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THE SECURITIES INDUSTRY IN THE YEARS AHEAD

An Address By

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INTRODUCTION

I am pleased to have the opportunity once again to address this gathering of the Securities Industry Association. Today marks my fourth appearance at your Annual Convention. This is, I believe, a fitting occasion for me to share with you, as leaders of a vital national industry, my perception of our experiences over the last several years and of the future which lies ahead.

Such an exercise is important. Because of the rapid pace of change in the economic and regulatory environment, the securities industry has not typically taken the opportunity to formulate a long-term perspective. Indeed, the past decade saw the industry buffeted by unprecedented economic and regulatory waves. May Day, 1975, and its aftermath, the trend towards industry concentration, the emergence of new product lines and services, the increasing dealer-orientation of many firms, and the extraordinary levels of interest and inflation rates have all served to alter permanently the familiar contours of the securities business. Nevertheless, I believe that the industry has emerged from this traumatic period more efficient, better managed, and better capitalized than it entered. While the changes have not been pleasant -- and, for some who were in this audience ten years ago, have even proven fatal -- those changes have, I believe, produced a stronger securities industry.

The pressure of these developments has, however, forced many in the industry to devote themselves to dealing with a series of crises rather than to planning for the long-term future of their firm or their industry. As a result, I do not believe that any of us -- in the industry, in government, or in the academic world -- understand fully the ultimate consequences of the changes which the past decade has wrought. Yet, as investor interest in the markets begins its long overdue renewal, as the Nation's need for new investment capital accelerates, and as the 150 million share day looms on the horizon, it becomes increasingly important that we develop an understanding of what the securities industry is and what it should be during the balance of this century.

For that reason, I would like today to raise for you questions which I believe must be asked as the securities industry faces the future. I do not claim to have the answers. It is, however, clear to me that both the industry and the Commission need to understand better the long-term implications of our past and present actions and to ensure that our short-run decisionmaking is in harmony with the longer-term.

In that light, let me share with you my perspective on the securities industry's future. I want to divide my remarks -- the concerns which I believe you need to address -- into five areas: the economic challenges; the industry's role in the capital formation needs of our country; the market structure challenges; the challenge of preserving the vitality of the securities industry's unique self-regulatory system; and, finally, the role which the SIA ought to play in addressing these matters. I have placed industry economics first because, without an economically viable securities industry, any other questions concerning the industry's future are irrelevant. I want, therefore, to turn first to the economics of the securities business.

The Economic Challenges Ahead

The long-term implications of the economic environment in which the industry today operates are both especially important and especially difficult to fathom. For example, changes in the composition of security firm income streams, financing arrangements, and capital structure cannot help but have significant implications for the future structure and regulatory environment of the industry. As all good managers must in an inflation-plagued economy, those in the securities industry also should take careful stock of the business planning and risk management implications of their immediate reactions to inflationary pressures. Moreover, such managers must expect that non-traditional solutions to current economic problems may call for careful consideration of the regulatory implications of those innovative business decisions. The efforts of firms to protect themselves against market volatility and cyclicability, by diversification and by measuring its trading and investment activities also has its regulatory, as well as business implication.

Similarly, the increasingly dealer-oriented nature of the securities industry may well have profound implications for the way in which such firms do business and raise the requisite capital to support securities activities. How adequate is industry capital and how able is it to compete for capital in the marketplace or raise capital by means other than retained earnings. And, concerns about the efficiency of the pricing mechanisms of the securities markets and the best use of scarce industry capital cannot be ignored. Nor are the potential regulatory and competitive concerns raised by such an industry configuration without moment.

Finally, the tendency towards industry concentration may lead to changes in the short-term which could have long-term impacts on the industry. The Commission Staff Report on the Securities Industry in 1979 reported, on the basis of not full comparable data, an increase in concentration levels of the top 25 broker-dealer firms in the industry from 44 percent of gross revenues in 1971 to 61 percent in 1979, and from 56 percent of total assets in 1971 to 77 percent in 1979. The study points out, however, that there is an inverse correlation between size of firm and profitability, i.e., the larger the firm the lower the percentage of profitability -- however measured. Here we are, of course, all aware of the short-term difficulties which some firms have experienced in merging together the operations of two disparately organized and functioning entities. Just as significant, however, are the long-term implications of the marriage. It is, for example, much easier to talk the benefits of merger than to achieve -- and sustain -- them. Similarly, diversification of product lines in one entity without sufficient attention to sound management organization and internal control has, at times, threatened to allow difficult situations in one area to ripple not only throughout a firm, but also beyond the individual firm to the ever-increasingly-interdependent sister firms and markets of the securities industry.

But, just as responsible individuals in the management of securities firms and industry bodies must proceed with a full awareness of the implications of their present-day actions, so, too, the Commission is endeavoring to understand better the economics of the industry and the long- and short-term implications of regulatory actions which it may take.

Recently-proposed changes to the FOCUS reporting system are designed in part with the goal in mind, of providing better information to both the industry and the Commission.

Also, as you know, the Commission, in conjunction with the SIA's recommendation, is presently taking a careful look at the Commission's net capital and customer protection rules to ensure that they are consistent with present economic and regulatory needs. Recognizing the need of heavily-leveraged firms for increasing amounts of business capital, the Commission is exploring the possibility of freeing up some of the regulatory capital presently restricted by the Commission's rules. At the same time, however, the Commission is also considering the effects of inflation and the federal government's monetary policy on the volatility of the debt market -- and the resulting impact which such volatility has on the liquidity position of firms -- while attempting to adjust the "haircut" requirements of the net capital rule accordingly. Again, the Commission's proposed changes to the FOCUS reporting system should enable us to move more intelligently and responsibly in these areas.

Finally, the Commission is also committed to fully understanding and taking into account the issues of industry concentration and firm size and div· ·sification. In the first place, the Commission has long been conscious of the need to carefully differentiate between industry firms according to their size and their functions. An awareness of the possibly differential impact of regulation has formed a significant part of the Commission's deliberations concerning the still-pending Papilsky proposal from the NASD and has also been integral to its reconsideration of its net capital rule and FOCUS report system. At the same time, however, I am concerned that, while SIPC coverage may indeed be a factor which the Commission can responsibly take into account when attempting to guage the proper level and mix of regulatory capital that should be required, the increasingly large and complex nature of some securities firms may require us to consider carefully whether some system to rehabilitate troubled firms may be called for as an alternative to SIPC liquidation. So, too, I have repeatedly expressed my views concerning the need for securities firms to ensure the continuing integrity of existing activities before embarking into new areas, and I have stressed the urgent need to take meaningful action to prevent crises in one product line from bringing down the entire firm.

The Securities Industry's Vital Role in the Capital Raising and Distribution Process

Simply stated, the securities industry and the Commission must not lose sight of the importance of the traditional underwriting and broker-dealer functions -- which the securities industry has performed so ably over the years -- to the vital capital raising and distribution process of this Nation. While competitive pressures and customer preferences cannot be ignored, the industry must take careful stock of the type of core businesses to which it has committed itself before venturing into new areas. Neither the economy nor the government can long tolerate a lack of commitment -- both in terms of capital and regulatory oversight -- to those areas which have traditionally provided the securities industry with its reason for being. Rather, the industry's traditional role is what the "public interest" protects, and what forms the basis for the special and favored treatment afforded the industry. And, it is that special and favored treatment which also carries with it special responsibilities.

Thus, just as the Commission has devoted considerably more attention in the last few years to removing impediments to and facilitating the capital raising and distribution process of this Nation, so too the securities industry must recognize that it is the industry's preeminent role in that process that forms its greatest contribution to the public interest and the national welfare. In this regard, the Commission has become increasingly concerned about capital formation in American business and the health of the securities industry which is so vital to that formation and distribution process. It has done so without a specific statutory mandate, sensing a strong responsibility to contribute, where it can, to facilitating this crucial process.

In addition to being able to serve the capital needs of established clients, the special problems of small or start-up businesses must be addressed. Commission concerns and sense of responsibility for the capital raising needs of such businesses must be shared by the industry. As securities firms become larger, more diversified, and seek to "go national" -- or "international" -- and the industry becomes more concentrated, the financing needs of small or local enterprises must not go unmet. We must assure ourselves that the securities industry will provide adequately for the capital needs of those issuers which can presently muster only localized interest and support.

Similarly, Commission actions to help small business and to integrate and streamline the registration process should not be met by the industry only with narrow concerns about underwriters' potentially increased exposure to liability or economic risks. Rather, the Commission's efforts to remove unnecessary impediments to securities sales to business development companies or through limited or secondary distributions present the industry not only with added opportunities to contribute its genius and resources to restore the lost luster of American productivity, but also with new and additional responsibilities to ensure that these innovative avenues of capital flow are not choked off due to the irresponsible actions of the few. In sum, it is a spirit of cooperative and constructive dialogue between the industry and the Commission -- such as that which characterized the Commission's recent deliberations on the Papilsky matter -- that must prevail if this Nation's capital raising and allocation needs are to be met in the future, and if the industry is to demonstrate its continuing strong commitment to its traditional roles.

Indeed, to the extent that the Commission's and the industry's actions succeed in facilitating the vital capital formation and distribution process of this Nation, they serve also to present renewed opportunities for the securities industry to demonstrate to the Congress and the American public that it fulfills a unique and notable role which our economy cannot afford to weaken or endanger in any way. At the same time, however, to the extent that American industry finds itself unable to raise the capital necessary to sustain its productive capacities and our national well-being -- or seeks it elsewhere -- it will be the securities industry whose reason for being may well be called into question. It is here -- rather than in commercial banking, real estate, or insurance -- where the future of the securities industry, and the expectations of the American public for it, lie.

Thus, while the securities business of tomorrow may differ vastly from that of today, the industry must not lose sight of its core responsibilities as dealer-underwriters and secondary market brokers and dealers. The public and the government will have very little patience for industry diversifications into new product lines to the extent that the industry's capital, managerial, and regulatory commitments to the core area of its traditional concerns go unfulfilled. An increasingly leveraged, concentrated, dealer-oriented, and diversified securities industry must, as several of my fellow Commissioners have stated, be prepared for that inevitable day when it is perceived by the Congress that the securities industry has succeeded in breaking down the barriers between its traditional functions and those of, for example, the commercial banking sector. While the implications of the Congress' relooking Glass-Steagall are beyond the scope of my remarks today, the securities industry should not proceed without a full awareness of the effects of the transmutation which it has been undergoing.

Progress Towards the National Market System

But, more is necessary, of course, to ensure a truly fair and efficient securities industry than simply understanding and dealing with the economic health of the industry and ensuring that the industry continues to focus on its traditional roles. As you know, the 1975 Acts Amendments direct that the Commission ensure that there be no burdens on competition in the securities industry that are not necessary or appropriate in the public interest and for the protection of investors, and that the Commission facilitate the development of a national market system. Time will not permit me to cover the near-term national market system priorities of the Commission in the same detail here as I did in my prepared remarks before the National Securities Traders Association this past October 5th. But, I do wish to say a few words about industry progress towards the NMS.

Here, too, the Commission is proceeding cautiously -- fully mindful of the risks involved in tinkering with a system as delicate -- and successful -- as the present securities markets. As you all know, the Commission recently adopted Rule 19c-3 as an "experiment" by which it expects to better understand the effects that enhanced dealer competition would have on the fairness and efficiency of the securities markets. The Commission views the process of the evolutionary development of a national market system as one during which risks must constantly be reappraised -- and appropriate corrective action taken. In order to ensure that the vital mechanisms of our existing securities markets are not unduly threatened in preparing for an even more competitive and efficient future, it is continuing to monitor the industry's 19c-3 experience and actively considering whether and when it becomes necessary or appropriate to address the internalization, equal regulation, and other concerns which have been raised concerning it. Nevertheless, as all participants seem to recognize, an effective ITS/NASDAQ linkage must be implemented before the 19c-3 experiment is truly operational and the industry and the Commission can gather the necessary data and experiences on which to base those difficult -- but crucial -- regulatory decisions.

From the perspective of facilities design and implementation, the industry has made considerable progress in the last few years, but much more needs to be done. Prompt implementation of a workable -- and meaningful -- "LOIS" pilot must be a near-term national market system goal of the industry and the Commission. So, too, the ITS must be improved, the NASDAQ enhancements must come on line, and the two trading systems must be interfaced. Similarly, efforts to improve audit trail and surveillance capabilities in an increasingly active, complex, and competitive marketplace must not flag.

Commission action on the first step in the process of designating securities as qualified for trading in the national market system can be expected shortly. While the Commission has not yet considered the matter, any such initiative should, in my view, include the designation of at least a limited number of over-the-counter stocks as qualified securities. Over-the-counter securities which do become so designated should immediately be introduced to last sale and quotation reporting of the type that now prevails for listed securities and, in general, should eventually be eligible for unlisted trading privilege applications by exchange markets. Such initiatives, of course, would build on the enhancements to the NASDAQ system and the ITS/NASDAQ interface and their eventual realization would, in turn, make such facilities developments all the more necessary and rewarding.

Thus, significant additional progress must be made -- and made as rapidly as possible without jeopardizing the continuing health and vitality of the current securities markets. Indeed, significant advancements must be made simply to ensure the continued efficient and effective functioning of our markets in light of changing economic and regulatory circumstances.

As I stated from this podium last year, the industry must develop the near-term capability to handle a growth in trading volume characterized by 150 million share days on the NYSE. Some at that time may have thought that I was being unduly alarmist. Today, in looking at recent volume figures, I wonder -- as must we all -- whether even that capacity is sufficient.

Much of what needs to be done to deal with increased volume -- in terms of back office, exchange floor, execution, and settlement capacities, through automation and systems rather than bodies pushing paper -- must occur regardless of national market system developments, but must be designed and implemented in such a way so as both to reflect those developments which have occurred to date and to facilitate the continued evolution of the markets. Increased exchange automation is inevitable if they are to be able to deal with and hope to retain their order flow. Existing economic interests had best recognize the alternatives. In fact, the most critical tests of the industry's ingenuity, innovation, and capital may derive not from the evolution of the national market system viewed by itself, but from more fundamental demands to service the marketplace as it exists today, and as it will change in the future. Assuming this objective requires heavy investment in capacity -- which is absolutely non-discretionary on the part of any firm or exchange -- and yet provides none of the internal or marketplace excitement as does an equal investment in creating a new profit center.

Preserving the Industry's Most Valuable asset

At the same time, however, in addition to focusing on these economic and structural challenges, the industry must continue to safeguard the sense of integrity, fairness, and efficiency which is its greatest asset -- and which is best sustained by self-regulation. Strong self-regulation, with effective government oversight, is clearly the regulatory system which most challenges its participants -- but which, in my opinion, also has the best built-in capacity to continually and sensitively serve, as necessary, the interests of the industry and the public.

1. The Self-Regulatory Model

Self-regulation, first of all, tends to result in much different regulatory standards than does direct governmental regulation. Historically, direct regulation has shown inadequate sensitivity to its costs and practical consequences. The result is too often poor regulation.

Self-regulatory standards, in contrast, which emanate from the regulated industry itself, are more likely to confront in realistic fashion difficult questions such as, what will it cost; what behavior will it encourage or hamper; and what potential business will it attract or discourage. Self-regulation thus tends to be a more knowledgeable and sensitive standard-setter: Rarely does an industry impose unreasonable economic burdens on itself.

But, at the same time, self-regulation can easily ignore the public's needs, compromise them in favor of industry profits, or neglect to enforce its standards. Thus, self-regulation places special obligations on those who administer the system. When an industry establishes its own standards of conduct, the industry itself must accept responsibility for justifying and enforcing those standards. Blame cannot be shifted to the government or others, and it is the industry -- as well as the public -- which suffers most directly when failures do occur.

There is, a vital role for government to play in the self-regulatory process. Indeed, experience instructs us that, absent external oversight, self-regulation is not effective -- particularly when the self-regulator also has a mandate from its members to promote the industry's business.

The responsibility of government, in its oversight capacity, is to assure a reasonable balance. And, of course, if the private sector, for whatever reason, fails to meet the public's expectations, government may be compelled to fill the void.

2. Self-Regulation: A Promotional Program

I would expect that, if the securities industry maintains a perspective of its own long-term interests, a strong commitment to meaningful self-regulation will flourish. Simply stated, the most productive promotional program that the industry can undertake is effective self-regulation.

The investment process is bottomed on trust. The securities industry requires the investor to part with substantial sums of money -- often a considerable portion of his life savings -- in exchange for an uninsured and intangible concept: a property right in a risk venture often evidenced only by some book entry or an intrinsicly worthless certificate. Moreover, the potential investor has an increasing number of alternatives to traditional securities: Some, like bank certificates, are federally-insured; others, such as art or real estate, also provide their owners with possession, beauty or utility; still others, such as insurance, are promoted by sophisticated marketing systems and also guard against a measure of actuarial risk.

In such a competitive environment, a potential investor will come to the securities marketplace only if he expects to receive fair treatment and quality services. Thus, for example, the most severe penalty for back-office problems, I need not remind you, is not a Congressional reprimand or a Commission rule, but rather customers who are lost to the securities industry, and capital which is lost to American industry. And, a customer who feels mishandled or mistreated is not likely to further participate in the market.

The point here is that, even in its most promotional sense, the industry's profitability and worth depends upon the public's perception of its integrity, quality and purpose. It is, therefore, the industry itself which has the greatest stake in maintaining high standards of conduct and purpose among its members. This fact often becomes lost in the shuffle of day-to-day interaction between the Commission and the industry -- as though the stake and responsibliity was primarily that of the Commission rather than the industry.

3. Self-Regulation: Recognizing the Limits of Government

Of course, the Commission also has a strong commitment to the self-regulatory model. In providing the constructive tension of which I spoke earlier, the Commission, through its oversight activities, seeks not to displace or override industry self-regulation, but to support and enhance it -- not to question or erode its legitimacy and value, but to support and bolster it.

Indeed, to my mind, the Commission has been regarded as a successful regulator, in part, precisely because its regulatory role has traditionally been a rather limited one. Unlike some sister agencies, the Commission's organic statutes, for the most part, require it only to administer a disclosure system and provide effective oversight to industry self-regulators.

The 1975 Acts Amendments, in contrast, place the Commission in the less comfortable posture of both industry regulator and facilitator of the development of a national market system and a national market system for the clearance and settlement of securities transactions. And, during my tenure as Chairman, some of the most difficult decisions we have faced have grown out of that new role. The dilemma in which this has placed the Commission is an apt illustration of the limitations of government as a planner for industry -- a role for which it is not well suited by experience or disposition -- as a consequence of which I have so strongly urged -- and urged again -- that the industry maintain the initiative in design and implementation of the system. Our slow and deliberate movement is a consequence of the recognition of our limited competence rather than the naive, dangerous and careless conclusion that we are timid.

4. Self-Regulation: Shared Interests and Objectives

In sum, both the Commission and the industry are best served by the self-regulatory system. Indeed, for most important issues, we share a commonality of interests and objectives. Therefore, while I recognize that there may always be good-faith differences of opinion on how to reach our shared goals -- and that these differences need to be aired and resolved -- I do not fully understand the seemingly adversarial postures which sometimes develop between the Commission and the industry's spokesmen.

5. <u>Self-Regulation: The Challenge</u>

To a much greater extent than we have succeeded in doing, we should be able to encourage and support each other's goals. In this regard, for example, the industry should champion the Commission's efforts to secure sufficient resources to adequately and credibly meet our oversight responsibilities. That responsibility, in turn, necessitates for example, an inspection program greater than the Commission has monitored in the past.

Similarly, in a sophisticated financial world, adequate and credible Commission market oversight requires that the Commission develop the kind of technically advanced capabilities on which the industry itself relies. This is the objective of the Market Oversight and Surveillance System -- MOSS -- which the Commission is currently implementing. MOSS is not a tool for the Commission to usurp the surveillance role of the self-regulators. On the contrary, MOSS will, make the Commission's oversight of the self-regulators credibile and enable it, when necessary to demonstrate to both Congress and the public that self-regulation is a meaningful alternative to government regulation.

Mutual support also means that both the Commission and the industry have the same interest in endorsing a reading of the federal securities laws which allows the Commission to protect adequately the investing public. In the long-run, the credibility of Commission and private plaintiff enforcement of the securities laws is, in my judgment, directly related to the public's perception of the industry's integrity.

The experience of the last four decades has demonstrated the wisdom and value of the self-regulatory model. Indeed, I, for one, have long wondered why the model of securities industry self-regulation has not been copied -- or at least considered seriously -- whenever the government perceives a need for regulatory intervention. Yet, the securities industry should not be sanguine that self-regulation of its activities is immutable. Effective self-regulation requires continuous nuturing to survive.

The Role of the SIA

The SIA has an important role to play in sustaining self-regulation. Its members are not simply businessmen. You are also important participants in the self-regulatory process. And, in that capacity you must continually strike a balance between your individual economic interests and your aggregate responsibilities in making this unique regulatory scheme effective.

Nor is the SIA simply a trade organization. As the most inclusive organization of securities professionals -- and one which transcends the bounds of particular SROs -- the SIA should be expected to contribute significantly to the broad perspective necessary to make the system work.

Such a broad perspective, first of all, recognizes that the likely substitute for failed self-regulation is not the absence of regulation, but an ultimately greater level of direct government control. And, as the umbrella organization of the industry, it is the SIA, rather than a government agency, which is in a unique position to ensure -- by education, by advocacy, and by peer influence -- that an effective self-regulatory system does not erode.

In this vein, one would expect the SIA to relate to the Commission with a presumption of common purpose -- not a posture of reflexive opposition. And, as a corollary, one would expect the SIA to support the Commission's requests for sufficient resources to adequately and credibly meet its responsibilities in the self-regulatory process. Yet, this has not always been the case.

Finally, the SIA is perhaps the body best situated to appreciate the longer-term consequences of the new industry environment. The securities industry performs tasks which effect our National economic well-being and are infused with a substantial public interest. Regardless of the composition of government or the particular political philosophies of the moment, the industry will inevitably and ultimately be held accountable according to its success or failure in meeting these challenges. I would urge you, as strongly as I know how, not to permit the current political euphoria to cause you to lose sight of that ultimate fact. Am I naive in urging your enhanced support for the self-regulatory model and for a statemanship role for SIA? No I am not. I understand the countervailing forces at work. Unrealistic. Not for those who are prepared to go beyond complaining about the existing business-government relationship and committed to righting the balance.

Conclusion

In conclusion, based on my personal experience over the past three and one-half years, I am most confident about the future of the securities industry. The industry's direction has been encouraging: It includes improved market mechanisms, a sounder financial footing, better management and stronger leadership.

If you are to shift the balance in the business-government relationship back to business and keep it there, it will take increased business initiative and assumption of responsibilities to achieve. Whether my relationship with the industry will continue in its present capacity to the completion of my full

full term remains to be seen. If it does not, I will leave the Commission with a sense of optimism for the industry's future and for its continuing contribution to our Nation. If, on the other hand, I have the opportunity to visit with you next year for a fifth time as the Commission's chairman, I expect to be able to observe that the trend of the industry is even more positive.

Thank you.