CAUTION - ADVANCE
FOR RELEASE UPON DELIVERY

ADDRESS

OF

JEROME N. FRANK

Chairman, Securities and Exchange Commission

Before

the

Association of Customers' Brokers

Hotel Roosevelt

New York City

7:00 P.M. E.D.T.

June 23, 1939

34965

If I were called upon to guess what is in the minds of the great majority of you at this moment, I would say that most of you are thinking: "Well, what are you fellows at the SEC going to do to us next"?

That is almost the first question that everybody from Wall Street asks the moment he comes to Washington. The more I hear that question the more I am convinced that it does not spring merely from an interest in what the future will bring, or from a fear of government regulation, and that it is not merely a desire for advance "inside dope." That question indicates the existence of an unfortunate and widespread belief in Wall Street that the regulation of stock exchanges and security markets is in the hands of five fellows down in Washington who do pretty much as they please and who spend most of their days thinking up new matters to regulate and new ways of regulating them.

If you really think that, and I suspect that many people in the financial community do, you must be plagued with uncertainty. I know I would be. And uncertainty is the bane of business. Moreover, uncertainty generates uncertainty until the situation may become well nigh unbearable. I've lived in the financial community myself long enough to know.

For that reason tonight I would like to try to take some of the uncertainty out of this business of stock market regulation. I want to give you some basic facts that you can tie to. I want to show you why I believe a great part of the uncertainty is unnecessary and the result of lack of reflection.

Let's start with the things we can agree on.

We all agree that, in the nineteen-twenties, there was a great speculative boom which brought with it many abuses of the country's financial system. We agree, I think, that these abuses, having been followed by the worst stock market crash in history, destroyed investor confidence to a high degree and resulted in a nation-wide demand for reform. There is no question that our federal securities legislation was the product of that insistent demand. The Securities Exchange Act of 1934 was adopted by the Congress of the United States after months of careful and intensive deliberation, participated in by stock exchange and financial leaders. Its passage was in response to the urgent wishes of the country as a whole. It reflected accurately the opinion of the country that financial markets should be regulated. That the country is still overwhelmingly of that opinion is indicated by the most recent Gallup Poll on the subject. Indeed, I know of no financial leader who does not approve of regulation, at least in principle. There is agreement, and no uncertainty, as to that.

The Securities Exchange Act was not intended to be, and is not being administered as, a piece of punitive legislation. It was not intended to be a visitation on the financial community to avenge the losses which investors had suffered. Its broad purpose was to restore shattered investor confidence by setting up protections against the recurrence of past abuses and intelligently to readjust our financial practices to conditions which had changed severely in twenty years.

The Act, in short, is one of the country's bulwarks against assaults on investor confidence. Investor confidence is something in which you, as brokers, have a legitimate selfish interest. But it is something in which all of us as Americans have a vital interest. Our great middle class comprises directly and indirectly, the bulk of investors. If ever that body of investors comes to believe that it is being unfairly treated by its business and financial leaders, it may fall victim to the disease of dictatorship, of either the communist or fascist variety. In either case, that will be bad medicine for American democracy. The SEC, therefore, has the job of helping to preserve democracy, of preventing dictatorship, by depriving potential dictators of one of their most important implements - the anger of mistreated investors. And you have, as I say, a selfish stake in our effective accomplishment of that task. Your stake is to convince the public that you can be trusted with its money, which is just another way of saying that it can go on investing, as it must do if the capitalist system is to continue. For you, the job of being public-spirited is the same as that of being far-sighted business men.

You know the phrase "Art for Art's sake." Well, there may be some men who believe in government dominated by the philosophy of "Regulation for Regulation's sake." I can assure you that the SEC does not subscribe to that philosophy. It wants to impose the least amount of regulation compatible with adequate investor protection. Doubtless we make mistakes, since we are no less human than you are. You shouldn't complain of that fact. Only in dictatorship countries is it assumed that those who hold office never make mistakes.

We have encouraged free and informal discussions with Exchange officials. In the past few weeks there have been several such discussions concerning restrictions on margin trading by partners and member firms. They were highly profitable. Each side came to know the other better; respect on the part of each for the point of view of the other was furthered; and the area of differences was happily narrowed almost to the vanishing point.

We recognize that old habits, accustomed ways of doing business, ought not be altered over-night, without warning and without study of the effects of new proposed ways of doing business. With respect to change, men, roughly speaking, can be divided into these three groups: Those to whom anything new is inherently wrong; those to whom anything new is inherently right; and those to whom novelty is a badge neither of rightness nor wrongness. We find ourselves in the last group. We are for as little change as is needed, but we want every bit as much as is required. We, on the SEC, are not impatient zealots who insist on wholesale alterations of customary behavior. But, although we are patient, although we recognize the need for careful scrutiny of proposals before establishing new modes of conduct, we cannot ignore our duty under the law. While we accept the necessity of making haste slowly, of working out a program of investor protection piece by piece, we must not -- and the Street, in its own selfish interest, must not ask us to -- falter in our determination to bring about a state of affairs where those who deal with the Exchange and its members will be sheltered from all *needless* harms. I stress the word "needless" for no one will ever devise means for freeing investors of all risks of loss. But there are some risks which are unnecessary and, practically, avoidable. It is those practically avoidable risks which the Street and the SEC must eliminate.

Anyone who wants to know what the SEC is doing or will do should begin by reading the Securities Exchange Act. All the objectives are set out there in black and white. That is the law of stock exchanges and over-the-counter markets. It was made by Congress and not by the members of the SEC. The SEC cannot add to it or detract from it. It is our duty to enforce all of its provisions; at the same time we cannot go beyond any of them. Recently when I became Chairman of the SEC I was asked what my policies would be. Such a question is unrealistic. Neither the Chairman of the SEC nor any of the Commissioners can have any policies,-that is, purposes-which deviate from the purposes of the law. What are those purposes of the securities law?

First, the Act prohibits pools and manipulations. It is the duty of the SEC to prevent manipulation and to apprehend manipulators.

Second, the law calls for the disclosure of full information on corporate securities and it is our duty to see that that information is supplied.

Third, the law regulates the use of credit for the financing of security transactions. While the credit restrictions are set by the Federal Reserve System, their enforcement is placed with the SEC.

Fourth, the law makes us responsible for seeing to it that brokers do not conduct themselves in such a way that their interests seriously conflict with the interests of their customers.

Finally, it is our duty under the law to protect investors against practically avoidable risks of loss through insolvency or dishonesty on the part of brokers or their employees.

These then are the purposes or the objectives of the law. The SEC has no choice but to move constantly toward making these purposes effective. Therein lies a difficult problem. It is no simple matter to regulate the complicated mechanism of our financial markets and still not disrupt the functioning of those markets. That is another point, I daresay, on which we are all in agreement. Congress recognized it back in 1934 when the Securities Exchange Act was being considered. Making law for complex mechanisms like stock exchanges is not the same as making law to govern the conduct of individuals. You can prohibit the carrying of a gun or the stealing of automobiles simply by saying so. The legislature says it is illegal to carry a gun and thereafter anyone caught carrying a gun is guilty of a crime. It takes but five minutes to make such a law. A law governing stock exchange practices, if it is to be workable, takes infinite patience to develop. Congress foresaw that, and so, in certain cases Congress simply said to the SEC: "This is what we want you to do. You work out the details of getting it done."

Undoubtedly, from some of the criticisms you have heard you have formed the impression that such delegation of discretion to the SEC is obnoxious to the stock exchanges and the financial community. But if you look up the history of the statute you will find that it was the stock exchange representatives and the financial leaders who urged Congress to leave certain matters to the discretion of the SEC. Here is what the Interstate Commerce Committee of the House of Representatives said, in 1934, in its report on the bill:

"...Representatives of the stock exchanges constantly urged a greater degree of flexibility in the statute and insisted that the complicated nature of the problems justified leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case. It is for this reason that the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive rules and regulations, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced."

And so, in a number of provisions of the law, it was left to the SEC to work out the mechanics of regulation. But the objective, the purpose, was written in the law. It was something that, Congress said, had to be done. Only the method was left to the SEC.

One example of what I am talking about is the power which the law gives the SEC to make rules and regulations restricting floor trading by members of exchanges to the end that their interests shall not conflict with those of their customers, and also, for like reasons, to restrict the activities of specialists. In the past several years there has been much discussion between the SEC and the exchange authorities on that subject, but as yet, little has been done. It is a complicated subject, and deserves and has received much study. We shall not, in that field, move forward with undue haste; but, before long, we must do more than we have thus far done to carry out the Congressional instructions. The privilege of postponing action does not mean that we can forever ignore the objective.

Another example is the power which the law gives the SEC to establish rules and regulations protecting brokerage customers from losses due to insolvency or dishonesty of the broker or his employees.

We and the New York Stock Exchange have been moving in the direction of carrying out that objective. Last November, you will recall, the Stock Exchange and the Commission laid out a program for the protection of brokerage customers. A number of the steps in the Stock Exchange part of the program have already been completed. Capital requirements of member firms have been increased; new rules have been adopted governing borrowings and loans by members; there have been new requirements for financial statements and audits of member firms; and the Exchange is about to make another important step in the new rules restricting margin trading by partners and firms.

Those are first steps and it is proper that they should have been taken first. While they are unquestionably noteworthy accomplishments by the Exchange, they still leave brokerage customers exposed to avoidable risks. Brokers still accept customers' cash and securities for deposit. To this extent they are just as much banks as any other banks. They have the same custodial functions — the same responsibilities. But they are subject to no banking regulation or supervision. I understand that our largest department store accepts customers' cash for deposit against future purchases. *But* — as most of you know — those deposit accounts are not commingled with the general funds of the store. They are deposited with a totally separate banking company set up under State banking laws and supervised and examined periodically by State banking authorities just like any other bank. The store itself never sees a red penny of those deposits until after a purchase has been made. But brokerage customers have no such banking protection.

I suspect, however, that most members of the Congress and most of the public think that the SEC and the exchange authorities between them have already effectively secured full protection of that kind for the public. And if anything happens in a big way to demonstrate that we have not -- well, all I can say is that our faces will be pretty red.

I venture to say that not one customer in a thousand knows this: If a customer owes nothing to and yet leaves cash with a broker, and that broker becomes insolvent, the customer is by no means certain of receiving back all his cash. Most customers believe that such "free" cash is so handled by the broker that, if the broker "goes broke", the customer can recover every dollar of his "free" cash and no one else can have a claim on it. They are wrong -- as matters stand today. In most cases, all the cash in a broker's hands is intermingled; none of it constitutes a trust fund; the customer, as to his "free" cash has no special claim, but is a mere unsecured creditor who must share with the other creditors in the amount of cash found in the assets of the insolvent broker. As a matter of fact, the actual figures reported by member firms of the New York Stock Exchange to the Federal Reserve Board demonstrate the fact that most brokers neither attempt to segregate, in a trust fund, cash balances of their customers, nor keep cash on hand or in banks sufficient to meet the total of their free credit balance obligations to their customers. On the contrary they commingle their customers' funds with the funds of the firm and use them as the needs of the business require.

In other words (as the SEC said last November, in its report on the Whitney case) most brokers today are doing a banking business - accepting deposits just like banks - but are neither regulated nor inspected by state or federal bank examiners. They are functioning outside our regular banking system. There is virtually no protective governmental supervision of the hundreds of millions of dollars deposited with them.

It is true that Exchange supervision of the financial condition of Exchange members has done much to reduce risks. But the attempt to assure complete protection through such supervision imposes a terrific burden on a private association. It has been a long time since we have been content to let the banks regulate themselves. We have found that that doesn't work. If brokers are to continue to act as bankers, then the government must provide for the public's protection a supervisory system equivalent to the government's supervision of banks.

I know that it is said, with parrot-like reiteration, that customers are now sufficiently safe. "Virtually no brokerage failures have, in recent years, caused large losses to customers," we are told. But is that a satisfactory answer?

In the Whitney failure, members of the public generally were not involved because the firm was not doing any large public business. But that was only good fortune. It was even more of a fortunate accident that the recent Elfast insolvency did not involve the public. That was sheer good luck.

I am not suggesting that, as matters now stand, any brokerage failures, injurious to the public, are at all likely to occur in the near future. The record of member firms with respect to losses suffered by the public has been exceptionally good in recent years. Yet, in the past,

under various types of stresses and strains, persons who had been trusted and respected have utilized for their own purposes funds and securities belonging to others.

You will surely miss my point completely if you interpret my remarks to be alarmist in any way. On the contrary, my point is that the time to build fire-escapes is not while a fire is raging, but when the building is in good condition; the time to build a strong bridge is not in a flood time, but when the waters are quiet.

What would you think of an engineer who said it was foolish to put enough steel or concrete in a bridge to withstand a high flood because there hadn't been such a flood for the past ten years, or because guards could be posted who would see to it that people didn't use the bridge if such a flood occurred? You'd say he was an incompetent engineer. And the Commission and the brokerage and investment banking community as a whole would be incompetent if they were persuaded by similar arguments.

We cannot permit, and brokers dare not risk, the possibility that, at a time when all feasible safeguards have not been installed, a brokerage firm, doing a very extensive business with hundreds of customers, may go down. I ask you to consider whether, should that happen, ever again the brokerage community would be in good repute, if the public then learned that practical measures had not been employed to avoid such investor injuries. Of course, we always hope that each scandal will be the last. That's why the Elfast case was so shocking. It meant that it *could* happen again. We cannot now quietly accept assurances that the Elfast failure is the last and greatest of such occurrences.

That is not to cast any reflections on the honesty and integrity of brokers as a group. But you know as well as I do that in the financial community more than anywhere else, instances of insolvency or dishonesty, though they be isolated exceptions, cast a cloud over the community as a whole. In the interest of good business, the Street simply cannot afford any avoidable major bankruptcy involving large losses to customers.

We must promptly move forward in attacking this problem. Either the SEC or the brokerage business (and when I say the "brokerage business" I refer to over-the-counter brokers as well as exchange members), must see to it that the banking functions of brokers are more fully regulated or the financial community must take steps to render more detailed regulation unnecessary.

You will remember that, about a year ago, the suggestion was advanced that these banking functions now performed by brokers be transferred to properly supervised banking and trust institutions located in the various financial centers of the country. Let me review briefly the outlines of this plan. Those institutions - call them brokerage banks if you wish - would be set up as part of existing institutions or as separate entities. The question of the ownership and management of these institutions - whether by the brokers, the exchanges, the banks, or even private individuals - is, an open one. In either event they would have possession of all securities and cash belonging to customers. They would also, on instruction of the brokers, arrange margin loans direct to the brokers' customers. They would hold all customers' collateral securities, securities left for safe-keeping, and cash representing free credit balances. They would, without the

intervention of the brokers, make and receive payments and deliveries, directly to and from customers. Of course I appreciate that many details, such as the fixing of interest charges, interest spreads, service charges, handling of margin calls, and the like, remain for discussion. These matters can be threshed out at the work table. If some such plan is adopted, brokers would then be exclusively what their name implies - those who execute orders for others. They would cease to be bankers, and, all the complicated mechanisms, arising from the fact that today brokers are bankers, would vanish.

This proposal was again advanced by the Commission in its report on the Whitney investigation. In that report the Commission said:

> "...It is our view that the ideally effective measure for dealing with customers' free credit balances and customers' fully paid or excess collateral securities would be the establishment of trust institutions in various financial centers. . . . Their use would also serve to remove customers' cash and securities from the risks of insolvency involved in the combination of the dealer with the brokerage function."

The Commission is still of the same view. At the time we made that report, it was, however, understood with the New York Stock Exchange authorities that as a step towards the creation of such banking institutions, the Exchange would canvass its own proposal of the possibility of creating a so-called central depository.

At this point I want to say something about the so-called central depository. It is clear to me that there has been a great deal of confusion in the minds of a great many people regarding the central depository. Because this kind of device was suggested by the Exchange as a partial step, shortly after we initiated the discussion of the trust institution, I am afraid that many people believe that the trust institution (or brokerage banks) and the central depository are one and the same thing. They definitely are not. The central depository would be at best a half-way measure. On that basis, and on that basis alone, has it ever been considered.

The plan for a central depository for securities is therefore totally different from the proposal to establish brokerage banks. The central depository would not arrange for margin loans and would not take over customers free credit balances, whereas the banks would. Nor at the outset would the facilities of the depository be available for other than exchange members. The central depository would not provide complete protection for customers' funds and securities. Just the other day the head of one of the largest brokerage firms in the Street said to me that he was opposed to it because it was an expensive half-way measure. But he added that a plan for something like brokerage banks would be acceptable to him because it would entirely solve the problem of customers' safety which I have been discussing. He clearly recognized the important differences between the two proposals and I am sure all of you will when you have considered them.

I believe your studies will bring you to the conclusion that the central depository will be far too expensive and will not work. You will, then, have explored that avenue. As most of you know, the SEC has never been too enthusiastic over the central depository idea. Our thinking has clearly

indicated only two courses - either the brokerage bank or regulation and supervision by the SEC. And we've done a good deal of thinking about it. Has the brokerage business done any thinking? Or has it merely said, "We don't like the brokerage bank and we don't like the idea of having our banking business interfered with and that's all there is to it?" This latter attitude will get none of us anywhere. The problem must be solved. The customer must be more fully protected. Therefore, if you don't want supervision and regulation by the SEC, you've got to suggest something at least as effective as the brokerage bank. We're ready, willing and eager to hear any suggestions you want to make. We sincerely hope you will find a solution which will really do the job. We don't care whether it's a trust institution, a brokerage bank or what it is as long as it will give customers the kind of protection which the law says they must have. But progressive thinking on the subject is essential. We cannot be satisfied with a lot of reasons why nothing can be done or nothing should be done. Because something has to be done. The SEC has no choice as to that.

As I see it, then, our problem here boils down to simply this: Which does the Street prefer? More of SEC in this field - or none at all? Complicated SEC regulations - or none whatever? More government supervision of brokers - or a withdrawal - in this large area of customer safety - of governmental supervision. There are no other choices. We cannot, we must not, we dare not offer you any other.

In other words we offer you this choice: (1) You can have more SEC regulation of brokers' activities - regulation designed to insure customer safety or (2), by the establishment of brokerage banks, you can, as far as this subject of customer protection is concerned, get rid of the SEC and of SEC regulations on that subject. We much prefer the latter: It is far simpler, less expensive, less irritating to you and less difficult for us - and it will wholly solve the problem in an easy traditional manner.

This program does not call for less private business and more public business. On the contrary, it calls for more private business. It calls for turning over to privately operated banks a function which, if it continues in the hands of brokers, will necessitate more and more governmental interference. Public safety in this sphere cannot be ignored. If the stock exchange wants to work with us to bring that about in a simple, clean-cut manner, we shall be more than delighted. We can close the chapter on that part of our activities. We can save the government thousands of dollars, we can save much labor and money for the brokers, and we can do the job thoroughly. The alternative is increasing regulation, increasing governmental interference. Happily, here is one area where getting rid of the government is exquisitely simple. I wish that all the problems of contemporary life where government and business interact were as simple.

If I have dwelt at length on this problem of customer protection it has been to illustrate that, while protection of investors is our first responsibility, we approach our task mindful of the practical functioning of the financial machinery. Almost without exception, every rule adopted by the SEC has been thoroughly explored in advance with those whom the rule will affect. There have been no bombshells or surprises from the SEC,

The financial community and the public have always been advised, as far as was possible, of exactly what was being contemplated and considered. We have tried to avoid unnecessary uncertainty. But where uncertainty results from the necessary flexibility of the law, I am sure you will agree that it is worth its price. If certainty were the only thing desired it could be obtained simply by freezing all the rules and regulations into statutory form.

Not only have we sought the technical assistance of the financial community, we have also been willing to hear the legitimate selfish interest of anyone subject to the laws we administer.

I want to make it very clear that those of us in government have no possible objection to a vigorous assertion by any group of citizens of their legitimate selfish interest. It is the business of persons in private life to look out for their own self-interest. During those periods when I have been in government service, I have been moderately suspicious of any business man who came to me urging something in behalf of his own business and saying that he was doing so solely for the public welfare. I do not mean for a moment to decry assertions by any business man that what happens to be for his own welfare will also be beneficial to the public interest, or at least not injurious to it. That he should make such an argument is highly desirable and shows that he is intelligent. But I do mean that he would not be intelligent and would be ascribing to government officers a lack of intelligence if he told them that he was working only for the public at large in those instances when he was really seeking to enhance his own interests.

In other words, when so-called pressure groups from Wall Street or anywhere else come to discuss their business affairs with government officers, the former should be encouraged, frankly, to argue in behalf of what is best for them. For the men in government service are there to look out for the general welfare, for the interests of other groups not represented or present at the conference. But just because those men who happen to be holding government offices are, while in office, obliged to consider the long-range general public welfare, they are not unlikely, at times, to be too far-sighted. And just because business men must consider tomorrow's profits, it is not unreasonable that there should be a certain nearsightedness there. The near-sightedness of the private group and the excessive far-sightedness of the government officers tend to correct one another. Sensible working compromises then result. I believe in pressure groups. The interactions of numerous groups, if there are enough of them, and if their real purposes are made clear, are essential to the proper functioning of a democracy.

I say that with all sincerity and say it with particular emphasis at this time - because some careless or misguided persons occasionally tell you that we are eager to extend governmental regulation to every aspect of American life - that we have sinister plots to establish totalitarian controls. Don't you believe those stories. They are 100% falsehoods. They are viciously unfair to us and miserably misleading to you. The SEC commissioners, everyone of them, are devoted to democracy. And since they are fully aware that, in America, the profit system and democracy are intertwined, that private initiative and private profits are cherished by most Americans, and that democracy will give way to dictatorship if those aspects of American life are seriously endangered, it is the ardent desire of the members of the SEC to do everything possible to make our profit system work efficiently,

and accordingly, within those limits, to give the largest possible scope to private enterprise and to the making of legitimate profits. We do not want excessive governmental regulation. We want only so much of it as is essenti to make our kind of economy function competently so that this country may enjoy the prosperity for all its people which its fortunate position and rich endowment of resources make possible.

I cannot close without a word of thanks for your generous patience and for the kind hospitality of the Association of Customers Brokers. We at the SEC have followed the recent developments in your organization with great interest. For your effort to raise the standards of practice in the brokerage profession we have only encouragement. To the extent that you seek to furthe the public interest and the welfare of your clients you and we have a common purpose. We hope to be able to work with you and through you towards the attainment of our common objectives.

---oOo---