

THE SEC AND SOME CURRENT REGULATORY PROBLEMS

Address by

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Washington, D. C.

Before
Connecticut Investment Bankers Association
Hartford, Connecticut
December 10, 1968

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I am honored to be included in this evening's function, commemorating as it does in the State of Connecticut the 65th anniversary of the signing of the first laws pertaining to the supervision of the securities industry. This is an auspicious occasion indeed.

Tonight I would like to discuss several regulatory problems in which the SEC, as well as the various self-regulatory organizations, is vitally concerned. As you are all aware, our securities markets are currently expanding and changing at an unprecedented rate. More than 24 million stockholders now directly own shares in American industry, with another estimated 100 million shareholders indirectly investing in the securities markets through various financial institutions such as mutual funds, insurance companies, bank trusts, pension funds and others. The average daily dollar value of securities traded on all markets now is \$825 million, accounting for an average of 22 million shares exchanging hands every day. This volume has created a strain on the securities markets and has raised important policy questions which require resolution.

One of the major problem areas is how to handle effectively the undesirable aspects of the super-heated speculative fever now existing in our markets without diluting the vitality so necessary to the continued growth and progress of our economy. As a matter of policy, the Commission does not, absent fraud and manipulative practices, view speculation per se as either illegal, unethical or opprobrious. The Congress, however, when enacting the Securities Exchange Act of 1934, recognized that excessive speculation was detrimental to the national interest, and provided, therefore, various regulatory controls such as margin restrictions, prohibition and limitations on short sales, and other devices to contain such speculation. I believe that the Federal regulatory agencies responsible for the enforcement of such controls have attempted to use them judiciously to maintain public confidence in the securities markets, and without reservation I can state that it has been the SEC's position to exercise the minimum amount of regulation of the securities markets consistent with the public interest, and the interest of investors and the securities industry alike. While my talk is entitled "The SEC and Some Current Regulatory Problems," I wish to give recognition to the valuable services performed by the self-regulatory organizations, and to say

that while our cooperative efforts have accomplished many of their objectives, nevertheless, much needs yet to be done, particularly in the area of the back office problem, which I will discuss more fully later in my talk.

Although speculation in the securities markets has long attracted the attention of the Commission, until more recently our activities in this respect have primarily been directed toward uncovering situations in which fraud and manipulation are present or, due generally to the absence of adequate information, situations where serious market problems involving a particular stock have occurred. Currently, however, we also view with considerable concern certain new developments which are progressing to a point of "institutionalizing" our securities markets. In our Report of Public Policy Implications of Investment Company Growth, we called attention to certain facts which, when now supplemented with information obtained from more recent surveys conducted by the New York Stock Exchange, are even more significant than when the Report was first published in late 1966. Illustratively, some of these facts show that:

1. the percentage of all outstanding stock held in institutional portfolios is rising at a rapid rate (25% in 1957, 30% in 1965 and 33% in 1967);
2. the increases in the stockholdings of all institutions have been striking (from a total of \$66 1/2 billion in 1957, to \$200 billion in 1965, and finally to \$230 billion in 1967, an increase of about three and a half times over 1957);
3. institutions and institutional intermediaries account for a much larger proportion of trading volume in securities than the above holdings indicate (a recent survey indicates as much as 50% of all non-members' volume on the New York Stock Exchange in 1968 was due to trading activity by such group as compared to 35% in 1967);
4. the combined value of common stock transactions in 1967 for four principal classes of financial institutions -- non-insured pension funds, mutual funds, life insurance companies, and property and casualty insurance companies -- exceeded \$47 billion, an increase of 46% over 1966; by

comparison, the dollar volume of all stock transactions on the New York Stock Exchange in 1967 showed only a 26% increase over 1966;

5. mutual funds have, by far, the highest portfolio turnover rates of all institutional investors. The latest data available indicates that mutual funds as a group were turning over their portfolios at an annual rate of almost 40% in 1967 as compared to less than 35% in 1966 and an estimated 14% in 1957; also, compare this 40% figure to the fact that the average turnover rate for all equity securities traded on the New York Stock Exchange was only about 20% in 1967. Mutual funds, moreover, tend to engage in larger size transactions than other institutional investors, and account for a large portion of negotiated crosses and block distributions of securities.

Our Report noted further that, despite the fact that the assets of mutual funds have grown at a rapid rate in recent years, many of the large funds have reduced the number of different stocks in their portfolios. This concentration of power has led to the increased probability that a few fund managers by their investment decisions will affect dramatically the stability of the market in particular securities in which they trade, regardless of any intent to do so. Further, as the irregular and relatively infrequent transactions of individual institutions in sizeable blocks of securities become relatively more significant and the comparative importance of round lot orders by small investors decreases, the auction markets may find it increasingly difficult to maintain the liquidity, depth and continuity which they traditionally have sought to achieve.

The figures and facts which I have just mentioned still primarily reflect the market activities of the more numerous traditional capital appreciation and income funds. Nevertheless, recent emphasis on short-term movements by funds and other more conservative institutions has had, and will increasingly have, an important impact on the markets.

It is not yet known to what extent the original purpose of providing safety through diversification has now been "rephilosophized" or how much of the additional institutional activity is a result of the emergence of the "cult of performance," with its emphasis on new market techniques to develop short-term profits.

Although there are restrictions on their use, these techniques include use of leverage, short-selling, purchase of puts and calls, option contracts and warrants, and investing in "special situations" and restricted unregistered stock.

As you know, in July of this year, Congress authorized an economic study to explore the effect of financial institutions on the overall securities markets, the securities industry, issuers of securities and the general public. This will, of course, not only be a very important undertaking, but a complex one as well, and we will need the cooperation and assistance of the entire industry.

Most of us connected in one way or another with the securities industry are optimists, which I believe is a desirable and even necessary trait. On the other hand, we surely cannot afford to ignore the fact that just six years ago Wall Street was, as it is now, almost at a point of being overcome with the enthusiastic embrace shown it by the investing public. After the 1962 market break, however, not only the investor suffered from severe withdrawal pains, but the industry saw the expiration of a number of its members, both large and small, and consolidations among others.

May 1962 also brings to mind a practice, existing then and now, in which much of the general investing public (at least for a time) happily participated -- gambling on "hot issues." For comparative purposes, I find it not dissimilar to the "pyramid club" crazes which stem from the oldest of man's aspirations -- something for nothing.

Many of you may be familiar with a survey given some publicity a short while back, summarizing the financial fate of a number of offerings made during the previous so-called "hot issue" period. In any event, I believe the figures merit repeating, as has been done by some brokerage firms who I understand distributed copies of the survey results to their customers. The survey, encompassing some 504 companies going public for the first time during the period 1952 to 1962, indicated that:

1. almost 12% of such companies had vanished without a trace;
2. another 43% were known to have liquidated, dissolved or gone into receivership;

3. 26%, while still in business, had reported a loss on their most recent income statement; and

4. if my mathematics are correct, only approximately 19%, or about one out of every five, of such new issues could be measured in terms of some success. Recognizing, however, the importance of assuring the unhindered passage of venture capital into new enterprises, while at the same time attempting to contain excessive speculation, not only the SEC, but the self-regulatory bodies, associations and state authorities are faced with a dilemma for which there seems to be no easy or ready solution.

It is with this in mind that I am appealing to you as individuals with an obvious interest in the outcome of this matter to assist your regulatory organizations in determining and implementing meaningful steps which can appropriately be taken to avoid another serious market break. Your comments and suggestions in this area are not only welcome at the Commission, but I assure you that we earnestly solicit them.

Closely aligned, and quite likely as a direct result of today's excessive speculation boom, is the current back office problem. A collateral aspect of that situation which I want to touch upon first is the failure of a great number of firms to carry out properly their supervisory functions regarding the handling of customer accounts. The Commission, in its opinions, has repeatedly held that failure to supervise adequately is a violation of the anti-fraud provisions of the securities acts and has taken appropriate action against both the member and its supervisory personnel for the neglect of such responsibility. In a recent release (Securities Exchange Act Release No. 8404, dated September 11, 1968), the Commission cautioned that effective regulatory action will be continued against firms and individuals who fail to comply with proper supervisory procedures. Sadly enough, the Commission has found in a great number of instances that, if procedures established by brokerage firms designed to deal with this problem had been properly implemented, there would not have been an opportunity for the violations found to have occurred. As you know, the minimum requirements of adequate supervision are set forth in rules of the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers, Inc. The New York Stock Exchange and the NASD have also published guidelines describing procedures widely accepted as representing sound supervisory practices.

Passing now to the subject of back office problems, I must begin by saying that it is, indeed, difficult to find words which will adequately convey my concern. Warnings are received at the Commission almost daily from knowledgeable people in the industry expressing their concern and the need to take immediate and appropriate steps. Many see the "fails" situation crippling market liquidity and, coupled with some political or economic event, precipitating a run on brokerage firms by customers for cash or certificates. If, as a result, any major firm is then forced to suspend or liquidate, they fear a general chain reaction among other firms will follow, which could seriously threaten our whole economy.

An analysis of the situation discloses that the current back office problem, resulting primarily from the unpreparedness of firms to handle the sales volume long sought, stems from one or more of the following contributory factors:

1. inefficient or inadequate back office procedures;
2. insufficient number of back office personnel ;
3. failures of delivery from other broker-dealers;
4. delays in transfers by the issuer, registrar or transfer agent; and/or
5. obsolete or inadequate central clearing facilities.

The foregoing not only exposes a brokerage firm to possible substantial losses in the event of a sharp break in market prices, but, among other things, hampers the prompt determination of net capital compliance and, in the absence of accurate and current books and records, may result in improper extensions of credit.

Part of the difficulty in attempting to deal with the back office problem has been the mental attitude of some managements and "front office personnel." In many instances the back office operation is merely considered a non-profit-making appendage which must somehow be tolerated. Far too often brokerage firms attempt to economize on capital items and/or personnel for this aspect of their business, while increasing expenditures in those areas which directly relate to sales promotion, thereby aggravating what may already be a serious problem.

The irony is that, while the securities industry today is experiencing a prosperity it has seldom before enjoyed, some sizeable brokerage firms have found it necessary to curtail business and even suspend or liquidate operations simply because of their unpreparedness to handle this prosperity. This is, indeed, a unique situation.

Assuming that the regulatory organizations have been able to pinpoint the major problem areas, it then becomes a question as to whether appropriate solutions can be developed. At the expense of other important enforcement activities, the Commission, in conjunction with the exchanges and the NASD, has directed its staff to conduct special inspections of brokerage firms in order to ascertain the extent to which such firms are carrying out their responsibilities in the area of back office compliance. In connection therewith, the Commission has stated that it would continue to take prompt enforcement action against individual firms and persons where there had not been full compliance with our applicable rules and regulations. Cooperative enforcement in areas of concern, such as examinations for possible violations of net capital rules or delinquencies in properly maintaining books and records, has been improved. Information-gathering has been stepped up to cope with present problems, as well as to assist in future planning.

Recent self-regulatory measures which have been implemented by the major exchanges include:

1. amendment of the mandatory buy-in rule to provide for the closing out of contracts which are still open 30 days after settlement date;
2. adoption of mandatory monthly "fail" reports for the purpose of taking corrective action;
3. shortening of weekly trading hours by Wednesday closings;
4. revision of handling procedures with respect to questioned trades to expedite their resolution; and
5. prohibition from making long sales for a customer unless assurance can be obtained that the securities being sold will be delivered promptly.

In addition, automation programs in the area of exchange clearance and delivery systems are apparently beginning to show results. The Central Certificate Service, inaugurated in late June, is currently providing computerized delivery for 362 stocks. Recently, member firms doing an over-the-counter business in the New York City area have been directed to join the National Over-the-Counter Clearing Corporation, or to clear their over-the-counter transactions with an NOTC member. It is expected that further automation of procedures will lead to additional efficiencies in both internal transactions within firms and among the exchanges and such entities.

Other regulatory measures which have either been put into effect or have at one time or another been discussed by the exchanges, the NASD and other self-regulatory organizations are:

1. cutbacks or a freeze on the number of daily customer orders that restricted firms can accept, or similar restrictions on new salesmen or branch offices, until their back office problem subsides;
2. cutbacks or a freeze on advertising or sales promotion by firms, which tend to increase sales volume while their back office problems multiply;
3. restriction of trading for firm accounts, with appropriate exceptions;
4. further curtailment of trading hours in addition to Wednesday closings; and/or
5. the hiring of additional personnel by the self-regulatory bodies to assist firms with unusually serious back office problems.

In some isolated instances, when restrictions have been placed on firms as a temporary measure until their back office problem has been alleviated, registered representatives have resigned to work for other firms. Such restricted firms simply refuse to realize that it is less expensive to establish adequate and appropriate back office procedures, and hire necessary personnel to carry them out, than it is to suffer the loss of sales personnel, loss of customers' confidence and invite problems with the regulatory bodies.

The Commission has also recently affirmed its position that it is a violation of the applicable anti-fraud rules for a broker-dealer to sell a security as principal for his own account, or to purchase it as broker for any other person, if he (1) knows, or has reason to believe, that there will be difficulties in obtaining deliveries with respect to a particular security because of delays in transfer or (2) because, in order to obtain the security either for his own account or for a customer, it will be necessary to purchase the security from another broker-dealer whose deliveries to him have not been prompt in accordance with traditional customs and usage of the trade.

The Commission at the same time warned that it is a violation of the anti-fraud provisions for a broker-dealer to accept or execute any order for the purchase or sale of a security, or to induce or attempt to induce such purchase or sale if he does not have the personnel and facilities to enable him to execute promptly and consummate all of his securities transactions.

To handle the other side of these problems, the Commission has now received comments with respect to proposed Exchange Act Rule 10b-14, which would make it unlawful for any issuer publicly offering any security, or which has any class of security outstanding, to offer or sell such security without providing for adequate registrar and transfer facilities.

Notwithstanding the importance of the above measures, the rule as adopted by the major exchanges and as proposed by the Commission, which hopefully promises to be the most effective for minimizing the back office problem, is the modification of the "fails to deliver rule." This amended rule now provides for deductions from a firm's net worth of from 10% to 30% on contract prices of "fails to deliver," and combined with strict enforcement of the net capital rule and books and records requirements, it is anticipated that such action will have a highly salutary and significant effect on the present discouraging fails situation.

Corresponding to the fails situation, complaints involving investor grievances communicated to the Commission indicate a continuing substantial increase of problems experienced by investors with respect to delays in receiving stock certificates, dividend checks, payments due from sale of securities, and others. Such complaints received during the year 1967 numbered between 720 and 786 per quarter. In 1968, however, complaint letters increased from 789 in the first quarter to 1,147 during the second quarter, and reached a record high of 1,401 during the third quarter of 1968. Gentlemen, that is more than 100 investor grievances a week. This

does not, of course, represent those complaints never reported to the Commission. A very important element in all this, not even hinted at by the statistics, is the consumption of man hours at the Commission and in the industry by the mere processing of the complaints.

In closing, I would like to say that I think we can all agree that it takes years to build investor confidence in our securities markets, and only months, or even days, to destroy it. Unquestionably, the securities business is one of the great and vital industries of our country, and is respected throughout the entire world. It would most certainly, therefore, be one of the bitterest ironies if that industry strangled on the effects of its own affluence. You gentlemen and your colleagues must see to it that this catastrophe does not occur.