GOVERNMENT-INDUSTRY RELATIONS

# SECURITIES AND EXCHANGE COMMISSION AND CORPORATE SECURITIES REGULATION

Address by

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There occurs in every business time for a thoughtful assessment of where you've been and where you're going. In most businesses, the close of the fiscal year represents a benchmark time--when it is convenient and appropriate to consider not only what the cold figures show concerning the past but also how the programs, the plans, and the relationships with people so crucial to progress can best be explained in a periodic accounting--a report of stewardship. Today--just a week from the end of our fiscal year and before this audience in particular--is a good time in our business to have a look, back to the near past and a look ahead in the general direction in which we seem to be moving.

Leaving aside some very important events which occurred but which may be viewed as aspects of ordinary operations and administration, the Special Study of the Securities Markets is the one event or activity which pre-empted our time, attention and energies during this past year. It is true, of course, that the Study had its origin in a joint resolution introduced in mid-1961. But it was almost the beginning of 1962 before the Special Study group of sixty-five people began to function as the well-knit, effective and coordinated investigative team it was destined to become.

At this time one year ago, the Commission had transmitted to the Congress the first installment of the report--five of thirteen chapters. The second installment of four chapters, to be transmitted in mid-July, and the final four chapters for delivery in August were still in various stages of preparation. Although there were certain unavoidable delays in printing, the entire report, consisting of thirteen chapters, together with a volume of the summaries and recommendations of the Study group and the various letters of transmittal are now public documents--available for purchase from the Government Printing Office at nominal prices.

It has been recognized as a remarkable work--thorough, objective and comprehensive--a valuable addition to our financial literature. In the language one sees in the theatrical reviews, it has received critical acclaim. Every lawyer, accountant, or businessman concerned with securities practice or the securities business should have a set. Every business school and law-school library should include it among their reference works. I do not intend to try to summarize the report or its major conclusions. It speaks for itself. Rather, I want to offer some personal observations about the chain of significant events engendered by two terse sentences of Section 19(d) of the Exchange Act the new subsection added to the statute as a result of H.J. Resolution 438 in 1961.*

At the risk of oversimplification, but to establish the general nature of the final conclusions of the Study group, couched in the language of your profession, I think it fair to say that the Commission, the securities industry and issuers of publicly held securities, i.e., industry

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* "The Commission is authorized and directed to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade. The Commission shall report to the Congress on or before April 3, 1963, the results of its study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable."

generally, received something less than a "clean certificate" and something more than a "comfort letter."

Again at the risk of oversimplification but to pay a tribute to the originating resolution and the nature of our system, one of the prime benefits of the Special Study is not to be found in the report or in the content of any other document published before or after it. In brief, that benefit was and is simply that many thoughtful, experienced, caring people in many walks of life recognized the fact of the resolution and the Study as a demand for reassessment and a call to action. Thus, the Special Study prompted many special studies in many places around the country. Industry not only announced publicly its intention and desire to cooperate with the Study group; it discharged that commitment fully. Further, it anticipated some of the predictable critical conclusions later to be reached by the Special Study and recognized other subjects as likely candidates for identification as problem areas. Long before even the first chapters had been delivered to the Congress, there was an evident awareness on the part of the leaders of the securities industry and a swelling tide of sentiment among the self-regulatory instrumentalities that responsibilities must be re-thought and the public interest served. One illustration of the genuineness of that sentiment was the sustained and thorough efforts of industry leaders in mustering vigorous, articulate support of the members of the exchanges and the NASD for the Commission's legislative program now awaiting action in the House--a program fully supported and justified by the data compiled by the Special Study and the Commission's experience over the years. Another is the fact that many firms voluntarily reviewed and modified their internal procedures, and the NASD and the exchanges accelerated and improved some of their programs relating to qualification and supervision of personnel and the controls over sales practice and sales literature.

The conduct of the Special Study generated severe pressures on the limited personnel of the Study group, upon the senior members of our regular staff and upon the Commission itself. The magnitude of the effort, the volume of material handled, the tremendous amounts of reading and discussion and commentary, the flight of time and the scope of subject matter all tended to blur an extremely significant fact. The fact was and is that the Study was the finest opportunity in thirty years for the Commission and industry to discover and ponder many things about our securities markets and securities business. The Commission learned about many aspects of the business which it encounters rarely or not at all in its day-to-day work. The Commission was confronted with the manifold problems and responsibilities of the self-regulators in a manner and to a degree virtually impossible in the ordinary course of administration arid enforcement of the securities laws. Equally important, industry had the opportunity to learn much about itself which had not been known generally. Thus, while some segments of the business knew their own fields very well, many knew little about the specialties of others. Only a relative few had the broad knowledge and experience flowing from familiarity with the whole sweep of the securities business which would encourage one to speak with assurance and authority for large industry groups.

The Special Study and the need to communicate concerning it--its specifics and its implications--initiated--in fact compelled--a tremendous education process within government, within industry and between government and industry. This process is one of the most important end products of the entire operation. It began early, has continued in good faith, and must

continue long into the future. It reminds one constantly that for all our capability for instantaneous transmission of words, we have yet to solve the problem of effective and rapid communication of facts and ideas. The complexity of subject matter, the diversity of interests, the constant development and changes, the dispersion of the population concerned with the particular problem, all prompt concern whether communication, results in comprehension. This is difficult at best when there is trust in motive and confidence in purpose. It becomes troublesome indeed if there exists distrust or doubt concerning what is said or what is done. But the process must go on. I--who am not one given to volubility--believe that we must keep talking. For reasons which are not always obvious to business or the ordinary citizen but which are important to our system of regulation, the various observations, conclusions and recommendations of the Special Study must receive the careful work and thought of those best able to judge them and their relation to the public interest. They may be accepted, modified, rejected, deferred or subjected to further study, but they must be dealt with. A record must be made and decisions reached. The Study deserves this. Common sense and good management call for it. Congress will demand it.

The Special Study criticized much of what it saw. One of its purposes was to probe, and probe deeply, to ascertain whether there was much or little which seemed to call for critical comment. But its main theme, in my judgment, cannot be characterized either as praise or censure. It was a sober, intellectually honest evaluation of what was recognized to be a most sensitive and efficient system of marketing and trading in securities--participated in by a whole people, to a degree not known elsewhere and regulated by a system entirely unique. Certainly there can be no doubt that the Study group confirmed the wisdom and in general the effectiveness of the regulatory scheme reflected in the various securities acts adopted by the Congress beginning with the Securities Act of 1933. This confirmation, I believe, judging by the House and Senate Reports on the pending legislation, has been a source of no inconsiderable pride and satisfaction on the part of our legislative committees. This regulatory scheme, as you know, relies heavily on the discipline of public disclosure of business facts, the willingness of businessmen to establish their own standards of ethical conduct, and the willingness of businessmen to enforce not only their chosen ethical standards but also legal standards established in the statutes--through self-governing self-regulatory institutions. It is significant, I think that the Study, in making recommendations designed to strengthen and broaden the concepts of disclosure and self-discipline, did not propose changes in the nature of the regulatory pattern which would in any real sense alter the character of the relationship in this field between business and government; i.e., the Commission, spelled out in the statutes thirty years ago. In other words, our regulatory tools are, on the whole, satisfactory. They must be employed wisely and as completely as the particular public interest requires. In many areas they roust be employed more vigorously, or in a different way or with modified objectives. In some instances they must be employed to deal with subject matters not heretofore reached by the regulatory or self-regulatory restraint.

The Study group, in emphasizing throughout the report the self-regulatory aspects of our system, was merely reflecting with great magnification the specific provisions of the joint resolution. This emphasis produced, in my opinion, a side effect throughout the financial community which was to the good. We of course have known in a general way of the work done by the committees of the National Association of Securities Dealers, the Investment Bankers

Association and the stock exchanges. But the Study, for the first time, I believe, gave the people intimately connected with the business and who knew at first hand the details and specifics of the problems of self-regulation an opportunity to speak out on subjects of concern to them--subjects as to which many were experts. More important, they spoke with an opportunity to be heard effectively--heard by government--heard by their fellows under circumstances which encouraged action.

Some were staff people attending to specific jobs. More often they were businessmen-volunteers who applied their time, judgment and experience to knotty problems of self-regulation--discipline of fellow businessmen, rule-making, policy matters, education, business standards, training of personnel, sales practices. They had convictions, ideas and concern about the securities business. They reflected an awareness of an aspect of their position which is receiving more attention around the country than ever before. The stock exchanges and, to a somewhat lesser degree, the NASD (the only registered securities association) are the possessors of delegated governmental powers of no mean scope. The Congress intended that that delegated power be used. There is nothing quite like Congressional oversight--the Special Study is a not so oblique species of that phenomenon--to cause the holders of government power and government responsibility to review their own conduct and their objectives. It seems to me that the membership has demonstrated a growing awareness that, as businessmen, they have a very special relationship to their government and to each other and a very special interest in seeing to it that this system of ours works and works well.

These volunteers, who served on business-conduct committees, for example, during the somewhat frenzied days of 1960 and 1961, developed, unaided by anyone in the Commission, firm convictions derived from their experiences in committee work that unlimited access to the securities business was not in the interest of the investor or the good name of their industry. The reaction of NASD Committee No. 12, as expressed in a formal resolution dated January, 1962, is eloquent. In part it states:

> ". . . We have had to deal with an increasingly high rate of influx of proprietors, officers, partners and other personnel who are unqualified by reason of lack of proper, moral attitudes, inadequate training and experience and insufficient capital funds; ... the Business Conduct Committee in this District has found it increasingly difficult within the present framework to enforce high standards of commercial honor and just and equitable principles of trade in such manner as to adequately protect the public interest . . . this . . . Committee strongly urges the Board of Governors . . . to provide for the establishment of a more rigid set of qualification standards in the area of character, experience and financial responsibility, preferably as a prerequisite to membership and/or registration."

An important aspect of our pending legislative program responds to this plea. In fact, the principles underlying the pending bill, their virtually universal acceptance by the securities business, their time-tested soundness have been so well demonstrated that we have high hopes that the operation of the proposed legislative amendments will have a beneficial impact upon the

securities business and the processes of regulation and self-regulation far greater than might at first glance appear.

It is easy for the scoffer to say that the SEC merely wants more reports and more power and thus brush the matter aside as another example of unwanted bureaucratic intrusion into private affairs. The Commission and the industry have been saying earnestly and with the voice of a joint, though somewhat different, experience that acceptance of this view would fail to grasp the magnitude of the potential for development of our securities markets. Essentially, the bill is aimed on the one hand at granting the NASD adequate authority to raise the quality and capability of those who seek to enter the securities business--to give an assist to a growing awareness of the need for a professionalism, if you please. On the other hand, the bill is aimed at making certain that a reliable security dealer can know his merchandise in the over-the-counter market, that he can have at hand reliable information as a foundation for reliable advice to his public customers.

One of the great opportunities and contributions of the Joint Resolution and the Special Study was the search for the dimensions, characteristics and operational techniques of the over-the-counter market. I think, for the first time, we now have a solid basis of fact and informed judgment based upon a really comprehensive survey which can be employed to advantage to construct a more efficient, reliable and quality system in over-the-counter securities. It is interesting, I think, to note that those who worked on the Exchange Act in 1934 realized in a general way that over-the-counter securities somehow should receive a rough sort of equivalence of treatment with listed securities. This was reflected in the peculiar language of old Section 15, which in effect provided that it would be unlawful, in contravention of rules of the Commission to insure to Investors protection comparable to that provided in the case of the exchanges, for a broker or dealer to make or create a market for an over-the-counter security or for any broker or dealer to use any facility of any such market. The section continued--authorizing such rules to provide for the regulation of all transactions by brokers and dealers on any such market--the registration of brokers and dealers making or creating such a market--and, please note, providing for the registration of the securities for which they make or create a market.

This section was dropped in its entirety when the Maloney Act was adopted in 1938 establishing the statutory basis for the development of the NASD as the great self-regulatory mechanism for the non-exchange part of the securities business. And of course there was no provision in those 1938 amendments for the registration of over-the-counter securities. But the principle was recognized in 1934 that regulation of the securities business could not proceed effectively and equitably with one part of the market carefully supervised from the point of view of the facts concerning the securities traded and the other part of the market free to operate in an informational dark of the moon. In looking back over the history of our legislation, it seems to me that the odd result reached in 1938 in this respect was probably due to two or three factors. I believe I am right in saying that there then was not nearly the activity or the interest in, or knowledge of, the over-the-counter market as compared with the exchanges. I think there probably were doubts as to just how to develop a suitable regulatory pattern for this then-little-known business. Finally, I think that this subject, like many others referred to in the ‘34 Act, was left for the Commission to learn from experience and to come forward when a need was established or a solution to a problem called for a legislative response.

Sixty-five years ago--thirty-five years before the Exchange Act--the New York Stock Exchange initiated a procedure requiring companies making applications for listing their securities to enter into a listing agreement with the Exchange by which they commit themselves to a code of performance after listing in respect of matters dealt with by the agreement. One of these, in the words of the Exchange, "represented the Exchange's effort to satisfy, by a formal requirement, a public need which it had long recognized, but which its previous unsupported efforts had been unable to fill--the need of investors for regular financial reports by the companies whose securities they held." A primary objective of the agreement was, again in the words of the Exchange, "Timely disclosure, to the public and to the Exchange, of information which may affect security values or influence investment decisions . . ."

This conclusion, so obviously right at the time of the Spanish-American War with respect to listed securities, is also obviously right in this day of Telstar, Polaris, backward-wave oscillators and yttrium iron garnet-tuned parametric amplifiers, with respect to the over-the-counter securities; if anything, more so.

The over-the-counter market has come of age; it is of tremendous size and importance; the public participation and direct and indirect public interest in it are growing. We depend on it for skillful, efficient marketing of new issues, for the seasoning process that every market must experience as a security finds its place among its fellows, to be judged in terms of price and volume by the flow of supply and demand.

The Special Study spells these matters out in detail, it arms the industry and the Commission with a sound knowledge, it confirms the wisdom and rightness of the Stock Exchange in 1899, the Congress in 1934 and the Commission's recommendations on the subject to the Congress on three prior occasions. Today, with solid support from the entire securities industry, we stand on the verge of completing a program almost but not quite consummated thirty years ago.

We have high hopes for this two-pronged advance. A better and more comprehensive flow of timely and reliable financial information from over-the-counter companies is bound to be beneficial to the investor and would-be investor. It will enable the broker-dealer to do a better job. It will facilitate the enforcement efforts of the Commission, the self-regulatory institutions of industry and the state securities administrators. It will give greater meaning to the other effort being made--the development of a quality and professionalism in the business which I think will come to have growing significance.

The Special Study and our efforts flowing out of it come at a critical time in the development of our economy. The report touches subjects which, clearly are undergoing or will call for great change.

The security-owning population is growing--it is anticipated it will exceed twenty million before long. It will make a great difference how that growing population finds its way into such ownership--directly through ownership of corporate securities or indirectly through ownership of intermediary agencies which will hold the corporate securities.

It seems quite clear that new competitive forces are at work. The banks are pressing for participation in various aspects of the securities business. The insurance companies have already pressed forward. The competitive struggle between the institution and the broker-dealer and the problems of the third market, it seems to me, are bound to intensify.

No one knows what automation will do in the securities business. The concensus seems to be that it will do much and its effects over a period of time will be far-reaching.

Indications point to tremendous growth in population in the years ahead, the need for a concomitant growth in industry and a corresponding capital market of quality, depth and receptivity to provide the monetary lubricant which keeps all this intricate economic machinery operating smoothly.

We cannot foretell precisely our own role or that of the securities industry in the evolution ahead, but our experience tells us that enforcement of the law, maintenance of public confidence and the flow of capital in both the new-issue market and the trading markets are best achieved with a market place bottomed on reliable information and operated by skilled, adequately capitalized, reliable investment houses.

A number of other developments are occurring which I think augur well for the future--developments which reflect an awareness on the part of various groups around the country of the importance of some of the matters I have mentioned to the well-being of the many aspects of our financial system.

The NASD and the exchanges have been working for some time to improve examination procedures, sales practices and sales literature and to establish qualifications for entry into the business which give recognition to functions.

Within the past year an advisory group of the Public Relations Society of America, Inc., has worked together and to some extent with our staff in a considerable effort to establish a Code of Financial Public Relations. In commenting to the president of the Society last December, our Chairman stated:

> "By adopting this Code, the Society--like a number of other unofficial self-regulatory groups in other areas--has expressed recognition of its responsibilities to the public. I am sure that the Society understands, however, that the new Code is merely the foundation for a program of self-regulation and not in itself a complete program. In the last analysis, the Code will have to be evaluated in the light of the level of conduct which it inspires or commands.
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> "I trust that the Society will build on this necessary foundation and enhance its efforts to achieve a level of practice in financial public relations consonant with the needs of investor protection."

The Financial Analysts Federation, an organization of some 7500 members in twenty-eight constituent societies in major cities of this country and Canada, has embarked on a very

fine program which should receive the support and commendation it deserves. Under its auspices, the Institute of Chartered Financial Analysts was organized in 1959. It has fostered an educational program and established examination procedures by means of which those who qualify by study, and demonstrate fitness by meeting the required standards, can become Chartered Financial Analysts. The Federation, which has a real interest in the objectives of our legislative program, has given it their full endorsement and support.

Recently it came to my attention that a new organization has been formed which, in my opinion, has a real potential for public service. I refer to the recently organized Society of American Business Writers. This group, which was originally proposed some four or five years ago, is reported to have, ninety charter members representing leading publications throughout the country. In my judgment, this group, which named as their first president one of our leading financial writers, should be encouraged and supported.

The state administrators continue their efforts to advance their programs of investor protection though they continue also to labor under severe handicaps of budget and personnel limitations. We have had occasion before to comment on the improvement in annual reports and corporate publicity.

In other words, there are a lot of people working in one way or another at various activities which are aimed at or collaterally affect the better working of our securities markets.

This leads me to observe that the Special Study did less than it might well have done in the matter of assessing the role of your profession in our business. I believe I am correct in saying that there is no specific reference or comment directed at the accountants. But in a real sense there is high praise in the report for the corporate financial officers and the independent public accountants, if you know where to look. The report made no particular effort to praise anyone, I think on this occasion I am permitted a freedom of expression above and beyond that usually found in "official" reports, and accordingly I will interpret.

In Chapter IX, the Special Study observes that "Disclosure is the cornerstone of Federal securities regulation; it is the great safeguard that governs the conduct of corporate managements in many of their activities; it is the best bulwark against reckless corporate publicity and irresponsible recommendation and sale of securities." In Chapter XII, the Special Study notes the Commission's "marked success" in administering the disclosure provisions for issuers.

Fair, adequate, understandable disclosures under these acts begin with the corporate accounting records and the financial statements synthesized from them. Almost everything else to be said about a company and its securities either affects or explains---finds cause or effect in the profit and loss statement and the statement of condition. In a very real sense the accountants are the unsung heroes of many a corporate drama and many an actor on the corporate stage cannot play his more dramatic part until the less spectacular work of the financial officer and accountant has arranged the scenery and perhaps established the basic theme.

Only we who live with these statutes can fully appreciate the extent to which, in the evolution of our regulatory scheme, we have relied upon the accounting profession to establish

standards and to apply them or the extent to which the accountants' work has influenced administrative policies generally. This reliance furthermore has been at the profession's invitation.

With statutory authority reposing in the Commission to prescribe--to require--to dictate by rule how financial statements should be prepared and presented, the Commission very early in its life, at the request of the profession, stood aside and not only withheld governmental action but actively encouraged the full self-development of the initiative sought to be exercised. The wisdom of that regulatory decision and the soundness of the administrative trust thus demonstrated really have never been seriously questioned. For twenty-five years it has been the exceptional situation which prompted the Commission to speak directly by rule on matters of accounting principles.

The profession thus has performed an important role as a self-regulatory institution. Although it is not the holder of delegated governmental power, as is the NASD or the stock exchanges, its accomplishments are a credit to volunteer activity--shaped by general statutory principles--which achieve a species of compulsion without the customary trappings of the compulsory process.

We have a continuing interest in the viability of this effort--this process, or however it should be described. Speaking for myself, it is better, I think, to have some of the looseness--the creaking joint, if you will--some sacrifice of the ultimate in consistency and uniformity and acceptability under such a system than to seek the rule--government or industry inspired--which either binds people to a rigid conformity or sets up a standard from which departures multiply in achieving solutions to problems. How many remember the two dozen or more exceptions from the rule for the use of old Form A-2 under the Securities Act which evolved over a period of time until the form itself was abolished?

We thought the dismay with which our reaction to the investment credit episode seems to have been greeted, in some quarters, most unfortunate. We intended no rebuff to the profession or the Accounting Principles Board. On the contrary, we have encouraged and continue to encourage them in their work. We would caution, however, against the profession undertaking to do what you have always pleaded that we not do.

We know from long experience that even a relatively simple matter such as our Rule 14a-3, which in effect says a company's financial statements in its annual report to its stockholders should not be inconsistent in any material way with the financial statements filed with us, becomes an extremely difficult and protracted exercise in rule-making and in fact somewhat contentious. The task you set yourselves to force conformity on matters of accounting principle when there is not in fact acceptability of conformity, I think, is an impossible one. In any event, such a step calls for full exploration of problems and procedures. But this view in no sense reflects upon the efforts of those dedicated, highly intelligent and articulate public-minded members of the profession who vigorously urge more, and more penetrating, research and who constantly seek to narrow differences and, where possible, broaden the scope of that which is truly "the acceptable" of the profession. We salute them and their efforts.

Those who wish to compel conformity--or rather seek to have us compel conformity--for only we in the final, analysis have the tools to enforce the law or to set enforcement in motion--will no doubt be less than happy with this approach. What then are we left with, say they, except education and persuasion?

The short answer in our field of activity, I think, is that these have been the principal tools by which so much has been and continues to be accomplished. They have been the genius of the administration of the disclosure provisions of the '33 and '34 Acts. With your continued assistance, I think they are likely, in major respects, to remain so.