

ADDRESS

of

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before

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I doubt if any of you can fully understand the pleasure which this visit to Seattle and the Pacific Northwest gives me. From my own personal point of view, my trip is the realization of an ambition of many years' standing; for although I have had many friends and relatives living in this part of the country, and even farther west, I have myself hardly succeeded before in getting more than a few miles from the eastern seaboard. I once got as far west as South Bend, Indiana, and thought I was in the Rocky Mountains; but the mountains I have seen in the last few days have shown me pretty clearly how wrong I was.

And apart from my own personal pleasure at being here, I am glad for more official reasons; for we have to sit at our desks in Washington and try to solve problems and answer questions which affect the economic well-being and the day-to-day lives of the entire country. Of course, with the telephone and telegraph, airplane and streamliner, we are not so much farther, in point of actual traveling and talking time, from Seattle than we are from Boston or New York. But there is a difference--the personal approach is lacking. In spite of all the letters and telephone calls, the reports and visits which we get from Mr. Karr, Seattle necessarily remains for us in some senses little more than a spot on the map. Consequently, the real point of my visit is not to read any lessons, or to tell you or anyone else what the S. E. C. wants you to do; it is to get as much as I can, in the few days I can be here, of the general background, the personalities and the business problems of the people who are actually living and working in Seattle, and from and about whom I have only been able to learn in letters in the past. Just to have been here for a few days is going to make it easier for me to do my work in Washington, and I hope that to some extent the process may work the other way round.

And I am doubly glad to be here today as the guest of the Seattle Bond Club, for I think it is fair to say that no part of the Commission's work is more active at the present time than its attempt to understand and cooperate with the great industry known as the over-the-counter securities business. Of course, as you all know, the Commission has given a great deal of attention to the securities exchanges of the country, and I am far from suggesting that it hasn't had, and won't go on having its trouble with the exchanges. But in some ways the exchanges offer a simpler problem. The economic functions, the delicate mechanisms, of the exchanges, may be tremendously important, but at least you know where and what an exchange is. If you are interested in some problem of exchange management or trading, there is something you can do about it; the exchange has rules, it has officers and governors, it has members; you can isolate it and study it under a microscope and find out what makes it tick.

That is why, when Congress in 1934 decided that something ought to be done about the securities markets of the country, it had an idea where to start. As I said, there was something you could do about an exchange; you could make it register with you, and then go over its rules at leisure, to see where they were really constructed in the public interest and where they were no more than gambling house rules. If a member of an exchange engaged in manipulation or other types of dishonest or unethical practices, you didn't have to try to fit his actions into the straight jacket of common law fraud; you could throw him off the exchange. But the over-the-counter markets presented a different

problem. Congress didn't know how big the problem was; it didn't even know *what* the problem was. It just knew there was a problem.

And there was, and still is, a problem--a tremendous problem of understanding, coordinating, cooperating with, and if necessary controlling, a huge amorphous industry, the ramifications of which are still to a considerable extent unknown. This industry handles daily the surpluses of the rich and the savings of the poor. In number of people engaged, in volume of transactions effected, the over-the-counter markets greatly exceed their more conspicuous brothers, the securities exchanges. Even now there is relatively little known of the precise scope of the activities of brokers and dealers in the over-the-counter markets, but at least we have by now a few comparative figures available. For instance, we know that our own records show a total of more than 6,800 brokers and dealers registered with us as such, of which only about 1,500 hold memberships on any securities exchange. We know that these 6,800 firms employ more than 25,000 people as customers' men, salesmen and traders, and more than 62,000 people in other capacities. We know that while only about 6,000 issues of securities are traded on the twenty-two national securities exchanges, quotation services used by brokers and dealers in the over-the-counter markets carry quotations of more than 60,000 issues which are traded only over the counter. But when the Securities Exchange Act was passed, even these elementary facts were largely unknown; and although it was perfectly evident that an act which dealt with the securities business and didn't cover the over-the-counter markets would hardly do more than scratch the surface, Congress just didn't know where to begin.

That is the reason why, when Congress created the Securities and Exchange Commission and directed it to go in and clean up some of the darker corners of the securities markets, the Commission's specific authority ran only to the organized exchanges, and its authority with respect to the over-the-counter markets was expressed in the most brief and general terms--in fact, in a single sentence, which directed the Commission to adopt such rules and regulations regarding the over-the-counter markets as would provide to the public a protection comparable to that provided by the Act itself with regard to the exchange markets. For the first two years of its operation the Commission had only this general mandate to go on.

It is consequently hardly surprising that the Commission's approach to the over-the-counter markets has been extremely cautious and tentative. At the outset the principal need was for facts, for at that time, as I have indicated, there was no reliable source of information even as to the number of investment bankers, brokers and dealers engaged in the business. The Commission started, therefore, with a system of registration, and a few very simple rules, covering only the most elementary principles of ethical conduct--for at that time the Commission felt that the unexplored character of the territory made it unwise for it to adopt any rules as to which there could possibly be any ground of disagreement among reasonable men.

Simple as these rules were in specific content, however, their formulation and administration required the most careful study, and consultation by the Commission's staff with experts in the field, and as a result, after two years of operation the Commission felt itself justified in going back to Congress, as the Act authorized it to do, and requesting that the results

of its experience be given more definite form in the statute. This was done and in May, 1936, the present Section 15 was adopted. This section gives statutory form to the process of registration, and spells out the grounds upon which denial and revocation may be based; and in addition, it prohibits the use, in over-the-counter transactions, of devices and contrivances which are manipulative, deceptive or fraudulent in character. This is the section under which the present over-the-counter rules were adopted, the basis for their adoption being merely an authority to the Commission to define such devices as are manipulative, deceptive or fraudulent.

There is no question but that these rules--the MC rules--are more pervasive in their character than the old MA rules. But at that there is not one of them that goes beyond the bounds which are imposed on every reputable investment banker by his own conscience. They are not rules designed to set up any new system under which brokers and dealers are required to do business, not to eliminate any types of business which have been done before. They are adopted by the Commission only under a power to define devices and contrivances which are manipulative, deceptive or fraudulent in character, and in substance they do only two things: first, they outlaw specifically some of the types of fraudulent activity which have always been regarded by reputable firms as inconsistent with fair and equitable principles of trade, and second they codify some of the business customs which as a matter of practice have come to be adopted by the best elements as desirable from the point of view of promoting public confidence in the integrity of the industry--a confidence which is absolutely essential to the economic well-being of the country as a whole.

Although you are probably all pretty familiar with the rules, let me just run over them briefly to prove my point. Rules MC2 and MC3 are the simplest, for they do nothing more than prohibit outright and obvious fraud. MC2 is essentially like Section 17(a) of the Securities Act; it prohibits false or misleading statements or omissions of material facts, and it prohibits acts, practices and courses of business which operate as fraud or deceit. It goes further than Section 17 of the Securities Act in that it applies to transactions of *purchase as well as of sale*, but otherwise the two are about the same.

Rule MC3 is like Section 24 of the Securities Act; it prohibits a broker or dealer from misrepresenting the effect of his registration with the Commission. Registration with the Commission does not in fact imply that the Commission has in any way passed upon the financial standing, business or conduct of the person registered, or upon the merits of any security in which he may be interested; and this rule makes it a criminal offense to represent that it does.

Rules MC4, 5, and 6 are a little more complicated, but the central theory underlying them is still pretty simple--namely, that in the securities business there are certain typical and frequently recurring situations in which there is a distinct possibility of conflict of interest, and that in these situations it is only fair that the circumstances which give rise to the possibility of conflict should be revealed to the customer. So, Rule MC4 call for disclosure of the all important fact of whether or not you are acting as a principal or an agent; MC5 for disclosure of any control relationship existing between you and the issuer of the security involved in the transaction; and

MC6 for disclosure of any financial interest or participation you may have in a distribution of the security. These rules are of course applicable to discretionary as well as other kinds of accounts, but MC7 is a special rule applying to that type of account; it prohibits churning up an account just for the purpose of increasing your own handling fee; and it requires making an immediate allocation of transactions effected for a discretionary account, so as to minimize the temptation to see how the market jumps and then give yourself, instead of the customer, the breaks. And Rules MC8 and GB2 deal with those venerable frauds of helping along an over-the-counter distribution by pointing to an over-the-counter or exchange market price which you are really responsible for yourself, and which is not a really independent market price.

This is a very crude summary of the rules, and insufficient for actual operating purposes; but I think it at least illustrates my point that the rules as they now stand are not a very thoroughgoing or meddlesome type of regulation, but are essentially rudimentary in character and cover but a small and elementary part of the problem. For the problem is not merely to eliminate the crook; it has really three aspects, which I think I can best describe in the language which Commissioner George Mathews recently used in a statement to the Senate Committee on Banking and Currency: "First, to protect the investor and the honest dealer alike from plainly dishonest and unfair practice by the sub-marginal element in the industry; second, to cope with the penumbra of inequitable and injurious methods of business which lies outside the area of definite illegality, and which can be dealt with effectively only by placing the business upon a highly professionalized basis; and third, to afford to the investor an economic service the efficiency of which will be commensurate with its economic importance, so that the machinery of our markets will operate to avoid the misdirection of our nation's savings which contributes so powerfully toward economic depressions, and breeds disintegrating mistrust of our financial processes."

Certainly it is clear that if the Commission were to try to do the whole job outlined in this statement of Commissioner Mathews, it would have to turn itself into an armed policemen, or several thousand of them. The Commission hasn't the least interest in doing this, unless it is absolutely necessary, and even if it did, the results would probably be noticeable only with respect to the first problem--that of catching the out-and-out crook. The other two aspects of the problem would still be with us, at least in large part, and they are quite as important.

And so, the Commission has concluded that the next stage in the job--the job of raising the standards of those on the edge to the level of the the standards of the best--can best be handled, not by more policemen, but by placing the primary responsibility on the organized associations of security dealers throughout the country. When I say that the Commission has concluded this, I do not mean that the idea necessarily originated with the Commission. For if one thing has stood out in the history of the Commission's concern with the over-the-counter markets, it has been the whole-hearted, progressive and public spirited cooperation of the leaders of your industry in the monumental attempt to understand and analyze the problems of the over-the-counter markets. From the beginning the Commission has been immeasurably assisted by the advice and criticism of the informed members of your business, advice and criticism which were just

as realistic and constructive as they were direct and forthright. Representatives of the industry acknowledged from the beginning the need for some such rules as have been adopted. The only problem was to frame the rules; and representatives of the industry sat down with representatives of the Commission in a spirit of whole-hearted cooperation to help make the rules sensible, workable and sound.

That is why the Commission feels that the latest phase of its program with respect to the over-the-counter markets enjoys some considerable prospect of success. By the latest phase of the Commission's program, I mean, of course, the Maloney Bill, which since I left Washington ten days ago has been reported out favorably by the Senate Committee on Banking and Currency, and seems well on its way to enactment into law. Many of you are probably familiar with the provisions of this bill, for at every stage in its formulation and its presentation to the Senate Committee the Commission has had the unremitting cooperation of and assistance from representatives of the Investment Bankers' Conference, the Investment Bankers' Association, and many other representative associations throughout the United States. At every stage of congressional consideration the bill has been shaped by the constant suggestions and criticisms of the members of the industry.

The framework of this bill, which primarily will become a new Section 15A of the Act, is relatively simple. In its essentials, it does no more than set up a system of cooperative regulation of the over-the-counter markets, through the activities of voluntary associations of investment bankers, dealers and brokers doing business in these markets--associations which although of national concern will not necessarily be nation-wide in character, but will rather be representative of regions sufficiently substantial and cohesive from an economic point of view to give some assurance of successful control over the practices of their members. The Commission will assume some degree of supervision over these associations, to the end of seeing that their geographical scope is of sufficient breadth to enable them adequately to fulfill their functions under the Act, and that their rules are so designed and administered as to assure adequate representation and equal treatment to all members of the industry who are willing to abide by fair and equitable principles of trade; but beyond this, the associations will be purely voluntary in character, and their success or failure will depend not upon government but upon the members of the industry itself.

I am not here to argue for the Maloney Bill; in fact, since I left Washington a new revision of it has been accepted by the Senate Committee, which I have not yet had any adequate opportunity to examine, so that I can't even speak with confidence of its precise terms. Furthermore, I know that there has been some disagreement between the Commission and some of your representatives as to particular features of the Bill, and I know also that largely as a result of the cooperative attitude which has grown up between us in the past few years these disagreements have in great part been ironed out, so that the Bill has now been formally endorsed by the I. B. A. and the Investment Bankers' Conference. But anyhow, whether the Bill passes in substantially the form in which I last saw it, or passes at all, it will serve to illustrate the point I do want to make, which is that the job of supervision over the practices of the over-the-counter dealers and brokers of the country is fundamentally one for the industry itself. In the past we have had the

fullest degree of cooperation and assistance from the industry, but that cooperation and assistance has of necessity been largely advisory in character. Under the Maloney Bill, or some similar legislation, associations of the type which have helped us so greatly in the past will receive legal standing and legal rights not heretofore available; they will receive power not only to establish standards of financial responsibility, professional conduct, technical proficiency, and general fair dealing, but also to enforce such standards upon their members, subject only to the cooperative supervision of the Commission. Should the Maloney Bill, or some revision of it which preserves its essentials, become law, it will mark the beginning of a new era of cooperation between the industry and the Commission on a broader basis than has been possible before. It will place upon the industry, *where it belongs*, the primary responsibility for its own salvation-- and the salvation of the rest of us. The government will retain residual powers, and the Commission's assistance and cooperation will at all times remain available; but in proportion as your own work becomes more effective, the activity of the Commission will become less rather than more pervasive. The job is yours to do, and it is a job worth doing.

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