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STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE ON H. R. 6789, 6793 AND S. 1642 BEFORE THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE HOUSE INTERSTATE AND FOREIGN COMMERCE COMMITTEE NOVEMBER 20, 1963

My name is G. Keith Funston. I am President of the New York Stock Exchange. With me today are Edward C. Gray, Executive Vice President of the Exchange, and Samuel L. Rosenberry of Milbank, Tweed, Hadley & McCloy, counsel to the Exchange.

We appreciate having the opportunity today to present the Exchange's views on H. R. 6789, H. R. 6793 and S. 1642. Furthermore, pursuant to the Committee Chairman's request in a letter of October 16, 1963, we have filed a statement with the Committee analyzing the adequacy, for the protection of investors, of the Exchange's rules. This statement reflects comments by the Exchange on the views expressed by the Special Study of the Securities Markets and by the Securities and Exchange Commission in its letters of transmittal to the Congress.

H.R. 6789 --- H.R. 6793 --- S. 1642

First, I would like to briefly state the New York Stock Exchange's position on identical bills H.R. 6789 and H.R. 6793. In my testimony before the Senate Finance Committee (attached as Exhibit A), we supported the Senate Counterpart bill without reservation. We support without reservation this Bill S. 1642 as amended and passed by the Senate.

Adequate Disclosure

For over 20 years, the Exchange has favored legislation to extend the disclosure and reporting requirements of the Securities Exchange Act of 1934 to all publicly held companies. Full disclosure--a cornerstone of the Securities Acts--is weakened by the illogical double standard under which publicly held unlisted companies are not legally required to give their shareowners the information and benefits that Congress prescribed for shareowners in listed companies as long ago as 1934. The present bill would go a long way toward providing equal protection for all investors and we urge that it be enacted without delay.

Self-Regulation

The 1934 Act adopted self-regulation as a basic concept. The premise of that legislation was that the national securities exchanges would regulate themselves, subject to oversight by the Securities and Exchange Commission of the efficacy of self-regulation in certain areas spelled out in Section 19(b) of the 1934 Act.

This concept was extended by the Maloney Act amendment to the 1934 Act, Section 15A, with a somewhat different pattern. Under this pattern, the SEC reviews disciplinary actions of the National Association of Securities Dealers as well as any rule changes.

The endorsement of self-regulation, which appears in the report of the Special Study of the Securities Markets and in the Commission's letters of transmittal to Congress, is particularly encouraging. The legislation before you today would improve the present system by helping to close several gaps in the basic regulatory pattern. It would strengthen the self-regulatory role of the National Association of Securities Dealers by empowering that Association to establish such minimum capital requirements and appropriate standards with respect to training, experience and other qualifications as that Association may find necessary or desirable in order to set standards for individuals and firms dealing with the investing public.

This added authority, in conjunction with the requirement in the bill that all broker-dealers must be subject to the self-regulatory authority of an appropriate securities association, would give an important new dimension to the industry's overall self-regulatory pattern.

SEC Disciplinary Controls

Another important effect of the proposed legislation would be to place the Securities and Exchange Commission's direct disciplinary authority over firms and individuals on a sounder basis. In the enforcement of the securities laws, the Securities and Exchange Commission has operated under a dual handicap; that

is, it has lacked first the authority to impose intermediate sanctions short of broker-dealer revocation and second the authority to proceed directly against an individual violator except through action against his firm. Hence, the SEC has had to choose between permitting less serious violations to go unpunished and invoking overly harsh penalties that affect the innocent as well as the guilty.

The bills before you would strengthen the Commission's disciplinary controls by empowering it to proceed directly against an individual who has violated the Securities Laws and to impose the intermediate sanctions of censure or suspension in appropriate instances.

To recapitulate, the Exchange urges enactment of this legislation because it would close major gaps in corporate disclosure requirements, the industry's basic self-regulatory pattern and the Commission's direct disciplinary authority over firms and individuals.

Special Study of the Securities Markets

The Special Study of the Securities Markets was authorized when Congress enacted the House Joint Resolution on September 5, 1961. The Study continued over the succeeding 23 months, culminating on August 8 of this year in the transmittal of the final section of the report to the Congress.

Naturally, a study of this bulk could not be fully and objectively evaluated during the relatively short period of time since it was made available to the industry and the investing public. However, the Exchange has devoted a significant amount of time and effort over the past three months to reviewing some 176 recommendations which directly affect our organization. On October 18, 1963, I sent a letter to our membership explaining the steps already taken in connection with possible Exchange responses to these recommendations. A copy of that letter is attached, as Exhibit B.

The responsibility for making whatever policy decisions may stem from our review of the Special Study Report lies not with the Exchange staff, but with the 33-man Board of Governors. To evaluate the recommendations of the Study Group more efficiently and promptly, the Board has appointed five special committees to review the major recommendations. Included in Exhibit B is a list of these committees and some of the more important recommendations that have been assigned to them.

The Exchange has also engaged consultants to assist the Board in arriving at determinations in three key areas. The names of the consultants are indentified and their particular subjects for study are also indicated in Exhibit B.

The size and scope of the study make it obvious that much work remains to be done before final determinations can be reached on most of the recommendations affecting the Exchange and its delicate mechanism, the auction market. The views of our membership have been solicited by the Board to assist the special committees and the Board in their deliberations. Obviously, in many areas, discussions must be held with the SEC before the Board arrives at a determination. Though the task is enormous--especially when it is realized that we cannot divert all of our energies from the day-to-day task of running the Exchange--I want to assure this committee that the job will be pursued thoroughly and promptly. Where action is deemed desirable in the interest of the investing public, it will be taken.

In my letter to the Exchange membership, I commented that it was no surprise to the Exchange Community that the Special Study Group found no pattern of fraudulent activity involving our organization. And while the report is critical of some specific details of Exchange operations, in general it does not challenge in any basic respect the Exchange's stewardship of the marketplace. Equally significant to the entire securities industry is the strong reaffirmation of self-regulation which appears conspicuously throughout the report.

We recognize that a fresh perspective can often be obtained from a study conducted by people outside the Exchange Community. Our analysis of the Special Study's recommendations is proceeding with this thought in mind. Although it would be inappropriate for me to comment on the Special Study's recommendations before our Board of Governors has completed its deliberations, I would like to offer some general comments on various aspects of the Report.

The first of these involves the question of floor trading. As you know, the Commission agreed with the Study Group's suggestion that it should be abolished unless the Exchanges can demonstrate the need for its continuance. The essence of a securities auction market is the gathering together of all buy and sell orders in one place at a given time--so that a fair auction can occur, enabling buyers and sellers to receive the best price possible at that moment. The flow of orders to one central place from the various segments of the investment community--the public investor, the institutional investor and the professional investor--all combine to provide the market liquidity that is so essential. The more liquid the market, the more able it is to serve the investing public.

Any recommendation to limit or eliminate an important element of supply or demand must be carefully weighed in the light of its potentially harmful effect on liquidity as well as the benefit to be gained.

No one would dispute, I think, that floor trading contributes to market liquidity. The Study Group appears to recommend that it be abolished in spite of that important factor. The Commission, in accepting that recommendation, stated in its letter of July 23, 1963 to the Congress that "...the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless those Exchanges demonstrate that its continuance would be consistent with the public interest." The Exchange has accepted the Commission's invitation and has requested an opportunity to discuss this subject with the Commission as soon as the Board of Governors has completed its analysis of floor trading, in the light of the studies by an outside consultant retained by the Board and of other relevant information.

A second recommendation we view with concern involves off-board trading in listed securities (the so-called "third market") and dual trading of listed securities on the New York Stock Exchange and one or more regional exchanges. These practices have been accepted and encouraged both by the Special Study Group and by the Commission in its letters of transmittal to Congress. Here again it is essential to recognize that diverting buy and sell orders from the primary market detracts from the liquidity of that market. We are particularly disturbed by the Commission's ready acceptance of the "third market" as a healthy influence.

No one questions that competition is an essential element of our free enterprise system. However, competition should be on an equal basis and competitors should be subject to similar restraints and controls. It is difficult to understand the logic that encourages a dilution of the primary market by the "third market" without subjecting the latter to the same regulatory controls imposed on the former. Surely, the investor entering either market should be entitled to such safeguards as the public disclosure of price and volume information, the restrictions on short sales, the regulations governing dealers and traders in an Exchange market, and the requirements that a fair and orderly market be maintained at all times.

The "third market" operates under the umbrella of the Exchange's auction market, often gearing transactions to prices in our market. In times of crisis, however, over-the-counter dealers in listed securities are presently free to step away from the market or even use the Exchange as a convenient dumping ground. And while there are many recommendations in the Report which, if adopted, would affect the over-the-counter dealers in listed stocks, the overriding consideration--here as elsewhere--should be to maintain the highest possible degree of liquidity in the primary market. The continuing health and responsiveness of the primary market are by no means accidental or automatic. Its liquidity, its ability to provide

tight markets in individual securities, to absorb or supply large blocks of stock, and to keep price changes within extremely narrow ranges, all depend upon the maximum accumulation--in the central marketplace--of orders from institutions and individuals alike. I believe it is abundantly clear that the problems which must be dealt with in this area are particularly complex. They involve not only degrees of regulation and responsibilities to the market, but rates of commission and dealer profits--among many other considerations.

The Exchange welcomes the opportunity to study these problems internally and we look forward to discussing them in detail with the Commission and other interested parties in the months ahead.

A third general comment I would offer is that the Study Group's recommendations must be examined not only on an individual basis, but also as to their total impact on the entire securities industry. To put into effect and to enforce all of the recommendations would call for a significant expenditure of manpower and money. The industry's ability to bear such expense should by no means be taken for granted. It is true that in the specific years prior to 1962 covered by the Report, the industry as a whole presented a reasonably healthy profit picture. A healthy industry is essential if the nation's investors are to be served adequately and the nation's industry is to obtain the capital necessary for expansion and modernization of its productive capacities.

It is also true that 1962 was not a very profitable year for the securities industry. The Exchange, with the approval of the SEC, has developed an income and expense survey, which is designed to show the profitability of the commission business for our member firms from all sources---New York Exchange, American Exchange, regional exchanges and agency transactions over the counter. The 1962 survey included 365 of our member firms, accounting for approximately 85% of all NYSE commission business during the year. The results indicate that in 1962 the average net profit of member organizations' commission business, after taxes, was 4/10 of 1% -- with more than half of our member organizations showing losses. This, combined with a sharp decline in underwriting in 1962, presents a very unsatisfactory profit picture on which to superimpose the additional burdens that would result from indiscriminate adoption of the Study Group's recommendations.

I do not mean to suggest that action should not be taken promptly where its need has been clearly demonstrated. But I do mean that the efficient operation of an industry should not be stifled by restrictions designed to avoid or to eliminate an occasional situation. Neither governmental regulation nor self-regulation can hope to protect the imprudent investor against himself. I think it is extremely important that a point-by-point approach should not ignore the overall impact on the industry, and

that any change should be based on clear evidence of its necessity. Each change must be both feasible and economically practical if, in the long run, the securities industry is to continue to serve the investing public.

Conclusion

In conclusion, I would like to return for a moment to the subject of self-regulation. The Special Study and the resulting legislative proposals reaffirm the wisdom of Congress in establishing industry self-regulation as a practical and effective method of providing investor protection. Nevertheless, a number of the Study Group recommendations call for Commission action in areas where the self-regulatory bodies themselves could act.

If self-regulation is to continue in the pattern established by Congress, then the basic responsibility of the self-regulatory bodies to adopt, revise and enforce their own rules must be maintained.

We would like again to make the point that the Exchange already has rules in many of the areas in which the Study Group recommends that the Commission adopt rules of its own. The Commission should act only when the self-regulators fail to make such changes, or when action is necessary in areas where the Commission has sole jurisdiction. The practical application of the concept of industry self-regulation with Government oversight requires the striking of

a delicate balance in which Government should not become involved in the day-to-day self-regulatory operations. The proper role of Government is to determine the effectiveness of self-regulation by reviewing patterns and practices, leaving the daily regulatory job in the hands of the self-regulatory bodies. We believe that this was the relationship envisioned by Congress when passing the Securities Exchange Act, that the philosophy has been proved in practice over the years, and should be encouraged to continue its further development rather than to be curtailed.

We sincerely hope that, in accordance with this concept, implementation of any of the recommendations now under study will be sought where possible through the Exchanges and the NASD.

In closing, I want to urge once again the passage of the proposed legislation before you.