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FUTURE SECURITIES MARKETS -- REFORM, NOT REVOLUTION

An Address By

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Securities and Exchange Commission

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It is a pleasure for me at last to be able to attend the Annual Conference of the North American Securities Administrators and to extend my personal greetings to all members of this Association and their guests. That this is my first appearance as Chairman of the Securities and Exchange Commission at your Annual Conference is certainly no fault of yours. I have been invited each of the last two years, but for one reason or another, have been unable to make it.

Last year was a particular disappointment, because until almost the last minute I had expected to be in Portland and was much looking forward to it. As it turned out, however, the President's economic summit conference preempted my attention. I frequently have difficulty deciding between conflicting demands upon my time, but I have no difficulty when I receive an invitation from the President, as you can understand.

I trust, nevertheless, that you have not felt neglected by the Securities and Exchange Commission. It is our conscious policy to cooperate in every way with your Association and its members, and we know that it is your policy to do the same with us. It is our impression that we are succeeding. Although there have been periods in the past when our relationships were characterized by some disaffection and estrangement, I think today we are doing the best we can to work harmoniously and constructively in view of our disparate jurisdictions and resources.

Certainly you should feel that you are getting plenty of attention -- I hope not too much. It is essential that the spirit of cooperation be developed and nurtured at the staff level. That is where the daily work is done. And year after year that is where there tends to be more continuity of personnel -- meaning that Commissioners and Administrators are somewhat less likely to be around over an extended period.

There is so much to do that I have long believed a more practical division of statutory responsibility could be devised and would be salutary. There are areas where you are forced, to a degree, to duplicate our work and responsibility. There are other areas where the federal government might more wisely defer to state jurisdiction. The federal securities code project is laboring in this direction, and I wish it success. In the meantime, however, we must do what we can to achieve a harmonious pattern of federal and state administration within our respective statutory mandates.

The other day, at the Commission table, we had finished consideration of some enforcement matters, including some staff recommendations for formal orders of investigation that came from one or more of our regional offices. You probably know, but some of you may not, that our appropriate staff offices -- the Division of Enforcement, in Washington, and

the several regional offices -- may, and do, make informal inquiries regarding possible violations of our laws without any specific authorization from us and without even telling us about it. But the issuance of subpoenas and the compelling of testimony requires a formal order of investigation entered by the Commission itself. The recommendations that we enter such orders are supported by rather comprehensive memorandums, supplemented, where appropriate, by oral presentations.

As one would expect, these memorandums, while following a more or less established form and always reflecting a great deal of labor, vary considerably as vehicles of communication. It was this variation that became the subject of comment among the Commissioners and led to speculation whether, at our forthcoming Regional Administrators Conference. we could do something to improve the situation. Among the comments, I observed that some staff members seem to be singularly lacking in insight as to what is likely to be decisive to a Commissioner. I have often read 20 or 30 pages of more or less inconclusive narrative and legal exegesis before coming to the clincher. For example, we have, I believe, never declined to enter a formal order when the investigative effort has been requested by a state administrator. Such a request is virtually dispositive and should be on the first page of a memorandum to us. The other Commissioners readily agreed.

I am assured that a like spirit prevails generally among the state administrators, if we need help, and I am glad that this is so and urge its continuance.

As important as our mutual enforcement activities are, however, it is not likely that I can contribute anything of a concrete nature in that area beyond the discussions you will be having with others from our Commission, so I would like to divert your attention for a few minutes to other aspects of our securities markets and, in particular, developments in the securities markets with special reference to the 1975 Amendments to the federal securities laws.

I have declined to engage in the game of deciding what has been the most important federal securities legislation since 1934. In terms of its pervasive effect upon corporate life and investor protection a strong case can be made for that provision in the 1964 amendments that inserted Section 12(g) in the Securities Exchange Act and thus subjected unlisted companies, plus banks and insurance companies, to the reporting requirements, proxy regulations and short-swing trading inhibitions of that Act. But, if those who struggled so long to produce the 1975 Amendments find satisfaction in thinking them to be more important -- perhaps because they have short memories and forget that Section 12(g) has not always been with us -- I will not quarrel with them. Surely the 1975 legislation is quite important enough to demand attention.

Nevertheless, the legislation itself is but a formal phase in the overall metamorphosis of our securities markets from the post-World War II pattern, that served so well the unprecedented burgeoning of the individual investor as the dominant feature in our equity markets, to the markets of the future, that surely will, as they have been for some time, be dominated by institutional investors. This fundamental trend has not been the creation of the Congress, and certainly not the SEC, but rather of other economic and social forces not, on the whole, planned or decreed by anyone, although Congress has from time-to-time stimulated the move toward increased institutionalization of equity investment through various income tax provisions, as it did just recently with the Employee Retirement Income Security Act of 1974 ("ERISA").

Of course, the most dramatic feature of the securities markets of the 50's and 60's was its ultimate inability to cope successfully with the volume of transactions which developed in the late 60's. The great back-office crunch led to four-day weeks on the New York Stock Exchange, widespread discontent among investors who waited weeks and months for delivery of securities, and ultimately to the financial collapse of scores of broker-dealer firms, including some of the largest and best known.

It all revealed some glaring inadequacies in the system -- all aspects of the system, including the regulatory. The facilities for handling transactions were horse and buggy equipment trying to meet the needs of the jet age. And this, in part, was the consequence of the historic domination of the industry and its components by salesmen and the relatively little attention paid to operations -- or to compliance with the law in all too many cases. When salesmen are permitted, indeed encouraged, to generate or accept orders without regard to whether the customer can be properly serviced, and the salemen are successful, disaster is inevitable, and it came.

As we contemplate the future, it is important to reflect on how far we have come since 1970. There has been much more of a reformation, if not revolution, in the securities industry than may be readily apparent. In terms of operating facilities, we have moved into a new order of magnitude. In the late 60's, when daily volume was in the neighborhood of 20 million shares on the New York Stock Exchange, the market was drowning in paper work. In recent months, 30 million share days have been taken in stride. Net capital requirements have been tightened and the self-regulatory, as well as regulatory surveillance systems, vastly improved. SIPC has been established and proved itself

as a major source of investor protection. Tons of paper have been brought in off the street, so to speak, through the establishment of securities depositories, by far the largest of which is Depository Trust Company in New York. The facilities for clearing transactions have likewise been modernized and will be further coordinated among the various markets. Of a less obvious nature, but perhaps most important of all, operations men have been let out of the cage and given dominant roles in firm management, as have those whose primary responsibility is compliance. We all realize that the most efficient and lawful system in the world is useless if you do not get any business, but a better balance is being achieved.

All of this has already come to pass. And there is more. Last May 1, as everyone knows, through Commission action, fixed minimum brokerage commissions for exchange transactions were abolished. What this means for the future we are, I am sure, just beginning to learn, but a change so radical is certain to have a profound, long-range effect. The observations and expectations that have been expressed so far have either been wrong, or superficial and transitory, or unproven one way or the other.

The early predictions of immediate catastrophe have, fortunately, proved mistaken. One thing regulators can use as well as anyone else is a little bit of luck, and in this case we had it, as the stock market took a sharp upturn in price level and volume last spring. I have facetiously hinted that we planned it that way, but that would be like Chanticleer claiming that his crowing brought the sun up every morning, or that we had a frightening faculty of forecast not ordinarily accorded to mortals. In fact, of course, we eschew claiming credit for the ups lest we be blamed for the downs, and, incidentally, because we do not deserve either.

Nevertheless, if May Day had to come, as we believe it did, the timing was fortuitous. The securities industry, on the whole, has had good earnings to cushion the shock of the initial shakedown period. I wish that Congress would see fit to provide the firms with a tax sheltered reserve, so that more of these earnings could be set aside against less profitable periods in the future, but even without this, things are currently good in this area despite the discounts in commission rates.

So far, most of the attention in the press and the trade services has naturally been directed to the daily or weekly changes in commission rates, usually expressed in terms of discounts from the prevailing fixed minimum rates as they were on April 30. In this regard, what has happened has been more or less what one should have expected, although I confess that I experienced some surprises, emphasizing the wisdom of our declining to make any detailed predictions. In particular, so much had been made of the prospect that the large, strong firms would price the little fellows out of the business -- something that I did not expect, at least initially -- that I was surprised when the deep discounts began with the smaller, less strong firms. But that is the way it was. Of course, the strong firms responded and, after a period of rather wild and irresponsible discounting, things appear to have stabilized a bit.

Has all this been good? Its value cannot, in my opinion, be measured entirely, or even primarily, by the commission rate level. Our objective in eliminating fixed minimums was not to cause rates to go down or up or reach any particular level. If we had thought we knew what rates ought to be, we could more simply have used our statutory authority to assure that result. Rather, after years of studies and debates,

we concluded that competitive forces could determine the "proper" rates better than any rate-making theory that had been presented to us or that we had been able to contrive. It is still possible that this could prove not to be the case and that we could be forced back into commission rate regulation on some formula or other, but I do not expect that to happen. In the meantime, absent any conspiracy or other artificial restraint, whatever the rates are is what they ought to be.

There is much more to all of this, however, than rate level. Fixed minimum rates supported a whole host of services and practices beyond the simple brokerage functions for which the rate was ostensibly charged. Of these, research, as it is called, is the most obvious and possibly the most important. Many thoughtful persons predicted that the lack of a fixed minimum would drive rates down to a level at which they would no longer cover the cost of research, that investors, particularly institutional investors, would not pay hard dollars for research, and street research would inevitably wither and die. This has not happened yet, but it would be hasty to conclude that it will not happen to some degree. There is already evidence that the so-called research "boutique,"

the small firm of limited capacity to execute orders but with extensive research capability, may be in trouble. Some firms that were in that category saw what was coming and developed trading and execution facilities in time to ease them into the new world. Others did not and appear to be suffering.

There is great cynicism about the value of much that passes as research on the street, and no doubt some of it is not worth a great deal. But some of it clearly is. Furthermore, while one cannot know what may be the optimum number of the sources of investment opinion, there is a need for diversity to preserve liquidity, if nothing else. A seller needs a buyer. It would be bad for our markets and our economy, for all, or even most, of street research to disappear. Whether there is any danger of this, from the brokers' point of view, is a complex question. The concept of the execution-only commission rate -- providing no increment to cover the cost of research -- unrelated to volume is easier to imagine than to see in practice.

The problems presented by unfixed commissions related to research are not by any means limited to the brokers' side of the business. Institutional investors, including mutual funds and their advisers, are equally involved. Heretofore, investment managers of all kinds have been able to rely on the commission throw-off of portfolio activity to produce research and other services at no extra charge. The system was not without its potential for abuses, but it clearly had

its benefits. Customary rates for investment management have in fact been based on the assumption, conscious or not, that the managers would be getting a lot of "free" research. To the degree that this should be denied to them now and in the future, what does this mean? For the same fee, is the manager now to provide an in-house substitute? Or should he be permitted to use the portfolio's funds to pay up for research -- meaning pay a higher commission to a firm that furnishes research than could be obtained from an execution-only firm, or from the same firm without research? If so, how much more? If he manages more than one portfolio, must he be sure that the paying up is done by the portfolio that benefited from the research? Finally, can he use the portfolio's cash to pay hard dollars for research?

It is easy -- too easy -- to dispose of the matter by saying that the investment manager, whether trustee, investment adviser or whatever, accepted the responsibility of portfolio management for the agreed fee, and that's it. He must do, and spend out of his own pocket, whatever is necessary to enable him to perform his duties properly, while keeping expenses charged to his beneficiaries as low as possible. It is easy, I agree, but it is too simplistic to accord with practical realities.

While the problem is most complex with respect to the trust departments of banks with their great variety of investment management functions, it also arises with respect to the investment advisers of mutual funds and other investment companies, which are of more immediate concern to the members of this association. Does a fund investment adviser have a duty to seek the lowest available commission rates even though so doing denies it access to street research -- assuming that such a choice becomes a practical reality, and assuming that brokerage commissions are charged to the fund as they normally are?

In considering this question, I believe everyone agrees that there is no duty to seek the lowest rate where the quality of services is not adequate. Clearly the adviser can cause the fund to pay whatever is reasonably necessary to obtain best execution. This becomes easy to demonstrate and justify for large and difficult orders requiring special knowledge by the broker with respect to the other side of the trade, or skill in handling market transactions so as to minimize market disruption, or possibly positioning by the broker. But small orders can also be mishandled, and there are many little things that contribute to the overall quality of brokers' services, just as there are for other services. Surely, absent any conflict of interest or other contaminating factor, the adviser is justified in using a broker, or a list of brokers, who he believes generally provide the best service

without regard to whether, on each trade, a lower commission might have been obtained from someone else.

The fund benefits most from best execution and overall quality of service. This must not be neglected simply because commission rates are so obvious and easy to compare.

But the research question goes beyond this. It assumes, in its simplest form, a circumstance like this. Brokerage Firm A and Firm B offer equal execution capability and quality of service, but A's rates are X percent higher than B's. However, A offers good research regularly, and B offers poor research or none at all. Can the fund adviser use A instead of B?

This question was much debated prior to the adoption of the 1975 Amendments, and the result was new Section 28(e)(1) of the Exchange Act, which provides that no person having investment discretion shall be deemed to have acted unlawfully or to have breached his fiduciary duty --

> solely by reason of his having caused the account to pay a ... broker ... an amount of commission for effecting a securities transaction in excess of the amount of commission another ... broker ... would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such ... broker ..., viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

Clearly Congress has answered our question, yes. Of course, this presents a subject for disclosure and possible negotiation of advisory agreements, and you may have noticed this being done in current prospectuses and proxy material.

Section 28(e)(1) was not without opposition. It shocks and frightens some persons -- including some within the ranks of the SEC -- to have the law relax to any degree the strictures imposed upon fiduciaries who manage other people's money to use that money solely for the others' benefit. But this assumes that it is the obligation of the adviser to provide all research at its own expense. If this were its obligation, then such paying-up as Section 28(e)(1) permits would arguably constitute using the fund shareholders' money to benefit the adviser by relieving it of an expense that it would otherwise have to bear. However, as I said earlier, this is simply not the practical fact in many, if not all, situations. The practical fact is that advisory agreements and fees were negotiated in contemplation of the availability of street research from brokerage commissions. If research can no longer be obtained in this way, something has to change.

It is quite unrealistic and unfair to expect every adviser, for the same fee, now to provide full in-house

research capability or to purchase research with its own money. The matter must be renegotiated.

I have gone into this subject at some length because of its abiding importance. As advisory agreements and patterns are readjusted to reflect the consequences of unfixed commission rates, some readjustment may be appropriate in regulatory patterns. A major purpose and intended effect of unfixing rates is to break out the various services traditionally provided by many brokers and paid for, if at all, only through commissions. Ideally, these services should be unbundled to the extent that research is paid for by hard dollars. But this cannot occur widely in the institutional area without substantial changes in the contracts, laws and customs governing investment management of all kinds. Section 28(e)(1) is intended to ease the transition. I supported it, and I hope it does the job to the extent required by practical developments. But it cannot do the job unless it is properly understood and applied by regulatory authorities.

As we observe the securities industry, and those who do business with the securities industry, learning to live without fixed commission rates, we are also engaged in a restructuring of our securities markets looking toward the establishment of what the Commission has referred to as a "central market system" but which the 1975 Amendments prefer

to call a "national market system." Both phrases allude to the same concept.

It is commonplace for those industry spokesmen who prefer things the way they are, or, more properly, the way they were, to say that everybody talks about a national market system but nobody knows what it is. In ultimate detail, this observation has a degree of accuracy, but that is simply to say that much remains to be worked out. In any event, the time for fundamental debate is passed, and the time for implementation is upon us.

Section 11A(a) of the Exchange Act, inserted by the 1975 Amendments, directs the Commission --

> having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities ... in accordance with the findings and to carry out the objectives set forth in paragraph (1) ...

Paragraph (1) reads in its entirety --

> (1) The Congress finds that --
>
> (A) The securities markets are an important national asset which must be preserved and strengthened.
>
> (B) New data processing and communication techniques create the opportunity for more efficient and effective market operation.

> (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure --
>
> (i) economically efficient execution of securities transactions;
>
> (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
>
> (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
>
> (iv) the practability of brokers executing investors' orders in the best market; and
>
> (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.
>
> (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

That is our goal, or those are our goals. The powers that we have been given to use toward that end include not only more direct authority over the content of the rules of securities exchanges, but also, for the first time, regulatory authority over transfer agents, clearing agencies, and, a new classification, "securities information processors" -- those who collect and disseminate information with respect to transactions in or quotations for any security.

To assist the Commission in this enormous task, the 1975 Amendments also provided for the establishment of a 15 member National Market Advisory Board, which we have already appointed, with John Leslie, the chief executive officer of Bache and Co., as Chairman. The Board will study and make recommendations as to steps appropriate to facilitate the establishment of a national market system. It is also directed to study "the possible need for modifications of the scheme of self-regulation provided for in this title so as to adapt it to a national market system, including the need for the establishment of a new self-regulatory organization...to administer the national market system."

Needless to say, neither we nor the industry had to wait for the final act of Congress to tell which way the wind was blowing. In fact, the basic elements of the national market system grew out of Commission and Congressional studies over the last half-dozen years or so and were set forth in the Commission report on the central market system published in March, 1973. Since then, there has already been established a consolidated tape for reporting transactions on all exchanges as well as the third market. Exchanges and third market makers must now make their quotations generally available, and we look forward to the early availability of consolidated, or composite, quotations. And, as I mentioned earlier, much has been done to make more efficient the processing of transactions.

As you observe the progress from here to the full national market system, you will doubtless hear some thunder and smell some smoke, more than once. It is already beginning.

While we have the duty, under the 1975 Amendments, to review all rules of the national securities exchanges, Congress, in its wisdom, not ours, required that we immediately review "any and all rules of national securities exchanges which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges." The most obvious such rule is Rule 394 of the New York Stock Exchange requiring its members to execute all trades in listed securities on the exchange, or some other exchange, unless certain inhibiting conditions are met.

We filed a report of our review of Rule 394 and similar rules on September 2, when it was due, and we said that the rules obviously had some anti-competitive effect but that we were unable to determine whether the rules were nevertheless justifiable under the new statutory standards without a hearing, which we said would commence October 1. Although we strove for objectivity in the report, the press editorialized to the effect that we had really already made up our minds to abolish Rule 394, and the thunder has begun to roll. I am frequently puzzled at how the press presumes to know better than we do what we think. The truth of it is that we meant what we said. Collectively, we have not yet concluded whether, and to what

extent, such restrictive rules are appropriate during the period while the full national market system is being developed. Our own advisory committee on the implementation of the central market system, headed by Alexander Yearley, of Atlanta, has recommended retention of Rule 394, and that naturally carries some weight.

I realize that you are not directly involved in this process and may have limited interest in what must seem like interminable intramural bickerings. So I will resist any temptation to get further bogged down in details. My purpose has been to bring you up to date on some current developments in the securities markets that we all participate in regulating. The movements now underway, and those mandated by the 1975 Amendments will be occupying the attention of the Commission and industry leaders for months and years to come, and it is important that you understand what is going on.

It is, and will continue to be, an exciting process. It is also one which requires as many cool heads and clear minds as can be brought to the task. Most reform movements start from a different base -- one of collapse and disgrace. In this case, such collapse and disgrace as there were have already been largely overcome by the developments that I outlined early in my remarks. We have now what all of us recognize as the best capital markets in the world. Congress

and the Commission and those industry spokesmen who supported the 1975 Amendments have concluded that our markets can be made even better and should be. But in the process of further improvement we must be careful not to destroy that which we have that is good until we can replace it with something better.

It is not, as far as we are concerned, a punitive expedition, and, through the Advisory Board and otherwise, we hope to draw as much as possible on industry initiative and cooperation.

Thank you again for inviting me. These annual conferences are a major institution and represent government at its best -- where representatives of federal, state and provincial government can meet with representatives of the industry and the bar to consider matters of common concern. We should all be proud of this institution and strive to keep these conferences productive as well as pleasant.

I wish you great success in both regards.