SECURITIES AND EXCHANGE COMMISSION DEVELOPMENTS

Address by

Hugh F. Owens
Commissioner
Securities and Exchange Commission
Washington, D. C.

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This evening I hope to give you a necessarily cursory report on recent developments in the securities industry and at the Securities and Exchange Commission. In the past few months, some commentators have alleged that the Commission has been less vigorous and not as effective as it should be. It is my hope that our discussion tonight will persuade you otherwise. As is customary, I must point out that my remarks represent my own point of view; they are not necessarily representative of the thinking of either the rest of the Commission or its staff.

Because of the deep concern felt today for the well-being of the brokerage industry, it might be appropriate to devote most of our attention to that area. Among their many other obligations, broker-dealers are now responsible for safeguarding billions of dollars in cash and securities belonging to millions of investors. Thirty million shareholders have placed cash or securities directly in the custody of these firms. Another 70 million, perhaps, are less directly affected through the investments which underlie their savings accounts, insurance policies and other similar savings or investment entities. It is vital to the operations of our national securities markets that all of these investors retain confidence in the industry's ability to safeguard the assets of its customers. Yet, during the last few years they have seen numerous brokerage firms close their doors. Some brokers have been forced to merge with others to gain financial stability; some have liquidated their accounts gradually; and some have closed more precipitously, at times forcing customers to seek the assistance of the New York Stock Exchange trust fund or trust funds of other exchanges when such help was available.

There are at present numerous federal and state imposed regulations which have been adopted in order to protect the interests of brokerage customers. In addition, the industry itself has been given much self-regulatory responsibility subject, generally, to oversight by the Commission. On the federal level, some of the more important requirements of brokers and dealers which the Commission administers are that they register with us, maintain certain minimum capital requirements and limit their aggregate indebtedness in relation to their net capital in order to maintain prescribed minimum standards of liquidity and financial responsibility. Critics of the Commissio have been quick to allege that the magnitude and frequency of recent brokerage failures indicate that our requirements are too lenient and our oversight of the industry's "self-regulation" too myopic.

It is my view that such critics give inadequate weight in their assessments to the severe pressures placed on this industry in recent years and that they display an inadequate knowledge of the efforts of the Commission to protect the public in the face of such pressures and within the bounds of its own statutory authority.

Ironically, the brokerage industry's recent problems all began with their own great success in recruiting customers and investment dollars. In 1962, the New York Stock Exchange handled an average daily volume of 3.8 million shares. Experts predicted that this figure would double by 1975. In fact, volume almost quadrupled by the end of 1968. The securities industry always has been highly sales oriented, and this is understandable given its nature. But this orientation worked to the industry's disadvantage during the great volume increase. Many firms tended to think more in terms of "how can we increase our share of this pie?" rather than, to continue the analogy, "can we eat the piece of pie we already have?" In many cases, eyes proved bigger than stomachs. Firms exploded in size, hiring larger and larger sales forces and expanding branch offices as rapidly as possible. But investor complaints grew even more rapidly than did sales. The industry's back office was both too outmoded in design and too insufficiently staffed to do the paper work necessary to support all the transactions taking place.

While the Commission, like the industry itself, did not foresee the magnitude of the trading volume increase, we did see the pressing need for reform in the industry's paper work system. As far back as 30 years ago, in connection with its investigation of the failure of Richard Whitney and Co., the Commission suggested changes in the back office area, including the establishment of a "central trust institution" which would take over from brokers all the banking and credit functions which they then exercised. In 1963, the Special Study of the Securities Markets conducted by the Commission recommended as follows:

> "The industry, with the cooperation of the Commission, should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing and delivery systems, with the goal of evolving institutions and procedures which would permit the reduction of physical transfers of securities and centralization of functions now performed by broker-dealer back offices insofar as possible."

When the sales crush came later in the sixties and complaints made to brokerage houses regarding failures to deliver securities, incorrect confirmations and other types of paper work problems went unresolved, numerous investors came to us for assistance. We attempted to help. In early 1967, we wrote to ten securities firms which were receiving particularly large numbers of complaints attempting to determine what was being done to assist customers and asking whether we might be of assistance. We were told that the firms involved had the situation in hand and that government intervention at this point would probably do more harm than good.

Despite such responses; despite the fact that this industry had been legislatively determined to be a self-regulatory one and despite the fact that we felt there to be some justification to the idea that brokerage firms should make for themselves such business decisions as the amount of investment to allot to their back offices and the structure of those offices, we did take action.

It was as a result of our expressed concern that the exchanges shortened their trading hours temporarily in order to handle back office problems. We made public statements in Securities Exchange Act Release Nos. 8335 and 8363 of our concern about the industry and placed brokers on warning that they would be violating the antifraud provisions of the securities laws if they accepted any orders or even attempted to induce a purchase or sale at a time when they did not have the personnel or facilities to consummate such transactions promptly. We employed administrative proceedings against firms whom we felt were not administering their back offices properly.

But not all of our actions were successful. The Commission's responsibility for the brokerage industry is an oversight responsibility. The design of the Securities Exchange Act of 1934, in affording special privileges to national securities exchanges, was to place upon such exchanges the immediate and primary leadership role in enforcing the Act and the rules and regulations thereunder with respect to their members. While we are empowered to modify certain decisions of those bodies where necessary or appropriate for the protection of investors, in general, the administration of the rules and practices of the self-regulators, such as the exchanges and the NASD, must be left to their judgment. Because of this, many of the steps we took in reaction to the back office crisis were of an advisory nature. Inasmuch as it appeared that the root of the problem lay in increased sales, we urged the industry to consider temporary measures that might stem the pressure of such increases. For example, we urged a suspension of promotional and advertising activities and a pause in the opening of new sales offices. This advice was largely disregarded.

The back office problem was substantially reduced when trading volume and stock prices declined in 1969. It was a mixed blessing. On the plus side, the industry had a chance to bring records up-to-date, to research stock record differences and to catch up on fails and the collection of old receivables. On the minus side, however, many firms had expanded their sales offices and staffs, belatedly hired large operations crews and installed expensive computer systems to handle 13 million share days. A resurgence of the 1968 boom period was necessary to meet the increased fixed expenses that necessarily accompanied these decisions. Such a boom was not immediately forthcoming All of this combined to result in widespread losses on the bottom line of broker-dealer income statements. The losses, in turn, prompted a flight of subordinated capital from broker-dealer firms and discouraged the infusion of

new capital. At the same time, the value of firm positions and accounts, usually invested in securities and subordinated for capital purposes, followed the declining trend of the general market. Given these facts, it is difficult to imagine, even with the benefit of hindsight, how brokerage firms could have avoided the substantial financial difficulties which beset them. Even as volume on the New York Stock Exchange has risen again to the point where in the year 1970 it was the highest in the Exchange's history with just less than 3 billion shares changing hands, other important factors have contributed to a continued lack of profitability for many firms in this business. Securities prices on which commissions are based have yet to reach their previous levels, there has been a substantial reduction in trading on the American Stock Exchange and in the over-the-counter markets and the proportion of odd-lot and single round-lot orders has declined as institutional business has increased.

Just as we had once made recommendations to the industry in the hopes of somewhat dampening sales, we also proposed the adoption of new reporting requirements and suggested that the exchanges issue a questionnaire to obtain a more complete understanding of the financial condition of member firms. We were met with strong resistance on these points. Our recent letter to the Exchange with regard to its request for increased commissions dismissed such resistance and asked that, along with other long-range thinking necessary to modernize this business, the Exchange present no later than May 31, 1971 a plan for a uniform accounting system for member firms. The letter also directed that uniform methods of cost allocation be developed.

The tool that has been used traditionally to measure the financial stability of member firms has been the net capital rule of the Commission or comparable exchange rules. Rule 15c3-1 under the Securities Exchange Act of 1934 provides an exemption from the net capital requirements enumerated therein for members of certain exchanges whose own net capital rules and procedures have been deemed by the Commission to be more comprehensive than ours.

The Commission is constantly re-examining the manner in which the stock exchanges, particularly the New York Stock Exchange, administer and interpret these rules of theirs. I should point out here the foresight of the Midwest Stock Exchange in this area. The maximum net capital ratio which their rules prescribe, 15:1, is the most stringent in the country. Where we feel that an exchange is interpreting its net capital rules in a manner that makes them less strict than the Commission's, we have attempted to induce them to become stricter. It was as a result of our many discussions with the New York Stock Exchange that they agreed not to give capital credit for such items as restricted stock, aged dividends receivable, insurance claims and reserves for stock record differences. The exchanges are, however, jealous of their prerogatives in enforcing their own rules. This feeling is somewhat understandable where a trust fund created by an exchange may be at risk. We have also conducted thorough inspections of troubled New York Stock Exchange firms.

The insolvency of a number of broker-dealers apparently exhausted most of the assets of the trust fund of the New York Stock Exchange and has rendered it incapable, absent further assessments on its members, of fulfilling its function to indemnify and protect customers of its member firms which have become insolvent. While other exchanges have trust funds, they are relatively small in comparison to possible future needs. And customers of broker-dealer firms which are not members of exchanges with such trust funds have had no protection at all of this type. Recognizing the inherent deficiencies in the operation and coverage of the exchange trust funds, legislation was drafted through the combined efforts of the SEC, the Treasury Department, other government agencies, and an ad hoc industry task force providing for the formation of the Securities Investor Protection Corporation, referred to as SIPC, to protect, within certain specified limits, the accounts of customers of member brokers and dealers. This bill was passed by Congress with strong bipartisan support and on December 30, 1970 was signed into law by the President.

The creation and establishment of SIPC is a very necessary but only interim step in the sense that it treats symptoms rather than causes. Chairman Harley O. Staggers of the House Committee on Interstate and Foreign Commerce has stated that the SIPC bill is needed and designed not only to protect public customers from brokerage firm insolvency and to reinforce investor confidence in the national securities markets but also to "mandate a general upgrading of financial responsibility of brokers and dealers."

As an interim step, the SIPC legislation itself clarifies and reinforces the Commission's powers to provide needed safeguards. Now that it is the security of the United States Treasury that protects customers' accounts, as well as the funds of exchange members, you can be assured that the Commission will have a far greater voice in determining what action should be taken in regard to ailing firms. As Congress probes the problems of the industry in more depth, as it has promised to do, I am confident that the Commission will receive, through legislation, increased encouragement and authority. As we have indicated to the Congress, if there is any lesson that has been learned from our experiences of the last few years it is that the Commission must have plenary power to take whatever action is required in the public interest and should not have to wait and see what action a self-regulatory body will or will not take before it acts.

Moving now to the second major area of my remarks, I think it might be of interest to you for me to review quickly some recent developments in federal regulation of mutual funds and other investment companies. Obviously, the most important of these is the recent enactment into law of what has been commonly referred to as "mutual fund reform legislation," which the Commission had been endeavoring to secure for four years. This legislation consists of over 40 amendments to the Investment Company Act of 1940, which is the basic regulatory statute for mutual funds and other investment

companies. The amendments include most of the Commission's recommendations in their original or modified form and are intended to provide greater protection for the more than seven million investment company shareholders.

The Commission's principal proposals related to problems that have arisen in connection with management fees and sales charges imposed on mutual fund investors, and four of the more important amendments to the Investment Company Act deal with these areas.

First, investment advisory or management fees. Mutual funds, with rare exception, are not operated by their own employees. They are typically organized, sold and managed by external organizations called investment advisers which are separately owned and operated. For their services, investment advisers receive management fees which are usually calculated as a percentage of the fund's net assets.

As a practical matter, shareholders have not been able to test the reasonableness of these fees in the courts because of heavy burdens of proof normally demanded of plaintiffs in such cases.

New Section 36(b) of the Investment Company Act, which becomes effective June 14, 1972, eases these burdens. It reflects the experience and the unique structure of the mutual fund industry by specifying for the first time that an investment adviser of a mutual fund or other registered investment company has a fiduciary duty with respect to the receipt of compensation from such fund or its shareholders. The amendment also authorizes the Commission or a fund shareholder to bring an action on behalf of the fund in federal court against any person who has breached such fiduciary duty and provides that a court shall give shareholder approval of an advisory fee only such consideration as the court deems appropriate under the circumstances.

Second, performance fees. In the past few years, a substantial number of mutual fund advisers have devised compensation arrangements in advisory contracts whereby the fund pays management a basic advisory fee and then additional incremental fees based upon the so-called "performance" of the fund. I believe that such arrangements may give advisers incentives to take undue risks with investors' funds. Furthermore, while good performance is rewarded under such a contract, bad performance is rarely punished by a reduction in advisory fees; or if such a reduction is possible, it is not commensurate with the upside potential for reward. The legislation just enacted will prohibit such a performance fee arrangement except where the fee is scaled to an appropriate index of securities prices and increases and decreases in equal proportion from the base fee that would be paid if the fund's performance were exactly equal to that of the index. This amendment will become effective on December 14, 1971.

Third, sales loads. At one time the Commission recommended that sales loads on purchases of funds' shares should be limited to no more than five percent. The legislation contains no such specific percentage

limitation but, rather, provides that the National Association of Securities Dealers, Inc., the NASD, a self-regulatory organization of brokers and dealers, may adopt rules for the purpose of prohibiting excessive sales loads. The amendment provides that the Commission may alter or supplement any rules adopted by the NASD or, if the NASD does not adopt any rules after 18 months from the date of enactment, the Commission may adopt its own rules.

And fourth, the front-end load on contractual plans. The front-end load is the amount of an investor's first year payments which may be deducted for sales charges on a contractual plan. Such a plan typically provides for installment purchases of mutual fund shares on a periodic basis for 10 or 15 years. The Investment Company Act permits sellers of contractual plans to deduct as sales load up to 50 percent of the first year's payments, with a lesser charge during the remaining years to average not more than nine percent over the life of the plan. Because experience has demonstrated that substantial percentages of investors drop out of contractual plans during the first three years--thus paying effective sales loads of 16 to 50 percent--the Commission had recommended that the front-end load be prohibited.

The provision in the amendments in this area will permit the continuation of the 50 percent front-end load but, for sales made on and after June 14, 1971, will require plan sponsors to refund to any investor who redeems during the first 18 months of this plan that portion of the sales charges which exceeds 15 percent of his gross payments, as well as the value of his account. This amendment also provides an alternative--a spread front-end load--whereby a contractual plan seller could charge a sales load which does not exceed 20 percent of any payment or average more than 16 percent over the first four years of the plan.

Apart from the amendments to the Investment Company Act which I have just described, there are several other matters currently under consideration by the Commission and by the courts which may affect the Commission's regulation of mutual funds.

On July 1, 1969, the United States Court of Appeals, District of Columbia Circuit, decided that, notwithstanding certain restrictions in the National Banking Act, the Comptroller of the Currency is empowered to permit national banks to operate and the Commission to regulate commingled investment accounts similar to mutual funds. 1/ The Investment Company Institute, an association of mutual funds and their investment advisers and underwriters, and the NASD had instituted the case claiming that this competition of banks with mutual funds was unlawful. The Supreme Court granted a writ of certiorari

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1/ NASD v. SEC, 420 F. 2d 83 cert. granted 38 U.S. L.W. 3369 (No. 835, March 23, 1970).

in this case and heard oral argument on December 14 and 15, 1970. The Court has not yet issued its opinion. The case is obviously of the greatest importance to the mutual fund industry, for, if the decision of the Court of Appeals is affirmed, mutual fund investors may choose to make their investments by means of a bank rather than a conventional type of mutual fund.

The Commission is currently engaged in studies which may or may not eventually result in additional legislation or rule-making in the mutual fund area. One subject of such a study is Section 22(d) of the 1940 Act which requires that mutual fund shares be sold at a uniform public offering price and which might be described as a fair trade provision in the investment company area. Our Institutional Investor Study will report on the effect of institutional investors such as insurance companies, banks and mutual funds on the securities markets.

Moving on now to the last general area of my comments, I would like to give you just a short description of the most widely discussed recent proposals in the area of securities law covered by the Securities Act of 1933. I speak, of course, of the "160 Series" of rules under the Securities Act of 1933, proposed by the Commission's Disclosure Study, and the subsequent, alternative proposed Rule 144.

These rules were designed to provide a greater degree of certainty, to the investing public, in the definitions employed by the Commission of the terms "underwriter" and "distribution," as those terms have relevance in the application of Section 4(1) of the Securities Act.

Section 4(1), which provides an exemption from registration for persons who are not issuers, underwriters or dealers in securities, is the exemption usually available to persons involved in ordinary, day-to-day transactions in securities. More important, it is the exemption usually relied upon by persons wishing to sell unregistered, or what is more widely known as "restricted," stock.

Proposed Rule 144 is similar in many respects to, and differs in several significant areas from, the "160 Series." First of all, Rule 144 does away with the so-called "qualified issuer" concept of the proposed "160 Series" of rules. This was necessary because maintenance of a list of qualified issuers, an implicit feature of that concept, would have required the use of far more manpower to keep such a list current than the Commission has available for such a purpose. Further, such a list could have been unfairly discriminatory to smaller companies who, although possibly "qualified" in many other senses of the word, would have been ineligible for inclusion in the list because of the lower volume of revenues and earnings they generated or because they did not file 1934 Act periodic reports with the Commission.

Another area of difference between the proposed "160 Series" of rules and proposed Rule 144 relates to the amount of securities that might possibly be sold over a period of time. The "160 Series," in effect, required that securities be held initially for a period of one year and that thereafter a limited amount of securities could be sold in each succeeding six-month period. Proposed Rule 144, by contrast, calls for an initial 18-month holding period with provision for the sale of a limited amount of securities in each 12-month period thereafter. To use the terms of the statute, proposed Rule 144 creates a presumption that a person who holds securities for 18 months and then sells only the limited amount specified in the rule will not be engaged in a distribution and, thus, will not be deemed to be an underwriter. The presumption created by the rule would apply to control persons and private placees alike thereby negating the distinction in favor of control persons which currently exists between the two groups. The presumption created by Rule 144 is just that, a presumption.

The most significant similarity between the proposed "160 Series" of rules and proposed Rule 144 is that both require that there be publicly available current and informative financial and other information about the issuer. As I have mentioned, the proposed "160 Series" does this by providing that only a company that files 1934 Act periodic reports can be a "qualified issuer." Proposed Rule 144 provides that a company filing 1934 Act reports will be presumed to have provided the required information to public investors, but it goes further than the "160 Series" by attempting to delineate what kind of information about a non-reporting company would also satisfy the standards of the rule. By so doing, proposed Rule 144 allows security holders of both reporting and non-reporting companies to take advantage of the rule and, thus, lessens the possibility of discrimination against security holders of small companies which do not file reports with the Commission.

This is not meant to be a comprehensive description of Rule 144; for that, reference must be made to the rule itself. I do want to make clear that Rule 144, at present, is only a "proposed" rule. The period for comments on the proposal has expired, and our staff is currently studying the more than 200 comment letters received. No final action will be taken by the Commission on the rule proposal until after a thorough evaluation of those comments.

My remarks this evening have not been short and simple, but, hopefully, they have been expository of the critical days through which the securities industry has passed and the unbelievable strains placed upon the self-regulatory agencies and the SEC in meeting revolutionary challenges of the market place. The complexity and variety of the matters I have discussed

are characteristic of the nature of our diversified financial industry. In my opinion, the years immediately ahead will present you, as businessmen with interests in the financial community, and the Commission, as a regulatory authority concerned with the industry, with ever more complex and varied problems. I am optimistic, however, about our ability--yours and ours--to solve them. With the improvements in technology and the capable minds in this area upon which we will be able to draw, there is every reason to look forward with confidence to what the future might hold.

Thank you for the opportunity you have extended to me this evening.