THE BROKER-DEALER QUEST FOR CAPITAL AND PROBLEMS OF SELF-UNDERWRITING

Address by

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before the
Mid-Atlantic District of the
Investment Bankers Association of America

Hot Springs, Virginia
October 22, 1971

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The subject which I would like to discuss with you today is the broker-dealer quest for capital and, in particular, the issues posed when that quest takes the form of self-underwriting. These matters are obviously of the greatest importance to members of this group; and, I can assure you, they are of equal importance to my Commission. Because of the sensitive nature of the subject, especially at this particular moment in time, I must caution you that my remarks are representative of my own views and are not intended to convey the views of my fellow Commissioners or the staff of the Commission.

The concept of broker-dealers going public is, of course, not entirely a new one. The largest underwriter in this country, The First Boston Corporation, has been publicly owned for more than thirty years, and a number of regional stock exchanges have long permitted their members' stock to be sold publicly. Despite this fact, the New York and American Stock Exchanges have not amended their rules to permit such public ownership of their members until a relatively recent date. In 1961, Merrill Lynch, Pierce, Fenner & Smith sent a letter to the New York Stock Exchange proposing public equity ownership of member firms. The proposal did not meet with acceptance, and it was not until 1964 that the Exchange gave serious consideration to permitting firms to go to the public for the capital that was so obviously needed for the creation of facilities adequate to serve their rapidly expanding business. In that year, the Exchange appointed a "Special Committee on Permissive Public Ownership of Member Organizations."

In 1967, the Committee submitted the results of its study of public ownership to the Exchange's Board of Governors; but, even then, the suggestions made were extremely conservative when viewed in the light of what actually has happened in the intervening period. The Committee recommended that member firms be permitted to sell debt securities under certain specified restrictions but determined that even further deliberation would be necessary before a recommendation could be made relative to the concept of public equity ownership. The Exchange followed up on the Committee's proposal by soon thereafter submitting to the Commission a proposed amendment of Exchange Rule 325 which would have permitted members to issue freely tradeable debt securities. The American Stock Exchange subsequently submitted a similar proposal. These particular proposals were never adopted by their respective exchanges. I think it was apparent to everyone involved that the subject of public ownership of broker-dealer debt securities, and the problems related thereto, and the subject of public ownership of broker-dealer equity securities were so tightly interwoven that they would have to be attended to simultaneously.

As is not surprising in this particularly free enterprise branch of the American economic system, the securities industry, the industry's regulators were forced to give more thorough consideration to the problems of public

ownership of exchange member firms because of a business decision made by an individual broker-dealer. In May of 1969, the firm of Donaldson, Lufkin & Jenrette filed a public offering registration with the Commission and announced that it would resign its Exchange membership if the Exchange constitution and rules were not amended to permit such an offering. After consideration of amendments which would accomplish this end by the Exchange, by the Commission and, through the medium of a Commission notice and opportunity for comment, by the public, the Exchange finally approved of public ownership of its members' equity securities on March 26, 1970.

Because of the great interest of member firms in the public offering mechanism resulting from the industry's capital problems at this particular juncture, it soon became obvious that very substantial amounts of broker-dealer securities were going to be registered and sold as quickly as possible. In the 18 months since the Exchange approved public ownership, five of its leading members have tapped this capital source for more than $180 million. Other, smaller brokers have also gone to the public for lesser amounts of capital. This has occurred despite the fact that some very basic regulatory decisions relating to public ownership remain to be determined. In particular, the mechanism whereby brokers' securities actually are to be transferred into the public's hands has had to be studied in greater depth before any definitive rules or guidelines could be adopted. Even more precisely, it has been obvious to the Commission and, of course, to the self-regulatory organizations, that the issue of self-underwriting has to be faced and dealt with as soon as practicable. I believe that the record will indicate that we are meeting this challenge.

As you know, from 1969 until very recently, the NASD's interpretation of its rules placed very tight restrictions on broker-dealers underwriting their own securities or those of their affiliates. The SECO rules, expressly intended by Congress to be an alternative to the NASD rules but no more permissive, were similarly applied. Prior to 1969, the issue of self-underwriting by broker-dealers was of such small import that no specific rule on this subject was considered necessary. The logic of the restrictions adopted against self-underwriting became far less persuasive as a number of the larger industry firms became interested in making sizeable first-time public offerings of their equity securities and broker-dealer back office and capital problems came more to the surface, demonstrating the industry's great need for more permanent capital.

I would prefer today to avoid talking in terms of particular brokers. Imagine, therefore, if you will, one of the ten largest securities firms, an Exchange member with a national distribution system and an average net capital situation. This firm has decided to go public and to issue $10 million of equity securities. Who are the prospective purchasers most likely to be interested in an offering of this type and size? Quite obviously, they are the firm's ordinary customers. In choosing this particular broker to execute their securities transactions, these customers have evidenced some degree of faith in many of those same attributes of the firm that will determine its viability in its new role as an issuer -- its capital situation, its managerial, research

and back office capabilities and its general business reputation, which encompasses these and other less specifically identifiable characteristics. If these are the logical customers to whom the securities are to be sold, does it make sense to preclude employees of the issuer-broker from themselves selling the securities to their individual customers?

When an issuer is forced to interpose another, competitor broker between himself and his own regular customers for the purpose of providing an independent underwriter for its securities, it can be argued that it is being obliged to assume a burden out of proportion to the actual need for investor protection. The issuer will be compelled by marketing logic to give its competitor not only its customer list but to encourage him to contact those clients and, not unimportantly, will invest him with some esteem in customers' eyes as the outside broker "chosen" by the firm.

What is the protection afforded to investors by interposing this intermediary broker? Presumably, it is to prevent the exercise of undue influence on the customer by a broker who is normally relied on for objective advice but in this case would be placed in the position of analyzing its own worth for its customer. The underlying assumption appears to be that a registered representative would be less likely to find his own employer's securities "unsuitable" for a client than some other security which might be just as speculative or less so.

Apart from the external or sales functions which can prove troublesome in broker-dealer self-underwritings, there are comparable difficulties in the internal functions which an underwriter performs. Any underwriter has distinct obligations to both the issuer and the ultimate purchasers of the securities underwritten in the way he assists in the actual construction of the offering. Since he provides the means of furnishing the issuer with needed capital, he has an interest in setting terms that will provide funds sufficient to accomplish the issuer's objectives in making the offering. On the other hand, he must serve the public interest by bringing to the market a security that is reasonably valued, an appropriate type of financing, not overly diluted and otherwise suitable for investors. By his participation in these determinations, the underwriter often provides a significant degree of protection to the public investor because of the traditional value of his arm's-length relationship with the issuer. Where the issuer is himself the underwriter, there is no such arm's-length relationship between the two entities, and important investor protections may be weakened significantly.

The usual independence of the underwriter from the issuer also has a bearing on what provisions are made for underwriting compensation. Although the NASD and the Commission, acting for its SECO broker-dealers, have developed guidelines with respect to maximum permissible limits of underwriting compensation, just what compensation is received within those limits is a matter of negotiation between issuer and underwriter and may to a significant extent be dependent on the degree of their independence from one another.

These conflicts I have mentioned were some of the reasons that the NASD and the Commission, in the administration of its regulatory program for non-NASD broker-dealers, maintained for a period the tight restrictions I have mentioned on self-underwritings. After their experience with this policy, however, and in view of the need to improve the capital foundation of the brokerage industry, the NASD concluded that some relaxation was needed so as to give broker-dealers greater flexibility in obtaining public financing for their operations. Accordingly, the NASD has submitted proposals in this area to the Commission which would authorize self-underwritten distributions under certain circumstances but, it is hoped, would minimize the dangers inherent in such sales. Some firms have been permitted to proceed with offerings in reliance on these proposals, which have, thus far, been considered sufficiently safe. This is a temporary procedure necessitated by the fact that the former rules governing self-underwritings are no longer in effect and that the rules designed to replace them have not yet been adopted. I would caution, however, that the Commission is not necessarily committed to the continuation of this procedure in the interim prior to the adoption of formal rules.

Rather than discussing all of the specifics of the new NASD proposals, the provisions of which I am sure are well known to you, I think it would be best if I could give you some feel for the spirit with which I perceive the Commission is approaching them, some of the major difficulties I, as one Commissioner, find with them, and the hopes I have for the future of self-underwriting.

Suitability, which I mentioned previously, is clearly the prime problem in self-underwriting with which the NASD proposals attempt to deal. Their proposed rules on the subject specify that if the broker-dealer recommends its own securities to a customer it has to make, record and file its explanation for determing such an investment suitable to that investor's needs. That explanation is to have reference to the customer's investment objectives, financial situation and needs and any other information known by the broker-dealer. Additionally, the net capital and net worth requirements which would apply to all broker-dealers going public and other specific requirements made by the NASD of brokers who would self-underwrite would hopefully weed out issuers whose securities contain too high a speculative factor. These requirements can be viewed as adjuncts to the suitability rule since they provide a standard of quality in this type of offering that simply is not present in other types. Congress did not intend that either the Commission or the self-regulatory bodies should normally rate offerings as to their quality or desirability. When the industry involved is one regulated by these bodies, however, and where the selling broker is not an independent party but the issuer itself, then we do have a greater than usual responsibility which justifies the imposition of reasonable outer limits on the kind of financial condition an offeror can be in when he solicits additional public capital. Section 15A(b)(4)(A)(8) of the Securities Exchange Act of 1934 epitomizes that responsibility. It provides that a national securities association shall not be permitted to register as such unless its rules appear to the

Commission to be "designed to promote just and equitable principles of trade, to provide safeguards against unreasonable profits . . . and, in general, to protect investors."

Taken together, these measures appear to be an adequate solution to the suitability problem. Personally, I have never had a great deal of confidence that the interposition of a new broker between the issuer and its normal customers, now potential owners, can do much to ensure suitability; and, in some instances, it may even possibly exacerbate the problem. Firstly, in terms of customer reliance, the use of an intermediary broker cannot be expected to accomplish much in terms of making more objective a customer's opinion of the brokerage firm he uses. The intermediary broker who wishes the offering to succeed and has a common supply of business ethics will certainly be reluctant to convey to the customer even truths about the issuer which would act as deterrents to the sale he is attempting to make. Secondly, the customer's regular registered representative who has firsthand knowledge of the customer's portfolio and investing habits and a good knowledge of his employer, the issuer, is probably in a good position, somewhat biased though he may be, to make a suitability determination as to the appropriateness of this security for this customer. A new registered representative employed by the intermediary broker, previously unexposed to the customer and with little confidence that he will have him as a client after this one transaction, may well be disinclined to make a thorough examination of this customer for suitability purposes. Please understand that I am not now trying to make a sales pitch for self-underwriting. I am simply trying to point out some of the factors that militate against any absolute prohibition of it.

One problem area to which the NASD has not yet spoken, at least so far as I am concerned, is that of secondary distributions in self-underwritings. By "secondary distributions" I refer to the issuer including in its offering previously unregistered securities owned by its own insiders. By doing this, the necessity for separate registration of the securities is avoided and they can be marketed in an organized offering rather than in an ordinary trade. It is not unusual if the percentage gain made by the insiders on such a sale is quite substantially in excess of any true gain in the value of the assets underlying the shares.

How does the issuer benefit from such a secondary distribution? Well, it does not gain the benefit of increased or more permanent capital which I mentioned before as the prime factor in the desirability of broker-dealers going public in the first place. In fact, somewhat the opposite is true. If an officer of our hypothetical issuer purchased 1,000 unregistered shares at $10 per share two years ago and now is having them sold to the public as part of the firm's general offering at $20 per share, then those shares will have been only half as effective as non-insider stock in the offering in bringing in new capital to the firm. The $10 per share increase in price in the stock will represent a gain for the officer, not for the issuer, and will go into his pocket. If this increase were the result of the officer's keen business judgment and the growth of the issuer over the two years, that might well be very

acceptable; but often this is not the case, and the gain results from the fact of registration of the shares and their inclusion in an offering. If the offering were the identical size and the insider required to sell his shares elsewhere, then the issuer itself would realize the $10 additional. My point here is that insiders should not be tempted to deprive broker-dealer issuers of additional capital where such funds are seriously needed.

Since similar secondary distributions are standard practice for other types of issuers, why then do I question them here? I do so because, again, this is an industry regulated by the Commission where an innovation, such as self-underwriting, must be examined in the light of benefits it will confer on the public and the industry, not benefits in terms of private gains for individuals within that industry. I am given further pause by the fact that in a self-underwriting which includes insider stock certain of the personnel acting as sales agents may be selling their own stock or that of their coworkers or supervisors. This last is a subtle point, but I think it important to realize that the safeguards we plan to erect against the conflicts in self-underwriting may not be as adequate to deal with conflicts created by an even more direct personal involvement in the offering -- the personal involvement that comes from an ownership of the item being sold or from being supervised by or working along side an individual who is in such an ownership status. The pressures on a registered representative in such a situation to make a sale may well be greater than those felt by one simply selling the securities of his broker-dealer employer. The problem is particularly accute in a first-time offering where there is no active, independent market to judge the merits of the securities being distributed. As far as our being a regulator of this business is concerned, I will just say that in taking the liberal steps of recognizing the needs of broker-dealers to go public and self-underwrite, I am intent on doing my part to ensure that such steps do not result in abuses injurious to the public.

One other important problem with self-underwriting that I will raise with you relates to the issue of exactly who does share in the responsibility for self-underwriting where there has been inadequate or inaccurate disclosure and investors have been damaged. In the standard underwriting, by virtue of the protections built into Section 11 of the 1933 Act, liability for untrue statements of material facts in a registration statement or omissions of such facts attaches to certain persons directly associated with the issuer and the underwriter. The possibility of such liability, of course, is the strongest kind of incentive for an underwriter to maintain some independence from the issuer he serves and to assure himself that full disclosure is made in the registration statement. In a self-underwriting, however, the underwriter is the issuer, and it would obviously be fallacious to assume any independence between these two roles. Does this, then, result in an additional problem in self-underwritings?

Fortunately, because of another provision in the NASD's requirements for self-underwriting and because of the broadness of Section 11 itself, I believe that it does not.

I mentioned earlier that an important function of the independent underwriter was his role in determining certain characteristics of the offering, including the price. Setting the price is important in a business sense in that it is important not to underprice the offering and, therefore, deprive the issuer of proceeds he would otherwise receive or to overprice it and endanger the success of the offering in attracting new money. It is also important in a public interest sense in that investors depend upon knowledgeable, reputable underwriters for their evaluation of what a new security is really worth. If such reliance is to be justified, the person setting the price must obviously be objective in a way that the issuer itself cannot be. Because of this, the NASD has proposed that in self-underwritings the issuer-underwriter must obtain jointly arrived at price determinations from two qualified independent underwriters. The eventual offering price may not be higher than this joint recommendation. The independent underwriters are also charged with participating in the preparation of the registration statement and with responsibility for due diligence in such participation.

The important question that comes out of all of these background facts is whether an independent underwriter who takes on the pricing and due diligence functions I have described, but does not perform the marketing function which is the primary responsibility of the usual underwriter in an offering, also takes on Section 11 liability. While the NASD has stated that it is its view that such liability attaches to the independent underwriter in this situation, that underwriter is not required by the proposed NASD rules to admit such liability, and no court has yet ruled that it attaches. I believe it is clear that it does, however, and agree with the NASD position to this extent. Section 11(a)(5) applies the liability to "every underwriter with respect to such securities." To determine how broad this classification "every underwriter" is we have only to look to Section 2(11) of the 1933 Act. It states that "the term 'underwriter' means any person who participates or has a 'direct or indirect' participation" in the distribution of the security. The independent underwriter who sets the price for the self-underwritten offering is clearly a necessary participant in it under the proposed NASD rules. As such, in my opinion, he must be viewed as falling within the definition of underwriter in the Act and as subject to the resulting potential liabilities.

The decision of the NASD to permit self-underwritings under certain protective conditions is obviously motivated in great part by the judgment of some members of that Association who are planning on going public for needed capital that they will benefit from managing their own offerings rather than seeking outside management. I do not wish to disparage that motivation. While it has important regulatory functions, the NASD is also, like your own group, an industry association duty bound to be mindful of the needs of its members. Happily, it would appear that those needs and the needs of the public as a whole can both be served by the adoption, with some modifications, of the changes contemplated in the Association's rules as to self-underwriting. I say this because, despite some reservations about the potential conflicts necessarily

built into a self-underwriting, I believe that the practice can be justified on a public interest, as well as business judgment, basis. The problems I mentioned earlier can be kept under control with appropriate safeguards so as to make a broker-dealer self-underwriting no more inherently risky for investors than is any other underwriting in a business as complicated and competitive as this one. Even more, to make a positive statement instead of just refuting possible negatives, I believe that the availability of the self-underwriting mechanism will cause many broker-dealers to seek public capital who would otherwise confine themselves to more traditional capital sources. Such a change in the type of capital being put into these operations, and by that I mean a change to more permanent capital, cannot help but be beneficial to both the firms involved and the investors whom they serve.

We must all face the fact that a prime factor underlying the chaotic conditions our market place has recently passed through was the insistence of many broker-dealer managements that sales efforts be expanded without a corresponding bolstering of back office facilities. Obviously, the industry is now intent on modernizing and strengthening non-sales, support activities. They have learned that a dollar spent today in this area can save numerous dollars and managerial headaches tomorrow. Service facilities and personnel to carry on this work now cost more than ever, however, and there is a great problem of where an industry, just having passed through times that have drained a good deal of its financial resources, can find the dollars necessary for such improvements. A good part of the answer lies in the same source of capital that the industry has been tapping for others since its beginning -- money supplied by individual public investors. A number of broker-dealers thinking of going public have made a business judgment that self-underwriting is the best, in some cases perhaps the only, way for them to take such a step. I am confident that the Commission and the self-regulatory bodies will work out in the very near future a formal set of rules that will permit them to do this while ensuring optimum safeguards for public investors.