SECURITIES INDUSTRY ASSOCIATION
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August 3, 1983

Task Group on Regulation of
Financial Services
Department of the Treasury
15th Street and Pennsylvania Avenue N.W.
Washington, DC 20220

Dear Sirs:

Re: Federal Regulation of the Securities Industry

The Securities Industry Association ("SIA")1/ appreciates this opportunity to comment further on the request of the Office of the Vice President's Task Group on Regulation of Financial Services ("Task Group") for comments concerning its study of the problems of the existing system of federal regulation of financial institutions and services.2/ SIA submitted a letter on April 4, 1983 and this letter is a supplement to address specific industry concerns regarding the impact of federal laws or regulations on the conduct of the securities business.

1/ The Securities Industry Association is the trade association representing over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types -- investment banks, brokers, dealers, and mutual fund companies as well as specialists and other firms functioning on the floors of exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

2/ 48 FR 5704 (Feb. 7, 1983)(the "Release").

I. Options Disclosure Document

The Securities and Exchange Commission ("SEC") recently changed its rules to permit the sending of a disclosure document to persons opening an option account in place of the Options Clearing Corporation prospectus. This was done to allow the investor to obtain a simplified document explaining the mechanics and the risks of options trading without the burden of digesting many pages of highly technical details of the mechanics of the Options Clearing Corporation. This reform had long been sought by SIA and was also recommended in the SEC's Special Study of the Options Market ("Special Study"). However, in adopting the new rule,3/ the SEC did not precisely follow the recommendations of the industry or its own Special Study. Instead of providing for one disclosure document that would be general in its description and encompass the risks and uses of all put and call options, the SEC requires multiple disclosure documents that are detailed and which refer specifically to particular types of options. This multiplicity requires that options clients receive several disclosure documents as they become engaged in the trading of various forms of options. This was not the intention of the Special Study and most certainly it was not the intention of the industry. The purpose of the disclosure

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3/ SEC Release Nos. 33-6426 and 34-19055 (September 16, 1982); see also SEC Release No. 34-19192 October 29, 1982).

document was to reduce unnecessary paperwork. The creation of a variety of disclosure documents has only increased it. SIA recommends strongly that the original concept as outlined by the Special Study4/, that there be only one general disclosure document, be implemented.

II. The Racketeer Influenced and Corrupt Organization Act ("RICO")

RICO was passed in 1970 as part of a massive piece of legislation attacking organized crime. One of its provisions permits private litigants to commence civil suits for violations of RICO and to recover three times the damages sustained as a result of those violations. Unfortunately, the courts have interpreted the vague wording of this statute very broadly. This broad interpretation has resulted in a number of garden-variety disputes between broker-dealers and their customers to be complicated by the presence of a separate allegation of a RICO violation being added to the substantive charge. This has created much confusion in the courts and certainly has subjected legitimate businesses to complex and degrading litigation which could never have been the rational intention of the proponents of this statute. The civil remedy provision of RICO reads as follows: "Any person injured in his

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4/ The Report of the Special Study of the Option Market, Ch. V, p. 90.

business or property by reason of a violation of Section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit including a reasonable attorney's fee."5/ Section 1962 prohibits among other things, the operation of a business through a "pattern of racketeering activity." Section 1961 of the Act defines a pattern of racketeering activity as at least two acts occurring within 10 years of each other of any of approximately 50 different offenses, one of which is securities fraud. Because of the peculiarities and technicalities of the federal securities laws, ordinary contract disputes between brokers and their customers are elevated into the realm of "fraud."

There are two possibilities for correcting the increasing abuses of this law. One would be a statutory amendment permitting a civil recovery to any victim of RICO against someone who has been convicted of violating the statute. This would assure that only those who were truly victimized through racketeering could avail themselves of the remedies provided by this statute.

A second approach is to amplify the concept in Section 1964 that the person must be injured "by reason of a violation of Section 1962." The main source of confusion in the civil cases to date has been that some courts have

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5/ 18 U.S.C. §1964(c)(1970).

permitted recovery when there was a showing of injury resulting only from the underlying offenses. The victims of these underlying offenses have civil remedies available to them under other provisions of federal and state law. It should be fairly obvious, though it has not been to some courts, that a plaintiff has the burden of showing an additional level of injury to qualify for the additional civil remedies bestowed by RICO. In other words, a RICO injury has to be over and above the underlying injuries, and separate damages must flow from the racketeering activity itself. To express this more clearly than does the current formulation of the statute, the following is a suggested alternative amendment to Section 1964(c):

> (c) Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee. <u>The civil right and remedy set out in this subsection (c) is available solely to redress injury to a person's business or property resulting from a violation of section 1962 of this chapter. To the extent that any such injury is also caused by any of the acts or offenses referred to in subsection (1) of section 1961 of this chapter, any person so injured may not sue therefor pursuant to this subsection (c) and is limited to such civil right or remedy as may be available other than pursuant to this subsection (c) to redress such injury.</u>

SIA recommends very strongly that the spate of vexacious litigation spawned by the improper application of RICO be stemmed by Congressional action.

III. Dual Registration of Broker-Dealers as Investment Advisers

As the term investment adviser is defined,6/ there is an exemption from registration as an investment adviser for "any broker-dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." There are other exemptions from registration in this definition that are not qualified by the underlined portion of the above quotation. For example, there is an exemption for "a bank or any bank holding company...which is not an investment company." There is also an exemption for any "lawyer, accountant, engineer or teacher whose performance of such services is solely incidental to the practice of his profession."

The most essential and important aspect of a broker's service to his clients is the advice and portfolio management which is given to the customer. It is an incidental part of the services performed by a broker-dealer. There is no justification for the qualification of the exemption given to broker-dealers. It makes no sense to exempt a bank, a lawyer or an engineer outright, without any qualification, and then to qualify the exemption given to brokers

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6/ Invéstment Advisers Act of 1940 §2(a)(11), 15 U.S.C. 80b-(a)(11)(1940).

who, after all, are already registered with the SEC. The sole purpose of the Investment Advisers Act is to require that certain people, who render investment advice, register with the SEC and become subject to its jurisdiction. Broker-dealers are already subject to the jurisdiction of the SEC, since they must register as broker-dealers. On the other hand, banks, lawyers and engineers are not registered with the SEC. The SEC can very well regulate broker-dealers under existing rules pertaining to broker-dealers. There is no need to require broker-dealers to register a second time as investment advisers. This only duplicates paperwork and creates unnecessary costs for the broker.

All of this was made more illogical on May 1, 1975 when fixed commission rates were abolished. Since commissions are now negotiated, the phrase, "no special compensation" is difficult to define and understand. The whole concept of "special compensation" was based on the existence of fixed rates.

Many of the sections of the Investment Advisers Act, and the rules promulgated thereunder are specifically directed at people who manage other people's money, but who do not carry accounts and maintain custody of customers' securities as do brokers. When these specific rules, regulations and laws are applied to broker-dealers, the result is an unduly cumbersome and complicated duplication of regulation. Added to this is the fact that a broker-dealer that is forced to register as an investment adviser under the federal act is automatically obligated to register with states which also have separate investment adviser registration requirements. All of this could be avoided by an amendment to the definition of investment adviser eliminating the phrase "and who receives no special compensation therefor." This simple change would effect a broad reform without lessening the SEC's ability to regulate broker-dealers and all of their activities.

This improvement would be consistent with points made in the April 4, 1983 SIA letter that overlapping registrations, examinations, reportings and inspections should be abolished. One registration, examination, reporting and inspection system for broker-dealers should suffice for the SEC, CFTC, the states and the self-regulatory organizations.

IV. Arbitration

Because of a rather dated Supreme Court case7/ courts have held that they will not enforce predispute arbitration clauses if a cause of action arises under certain federal securities laws. The Congress of the United States has established a policy of encouraging arbitration. The exception carved out for everyday securities disputes militates against this general policy. If a routine dispute between a broker and his client is forced into court litigation, no one wins except the lawyers involved. The inordinate delays (sometimes over seven years), the court cost and the large legal fees create a cumbersome

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7/ Wilko v. Swan 346 U.S. 427 (1953).

methodology for the resolution of essentially simple disputes. Leaders of the bar associations, the judiciary and the academic world have been calling for a reform to our court system. They point out that our legal system is too costly, too cumbersome and too crowded. One of the obvious alternate dispute resolution systems available is arbitration. Arbitration is less costly and far more efficient in settling disputes in a timely manner. Customers and broker-dealers are far better served if, in the case of an irreconcilable dispute between them, this far swifter and less expensive method of resolution is available to them. Reversal of Wilko v. Swan and the cases which have come after it is long overdue. Legislation is needed to establish arbitration as a viable and, in fact, desirable method of dispute resolution for all securities matters. The federal arbitration laws should be amended to point out that the legislature contemplated no valid exception for securities cases such as was created by the courts in Wilko v. Swan. Congress should correct this situation promptly.

V. 1934 Act Section 13(f)

Section 13(f) requires investment managers to file quarterly public reports of their securities holdings. Reports have been generated under this section and the rules promulgated thereunder for approximately three years without any demonstrable public benefit. In addition to the cost and paperwork in generating these reports, firms must cope with the possibility that their investment accounts' strategies will be exposed. This hinders risk arbitrage and other endeavors.

This section was passed in 1975, together with a large package of amendments to the federal securities laws. None of the expected benefits of the reporting requirement have been realized. At the same time, the quarterly reports that have been filed do reveal investment strategies and insights. If the SEC decides to revoke the confidential treatment of risk arbitrage positions that it has granted pending a final determination, the disclosure of these strategies would effectively hinder risk arbitrageurs. The arbitrageur plays a vital function in maintaining the stability and liquidity of markets, particularly in uncertain periods. Both investment strategies and risk arbitrage strategies represent very sensitive proprietary information in a highly competitive environment. Disclosure would seriously diminish the value of this work. Absent compelling evidence of a public benefit, Section 13(f) and the rules thereunder should be repealed.

VI. <u>1934 Act Section 16(a)</u>

Section 16(a) requires that any person who beneficially owns more than 10% of any class of equity security or any security that is convertible into equity must file a report with the SEC. Such persons are also subject to the so-called "short swing" penalties imposed by Section 16(b). Section 16(d) and Section 16(e) grant certain exceptions for market making and for arbitrage. The same exemption should be afforded to those broker-dealers engaged in block trading and "bought deal" transactions. Quite obviously, the block trade and the "bought deal" are valuable services provided by broker-dealers to increase the liquidity, depth and efficiency of markets. For the same reasons that arbitrageurs and market makers are afforded the exemption (their contribution to the efficiency of the market), block traders and those firms participating in "bought deals" should be afforded the same exemption. The Act should be amended to provide for this.

VII. Security Investor Protection Act

This Act should be amended to allow greater flexibility for the SIPC trustee. At the present time, all that the court-appointed trustee can do is to freeze the activity of the insolvent broker-dealer, gather its assets and use them to satisfy the broker-dealer's obligations to its customers and general creditors. There has been much criticism of this restriction of the trustee's discretion. Customers of the defunct broker-dealer are frozen in their security positions, and can neither buy nor sell while the SIPC trustee reconciles the books of the broker-dealer and makes the payments. During this process, the securities of the customer are subject to the risks of the market, but the customer has no means to protect himself. It is recommended that the Act be amended to permit the trustee to continue to operate the broker-dealer during the process of liquidation so that, at the very least, the trustee will have the ability to accept buy and sell orders from the customers, to avoid injury to them. This recommendation was also made in a "Report of the Special Task Force to Consider More

Flexible Procedures for Liquidations Conducted under the Securities Investor Protection Act of 1970," which was submitted to the Securities Investor Protection Corporation in 1981.

VIII. Employee Retirement Income Security Act of 1974

This Act, of course, deals with pension and other types of retirement income plans and the relationship between the plans and those such as broker-dealers that provide services to, or manage assets of, plans. The Act, and the rules thereunder, are in need of modification. SIA has been working with the Department of Labor ("DOL") to effect changes in the rules promulgated under this law. The aim has been to establish a regulatory scheme that protects employee benefit plans but also permits the cost-effective provision of multiple services to such plans by broker-dealers and investment advisers. The overall theme is that ERISA must take into account the pervasive regulation of broker-dealers and investment advisers by the SEC. Some of the suggested changes are as follows:

1. Agency transactions -- Revise the current class exemption so that its consent and reporting requirements conform to SEC Rule 11a2-2 under the Securities Exchange Act.

2. Dealer transactions -- Revise the current class exemption on principal, underwriting, and market making transactions so that it can be utilized by any broker-dealer or investment adviser that is a plan fiduciary.

3. Credit extensions -- Revise the current class

exemption on credit transactions so that it can be utilized by any broker-dealer or investment adviser that is a plan fiduciary.

4. Stock loans -- Revise the current class exemption on stock loans so that it can be utilized by any broker-dealer or investment adviser who is a plan fiduciary.

5. Bonding requirements -- Propose new rules to limit the class of persons who must purchase bonds and to permit alternative methods of satisfying the bonding requirements.

6. Plan assets -- Adopt final rules narrowing the definition of plan assets in the context of pooled investment vehicles.

7. Fiduciary definition -- Revise the relevant DOL interpretive release in this area, so that a broker-dealer or investment adviser will not be deemed a fiduciary by virtue of providing individualized investment advice to a plan, unless it acknowledges in writing that status or receives separate non-transactional compensation for investment advice.

SIA recommends that this law be modified to effectuate easier methods for pension fiduciaries to operate for the benefit of all, most specifically for the plan beneficiaries.

IX. Investment Company Act Section 12(d)(3)

This section prohibits the purchase by a mutual fund of shares of any broker-dealer engaged in the business of selling mutual funds or acting as an adviser to mutual funds. This provision was written at a time when most broker-dealers were privately owned. Today, many securities firms are publicly owned and their securities are traded on national exchanges. In such a climate, Section 12(d)(3) has long outlived its usefulness or meaning. Actually, since the securities of broker-dealers have been rather good performers in the stock market recently, portfolio managers of mutual funds are penalized by their inability to purchase these securities in the open market. Also, Section 12(d)(3) discriminates against the public shareholders of broker-dealer securities by precluding the purchase of such stock by a good segment of the institutional purchasing market. Institutional interest in a security is a very desirable factor for securities and it is not fair to the public shareholders of brokerage firms that such sponsorship be denied to them. For these reasons, this prohibition should be removed either by Congressional action or by SEC rule amendments.

X. Prospectus Delivery

Because of the language of Section 5 of the 1933 Act and the definition of prospectus as contained in Section 2(10) of the same Act, confirmations of trades in registered offerings must be accompanied or preceded by a prospectus. This requirement is now archaic; the requirement relates back to a time when new issues could not be sold to the public for a period of at least 20 days after the filing of a registration statement with the SEC and the whole process moved very slowly under the 1933 Act. With the advent of streamlined registration under Forms S-3 and S-2 and the introduction of shelf registrations under Temporary Rule 415, the whole registration process under the 1933 Act has all but been bypassed. Today, a prospectus for most companies consists of nothing but material incorporated by reference from the ongoing annual and quarterly reports filed with the SEC under the 1934 Act. It gives the recipient little meaningful information. Only those companies that are unseasoned and are coming to the public for the first time have any requirements to furnish a meaningful prospectus.

The problem of mating a trade confirmation with a prospectus is particularly acute for the large national brokerage firms. Such firms generally mail trade confirmations locally after they have been transmitted electronically overnight from the home office. The necessity to mail a confirmation together with the prospectus means that syndicate trades must be pulled from the normal routine and handled separately and manually at the home office. This creates serious delays in confirming trades to customers, and impedes the modernization and automation of brokerage firms.

SIA recommends either SEC-promulgated rules or a Congressional amendment of the 1933 Act, permitting trades of new issues of companies that are registered on Forms S-2 or S-3 (that is, the seasoned companies whose prospectuses incorporate by reference the materials on file with the SEC) be confirmed in the same manner by which all trades are confirmed. Confirmation notices would be sent out automatically, without an accompanying prospectus. The prospectus would be mailed to the customer separately from the home office as soon as it is available. Companies that must use Form S-1 (that is, the unseasoned company), would confirm syndicate trades in the usual way, without the necessity of mating a trade with a prospectus if a copy of the preliminary prospectus (known as the red herring) had been previously delivered to the customer. Again the final prospectus would be mailed from the home office to the customer separately as soon as it is available.

This will permit prompt confirmation of syndicate trades to customers without lessening the protections of the securities laws. It is not intended by this proposal to limit any rights that a customer may have under the federal securities laws, but only to simplify and speed up the confirmation and billing process. Most certainly, this modernization is much needed to update the syndicate procedures and to make them current with the progress in automation now occurring in the brokerage industry.

XI. Accelerated Offerings, Rule 415 and Underwriters Liability

SIA has advised the SEC that accelerated offerings and the use of shelf registrations under Rule 415 will lead to a concentration of the investment banking business into the hands of a few well-capitalized underwriters capable of handling large "bought deals." SIA feels this will lead to a greater institutionalization of the market and will exclude smaller regional broker-dealers from the underwriting process as well as their retail customers. This will eventually impact adversely on the underwriting and distribution system which has served the capital markets of the United States so well and will create difficulties for smaller issuers in raising capital.

An issue related to Rule 415 and accelerated offering is the onerous liability Section 11 of the 1933 Act imposes on participants in the registration process. Section 11 creates a real problem for underwriters within the framework of accelerated offerings and incorporation by reference. Stated simply, underwriters are liable for misrepresentations and omissions in a prospectus unless they can establish a due diligence defense. Incorporation by reference has resulted in underwriters being subject to liability under the 1933 Act with respect to Exchange Act filings which they neither prepared nor had the power to influence meaningfully. Underwriters simply cannot develop what the Commission referred to as "reservoirs of knowledge" and thereby sufficiently verify information about every issue on which it wishes to place bids in the context of Rule 415 offerings. SIA believes the Commission should address promptly this problem for underwriters.

We believe there are two approaches to remedying this problem. One approach involves simply eliminating the doctrine of incorporation by reference with respect to the responsibility of underwriters. The Commission could accomplish this by either revising its registration forms and/or Regulation S-K or promulgating a rule under the 1933 Act. The second approach under consideration is for the Commission to outline with precision the steps an underwriter must take to be sure it has conducted a reasonable investigation and has reasonable grounds for belief that statements contained in a registration statement are accurate--the so-called safe harbor approach.

One final note concerns the issue of accountability of regulatory agencies. Unlike the Executive and the Congress, the regulatory apparatus is largely independent of review of its responsibilities. The budgetary reauthorization process is usally not searching enough to accomplish such an evaluation. We believe that a regularly planned examination of the continued need for a regulatory agency, as well as a careful attempt to measure its performance, would be in the interests of the citizens.

SIA appreciates the opportunity to express its concerns to the task force. If there are questions concerning any items raised by our letters, it is suggested that you contact our General Counsel, William J. Fitzpatrick, for further amplification.

Sincerely,

Robert E. Linton
Chairman

Edward I. O'Brien
President