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CAN THE SEC HELP THE CAPITAL CRUNCH?

AN ADDRESS

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Certainly by now, no one can dispute the fact that the capital needs of this country in the next ten years, not to mention for the remainder of the century, vastly exceed the needs of any decade or quarter of a century in our history. A bewildering number of powerful forces have come together in this moment of our history to create this overwhelming need. We have suddenly become aware of the abuses that we have heaped upon our surroundings and have realized that we, and past generations, have bought our high standard of living at the price of considerable damage to our environment. Thus, we are confronted with a critical need not only to halt further pollution, but also to incur the costs of undoing much of the damage of the past. This task, even when it is moderated considerably below the demands of the environmentalists, is vast and unfortunately in many instances the expenditures are necessary lest irreversible damage be wrought.

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Furthermore, we are finding ourselves increasingly engaged in fierce competition throughout the world with other industrial nations which in some instances have the advantage of newer industrial facilities and have done more to facilitate and encourage capital investment than we have. If we are to succeed in this competitive race - and it is a race in which there are more runners every year - we must have the means of making our plants and other facilities more efficient, productive and competitive.

Were these two factors not enough to frighten of themselves, added to these burdens on our capital resources are the needs created by the energy crisis. President Ford announced last week plans to create a one hundred billion dollar federal corporation for the purpose of developing energy sources to make this country less dependent of foreign sources ten years from now. This, as we all know, is not the limit of the requirements for capital that have arisen out of the energy crisis.

And finally, we have the constant demand for a better standard of living. There are those among us who suggest that perhaps the American people will have to settle for a less affluent, less comfortable style of life than they have had in the past. This may indeed be true, but I think it is the expectation of Americans today, as it has been throughout the history of this country, that their children will live a little better than they have, that they will enjoy, hopefully contemporaneously with a spiritual well-being, a material prosperity. If we abandon hope of an economy growing in real terms, putting aside inflation, then I think we will be in for a period of social unrest and it will be extremely troubling, for new, sharper conflicts in society will develop as the various constituents of it seek to enlarge their share of a fixed or even shrinking pie.

All of this has led, for instance, the New York Stock Exchange to estimate most recently that there is a gap of 650 billion dollars between present projections of the capital that will be available in the next ten years and that which will be necessary to satisfy these multiplying needs of our society.

Complicating our efforts to get a grip on this problem and resolve it has been the growing dependence of American corporations on debt rather than equity capital. Historically in this country, unlike some others, businessmen and their credit sources have been cautious in maintaining reasonable ratios between debt and equity. But during the last ten years this ratio has grown from 25.4% in 1964 to 44.3% for the first quarter of 1975. Such a phenomenon, of course, creates greater dangers of business failure, with concomitant huge losses to shareholders, an effect which further discourages investments in equity securities. We are acutely aware that equity markets, if they have not dried up, have nonetheless become substantially less fruitful than they have been in years not too distant past.

Obviously, if this crisis is to be overcome, it is going to require a good deal more than gimmicks, public relations, even innovative tax policies, and certainly it is going to need more than the fullest ministrations of the Securities and Exchange Commission. If people are to undertake the risks of equity investment, they must have a confidence in the future of the economy, a belief that there is a reasonable prospect of gain commensurate with the risks they undertake, and a conviction that the success of their investment is not going to be nullified by the forces of inflation.

And they are going to have to have a belief that the marketplace is an honest one, that they are receiving a fair shake, and that if they lose it will be the result not of fraud or overreaching by entrepreneurs and businessmen, but rather of the inexorable operation of the risk-return concept.

When the role of government in helping to solve the capital crisis is spoken of, I think this is one aspect of it that is frequently overlooked. Much of our discussion has been of the importance of tax policy in solving these problems, of the importance of government avoiding policies that encourage inflation and using various other means to promote investment. But I would suggest that, as important as these are, there is a word to be said for the fact that honest markets and honest solicitations of capital have a double importance: first, confidence in the integrity and efficiency of the financing process and the marketplace is essential if investors are to take risks, and second, the expulsion of the swindlers and the crooks from the marketplace prevents the diversion of needed capital resources into the vast varieties of dishonest and ill-conceived schemes that often, unfortunately, are more appealing than legitimate investment.

It seems to me that if there is a role for the Commission in the process of capital formation - and time and again, I have been asked what the Commission is doing to alleviate the impending crisis - it is in performing well its historic chore of protecting investors.

There are innumerable sources of protection for people when they commit their resources to the stewardship of others. When you or I deposit money in a bank, we are not too concerned about the quality of representations that are made with respect to the solvency of the bank as long as our deposit is within the limits of insurance by the Federal Deposit Insurance Corporation and the bank is insured by that entity. Similarly, when we invest in United States government securities, we know that while the price of those securities will vary with factors such as interest rates, nonetheless safety - at least in nominal dollars, if not in real dollars - is assured. It is when investors put their funds to use in riskier undertakings that it is imperative that they receive the information that permits them - or their advisors - to assess the extent of the risk to which they are exposed. In an effort to afford this protection of investors we have developed since 1933 an extensive and sophisticated system of disclosure, not only at the point where securities are being distributed to the public, but also in the secondary markets as well. The integrity of the information in the secondary market is surely as important - in the eyes of many people, more important - than the integrity of the distribution process. For every dollar that is committed in distributions, six dollars are committed in the secondary trading market. Thus it is important that those who invest in this secondary market have confidence in the information that is available to them about the investments they make there.

The secondary market is of a tremendous significance to the capital formation process. Those who invest in primary distributions usually do so with the expectation that, even with respect to new companies going public for the first time, somewhere down the road there will be an opportunity to dispose of the securities in the secondary market, and when they do they expect that market to function efficiently and economically. Thus, the preservation of that market is of the utmost importance in the capital-raising process. The presence and the efficiency of that market is going to be vitally affected by the extent to which it is an honest market, fully informed concerning the securities traded there.

Fortunately the burden of administering the disclosure process is lightened because most - in fact, an overwhelming number of companies in this country realize the value of the disclosure system and cooperate fully in the effort to procure for investors the fullest possible information which may bear upon investment decisions. Available in our files is up-to-date and voluminous information concerning over 10,000 publicly-held companies. In those files any would-be investor can secure a remarkable array of information on any company in which he may be interested. He can find the certified financial statements from the most recent fiscal year as as well as earlier years, abbreviated interim statements on a quarterly basis, information about the compensation and other employee benefit practices of the company, a description of its business, detailed information concerning lines of business in which it engages, its capitalization, and a plethora of other data. Thus no one in this country needs to invest on the basis of a salesman's say-so or the blandishments of a pitch artist - and yet it continues to be shocking how many people invest their life savings, or a large part of them, on the basis of a telephone call, a tip from a friend, an ostensibly casual call by a promoter, a single sheet of beguiling prose. This abundance of information has been created largely as a result of the system of federally mandated disclosure which has been developed over the last forty years; but more important, I think there has grown through those years a steady realization on the part of business that its interests are served by a capital market that is fully and fairly informed abut investment opportunities. Businessmen fully realize their best opportunity to tap the capital market is afforded by developing a record of candor in informing the securities markets about their affairs. They have witnessed the severe penalties that the market inflicts upon the business that doesn't level with the investment community.

Experience has established that simply pumping information into the marketplace does not solve all problems. It is equally essential that the marketplaces themselves, and those who are professionals in them, be characterized by adherence to strict standards of propriety and integrity. Thus, the Commission and the self-regulatory organizations - exchanges and the National Association of Securities Dealers - have developed a complex set of rules governing the conduct of those who participate in the trading markets.

Thus, American investors can do business with American broker dealers reasonably confident of many things: first, that the firm has sufficient capital; that its salesmen and supervisory personnel have had to pass examinations with respect to their understanding of securities markets and their regulation; that registered representatives are adequately supervised in meticulous detail; that recommendations will not be made without a sound, factual foundation or without concern about the suitability of the investment to the investor; that confirmations will be promptly delivered and records carefully and fully maintained; that the manner in which the broker-dealer conducts its business will be periodically examined by either a self-regulatory organization or by the SEC.

After two years plus experience in the SEC, I would be false if I were to claim that there are no departures from these standards; however, the extent to which there are departures these days are relatively minuscule when compared with the total number of transactions done. Furthermore there exist extensive means by which investors who think that in one fashion or another they have been the victims of improper conduct on the part of broker-dealers may secure redress.

In addition to its concern for the honesty of securities markets and those who make them operate, the Commission is also concerned with the efficiency and the fairness of the markets. As most of you know, the Commission has for the last four years been developing the so-called "central market concept." In its simplest form this is a plan to link together all of the marketplaces in the country where securities are traded in a manner that will make it possible for customers to secure the best execution of their transaction regardless of where they are located and regardless of where the best market is geographically. In pursuit of this goal, the Commission has already done a number of things. By the process of rulemaking it caused to come into existence the Consolidated Tape Association which now has developed a consolidated tape, more accurately, consolidated tapes, one of which carries transactions in all New York Stock Exchange listed securities and the other which, when it becomes operational, will carry all transactions in most securities listed on the American and other exchanges, regardless of what exchange they are done on and regardless of whether they are done on an exchange or in the third market. Further, the Commission has created a climate in which, hopefully, by the end of the year, there will develop a common quote system which will make readily available the quotations of the various market makers in many securities so that securities dealers throughout the country will be able to select the market in which they can accomplish the best execution for their customers.

I think the contrast between the method used to develop the consolidated tape and that which was used to develop the common quote system is an interesting one. With respect to the consolidated tape the Commission adopted a rule which required that each exchange and each national securities association (the only one in existence is the National Assocation of Securities Dealers) submit a plan looking toward the development of a system whereby all transactions in most listed securities would appear on the same tape. In response to this, five exchanges and the NASD combined their efforts, prepared such a plan, negotiated many details of it with the staff, and finally adopted it, thus setting the stage for the advent of the consolidated tape. That is now partially operational. The result is that an investor may see, by examining the appropriate tapes, a contemporaneous record of every transaction in the securities on the tape regardless of where the transaction occurred, whether in the third market, on the New York Stock Exchange, the Pacific Stock Exchange and so on. It is expected that in the not distant future with the development of high speed lines the system will become even more effective. In this case the efforts of the Commission in its regulatory function and the self-regulatory agencies, which are owned and operated by members of the securities industry, were combined to do the job.

With regard to the common quote, however, the approach taken was different. Initially, it had been suggested that the same method used in developing the consolidated tape be used again. However, after considerable discussion at the Commission, it was decided that perhaps this was a good opportunity to turn loose the forces of competition and see how well the job was done. Thus the Commission, instead of adopting elaborate regulations or encouraging the industry to do so, simply requested that all the exchanges remove all barriers in their rules preventing the dissemination at a reasonable cost of the quotations of their market makers. All of the exchanges to their credit responded affirmatively to this Commission initiative and removed these barriers. Thus the quotations of the New York Stock Exchange specialists are available to those willing to pay the reasonable charges established, as are the quotations of the various other exchange specialists throughout the country and the third market makers. In response to this new availability, various disseminators of financial information have been exploring the possibility of selling a composite of these quotations to members of the securities industry and there is some hope that such a system may be in operation by the end of the year.

Further pursuing the idea of the central market, the Commission organized an advisory committee under the chairmanship of Alexander Yearley, IV, to develop some of the concepts that are essential to the full implementation of that idea. This committee completed its work a couple of weeks ago and presented to the Commission a most valuable report setting forth the results of deliberations which I might indicate absorbed 23 days of actual meetings plus innumerable hours of planning and drafting, a very substantial contribution by the securities industry to the development of this idea. Succeeding that committee is a new committee mandated by Congress as a part of the securities legislation adopted and signed by the President in June, which will further examine the issues posed by the central market and report to us and to the Congress no later than December 31, 1976. This committee includes eight members selected from the securities industry and seven representing the public, and it is chaired by John Leslie, the distinguished Chairman of Bache & Co.

Through the development of the central market system it is expected that all investors, large and small, will secure the best possible execution of their transactions. At the present time there is no such assurance.

Further in an effort to assure the efficiency and the fairness of markets, the Commission on May 1 eliminated fixed commissions on the securities exchanges of the country. Because of the inflexibilities of the fixed commission system, which had existed since 1792, the development of new methods of serving investors, both institutional and individual, had been thwarted. Since the time that fixed commissions were removed on May 1, many aggressive and imaginative brokerage firms have developed new programs and ideas in an effort to serve individual investors better. As a further dividend from this decision, Paul Kolton, the president of the American Stock Exchange, has pointed out that at a time when the capital needs of the country are the greatest, because of the relative stability of individual commission rates as contrasted with the sharp reductions in institutional rates that came after May 1, brokers are much more concerned with serving their individual customers and providing them with the services that they need. Thus as a collateral, and I might say welcome, consequence of the elimination of fixed commissions, it may well be that the presence of individual investors in the marketplace will be further encouraged, with hopefully some alleviation of the capital crunch that we are experiencing.

Finally, one of the important results for the United States capital markets of these efforts by the Securities and Exchange Commission, the self-regulatory organizations and the state authorities to maintain proper standards in the securities industry is the prevention of money being drawn out of the corporate capital formation process into frauds and unsound promotions. I doubt if anyone knows the amount of money that goes down a rat hole in this country as a result of schemes ranging all the way from the well-known Ponzi schemes to more sophisticated real estate and commodity manipulations; judging by the number of cases we see at the Commission involving outrageous and mischievous frauds we're confident the amount is shockingly large. When this money goes into the pockets of promoters or is sunk in the ground in unsound oil schemes or is spent on fraudulent promotions, legitimate businesses in this country are denied those funds. Thus while the SEC cannot - and should not in my estimation - make investment decisions for the American people, nonetheless, by preventing sharpies and the crooks from bilking the American people, I think the Commission is having a beneficient and thoroughly wholesome impact upon capital formation.

Honest securities markets; informed securities markets; efficient securities markets using the tools of modern technology: these are essential ingredients of any effort to deal constructively and effectively with the present dramatic demands on the capital formation process in this country. Notwithstanding the shortcomings of our tax system in promoting investment, through the history of this country we have successfully developed enormous capital resources which have made it possible to achieve the highest standard of living in the world. In a not insignificant measure that success has been the consequence of our constant efforts to provide markets with ingredients I have described. A continuation of those efforts, in which your organization, the companies you represent, and you play a vital role, can make a solid and meaningful contribution to meeting and besting the problems we now confront.