industry, the states and the Commission, stem from the difficult adjustments which had to be made. A few statistics may help illustrate the more significant trends. In 1959, there were about 12½ million individual shareowners, including owners of mutual fund shares. By 1965, this figure had reached 20 million, and at the start of this year there were an estimated 31 million shareowners. Additionally, 100 million have participated indirectly through their savings,

insurance policies and in pension funds. Trading volume exceeded every expectation. While the volume of shares traded on all registered stock exchanges has declined in the first six months of this year, about 18 percent from its 1968 first half highs, it rose 156 percent between 1964 and 1968. In the over-the-counter market the increase also has been substantial. As the overall volume has increased the mix of this volume has significantly changed. While the block volume (trades of 10,000 shares or more) on the New York Stock Exchange has risen from less than three percent of total volume in 1964 to fourteen percent today, the number of transactions in the last two years on that exchange has dropped by 28 percent; and in the same two-year period, the one-hundred-share round-lot transactions are down 35 percent and the odd-lot volume is down 37 percent, while transactions of 10,000 shares and over have more than doubled.

One of the most noticeable trends and one which is currently the subject of major study in the Commission, is the rapid growth of institutions. It is estimated that, at present, the major financial institutions, i.e., investment companies, insurance companies and private noninsured pension funds, as a group, account for over 60 percent of the value of public trading on the New York Stock Exchange. The size of institutional orders has also risen substantially and over 70 percent of them are for over 1,000 shares. This explains, in part, why the number of trades has declined more than share volume over the last two years. Portfolio turnover of the institutions continued to increase until the first quarter of this year. Leading this increased activity were the mutual funds, whose turnover rate increased from 19 percent in 1964 to 50 percent last year, and is at a current rate of 39 percent. The major institutions as a group have been heavy net buyers of stocks in recent years and in fact their net acquisitions have been larger each year since 1963 with a record \$9.6 billion total added last year. This was more than a fifth greater than in 1968. While net stock acquisitions of these institutions thus far this year are still greater than in the

comparable period of 1968, they lag somewhat behind the record total of last year. Nevertheless, if the transactions of mutual funds which tend to follow the market trend were excluded from both periods, the net acquisitions of the other major institutions would have set a new record high in the first six months of this year.

The securities industry did not fully anticipate some of these market developments. When I first came to the Commission in 1964, for example, an official of the New York Stock Exchange predicted that by 1980 NYSE volume would reach 8 to 10 million shares a day. Of course, trading volume in this range soon became routine. In one day in 1968, volume of the NYSE exceeded 21 million shares. However, in fairness, it must be said that no one really foresaw in 1964 the tremendous surge of activity which was imminent.

Not unexpectedly, the changes in the securities markets had their impact on the Commission's work load. This was so even in periods when security prices were declining. We still have more business than we can handle. During the year I first joined the Commission, 1964, there were a total of 1,192 registration statements filed under the Securities Act. I watched this number progressively increase to 1,376 in 1965, 1,697 in 1966; 1,836 in 1967; 2,906 in 1968, until it reached a record high of 4,706 in 1969. During the last fiscal year, a total of 4,314 registration statements were filed. Recent indications are that the number of filings may be declining in comparison to last year.

The Division of Corporation Regulation, which is responsible for the review of filings made by investment companies registered under the Investment Company Act of 1940, has been faced with the same increased workload as the Division of Corporation Finance. At June 30, 1964, there were 731 investment companies registered with the Commission. As of August 31, 1970, this number had risen to 1,329, an increase of approximately 82 percent since 1964. Even during the recent market decline Securities Act registration statements and post-effective amendments filed by investment companies continued at a high level. In fact, since January of this year, 977 of such statements were filed and in August, 70 were filed.

Federal-State Cooperation

The dynamic changes in the securities markets which have been experienced in recent years and the ever growing number of public investors have made us increasingly aware that a constant vigilance on our part and yours will be necessary to maintain the fairness of our markets. This will require the greatest of cooperation between federal and state authorities since it is obvious public investors cannot be placed in "federal" or "state" categories any more than can the violators of the securities laws -- we have the same "constituents" to protect.

Although we have the same objectives, we have not always been as effective as we are today. As you are aware, the first comprehensive securities statute in the country was a state statute enacted in Kansas in 1911. By the time the first federal securities legislation was passed in 1933, 47 of the 48 states then in the Union had enacted blue-sky laws of their own. The federal government is a relative newcomer to the field of securities regulation, having entered the field on the heels of the chaotic conditions in the 1930's when the increasing interstate nature of securities transactions and modern business made it apparent that a federal statute was needed to correct the abuses in the securities markets and to supplement the state statutes. But the federal securities laws were not intended to displace the state statutes. The state and federal statutes are complementary parts of a statutory plan designed to prevent inequitable and unfair practices, to protect commercial and credit systems, and to insure the maintenance of honest markets in securities transactions. In the years that I have been on the Commission, I have noticed that material improvements have been made in the working relationship between the Commission and state agencies. We have had the good fortune to be assisted in our efforts by our own Hugh Owens, a tireless and enthusiastic exponent of federal-state cooperation. The current program is something in which we can all take pride, because it exemplifies effective cooperation. Let me review briefly the major areas of this program, since each of you may not have experienced every aspect of it.

There is of course a basic difference in approach as between the federal government and some states in the laws governing the public offering of securities. The federal statutes, of course, do not authorize the Commission to pass on the merits of particular securities. Rather, we are largely limited in this area to assuring full and fair disclosure. Some states, of course, have authority to consider the merits of the securities involved. However, the joint application of these two systems affords significant investor protection when the states review securities offerings for compliance with fair and equitable standards, and the federal government requires full and adequate disclosure of all pertinent information. In addition to making these complementary systems work, there is almost a daily exchange of information with respect to securities registrations, trading data and other information relevant to your daily activities. Where possible, the states and the Commission conduct joint inspections of broker-dealers so as to conserve manpower, to train new personnel and also to prevent unnecessary duplication of activity.

To further strengthen our cooperative efforts, we also have sponsored regional enforcement conferences. This program, which is operating on a national basis, is now entering its third year. At these regional conferences, attended by Commission personnel, staffs of the Securities Commissions, Post Office inspectors, Federal, State and local prosecutors and local representatives of self-regulatory agencies such as the NASD, there is an exchange of information concerning regional enforcement problems, discussion of methods for increasing cooperation and communication and for conserving resources and manpower. Although the Securities and Exchange Commission has served as the coordinator in establishing these cooperative enforcement conferences, we are pleased that they have progressed to the point where State Securities Commissions are now more often the hosts or co-hosts of the program.

The Commission's annual training program has been enlarged to include all the states and representatives of foreign countries. Indeed, at our session this past May, in addition to representatives of numerous states, there were staff people from France, Canada and Brazil in attendance. Also, there has been active cooperation in numerous actual enforcement cases of mutual interest.

No regulatory program can be effective unless it is coupled with vigorous enforcement and surveillance. Failure to enforce rules strictly at all levels of regulation leads to an inevitable weakening of the regulatory scheme, whether it be in the disclosure area, the fraud area or in providing for the financial responsibility of broker dealers.

Although the Commission has always attempted to maintain a strict enforcement program, we have also operated under the basic principle that the securities industry should make every effort to keep its own house in order, not only because this is what the Congress intended in granting it the privilege of self-regulation but also because compliance is fully consistent with good business practice, the protection of investors, and the general public interest. The application of this principle has led the industry to develop such basic tenets as "know your customer" and the "due diligence" concept, both of which are grounded in sound business practice. Wholly aside from the legal risks encountered by a person who engages in a distribution of unregistered securities or who unlawfully extends credit to customers, no businessman following sound business principles is likely to commit his underwriting capital without knowing the full background of the issuer and no businessman is likely to enter into brokerage transactions on behalf of a customer without assurances that the customer has the ability to meet his financial obligations. These are, of course, only two examples.

Another important principle that we follow is the blending of regulatory and enforcement programs. While we must be alert to move against fraudulent activities, we attempt to be selective in our choice of enforcement targets and endeavor to choose cases whose impact may assist our

regulatory goals. Our efforts to eliminate trading by corporate insiders on the basis of non-public information and our efforts to curb shell corporation promotions demonstrate this principle. It is our hope that the actions brought by the Commission in the Texas Gulf Sulphur case, the Government Bond cases and the Van Alstyne Noel case have served to emphasize the importance of strict adherence to the principles applicable to insider trading. Similarly, with regard to shell promotions, the Commission has issued an interpretive release and proposed a new rule in combination with several enforcement actions such as the Capitol Holding Corporation and North American Securities cases. I might also observe that when the Commission first addressed itself to the shell corporation problem, more than 50 percent of the new issues quoted in the "pink sheets" were issued by shells. While a number of unscrupulous promoters undoubtedly became rich from the "shell game," these promoters drained money from a market place that could ill afford to lose such a scarce commodity. Had this money not been put into shells it undoubtedly would have gone into legitimate existing enterprises and to venture capital. In this connection the Commission has urged the NASD to institute adequate safeguards to prevent the unscrupulous from attempting to play the "shell game" with the NASDAQ system which is scheduled to become operational by the end of this year. The NASD has responded to this concern by establishing standards for the listing of securities in the system. With the cooperative efforts and assistance of brokers participating in NASDAQ, it is hoped that these standards will be sufficient to assure the system's basic integrity.

I would like briefly to mention a few recent examples of how our mutual enforcement program has worked. In the recent action involving Arkansas Loan and Thrift Corporation, the State of Arkansas asked for Commission assistance because of the serious nature and scope of the violative conduct. We ultimately uncovered a multi-million dollar fraud and were able to obtain a permanent injunction against the persons involved and the appointment of a receiver to preserve the remaining assets for public investors. The civil proceedings was then followed by criminal action which resulted in the conviction of three of the principals of the company. A fourth awaits trial.

Currently, we are working on a number of matters where we have joined efforts in obtaining state receiverships to preserve the assets of companies issuing securities to the public. Often this occurs in situations in which the securities were originally offered pursuant to an intrastate offering licensed by a state commission or situations in which the investors are confined to one geographic area. In such cases, even though violations of federal law may exist, we have wherever possible worked with state commissions and sought state court receiverships. With your assistance we are also enlisting the aid of state prosecutors to bring more securities cases in the state courts. Indeed, one of our current investigations which has international implications was brought to our attention by one of your members. We are presently assisting one state with its conduct of a study of "hot issues" and have been actively working with a number of states in situations involving the insolvency of broker-dealer firms.

Aside from our joint activities in the enforcement area, the Commission is also keenly aware of your other interests and you are to be complimented on the roles you have taken in the development of regulatory measures to deal with the emerging problems in the sales of oil and gas interests and in those problems presented by real estate and mortgage investment trusts. I am also mindful of the steps that many of you have taken to stamp out the unlawful pyramid and multi-level dealership promotions as well as your endeavors with respect to curtailing franchise frauds. It seems evident that the further along we proceed in our cooperative efforts, the more our respective roles become complementary rather than duplicative. We are all faced with mounting budgetary limitations and many of our budgets have not expanded fast enough to keep pace with the growing workload. This, of course, means that if the responsibilities that have been entrusted to all of us are to be met, we will have to rely on each other to an even greater extent in the future.

Conclusion

If we have learned anything from past experience it is this: neither the federal government nor the individual states, standing alone, can provide the regulation necessary in the increasingly complex securities industry. However,

acting as a partnership, we have and can continue to contribute in making the securities market in the United States the finest anywhere. But, if we are to continue to perform our job well, we must be ever alert to develop new methods to cope with tomorrow's sophisticated markets. In addition to more fully utilizing the available computer technology, we must develop new techniques of surveillance, safeguards against manipulation, and most of all, we must increase our cooperative efforts. Thus, I believe that it may not be too far in the future before the Commission, through your efforts, will be able to retrieve necessary information on almost a real time basis from any place in the 50 states. Similarly, each of you, through the Commission's assistance, will be able to reach beyond your borders to develop your important cases. In this way, securities promotions which, because of the modern methods of communication and transportation are virtually impossible to confine within state lines, will be promptly eradicated. I look forward to the achievement of these goals and I am sure with your support they are attainable.