HOLD FOR DELIVERY

Address By

THE HONORABLE MANUEL F. COHEN

Chairman, United States Securities and Exchange Commission

Before The

Investment Bankers Association of America

Hollywood, Florida - November 29, 1966

This has been a busy year, and there are a great many things I could talk to you about this morning. However, I propose to discuss only two subjects, both of which are of great importance: The disclosure requirements of the 1933 and 1934 Acts, and the impact of institutional investors on the securities markets.

Two weeks ago the Commission proposed a new short form for the registration of equity securities under the Securities Act of 1933. I should like to acknowledge the very valuable and constructive assistance which your association has given us (and I am sure will continue to give us) in the development of this form and the standards for its use. Albie Pratt made this an important plank in his platform. He deserves special commendation for his efforts.

Since the enactment of the Securities Act of 1933, the Commission has continually sought to simplify the procedures and requirements for registration under that Act. However, in undertaking the adoption of any short form of registration under the 1933 Act, we must be careful not to lose track of the statutory objective of full disclosure which is at the heart of the statutory scheme.

The registration statement fulfills several vitally important purposes. There is, first, the salutary effect of requiring the management of the issuing company, in conjunction with the underwriters, and assisted by their counsel and the independent accountants, to make a thorough and comprehensive study of where the company stands and where it is heading. Second, the prospectus, which started as a mere appendage to the registration statement, is an effective means of making information about the issuing company available to public investors and to the dealers and other professionals in the securities markets who serve them. Moreover, we must not lose sight of the fact that the prospectus which must be made available to persons trading in the secondary markets for the registered securities is, as a practical matter, available and used by all persons trading in the markets.

For these and other reasons, it is important that we limit the use of this new form to companies concerning which elimination from the prospectus of certain items of disclosure would not have a substantial adverse effect on public investors, securities dealers and their advisers. We have therefore proposed four basic limitations on the use of the form. We do not believe these are unduly restrictive -- between 400 and 500 companies will be eligible to use the new form -- but we welcome your comments and suggestions.

The first requirement is continuity of business and management for an appropriate period so that information previously available can be effectively used in conjunction with the new short form.

Second, we have suggested a size limitation, based on sales or gross revenues, to assure that the form is limited to use by larger companies as to which the public, at least theoretically, has a greater familiarity with the basic information already available.

Third, we propose to require that the company have reached and maintained a certain minimum level of earnings, on the assumption that such companies will have an orderly market for their securities and are less likely to undergo radical changes than companies whose financial history has been erratic.

Fourth, it is proposed to limit the short form to companies with securities listed on a national securities exchange. There is no doubt that the thrust of the 1964 amendments to the Securities Acts was to put listed and over-the-counter companies on a comparable basis, as far as continuing disclosure to the Commission is concerned. The statutory requirements, however, represent only a minimum. The rules of the stock exchanges on which the eligible companies are listed are, in many respects, substantially more rigorous, and offer a higher standard of protection for investors, than our requirements under the 1934 Act. For example, they require submission of certain matters to stockholders, publication of results of operations on a current and frequent basis, and prompt disclosure of important events affecting the company.

The great bulk of securities transactions take place in secondary trading to which the requirements of the 1933 Act are inapplicable. A substantial upgrading and improvement of the 1934 Act disclosure requirements, therefore, is essential wholly apart from the possibility that reliance on material facts filed under the Securities Exchange Act of 1934 may be a key to simplification of the disclosure requirements of the 1933 Act. We solicit your assistance in modifying the regulations and forms under the 1934 Act to assure that adequate information about all publicly held companies is continuously available to investors and others in useful and understandable form.

I turn now to the second subject of my remarks. In view of the current debate within and outside the industry on the commission structure of the New York Stock Exchange it seems appropriate to discuss one of the factors which is at the heart of the debate -- the institutionalization of the securities markets which I will define, for the purposes of my remarks, as the process by which a steadily increasing proportion of stock transactions is accounted for by institutional, rather than individual, investors.

This has become a popular topic, but I venture to embark on one more discussion of the subject because I am not sure that some of the ramifications of this growth are as widely understood as they should be.

At the outset I emphasize that I bring you no pat solutions. There are no easy answers to the problems I will describe. My remarks today are intended to expose some of the complications and effects of the current situation and, in addition, to touch on some of the implications of change. We hope to stimulate further study, discussion and debate and to suggest the need for speedy progress towards sound solutions. As many of you know, we have been engaged for some time with your organizations, and with many firms in the business, in a wide exploration of the problems and possible solutions. The task we face is of the gravest importance.

There are two characteristics of institutional investors which create unique problems. First, there is a major difference between an institution and an individual who is in a position to make his own decisions for his own benefit. The institutional investors which have grown most spectacularly in stock market participation in recent years -- mutual funds and pension funds -- are characterized by the fact that a small group of sophisticated managers make investment decisions for the benefit of a large and scattered group of indirect investors who reap the rewards or penalties of the managers' decisions. Many of these investors are unsophisticated, and, in the case of the pension funds, frequently unaware of the extent to which their resources are committed to the markets for equity securities.

Secondly, the institutions are large -- with resources that may be thousands or even millions of times greater than those of the ordinary public investor. Any significant investment decision by an institution necessarily requires a very substantial transaction, or series of transactions. It must select the stock of a company which is large enough to permit such transactions without domination of the issuer or of the market for the stock. In consequence, the institutions tend to limit their interest to the stocks of the very largest companies, most of which are listed on the New York Stock Exchange.

This has led to significant effects on the operations of the securities markets. To the extent that the institutional transactions are actually executed on the floor of the exchange, they, have placed a great strain on, and provided a real challenge for, the continuous auction market concept -- which was developed and flourished in a market characterized by a steady flow of hundred share orders by a multitude of individual investors. Unless we are pursuaded that the purpose and functions of the organized exchanges are obsolete, there is an urgent necessity to provide additional depth and liquidity to meet this challenge. We hope that the recent amendment to Rule 394, which the New York Stock Exchange adopted at our request, will make an important contribution to the principal market -- the Exchange -- by making the substantial resources of non-member market-makers available in handling large transactions for the institutions.

Another outgrowth of these large transactions has been the development by the larger exchange members of arrangements for crosses to accomodate institutional buyers and sellers. These are reported as transactions on the exchange, but in fact, never enter the conventional auction market provided by the exchange. This technique is but one of a number that have been developed, all of which have the common ingredient of using the exchange as a convenient place to record the size and other terms of the transaction.

The shift of business from individual transactions to institutional transactions has also had a dramatic impact on the economics of the securities business. We estimate that currently about half of the total public commission income of New York Stock Exchange members on round-lot transactions is attributable to transactions by institutions.

While the largest institutional transactions frequently can only be effectively executed as underwritten secondary offerings at levels of compensation far higher than the standard commission rates, there is a tremendous volume of institutional business which is done at rates of compensation substantially less than the minimum commissions specified by the Stock Exchange. We know this not because we are endowed with any special omniscience, but because securities firms are engaged, presumably for profit, in effecting these transactions every business day at the request of their regular customers or to attract new customers.

The question arises how institutions are able to have portfolio transactions executed at these lower rates in view of the rules of the New York Stock Exchange which specifically prohibit member firms from executing transactions for non-member customers below the specified minimum rates and which also prohibit the payment of rebates. At least three basic techniques have been developed:

First, the rules of the New York Stock Exchange have not been interpreted to mean that the broker executing the transaction must retain the minimum commission. Members of the New York Stock Exchange may share in that commission at the direction of the executing broker or of his customer. An institutional manager may direct the executing broker to "give-up" a portion of his commission -- in some cases as much as 60% or even 70% -- to other members of the New York Stock Exchange community usually because the other members have performed services at the request, and often for the benefit, of the manager.

Second, an institution may direct a member broker to execute the transaction on a "regional" exchange, in which he also holds membership, instead of the New York Stock Exchange. The minimum commission rates of all the exchanges are the same, but some of the regional exchanges have taken a more expansive view of the "community," to which their members belong and have permitted them to "give-up", or "give away" as it is sometimes called, portions of their commissions to members of the National Association of Securities Dealers or to others. Indeed, one regional exchange permits certain institutions, through subsidiaries, to become members and thus to share in the commissions on their transactions.

The third technique is for the institutions to go directly to non-member dealers who trade as principals in listed securities -- the so-called "third market" -- and who are willing to buy and sell these securities at a net price which is better than the stock exchange price plus the minimum commission. (There is also a "fourth market" -- as yet insignificant -- in which institutions trade directly without professional intermediaries.)

These techniques have certain consequences. One, they promote fragmentation of trading in these securities into different and often unconnected markets. Frequently, this is a deliberate choice to secure the best aggregate prices. Not infrequently, however, this technique is used for reasons unrelated to the realization of the best executions and have results which may not promote the health of the principal markets for these securities.

For another, the actions and motivations of institutions are more complex than those of individual investors; their managers are obligated to act on behalf of the indirect investors who are their beneficiaries. Examination of the techniques which I have just described suggests that, while the executing broker in each case is willing to do the business at a very substantial discount from the "minimum" commission rate set by the Exchange, in some cases the reduction benefits the investors in the institution while in other cases the reduction is available to the institutional managers to distribute in ways that may or may not benefit the investors.

I am sure you will understand our concern with techniques which have the effect of diverting savings available in institutional transactions from the investors who are the real parties to the transactions. The "give-up", or the "give away", raises serious questions for the customer who directs it, for the broker-dealer who gives it, and for the broker-dealer who receives it. An inflexible commission schedule which may induce institutional managers to seek advantage for themselves raises serious questions of public policy.

The availability of the "give-up" or "give away" techniques affects the choice of markets and the manner in which securities transactions are consummated. It also has the immediate effect of drastically reducing the income derived by executing brokers, not as the result of systematic analysis and equitable distribution of the costs of such transactions, but because of the power of influential customers to secure preferential treatment. It provides an incentive for brokers who receive it to channel their customers' purchases into mutual fund shares rather than into direct investment in the stock market. And it introduces elements of complexity into the pricing and the economics of broker-dealer services that make it difficult for the industry or the exchanges to make an effective presentation, and for the Commission to make a thorough analysis, of the economic situation and the needs of the industry as a basis for a fair and rational commission rate structure and level.

But we are told the "give-up" and the "give-away" are necessary to assure the continued viability of some broker-dealers and certain stock exchanges. The merits of these contentions deserve and will receive close and open-minded consideration and evaluation. We are now analyzing information which suggests that a large percentage of these payments go to firms -- generally the more substantial ones -- which are able to take care of themselves and that the commission income diverted to the smaller firms is considerably less important to them than had been generally supposed. In any event, acceptance of the arguments made necessarily assumes that the larger broker-dealers who give away a substantial portion of their commission income can do so without adverse effects to their continued economic health. And, even if it is established that these practices do provide a needed supplement to the income of smaller firms, we must recognize, first, that they do so at the cost of shutting off an opportunity for the sharing of the economies of size in securities transactions with the real parties in interest -- the indirect and small investors -- on whose behalf the transactions are effected and, second, that the supplementary income may be produced at the cost of considerable inefficiency. The further question is raised whether these larger members who effect the vast bulk of the institutional transactions can justify giving away 40% or more of the commission from institutional business and, at the same time, oppose a volume discount. Of course, implicit in this discussion is another question -- whether there is justification for seeking a commission rate increase when so much of the commission revenue is spread around in the manner I have described for services unrelated to the execution of the stock market transactions and, in many cases, to persons who are not members of the exchanges.

I hasten to add, however, that neither my remarks nor the raising of these questions is intended to imply a lack of concern with the problems and the needs of small broker-dealers, or of broker-dealers of any size, or with the needs of the various exchanges. I can assure you that these considerations are before us constantly and that they are evaluated carefully in connection with all of our activities.

It is important also to note that the growth of institutional investors has stimulated the growth of institutional dealers, that is, dealers with the resources and talents needed to service the special needs of the institutions. And many small broker-dealers have become to a large extent indirect participants in the securities markets -- they sell primarily the mutual fund shares which smaller investors buy. On the one hand we must recognize that our society has long accepted the view that social and economic benefits are derived from a system in which decisions are made by large numbers of independent businessmen. The need for, and the maintenance of, viable small economic units in the securities business are problems which should challenge all of us. On the other hand, we cannot ignore the loss of efficiency and the cost of subsidization inherent in certain current practices, a cost which is borne by a host of individuals who have no effective voice in determining whether this is in their best interests.

Unfortunately, the development of the "give-up" and the "give-away" may have diverted our attention from alternative, and possibly more constructive, ways of helping smaller broker-dealers. Is it possible that giving such broker-dealers economic access to the New York Stock Exchange, by permitting them to share commissions with Exchange members on a realistic basis when they originate transactions in listed securities, might be a more constructive approach to the problem? This approach might create problems for some regional exchanges, but it might, on the other hand, help to redress the present imbalance, which apparently encourages non-member broker-dealers to channel their customers' investments into indirect and more narrowly focused participation in the equity markets. I do not mean to suggest that the New York Stock Exchange has not given this problem close attention. Indeed, some time ago it presented to the Commission certain proposals designed to meet this problem.

One argument, that has been used to justify the "give-up" or "give-away," has been that the various steps in a brokerage transaction can be separated and parcelled out to different firms so that some "service" can be attributed to each one to justify its participation in the commission income. I cannot over emphasize the serious difficulties we may encounter if we permit the development of inefficient and uneconomic practices because we wish to preserve, or hesitate to change, present patterns with respect to the distribution of brokerage income.

Finally, the march of events requires us to face up to the question of institutional membership in a stock exchange.

Is such membership a reaction to the absence of a volume discount? Should all regional exchanges permit institutions of whatever kind to become members? Where should the line be drawn and by whom? Should the Commission permit or foster competition among exchanges as to the character of their membership? What should be the rules for dealing with the third market by dual members on regional exchanges?

Other questions have been raised. What is the Commission's role in this situation which is so fraught with dilemmas? Should we concentrate on strengthening the small non-member dealer by providing him with access to the New York Stock Exchange or should we protect the regional stock exchanges -- is there a middle ground -- or should competition be permitted to flourish in full flower -- without our intervention even if only as a referee?

The only thing that I am completely sure of is that the problems will not go away. We must meet and resolve them.

These developments have occurred rapidly. For the most part they have not allowed reasoned deliberation and debate as to their impact on the securities markets and on the professional securities community. Rather, they have come upon the scene with little analysis and as reactions to demands by non-member brokers and other institutions for a more flexible use of the commission dollar. The problems raise the most sophisticated issues and implications. They demand communication and discussion among all segments of the industry and with the Commission -- a full and frank dialogue in which all of us put our cards on the table and explain what is bothering us. Unless we do this, many of us will be nothing more than interested but bewildered by-standers to a series of apparently unconnected actions whose consequences are uncertain. I do not particularly like being bewildered and my job description precludes me from being a by-stander.

As I stated at the outset, I am not prepared today to offer pat solutions. We recognize the difficulties in identifying the problems and evaluating the implications of suggested solutions. While there is merit in the suggestion that the level of commission rates, the rate structure, the

plight of the small non-member dealer, the growth of the institutional investor and the vitality of the regional exchanges are related, we cannot allow the "one ball of wax" argument to rationalize paralysis and to prevent steady progress toward responsible solutions. The problems are not academic in the sense of their having nothing to do with the real world. They require cold analysis of their economic impact and the making of hard business judgments. I suggest that if we get the material on the table and start talking about it the answers may not be as difficult to find as now appears. We cannot assume that the current situation in which decisions are made almost at random and change is erratic and to some extent accidental, will produce the right solutions.

I only touch on the obvious anti-trust questions involved in adopting solutions for these problems. It is not inappropriate to note that while the public policies inherent in anti-trust considerations cannot be overlooked, these considerations should not be permitted to retard the development of solutions which serve the public interest best.

The public interest necessarily includes not only the interest of investors but also the legitimate interests of the securities industry and its institutions. All of this, of course, requires the active involvement of the Commission.

To turn to a related subject, we should recognize that the problem of inefficient and uneconomic practices in the securities industry is not limited to techniques developed principally to justify "give-ups" and "give-aways." In recommending securities to your customers, I am sure that you give significant weight to the readiness with which the management of an issuing company has met the challenges and grasped the opportunities of the rapid technological progress which is being made today as a result of automation and related developments. It is vitally important that the securities markets, and the firms which participate in them, utilize these techniques to the fullest in meeting the problems and the needs of the industry, its institutions and its customers. It is disappointing that rapid progress has not been made in the use of available technology to improve the quality of service to the industry and to the investing public. As the securities markets are growing in size, they are also growing in complexity. We cannot continue to conduct markets which provide capital for the exploration of space and the automation of industry by techniques that were developed in the era of the horse and buggy.

This has, as I said at the start, been a busy year, both for the Commission and for the securities industry. Undoubtedly, I emphasize the obvious when I suggest that the pressures for change in the securities business do not emanate from the Securities and Exchange Commission; they arise from the interplay of strong economic forces and interests. The duty of the Commission is to help direct these forces into constructive channels which promote the health of the securities markets and the protection of investors.

Our society will not permit inequitable and inefficient arrangements to endure indefinitely. The longer they are permitted to continue, the greater will be the pressure for sudden and drastic change, pressure that can be eased by a willingness to make continuous progress in an evolutionary manner. We believe firmly that it is in the best interests of the investing public and of the securities community for industry and government to proceed promptly and cooperatively to deal with developing problems as they arise and not wait until the situation has deteriorated to the point where radical steps have to be taken.

We have been urging the industry to commence a constructive joint effort to cope with the vast and difficult problems raised by the institutionalization of the securities markets. We have made a beginning, but we are not progressing fast enough to preserve and to enhance the economic well-being of the securities business or to attract to it the capital, the imagination and the energy so necessary to the continued growth and development of our national economy. Your industry is an essential one. It must continue to play a key role in directing the savings of our growing population into productive channels. You have the ability and the know-how. What is required is a willingness to sit around the table, to examine the problems and the alternatives, and to arrive at sound solutions. We at the SEC offer our fullest cooperation.