NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-1160

U.S. SECURITIES & EXCHANGE COMMISSION
RECEIVED
1971
LIBRARY

FOR RELEASE NOON JUNE 17 1971

THE PUBLIC INTEREST IN OUR SECURITIES MARKETS

AN ADDRESS BY

WILLIAM J. CASEY, CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

INSTITUTIONAL TRADING CONFERENCE

NEW YORK HILTON N.Y. JUNE 17 1971

THE PUBLIC INTEREST IN OUR SECURITIES MARKETS

We are participating in this Conference at a time when all of us involved in the securities markets face some tough and critical decisions. As we move toward those decisions, we should be going through a period of review and self-assessment and we are as this conference demonstrates.

What I would like to do today is take a look with you at the breadth and the multiple dimensions of the public interest in the securities markets. Perhaps if we review the many ways in which the public is interested in the functioning of the securities markets we will be in a better position to assess what the public should expect from the market, the relative value and importance of its multiple interests and how the institutions of our market should function and relate to each other in order to best satisfy those interests.

I'm here at the SEC because I believe that the securities markets of this country are important national assets. They are at the heart of our economy. The living standards, and the opportunities available to 200,000,000 Americans depend on the ability of our securities markets to properly direct and propel our economic progress. Some 100,000,000 Americans, 31,000,000 of them owning stocks and the balance through pension and other employee funds, investment companies and life insurance, have a direct stake in the values established and the liquidity offered by our securities markets. As other countries improve their own technology and license our technology and continue to work longer hours for less money, our ability to compete in the world depends increasingly on our unrivaled ability to mobilize capital and apply it to productive purposes here and abroad. As we struggle with the immediate bread and butter problems of capital and reserves and commissions, we must never forget that we are dealing with a priceless asset, the repository of the retirement hopes and educational aspirations of millions of Americans, a unique barometer of our economic health and engine of our economic progress.

What does it take for our markets to achieve these great purposes. The markets themselves must have characteristics of liquidity and sensitivity to economic reality. They must be honest and fair and orderly. The public must have confidence that those characteristics prevail. Broad public participation is essential to liquidity. Full disclosure is essential to public confidence. The application of solid research and informed judgment to fully disclosed information about trading and corporate performance is necessary for sensitivity to economic reality as well as to public confidence.

Now, let us examine what the individual investor wants of the market. It seems to me that he is interested in these things.

First, he wants to maintain the value of what he invests and see it grow. This means that he needs good information, good research and good advice. This might be summed up as experienced service.

Then, he wants safety for his funds and his holdings. He doesn't want to see them disappear.

That means solidity in the firms that serve him and that, in turn, means that they have adequate capital and cash reserves and segregation practices that will protect his cash and securities from insolvency.

Then, he wants a market in which the spreads are not too great and the swings too deep. A big spread between bid and asked prices can cost the investor much more than a slice off commission rates can save him.

Finally, he wants to pay commissions on his transactions which are no more than necessary to pay for the service he wants, attract the capital this service requires and produce a proper profit to those who produce the capital and provide the service.

It's clear that we are going to have new commission rates, new rules on access to exchanges, new relationships between institutions, new technologies and new competitive forces. It's important that in this restructuring we keep firmly in mind the sensitive interrelationship between service and safety and capital and income and market pricing and liquidity and that we have a clear conception of the relative importance to the investor of research and reserves and spreads and commissions.

If we can get these interrelationships satisfactorily resolved, we should have a healthy capital machinery and well served investors.

Let me now touch upon a few issues and problems that relate to improving our disclosure and regulatory policies with a view to adapting them to new economic and legal developments.

The quality of disclosure which we require and the quality of your research and analysis are critical not only as the basis for investor confidence but also in directing investment funds where they are most needed or, to coin a phrase, in reordering our economic priorities.

I'm afraid it hasn't always worked as well as we are entitled to expect. If a man from Mars or an archaeologist of the 25th century found the offering circulars of the 1967-1969 period, how would the American society of our time be reconstructed. It could well be something like a string of communities made up of precut houses, with a nursing home and a hamburger stand on each corner, all hooked up by wire to a battery of electronic gadgets and fast food stores, synchronized by unbundled programs on leased computers. It is my personal view that the investor is entitled to something better than the usual boiler plate to the effect that there are strong competitors in the business. If the issuer has researched the market and analyzed the competition, the investor should be told what it found. If it didn't, the investor should at least know that he's being asked to fly blind. At some point the investor is entitled to have the question raised as to how many fast food chains or bowling alleys can be financially viable.

We are constantly working to bring our disclosure more closely in line with economic reality and the requirements which public polity imposes on businesses. Right now, for example, we are developing guidelines on the disclosures a company should make in the light of increasing public concern about the environment. We will require disclosure of any material litigation against an issuer under the various air, water, and other anti-pollution laws. More than that, in the examination of filings made with the Commission, we will look to the nature and character of the business to see if significant capital outlays are likely to be required in order to eliminate pollution of streams or atmosphere or if significant product redesign may be called for to meet anti-pollution standards. The same kind of inquiry will be made with respect to the impact of safety standards on a company's product line. Where these problems potentially exist, the burden should be put on the company to represent that they do not exist or that they do not materially affect the capital needs or earning power of the business or to disclose their financial impact and the company's plans for dealing with it.

We are developing a set of guidelines to more fully bring out the risks and uncertainties in defense contracting.

The responsibility to interpret information is as important as the responsibility to make it available. It has important consequences not only to investors but to the economy as a whole. It is less clear where that responsibility rests. To illustrate, there is little doubt in retrospect that some conglomerates got more capital during the sixties than they were entitled to. This resulted in large measure from the manner in which the impression of earnings growth per share could be exaggerated by skillful use of pooling of interest accounting, by using convertibles and warrants to acquire additional earnings not reflecting the potential dilution in reporting earnings per share and by other such shenanigans. The accountants were slow in tightening their rules, the SEC was slow in not requiring disclosures to correct misleading impressions and the analysts were slow in not putting the information which was available in proper perspective. It seems to me that corporate officers have a primary obligation to rise above accounting conventions and lay economic reality on the line. As Clemenceau said, accounting is too important to be left entirely to the accountants. Their laudable efforts to maintain consistency in financial reporting can not serve as an excuse for the rest of us to obscure economic reality which will effect market values in the long run if not in the short run.

Investment decisions and the sensitivity of the capital market in directing the flow of funds depend very heavily on the flow of information to security analysts and on their initiative in pinpointing critical areas of information. I hope that corporate officers and analysts have overcome the initial confusion and uncertainty generated at the time of Texas Gulf about potential risks in private meetings and discussions. This is a process which can be valuable to both parties as well as the investing public. It seems to me that this process is substantially risk free as long as it consists of providing what our General Counsel, Phil Loomis, has called "links in a chain of analytic information" and as long as both parties to the process keep their wits about them and make public disclosure of anything of "sharp and immediate significance" which is communicated or generated as a result of the meeting. If something as specific and immediately related to market value as a projection of company earnings is given to one analyst it should be made public. When management is requested to comment on an analyst's projection, I think it is not safe to underwrite the projection unless the management is prepared to make public disclosure of its own projections, if the projection is of a character which could have a sharp impact on market.

I see no great reason why a corporate officer need refrain from discussing trends in the business and the industry. However, if a company knows that an analyst has made an accurate projection on what a new product or some new development will do to a company's earnings per share and that his projection will be given to investors, this combination of events creates an obligation for the company to make some kind of announcement. This possibility may lead the analyst to avoid a meeting but the corporation would incur the obligation to make its information public at some point in any event, perhaps when the stock started to move significantly. Delay in making the information public merely inhibits insiders from buying stock and creates the possibility of claims from shareholders who sell without the information. Se it seems to me that the corporation has nothing to lose and something to gain by engaging in the dialogue. On the other hand, I see no point in talking to the analyst who hasn't done any independent work but is looking for advance information on something like a dividend cut or a merger.

I know that you are concerned about how the critical research function will be financed in the future -- specifically, the degree to which commissions can be used, where rates are negotiated and under developing legal concepts, to pay for research. It seems clear that negotiated rates have brought to the fore the question of whether cash ("hard dollars") have to be used to pay for research. These are exceedingly complex questions. In discussing them with you I am not expressing the policy of the Commission nor am I giving you legal advice. I am merely giving you my own personal first impressions because I think it important that all of us who will be involved in determining the ultimate answers should begin the dialogue which hopefully will produce the right questions and ultimately the right answers. The recent decision of the First Circuit Court of Appeals in Moses v. Burgin reemphasizes the serious legal risks in using commission dollars to pay for sales services. This springs from the fiduciary duty to use the transactions of a fund for the benefit of the fund holders and the fact that sales of new shares which increase the size of the fund does not help the fund holders but has the primary effect of increasing the management fee. The use of commissions to pay for research does benefit the fund holders and is therefore not subject to precisely the same objection as the use of commissions to pay for sales services. However, there is a contractual problem where the mutual fund management contract requires the manager to perform all services in the management of the fund. Ordinarily, this includes the provision of research necessary to perform the management services. It might be argued that since the mutual fund shareholders, pension funds and trust beneficiaries had been paying for research in addition to the management fees they pay, why should they not continue to do so? Assuming that the research that has been paid for with soft dollars was not acquired merely because the institutional manager had nothing better to do with the portfolio brokerage, perhaps it is appropriate to pay the beneficiaries' cash to continue to receive this research to be used for their beneficiaries. There are two obstacles to this. One is that existing mutual fund management contracts do not provide for the mutual fund to pay hard dollars for research. Management contracts would have to be revised to provide for this in some fashion. Secondly, there are a number of state laws that impose limitations upon banks and, about a dozen states, on mutual funds respecting the maximum expenses that may be incurred. These maximum expense limitations also have not included brokerage ("soft dollars"). They have been limited to hard dollars. It will take time to amend mutual fund management contracts as well as state laws, as necessary and appropriate.

The obligation of the institutional manager is to obtain best execution which means the best net price available, inclusive of commissions. If the institutional manager pays the lowest brokerage rate available but gets a bad net price, that is not the best execution.

Some individuals have expressed the view that an institutional manager has the duty to bargain for the best price on each order. With this we do not quarrel. However, it is not so simple to apply this principle to large block orders. An institution's trader does not shop the block among a number of brokers to see who will obtain the best price. If he did so he would advertise to the world that a block was for sale and would probably see the 100 share market (tape) drop before he was finished shopping. The large block must be given to a broker in whom the institutional manager has confidence. Skill in selling mutual fund shares is not a basis for that confidence nor is research expertise -- best execution is not commonly understood to include these services. In the final analysis, it will take time to shake down these questions and they will probably be resolved under the provisions of the Investment Company Amendments of 1970, particularly the provision imposing on the investment company managers the fiduciary duty in setting management fees.

What other factors may be taken into account in negotiating commissions? Where a firm positions a block, it is more likely to give a better price to an institution with which it does a substantial amount of business than to an institution that gives it little or no business. Similarly, one of the considerations in negotiating the commission in an agency transaction may be the existence of a continuing relationship between the broker and the institution -- including the institutional manager's desire to see "good merchandise" from the block broker. Thus the negotiation of the commission does take these factors into account and, indeed, it is difficult to conceive of how commissions can be negotiated, as opposed to being "posted", without such factors being considered. But in negotiating the rate the fund manager is obligated to focus on what is best for the fund shareholders without giving up anything for the benefit of other interests he may represent. This will take the wisdom of Solomon but that's the kind of a problem we have.

Let me say a word about the institutionalization of the trading markets. This has resulted in a smaller number of larger trades making up a larger portion of total market activity. Pressures of a trading nature may be found affecting individual public trading any time a substantial number of shares are offered or bid for in the market. This is a phenomenon of any market with good communications. Over the years methods were developed to accommodate these transactions within the framework of the public market without upsetting that market. Special acquisition and distribution plans were devised by the exchanges to distribute to and acquire from individual holders sizeable quantities of securities of an issue. The introduction of negotiated rates on that portion of a transaction which exceeds $500,000 seems to have been followed by a sharp increase in use of the secondary distribution method of moving large blocks. In the first quarter of 1971, the NYSE reports 15 secondary distributions involving 4,523,319 shares and $159,106,294. The mean size of a secondary during this period was 302,000 shares and $10,607,000.

In the first seven weeks of the second quarter of 1971 (through May 25, 1971) the volume of secondaries has increased dramatically. During this period there have been 26 secondaries involving 11,636,884 (an increase of 157%) shares and $407,718,144 (an increase of 156%). The mean size of a secondary during this period was 448,000 shares (an increase of 49%) and $15,681,000 (an increase of 48%). In 11 of the 26 instances the distribution had a predominately retail firm as the manager or principal underwriter and in the remaining 15 instances had a predominately institutional firm as manager or principal underwriter. Although dollar and share weighted averages have not been prepared, a scan of the data submitted indicated that during both quarters the cost of the secondary to the vendor averaged approximately four to five percent of the total value involved.

A rise in secondary distributions should always be expected in a strong market. The distribution depends for its success on two correlated factors: the strength of the market in general and the marketability of the security at hand; investor interest is crucial. However, this factor would not account for the increase in such transactions in the second quarter of 1971 since both the volume and the Dow Jones Industrial Average were comparable in strength in the first and second quarters.

We are studying whether this increase resulted from the reduction of the commission cushion on large block transactions or whether there may be other reasons. There is some concern that the secondary distribution may be a particularly amenable vehicle to reward retail firms that merchandised significant amounts of the fund shares, as opposed to the Exchange Special Offer and Distribution plans, since it permits the inclusion of NASD-only members in the selling group.

This is just one illustration of the kind of thing which calls for attention as we work on the broadest possible analysis of the impact of negotiated rates on the structure and the economics of the market. We intend to study this in great depth and with great care and we welcome your help and cooperation on this important front.