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PRIVATE SECTOR RESISTANCE TO DEREGULATION

ADDRESS BY

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I appreciate the opportunity to participate in this seminar covering a broad range of important subjects relating to investor protection and capital formation. Over the past several years, the Securities and Exchange Commission has introduced some major changes designed to open up opportunities for competition, improve the efficiency of securities markets, reduce regulatory burdens, and make it easier and less costly for firms to obtain funds from public investors. I had intended to list some of the more significant deregulatory changes today, but found that there were so many that it was impractical to do so. Some of them, of course, will be discussed thoroughout this Seminar.

Despite all of our efforts, earlier this month at a securities institute in Florida, a law school professor asked if I expected the Commission to meaningfully deregulate securities markets. From past conversations I know that some of you also are anxious that the Commission take additional deregulatory action, particularly with respect to small business. As you consider Commission deregulatory initiatives it is important to remember that our primary responsibilities are to administer securities laws enacted to protect investors by requiring full and fair disclosure of the financial condition and operations of public corporations and to assure that securities markets are fair, honest, efficient and free from unnecessary barriers to competition. It is also important to understand that existing rules and regulations were established in response to perceived problems and improper practices and that, on the whole, such rules and regulations have contributed to the world's best securities markets. Deregulation entails some risk, and to be responsible it must balance the possible immediate cost savings against the likelihood of undermining an environment in which investors can have confidence that they are being fairly treated. To the extent that confidence is reduced, investors will put their savings elsewhere and firms will find it more difficult and costly to obtain needed funds.

Just yesterday the Commission approved for public comment a proposal to extend the availability of Form S-18 to non-corporate issuers and issuers engaged in oil and gas operations and a proposal to amend Rule 10b(6) to permit participants in a distribution of securities to continue trading such securities until three business days before commencement of the distribution instead of the present ten day requirement. These proposals would provide benefits such as additional freedom from restrictions and paperwork but also would increase the opportunity for fraud and manipulation. We hope you will give us your views on these proposals.

In our meeting yesterday, we also authorized a release announcing ten rulemaking actions implementing an integrated disclosure system which we have been working on for several years. This package is a rather massive undertaking reflecting thousands of hours of research, drafting, review of comments, and deliberation. It substantially reduces regulatory burdens and simplifies disclosure requirements. One of its rules provides opportunities to offer securities quickly when the market appears to be most receptive. We found in this instance that it was not the Commission or investors who opposed deregulation but industry participants. This is not an isolated case. In fact, I have found that affected industry participants are often the greatest obstacle to meaningful deregulation. It appears that underlying much of this opposition is the desire that government preserve existing participants and market structures.

One of the Commission's early major deregulatory initiatives was the removal of fixed minimum brokerage commission rates in 1975. The motivation was quite simple and applied a basic, well accepted principle that obstructions to competition distort the operation of an economic system. We believed that fixed rates had caused serious problems in our securities markets and should be removed so that market forces could have a greater influence on brokerage charges for securities transactions on exchanges.

Who would have thought that in a free enterprise system this would be perceived as a radical idea? Nevertheless, many in the private sector mounted sustained and substantial opposition to the Commission's decision to require competitive rates. Dooms day predictions were heard from highly respected industry leaders. Among other things, it was said that competitive rates would create confusion and chaos in the markets for securities, reduce the participation of small investors in our securities markets, bring about destructive competition and thus cause a high rate of failure among broker-dealers and concentrate the securities business in a handful of firms, lower standards in the industry, weaken desirable surveillance mechanisms that protect public investors, reduce the depth and liquidity of our markets, eliminate public markets for many securities, destroy the New York Stock Exchange as well as other exchanges, and undermine our capital raising system. It must be assumed that those making these predictions actually believed they would occur but we were not presented with economic theory or empirical information that would lead to such conclusions.

As we all know, the predictions went unfulfilled. On the contrary, the results were just what should be expected when competitive forces are released in an industry formerly characterized by administered prices. Some inefficient firms went out of existence or merged in order to survive. Others

became better managed, altered their business practices, offered new services, and became more competitive. The Commission's latest monitoring report shows that the securities industry has become more profitable, more stable, and better capitalized. In addition, more efficient trading mechanisms have been developed; the number of individuals investing in U.S. securities has increased significantly; individuals are receiving better brokerage service and more attention and investors have saved several billion dollars. Moreover, there is no evidence that meaningful research has been reduced or that depth and liquidity have been adversely affected or that public markets have been eliminated for the securities of any viable public companies.

Incidentally, prior to our deregulatory action in 1975, fixed commission rates on exchanges had caused a so-called third market in exchange listed securities to develop over-the-counter where lower net prices could be obtained. Instead of changing their operations to meet this competition, exchange representatives asked the Federal government to intervene with increased regulation to make such off-board trading illegal.

In 1977, the Commission proposed rule 19c-2, which would have removed regulatory restrictions that prohibit members from making markets in exchange listed securities other than on an exchange. This deregulatory proposal was successfully opposed by industry members who argued that such competition should not be permitted because markets would become fragmented, dealer markets with "in house" agency trades would supplant auction markets, bid and ask spreads would widen, markets would become less liquid and more volatile, small broker-dealers would go out of business, and exchanges would not survive. The industry's success in stopping this deregulatory proposal has necessitated much greater government intervention in market system developments to facilitate a national market system, as mandated by Congress, than would otherwise have been necessary.

In early 1979, the Commission proposed Rule 19c-3 so that exchange off-board trading regulatory restrictions would not be permitted to extend to newly listed securities which previously were traded in an environment free of such anti-competitive barriers. Industry participants opposed the proposal with arguments similar to those made with respect to proposed Rule 19c-2, including fragmentation, internalization, and overreaching in the absence of an efficient linkage between exchanges and OTC marketmakers or a system providing for automated execution of orders. The Commission was not persuaded and in June of 1980, Rule 19c-3 was adopted.

In February of 1981, in order to deal with fragmentation concerns and permit broker-dealers to seek executions of buy and sell orders in the best market, the Commission issued an order that an efficient linkage be established

between exchange and over-the-counter markets. This order, which was to become effective more than four years after we had indicated our intent to mandate a linkage system, if it was not established voluntarily by the industry, also was opposed by industry participants who would be exposed to greater competition and possible loss of order flow.

Options trading is another area in which the government has been requested to intervene with regulatory restrictions. Last September, opting for more rather than less government regulation, industry representatives asked the Commission to prohibit competition in exchange listed options on non-equity securities, such as mortgage backed securities guaranteed by the Government National Mortgage Association, Treasury notes, and Treasury Bonds. This, it was proposed, should be accomplished by granting exclusive franchises to individual exchanges rather than permitting competitive forces to perform the market allocation function. The primary basis for such requests was that competing markets result in duplication of costs and fragmentation of order flow. The SEC declined to grant their requests because experience indicates that market participants soon establish a primary market and we concluded that the Commission should not be in the business of allocating markets among exchanges.

I could provide many other illustrations of industry opposition to deregulation such as proposals to withdraw Glass-Steagall restrictions, various investment company requirements, and our involvement in shareholder proposal determinations, but let me conclude with some comments on private sector resistance to deregulation with regard to a rule proposed under the integrated disclosure project, which I mentioned earlier. As part of that package, the Commission proposed Rule 462A, which would permit the registration of securities that were to be offered or sold on a delayed or continuous basis in the future. Yesterday, the Commission adopted this as a temporary rule which has been redesignated Rule 415. The genesis of this rule was administrative practice that became necessary to provide issuers maximum flexibility for the timing of offerings.

In recent years fluctuating interest rates have resulted in brief "market windows" when it is most advantageous for issuers to offer debt securities. The Commission staff responded to this development with a policy which permits issuers and underwriters to file a registration statement on Forms S-16 and S-7 and go effective within a 48-hour period. To further accommodate the needs of issuers confronted with volatile markets, another technique was developed under which issuers are, in essence, able to go effective on demand. Under this technique, an issuer files a Form S-16 registration statement, receives a no-review letter from the staff in most cases, waits until market conditions are right and then requests acceleration, which is usually granted within hours. Thus,

virtually instant access to the market is available under present administrative practices.

After an exhaustive review of the policy underlying the Securities Act of 1933, the Commission stated in its proposing releases that "a restrictive policy on shelf registration is not appropriate or necessary for the protection of investors."1/ While the objective of this rulemaking was to provide maximum flexibility to issuers, it was, of course, necessary for the Commission to assure that appropriate investor protections would be present. Accordingly, the temporary rule provides for: (1) adequate disclosure, (2) updating to assure that the statutory time limits on liability provisions do not expire prior to the completion of an offering, and (3) staff review where necessary.

Versions of the proposed rule were exposed for public comment twice in the past 14 months and received overwhelming support. However, although the comment period ended in October, during the last few months and especially the last few weeks, the Commission received numerous requests from investment banking firms and some issuers to delay action on the shelf rule pending further study. They stated that the proposed rule had been viewed as a technical change to improve the efficiency of the registration process, but that they have serious concerns that it may produce fundamental structural changes in the capital-raising process. According to the sincere and strongly held views of these commentators, shelf registration could have an adverse impact on the market by, among other things:

-hampering the formation of fixed-price underwriting syndicates;

-jeopardizing the quality of disclosure and the ability of underwriting firms to perform adequate due diligence;

-permitting institutions to buy directly from issuers thereby accelerating the trend towards institutionalization of the marketplace;

-creating volatility in both primary and secondary securities markets; and

-impeding the ability of underwriting firms to compete for business as "managing underwriters" as well as the ability of smaller or regional firms to participate in the underwriting business.

1/Securities Act Release 6276 [December 23, 1980].

Due to the nature of these comments and the stature of those making them, the Commission determined that it would be appropriate to approve Rule 415 on a temporary basis so that the concerns raised could receive further study and evidence of adverse market effects could be offered in public hearings. It is important to understand that this deregulatory rule is permissive and does not require a reduction in the time period necessary to bring an issue to market. In the absence of evidence to the contrary, it is my view that if syndications are the most efficient method of raising capital, they will continue to be formed, either in the context of a traditional offering or in advance of a shelf offering. Issuers and underwriters can take whatever time they need to establish distribution plans or to perform due diligence investigations. If some are unable to do what is necessary quickly, they need not offer securities by means of shelf registration. If, as feared, institutions become more involved in the distribution process by purchasing securities directly from issuers, it will be because it is less costly or because they obtain some other economic benefit. Thus, such an occurance should not necessarily be cause for alarm.

The criticism that the shelf rule might bring about competing syndicates or a possible competitive bidding process for underwritings seems to suggest that the Commission should maintain proscriptive rules for the purpose of stifling competition and the resulting evolutionary market forces. We all should have learned long ago that such artificial barriers are neither desirable nor effective in the long run. In this regard, I was impressed with the candor of one small regional broker-dealer who stated that his request for the Commission to reexamine the proposed shelf rule was primarily motivated by his own selfish interest, but that he believed the rule might also have adverse consequences for the market in general.

I do not quarrel with the notion that change may result from the shelf rule, but I do question the magnitude of such change given present Form S-16 practices. The issue is whether such change is desirable, and perhaps equally important, whether regulations under the Securities Act, a disclosure statute, should be fashioned to favor one marketing method over another. There is nothing in the Securities Act that requires, or perhaps even permits, the Commission to use rulemaking to protect fixed-price syndication from other possible methods of securities distribution. Temporary Rule 415 will afford market participants the opportunity to choose the distribution method that best serves their individual needs. In my opinion, government should not be making that choice for them.

I hope my comments today have provided a new perspective on the difficulties faced by government agencies in their attempts to deregulate responsibly. My intent has

not been to single out the securities industry as being unique and I do not believe their arguments are without merit. Moreover, it is not improper for private parties to seek to influence government actions to conform with their interests. I have discussed securities industry opposition to deregulation because I am most familiar with it and because in some instances it has frustrated deregulatory efforts which I have strongly believed would be in the public interest.