REMARKS OF
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of the

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In compliance with the policy of the Securities and Exchange Commission, I am required to read the following disclaimer:

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Regulation is intended to protect the public interest. With regard to the securities industry, the Special Study in 1963 had this to say with regard to the Commission's role in the regulatory scheme:

> Regulation in the field of securities should continue to be based on the principle of giving maximum scope to self-regulation, wherever and to the extent that a regulatory need can be satisfactorily met through self-regulation.

However, the Study also pointed out that it was a responsibility of the Commission "to assure that there is no gap between the total regulatory need and the quantity and quality of self-regulation provided by the recognized agencies." Furthermore, the Study said that it "is necessary also to assure that action taken in the name of self-regulation fairly serves a valid public purpose and is not for a purpose inimical to antitrust or other public policies." The Study went on to say that "Regulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise and standing ready to regulate directly where and as circumstances may require."

These statements lead one to conclude that the Commission should maintain its oversight responsibility, giving encouragement, inspiration and incentive to the self-regulatory bodies when necessary, and, that additional regulation should only be imposed to fill the void between the regulatory need (that is the public interest) and the quantity and quality of self-regulation.

The Securities Exchange Act of 1934 certainly had in mind that the primary responsibility for the maintenance of an orderly market place was to be left with the national exchanges and, later on, the National Association of Securities Dealers.

As a practical matter, were it otherwise, the cost of regulation could be substantially increased and perhaps not of the same quality as exists today.

Thus, it can be said that the responsibility of operating the market places is in the private sector by Congressional design. It is a heavy responsibility and one which cannot be taken lightly. The public interest is paramount and cannot be compromised. To do so would be to inflict violence on the will of Congress and, in the long run, would be contrary to the best interests of the securities industry. So it is a self-serving interest, as well as the public interest, that should motivate the self-regulators to see to it that the market places are regulated properly and maintained in a viable condition.

Before delving into the main subject of my talk, let me brief you on two matters of interest currently pending before the Commission.

Chairman Budge has said with regard to public ownership ". . . that we have no objections to the concept." How did we reach that conclusion? Well, we approached it from the point of view as to whether public ownership was contrary to the public interest. We concluded it was not. We approached it from the point of view as to whether it interfered with the regulatory scheme. We concluded that it did not.

As you know, we have not reached any conclusions with regard to the regulatory features which should be imposed as a condition of public ownership. We do have the proposals in this respect -- from the New York Stock Exchange, the Midwest Stock Exchange and the Pacific Coast Stock Exchange. There are variances of one from the other, but all will receive our serious attention. If additional regulation is deemed necessary, hopefully there could be one set of principles which could be applied universally within the securities industry and which could be supplemented to recognize the peculiarities of each exchange.

In 1968 the Commission commenced public hearings on the question, among others, of whether it was necessary to revise the minimum commission rate schedule. In May 1969 these hearings were recessed after taking testimony of consultants engaged by the New York Stock Exchange to study the commission rate structure and subsequently submit a revised commission rate schedule which would take into account an adequate return on capital and which would yield a satisfactory operating result. The economic data by which the revised schedule was to be determined includes the operating results for the year 1969. Because of the use of this recent data, the New York Stock Exchange was precluded from making its submission prior to this time. It is anticipated the consultants will submit their proposal with regard to commission rates in February of this year. The Commission will then proceed to study the proposal to whatever extent is considered necessary.

At issue, of course, is whether the rates within the industry should be set by competition or be established as part of a minimum rate structure. The Commission has not made any decision with regard to this matter, nor has it made any decision with regard to any other aspect of the commission rate structure public hearings. It has been estimated by our staff that at least two months will be required in order to study the proposal to be submitted by the New York Stock Exchange. Any such estimate necessarily must be subject to qualification depending upon the nature of the proposal and the adequacy and completeness of supporting data.

The viability or, if you will, the profitability of the securities industry is of great concern to the Commission. We do not savor the role of a rate maker -- even in an oversight capacity. But it has been given to us and we will discharge that responsibility. However, we cannot guarantee profits to the marginal or inefficient broker-dealer. I am sure you will agree it is not our function to allocate the gross national product.

We recognize how eagerly the industry and the public await the conclusions of the Commission. They will be made known as soon as possible, for we consider this matter to be of the highest priority.

The industry is indebted to the New York Stock Exchange for undertaking the massive project of studying the commission rate structure. It is a fine example of a self-regulatory body discharging its statutory responsibility.

With the Commission's oversight responsibility in mind, I am here today to discuss what has been and continues to be a most important and fundamental cornerstone of the success of our securities markets: the protection of customers' funds and securities.

I am not referring to the typical disclosure and anti-fraud aspects of our securities laws, but rather to the duty of a broker-dealer to handle customers' assets in a responsible manner and to provide appropriate safeguards and procedures to protect a customers' interest in those assets which he has entrusted to his broker. It is the confidence of the investing public that their funds and securities are adequately protected which has contributed in large measure to the tremendous growth which our securities markets have experienced in recent years. Ironically, however, it is this unanticipated growth which has led to the operational back-office problems being experienced on an industry-wide basis. It is, therefore, imperative that the entire financial community cooperate to solve operational and other problems necessary to preserve public confidence.

Before I get into a more detailed discussion of investor protection and related problems, I would like to mention briefly the basic regulatory features related to the handling of customers' assets left in the custody of broker-dealers.

Generally speaking, customers' assets in the custody of broker-dealers fall into four categories: "free credit" balances, other cash balances, fully paid securities, and "excess margin" securities as well as other securities in margin accounts.

There are three principal ways in which the regulation of broker-dealers has attempted to protect investors from broker-dealer insolvencies, broker-dealer misappropriation of funds, and broker-dealer financial problems of whatever origin.

The principal method has been through the requirement placed upon brokers to maintain an adequate "net capital" as a cushion against possible problems. A second way, in which the statutes and regulations have attempted to protect customers, is through the rules regarding hypothecation of securities. These rules, although complicated, expressly limit the hypothecation of customers' securities. Finally, there are requirements for periodic audits and the segregation of customer securities. Through inspection programs and the filing of audited annual financial reports, checks are made on whether or not the hypothecation and segregation requirements are being followed.

The operational problems being encountered could have caused grave financial consequences if the stringent net capital rules were not in effect. Nevertheless, the regulatory mix of required "net capital" and the related hypothecation and segregation rules may not be the optimum from the standpoint of investors. That is to say, perhaps too much reliance is being placed on the "net capital" requirements and not enough reliance placed upon segregation for accounting and legal purposes of broker-dealer activities.

It might be helpful to consider the broad financial dimensions of financial strain as an illustration of the importance of this discussion.

Balance sheet data on member firms as of December 31, 1965, 1966, 1967 and 1968, compiled by the New York Stock Exchange, shows that the total of assets and liabilities almost tripled from the beginning to the end of that period. Interestingly, during the same period the aggregate of proprietors' accounts of firms only doubled; consequently, the percent of proprietary accounts to total assets decreased from 17.9% to 14.7%. In other words, proprietary investment in the business decreased as a percent of total assets employed during a period in which the industry experienced spectacular growth. A phenomenon of this type is unusual -- an indication of the leverage available to the industry. The proprietor's account I have referred to here is not the same as "net capital" as defined in the regulations of the Commission and the Exchanges, which is a test of liquidity. Prescribed "net capital," designed to protect customers, has increased with the expansion of the industry.

Two types of leverage are reflected in broker-dealers' financial statements. One is the leverage which customers are utilizing in connection with their margin accounts but in which the broker-dealer is merely the communicator of the leverage from customers to banks.

The other form of leverage is the one apparent in the proprietary account of the broker-dealer. This leverage, on the one hand, can help serve as a cushion to losses that might result from a failure of a customer to meet his obligations; but, on the other hand, it may introduce a substantial element of risk to customers should the security positions taken by the broker-dealer result in losses. The question arises, "Is it necessary for a broker-dealer to function in such a fashion that risks on the dealer side of the business can be communicated to the agency part of the business; or alternatively, is it possible where there is a combined broker-dealer business to isolate in both an accounting and legal sense the agency customer accounts, credits, debits, and securities, etc., so that we can be confident investors will not be subjected to unnecessary risks?

It is clear that most customers when they leave securities and funds in brokerage accounts do not contemplate that they are creditors, but rather view themselves somewhat like depositors in banks and savings and loan associations. They are not striking a bargain with the broker-dealer when they leave securities and funds there; it is merely a convenience provided by the broker-dealer.

The point of considering these issues is not to question the advisability of a broker-dealer to commingle customer securities and funds for purposes of performing his brokerage function. Clearly, restrictions cannot be put on every dollar a customer brings in -- and it is highly improbable that few customers would anticipate such segregation would occur.

Nevertheless, every customer probably expects that if the broker has losses in his dealer account, the customer's securities and funds would be sufficiently insulated. Furthermore, every customer has the right to expect that regulation by the Securities and Exchange Commission, and by the industry, sufficiently protects him.

Consideration as to the advisability of increased segregation and protection of customer funds and securities is not new. In fact, Minnesota already has a provision in its statute requiring that securities and funds be segregated "in trust." There are no total figures available on the value of securities that are held in safekeeping in brokerage accounts. I might add that the Commission, in another context, is examining the need for this information. The only figure that has been circulated recently was the amount reported by Merrill Lynch that it held approximately $18 billion of securities in safekeeping for customers. Since Merrill Lynch is just one firm, albeit the largest, the amount of securities and funds held in safekeeping by all broker-dealers is substantial.

Under New York Stock Exchange rules, customers' excess margin and fully paid securities must be physically separated from usable margin and firm securities, and their ownership specifically identified. Also there are rules which restrict the extent to which a broker can hypothecate customers' securities.

Another form of protection afforded the customer is the requirement that brokers report to customers concerning transactions in their accounts and the status of the assets in their accounts. This is accomplished by periodic statements of account rendered at least quarterly, showing security and money positions and transactions in the account. Of course, information respecting essential details of each transaction must be furnished currently to the customer.

As an additional protective provision, the Commission has recently adopted a "Truth in Lending" rule requiring broker-dealers to make adequate disclosure in customers' monthly statements about interest charges for margin accounts.

As was mentioned before, broker-dealers are required to meet certain minimum "net capital" requirements which are intended to maintain prescribed standards of liquidity and financial responsibility.

As an additional protection, some exchanges have voluntarily established trust funds to further insulate customers from the financial difficulties of brokers. It is a credit to the industry that there have been few occasions when it was necessary to resort to the use of these funds.

To further safeguard customers against loss occurring due to a broker's misplacement, fraudulent trading, or forgery of his customers' securities, fidelity bonds are required of most members by a number of exchanges.

To ascertain compliance with these requirements, the various regulatory organizations carry out "on-site" inspection programs for the purpose of determining the general financial condition of a firm; its pricing and selling practices; whether it has engaged in unlawful practices; whether its books and records are maintained in accordance with applicable rules; as well as the nature of the safeguards employed in the handling of customers' funds and securities.

Also, the Commission performs "conduct examinations" to insure that national exchanges comply with their responsibilities under the Securities Exchange Act.

One of the means of protecting customers from loss due to a brokerage firm's insolvency is, as I mentioned earlier, the trust funds maintained by a number of national securities exchanges. Under the trust fund concept (a form of self insurance), an exchange would reimburse public customers of a troubled member firm for any cash, securities or other holdings on deposit at the firm. Reimbursement is made at the discretion of the exchange where the fund's resources allow. The exchange then attempts to recover its payments from the disabled firm's remaining assets. However, because of industry growth there is a question whether the total of the trust funds is adequate to insure the risks of customers. For this reason, a bill introduced in the last session of the Congress should receive serious consideration. The bill would provide for a federal insurance program, similar to the Federal Deposit Insurance Corporation, to protect customer accounts and securities carried by broker-dealers.

The Commission and the self-regulatory bodies should constantly strive to achieve maximum investor protection within the framework of a free society. Part of this effort requires continual re-examination of industry practices and modern technology so as to maintain an efficient market place.

The words of John Gardner bear repeating in this context. He said:

> We know our lakes are dying, our rivers growing filthier daily, our atmosphere increasingly polluted. We are aware of racial tensions that could tear the nation apart. We understand that oppressive poverty in the midst of affluence is intolerable. We see that our cities are sliding toward disaster. . . . But we are seized by a kind of paralysis of the will. It is like a waking nightmare.

The same could be said about many of the "facilities" so essential to the proper operation of our economy. The serious condition of our passenger railroads is known to you -- particularly those of you who ride the Long Island Railroad -- which I sorely miss! The power failure of several years ago alerted us to the fact that perhaps our consumption of this type of energy was far exceeding the supply available. The same condition has existed in the securities industry for the last several years in that it, too, has been unable to cope satisfactorily with its operational problems because the "facility" is outmoded. Thus the consequences of inaction in the past become the problems of today.

On the other hand, the industry deserves commendation for the amount of effort and resources it has applied recently to the study of its "facility" so as to make it more efficient and useful in serving the public interest. But the time has come for action. The time has come for decisions to be made. The time has come to effect the changes that are required. It is not too late to resolve these problems.

As studies of the industry have indicated, the securities industry is highly fragmented. It is composed of businesses that are entirely different, but all interrelated by virtue of the group they serve -- the investor. Adding to the complexity of interests are the many regulatory bodies to which these businesses must account; so that there is not only an overlapping of type of business but also an overlapping of regulatory authority. What does one do when confronted with a heterogeneous group such as this? One answer could be the formation of an inter-industry group which would be responsive to the needs of all of the groups and would make the kinds of decisions which are necessary to coordinate the activities of the various interests involved.

This approach was conceived first by the industry and later recommended by outside consultants. On the surface, it appears to be a reasonable manner to accomplish the coordination that is necessary at this time. The Wall Street Journal reported that such a group is in the process of being formed. Hopefully this is the case, for as water quite naturally seeks its own level, history shows the same is true with regulation. It is imposed in areas where people are unwilling to do voluntarily those things necessary to better serve the public interest.

The Commission and the self-regulators have many joint interests. By working together not only will our tasks be made easier, but investor protection will be more comprehensive.