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"The Conservative Regulator as Adventurer"

Stephen J. Friedman, Commissioner

A few weeks ago, I suggested that there was a critical need to start thinking in new ways about the structure of financial regulation in this country. There has been a dramatic merging of function among the traditional financial institutions -- banks, securities firms and investment companies, and although we continue to regulate them in different ways, what they do grows more similar by the month. I was not suggesting that we simply throw up our hands and permit every financial institution to do everything and lodge oversight in one agency, but rather that it is terribly important to look at events with clear eyes, avoiding the special purpose prisms of the traditional regulatory framework. Those prisms bend the light and what we see falls into expected patterns. But what is there does not.

The problem -- of the effect of institutional change upon regulatory matters -- is one that is also found in the classic areas of Commission concern, such as regulation of broker-dealers. And its existence has important and interesting implications for the appropriate role of the regulator.

There is great appeal in the proposition that a regulatory system, once established, should be administered in a conservative manner, that regulators should not be constantly reinventing the wheel and searching for new conduct to regulate. Change should flow from a demonstrated need. That approach characterizes the deregulation of commission rates, for example, which did not finally take place until the evidence of breakdown in the established regulatory system was all around us. The beauty of that approach is not that it makes a virtue of indecision. It also recognizes the real uncertainty about the full effect of the consequences that attend any important change in the economic ground rules.

Against that portrait of conservative and responsible behavior, the SEC's constant tinkering with the system, the flow of new rules and of changed rules, and the conceptual elaboration that occasionally approaches the rococo, strikes some observers as regulatory adventurism. We hear complaints from companies, broker-dealers and investment companies that new rules are proposed before the old ones are digested.

Nevertheless, I think that a regulator which clings to concepts that no longer correspond to the world for which they were designed is not acting conservatively, merely blindly. I have a favorite story about the Japanese artist Katsushika Hokusai, who died in 1849. He was wildly prolific, and produced more than 13,000 prints and drawings. As he lay dying at the age of 90, his daughter heard him murmur: "If I could only have just five more years I could become a really great painter."

The same wistful feeling inhabits the souls of financial regulators: "In a year or two the regulatory system will be just right -- if only the financial markets would stand still for a while."

But the markets do not stand still. And if the regulatory system stands still, at best it may become irrelevant. At worst, it may interfere with competition, inhibit evolution and prevent adaptation. We exist to help maintain the efficiency, stability and fairness of the markets. Regulatory action that cannot meet that standard has no justification.

Thus, in a curious way, it is not really possible to maintain the status quo through inaction. The rate and degree of change in the financial markets forces on us a constant process of self-examination -- and upon you a constant burden of contributing to that process. The increasing application of ex parte concepts developed in the context of adjudicatory and formal rule-making proceedings to informal rule-making proceedings, has made the communications process rigid and formal. It has limited our ability and that of the staff to talk directly to affected groups about proposed rules.

I think it is the confluence of these two factors: the rapidity of change in the marketplace -- which gives rise to the need for constant re-examination -- and the requirement of a relatively formal communication process, that has produced the constant stream of concept releases, proposed rules and requests for comments.

I would like to test that hypothesis, or at least the first part of it, by briefly examining three matters at the core of our traditional concerns and one to which we have devoted relatively little time:

1) inflation accounting,

2) the net capital rule,

3) the suitability concept, and

4) patterns of compensating registered representatives.

Inflation Accounting

I begin with inflation accounting, although it is not directly related to broker dealers. Nevertheless, it strikes me as the prototypical example of the beguiling dangers of

inaction. There are few conceptual systems as comprehensive, elaborate and detailed as historical cost accounting. It is a monument to the human need to impose order on the chaos of reality. With all its limitations, the system has basic internal consistency and within its parameters, it works pretty well.

The inflationary experiences of the last decade are not within these parameters. The Commission has responded with what some regard as a misadventure into reserve recognition accounting and accounting for the effects of changing prices. The current manifestation of the latter, of course, is the experiment known as Statement 33 of the FASB. I would like to put aside for a moment the merits of those particular proposals and ask you to consider whether we should have done nothing at all in this area.

Price Waterhouse recently analyzed the Statement 33 data of a group of industrial companies and concluded that real corporate income is only 60% of the reported amount, and probably less. The inflation-adjusted return on assets of the group shrunk from 17% in nominal dollars to 8%.

That state of affairs presents alarming opportunities for self-delusion -- on the part of investors, management and policy-makers. For example, it was widely believed that corporations are taxed at an effective corporate tax rate of 39 percent. In fact, inflation accounting methods reveal that the composite of industrial corporations pay a significantly higher real tax rate of 53 percent. Similarly, the general assumption, using historic cost accounting, had been that cash dividend payments on common stock are about one-third of corporate aftertax income, when in reality they are double -- two-thirds of inflation-adjusted income after taxes. Harold Williams has recently pointed out that the aggregate of those composite figures for taxes and dividends paid on an inflation-adjusted basis approaches -- and in some industries exceeds -- corporate income. That suggests that portions of the industrial sector must be paying their taxes and dividends out of capital resources.

In my judgment, that puts the difficulties of inflation-adjusted accounting in an entirely different light. The issue becomes not "whether," but "how." The question of whether to take some step has been answered by events.

The Net Capital Rule

With that example before us, let me turn to the net capital rule. Again, we have a highly complex and elaborate conceptual system -- arcane to the outside observer -- of time-honored

lineage. Its last major revision was as recent as 1975. Moreover, the rule appears to have been working effectively. Indeed, it may be too protective. The SIA has suggested that the rule hampers growth in ways that are not related to its objectives.

The primary purpose of our capital requirements is customer protection. A broker-dealer is highly dependent on liquid assets, perhaps more so than any other financial institution. The net capital rule is designed to insure that firms have sufficient liquidity to meet their commitments to customers -- to satisfy current claims for cash and securities promptly. The net capital rule also provides assurance to other members of the broker-dealer community that a broker-dealer will be able to meet its obligations.

Now, what is the significance of the proliferation of financial instruments -- for example, options, forwards, repurchase agreements, financial futures and commercial paper -- of the growth of government securities activities and of the general diversification of securities firms? When the net capital rule assumed its current form in 1975, it was revised to take into account the development of new instruments and to deal with the new assets and liabilities that were appearing on broker-dealer balance sheets. Is that enough?

For a variety of reasons, some firms have begun to place their nontraditional securities activities in separate corporate pockets in the holding company structure. One could conclude, of course, that the isolation of broker-dealer activities in a corporation subject to the net capital rule is enough to protect the firm's securities customers, which are the only customers for which we have full regulatory responsibility; and that so long as there are adequate liquid assets to pay those claims as they fall due, our duty has been discharged. After all, the proponents of this view argue, the alternative is to regulate the non-regulated activities, which is not within the SEC's mandate.

Before making that judgment, however, I think there are some questions we must answer. Insofar as securities activities are concerned, the net capital rule provides stability as well as customer protection. It does not, of course, insure against bad business judgments or the adverse effects of bad markets. But, at least in theory, it brings close regulatory supervision when a firm begins to experience real financial problems, and requires a cessation of operations at a point when all or most of the customers' claims should be covered by liquid assets. To the extent that government securities activities, or trading in the Ginnie Mae forward market, are conducted by a broker-dealer, the net capital

rule functions in the same way for those activities. But if they are carried on by another subsidiary of the holding company, the net capital rule has no application. The effect of that rule on the stability of those other operations is lost.

Notice that the rule has not changed. Indeed, it was improved in 1975. But the facts have changed, and the assumptions that underlay the decision to adopt the rule may no longer be applicable. The theory of insulating the broker-dealer operations in a corporate subsidiary works fine when there is relatively little from which to insulate them. But it is excessively utopian to believe that the bankruptcy of a sister corporation is not an event of great, or even mortal, moment for the broker-dealer. My point is simply that while nothing may have happened to the functioning of the net capital rule, it may be equally the case that the assumptions which made that rule a sufficient response to concerns about broker-dealer stability are no longer tenable. I do not know the answer to that question. But I suspect that the Commission inevitably will be drawn into the very difficult business of thinking further about the implications of non-securities activities of broker-dealer holding companies.

Suitability Rules

The obligation of a securities salesman or counselor to deal fairly with his client is an essential element in maintaining investor confidence. It was born in the conventional wisdom that securities are sold to individual investors, not bought, and in a well constructed regulatory system that obligation should extend widely. Yet the current department store of financial instruments and services has produced seemingly anomalous results in the suitability area. Different standards and rules apply in the options and equity markets, and no such rules exist for commodities trading or trading in government securities. Yet in some cases the same salesmen are selling all of those instruments to the same customers as alternative investment opportunities. That situation should be remedied. The collateral effects of bad sales practices in any one area tend to spill over into others.

At the same time, it would be silly to think that the same old rules and procedures can simply be transplanted to each new instrument. Let me give you a few examples. Options transactions are more highly leveraged than stocks and, as a class, the likelihood of speculative risks is greater. Moreover, options strategies are more complex and harder to understand. The SEC staff's study of the options markets suggested that the existing suitability rules in the options area were simply inadequate to prevent many quite improper

sales practices. Now the options exchanges have adopted uniform suitability rules which are unique in requiring a registered representative to assess whether a customer is able to bear the risks of an options transaction and to evaluate the customer's financial sophistication.

On the other side of the coin, there are cases in the Ginnie Mae forward market that involve aggressive marketing of interest rate risks to small financial institutions. Whatever the lack of sophistication of the management of some of those institutions, it is very clear that the usual notions of what a securities salesman should do for an individual customer are not useful here. The customer is a financial institution. Other state and federal regulators have the responsibility of determining the propriety and safety of their investments. For better or worse, depository institutions are in the business of forecasting interest rate movements. Moreover, can we really expect a registered representative to second guess the bank's asset and liability management decisions?

At the same time, it would not be responsible for the Commission to simply walk away from that relationship; the evidence of abuse is too great. What is needed, I think, is a new definition of a broker's responsibility to financial institution customers. For example, I would think that the questions to be asked concern not the bank's "lifetime investment goals," but its investment manager's authority to act, limitations on the scope of that acitivity, the bank's ability to take delivery or to lay off that obligation on others; and the extent to which the purchase of securities of the type and quantity involved have been considered at an appropriate level of management.

Broker-Dealer Compensation

The Commission's concern with sales practices has even broader implications than our mandate to promote fair dealing with investors. Those practices have implications for the efficiency of the pricing mechanism and for allocation of capital as well. The efficient functioning of the market rests upon an assumption of rational choice. And if neither the customer nor the broker acts rationally -- the customer because he is relying on the broker, and the broker because he is motivated by some external factor -- then, at least in a marginal way, one of the basic assumptions of the market economy becomes eroded.

In general, we touch the registered representative-customer relationship at two points. First, to insure that the registered representative is adequately trained; and second, in retrospect, usually as a result of a complaint.

We do not examine, no less regulate, the compensation structure that determines so much of what registered representatives really do. Nor am I suggesting in any way that we should regulate those matters. But I do think we should have more information about compensation structure and its likely impact on the recommendations made by registered representatives. Once again, it is a question of the financial markets having shifted beneath our feet. When the number of different kinds of investment vehicles is quite limited, and each serves a distinct investment need, then the compensation structure is of comparatively little public concern. But when new equity issues, options, futures, forwards, standby commitments and other instruments all compete for the same high risk dollar, then the shape of the compensation structure has a very important impact indeed on which securities it is that are "sold and not bought."

In its options study, the Commission staff examined the way broker-dealers were compensating their registered representatives for effecting options transactions for customers. It concluded that the structure created substantial incentives to recommend options rather than equity secuities. One can and should ask similar questions about interest rate futures and other instruments.

I am not suggesting a major study or a concept release requiring public comment. I do think, however, that, as in the case of securities holding company activities, it is quite important that we begin to think about these questions and to debate them. If it should appear that there are indeed problems in some of these areas, the time to begin to deal with them is now -- not when we discover that what we thought was the status quo disappeared long ago.

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When regulatory change is forced upon us this way, the process of discerning the course of underlying trends is very difficult. Our glimpses of the future are always clouded. In that endeavor, the Commission values and welcomes your skeptical scrutiny, which Carl Sagan has called the process of winnowing deep insights from deep nonsense.