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SECURITIES AND EXCHANGE COMMISSION

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During the past two years deregulation, reregulation and regulatory reform have been the slogans of practically everyone, those who are running for office, those who defend past positions or those who are explaining current regulatory efforts.

During the primaries, each candidate vied for the public's attention with claims of what he could do to reduce government if only elected. Some candidates seemed to campaign on the premise that they were qualified to do less better than anyone.

Since almost every voter has had some spat with a governmental agency, it is tempting for each to think that the election of one man or the appointment of one agency head might get rid of that activity which has caused his personal headache.

Notwithstanding the unanimity of opinion that less government is better government, we proceed inexorably with more laws and more regulations that increase government regulation of the economy. Even now there is broad bipartisan support for the notion that an all-encompassing federal, master, long-range economic plan will solve all our problems.

Since 1970, 21 new Federal agencies have sprung from the ground. In 1976 alone, there have been 309 new rules and 7,000 final rule amendments. Between 1955 and 1970, rules and regulations increased annually at a rate of 8 percent and have exploded to an annual growth rate of 24 percent during the last five years.

There is, in short, an apparent contradiction between what we seem to be saying and what seems to be happening.

My own view of regulatory reform is dictated by the peculiar form of schizophrenia that I developed from spending nine months as Co-Chairman of the President's "Committee on Regulatory Reform" to resolve the <u>problem</u> of government economic regulation, and from spending now 11 months as part of that problem. Nonetheless my remarks this evening will be an effort at an objective exposition of governmental efforts to reform the capital markets of the country: where we are, where we are going and what is at stake.

You whose work is related in varying degrees to the success of our capital markets may ask, can the SEC deregulate those markets without doing serious damage? You may ask with even greater concern, do we know enough about where we are going, to leave where we are?

Even economists long committed to a notion of economic deregulation question whether we have the will and the capacity to go all the way and some may conclude that we better not start if we leave the job half undone.

Last week, viewers of the Today Show saw Dr. James Boren give a humorous but all too realistic view of Washington. Dr. Boren, who poses as the President of the International Society of Professional Bureaucrats, gave his three guidelines for bureaucratic success:

> "When in charge, ponder.
>
> When in trouble, delegate.
>
> When in doubt, mumble."

He was asked whether he was worried about regulatory reform and the election. He answered:

> "No, we're not concerned about election year oratory. We welcome organization and reorganization. Every time there's a reorganization we proliferate.

* * *

> We can take any new policy and buzzify it so that at the time it comes out for implementation it's the same as the old policy with new buzz words."

Well, for classic buzzification one can look at at the veritable cacophony of laws, carrying the label of regulatory reform that were proposed in Congress this past year. More than a dozen of them, all different but with a common theme: the presumption that a quick fix is possible. Sunset laws were proposed to effect summary execution of any agency not meeting an unspecified criteria of performance. A veto power was proposed for Congressional committees or for each House of the Congress -- to reverse any regulation deemed deficient by a hasty review by that Congressional body. Again, no criteria for reversal is set forth; merely a threat if you do not do it right, we will fix it for you and quick.

No doubt there are governmental programs, and indeed some governmental agencies that deserve capital punishment. No doubt the economy will be well served by a speedy judgment. No doubt some individual regulations deserve speedy destruction by any means. But this persistent notion that a quick fix is the proper approach to melt away the layers of misdirected regulation that have been built up over so many years is the most severe impediment that faces effective regulatory reform.

To prescribe the remedy before we diagnose the sickness is only to assure failure. Why is it then that otherwise sensible legislators and commentators continue to do so?

They are, of course, moved by despair; despair that efforts for more precise reform will never overcome the protests of protected industries and the reluctance of regulators to change.

It is axiomatic that opposition to government regulation increases in direct proportion to the distance ones own economic interest lies from the regulation. We all favor reform in general, but each of us have reasons not to reform practices that may seem to protect our own income.

The small businessman who suffers more than any at the hands of government bureaucracy and the paperwork it spawns, is vocal in his support for deregulation, but he is far more effective in opposing a repeal of the Robinson-Patman Act. The Aerospace Industry has been heard, in chorus with American business, to demand less government, but it vigorously opposes laws that would expose the airlines to real competitive forces because such competition could cause great uncertainty for some airlines who are now buying their airplanes in an environment of protected competition.

Even the consumer advocates who ask for deregulation of fares for air, rail, sea and truck transportation seek at the same time a new federal chartering of all corporations that would inexorably subject business to a far greater degree of regulation.

The sobering fact is that in only one significant instance has our federal government ever abandoned an industry whose income was protected by regulation -- to the perils of competition. Sixteen months ago, the Securities and Exchange Commission unfixed brokerage fees and told the industry that they must now be freely negotiated.

Simple enough, some say. Commission studies indicate that investors have already saved $335 million in Commission fees and daily news reports demonstrate a vigorous new competition is evolving, particularly for the business of the institutions.

With competitive rates, many undesirable types of give ups and reciprocal arrangements have disappeared and most firms have adopted more efficient business methods.

There is, in short, reason to assume that this one instance of deregulation has proven its value so well that all other agencies of government should follow our example.

I have no doubt about the wisdom of the course we have begun, but I have considerable doubt as to whether we or the industry fully appreciate the overall consequences of what we have begun.

There is a need to put the matter of competition in our capital markets in a broader perspective.

There are compelling reasons, -- the Congress and good economics to name but two -- to seek further major changes. But it is critical we recognize and deal with all the issues, not just those that seem more visible today.

If we yield here to the temptation of the quick fix, we can obviously do more than merely delay reform -- we could severly damage the very market we seek to reform.

Most important, I believe, our objectives and the widom of the objectives must be sufficiently clear to keep and attract the capital and people needed to maintain the superior markets that we have.

We have indeed removed some barriers to competition but we have left others in place which continue to have a detrimental effect upon capital formation. And, there are other forces at work that threaten to concentrate control over capital to an undesirable degree. Unless these barriers are modified and unless these other forces are maintained in a truly competitive stance we could cause a new market system to evolve which will have as many anti-competitive aspects as the one that we are changing.

Until we do deal with the subject in a broader perspective, the roles of the traditional securities industry, the banking industry, that of foreign competitors, of market makers, of the exchanges, of institutional investors, and of the issuers may evolve into a pattern of such concentrated fiscal control that it would compel in turn a far more pervasive governmental presence than any kind of regulatory scheme we have seen so far.

Let me illustrate the point. It was easy to tell stock brokers that they must now negotiate commission rates. If some cannot survive in this newly competitive market (and many are not), some say, with little concern, so be it. But how can we ignore the unmistakable loss of some firms from competitive rates when at the same time maintained tax policies that obviously discriminate against the basic product these same brokers sell: equity securities.

For more than 50 years we have permitted the deduction of interest on corporate debt securities and refused to permit a similar deduction of dividends on corporate equity securities.

Careful planning could not have created a more effective anti-competitive shroud for stock, yet we did it by accident. At least no one ever admitted that he wanted to discriminate against equity capital in favor of debt capital. The result has had a profound and I believe dangerous impact on debt/equity ratios -- a matter I will touch on later -- but it also have made it far harder for the broker to peddle his wares.

Is it not apparent that the reasons for eliminating this impediment to formation of equity capital are at least as compelling as those which forced brokers to negotiate commission rates? How much better it would have been to stop this tax discrimination at the same time that we eliminated fixed rates.

How many brokers would have stuck it out, and how many would be making different plans now if they knew that our government had the will to rectify this long, unfortunate and unplanned diversion of capital away from equity? Indeed, would not many stay in the industry even now if they could tell with any clarity how government means to change their business?

Having made dividends twice as expensive as interest on debt for all these years, we can hardly wonder now why the investor has lost some interest in stock investments and why corporate management have increasingly opted for debt financing.

The Commission worked for years under Congressional guidance to make commission rates competitive. In the year ahead the Commission will make an equal effort to provide compelling empirical data to help the Congress create the same competitive environment for equity securities.

We are <u>now</u> working with a Congressional mandate, to create a national market system that will afford far better competition between all existing market places.

No longer says Congress, are there to be specialists who have the same monopoly-type control over market making in specific stocks and the exclusive right to execute certain limit orders of their books. Obviously, when we have given the opportunity to compete on more equal footing at the other exchanges and in the other market places, market making will attract more capital and more efficient markets will surely evolve -- at least for awhile.

But again our perspective is too narrow. What about the anti-competitive rules that inhibit the specialist from offering more effective competition to others in the system: the upstairs traders, and the institutions that deal in larger transactions.

Let me remind us all of the profound impact that the growth of institutional trading (mutual funds, trust funds, pension plans) has had on the market system. In the early 1950's, institutions accounted for about 30% of the dollar volume of transactions on the New York Stock Exchange. Today they account for more than 70%.

Institutions buy and sell larger blocks than do individuals. Their desire to so deal led to block trading where traders must use far greater amounts of capital to effect transactions. To reduce the risk when using such capital, organized trading in options developed which permitted block traders to hedge. And now, with appropriate changes taking place in the tax laws, institutions can deal more effectively with options to hedge their risks. But what about the market makers?

They cannot now hedge as effectively, for their market-making is limited to equity securities. Exchange trading in option contracts is effectively separated from that in equities.

The obvious question is: how can we force the specialist to yield the position he has held with our blessing for so long, without at least trying to give him a better competitive position with others in the system?

I have no knowledge whether the ability to hedge his risks will offset the income the specialist is likely to lose from the pending changes. Indeed, I cannot even say that the potential abuses from manipulation that such dual trading could bring, can be overcome. I can only suggest both questions are relevant.

Six days ago we notified the National Association of Securities Dealers that we agree in principle to their proposal to begin dual trading in certain options and stocks that have a very large number of competitive market makers.

Such dual trading may not evolve, and if it does there may be no similar development on the exchanges, but the matter surely has immense potential. The decision of whether to merge and how to merge our major exchanges and the development of a national market system will depend, to a very large degree, on this issue.

The question of whether to permit dual trading highlights the perennial dilemma of government regulators. We know certainly that options trading today has pitfalls for the individual investor caught unsuspecting in the complex trading strategy of those who deal in 10,000 share type blocks, and who may have knowledge of pending transactions that practically cannot be made available to individuals.

The SEC, however, is committed to the protection of the individual and so our first instinct is to stop the use of strategies that increase the risks to the unsuspecting. Yet, we are taught that the greatest regulator of all is competition.

Which shall it be? More restrictions with protective regulation that eliminates sensible trading strategies or more competition? There are no absolutes and there of course must be a balance, but I confess my hope that a careful analysis will permit a tilt toward more competition.

Forgive this tedious trip through trading techniques. I offer it only as concrete evidence of the point that reform is not for the faint-hearted, and to acknowledge that one person's competition may be another's monopoly.

For those who prefer lighter fare, let's circle the institutions again; the funds that are increasingly the dominant factor in capital formation. Take our mutual funds -- over $50 billion dollars in collected assets, which are fading fast. The so-called front end load mutual funds now find they cannot easily get customers to pay a 7% commission for the privilege of buying fund shares, but salesmen want commissions to sell them. A marvelous dilemma, yet unresolved. More and more funds are proposing that they use accumulated earnings (which obviously belong to the prior investors who paid the 7%) to sell more participations. But can we make those who paid their ticket of admission now pay for latecomers out of their earning? Well, what's the alternative? Shall we let these funds dwindle to save the investors from themselves or shall we submit the issue to a proper vote of ratification, and if approved let these funds advertise and pay sales commission out of past earnings. Mutual banks, mutual savings and loans, and mutual insurance companies have done so for years. I hope again that we can find the way.

And shall we continue to regulate advertising of funds as we have done in the past. You should see how they advertise now!

-- One large fund, obviously believing in the modern maxim that less is more, merely sets forth its name in distinguished type face.

-- Another asserts that "Yes Virginia there is income with Growth," a nostalgic truism but hardly helpful to the thoughtful investor.

-- And just as 7-UP is advertised as the "UNCOLA", one fund promotes itself as the "non-bank account."

Not a word about past performance. No one says to the investor in a rival fund: Hey! Sell yours and buy ours! We did better last year!!

No comparative statistics: None of the information that you would expect to be the most important to people choosing a fund.

Why not?

Well, we won't let them do it. That's why! There are reasons for the rule, based on past abuses -- but a new perspective more influenced by the curative of competition may break through soon and change that rule so that funds like corporations can brag about their past profits.

Look too at the difference between the various kinds of funds. Since 1950 pension funds have grown from $7 billion to almost $150 billion today. Again, we use tax incentives to divert capital to them. Good policy? Probably. But, our laws also greatly restrict their right to invest. Except through cumbersome subsidiaries, all these monies are forbidden from investing in new securities offerings. Pension fund advisers are not kept from making so-called "prudent" investments in municipal obligations that later default, but we don't trust their judgment to offer equal capital to good, new businesses.

Is that the way to protect our economy or is it a way to restrict our economy?

I will touch briefly -- ever so briefly -- on the growing dispute between the banking and securities industries. They have, of course, always competed in some areas but they now clash with more feeling and there does seem to be a new seriousness about the dispute.

In this case the advocates of free competition seem confused, and I include myself. Some say let them compete but don't give the banks any unfair advantage. Let's make sure that their taxes and regulations are just as heavy as ours and that they do not use their trust departments, control over credit and relationship with the Federal Reserve system unfairly.

Here too the trick is to define those areas where bank capital, equipment, and expertise can provide real assistance to our equity markets without eliminating a viable, independent securities industry that will continue to play the primary role with respect to the market in equity securities. More competition obviously, but not too much more concentration of fiscal control.

There is a far longer list of competitive problems facing the capital markets but the point is hopefully made and the evening is late.

Let me return to the theme.

The American economy is based on private, not government, ownership of the means of production. Its health requires strong and efficient capital markets to facilitate capital formation.

Within those capital markets there must also be a healthy competition between debt and equity. The simple economic reality is that an economy too dependent on debt cannot be as flexible or as innovative as one with a balance between debt and equity. And it is equally true that innovation, growth and flexibility are the essential characteristics of a capitalistic society as contrasted to socialism or fuedalism.

The measure of my concern for the present state of our economy is that we are increasingly becoming a debt-based society rather than the essentially equity-based society we were 25 years ago.

In the early 1960's roughly 15% of all gross corporate profits were used to pay interest on debt; today interest takes 40% of gross profits. Many more statistics can make the same point -- the significance of that point is that we may be losing some capacity for innovation and there may develop a greater concentration of capital and of the means of production.

I suggest tonight only that government tax and regulatory policies together with traditional methods of doing business have placed equity investments at a competitive disadvantage. During this same period for many of the same root causes, we have as a nation in a far broader sense become less willing to allow free competition to make necessary economic choices.

Unwilling to await the verdict of the marketplace we more and more seek decisions from the political arena. With government expenditures about 40% of our gross national product, our major political issues too often deal with the allocation of capital.

When such decision making is subject less to market forces, a fundamental change can occur in society as it organizes to politically influence capital allocation.

Professor Vernon's recent study of European business sees there:

> "a growing tendency to use large national enterprise
> . . . to solve specific problems as if they were
> agencies of the state. And, there has been a related
> tendency to develop methods of government that
> have reduced the role of the parliamentary process
> and evelated the role of specialized groups."

I would say it, only a bit differently. Each time government manipulates capital allocation, intentionally or unintentionally, to solve problems of the state or when private industry pressures the government for capital advantage, the state tends to be a little less democratic and the industry tends to be a little less efficient.

The challenge to us all now is to institutionalize the process of change toward a more competitive environment with a better functioning market system based upon good economics. I will say again our objective in this process of change must be sufficiently clear and their wisdom sufficiently understood to attract and maintain the capital and people necessary to make it work.

Last week a journalist friend visited me to learn of our work. While I was on the telephone he glanced at the current issue of Securities Week. He said:

> "Look at these headlines:
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> "SEC Approval of NASD Dual Market Making Imminent"
>
> "Securities Industry Asks Probe of Chemical Bank Brokerage Service"
>
> "Opponents to Consolidated Limit Order Book Carry the Day"
>
> "SEC Appears Open to 'Order Indication System'"
>
> "Midwest-CBOE Merger? Some Say There Have Been Talks"
>
> "Moss Oversight Hearings Cancelled Possibly Easing Merger of Clearing Houses."
>
> "NYSE-AMEX Merger Talks Are Getting More Serious"
>
> "Morgan Stanley Deep Discount Plan Scheduled to Start"
>
> "NYSE Access Committee Finds Most Favor Access Status Quo"

> "PSE Endorses Firm-Quote Rule"
>
> "AMEX Loosens Restriction on Specialist Off-Floor Trading"
>
> "Over 100 NYSE Firms Report Loss in Second Quarter"

"You sure get", he continued, "a whole lot of different problems to work with, don't you?"

My answer to him then and the point of my remarks tonight is the same:

> No they are not different. They are all closely related parts of the same problems!

It's with that perspective that I am pleased to be with you to tell you what, in the name of competition, is going on at the SEC.