THE SECURITIES AND EXCHANGE COMMISSION AFTER THE SPECIAL STUDY OF SECURITIES MARKETS

Speech by

William L. Cary
Chairman
Securities and Exchange Commission

Investment Bankers Association of America
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I am delighted to be invited a third time to speak before the Investment Bankers Association. I might say I now feel very much at home mingling among you as a bureaucrat in sheep's clothing. At the outset I should like to say a few words about your retiring President, with whom I have worked so closely during the past year. It has been a most pleasant association. He has demonstrated wisdom and realism. Perhaps I dare go no further in superlatives lest he be tarred as a businessman who has turned soft and thinks government is occasionally responsible. Let me assure you: he has not given anything away!

I.

In my appearances before the securities industry I have made two promises. One was that the Report of the Special Study of Securities Markets would be responsible and not flamboyant. This promise has been kept. In fact the London Economist discussing the Report made the following statement:

> "Americans who have long admired the quality of investigations conducted by British Royal Commissions may take heart. It can happen here."

The second promise was that we would consult with the industry in advance both with respect to legislation and rule making--formally as well as informally. This too has been and will be fulfilled. Some may ask why we regard it as necessary and desirable. Since the industry was not consulted on the recommendations of the Study, we need to test them against business practices and reactions to insure that they are supported by experience as well as logic. At this stage, of course, our objective is not to gauge the emotional level of the securities industry but to have carefully documented criticism or support--as the case may be. (I might say in general we find support likely to be less vocal than criticism.) Another reason for discussion with the financial community is a realistic one: Congress always asks whether we have talked with the industry and is not favorably inclined toward legislation when the responsible leaders have been kept in the dark.

Agency discussions with the industry always generate the criticism or the fear that we might become your captives. This is a problem we all face in Washington. The Scylla and Charybdis of the bureaucrat are the claim that we are encroaching on private enterprise too deeply on the one hand and that we have become its captive on the other. I might say that the SEC has been subject to both criticisms in the same newspaper in the same month. Frankly, I do not have any fear about becoming a captive. My only worry, and in my opinion the worry that should haunt all government

regulatory agencies, is over inertia--the loss of initiative. This concern is dramatized by Professor J. K. Galbraith:

> "Regulatory bodies, like the people who comprise them, have a marked life cycle. In youth they are vigorous, aggressive, evangelistic, and even intolerant. Later they mellow, and in old age--after a matter of ten or fifteen years--they become, with some exceptions, either an arm of the industry they are regulating or senile."

I do not accept this analogy, although at times there may be a need for revitalization. Still I differ with some of my fellow agency heads who express annoyance and occasionally indignation because their actions are under scrutiny by the Antitrust Division of the Department of Justice, a roving center of the government, or even by the press. These keep us alert and serve as appropriate stimuli.

In sum, I do not oppose working with industry. We have the conviction that discussions with the industry and self-regulatory bodies make for fair, reasonable, and responsible solutions. At the same time we do not have the illusion that every rule or decision can be arrived at with unanimity. Finally, I would emphasize that a belief in fairness and discussion does not mean that we are going to procrastinate in our program of implementation of the Study Report.

II.

Since I recognize the IBA as representing many leaders of the securities industry, I have become accustomed to report annually upon our present thinking. This time I shall touch on the three major areas of action in which our Commission is presently involved, with emphasis upon the Report of the Special Study.

A.

The Study contains a wealth of information and analysis. As you all recognize, it is not an academic exercise but a program for action--and action has indeed begun. I shall discuss that action, or implementation as it is described in "governmentaleze." I do not mean to take up the merits of specific recommendations but rather to consider our respective roles in the program and the manner and spirit in which we may go about discharging them. Implementation may be broken down into two major areas--first, our proposed legislation, and, second, the changes which you or the Commission may make without legislation by rule-making and otherwise.

With respect to legislation, we have made a good beginning. Working closely with the financial community through the Industry Advisory Committee, the Commission has submitted a program which we both regard as constructive. The bill itself, as you well know, involves two primary objectives: namely, to extend disclosure to unlisted securities having a broad public interest and to strengthen qualification standards

and controls over those in the securities business. We believe that improvements in the securities markets are best insured by the combination of better information about securities on the one hand and better qualified persons to use and evaluate that information on the other. I am sure you concur with this view.

There is a lesson which may be drawn from this effort. It is possible to evolve a program which serves both your interest and the public interest. Undoubtedly the exchanges may obtain some new listings as a result of this legislation and the NASD will obtain some new members and increased stature. However, you support the bill not for these reasons alone, but because it will raise standards and serve the interests of the investing public. To that end the NASD, for example, has stated its clear willingness to assume the additional responsibilities and the added burdens which this legislation will entail for it.

Our joint approach to the bill thus furnishes a constructive foundation upon which we can go forward with the more intricate, and I suspect more controversial, problems involved in those changes which we and you may make without legislation in response to the Study's recommendations. The greatest number of the Study's 175 specific recommendations fall in this category. These recommendations cover the gamut: the securities industry, the markets, the self-regulatory agencies, and the Commission itself.

In this area we have so far done several things. We have expressed our views regarding the Study's recommendations in three letters to the Congress. We indicated where we agreed with the Study and where we believed a problem warranted further examination. Further, we have established certain priorities which I recently detailed to the Congress. The priority projects may be broken down into those which are of industry-wide concern and those which, while of importance to all, relate to a particular self-regulatory agency. In the first category there is the vital area of selling practices which go to the heart of the relationship between a broker-dealer and his customers, the matter of minimum capital requirements, and controls over distributions. Turning to the exchanges, we have set as the first order of business the questions involving floor traders, odd lots, specialists and automation; and with respect to the NASD--quotations, retail executions, markup policies, and the organization and structure of the NASD itself. In addition to responding to the Study's recommendations and establishing priorities, we have initiated discussions with the industry at several levels. We have endeavored to arrive at target dates for responses or action. At the same time our staff is continuing an intensive examination of the Study's recommendations and the best means for carrying them into effect. The industry in the meantime has not been idle. You have formed your own study groups and,

significantly, you have already taken action upon a number of r ecommendations of the Study and upon a number of questions that it raised. I shall not itemize these here today but we are certainly not unmindful of them.

The industry's reaction to the Report has, with few exceptions, been a responsible one. There is not only your contribution to the legislation but your willingness to review, to study, and to evaluate the recommendations. You have not allowed your thinking to be dominated by what might perhaps be an understandable emotional reaction to criticism and to suggested changes in traditional practices.

Carrying on from there, I would like to offer a few points of departure for the future. In the first place, we firmly believe that the Study has exposed a wide range of serious problems demanding attention and action. Neither the letters to Congress nor the establishment of a schedule of priorities were intended to detract from the importance of the Study's recommendations or to relegate any of them to the shelf. In the second place, it would be idle for me to urge upon you the immediate adoption of all or most of the Study's recommendations. I know, as you know, that solutions for many of these problems will have to be hammered out through a process of serious discussion and interchange of views. Nevertheless, hammered out they must be. They are important and they are here before us--and before the Congress

and the public. We recognize them, and we must deal with them.

In so doing, there are, I submit, certain principles to be observed and certain pitfalls to avoid. Some recent public statements by industry leaders with respect to implementation have pointed out the need to proceed with caution and to test every proposed change for all of its possible ramifications and repercussions since the securities markets are a delicate and crucial part of our economy. With this one cannot disagree in principle. It is obvious that we must proceed with care, but proceed we must. The issue is one of degree, of emphasis, and of a genuine desire to effect changes which are needed. The fact that a problem is intricate does not mean that it can be ignored. We must be prepared to consider fresh, clear approaches; we cannot afford to think in cliches. If a particular recommendation of the Study strikes you as impracticable or unwise, this does not mean that the problem with which it attempts to deal should be left unresolved. Alternatives must be examined and solutions--perhaps less than perfect from the viewpoint of either of us--may have to be accepted.

Let me give you an example of the type of approach and understanding which concerns us. The Study found it necessary to discuss at various points the emerging impact of automation upon the securities markets and the possible regulatory and other uses to which this technology might be put. We observed in some quarters a misunderstanding of these discussions.

It was suggested that we were trying to tell businessmen how to run their businesses or implying that the skill and judgment of professionals in the market place could be replaced by a computer. We have no such ideas and the Study did not have them either. But the Commission has a definite interest in automation in so far as it expands our capacity to understand the markets and to discharge our regulatory responsibilities. There is every reason to believe that the capacity of such equipment to collect data and to reconstruct the market will be an invaluable tool for surveillance and for the collection of essential information. The availability of this equipment--which is now being studied or installed at the two large New York exchanges--presents both an opportunity and a challenge. It may well obviate certain problems presented by the Study.

Another entirely separate incident of recent days illustrates the need to face up to underlying problems. Within recent time responsible industry groups have publicly stated, in response to the Study's recommendations in Chapter III, that their concern for the financial responsibility of members avoided the need for action with respect to these recommendations. Last week the New York Stock Exchange gave a dramatic, impressive demonstration of its strength and concern for the public interest by taking action, in a specific case, to support the position it had publicly stated.

We were, of course, gratified by this prompt and decisive response to a public need in a particular situation. This, however, should not divert attention from the need for the adoption of rules to prevent recurrence of the sorry situation which gave rise to it. Fresh and imaginative thinking of the type given to the particular case must be devoted to the general problem. We should not wait for crises; but if one occurs, we should profit from it and move towards a long-range solution.

There is another aspect of implementation which warrants mention. Some may think that all that is asked of you is a response to the suggestion (or if you will, the prodding) of the Commission. I would say that many of the problems described in the Study Report would have to be met by the securities industry whether or not there was a Commission to provide oversight. The industry, through its self-regulatory associations, has taken collective action which has an immediate and important economic impact on the public. For example, an exchange as a body may set minimum commission rates to be charged by its members; it may prohibit its members generally from dealing in listed securities off the exchange; and may not allow non-members to deal on the exchange. I am not here casting doubts on the benefits and necessity of this system or the traditional structure of an exchange. I

am only suggesting that these characteristics inevitably raise questions of public policy. We must all recognize this is not pure private enterprise but has ingredients of private government. Certainly if the Commission were not here to focus on these questions, and even with the Commission here, other arms of the government might believe scrutiny was necessary.

Similarly, in the field of retail quotations of over-the-counter securities, even if the SEC had no jurisdiction, there is another factor which might well affect your thinking. As you know, one prominent newspaper has changed the masthead on the retail quotations it publishes and has undertaken its own assessment of that system. Government is not the only force affecting judgment. There are forces active outside the formal government structure which precipitate our thinking.

Although the Study considered many things, not all the problems confronting the financial community are fully described within the covers of its Report. There are, for example, forces moving towards concentration in the securities industry--a trend not unrelated to automation and its costs. Mergers are being announced and local firms are being absorbed by nationwide ones. Upon the basis of our own experience and the examples cited in the Study Report, this trend toward concentration seems to be accompanied by a correlative problem of supervision over branch offices, a problem of particular difficulty in rapidly expanding firms where growth outruns existing controls. Furthermore, mergers and concentration in the

securities business, like any other business, must be viewed with an eye to the antitrust laws. All of these factors--the costs of running a business, the need for supervision, and the principle of competition--must be kept in balance as the industry realigns itself.

B.

With respect to the Investment Company Act, I can report steady progress and better understanding on the part of the Commission of the underlying problems. From the enactment of the 1940 Act until 1961, there had been inspection of only 30 investment companies. We have activated a broad inspection program of investment companies which is gradually showing important results. Irregularities and violations of the 1940 Act have been found, and even larceny or violation of fiduciary responsibility uncovered in a few situations. Except for the latter, however, the basic problem seems to be one of education, the understanding of an Act which has meritorious objectives but is complex.

In addition, we are in the last stages of developing a new comprehensive annual report form which in our opinion will meet two objectives. First of all, it will help educate or remind investment companies about the basic requirements of the Act. Secondly, it represents a movement towards self-inspection which is consistent with our philosophy that part of the regulatory responsibility should be placed on the industry. We expect to enlist the aid of the independent certified public accountant who would

certify not only the financial statements but also compliance with those sections of the Act which he is in a position to check. This report will avoid an inordinate increase in the Commission's staff. At the same time it will help to assure that the major points are being examined and can be readily reviewed by us. There is no reason why government should expand when others can be induced to fill the vacuum.

The second matter with which we have been dealing involves the proposed com mingling by commercial banks of managing agency accounts and the expansion of their common trust fund activities far beyond the traditional limits permitted during 25 years of Federal Reserve Board supervision. We have taken the position that here the banks are moving squarely into the mutual fund business and hence this new phase of expansion must be s ubject to the Investment Company Act of 1940 and the Securities Act. Consistently, we have applied the same rationale to variable annuities, and have prevailed in the courts--at least thus far. To us, all investors in mutual funds should receive the same protections regardless of whether the fund is sponsored by a bank, an insurance company, a broker, an investment counsellor or any other person.

The third subject of concern is the front-end load or the contractual plan. Although the Special Study expressed the view that consideration should be given to abolition (that is, abolition of future contractual plans), the Commission has not yet arrived at any decision. Only the Association

of Mutual Fund Plan Sponsors has asked for an opportunity to present evidence. Yet clearly the question is not limited to that group alone, since roughly one-sixth of all mutual fund shares are being sold through contractual plans. The problem of this initial sales cost is therefore one which the whole mutual fund industry should face squarely.

Conceivably this problem may find some resolution without Commission or Congressional action through the operation of developing competitive forces. The entry of banks into the mutual fund field may have an impact, particularly if, as they have indicated, their offerings would be on a no-load basis. This competition as well as the planned entry of mail order firms and even the stretch-out front-end load plans presently before us may sow the seeds of change.

Meantime, until definitive Commission or Congressional action has been taken, our processing of filings of conventional front-end load plans will continue, and hopefully with expedition. It would be unconscionable for us to delay the registration process pending implementation of Special Study recommendations or because of individual opinions as to the desirability of continuance of future front-end load plans. To do otherwise would be bureaucracy at its worst.

C.

Turning now to registration matters, the Report says "The Commission's administration of the registration . . . . and related

exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable." Here perhaps we have the least problems--relatively. And yet improvements can be made.

Present controls over new issues--particularly over the "hot issue"--were subjected to criticism, and the Study's proposals are being explored. One very practical point has been brought home to us: that disclosure is not enough unless the facts are widely disseminated. We have taken this problem up with the principal investment services, and expect to make headway with their cooperation.

Independently of the Study Report, we have recently begun a review of our over-all program in the disclosure field. Simplification in the established registration process is not easy to achieve, and yet it is a worthy goal. We are trying--by developing a shorter form for equity securities of established issuers, by publishing a series of releases designed to clarify Commission policies in a number of areas, and by other approaches. Our proxy rules are also presently undergoing thorough reanalysis. These are areas which most of you are not only interested in, but in sympathy with, and we shall undoubtedly be soliciting your views.

III.

In conclusion, not only the Commission but the times and the needs of your industry and of the investing public call for action upon the

Special Study's recommendations and the other matters discussed today. By that I mean not action on some distant tomorrow but in the immediately foreseeable future. I know that the problems are many and often complex. They did not sprout up over-night, and many of them are not likely to be settled over-night. But time is a crucial element in this program to raise the level of investor protection. Some items require further study. But many have already been the subject of a great deal of study. The need now in many cases is for decision and for action.

In this connection, let me remind you--if reminder of such a point is needed--that to offset the intricacy of some of the problems is the wealth of able, experienced people who make up this industry. In a word, you have the capacity to meet the challenge, and I am confident that with sincere and conscientious effort the industry can join with the Commission to find answers to these pressing, common questions.