NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR 12:00 P. M. RELEASE, MONDAY, JUNE 10, 1974

THE SEC IN THE MIDST OF REVOLUTION

An Address By

A. A. Sommer, Jr., Commissioner

Securities and Exchange Commission

New York Stock Exchange
Marketing Conference:
"Securities Industry Revolution"
New York Hilton, New York, N.Y.

June 10, 1974

THE SEC IN THE MIDST OF REVOLUTION

A. A. Sommer, Jr.
Commissioner
Securities and Exchange Commission

That there is a revolution going on in the securities industry is beyond question. Revolutions are characterized by deep and quick change and surely that is now occurring in the industry. Another characteristic of revolution is the unpredicability of the outcome and the fate of the participants. Out of the French Revolution emerged a Napoleon, a most unexpected consequence; in the course of it Robespierre and those who expected to emerge on top perished.

The revolution in the securities industry probably will share these characteristics, too. Some confident of their survivability may economically perish in the course of it; others who view their future bleakly may prosper and ultimately triumph. It is probably now too soon to say who will be in which category, even though most of us probably have some hunches about the outcome.

The role of the regulator during the revolution and its role in the post-revolution world is a matter of some moment, not only to the regulator, but to those regulated as well. If the regulator manages to maintain some semblance of its authority through the revolution, in some measure it may determine the shape of the post-

---

* The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

revolution world. But it is not unknown that the regulator undergoes change, sometimes radical, in the course of the revolution. And such may be the fate of the Securities and Exchange Commission.

During the post-1933 period the Commission began to reach maturity somewhat conventionally. Like most independent regulatory agencies it did the expected things: it made rules to govern the securities industry and investment companies; it brought actions to enforce the laws entrusted to it; it conducted administrative proceedings looking to the discipline of those over whom it had regulatory powers. During this time, the Commission had its critics: some charged it occasionally with excessive rigor, others with undue torpor; during that time I think it generally escaped the charges leveled at many of its regulatory brethren that it had become the captive of the industry it was assigned to regulate. But during this time no one seriously suggested that the whole role of the Commission needed revision, that perhaps a differently constituted and differently empowered entity was called for.

Those calls for change have now been made - and that is not surprising given the times. It has been suggested that the Commission's regulatory role should be modified to include a mandate to act in defense of the securities industry, to shore it up in troubled times. It is suggested that perhaps the Commission's composition should be different, that perhaps it should be given powers to function somewhat like a public utility commission, adjusting rates to assure profitability in good and lean years.

I would not demean or denigrate the sincerity of these proposals. I would, however, question their timeliness and their present practicability. I think they underestimate the flexibility of the present structure and its ability to ride through and perhaps moderate the storm that envelopes the industry.

In the past - say, pre-1970 - the Commission did not attempt significantly to alter the structure of the industry. Largely it took the industry as economics shaped it and sought to regulate conduct within that framework so that the activities of those functioning within the structure did not abuse the public interest, the integrity of markets, the interest of the investing public.

As the economics of the industry began to change markedly, faster than ever before, the Commission's interest quickened and it re-examined its role. Evidences mounted that the old system of fixed commissions was suffering from all the evils that historically have characterized cartel conduct: evasions, side deals, economic distortions. These occurrences were witnessed by the anti-trust authorities and by powerful elements within the industry. The institutional investor emerged increasingly as a dominant, if not the dominant, market force. The old structure began creaking, rends appeared in historical fabrics, and it became evident that the old ways of doing business could not long endure. The question became not whether far-reaching change would occur, but when, after what upheavals, under whose aegis? Should the emerging forces be permitted to work themselves out within an industry rarely characterized by unanimity of view over God knows what time frame and in God knows what manner? Or should an effort be made to order the emerging forces in a rational manner and do it within a tolerable and reasonably prompt time frame?

As you know, half of the Commission's advisory committee on a Central Market System opted for the former course, half for the latter. The Commission chose the latter.

Notwithstanding this choice by the Commission, it has been solicitous of the views of the industry. Early in the discussion of a central market system it sought industry thinking through an advisory committee. Through Rule 17a-15 it elicited from the industry a plan for the development of the consolidated tape. To carry forward the next step it has organized an advisory committee and given it a broad charter to participate in the development of suggested solutions for some of the troublesome problems posed by a common quote system and the regulatory necessities posed by that. It has stimulated, but left essentially to the industry, resolution of the costly multiplicity of clearing and settlement systems.

It chose the activist role, I can assure you, not out of any desire for bureaucratic empire-building - all those on the Commission when the Commission first mentioned a central market system in its covering letter to the Institutional Investor Study are gone and those now there will probably be only pictures in the reception room when the concept is fully realized - but rather out of the belief that these reforms will not only serve investors, but will ultimately make for a healthier and sounder industry.

I suppose it is somewhat Marxian to suggest that people don't bring on revolutions, but rather economics do. Marxian or not, I think that is true. The Commission did not bring on this revolution, the New York Stock Exchange did not bring it on, William McChesney Martin did not bring it on. Simple economics brought it on and in

some measure institutions like the Commission and the Exchange are simply the conduits through which this has been articulated and like it or not they are the ones which have to both ride the torrent and try to tame it.

It has been said that it is unfortunate that the revolution did not occur ten years ago when the economics of the industry could absorb the shocks of it better. That may well be, but the historic fact is it is happening now and the unfortunate fact is that it is occurring when the industry would be in a state of shock were there no revolution - again because the economics of the industry have changed so radically for reasons that have their basis in national policy, world trends, human psychology as well as in the fruits of past practices.

What can the Commission do to help the industry? I don't think it can or should turn the clock back on negotiated commissions; I don't think it should permit resumption of customer-directed give-ups (they pretty much become historical freaks anyway in an era of negotiated commissions); I don't think it should abandon the effort to rationalize the market in a manner that is responsive to economic forces. And I don't think any of these retreats would over the long run help the industry.

I think the Commission, whatever its shortcomings, will be here through the revolution; it is too much to expect Congress to make the changes suggested unless a far more compelling case of our inadequacy can be made than has been made. Yearning for a new regulator can only delay the pace and sureness of beneficial change. And I think that, if anything, the Commission should take an even stronger role of leadership

in bringing about the conclusion of the revolution. If the movement toward the composite tape and quote systems falters, it should move aggressively within its present powers and those Congress may give it to bring them into existence at the earliest possible moment. If the effort at comparable regulation of comparables slows, then the Commission must move strongly. If the commencement of negoiated rates combined with the continuation of fragmented markets threatens the auction process, then the Commission should do whatever it can to assure the continuation of the auction process until the central market system, with its emphasis upon the discipline of competition, can do the job. Nothing in my estimation can do more harm to the securities industry than unnecessary prolonging of the uncertainties that now shroud it. These uncertainties confuse planning, postpone needed financial commitments and deepen the pessimisms of people. Chairman Garrett recently quoted Clausewitz that the worst enemy of a good plan is a perfect plan. Waiting for the perfect plan or complete consensus can only hurt this industry.

I know there are many who think this Commission role and these initatives endanger the industry. None of the Commissioners and none of the staff expect or want the role of undertaker to this magnificent industry. We don't think we will be. But I do think that while we must press forward toward greater competition and the central market system we must also be alert for opportunities to strengthen the industry, to protect it from unfair competition, and perhaps, at least in the short term, provide some shelter perhaps not fully economically justified.

One area in which something might be done to cushion the shock of this revolution occurs to me: that is the permissibility of institutional investors paying more than rock bottom execution prices in exchange for which they receive services in addition to execution, particularly research. I understand that the counsel of many institutions have indicated to their clients that this practice might be questionable and subject them to liability to the beneficial owners of funds they invest.

Like just about everything else in the securities industry this problem is complex, multi-faceted and not easy of resolution; furthermore it is caught up in broad considerations of desirable social and economic policy. Addressing the latter first, it seems to me that individual investors, if they are to return to the market, must be encouraged to avail themselves of the research resources which the securities industry has so expensively and in the overwhelming number of instances, so well developed. If institutional investors are not legally able to purchase services with "soft dollars" and if they are, as many have indicated they would be, opposed to payment for such services with "hard dollars", then it seems to me clear that the research capacity of which the individual investors are perhaps incidental, but nonetheless important, beneficiaries, may be substantially reduced. In that case those principally harmed would be the individual investors since, unlike the institutions, they do not have the "in-house" capacity to conduct their own research.

I think this would be an extremely unfortunate result. The question is, how to avoid it?

Our staff is presently investigating various aspects of this problem. The objection to this practice, of course, is that the managers are compensated in their fees for research activity and they should not be permitted to, in effect, charge the fund a second time for the same service by using the fund's resources to purchase advisory services which have already been once bought. But I would suggest without taking time for full discussion that may not upon analysis be the fact. If we so conclude, then it would appear that perhaps we have the power to abate the concern that the managements of investment companies may have with regard to this matter. Beyond that I have serious question whether the Commission has the power to impact the responsibilities and the powers of fidiciaries who operate under state law, for instance, bank trust departments, and those which operate in a different regulatory context, such as national banks and insurance companies. Nonetheless, I think it behooves all of us to explore as fully as we can what means might be used to preserve a tremendously important research capacity which I think in the future will be if anything even more important to the market than it ever has been in the past. As you probably know, one of the legislative proposals pending in Congress would, in certain circumstances, permit the use of Commission dollars by investment companies and investment advisors, to compensate for research. The Commission has suggested that this provision be expanded to permit such use in exchange for services in addition to research.

I would hope that counsel for fidiciaries and others who invest institutional funds would explore the possibilities anew that by means of contractual relationships and other devices the perils

which they see might be reduced or obliterated and perhaps in the course of this reexamination they would conclude that perhaps their caution was excessive.

As the gloom deepens in the industry, and as the economic plight of the industry becomes of ever greater concern, it may be that the industry should frame a legislative program that is frankly protective over the short term. Tax benefits, clearer indications of a line across which other financial insititutions may not cross, measures to entice the investor into the market through capital gains reform could be parts of it. Any such proposals should in my estimation be teamed with a final, resolute abandonment of the anti-competitive practices which have concerned Congress and the Commission. It might sell.

Revolutions are harsh. They leave nastiness in their wake, the revolutionaries fall out one with the other. They often end with a strong man in the saddle. I don't think that is the way the industry wants this revolution to end. I hope it doesn't either, because that strong man will be government, more of it than you will find comfortable once the revolution is over.