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(202) 272-2650

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Causes and Consequences

John S.R. Shad
Chairman
Securities and Exchange Commission

Ladies and Gentlemen:

It is a pleasure to be with you again this year.

I would like to congratulate Dick Jenrette and compliment Bob Linton. Bob has been an excellent spokesman and a vigorous advocate of the industry's interest in numerous meetings with the Administration, Congress and the Commission. Ed O'Brien and the SIA Committees have also done an outstanding job of providing in-depth support of their regulatory and legislative recommendations. I'll be mentioning some of them shortly.

These are unprecedented times. Just since August of last year, we have witnessed:

- not only the broadest and strongest stock, bond and new issue markets in history;
- but also unprecedented capital flows - over $380 billion into the bank and S&L money market and super now accounts, and over $55 billion out of the money market funds, into such bank accounts, the stock market and equity mutual funds.
- Over 700 banks and thrifts entering the discount brokerage field;
- Securities firms acquiring "non-bank" banks and a host of other financial service concerns.
- And banks commencing interstate banking through deposit machine networks, toll-free telephone systems and the mails.

The financial service industries are thundering over, under and around the Glass-Steagall and McFadden Acts.

This morning I would like to highlight some of the causes and consequences of these dramatic changes and also briefly discuss recent and prospective actions at the SEC.

Causes

When I spoke here two years ago, I mentioned that many of the nation's regulatory, monetary and fiscal policies have actually been antithetical to capital formation.

I said:

- o Mounting regulatory burdens;
- o Rising inflation, corporate and individual taxes;
- o Inadequate depreciation allowances for tax purposes;
- o Discriminatory taxation of interest and dividends;
- o As well as double taxation of dividends;
- o And one of the highest effective rates of capital gains taxation in the industrialized free world;

were distinct disincentives to saving and investing.

And that these policies have contributed to the significant decline in our relative rates of capital formation and productivity among industrialized nations. I also said the Economic Recovery Act of 1981 was an excellent beginning - in reversing these trends - and expressed great confidence in the President's program.

Since 1981:

- o corporate tax deductible depreciation charges have increased by 14%;
- o The rate of inflation has been reduced by over 60%;
- o The prime rate by 50%;
- o The maximum federal tax rates on interest, dividends and capital gains have been reduced by over 25%.

And our productivity has tripled. It is now growing at an extraordinary 7 1/2% annual rate and our Gross National Product, at a phenomenal 7.9% annual rate. Such exceptional growth rates are not sustainable, but continued GNP growth at over 5% and unemployment at the 7% level, will reduce the large federal deficits, presently projected.

The unemployment rate has already dropped an extraordinary two full percentage points within a year - from 10.7% last December to 8.7% today and it's expected to break 8% next year. This year's corporate profits are expected to exceed last year's by 30% - and the prospects for next year are excellent.

In my opinion, the foregoing increases in our investment incentives and reductions in the disincentives, have been reflected in the broadest and strongest stock, bond and new issue markets in history; and will be reflected - in 1984 and beyond - in rising demand for consumer durables, capital goods and jobs.

Thus, there has been a real change of direction in America. Major problems remain in the international arena, but the stage is set for an era of strong domestic growth and development.

Consequences

One of the consequences for the securities industry has been unprecedented growth and profits. Notwithstanding the sobering third quarter, this year's earnings are expected to exceed last year's record results by 50% and the industry's after tax return on equity is expected to be over 20%. These figures rank the securities industry among the most profitable in America.

The discount brokers are also enjoying strong growth and high returns on equity. Their 1983 revenues will be up about 50%, as compared with about 30% for the securities industry as a whole. And their after tax return on equity is expected to approach 20%.

Discounters have doubled their share of retail brokerage transactions in the past five years. They are expected to account for about 15% of such transactions this year and about 20% by 1985.

Strong growth and high returns on equity attract competition. Hence, the banks and thrifts are moving into discount brokerage in droves. The banks are also interested in the by-product benefits of one-stop financial services - the supermarket.

Some say the traditional brokerage firms could preempt the discount brokerage field, but have not done so, because of concerns over disaffecting their big producers and accelerating the shift of their customers to discount services. These are valid concerns. There are undoubtedly others.

While all firms grant discounts to valued clients, most are tacking, rather than sailing with the wind. On the other hand, many firms are very profitably trading up, rather than down - expanding and improving the quality of their sales organizations and clienteles - and broadening their product lines.

For those caught in the middle, it is worth noting that General Motors would not be the company it is today, if it had not been willing to enter into competition with itself. Many Chevrolet salesmen and dealers were unhappy when GM added Buicks, Oldsmobiles and Cadillacs on one end of its line, and Chevettes on the other.

Also, many full line downtown department stores rue the day they did not protect their flanks, with discount operations in suburban shopping centers. Their hesitation afforded exceptional opportunities to the K-Marts, Kings, Zayres,

Syms and other discounters. In less than a decade Timex garnered 40% of the watch market, while the traditional firms clung to the concept that watches are fine jewelry, not time pieces.

Cars, clothes and clocks are much different than stocks, but the annals of corporate history are filled with accounts of fine firms that have suffered the consequences, rather than reaped the rewards of shifting market trends. The discount brokerage trends seem inexorable. Taking advantage of them - directly or through separate affiliates - requires innovation and involves trade-offs, but so does taking refuge behind the crumbling Glass-Steagall barrier.

As for the SEC

As for the SEC, fiscal 1983, which ended on September 30th, was also a record year for the Commission - in terms of the volume and efficacy of its efforts. In fact, as a result of productivity improvements, the Commission's major divisions have achieved record results, or the highest levels in several years, in each of the last two fiscal years, despite budgetary constraints.

For example, by comparison with fiscal 1981, in fiscal 1983:

- over a third more enforcement cases were brought;
- over a quarter more investment company and adviser inspections were conducted;
- over 15% more broker-dealer reports were processed;
- and over 5% more full disclosure filings were handled;
- than in fiscal 1981, despite a 3% reduction in personnel.

More important than the statistics are the substantive programs being implemented at the Commission. Some are increasing investor protections. Others are saving investors, corporations and the securities industry over a billion dollars per annum, and reducing the SEC's paperwork, but not investor protections.

Enforcement

Enforcement of the securities laws is the largest activity at the SEC. It accounts for about a third of the Commission's total budget - which is justified by egregious examples of securities fraud, market manipulation, insider trading and criminal activities. The SEC is coming down hard on offenders, but easing the regulatory burdens on legitimate businesses and securities firms.

Integration

For example, last year's integration of corporations' registration and reporting requirements has increased their financing flexibility and reduced their expenses - for the benefit of their shareholders - by well over $350 million per annum. It has also reduced your and the SEC's paperwork, but not full disclosures to the public.

Shelf Rule

The revised shelf registration rule, adopted by the Commission last month, limits such offerings to S-3 companies - the largest, most creditworthy and widely followed corporations.

The Commission's decision was based on the following considerations. Over 85% of the shelves filed since March of last year have been traditional shelves, such as employee stock purchase plans, which will continue to be permitted.

Of the $83 billion of new corporate shelves filed, over 80% have been investment grade debt issues. Most such debt offerings - whether shelf or conventional - are of course, sold in large blocks to institutions. A recent study indicates that the discounted present value of the interest savings to issuers' of shelf debt offerings to date has aggregated over a billion dollars. Some question the size of the savings but they have been substantial.

Of the $13 billion of common stock shelves filed, only $2.7 billion would have been permitted under the revised rule. Over $10 billion have been so-called "convenience" shelves, or filings by S-1 and S-2 companies, which are not permitted under the revised rule. Not all of the $2.7 billion has come to market, but if it had, it would amount to less than 6% of the $46 billion of equity offerings since March of last year.

Furthermore, over 80% of the $2.7 billion has been filed by utilities, many of which publish their financing intentions a year in advance, and solicit competitive bids. Some of the utility equity shelf offerings, such as the $460 million Telephone, $120 million Texas Utilities and $90 million Arizona Public Service issues, have been negotiated, syndicated and widely distributed offerings.

This leaves only $500 million of non-utility equity shelves under the revised rule. Corporations may be reluctant to file equity shelf offerings, because of the dampening effect on the market of a large "overhang" of stock on the shelf. In any case, under the revised rule, equity shelf offerings are expected to amount to less than 5% of the total volume of equity offerings.

Shelf Due Diligence

I supported the revised shelf rule, for the foregoing reasons, but the SIA and others have expressed legitimate concerns over the ability of underwriters to conduct due diligence investigations under the accelerated time schedules permitted by the shelf rule.

The revised rule reduces the risk to investors and underwriters by limiting such offerings to the largest, most creditworthy and widely followed corporations. And the vast majority of shelf offerings have been investment grade debt issues, which are, of course, far less risky than equities. Nevertheless, the shelf due diligence approaches suggested by non-underwriters are of limited practical value.

It has been suggested that companies that have filed shelf offerings invite groups of underwriters and their attorneys to sessions following release by the companies of their quarterly and annual reports, and drafting sessions when they are preparing their prospectuses, proxies, annual, quarterly and other SEC filing documents. Such documents are difficult enough to draft with one underwriter participating, let alone, half a dozen.

It would be very expensive for senior corporate and underwriting executives and their attorneys, to spend hundreds of thousands of hours annually, attending such meetings on the speculative possibility that the companies concerned will decide to do public offerings, and that one of the underwriters attending such sessions will be the high bidder for the issue. It therefore seems unlikely that many senior corporate and underwriting executives, and their attorneys will attend many such meetings.

It has also been suggested that underwriters rely on due diligence reviews by attorneys hired by issuers. It is of course the underwriting firms that are liable for failure to conduct adequate due diligence investigations, and it is their capital and reputations that are at risk, if offerings are unsuccessful or perform poorly in the after-issue market. While due diligence reviews by issuer hired attorneys are used to defend actions brought by investor-plaintiffs, this is not the principal purpose of such reviews. The principal purpose is to protect investors.

Assessment of the underwriting and the after-issue market risks, require market judgments and careful reviews by experienced underwriters. However, under accelerated offering schedules, the critical judgment has become the price at which there will be sufficient immediate institutional interest to absorb the issue.

Issuer hired attorneys are used in competitive utility offerings. However, utilities are the most predictable of corporate enterprises. They are not subject to the vagaries to which industrial and other issuers are subject. In addition, many publish their financing intentions a year in advance. The reasonable certainty that their financings will occur, permit and justify preparatory efforts by prospective bidders for such issues.

Thus, the shelf due diligence techniques suggested to date by non-underwriters are of limited practical value. Perhaps they can be refined or improved.

Outright exemption of underwriters from liability for matters incorporated by reference in prospectuses is beyond the Commission's authority. But some feel the value of a new rule - adopted by the Commission last year - has been under-estimated. Rule 176 setsforth factors to be considered by the courts in determining whether an underwriter has exercised reasonable due diligence.

The factors include:

- o whether the underwriter had any responsibility for matters incorporated by reference;
- o the role of the underwriter;
- o and the type of company and security.

Rule 176 has not been tested in the courts, but over the years there have actually been very few due diligence cases.

One additional point on the shelf rule. The 21 months that the temporary shelf rule has been in effect, has encompassed the strongest stock, bond and new issue markets in history. Investors do not seek redress, unless securities decline in price. Therefore, the true test of the shelf rule will come in the next bear market. The Commission will continue to monitor the effects of the rule on the market, investors, issuers and the securities industry, with a view to prompt action if problems develop.

Electronic Filing

Next year, the Commission plans to begin, a pilot electronic filing, processing and information dissemination system. The objectives are to accelerate the dissemination and analysis of corporate information by investors and securities analysts and to reduce issuers', your and the SEC's expenses.

As corporations file such information electronically with the SEC, investors and analysts will have instant access to it on home and business computer screens. They will be able to analyze data in minutes that would otherwise take months. For example, they will be able to display all of the listed stocks that closed yesterday at less than 6 times earnings, and 75% of their book value per share, that afford dividend yields of over 6% - and a variety of other key comparisons. They can then instantly refine such lists by industry, size and other criteria and display the latest annual and quarterly reports of those companies that appear to be undervalued. They will also be able to obtain hard copy on accessory print-out equipment. The system will also accelerate the SEC's screening of filings and the rapid identification of those which require detailed review.

The pilot operation is expected to begin next year. It will be tested and debugged for a year or more. Industrywide implementation is intended to coordinate with the growth of home computers - from 5 million today to over 50 million in five years. By then, it is also expected that investors will be able to enter their market orders directly on their own computer terminals and receive instant confirmations. They will also be able to retain their portfolios in their data banks - price them to the market at any time - and maintain running totals of their dividends and their realized and unrealized capital gains and losses.

<u>The Bush Task Group</u>

Shortly after arriving at the SEC - 2 1/2 years ago - I began advocating in speeches, congressional testimony and meetings with Cabinet members and the Chairmen of key Congressional Committees, the formation of a task force to simplify, rationalize and reduce the costs of the regulatory structures of the securities, banking, savings and loan and insurance industries.

Specifically:

- Regulation by functional activities, rather than by outmoded industry classifications;
- Consolidation of overlapping, duplicative and conflictng regulatory activities;
- And elimination of excessive regulations within and between regulatory agencies.

The basis for these recommendations is the fact that the regulatory structures of the financial service industries are based on historical industry classifications, but new products and services - such as the money market funds and dozens of others - and major mergers and acquisitions, have bridged the traditional gaps between these industries.

Regulatory overlaps and conflicts have also multiplied. Today, 10 federal and over 100 state agencies regulate various aspects of the securities markets alone - at a cost of hundreds of millions of dollars to investors, the securities industry and issuers. In addition, many financial products compete on the basis of their regulatory classifications, rather than their economic merits.

Last January Vice President Bush formed such a Task Group. It includes cabinet members, the Chairmen of the financial regulatory Commissions and Boards and others. The Task Group is expected to propose major legislative initiatives in the near future.

Ideas under discussion include placing greater reliance on the disciplines of the marketplace and less on federal regulators. For example, individual bank and S&L deposits are insured up to $100,000. When federal regulators facilitate upstream mergers of troubled depositories, depositors of over $100,000 also receive the full amount of their deposits. Less than full recovery by large depositors would cause them to shift their funds out of weak, into strong depositories - without action by federal regulators.

In a related area, the same percentage premiums are presently charged all depositories for federal insurance. Risk-related insurance premiums would increase the cost to those depositories with high-risk loan portfolios.

Also, the public financial and other disclosures by depositories are presently administered by five different federal agencies. Consolidation within the SEC would result in more uniform regulation and enforcement of such disclosures, at lower costs. It would also facilitate decisions by depositors concerning the relative soundness of depositories, and by investors concerning the attractiveness of their securities.

Additional ideas under discussion include:

- Shifting margin regulations from the Fed to the securities exchanges, under the SEC's oversight;
- Consolidating certain bank regulatory activities administered by three agencies;
- And consolidating the antitrust responsibilities of the depository regulators within the Justice Department.

SIA Recommendations

Also, I have endorsed SIA recommendations to the Task Group:

- that the Racketeer Influenced and Corrupt Organization Act, known as RICO, be amended to reduce vexatious securities litigation;
- that registration of broker-dealers as investment advisers be streamlined;
- that block traders and "bought deal" underwriters be exempted from "short swing" profit penalties and 10% position disclosure requirements;
- and that SIPC be permitted to continue to operate broker-dealers during the liquidation process.

Other recommendations by the SIA, the exchanges, the NASD and at the initiative of the Commission staff that have been implemented include the following:

Net Capital and Letters of Credit

Based on the SIA's demonstration of the industry's improved financial and operational conditions, last year's update of the net capital requirements and letters of credit limitations, freed-up $700 million of the industry's capital.

Option Clearing Corporation Deposits

This year's updating of the Option Clearing Corporation's deposit requirements, is expected to free-up an additional $300 million.

Book Entry Delivery System

On the recommendation of the securities exchanges and the NASD, the expansion late last year of the book-entry delivery system, is expected to save brokers and agent banks over $350 million per annum.

Bank Release

Last month the Commission released for public comment a proposed rule that would, in effect, require banks that offer public brokerage services or in-house investment advice and brokerage services, to conduct such activities, in separate affiliates, subject to the same rules and regulations as all others who engage in such activities. Such a rule would be consistent with the positions of the Administration and most of the bank regulators. The Commission release stated that in view of the increasing numbers of banks that are engaging in brokerage activities, the Commission was proposing this action now, pending future Congressional action.

SECO Legislation

In a joint effort with the NASD, legislation was recently enacted to abolish the SECO program, under which the Commission staff has been supervising directly, 600 over-the-counter firms. Henceforth, these firms will be subject to the NASD's supervision, under the Commission's oversight.

Joint Registration

The Commission has out for comment, a joint proposal of the Commission, the State regulators and the self-regulatory organizations to simplify and conform SEC broker-dealer registration forms with the NASD's Central Registration Depository system.

Trading Practices

Earlier this year, on the recommendation of the Division of Market Regulation, the Commission reduced from 9 to 2, the days underwriters must be out of the market before certain offerings, and terminated certain issuer share repurchase regulations.

MMF Confirmations

The Commission also recently accepted the industry's recommendation to eliminate immediate confirmation requirements on certain money market fund transactions.

Reserve Accounts

The staff is studying the SIA Operations Committee's proposals to allow, under certain circumstances, the creation of temporary deficits in segregation accounts.

Transfer Agent Rules

In order to reduce transfer delays, improve dividend and interest disbursements and reduce brokers' expenses, in June the Commission adopted rules which require transfer agents to meet certain standards and report record differences to the issuers.

Intermarket Surveillance

At my initiative, the stock exchanges and the NASD are enhancing their electronic inter-market surveillance systems and audit trails, which permit the quick identification of market manipulation and insider trading. This program is expected to "pay for itself" by reducing transaction reconciliation costs.

Regulatory Simplification

National securities and commodities firms are subject to supervision by the SEC, the CFTC, the 50 state securities administrators and over 30 self-regulatory organizations. The following progress is being made in simplifying these regulations.

- o A standardized FOCUS report can now be filed with all regulators.
- o The SEC and CFTC net capital rules have been harmonized.
- o And broker-dealer and associated person registration requirements have been streamlined.

The SEC and the CFTC have also jointly solicited industry suggestions on the coordination of their regulations. Recommendations received to date include:

- o development of a single associated person registration form;
- o harmonization of the statutory disqualification provisions under the securities and commodities laws;
- o coordination of securities and commodities self-regulatory examinations;
- o and consolidation of finger print processing.

National Market System

With reference to the national market system,

- o The Intermarket Trading System has now been established as a permanent electronic linkage of all the exchanges, and the NASDAQ over-the-counter system.
- o During the latest 12 months, the ITS volume has increased 25% to over 4 million shares per day.
- o By next February, last sales in over 700 national market system over-the-counter stocks will be electronically reported throughout the country, as they are executed.
- o The New York Stock Exchange's expanded pilot operation - known as R-4, Registered Representative Rapid Response - permits derivatively priced, instant executions by account executives of orders up to 599 shares in 200 of the most actively traded NYSE stocks.

- The 19c-3 experimental linkage of the market in 30 listed stocks with the off-board market has not improved or hurt the markets in these stocks. Virtually all of the off-board market makers, have dropped out of this market. The Commission has, therefore, deferred action on an order exposure rule.

Proxy and Tender Offer Rules

On-going efforts also include Commission and Congressional staff reviews of the extensive recommendations of the Advisory Committee on Tender Offers. Major reviews of the merger proxy and contest rules and the Investment Company Act, are also in progress.

Legislation

In addition to the legislative initiatives expected from the Bush Task Group, the Financial Institutions Deregulation Act, the Insider Trading Sanctions Act, and major amendments to Glass-Steagall, and the Public Utility Holding Company Acts are pending; and members of the Senate Banking Committee have just introduced various alternatives to the Financial Institutions Deregulation Act.

Conclusion

To sum up, increases in the nation's investment incentives - and reductions in the disincentives - have set the stage for an era of strong domestic growth and development.

The accelerating rates of change in the financial service industries and markets afford unique opportunities, but also pose some difficult choices.

Progress is being made in improving investor protections and reducing regulatory burdens.

The future offers the prospect of further major improvements in the securities industry and the regulatory structure, as well as the exciting potential of high speed, electronic communication and analysis of corporate information.

Thank you.