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# A REPORT FROM THE SEC

An Address By

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Last week, as I paced my new office seeking an opening for my remarks this morning, I chanced upon the traditional scrolls which were given me as evidence of my two Presidential appointments. Their obvious virtue is their admirable ability to fill an otherwise large blank wall behind my desk, and, on close reading, I was pleased to see that in affirming my appointment as his "Counsel", the President took note in the printed script, that I possessed "Integrity, Prudence and Ability." Reassured, I looked for similar praise in the document appointing me a member of the Securities and Exchange Commission. I must say I was taken aback to note that, on this more recent occasion, I was cited only for my "Integrity and Ability." "Prudence" was either a quality to which the President was not willing to recertify after my eight months in the White House, or a quality that the faceless creator of certificates thought to be irrelevant to the duties of a Commissioner.

In either event, I worried that my wall contained evidence that could bolster critics of the SEC, so I turned quickly to the "Canons of Ethics" that were adopted by the Commissioners in 1958 to guide their conduct. There I found a number of exhortations, which clearly require the exercise of prudence - - we must, for example, act in a manner which commands the "respect and confidence" of our fellow citizens. Our conduct must be "beyond reproach." We must be guided "by a deep regard for the integrity of the system of law" which we administer and we must act "fairly and impartially and with dignity."

This flight of accidental whimsy convinced me that my baptismal message to the securities industry should be a strong and repeated call for prudence.

"Prudence," says Webster is:

> "sagacity or shrewdness in the management of affairs (as of government or business) shown in the skillful selection, adaptation, and use of means to a desired end".

Cicero said:

> "Rashness is the characteristic of ardent youth and prudence that of mellowed age".

As the industry approaches its own bicentennial, it is appropriate for me to pledge for the Commission a prudent course and to ask similar prudence from each of you, and perhaps even some mellowness, as we attempt to define the ends we seek for the securities industry, and then as we articulate and execute the means to these ends.

It serves no purpose for any person in government or in the industry to attack others for their views as to how to solve the problems, the conflicts or the turbulent economic conditions of the industry. If we at the SEC do nothing, all these controversies will remain. Our effort and my pledge is to seek a prudent, informed and calm dialogue through which we can address the problems.

My belief is that you in the securities industry and we who regulate it can raise the level of this dialogue; that we can find mutually acceptable definitions of the real problems facing the industry; and, to a far greater extent than has existed to date, find mutually acceptable solutions - -

> If we can spend far more time deciding what our problems are we will not have to spend anywhere near so much time quibbling about the solutions.

We are beset by change - - often a rapid and turbulent change, caused not by Congress or the SEC - - but propelled by new economic realities.

First, there is a great fear and perhaps a great danger that the capital needs of the next ten years or so cannot be met by traditional methods, and that we will be forced to turn repeatedly to more concentrated financial sources, even to forms of state capital.

A ramification of this fear is that banks and similar financial institutions could expand their role and thus displace others in the industry, and that this further concentration of financial power will reduce the great and healthy diversity we have today in our sources of capital.

To use the words of a very recent paper by the Treasury Department:

> "the concentration of investment advice in a small number of large institutions could adversely affect the liquidity and stability of the securities markets."

There are no easy solutions, but I do know that it is our responsibility to deal with this issue. There are obviously some incursions today by the banking industry into the traditional securities industry. Which of these should continue and which should end are matters of legitimate debate. I do feel certain that the matter needs better resolution. Initially, of course, we must know how to measure the consequences to our economy of any such changes.

There appears to be today strong interest in reviewing the Glass-Steagall Act. Understandably, some of you have expressed concern. I am sure you will agree, however, that we should not shrink from this review. The real issues include these:

> Is there any reason to believe that there is a need for bank participation as dealers and underwriters in corporate securities in order to assure sufficient sources of capital to American business?

> What effect would any erosion of the general understandings of Glass-Steagall have on banks' functions in allocating credit; and what effect would it have on the soundness of the banking system?
>
> To what extent should banks be permitted to solicit brokerage-type business?
>
> Is it important to have a segregation of financial functions mandated by law in order to eliminate unmanageable conflicts of interest and to build into our financial system a set of independent checks and balances to allocate capital and credit?
>
> In short, how can we both meet our needs for capital and yet prevent undue concentration in the financial markets of our nation?

The Glass-Steagall Act effected an organic change in the structure of America's capital and financial markets. Let us reduce the heat of the argument and focus with some precision upon what is good and what is bad about the status quo, and about any further changes that may occur.

We will cause such a focus at the SEC, and, while we will certainly not be blindly partisan, we can and should be professionally vocal in pointing out the dangers to the securities industry in the road ahead.

We must develop sufficient economic models to test the effects that greater financial concentration in the future would have on this industry and on the economy; and better economic models for forecasting. We will do so.

Second, there is no question but that corporations recovering from the economic slow-down of the last several years need to raise equity capital for future growth, and for debt repayment, but many are unable to do so, in part because investors today appear to be looking for more dividend yield.

To provide that yield, to provide more capital and to attract more investors, the Administration is asking for better tax treatment for dividends. That seems to be a sound position, and we shall attempt to provide sound economic evidence that is relevant to this proposal. If such tax treatment is needed for strong capital markets, then it is, I believe, our responsibility to say so!

Third, it is apparent that small and middle sized firms have even fewer capital alternatives. Banks, stung by the go-go years, seem to have less interest in supporting developing companies. There is no simple answer, of course, but even identifying the problem can help. And, there may be small steps that the SEC can take. For example, if we could give new vitality to the Regulation A exemption, we might well trigger new capital for developing companies.

Many feel that Regulation A has outlived its usefulness, that the Commission's most prudent course of action is simply to preside over its orderly demise. I do not agree - - it should at least be an important tool for newer companies striving to raise their initial equity. I shall not easily preside over its burial.

Studies by the Commission's Office of Economic Research into the issues raised by Regulation A are in progress, and one of the Commission's regional offices has conducted a study of Regulation A offerings in its region to determine the present status of those issuers and the effectiveness of the exemption. The results of these studies will aid the Commission in its continuing efforts to provide small companies with every opportunity to participate in our capital markets. If thoughtful research reconfirms my prejudices, we can seek a raise in the exemption from its $500,000 level

to $1,000,000 and redouble our efforts to simplify its use. I offer no promises other than the promise to make a responsible effort.

We can generally, I believe, redouble efforts already under way to alleviate the burdens of regulations that unnecessarily arise and which are a particular problem for the smaller company.

Fourth, there is today widespread controversy over the workings of our public market mechanism - - the SEC did not start the fight and the problem will not go away if we say it doesn't exist. We must face the problem, which means first of all that we must understand it.

Let me dwell on this issue for a minute, not because it is more important than the others, but because it offers a dramatic example of what is wrong with our present dialogue. Last May, the Commission caused competition in brokerage rates, and we now threaten to change restrictions on so-called off-board trading and to implement a national market system. Is all this being done to destroy our present system, our present exchanges? Of course not!

Congress has said that it is in the

> "public interest. . . to assure. . . fair competition. . . between exchange markets and markets other than exchange markets. . ."

The 1975 Amendments also find that:

> "the linking of all markets for qualified securities through communication and data processing facilities" will further these goals.

More pertinently, Congress has directed the Commission

> "to facilitate the establishment of a national market system
> for securities. . ."

The SEC did not lobby for this legislation, nor are we sure what it will take to fulfill its mandate.

We know as you do that our stock markets are the envy of the world, and that their continued vitality is an essential component of a strong economy. But, we also know that these markets are being changed by economic, congressional, and public pressures. Changes of a dramatic nature have occurred, and they will continue to occur, regardless of Congressional or Commission action.

Our choices are simple and obvious. We can be prudent and constructive together, or forces less constructive, less prudent will make the changes for us.

Let me say it more specifically. On behalf of the Commission, I ask each of you, and through you I ask the entire industry, to explore realistic alternatives. An honest statement of your own economic interests, joined with a real exploration of the facts, can produce practical and workable change, but stubborn insistence on status quo - - <u>a status quo that never was, and never will be</u> - - can only frustrate the opportunities we now have to preserve and enhance the real assets in capital and manpower that constitute the market system, as we now know it.

Let me emphasize this point. Our markets, our brokers, our specialists and our marketmakers, both on exchanges and in the over-the-counter markets, represent a very substantial asset to this industry, to the economy, and to the nation. No doubt their roles will change, and no doubt new competitive pressures will cause some to leave the

industry and others to enter it. But, as we adjust to change, we must maintain economic incentives that will keep them and their capital in the business. There can be no higher priority!

In this regard, the Commission has a particular responsibility to reduce uncertainty in the regulatory process, so that better judgments can be made about the use of capital.

The Commission must be committed to a search for, and the development of, the national market system that the Congress has ordered. Our failure would mean only that another Commission would begin again on a new effort, or worse, that Congressional impatience will take the step by fiat.

I am confident, however, that the Commission and the National Market Advisory Board will receive the cooperation of the industry, and particularly of the exchanges, and that a sensible, prudent course of action will evolve.

Let me turn to a matter of more pressing concern. Yesterday, the Commission released the first monitoring report assessing the impact of the decision last May to unfix Commission fees, on the securities markets. The report, in my judgment, is quite well done. But, as a first effort, it obviously has limitations, and it just as obviously does not answer all questions. We can only say that the data received during the first four months indicates that, although commissions paid by institutions declined after May 1, 1975, the overall financial condition of broker-dealers remained sound, and there was no noticeable impact on self-regulatory organizations, securities market places, or "market quality."

Let me illustrate the legitimate questions which are still unanswered.

First, it has become apparent that substantial differences exist between rates being paid by individual and institutional investors for the execution of securities transactions of similar size. That development could well reflect the free play of competitive forces and reflect the differences in services provided to institutions and individuals, and the costs incurred in providing those services. Some argue, however, that it reflects excessive market power on the part of institutions or uninformed or unjustified price leadership on the part of certain brokers.

Second, certain broker-dealers, particularly those performing brokerage functions for, and offering research services to, institutional investors, have experienced sharply reduced levels of revenues and net income. A few such firms have elected to merge, others have terminated, and still others appear to have experienced substantial personnel losses. These developments may indicate that there will be a restructuring of the investment community to meet investor needs; or, we may be seeing a first glimpse of a possible and unfortunate reduction in much-needed services. If so, this trend could be accelerated if institutional investors do not understand their right to pay commissions for research services, notwithstanding the so-called "paying up" provisions of Section 28(e) of the Securities Exchange Act. In fact, we may find that the truth lies somewhere between these two extremes.

Third, during the period covered by the report, securities trading volume was high, and securities prices were generally rising in relation to levels which prevailed in 1973 and 1974 - - events which have a positive influence on brokerage industry revenues. To this extent, our first report may be of little relevance to the longer-range trends.

All of this means that we are still in the process of framing the questions, and far more information is needed. We will produce another monitoring report as soon as possible after the first of the year, and we will produce further reports on a timely basis.

Given the nature of the tasks ahead, a major reorganization and strengthening of the Commission's capacity for economic research is needed. We must secure a more adequate data base for practically all of our work. For example, serious economists and analysts have doubted the effectiveness of our disclosure effort. However valid their point may be, proper economic models will produce a more efficient and less burdensome disclosure policy. My hope is that preliminary work will soon justify a major project to reassess these programs. Similar work can be done in accounting, investment management, and even enforcement.

We can do a better regulatory job if we define our problems better and collect empirical evidence with well-constructed efforts.

We have created a new staff position at our highest level to lead the effort, and we will develop an advisory council of leading scholars to help develop the economic models that are directly and practically applicable to the Commission's work.

I believe these steps will prove to be extremely important. Chairman Garrett began this effort. I assure you that the Commission will make very substantial further progress this coming year.

In the spirit of the season and within long-standing SEC policy guidelines, let me disclose my immense pleasure at having this opportunity to be among you here and in the job I now have. I have lived in, around, and on this industry for 18 years. I have, as a result, a great respect for the capacity of your leadership to meet the challenges, to

provide the ingenuity, the entrepreneurial spirit that will maintain the unquestioned superiority of our capital markets.

I have a strong conviction that it is our responsibility to respond to such constructive leadership in our regulation of the industry and in our efforts to better understand the industry. I believe equally that, where appropriate, we have an obligation to assist the industry.