

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 755-1160



### EVOLUTION IN THE CAPITAL MARKETS

An Address By

William J. Casey, Chairman

Securities and Exchange Commission

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## EVOLUTION IN THE CAPITAL MARKETS

There are a number of reasons why I am very pleased to appear before the Society of American Business Writers. Although I haven't been admitted to your distinguished society, I am something of a business writer myself. I know some of you from the early World War II days when I used to pound a beat at the War Production Board, the OPA and the Pentagon. I have never quit writing and I have turned out more words in the broad field of law and economics for the business and professional practitioner than I care to think about. More importantly, I am pleased to be here because the work of the Securities and Exchange Commission, the informing and protecting of the investor, and the very vitality of the capital markets depends so heavily upon informed and knowledgeable communications, for which you provide the primary channels. Finally, I am happy to be among you because I am an admirer of the diligence and sophistication of the business press. I have been interested and active in many forms of communication -- ranging from getting coded radio messages out of and propaganda leaflets into occupied Europe through book publishing, radio and television broadcasting, daily newspapers and trade journals, all the way to the more esoteric methods of storing and disseminating information on demand. In this entire panorama I find the American business and financial press one of the most remarkable and at the same time one of the most under-rated of all our institutions and I'm happy to have this opportunity to salute you.

I am here to speak to you so early in my tenure at the SEC that I feel a little brash. Today, I completed my third week on the payroll. As I stand before you this evening I have accumulated a great many questions and I don't pretend to have very many answers. But I do have some tentative evaluations, some notion of the future, some assessments as to relative importance and some sense of direction, and these I am happy to share with you.

Let me first say that I am glad to be at the SEC at this moment in time. I come here with both a strong feeling for the needs of the individual investor today and a keen sense of the importance of the capital markets to the economic health of all of us and to the position of our country in the world. I am aware that there are strong forces of economic and technological change impinging on our capital markets and that we are challenged to devise and absorb necessary change in a way which will protect the investor and maintain his confidence, and which will enable the capital markets to meet the expanding requirements of the future and develop a coherence which will command continuing public understanding. This is the task in which the institutions that make up our capital machinery and the bodies which regulate them must cooperate.

Last year, I had the privilege of serving on the Presidential Task Force on International Development. As we heard the testimony of experts on the development process, there was one thing they all agreed on and that was that no country will become capable of self-sustaining growth in the modern world until it develops its own indigenous capital market.

Certainly, one the truly revolutionary developments in America is the dispersion of ownership of our economic plant to over 31 million Americans and to about 100 million if we include indirect ownership through pension funds, life insurance and other intermediate forms of investment. Our national economic health and our ability to compete and maintain our living standards in the world depends on a continuation of this process -- which is to say, on our ability to maintain the two interdependent conditions of investor confidence and vitality in our capital markets.

The rest of the world is rapidly becoming technologically more proficient and, as the technologies developed here and abroad are operated at lower wage rates abroad, our unrivaled ability to mobilize and apply capital to productive purposes will become increasingly important to our balance of payments.

We know that a great many investment firms have been passing through a period of financial crisis. Over 100 New York Stock Exchange firms either went out of business or merged since mid-1969 and it is a tribute to the sense of responsibility on Wall Street that that community put up \$100 million of private funds to protect the customers of failing firms. In large measure the perils encountered in 1969 and 1970 came from the looseness and excesses of earlier years. It is now our task to see that we learn the lessons and take the steps which will permit us to live more comfortably and deal more soundly with both the highs and lows of the future. I would like to compliment my predecessor, my colleagues on the Commission, and the staff at the Commission on what they have already quietly achieved to improve and protect the position of the small investor.

During Judge Budge's term as Chairman, the new mutual fund legislation was enacted which will result in a review of selling costs and investment advisory fees which the investor in mutual funds will have to bear. It also gives the individual who buys a contractual plan a chance to review his decision and get some of his sales load back if he decides to drop the plan.

In addition, the Commission introduced negotiated commission rates on that portion of the transaction which exceeds \$500,000 and the resulting reduction of the commission charge on large trades will in large measure inure to the small beneficiaries of the institutional investors who make most of the large transactions. We have already seen substantially lower commissions on institutional transactions and most of the money saved will in fact be diverted from compensation for the sale of funds to the accounts of beneficiaries.

Then, the Securities Investor Protection Act has given the small investor insurance against the risk of financial mismanagement and the insolvency of brokers in much the same way as bank depositors have been protected for years.

The Commission also instituted a rule which brings home in a meaningful way to the public investor precisely how much he is paying for the money he borrows from a broker-dealer on margined securities. This accomplishes for the investor what the Truth in Lending Act achieves for the individual who buys merchandise on time.

In a series of steps, the Commission "spiked" the "shell game," in which promoters would acquire a defunct corporation with a substantial number of shares outstanding in the hands of the general public, transfer assets of doubtful value to the shell in exchange for newly issued shares, generate publicity inflating the prospects of the company and, as this produced market activity in the shares held by the public, the promoters would sell their shares at artificially inflated prices. In one case, a single company spun off more than 15 shells to the investing public, no filing was made with the Commission and investors were trading in these issues without the disclosure provided by the Federal law. Early in 1969, more than 50% of the new issues quoted in the National Daily Quotation Sheets were shells. By instituting a number of enforcement actions against shell promoters and developing new rules which would require brokers to know the company before quoting new securities in the sheets, the "shell game" has been substantially slowed down.

I think this record is one of which my predecessor and his associates can well be proud.

Today, the Commission, the self-regulatory bodies and the industry, are engaged in an intensive effort to eliminate the weaknesses which were revealed by the troubles encountered during 1970. This is a delicate and complex task which must be approached cautiously. Investor protection demands greater efficiency from the industry and strict rules more vigorously enforced by the regulatory authorities. These objectives will not be accomplished overnight but we should move on them as rapidly as we prudently can. We are in the process of reviewing and tightening capital requirements. An industry so important to the national economy and entrusted with the

savings of families must have more permanent and more liquid capital. As required by the Securities Investor Protection legislation, we will soon propose a rule which will require cash reserves for the net credit balances left in brokerage firms by their customers.

Recent failures, some of them so unexpected, demonstrated a need for more timely and adequate information about the condition of brokerage firms. Recently, we put forth for public comment a rule proposal which would have a major impact in this area. The rule would require that any firm which was not keeping its books and records current, or which was in violation of the "net capital rule" (which is the primary test of a broker's financial responsibility), give prompt notice of that fact to the Commission and to every exchange of which it was a member, and to the National Association of Securities Dealers. Hopefully, this will enable the appropriate body to intervene at a time when it was still possible to perform an operation rather than an autopsy. The rule would also provide for the monitoring of a troubled firm, by means of a follow-up reporting requirement. We expect that these rules will help to prevent the recurrence of industry-wide financial and operational problems.

As we analyze the recent problems of the industry, it was the inability to handle the back office problems, created by a surging volume of securities transactions, an inability which began to be discernible some years ago, which led to the financial and capital problems of last year. The more efficient handling of paperwork can substantially reduce the cost of doing business and increase the efficiency and the economy with which the public can be served. The Commission is meeting with key elements in the industry to review and, hopefully, accelerate the progress which is being made in this area. Central clearing, automatic matching of orders, completing the documentation of trades as they are consummated, called locking in the trade, can sharply reduce the cost and the time lags in the brokerage business and strengthen the industry.

There is a continuing, intimate and sensitive relationship between commission rates, firm capital and investor service and safety. We are and have been feeling our way in this area. I hope we will soon be able to make firm decisions as the Exchange submits a new money-oriented commission schedule, as cash reserves and segregation rules are established for the many billions of dollars worth of cash and securities which the industry holds for customers and the Commission completes the study of unsafe and unsound practices mandated by the SIPC legislation.

The structure and the workings of the market itself are in a state of evolution. We want a market of depth which gives the investor liquidity and solid information about prices and volume. We have seen some degree of fragmentation. We have not yet been able to measure the impact of competitive rates for large trades or to visualize the ultimate effect of the electronic market place illustrated by NASDAQ. We await the proposals of the New York Stock Exchange on non-member access and the report of William McChesney Martin on the structure of the New York exchange, its membership rules and its relationship with other markets. The resolution of these problems and the way we adapt to the relentless forces of economics and technology will determine the extent to which we have an auction market featuring an investor-agency relationship and the degree to which we have a market of negotiated trades featuring dealers. All this is likely to evolve slowly and that's probably the way it should be. As it evolves, one thing we must insist on is that accurate and complete information on prices and volume be collected and promptly disseminated to the investing public. The electronic market place, together with negotiated commissions, will present new problems in accomplishing this. The Nation's need for capital, our mandate to protect the investor and the need to maintain the liquidity of the market place require that, during all stages of this evolutionary process, the industry continue to provide full service to the small investor. During this evolutionary period there will be close review and scrutiny in the public interest of possible conflicts of interest among and between brokerage, investment management, dealer and underwriting functions.

So much for the solidity of the industry and the safety and service of the investor. Let me now turn to our task of keeping the American investor the most informed investor in the world. It is our full disclosure policy which makes the world pay more for a dollar of American earnings than any other kind of earnings and permits American corporations to plough a much larger share of their earnings back into new plant and new technology while their foreign counterparts have to pay out a larger share in dividends in order to maintain capital values. But we must seek to make our disclosures still more complete and our reporting of results more precise and reliable if the equity markets are to perform their essential function of directing capital where it is most needed and most effectively used.

I have reviewed the disclosure efforts of the Commission and tried to measure them in terms of where the most careful scrutiny is needed and where the largest amount of investor dollars are at stake. Most of our effort is in the painstaking review of new offerings. We have made progress in concentrating more intensive effort on first time offerings and relying more heavily on the experience and liability of issuers who have registered before and who are financially responsible. By moving further in that direction, I hope we can accelerate access to the capital markets, without sacrificing investor protections.

A much smaller amount of effort is devoted to scrutinizing regular disclosures of reporting companies despite the fact that investors each year commit a great many more dollars to buying equities regularly traded on the markets than they commit to the purchase of new issues. We have recently required the filing of quarterly operating results. It is my hope that we can, by using computer and other modern techniques, find ways to accelerate and amplify the flow of financial and trading disclosures from reporting companies to investors. Also, I would hope that our legal requirements can be adapted to give insiders greater certainty in the sale of their holdings and, at the same time, encourage more of the



smaller companies to assume responsibility for making regular financial reports public. I believe that this can be accomplished by moving the '33 Act and the '34 Act disclosure requirements toward a single integrated system.

The value of current reporting to investors and their advisors depends on its reliability and consistency. Also, the comparability of reporting by different companies has a great deal to do with the ability of investors to put their capital where it will be most effectively used. During the merger-conglomerate bubble of the mid-sixties, many of us were confused and dismayed by the extent to which pooling of interest and complex securities were used to inflate and pyramid earnings. The Commission and the accounting profession have curbed the use of the pooling technique. We now require product line reporting and the reporting of earnings per share to reflect potential dilution. But there is more to be done. We must consider how to disclose earnings distortion by such things as changes in accounting methods and an accumulation of adjustments, each of them not material by itself. I hope that the accounting profession will move toward disclosure of all optional practices selected for the determination of operating results and financial position and at least a broad indication of the differences which would have been reported if an alternate practice had been followed. Today, the Commission took what I consider an important step to focus attention on the reporting of financial results by calling for disclosure of changes in accounting method and changes in accountants. Such a change would be considered a material occurrence and call for disclosure on an interim report. As we call for more precision and detail in order to improve disclosure and comparability of results, we must, at the same time, struggle for a greater clarity and simplicity of editorial presentation. I believe both objectives are attainable. I am not going to be satisfied with the job we are doing in disclosure as long as the view prevails that no one really reads a prospectus. We will have to find and develop the editorial talent to give the average investor something he will read and, at the same time, give the professional the information he should have for deep analysis.

Let me conclude by listing a series of objectives which I would set for the Commission, all of which happen to begin with the letter "C":

1. greater Clarity and Certainty in the rules which govern securities transactions;
2. better Collection and Communication of information in reporting trading prices and financial results;
3. greater Consistency and Comparability in reporting financial results;
4. more Coherence in the relationship between the institutions which constitute our capital machinery; and
5. Confidence in the honesty and fairness of the markets in which securities are traded and of issuers in disclosing the information necessary for an investment decision.

We must steadily progress towards these objectives so that people will continue to meet the changing needs of our changing society by committing the savings, for which they sweat, and so that they will continue to rely on pieces of paper, or perhaps bits on magnetic tape, to educate their children and provide independence and leisure for themselves.