FOR RELEASE UPON DELIVERY OF SPEECH

"THE MALONEY BILL"

ADDRESS

of

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Commissioner, Securities and Exchange Commission

at the

ANNUAL DINNER

of the

NEW YORK SECURITY DEALERS ASSOCIATION

at

Hotel Waldorf-Astoria

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Mr. President and Gentlemen:

I was most happy to receive and to accept the invitation to come here tonight and take part in your meeting. For some reason which I shall not expose to the risk of analysis, we have seemed to understand each other whenever we have met. I cherish that understanding. It is my earnest hope that it will continue so long as we have anything to do with each other. In speaking tonight after a good dinner and on so convivial and pleasant an occasion, there is a temptation to avoid serious subjects. But that temptation must be resisted and I shall speak of a matter involved with your affairs, to be precise—the Bill recently introduced into the Senate by Senator Francis T. Maloney of Connecticut, generally known as the Maloney Bill. It deals with the over-the-counter market in securities, that market off the organized securities exchanges where securities are bought and sold. In 1934 when the statute for the regulation of Securities Exchanges was enacted and the Securities and Exchange Commission came into existence, it was recognized that the importance of the over-the-counter markets in and of themselves would justify a system of regulation, and that effective regulation of those markets was necessary to prevent evasion of exchange regulation. It approached unfair competition to regulate one market and not the other. Consequently the over-the-counter markets were dealt with in the Securities Exchange Act of 1934 - though very briefly - in Section 15 of the Act. The principal provision of this section was that the Commission might adopt rules and regulations concerning the over-the-counter markets "necessary or appropriate in the public interest*** to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges." When this statute was adopted in 1934 the investment bankers were operating under a code promulgated under the National Industrial Recovery Act (N.I.R.A.) Section 15 left much to be desired both as to form and substance. The Commission and apparently everyone else, with perhaps some exceptions, had very little authentic data as to the over-the-counter market which was regarded as a sort of *terra incognita*. As a result the Commission confined itself to creating a simple system for the registration of brokers and dealers in the over-the-counter market with some rather elementary standards for qualification and revocation. I seem to recall that about this time it was proposed by a small group in the industry that the administration of the N.R.A. Code be transferred out from under the aegis of the National Recovery Administration to the S.E.C.

In May of 1935 the Supreme Court of the United States handed down its decision in the Schechter case (Schechter Corp. v. United States, 295 U.S. 495) holding unanimously that the National Industrial Recovery Act was unconstitutional. The principal basis for the decision was that the Act provided for the making of laws in the shape of Codes, that the power and duty of making laws was vested by the national constitution exclusively in Congress and could not be delegated, assigned or given away to anyone else. In other words, the Court in effect said to the code authorities, what a former President is reported to have said to his wife when he thought she was tendering too much advice on how to run the country: "You weren't elected to anything." Thereafter it was represented to us by men in the investment banking field that their code had worked very well, and that some effort ought to be made in the interest of some form of self-regulation under the supervision of the Commission and within such permissible constitutional boundaries as the opinions in the Schechter case had indicated. The Commission was willing to consider such a program and in 1936 the Investment Bankers Conference, Inc., was formed. One of its objectives was to work with the Commission on the proposal just outlined.

In 1936, after a year and a half spent in accumulating experience and some further knowledge of the markets outside the exchanges the Commission recommended and Congress adopted a new Section 15. In Section 15(a) it provided that no broker or dealer should use the mails or facilities of interstate commerce unless he was registered with the S.E.C. Provision was made in Section 15(b) for registration and the Commission was empowered to deny registration or to revoke it for a few rather elementary causes which I need not now repeat. The Maloney Bill does not repeal or amend Sections 15(a) or 15(b). Those sections did not and do not require the registration of brokers and dealers devoting themselves exclusively to the purchase and sale of municipal securities, even though they use the mails and the facilities of interstate commerce.

In 1938 Section 15(c) was also added to the statute. It provides that no broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the sale or purchase of, any security (other than certain exempt securities) otherwise than on a national securities exchange by means of any manipulative, deceptive or other fraudulent device or contrivance. The Commission is authorized to define by rules and regulations such devices or contrivances as are manipulative, deceptive or otherwise fraudulent. This section does apply to brokers and dealers in municipal securities. Under the authority of section 15 we have registered about 6800 brokers and dealers and have issued only a few rules attempting to define manipulative, deceptive and fraudulent devices We have found that in certain quarters various unethical and unconscionable practices are being carried on which, despite their undesirability, are probably beyond the reach of statutory law. The Maloney Bill proposes to enact an additional section called Section 15A and to amend Section 15(c) of the Act. It has been sent to the Senate from the Committee on Banking and Currency with a favorable report. Section 1 provides that associations of brokers and dealers *may* register with the Commission as national securities associations or as affiliated associations. Associations which do not register are not denied the use of the mails or facilities of interstate commerce. The formation and registration of associations is a matter of voluntary choice. Membership in such a registered association does not obviate the necessity for brokers and dealers to register under the present Section 15(a) of the Act. To qualify for registration as a national securities association certain qualifications must be met. Such associations must either be actually nation-wide in scope or should represent a substantial and economically cohesive region. To this extent such matters are left to the associations themselves. Whether one or more large national associations will result or whether national associations will be based on divisions similar to those which exist under the Federal Reserve System is not predictable. The national association must satisfy the Commission that its general pattern of organization and its general character are such that it will be able to discharge its functions of carrying out the purposes of the new Act. All brokers and dealers who conduct an honest and responsible business shall be eligible for membership in some association. Particular associations may however by their rules restrict membership therein on such specified geographical basis, such specified basis relating to the type of business done by their members or on such other specified and appropriate basis as the Commission may approve in conformity with statutory standards. A broker or dealer may be disqualified for membership if he has been and is expelled or suspended from another registered securities association or from a national securities exchange for a serious infraction of rules, or if an order of the Commission is in effect denying or revoking his registration under Section 15(a), or expelling or suspending him from a registered securities association, or from a national securities exchange, or if his conduct while employed by, acting for or directly or indirectly controlled by a broker or

dealer was a cause leading to any suspension or expulsion of the character described which is in effect with respect to that broker or dealer. Provisions are included designed to assure to each member reasonable representations in all phases of the operation of his association, to restrict dues to an amount necessary to defray reasonable expenses of administration and that such dues shall be fairly allocated among the members.

The functions for the accomplishment of which the association accepts responsibility are found in the standards governing eligibility for registration. The rules of the association must be designed to prevent fraudulent and manipulative acts and practices, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, to promote just and equitable principles of trade and in general to protect investors and the public interest and to remove impediments to and perfect the mechanism of a free and open market. The rules may not be designed to permit unfair discrimination between customers or issuers or brokers or dealers, or to fix minimum rates, or impose any schedule of prices or to fix minimum rates or impose any schedule of commission allowances, discounts or other charges. The rules must provide that members shall be appropriately disciplined for violation of its rules. Discipline may be expulsion, suspension, fine, censure or other fitting penalty. The rules must provide fair and orderly procedure for proceedings leading to discipline.

A registered national securities association may be required or permitted to provide for the admission of an association registered as an affiliated securities association upon certain terms and conditions. The purpose of this is to enable soundly organized associations, which are local in character and hence not eligible for registration as national associations, to retain their identity as registered associations. A registered association may withdraw from registration by filing a notice of withdrawal but the Commission may take steps to assure an orderly liquidation of the association.

Any disciplinary action taken by a registered association against a member or any denial of admission is made subject to review by the Commission. This may be set in motion by an application to the Commission for review or by the Commission on its own motion, and either such course automatically stays the action of the association pending the review.

The proposed Act provides that a registered securities association may by its rules provide that no member thereof shall do business with any broker or dealer who is not a member of any registered securities association except at the same prices, for the same commissions and fees and on the same terms and conditions as are accorded to the general public by such member. These economic sanctions should aid effective discipline within the association and exclusion from such an association would be comparable in effect to expulsion from a national securities exchange.

The registered associations must file with the Commission such information as is needed to keep current the original registration statement. No change or addition to the rules may take effect until the thirtieth day after filing copies thereof unless the Commission orders an earlier effective date, and the Commission may prevent the change or addition from taking effect unless it appears to the Commission to be consistent with the requirements of the Act. The Commission is authorized, after notice and hearing to abrogate any rule of a registered securities association if this is found necessary or appropriate to assure fair dealings by its members to assure a fair representation of its members in the administration of its affairs, or otherwise to protect investors or effectuate the purposes of the Bill. The Commission may by order alter or supplement the rules of an association

with respect of four subjects all relating to the organization and operation of the association and not to the business conduct of the individual members. But the Commission must first request the association to adopt the specified alteration or amendment and can act only after notice and opportunity for hearing. The Commission is authorized after notice and hearing to suspend or revoke the registration of an association if the Commission finds that such association has violated any provision of the Exchange Act, of the rules and regulations thereunder, or has failed to enforce compliance with its own rules or has engaged in any other activity tending to defeat the porposes of the new Act.

The Commission may likewise, after notice and hearing, suspend or expel from a registered association any member who is found to have violated the Exchange Act, or who is found to have wilfully violated the Securities Act of 1933, or has aided another in doing so. The Commission is not empowered to suspend or expel a member for violation of an association's rules. It is empowered after notice and hearing to remove from office any officer or director of a registered association who is found to have wilfully failed to enforce the rules of the association or has wilfully abused his authority. Exclusively municipal brokers and dealers are not within the provisions of Section 1 of the Maloney Bill. By forming their own associations and not registering they violate no law of the United States so far as I am aware. To this point I have outlined too sketchily, I fear, the principal provisions of Section 1 of the Maloney Bill.

The Bill as first presented granted the Commission authority to alter or supplement the rules of these associations to an extent not permitted by the present version. Such action by the Commission would not have affected over-the-counter firms which chose to avoid membership in an association. For this reason, as I understand it, the provision was looked upon with disfavor by committees and individuals affiliated with the Investment Bankers Association and Investment Bankers Conference, Inc. They stated that the provision was inconsistent with the fundamental of self regulation, that it would place members of registered associations under broader regulatory powers of the Commission than non-members and hence at a potential disadvantage competitively, that it might require the associations to take over the work of enforcing the criminal law which was said to be more appropriately the Commission's function, and that the broad powers which the provision gave the Commission over the rules of the Association might deter firms from joining such an association. In response to these criticisms, the Commission agreed to support before the Senate Banking and Currency Committee the industry's proposals that this provision be removed. In its place, there was substituted a provision granting the Commission authority to make rules and regulations governing brokers and dealers engaged in the over-the-counter markets within the Federal jurisdiction and regardless of any affiliation with any registered association. This provision was embodied in a new section 2 of the Maloney Bill. That new section, as then proposed, extended the powers of the Commission beyond those now found in Section 2. In its original form, Section 2 amended the present subsection (c) of Section 15 of the Exchange Act to give the Commission a number of additional powers, all of which applied to brokers and dealers whose business exclusively is municipal securities. It was in this manner that the original Section 2 got into the Maloney Bill. It was not "sneaked" in or gotten in by trickery as some have charged. We don't do business that way. Nor does Senator Maloney. The Commission in its approach to whatever statutory amendments it has supported and in drafting forms and various rules and regulations has constantly sought the advice and criticism of those most directly affected by its proposals. It will continue

to do so. It has acted on the principle expressed by Mr. Justice Cardozo, in his concurring opinion in the Schechter case, that "when the task that is set before one is that of cleaning house, it is prudent as well as usual to take counsel of the dwellers." If the Commission ever decides to recommend to Congress that some system of disclosure through the medium of registration ought to be required as a protection to investors in connection with either the distribution or subsequent trading in municipal securities through the facilities of the mails and interstate commerce, it will say so clearly and explicitly.

But to resume my outline of the Maloney Bill in its present form. As you know, Section 2 has been modified and limited since its introduction. It now empowers the Commission to enact rules to prevent fraudulent, deceptive or manipulative acts and practices and to prevent fictitious quotations. These provisions apply to all brokers and dealers, including those who do business exclusively in municipals, who use the mails and the facilities of interstate commerce. Section 29(b) of the Act, which provides that contracts made in violation of the rules under the Act shall be void, applies to violations of such rules, as does Section 32 of the Act, which prescribes criminal penalties.

Section 2 likewise gives the Commission certain additional powers; namely, by rule and regulation to provide safeguards with respect to the financial responsibility of brokers and dealers, to regulate the manner, method and place of soliciting business and to regulate the time and method of making settlements, payments or deliveries.

Contracts made in violation of a rule of this type are void under section 29(b) of the Act only if the rule is one as to which the Commission shall determine and expressly provide that it is necessary and appropriate that Section 29(b) shall apply. Furthermore, criminal penalties do not attach to violations of rules of this type, except violations which consist of making false and misleading statements in reports or documents filed with the Commission. Moreover, rules of this type do not apply to transactions by brokers and dealers in exempted securities, which includes municipals.

Finally, the Maloney Bill amends Section 17 of the Exchange Act, to make every registered association subject to the same duties as to the keeping of records and the making of reports that are now imposed by Section 17 on every registered broker and dealer and every national securities exchange.

The exemption in favor of municipal brokers and dealers expressed in the amendment proposed by Senator Bankhead, found great favor with most of the members of the Senate Committee. It was included over the objection of the Commission. The Bill never did provide for, and the Commission never sought control over municipalities or over the issuance of securities by them. It has said so repeatedly in private and in public before the Senate Committee. I see no valid reason for excluding those men who make their money through buying and selling municipal securities from the provisions which apply to those of you who make your money through buying and selling private corporate issues. They are made of the same clay as you and I. I see no valid reason why the investor buying a municipal issue should not know whether the man handling the purchase for him is his agent or a principal dealing on his own behalf. The fact that a man is engaged in buying and selling municipal issues does not make him a sacrosanct or a different kind of man from the fellow across the hall who buys and sells corporate securities.

Some days ago we asked members of our staff to provide us with some figures about municipal dealers in the United States. They report that at best they can only estimate the number of dealers who specialize exclusively in municipals. It seems fairly certain that they are the exception and not the rule and not nearly so numerous as the general securities dealer. It is estimated that the exclusively municipal dealers in the country do not come to more than ten per cent of all over-the-counter brokers and dealers, and probably they are much less than ten per cent. Since we have about 6800 brokers and dealers registered with us, it seems that between five and six hundred would be the upper limit on the number of exclusively municipal dealers. A recent check of the firms and individuals listed in the Security Dealers of North America Red Book indicated that of the unregistered brokers and dealers in the country, only 310 deal exclusively in municipal securities.

A study of the banks, brokers and dealers participating in municipal offerings of $100,000 and over during the first half of 1937 has been made. We are told that three types of firms participated in their offerings -- (1) registered brokers and dealers (2) banks and trust companies, and (3) unregistered brokers and dealers. Obviously, the latter must be the exclusive municipal dealers. A count was made of the number of syndicates whose participations included all three types of firms and it was found that, in the period defined, syndicates of this type offered 109 issues aggregating $466,939,500. This was the largest group. The next largest group consisted of syndicates in which only registered brokers and dealers participated. These syndicates handled 193 issues totalling $110,608,578. Next in line came the syndicates composed exclusively of banks and trust companies and these distributed ten issues totalling $13,815,500. The smallest group was the syndicates of unregistered brokers and dealers, the municipal dealers, who handled 32 issues amounting to only $7,107,000.

A further breakdown of these figures indicates further the minor part played by purely municipal dealers in important financing. One issue of $60,000,000 was handled by 40 firms, 38 of them registered and two unregistered. Another issue of $50,000,000 was handled by 47 firms, of which 36 were registered with the Commission, 8 were banks or trust companies and 3 were unregistered firms. In a syndicate of 35 firms handling a $47,000,000 issue, 34 of the firms were registered and one was unregistered. Other issues and syndicates showed similar proportions and, if the figures for the first half of 1937 are typical, it follows that the part played by the exclusively municipal houses is not a leading one. These premises pose the possibility that the chief activities of the exclusively municipal houses are in the buying and selling of issues which have been outstanding for some time, an important element in the problem since is is estimated that in November 1934, 2654 taxing districts in 40 states were in default as to an aggregate indebtedness in principal and interest of $2,225,000,000.

I am not contending that trading in these securities is not a legitimate business, or that the maintenance of the secondary market may not be necessary to complement original distributions of municipal issues. I am contending that the men engaged in it should be subject to the same regulation as other securities dealers; that they should be held to the same legal and ethical standards as other dealers; that such regulation, far from injuring municipal financing, should in the long run improve the quality and reliability of municipal financing; that

their exclusion from parts of the Maloney Bill smacks of unfair competition as to those who deal in other types of securities and those who deal in other types and municipals as well.

Returning, however, to the Bill as it has been reported -- It is not a novel or revolutionary reform measure. It is rather the result of years of insistent effort on the part of leaders of your profession to bring a greater element of organization, of order and of self-discipline into what on a national scale has hitherto been a poorly defined field of activity. Your own organization, the New York Security Dealers Association, has made a distinguished contribution to this movement and it is particularly gratifying to us at the Commission that your Association, which I believe has had greater experience and greater success than any other organization in the over-the-counter field in creating and enforcing a cohesive system of effective self-regulation, should have through Mr. Dunne, your President, taken such a courageous and progressive position before the Senate Committee on behalf of the Bill.

Whatever the history of the Bill it seems plain that the over-the-counter market should submit to regulation. About 6760 firms of brokers and dealers are registered with us. There are 1375 members of the New York Stock Exchange and 647 member firms. Over-the-counter quotations for at least 60,000 separate issues are published in services to which brokers and dealers subscribe, whereas only about 6000 issues are admitted to trading on all the stock exchanges of the country. A great deal of trading takes place over-the-counter even in securities admitted to trading on exchanges even by members of the exchanges, and many high-grade bonds and preferred stocks not admitted to trading on any exchange have their only market over the counter. This market not only provides a medium for an immense volume of trading but it is also the principal channel through which the savings of the nation flow into new financing. Unfortunately, every successful business attracts an undesirable element and some serious abuses have been found in the over-the-counter market. In 1937 the Commission made investigations in three areas outside the large financial centers, in Cleveland, Detroit and the Pacific Northwest. A few attorneys and accountants were sent to make a flying survey. In the space of a few months thirteen individuals were criminally convicted, sixteen more were placed under indictment, seventeen corporations and forty-one individuals were enjoined and two firms were expelled or compelled to withdraw from national securities exchanges, all for elementary violations of law. I have in my brief case and I wish I had time to read to you the script of a radio broadcast used Sunday mornings by a securities house in a western city. It is out of business, it has been fined by the state, enjoined by the Federal Courts and its customers have suffered substantial losses. Its broadcast is made up of such hymns as "Fairest Lord Jesus," homilies, flag-waving, praise of the trading corporation and one of them ended with a hymn that struck a prophetic note, "God Will Take Care of You."

Some of the differences of opinion about the Maloney Bill are due, in my opinion, to failure to agree on a definition of self-regulation. Yet when Mr. Douglas, our Chairman, spoke in Hartford a month before Senator Maloney introduced the Bill, he stated that self-regulation did not mean private law making; that it did mean "first, self-discipline in conformity to law - voluntary law obedience, so complete that there is nothing left for government representatives to do - second, * * * obedience to ethical standards beyond those any

law can establish." It was Josiah Royce, according to Arthur Krock of the New York Times, who said that liberty exists through forestalling legal restraint by self restraint.

Sometimes I think the ultra conservatives of our day realize the principles of the Schechter decision rather slowly. The framework of the Maloney Bill is an effort to foster self-discipline within the law and the confines of the national constitution, to permit self-regulation subject to a tolerant government supervision designed to help set the general course and not permit private interests to overcome the public interest. It is an effort to create a legal framework for cooperation between your government and your business. It is not enough to say that we favor cooperation between business and government. It is necessary to work out the mechanics and tools for that cooperation. One way to cooperate is for business and government to sit down together and try to devise intelligent laws and then for business associations to insist upon its members obeying those laws.

What are the chances of failure if the Maloney Bill becomes law? If the associations do not compel their members to live up to the laws, to eschew unethical practices if control of the associations falls into the hands of a few, if they are used to monopolize the securities business, or to force poor issues into the hands of the weak members for the profit of the strong members, if the associations are run as merely private clubs or are used to satisfy grudges or in any way as instruments of oppression, failure will follow and the experiment written off as a loss. If the Commission does not exercise a wise and beneficent supervision, or bears down too much or too little, failure will follow. But I have a belief founded somewhat perhaps on wishful thinking that the Bill if enacted will be a success. Enlightened self interest points the way for the industry. The Investment Bankers Conference, Inc., and I say this despite some differences of opinion with them as to certain details of the Bill, has shown a spirit which augurs well for the future. I understand the Investment Bankers Association now supports the Bill. Your own Association has made an outstanding success. With little by way of precedent to guide you, you have achieved much in maintaining good standards of conduct, good order in your own field and good treatment of the public. I hope it continues. These are the grounds of my optimism. If we all fail the alternative is for the Commission to ask Congress for more pervasive powers in the over-the-counter market. If we succeed, we not only improve the condition of our own affairs and relieve government of greater burdens but we promote the public interest.

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