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DO WE MEASURE UP?

ADDRESS

BY

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I appreciate the opportunity to participate in a conference such as this in an area of our country in which the spirit of innovation and willingness to take major business risks with the prospect of substantial rewards is still alive. In my opinion, risk aversion and the increasing desire for security are among the primary reasons why productivity in our economy is lagging and our ability to compete in international markets is declining. Unfortunately, however, too often the willingness of investors to risk their capital in unseasoned businesses is seen by some promoters as an opportunity to take advantage of them through fraudulent schemes.

Every fraud, every misrepresentation, every misuse of corporate assets, and every unfair or inefficient market practice has a negative impact on our securities markets, on the ability of business enterprises to obtain capital from the public and upon the viability of our economy. The effect of each instance, except in major cases, is usually imperceptible but, nevertheless important, and all of us share to some extent in the loss.

One of the primary responsibilities of the Securities and Exchange Commission is to enhance the willingness of individuals to risk their savings in productive enterprise. This is done in several ways. Investors must have confidence that the venture in which they invest is what it is represented to be. They must also have confidence that funds will be used

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in a responsible manner to further their interests as owners of the business, and that there will be an accurate accounting of the use of corporate assets. In addition, investment is enhanced if intermediaries in the investment process are required to be fair in their dealings with customers and if customers can be assured that they will receive the best price obtainable when they purchase or sell securities.

Recently, I have had an opportunity to read drafts of a history of the Commission being written by Professor Joel Seligman of the Northeastern University School of Law. This caused me to reflect on the more than 7 1/2 years I have served on the Commission and to compare the events of those years with earlier periods in the Commission's history. I have found Professor Seligman's manuscript to be fascinating reading because it includes an inside look at the Commission based on official documents and the files of individual Commission members. It contains some of the give and take, the strongly-held differing views among members of the Commission, and the way various decisions were made.

Personalities, backgrounds, and biases played an important part in the early days of the Commission just as they do today. Some individuals, at least through the eyes of the historian, were heavily influenced by by those whom they had a responsibility to regulate. Others had definite views of their own as to what practices and standards were in the public interest and how they should be established. Some appeared to be indecisive and timid. Others pressed for

changes in order to obtain what they believed would be better investor protection and better capital markets. Of great interest to me was a comparison of the issues that were important several decades ago with those which are important today.

Felix Frankfurter, later to become a Supreme Court Justice, gave his views on the kind of individuals needed to deal with these issues. He said, ". . . plainly you need administrators who are equipped to meet the best legal brains whom Wall Street always has at its disposal, who have stamina and do not weary of the fight, who are moved neither by blandishments nor fears, who in a word, unite public zeal with unusual capacity." Another early comment by Professor James Landis, who had led the Federal Trade Commission's Securities Division and was one of the five original SEC Commissioners and its second Chairman, was that, "The assumption of responsibility by an agency is always a gamble that may well make more enemies than friends. The easiest course is frequently that of inaction. A legalistic approach that reads a governing statute with the hope of finding limitations upon authority rather than grants of power with which to act decisively is thus common."

During my experience at the Commission there have been events that have demonstrated the validity of both of these statements. I believe the challenge to the Commission is as difficult today as it was during any period since the agency was established over four decades ago. In fact, although there are new generations of participants, most of

the fundamental issues remain the same and appear to have become more complicated as new types of securities have been developed and our markets have grown and become more sophisticated.

The most basic question in the Commission's early history was whether the regulatory agency process would survive. In 1936 Alf Landon based his presidential campaign partially on the theme of doing away with the "Alphabet Agencies," and President Roosevelt's committee on Administrative Management suggested that such agencies threatened to become "a headless fourth branch of government - - - not responsible administratively either to the President, to the Congress, or to the Courts." As we all know, it is popular today to be critical of the regulatory process and to blame our lack of economic progress on burdens which regulatory agencies impose on business. Whatever the situation was at an earlier time, our decisions now are reviewable by the courts, and we are accountable to Congress. Despite the early critical comments and efforts over the years to eliminate administrative agencies, they have continued to exist and function because a better alternative has not been found. Agencies are necessary to handle routine government matters with which Congress, as a body, does not have the time and technical expertise to deal. After basic policy has been established, complex problems of regulation and administration remain. Even if Congress had time and the expertise to work out such details, undesirable rigidity would result if such decisions were embodied in statutes.

The necessity of a dynamic regulatory agency is clearly illustrated through an examination of the Commission's

statutory authority to modify the requirements Congress dictated for prospectus disclosure in Schedule A of the Securities Act of 1933. Without such authority in an expert agency the content of the prospectus would have been rigidly structured into law in response to a the economic climate existing at that time and a less complex business environment. Congressional action on a regular basis would have been necessary to achieve the benefits of such things as short-form prospectuses, small business initiatives, integration of the disclosure systems and financial statement changes to conform to emerging accounting and business developments. However, in its wisdom, Congress set forth a basic prospectus framework and gave the Commission the authority and responsibility to assure that disclosure requirements would not become stagnant and outmoded, but would remain dynamic and flexible in order to respond to new situations.

When it is determined that there is a necessary regulatory function for an agency to perform, it is important to give it the ability to fulfill that function. The answer to proper regulation is not to shackle an agency with Congressional or Presidential vetoes or unreasonable court review of its rules, or cost benefit analysis requirements that are impossible to meet, but as Thomas Corcoran stated in testimony when the Securities and Exchange Commission was being considered, "The answer is to pick good men," and I might add, women, "on your commissions."

We hear a lot of discussion about the burdens of SEC regulation on small business, the use of empirical information

and a need to assure that benefits of regulatory requirements exceed the burdens. Such rhetoric might lead to the conclusion that these are new factors in our decision making. To the contrary, they are not of recent vintage but have always been considered desirable and have continually played a part in Commission decisions.

For example, James Landis, an early New Deal liberal, insisted that issues be empirically studied on a case-by-case basis and that regulatory proposals not be made until the Commission thoroughly understood their consequences. According to Professor Seligman, the bitterest internal controversies at the SEC during Landis' chairmanship were his struggles with the Commission's economic and technical advisors whose reform proposals Landis considered inadequately analyzed.

There was also a concern about small businesses from the very beginning. One of the priorities of William O. Douglas, an early Commission member and proponent of economic deconcentration, was to find an effective way to equalize capital raising opportunities for small business. In 1937 an SEC study found that the relative cost of raising capital was significantly higher for small businesses. This conclusion was supported with statistics indicating that it cost about 15 percent of the gross amount of the issue to sell a block of common stock of $1 million to $5 million, whereas about 22 percent was required for issues of $250,000 or less. The differences in cost for selling preferred stock ranged from less than 4 percent for issues between $5-$10 million to over

17 percent for those of $25,000, and debt issues showed the same degree of disparity. Similar conclusions were reached in 1977, by our Advisory Committee on Corporate Disclosure.

In early 1937 President Roosevelt asked, "that the Securities and Exchange Commission consider such simplification of regulations as will assist and expedite the financing, particularly, of small business enterprises," and at that time the Commission expanded the exemptions for issues under $100,000 and provided a new simplified form for issues of less than $5 million. There is a striking similarity between these actions and those we have taken recently such as amendments to Rule 144; the adoption of Form S-18, which can be processed in our Regional Offices; increasing the ceiling on the amount of securities that can be sold under Regulation A; the adoption of Rule 242 and working with venture capitalists to develop amendments to the Investment Company Act which would reduce burdens while retaining important investor protection.

The comparison can also be extended to include larger firms. Form A-2 announced in January of 1935 with the purpose of reducing burdens and costs of registering securities for seasoned firms with existing securities, was based on the same concept as our 1978 Amendments to Form S-16 and our proposals last month which would permit companies widely followed by the market to use Form A which calls for very little prospectus disclosure in addition to incorporations by reference from Exchange Act information.

During some periods of the Commission's history, of course, regulation has increased. The point is, that the SEC

has responded to conditions that exist in our securities markets by providing the degree of regulation it believes is necessary to maintain fair markets and protect investors. Abuses bring heavier regulatory burdens. The Commission desires that access to capital markets be as free of government regulation as possible and if we find that securities attorneys, accountants, underwriters, and other professionals take the responsibility to assure that abuses do not rise to unacceptable levels, you can expect us to continue to remove burdens. If not, you can expect us to tighten the requirements.

Turning to corporate governance and accountablity, we find that in mid-1934, a law review article entitled, "Directors Who Do Not Direct," was published in which William O. Douglas suggested that codes of conduct for business should be upgraded considerably. He expressed particular concern about the board of directors being controlled or dominated by management, secret loans to officers and directors, undisclosed profit-sharing plans and trading in securities on the basis of inside information. He recommended vesting control in an independent board with power to supervise management and set general corporate policy. He urged that management be prevented from controlling the proxy machinery, and advocated greater opportunities for cumulative voting.

When rather reasonable proxy rules were adopted eight years later to require that top corporate officials disclose their compensation, and that an annual report either accompany or precede the proxy statement, the Commission was severely

criticized in various news publications and editorials, and it was alleged in Congressional hearings that the draftsman of the rules had communist sympathies.

Over the last several years, there has been increased impetus for corporate management accountability, both from public pressure and from formal and informal Commission action. For example, in 1974 the Commission adopted a requirement that the existence or non-existence of an audit committee must be disclosed by public companies. In addition, the revelation of questionable and illegal corporate payments in the mid-1970's brought renewed interest in audit committees. The Commission's view concerning the importance of audit committees was further expressed in a 1976 letter to the Chairman of the New York Stock Exchange suggesting that the Exchange consider requiring listed companies to have audit committees composed of independent directors. Shortly thereafter the Exchange adopted such a requirement. Other self-regulatory bodies and business organizations have also encouraged public companies to have independent audit committees.

In my view, our corporate payments program and the accounting and record keeping provisions of the Foreign Corrupt Practices Act ("FCPA") are significant accomplishments made against overwhelming opposition. Opposition that is presently pressing hard to bring about the repeal of certain FCPA provisions despite a lack of any evidence that the Commission has or will enforce such provisions in a way that would be detrimental to legitimate business operations.

Among other things that have occurred in the area of corporate governance are more inclusive disclosure of management compensation, more neutral proxy procedures, the tendency for boards of directors to be composed of a majority of non-management members, and the emergence of remuneration and nominating committees made up of non-management directors. In addition, the Commission recently published a detailed staff report indicating other areas of continuing interest.

The Commission has always seemed to have difficulty dealing with structural problems in our securities markets and in maintaining an effective oversight posture with respect to self-regulatory organizations. For example, one of the primary provisions of the original draft of the Securities Exchange Act prohibited any person who acted as a broker to also act as a dealer in or underwriter of securities. This was replaced in the final legislation with a provision directing the Commission to study the advisability of such a complete segregation and report the results to Congress. In response to this provision, in 1936, the Commission's chief economic adviser and its chief of special studies prepared a draft report to Congress recommending not complete segregation, but virtual abolition of floor trading by exchange members for their own account. The final report recognized the existence of abuses resulting from the combination of broker and dealer functions but was softened even more and indicated only that the Commission would use its rulemaking authority to preclude floor traders from acting as brokers, and commission brokers from initiating orders for their own account.

This proposal caused the president of the Associated Stock Exchanges to claim that the exchanges "have entered the dying industries classification by reason of the discriminatory operation of the Securities and Exchange laws," and the president of the New York Stock Exchange to charge that Commission regulation threatened to destroy a "broad, liquid market." Confronted with this opposition and a down turn in market activity in the fall of 1937, the Commission was unwilling to impose the proposed rule.

Additional studies in the intervening years have concluded that the activities of floor traders trading for their own account could not be shown to be in the public interest, yet the Commission is still considering whether floor traders in the form of Registered Competitive Market Makers on the New York Stock Exchange and Registered Exchange Market Makers on the American Stock Exchange should be permitted to continue their operations. How we as a Commission will decide this issue remains to be seen.

Another important early economic issue for the Commission was whether to permit the New York Stock Exchange to prohibit its members from trading NYSE listed securities on other exchanges. Following an announcement by the Exchange that beginning September 1, 1940 it would discipline any of its members who traded New York listed securities on another exchange, in late November the Commission formally requested the Exchange to amend its rules so that they would not prevent members from dealing on other exchanges. The Exchange declined,

and the Commission scheduled a hearing to decide whether to use its power to require a change. The then president of the NYSE accused the members of the Commission of lacking a concept of the market, and unintelligent administration of the securities laws. Late in 1941, the Commission ordered the recession of all prohibitions against members trading NYSE listed securities on other exchanges and the NYSE complied.

In 1973 and 1974 when the Commission was considering whether to require the removal of exchange rules fixing minimum commission rates, we faced almost total industry opposition. We were told by industry leaders that competitive rates would destroy the New York Stock Exchange as well as other exchanges, create confusion and chaos in securities markets, lower standards in the industry, weaken investor protection, reduce depth and liquidity in our markets, eliminate public markets for many securities, destroy our capital raising mechanism and bring the downfall of our free enterprise system. One witness at our hearings referring to the May 1, 1965 date which we had proposed as the time to require competitive commission rate barriers to be removed stated, "Mayday is a great holiday in Russia. And Russia has said there is no need to fight democracy. It will burn itself out. Well, Commissioners, you have the candle and the matches, and it will be a short fuse." Fortunately, the Commission at that time was not deterred by the dire predictions, which, of course, did not prove to be correct.

Perhaps the most difficult task the Commission has ever had is the mandate in the Securities Acts Amendments of

1975 to facilitate a national market system in which there would be an opportunity for customer orders, regardless of how they were entered into the system, to be exposed to the best alternative offer in any market in the system and in which there would be an efficient means by which best execution could be obtained. It was the clear intent of the statute "that the national market system evolve through the interplay of competitive forces as unnecessary restrictions [were] removed." The Commission was directed "to remove existing burdens on competition and to refrain from imposing or permitting to be imposed, any new regulatory burden 'not necessary or appropriate in furtherance of the purposes' of the Exchange Act."

The Conference Committee Report also stated that "The conferees expect however, in those situations where competition may not be sufficient, such as the creation of a composite quotation system or a consolidated transactional reporting system, the Commission will use the powers granted to it in this bill to act promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system are put into place as rapidly as possible."

Some important progress has been brought about through Commission rule making and the cooperative efforts of the securities industry and the Commission. Nevertheless, I believe the criticisms of the Commission in a recent Report by the Subcommittee on Oversight and Investigations of the House Interstate and Foreign Commerce Committee have substantial merit. I am particularly concerned that an automated linkage between

the exchanges and over-the-counter market makers has not been established to facilitate competition between those markets. It is also no secret that I believe we could and should have done more to remove anti-competitive barriers and create an environment in which market forces rather than institutional power could have a greater influence on developments in our securities markets. Moreover, it is my view that if we had acted more positively and consistently, market developments would have been more predictable and overall dislocations and adjustments to change would have been less difficult for industry participants.

On a more positive note, the Commission is making substantial improvements in the way we process filings required by the Securities Act and the Securities Exchange Act and the way we oversee our securities markets. Just as improved market efficiency depends on the use of modern methodology, the productive review of filings with the Commission demands thoughtful management of scarce staff resources. Our Division of Corporation Finance has just begun an innovative endeavor to help identify cases which may need careful staff examination. This is a project in which I have been interested for a number of years and I believe it has the potential of being a very positive development.

Another major development at the Commission is the Market Oversight Surveillance System ("MOSS") which is a sophisticated automated information system to assist the Commission to properly oversee the securities markets and

enforce the federal securities laws. The system has the following five basic functions:

to monitor trading in our securities markets and signal conditions which may indicate trading practice violations;

to provide for the reconstruction of market events surrounding particular trades and identify the professional participants in those trades;

to assist in scheduling and focusing on matters for review during inspections of broker-dealers, investment companies, investment advisers, and self-regulatory organizations;

to assist in, and provide for, coordination of self-regulatory organization and Commission inquiries and investigations; and finally,

to utilize an integrated data base to assist the Commission in evaluating market and industry conditions, the effectiveness of existing rules and the impact of proposed changes.

The system is needed for the proper performance of the Commission's statutory oversight obligations which are growing because of expanded market activity, increasingly complex financial institutions, new financial products, and additional regulatory responsibilities. There has been some concern that the Commission might use MOSS to encroach on the functions of the self-regulatory organizations. Considering the strong tradition and commitment by the Commission to the self-regulatory approach, I don't think there is any need to be concerned as long as those organizations fulfill their

responsibilities of maintaining appropriate practices in their markets and disciplining their members.

In conclusion, the question of how the Commission measures up in comparison with earlier periods remains to be answered by future historians. I believe there are some bright spots and some that are not so bright. I just hope that when the history of this period is written it will not conclude that we became "weary of the fight," that we refrained from necessary action because of "blandishments or fears" or that we took a "legalistic approach that reads a governing statute with the hope of finding limitations upon authority rather than grants of power with which to act decisively" when the public interest called for action.