



**SECURITIES AND
EXCHANGE COMMISSION**

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**REGULATION AND THE STRUCTURE OF THE
SECURITIES MARKETS**

Remarks By

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Securities and Exchange Commission

November 30, 1972

**SECURITIES INDUSTRY
ASSOCIATION**
Boca Raton, Florida

Last year I had the pleasure of addressing the first meeting of what was then the newly-formed Securities Industry Association. I reviewed what your industry had accomplished in applying the lessons and overcoming the deficiencies revealed by the time of troubles during 1968-1970. We discussed what had to be done to lay the basis for that renewal of public confidence which is necessary if our capital markets are to meet the needs of the future. Since that time, studies, policy formulations, legislative proposals, new rules and disclosure requirements have emanated from the committees chaired by Senator Williams and Congressman Moss, and from the Commission which I chair. As we stand here today, we can point to specific things which have been put into effect, and other issues which are in the process of being resolved or as to which proposed solutions have been formulated. We can see much more clearly the outlines of a nationwide market system which promises greater depth, greater liquidity, greater competition and more complete information to attract and serve the American investor.

Major steps have been taken to strengthen investor protection: the guarantee of customer accounts, over-the-counter clearing, a system of depositories, better back-office systems are all in operation.

On January 15, brokerage firms will establish reserves to protect customers' cash and be required to segregate customers' securities promptly or add additional cash to that reserve.

Next week the Commission will publish for comment a new uniform net capital rule.

After 40 years of mystery and uncertainty, we published this week standards on how companies can raise money in a private offering. This, together with Rule 144 on the sale of restricted stock, Rule 145 on the issuance and resale of shares in merger and acquisition transactions and Rule 147 on intra-state sales, on which we are still working, will complete our program to create greater clarity and certainty in the rules governing stock transactions.

We expect to introduce new disclosure requirements applicable to 1972 financial statements which will bring out into clear public view the use and the significance of accounting and tax elections which can exaggerate gains in earning or obscure operating losses.

I believe we are about to see a new climate of regulation. Senator Williams has been holding some very interesting hearings on the very important subject of the continued viability and basic structure of the unique institution of self-regulation, or cooperative regulation, as the House Committee chooses to call it. Cooperative regulation, adopting the House label which we tend to prefer, has been a basic part of the pattern of Federal securities regulation since 1934.

Growth and change in the securities markets, particularly since 1966, has thrown a strain on the self-regulatory mechanism and in fact changed in part the basic issues with which cooperative regulation had to deal. It has come to include, to a significant degree, not only adherence to ethical standards of conduct, but also participation in the resolution of major economic issues. Some have suggested that cooperative regulation is no longer viable in this new environment. We at the Commission disagree. Cooperative regulation is still necessary, but it must be strengthened and so also must the oversight which the Commission exercises over the process. Experience has shown inconsistencies and gaps in such oversight which

resulted from its development and various legislative decisions over a period of some 20 years. We have suggested legislation to the Congress which would strengthen our oversight and fill some of these gaps. This is the more necessary because cooperative regulation encounters problems when it must deal with economic issues. On these, economic interests of elements of the industry may diverge and may also conflict with the economic interests of others. While cooperative regulation is not incapable of resolving such issues, it needs assistance to avoid misguided decisions or paralysis as a result of conflicting interests among its constituents.

At the Commission we are working to make regulation easier to live with and at the same time more effective through greater clarity in our rules, by promulgating guidelines and by adding an educational dimension to our regulatory efforts. We will begin publishing guidelines on insider transactions early next year. We are working with members of the industry to develop a standard compliance manual. Recognizing that regulation entails costs and burdens, we have advisory committees reviewing reporting and recordkeeping requirements imposed by the Commission and the self-regulatory agencies to see if they can be simplified, consolidated and otherwise made less burdensome.

In reviewing our progress, we can't afford to turn our heads away from the problems still to be met. Since the Commission brought the level at which minimum commission rates may prevail down to \$300,000, transaction costs have been reduced for large investors. But it is anomalous that the record shows today that substantial publicly-owned brokerage firms which function at the very heart of our capitalistic economy are being valued by public investors at only 5, 6 and 8 times earnings. This kind of valuation will not attract the capital which the securities industry needs if it is to perform its function in raising money and making and maintaining the markets which will be needed to fuel our economic growth and meet the needs of institutional and individual investors. One way this situation can be improved is to simplify operations and reduce costs in handling the stock certificate and the paperwork associated with securities transactions. Movement must be reduced, paperwork standardized and duplication of operations facilities eliminated. This calls for a single nationwide integrated, modernized system for the clearing, transfer, payment and custody of securities. The proposed Securities Transaction Processing Act--better known as the "transfer

agent bill" -- the basic principle of which seems to be acceptable to both Houses of Congress, fell by the wayside in the closing hours of the last Congress. I believe and hope that there will be no obstacle to the early enactment of this legislation in the next session of Congress. On this assumption I have asked the Commission staff to do whatever can be done now so that no time will be lost in implementing this kind of legislation as and when it is enacted. I say this because I think it is important for the banking and securities industries to recognize at the earliest moment that insistent and urgent economic demand and strong public interest call for this reform. Whoever is designated to administer the Act will want to move as fast as possible towards a single integrated system of clearing, transfer, deposit and custody in which all component elements are interconnected and compatible with each other. This step alone, unless the savings are eroded by increases in other costs and revenue declines, could well double the profitability of the industry.

Senator Williams, Congressman Moss, and the Commission have called for continued movement towards competitive commission rates. I believe that the critical element in

this movement is how the industry adjusts to it. There are millions of words of testimony and analysis on the impact and effect of the removal of this umbrella of fixed commission rates under which the securities industry had operated for so many years. But, in my view, very few, if any, of them have reached the heart of the matter. There has been much superficial talk about the fact that it doesn't cost 100 times as much to handle a 10,000-share order as it costs to handle a 100-share order. That kind of analysis, while it is true with respect to the immediate out-of-pocket costs, fails utterly to reflect the paramount reality that large 10,000-share orders can not be satisfactorily handled without a far greater degree of skill, responsibility and risk. If the brokerage industry fails to reflect this in its pricing, some combination of three results will certainly ensue:

1. Brokerage firms will go broke;

2. Brokerage firms may try to cut costs by eliminating needed services that will affect the quality of brokerage services available to all sizes of customers, increase commission rates on small trades, or both;

3. The risk necessary to maintain the level of liquidity to which we have become accustomed will not be taken. As a result, institutions will not be able to sell their large blocks except at discounts which will disrupt the market.

This is a frightfully serious problem to which sufficient attention has not been given. If the securities industry fails to price its services, and attract capital for the market-making necessary to preserve liquidity, investors will not be willing to pay prevailing multiples for stocks. This is likely to result in saving a couple of hundred million dollars in brokerage fees while losing that many billion dollars, one thousand times as much, in capital values which now support the educational and retirement plans and indeed the jobs and prosperity of millions of American families.

I am not suggesting that the Commission contemplates any departure from its announced program of reviewing the impact of negotiated rates this spring and reducing the level if it seems prudent at that time, and, if the level of competitive rates does not then go all the way to \$100,000, doing the same thing again in the spring of 1974. That continues to be the Commission's policy.

What I am suggesting is that your adjustment to competitive rates is a top priority matter and that, among other things, you use the time available to persuade or require large investors to pay commissions which compensate for the special skill, the responsibility and the risk required to handle large transactions. Some institutions seem to think they are entitled to this for nothing. Unless the brokerage industry has the guts to properly price the services it provides large investors, there is trouble ahead for your firms, for the market and for the small investor who isn't going to pay for the instant liquidity institutions want.

I see three ways to alleviate this pressure. I think it will require all three. I've discussed lower transaction costs. I believe the common sense and self-respect of brokers, some painful experience and the good judgment of institutional investors will phase out the penny-a-share commission rate on huge slices of large orders. Let me now deal with the third and hopefully most important form of relief--a truly national market which is broader and deeper than the market we now have. We can see the outlines of this emerging. The Commission has adopted its composite

tape rule and plans to implement it are to be filed next month. The exchanges tell us it will take 40 weeks to put the common tape into operation. We have published the report of our advisory committee on a nationwide quotation system. We have another committee working to produce recommendations on the rules necessary to implement a central market system. The Commission's staff is working on a paper outlining and evaluating the choices and alternatives in a central market system. The task will be to open that system to all investors, all qualified brokers and all responsible market makers on a basis which protects public orders. This requires an organized market with specialists and other market makers to provide trade by trade stability and protect limit orders. It also requires block positioners and other market makers to provide liquidity beyond that which the specialist can provide. Exactly how to weave these two necessary elements into a working system has not yet become clear. The system must encourage and facilitate the market making which today's tempo of institutional trading requires. Yet, to get dealer participation, the balance must not be tipped so far as to weaken the auction market that you wind up with a dealer market. How to reach that balance is the crunch question.

I believe it can be resolved but it will take the best thinking that all of us can muster. That resolution will be made up of rules on conditions to access to the quotation system, on firmness of quotations, on stabilization and other obligations to the market, on direct dealings with institutions, on precedence and priority to public orders over broker-dealer principal orders at the same price, on the market maker's responsibility for various kinds of customers' orders, and on the protection of limit orders in block and other dealer transactions. It will take machinery to implement the necessary rules and new or modified governing and self-regulatory arrangements. Early this year the Commission formulated its opinion on what to do. We have worked for nine months on how to do it--always more difficult than formulating what should be done. We have not changed our minds on the objective and we have acquired increasing confidence that it can be achieved. The Commission is developing a working paper on the nitty gritty of the central market system and the choices and alternatives in the rules needed to make it work. We plan to publish it early next year to provide a basis for public discussion and reaction.

It should be an interesting year.