THE PUBLIC: WE NEED THEM

Address by

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THE PUBLIC: WE NEED THEM

The Securities and Exchange Commission wants to make the securities markets safe for and receptive to the small investor, and we want your help. I don't know how many of you have seen the March issue of the Institutional Investor magazine. I have; and, having found it quite troublesome, I'd like to share with you some of my reactions to it and my thoughts on the very important issue to which it is primarily devoted, the future of the small investor.

The magazine's cover depicts a very large hand and lower arm, the latter elegantly but conservatively dressed in what might be seen as Wall Street fashion, pointing out a door, in a gesture of rejection, past a sad and rather ordinary looking man who is drawn on a much smaller scale. The picture is somewhat reminiscent of those cartoons we've all seen many times of a father turning a young girl and babe in arms out of his house and into the snow with words such as "Go, and never darken my door again." In the case of this cover, however, the caption reads, apparently rhetorically, "The Public: Who Needs 'Em?" My comment on that question is "The Public: We Need Them."

If I can briefly summarize the position taken by Chris Welles, the General Editor of the Institutional Investor and author of the articles to which I have referred, it is that the small investor is playing an ever decreasing role in the stock market, that his participation in that market was never really as necessary as common myth held it to be and that, in the future, his investments will increasingly be effected through the medium of large, integrated financial service firms rather than the traditional broker. Such services will not only institutionalize the little man's effect on the market by putting him into mutual funds, for example, but will also direct monies that would ordinarily have gone into common stocks into other types of investment mediums such as bonds, commodities, real estate and insurance products.

I have no quarrel at all with brokers offering their customers new types of services and opportunities to invest in a varied range of investment products. The Commission has, as you know, permitted the New York Stock Exchange to proceed with its plan to permit members to sell insurance products as well as securities, just as we have previously permitted the Midwest Exchange to provide for similar activities by its members. We do, of course, have a concern in this area that adequate records and supervisory procedures be maintained to make certain that members' insurance activities do not imperil the financial stability necessary for their securities business and the protection of their customers. I have a similar view as to other types of products such as real estate investments, so long as they are properly registered as securities where that is required. (I might mention parenthetically here that the Commission has recently seen increasing numbers of limited partnership interests, condominiums, interests in real estate mortgages, real estate investment contracts and other real estate products which have been sold under circumstances requiring registration without being registered. We intend to take whatever action is required to correct these abuses.)

What I do quarrel with in Mr. Welles' articles is the implied acceptability of the securities industry's rejecting small investors who attempt to purchase stocks in the traditional manner. Although his text is not so strong in this regard as is the cover which I described to you, such a rejection is implicit in the substance of the articles. While this attitude may be understandable in a magazine catering to institutional investors, I believe, nevertheless, that it is also unfortunately characteristic of the present thinking and the business practices of many members of the securities industry at large. As one article states, "[r]efusals of many retail firms to accept small orders undoubtedly turned many potential buyers from the market." Referring to the attitudes of account executives, a vice-president in charge of investor services for a major Wall Street firm says "they don't want to spend their time just calling up people with the stock of the day . . . the decline of public trading in the market is not only going to continue, it's going to accelerate." Another executive quoted in the article says "[w]hen you look at the public's lack of interest in the market, and his pessimism and discouragement, you have to wonder whether he's just not being asked to buy anymore." The director of investment policy for a major firm represents that their salesmen are "'reprimanded' . . . if they disseminate certain research information too widely among small investors. 'Giving it to everyone downgrades the quality of the work . . . It cheapens it.'" I cannot buy this sort of philosophy, I don't believe that my Commission buys it, and I urge you not to do so.

To use the last quotation as an example, the Commission made it quite clear in our recent Statement on the Future Structure of the Securities Markets that we feel a prompt and fair dissemination to large and small investors alike is indispensable to the efficiency of the securities markets. Furthermore, we stated that brokers are bound by a positive duty to distribute research advice on a broad basis under certain circumstances. To quote from the Statement:

> "We believe that a broker is obliged to communicate any material changes in his prior investment advice arising from subsequent research he may do to all customers whom he knows have purchased and may be holding shares on the basis of his earlier advice, at least under circumstances where to do so would not impose an unreasonable hardship on the broker."

It is my own view that this is the bare minimum standard in this area. A broker will have to go a very long way indeed before he can prove that the distribution of this kind of information imposes an "unreasonable hardship" on him. Furthermore, it may be that the duty to communicate a change in research advice to customers is one owed to all customers and not just to those "holding shares on the basis of . . . earlier advice." The latter standard is difficult to enforce due to the practical impossibility of determining which customers hold shares "on the basis of . . . earlier advice" and which hold it on some other basis. Secondly, it does not operate to prevent future purchases of the security in question by customers who may erroneously assume that the broker still stands behind his original advice.

The Commission's position on the obligation of brokers to distribute research advice is just one example of the sum and substance of what I am trying to communicate to you; that is, that we will not, and you should not, tolerate members of the brokerage community who have traditionally relied on and benefited from the small investor now downgrading his importance, giving him inadequate service and rejecting his business.

With regard to the inadequate service problem I have mentioned, let me now trace for a moment the contribution the Commission has made in this area in the very recent past. Critics of our work in recent years have been quick to allege that the magnitude and frequency of recent brokerage failures, which occurred primarily in 1970 and early 1971, indicate that the Commission's requirements are too lenient and our oversight of the industry's "self-regulation" too myopic, all to the detriment of the interest of small customers who have entrusted their cash and securities to brokerage firms. 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.

While the Commission, like the industry itself, did not foresee the magnitude of the trading volume increase of recent years which initiated the industry's back office and then financial problems, 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, large and small but predominantly the latter, came to us for assistance. We attempted to help them. 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 aid 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 anxiety about the situation in the industry and placed brokers on warning that they would be violating the anti-fraud 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 managing their back offices properly.

Because of the fact that our authority over the self-regulators is greatly limited, 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.

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 those points. In a letter to the New York Stock Exchange with regard to its request for increased commissions, we dismissed such resistance and asked that, along with other long-range thinking necessary to modernize this business, the Exchange present us with a plan for a uniform accounting system for member firms. The letter also directed that uniform methods of cost allocation be developed. In response to these requests, the Exchange has employed a nationally prominent accounting firm to develop a revised, and hopefully substantially improved, income and expense reporting system for its members.

When the Commission allowed the Exchange's request for a commission surcharge and later when the surcharge was dropped and a new schedule of commission rates was permitted to become effective, we conditioned these rate changes on the Exchange's requiring its member firms who had traditionally done a public business to accept all investor orders however small. We did this because we had become concerned about the growing tendency in the industry to do exactly what I have objected to in the Institutional Investor articles -- reject orders from small investors. Additionally, our concern in this area caused the New York Stock Exchange to institute an Investor Service Bureau which is charged with locating member brokers to handle transactions for small investors unable to find a broker bound by the requirement I have just mentioned.

I cannot claim that the only reason the Commission permitted increased rates on smaller trades was to aid the investors making them. Quite obviously, we were also very much concerned with the welfare of the members of your brokerage community. We realize very well that brokers cannot and should not be expected to serve anyone at commission rates which do not yield a profit. Although some would still describe small order business done by brokerage firms as a "loss leader" type of business, I am convinced that well managed firms can derive a reasonable profit on small trades at present commission rate levels. The Commission permitted increased rates precisely so that this would be the case. The fact that some firms lose money on this type of business reflects, so far as I am concerned, more on the quality of management in those firms and their allocations of expenses and profits than it does on the commission rate structure.

In another important step to protect the interests of small investors, legislation was drafted through the combined efforts of the Commission, 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 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. You may remember that when SIPC was first suggested it was generally opposed by the industry. Now that it has been adopted, we find the industry generally delighted with it in practice. In fact, the existence of SIPC protection is now frequently cited by the self-regulators and member firms as another reason why individuals should invest in the stock market.

Subsequent to the establishment of SIPC, the Commission has taken further action to prevent a recurrence of the situation which necessitated its passage. Pursuant to the SIPC legislation itself, we undertook a Study of Unsafe and Unsound Practices in the industry which was transmitted to Congress in December 1971. As we stated in the transmittal letter accompanying the Study, its purpose was "not to indulge in recriminations and second guessing but rather to erect safeguards for the future." While I view almost all of the Study's findings as extremely important, the one that I think is of particular relevance to this discussion today relates to the Commission's authority, or relative lack thereof, over the rule making of the industry's self-regulatory bodies. We found it to be, as presently constituted, "an illogical patchwork of provisions which falls short of giving the Commission authority to act promptly and effectively where a rule, or a proposed rule, is or might be injurious to the public interest." Perhaps even more importantly, we found ourselves to be dangerously hamstrung in our ability to enforce rules of the self-regulators once adopted. As our transmittal letter stated: "The Commission's power to withdraw the registration of a stock exchange or of the NASD in the event that they do not enforce their rules is so extreme that it does not present a viable regulatory tool."

As a result of these findings, the Commission proposed to the Congress that our authority over the self-regulators be substantially increased. Although I am a strong proponent of cooperative securities regulation between the Federal, state and self-regulators, I am one hundred percent convinced of the necessity for such legislation. Furthermore, I believe that it is in your interest also to promote the granting of such authority to the Commission. Why? Because, just as was true with SIPC, action of this type taken at the Federal level which increases the confidence of small investors in the market place also increases the potential participation of those investors in the market place. At one point in time during the financial crisis and before SIPC's existence, all the seers were predicting that if an additional major firm went insolvent the market would be a shambles; there would be a run on the brokerage houses just as catastrophic as would be a run on a bank. In those times of trouble, not very long ago, the importance of the small investor was crystal clear to the industry. He is just as important today, and his confidence in your stability and the resultant safety of his investment is just as important as it was then. One very easy way to buttress that confidence is to opt for the strongest <u>reasonable</u> regulation of your industry. Increased authority for the Commission over the self-regulators is one relatively easy way to accomplish this.

What else is the Commission doing currently and what further can we do to promote the interests of small investors?

Now that volume has increased substantially and there is again some danger of snarled back office conditions, we are pressing harder than ever to eliminate the antiquated paper work problems besetting the industry. We have proposed new rules designed to safeguard the handling of investors' cash and securities by brokers, including the establishment of adequate reserve accounts. Just a little more than two weeks ago, we submitted to the Congress recommendations for legislation giving us additional authority over the handling, processing and settlement of securities transactions, particularly as those functions may be performed by securities depositories, clearing agencies, transfer agents, registrars and brokers and dealers. In addition, the proposed bill would confer upon the Commission the power to determine the form and format of the stock certificate. Just as modern technology is enabling us to push ahead with changes in the nature of the tape and other systems for reporting securities transactions, I personally am confident that, in the not too distant future, it will enable us to completely eliminate the stock certificate and greatly simplify the stock transfer process.

In the area of policing brokerage practices, the Commission has established a special inspection unit under the direction of Alex Brown, former Administrator of our Washington Regional Office, which will give increasing attention to on-site examinations of both brokers and investment advisers. We have taken increased action to eliminate the kinds of securities from the market place which play on the naiveté of the small investor, particularly interests in corporate shells and pyramid schemes; and, just a few weeks ago, we convened hearings to investigate the problems associated with hot issues.

Let us face facts, however; in almost none of these areas can the Commission move unilaterally. We must obviously rely on you for your cooperation and even your active support. Without that assistance, we can accomplish little. So when I say that the Commission is moving to make the securities markets safe for and receptive to the small investor, there is a very large assumption built into any hope on my part that we will succeed. That assumption is that you, the members of the industry, will aid us.

If Chris Welles is correct, however, you may have neither the desire nor the need to continue servicing small investor clients. Instead, you will be content to turn them over to an institution or advisory service where their investments can be handled on a more efficient, less personal basis. I believe that many small investors will not be satisfied with service like this, although others will be, some even preferring it. I further believe that the average investor should not be forced to invest only through the medium of a corporate pension plan, an interest in an investment company or some other group investment medium. If he wishes to invest a portion of his earnings for himself through his broker, he should be able to do so and should be able to receive proper service when he does. You, moreover, should support this decision of his. You should support it in your self interest.

Many individual stockholders who wish to continue to invest for themselves are not about to alter their traditional means of buying and selling securities simply because industry desires them to do so. If your firm will not service them, they will find one that will, or they will take their money and invest it in another medium such as real estate, for example, where they can be their own manager. If you abandon the small investor when he needs you, you are deluding yourselves to imagine that he will be there to support you when you need his purchasing power to sell your allotment of an underwriting. If you think that a small investor is difficult to deal with and sometimes unreasonable, think for a minute about the demands which may be made of you if you become totally reliant on a few large clients, each of whom knows how important he is to supporting your business.

Think also about the reasons you became a broker in the first instance. Was it because you enjoyed serving your friends and neighbors, because you felt able to earn their confidence and trust, because you thought you could make investment decisions which would benefit them at the same time as you too received benefits commensurate with the service you rendered? Do all of you think these same satisfactions can be achieved when you limit your sales to small individual customers to mutual funds or like institutional products or perhaps even refuse to service such customers at all? I'll tell you that I could derive no satisfaction from taking any role which could be characterized with the question "The Public: Who Needs 'Em?"

Institutions have grown greatly in importance in the last several years. They will undoubtedly continue to grow. I believe that this is a welcome trend. It means to me that many of the people who heretofore would have avoided investing in our securities markets because of lack of confidence in their own judgment or perhaps lack of personal financial discipline have found a way of obtaining good management for and regularizing their investments. This trend must not take place at the expense of the individual small investors who have made our markets what they are, however. To scorn those investors, to cause them to lack faith in the system, can only end in adverse consequences for the industry as a whole and for you individually. Let's not let that happen -- far better for everyone if we find ways to improve the lot of small investors and insure that their business can be handled both efficiently and profitably. It is this course that the Commission is embarked on, and I believe that it is the best one for the industry to chart as well. So let us do it together.