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Securities and Exchange Commission
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THE SHERATON-CHICAGO HOTEL, East Room

"Reflections on the Special Study"

"REFLECTIONS ON THE SPECIAL STUDY"

The program shows me as Director of the Special Study of Securities Markets. It should say "former," since I left that role last week. Thus I suppose that I am now free to speak as an outsider and even become a critic of the Commission and the Special Study. However, it is not so easy to change one's stripes, and for today you may assume that I am still speaking in the role I have had for some 21 months. On the other hand, it should be understood that I am expressing my own views and not necessarily those of the Commission.

One thing that has made my job as intriguing and challenging as it has been is that I have not been speaking for the Commission at any time in the course of the Special Study or in the Report. For a number of reasons, it was decided very early that the Commission would transmit to Congress a Report expressing the Special Study's conclusions and recommendations and that the Commission would separately express its views. While the Special Study benefited greatly from the experience and judgment of the Commissioners and many regular staff members in writing the Report, the final decisions on what we would say were ours. I should also tell you that we did not discuss our specific recommendations with individuals or groups in the securities business itself--their opportunity for hearing will necessarily come as the Commission proceeds to implement our recommendations.

As you may know, the report of the Special Study consists of thirteen chapters and was put out in three segments, the first in April, the second in July, and the third only last week. The first was generally greeted with a sigh of relief and the adjective "mild." I personally felt that this understated its real significance and I made a speech back in May in which I said that all the chapters taken together would add up to a major program of reform. The second segment, on the other hand, was described with such adjectives as "shocking" and "scathing." I feel that these overstated the case as much as the earlier reception understated the case. Perhaps the fact that we took more moderate positions in the first installment than some people had anticipated predisposed them to consider any positive recommendations on crucial points in the second installment as extreme.

Perhaps another reason for the different reactions is that we have not made it easy to characterize our Report with a single adjective by ourselves portraying what we have studied as either black or white. We have said that the basic institutions are strong and we have emphasized the record of broad accomplishments and successes. But at the same time we have pointed to a great many specific weaknesses and shortcomings and as to these we have made recommendations for such degree of change and improvement as we thought called for in each instance.

At any rate, the total Report covers a considerable number of different subjects and contains well over a hundred separate recommendations, a few of them calling for legislation, but most calling for action by the Commission or the self-regulatory agencies--that is, the stock exchanges and the National Association of Securities Dealers--under their existing powers. We are well aware that not all of our recommendations lend themselves to being implemented overnight. A broad survey such as ours is not made frequently; when it is made, it ought to look, not merely to tomorrow or next year, but some distance into the future. Thus some of our recommendations call for further study or consultation before specific action can be taken, while others are expressed as long term objectives rather than immediate ones. But there is also a great deal that should and can be accomplished very promptly.

One of the most important areas for immediate attention is that of qualifications to enter the securities business, which is discussed in our Chapter II. It is quite debatable whether, and to what extent, the securities business can achieve the aspiration of becoming a profession--

particularly debatable, I suppose, among members of a recognized profession --but it is hardly open to question that the securities business, as a business, is not an ordinary one. For many years there has been a wide consensus that rules and standards of conduct applicable to this business must be at a substantially higher level than is expected of the run-of-the-mill business. Yet, because of the complexity and multiplicity of components of the business, no mere regulatory system can maintain and enforce the necessary rules and standards if the entry gates to the business are left wide open to all comers.

Up to now the federal regulatory philosophy has been one of substantially unrestricted entry. The first imperative need--the foundation for realistic regulation in respect of the many technical and subtle questions of conduct and performance that are the subjects of other chapters of the Report--is that those entering the business be adequately qualified in terms of knowledge, integrity, and financial capacity, so that there is at least a reasonable expectation of their ability and willingness to conform to the high standards that the public may rightfully expect of those in the securities business.

The Commission's pending legislative program includes important reforms in this direction. It has been passed by the Senate but not yet by the House of Representatives. I believe it deserves the whole-hearted support of the Bar regardless of your viewpoint on the substantive rules and practices that are discussed elsewhere in the Report.

Another fundamental and urgent need relates to disclosures regarding securities traded in the over-the-counter markets--the other main component of the bills passed by the Senate and now pending in the House. What is involved here is, essentially, merely an equalizing of protections for investors in unlisted and listed securities. It is hardly necessary to state, and it would be difficult to overstate, how anomalous is the present situation in which investors in unlisted securities--even those that are as actively traded by the public as many listed securities--are largely unprotected by disclosure requirements that have long been deemed normal and fundamental for listed securities. Over-the-counter markets and the securities traded in them have become far too important, both absolutely and relatively, to be treated as second-class citizens in this or any other respect.

While a single chapter of our Report, Chapter IX, is devoted specifically to this topic, many of the other chapters serve to confirm how fundamentally important is a system of basic corporate disclosure. The problems of investment advice which are considered in our Chapter III, for example, in no small measure are related. The same may be said of irresponsible corporate publicity which, either through the channels of investment advice or independently, has been a source of difficulty and concern. The absence of a system of reliable, continuous disclosures fosters irresponsibility in both areas. The existence of such a system, while not altogether solving either problem, would be the foundation for responsibility.

There is one other topic that I would like to touch on today. Running through the entire Report, but particularly focused on in Chapter XII, is the important and interesting theme of industry self-regulation. In the securities business, I believe to a unique degree, there has been official recognition of authority and responsibility on the part of the business community to regulate itself. This concept was first applied to the stock exchanges, which of course were already in existence as private groups when the Securities Exchange Act was enacted in 1934. In this instance, public or governmental regulation was superimposed on an existing system of self-government, but the latter was now officially vested with authority and responsibility and at the same time was brought under public supervision through the newly-created Securities and Exchange Commission. In the case of the over-the-counter markets, the same concept was applied a few years later, but this time created out of nothing except the ashes of the NRA.

While there were significant statutory differences, the essential idea in both cases was that membership organizations would be given authority and responsibility for regulation of their members, but there would be governmental power of supervision or oversight as well as governmental power to be applied directly where self-regulation did not reach or where basic legal requirements or prohibitions were involved. In other words, there was to be a system of multiple protections, with the stock exchanges and the N.A.S.D. regulating their members' conduct, the Commission overseeing the regulators, and the Commission also having some powers of direct regulation of the same members and of nonmembers.

But despite this pattern of multiple protections, which has been in effect for a quarter of a century, there came to light in the past few years a number of prolonged abuses and gross violations on the part of certain members of the American Stock Exchange--the country's second most important exchange. Once the abuses and violations were exposed, they were dealt with vigorously; and in fact a complete overhaul of the self-regulatory mechanisms of the American Stock Exchange has been accomplished. But there remained the important and puzzling question--it was perhaps the most basic question that the Special Study was called upon to pursue--of whether, after all, self-regulation should continue to be relied upon as a first line of defense for investors, and if so, how it might be strengthened.

Before telling you how we have answered this question in the Report, I want to mention a case that, quite fortuitously, was decided by the Supreme Court while our Study was in progress and that focused on the question of self-regulation from a different angle. In the case of Silver v. New York Stock Exchange, 373 U.S. 341 (1963), the plaintiff was an over-the-counter securities dealer who was not a member of the defendant Stock Exchange but had obtained private wire connections with certain Exchange firms and ticker service from the Exchange itself. Rules of the Exchange, duly filed with the Commission, provided that member firms must discontinue connections with nonmembers when so instructed by the Exchange. In Silver's case the Exchange's approval had been temporary, pending completion of its customery investigation. After some months, the Exchange, without prior notice to the plaintiff and refusing at that time to divulge the reasons for its action, ordered the wire connections severed and discontinued its ticker service. Silver thereupon sued for an injunction and damages under the antitrust laws and on other grounds. The District Court held for the plaintiff, finding that the Exchange's action was arbitrary and unlawful and not justifed by the self-regulatory scheme of the Exchange Act. The Court of Appeals, dividing 2 to 1, reversed the decision on the ground that the statutory obligation of self-regulation precluded any liability under the antitrust laws, whatever other remedy might be available on account of the Exchange's arbitrary procedure. The Supreme Court, dividing 7 to 2, reversed the Court of Appeals, holding for the plaintiff on the basis of the Sherman Act.

The Court squarely held that removal of the wire connections, had it occurred in a context free from other federal regulation, would have constituted a <u>per se</u> violation of Section 1 of the Sherman Act, and the Court proceeded to discuss whether justification might be found in the self-regulatory obligations imposed by the Exchange Act. In discussing how the policies of the two federal statutes might be reconciled, and in finally deciding that there was a violation of the Sherman Act, it was crucial to the court's reasoning that, although the Commission had authority to approve or disapprove the rule in question, it did not have, as it did in the cases of the statute governing the N.A.S.D., any jurisdiction to review particular instances of an Exchange's enforcement of such a rule. Thus (I am here quoting from the opinion) "there is nothing built into the regulatory scheme which performs the antitrust function of insuring that an exchange will not in some cases apply its rules so as to do injury to competition which cannot be justified as furthering legitimate self-regulative ends." The Court quoted SEC Chairman Cary's statement that (I again quote) "Some government oversight is warranted, indeed, necessary, to insure that action in the name of self-regulation is neither discriminatory nor capricious." This being so, and in the absence of provision for Commission review of the particular action involved in the case, the Court felt that application of the antitrust laws was not incompatible with self-regulation but "peculiarly appropriate."

I will not comment on the merits of the decision or its rationale, but I want to point out that, while the case emphasizes the need to assure both procedural fairness and compliance with other public policies in self-regulatory activity, it also leaves an exposed flank of potential liability on the part of a self-regulator, which could tend to inhibit the kind of vigorous and thorough action that is essential if important reliance is to be placed on self-regulation.

In our Report, and particularly Chapter XII, we have reviewed comprehensively the phenomenon of self-regulation, in theory and practice, and its uniquely important role in the securities regulatory pattern. Let me now summarize our main conclusions:

First, we have concluded that self-regulation should not be abandoned but should be strengthened and improved. In 1934 and again in 1938, its advantages and benefits were weighed against certain limitations and dangers, and the former were found to be preponderant. After a thorough reassessment, for reasons spelled out in the Report but impossible of adequate statement here, we have reached the same conclusion.

Second, self-regulation is not and cannot be expected to be the complete answer to regulatory needs. The power of government--in this case embodied in the SEC--must be ample in scope and depth to assure that regulatory needs are met fully, effectively, and fairly, either by adequate self-regulatory performance or by direct intervention of government. This applies to all types of self-regulatory agencies--the Exchanges, the N.A.S.D., or any other--and to all aspects of self-regulatory activity--rule-making, surveillance and enforcement, and disciplining for violations.

Third, as demonstrated most dramatically in the case of the American Stock Exchange but as illustrated also in a great many other, more subtle ways, the Commission's role of overseer must be of an active, continuous kind rather than of a passive, *ad hoc* kind. The Commission must strengthen its programs and procedures for keeping itself continuously cognizant of market developments and regulatory needs, and for weighing the adequacy of self-regulatory rules, administrative machineries and disciplines in light of those needs.

Fourth, since the public policy favoring self-regulation must be reconciled with other public policies, as the Silver case exemplifies, and since the Commission is the specialized agency charged with guardianship of the public interest in relation to the securities markets, the Commission itself, rather than a District Court administering the antitrust laws, is the logical agency to have primary jurisdiction to review Exchange disciplinary matters in light of the total public interest.

Fifth, without in the least retracting what I have said about the need for ample governmental power in reserve and active, vigorous supervision of self-regulatory performance, the Commission should act with great restraint in exercising its powers of direct intervention. Here, as in other institutions, initiative and responsibility can be expected only if there is a due measure of autonomy. The Commission must be the public's ultimate assurance that regulatory needs are met and must stand ready to intervene where self-regulatory performance proves inadequate, but it must avoid the stifling of initiative and responsibility that would inevitably result from seeking to control each act of a self-regulatory agency as if it were a mere puppet. Were this the necessary and proper course, then indeed self-regulation would be merely an unnecessary appendage rather than an integral part of the regulatory scheme.

I cannot dwell longer on this subject or any of the many other subjects discussed in the Report, but I hope I have whetted your appetites so that you will want to peruse at least some parts of it. The Washington Post described the second installment of the Report as "a veritable goldmine of information." Whatever else it may be, I hope that the entire Report may be so characterized. I believe that it brings together more information on more different aspects of the securities markets than has ever been done before, and that it can serve as an important source book on many topics for some years to come.

I hope that it will also prove to be a goldmine of ideas. We have not been reticent--under the terms of our assignment we could not be reticent--in expressing conclusions and recommendations about the data we have assembled. Inevitably there have been and will be differences of opinion as to some of them. I of course believe them all to be sound, but whatever their specific merit, I believe that we have focused on a great many subjects that needed attention, and that we have expressed many ideas which, even if they turn out not to be precisely right, can be an impetus toward additional or alternative ideas for dealing with the same problems.