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CONTINUITY AND NEW CHALLENGES

An Address by

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Coming to the “Del” gives me a certain feeling of vicarious nostalgia. I only discovered this fantastic place a few years ago, and no romantic episodes of my younger years are associated with it. But I have heard a great deal about it. It is legendary in the memories of my many contemporaries who entered the Navy in World War II and were assigned to the Pacific Fleet. As an old Army man, I have mixed emotions on the whole subject.

We ground soldiers lived in envy of the Navy and Air Force - - especially the Navy. The Navy I imagined sailing around, drinking milk shakes, until the strain got so bad that they had to pull into some gorgeous harbor, like Pearl or San Diego. Whereupon, all of the junior officers checked into a luxurious pleasure palace to engage in activities appropriate to the shameless pursuit of self-indulgence, the details of which your own imaginations can supply. That, I was sure, was how my Navy classmates suffered through the long unpleasantness - - gentle cruises on the blue Pacific with endless supplies of milk shakes, interspersed with Sybaritic interludes of really high living.

And the Del, of course, was legendary as such a pleasure palace. So, when I learned to know it many years after the war, it fully confirmed the accuracy of my earlier imaginings. The Navy did, indeed, have it pretty soft.

Some time ago Stewart Alsop - - who himself had served with the British Army - - wrote a column to the effect that our handling of foreign relations and actual and potential applications of military force are governed by civilians whose experience, almost without exception, has been Navy or Air Force - - or, if Army, very much rear echelon - - like in Washington, or for the more adventuresome, Paris. This experience in

everything but ground combat, according to Mr. Alsop, leads to serious miscalculations as to the efficacy of military alternatives.

While I tend to agree with Mr. Alsop in this regard, it is not appropriate on this occasion to pursue that line of inquiry. The only relevant point is my own pedestrian background. Our guns, of the artillery battalion with which I served in Europe, could shoot at best about eight miles. This led to a short-range view of the war, compared to the spectacular perspective of drivers of bombers who could mess things up hundreds of miles beyond. But we also observed that nothing was really gained until we got there, and I have never forgotten the experience.

In this sense, some might observe that we have today a ground force - - or, as we used to say, a “dogface” - - Commission. I have been inclined to the view that we have had a plenitude of long-range bombing missions - - programs and promises. Our most appropriate mission today has seemed to me to be the securing of objectives already assigned. Interviewers from the press keep asking what is my program? My invariable response - - after observing that the Commission as a whole, not the Chairman alone, adopts programs - - is that our immediate program is to carry through the many projects begun by our predecessors. Facetiously, I say - - especially when Bill Casey is present - - that my program is to make an honest man of Bill. We don't need any more grand visions until the projects presently afoot are either completed or abandoned.

With many of them I am sure you are familiar. The “140” series of rules under the Securities Act is at long last nearing completion. Many of you surely remember that this all began quite some years ago, when Manny Cohen was Chairman and Frank Wheat, then a commissioner, was put in charge of what was called a disclosure study. This led to

the report popularly known as the “Wheat Report,” which remains about the finest piece of analysis and exposition that has ever been produced in this field. It should continue to be required reading for all lawyers beginning a securities practice.

As a practitioner, I was a strong supporter of the Wheat proposals for a “160” and “180” series of ’33 Act rules, and I thought it a great pity when the Commission abandoned that program. There was even some temptation last August, when Al Sommer and I joined the Commission, to consider reverting to the Wheat proposals. We resisted the temptation, because it obviously would have been poor administration of our laws once more to change courses. Furthermore, the “140” series are working out in a satisfactory way. I think they are good rules that the industry and the bar can live with for a long time, with modifications that no doubt will seem desirable as experience accumulates. In fact, the development of these rules has been an example of the Commission’s staff securities bar working together in the very best manner. Various bar committees, including that of the American Bar Association, chaired through most of this period by Al Sommer, studied the rule proposals diligently and with a feeling of responsibility for helping to improve the law. The staff, at the same time, listened carefully and accepted objections and suggestions that proved to be well-grounded.

This process is extremely valuable. For it to work well, there must be appropriate attitudes on both sides. If the comments from the bar are obviously just special pleadings to make life easier for their clients, with no serious concern for the protection of investors, the comments contribute very little. On the other hand, the staff must be open to the possibility that someone out there might have a better idea. It hardly needs saying that no one, not even the wisest staff member, can know everything and foresee all of the

possible effects of a proposed rule. Especially with matters as complex as the “140” series, submitting a proposed rule for comment in compliance with the Administrative Procedure Act should not be regarded as a mere gesture toward due process, but rather, a genuine search for information and ideas. This requires, of course, subduing one’s human inclination to defend his own creation and to resent criticism and suggestions for change.

I think, on the whole over the years, the SEC staff has been very good about its attitudes toward the rule-making process. I know for a fact that it has been throughout the development of the “140” series.

I wonder, incidentally, how many of you know what happens to written comments received on proposed rules. When the revised rule comes to the Commission for consideration and action, each Commissioner is given copies of all comments, or at least they are made available to him or his legal assistant. He is also given a memorandum in which the staff has summarized and responded to each comment of any substance, with attribution to the bar committee, firm or individual who made the comment. The memoranda on the “140” series have been models of objectivity. Of course, their preparation takes much time, and they are one reason why the whole process has been slow. We could act much faster by not giving careful consideration to each comment. But the Commission has long thought that the time was worth it, and I am sure you would agree. So, even though you don’t get personal thanks for your comments, and sometimes it seems as though you might as well have dropped your letter down a rathole, because you send it off and weeks or months go by and nothing happens, in fact, rest assured that your views are getting attention.

Returning to our concurrence in completing the “140” series, I referred not only to the fact that they are good rules, deserving of support, but also to the disruptive effect of changing course to achieve marginal improvements or the satisfaction of personal preference. We are acting during a time when I think we should avoid unnecessary disruption through changes in policy, goals and methods. The SEC has always experienced a relatively high turnover rate in commissioners, including chairmen. So much so that great weight must be given to the values of institutional continuity and the suppression of personal desires.

As we on the Commission observed in a letter of Season’s Greetings that we sent to members of the staff shortly before Christmas, only one commissioner who was in the office in December, 1973, had been there in January, and we have had three chairmen during this past year. The fact that the Commission survived all of these changes at the top in such good shape is mostly attributable to our strong and dedicated career Civil Service. But our own restraint, I believe, has helped.

We have, accordingly, agreed to pursue the special projects that were underway, reserving the right to make changes, and even to abandon projects that proved to be ill-conceived or not feasible or, perhaps, anachronistic, but with the benefit of doubt in favor of completing what our predecessors had begun. This has no doubt disappointed persons who didn’t like what was going on in one respect or another and who were hoping for radical changes. But right now, I don’t think that radical change in Commission activities and policies is in the public interest, and the other commissioners share this view.

Obviously this does not mean no change. The heart of the administrative process is responsiveness to change. Some ideas that sound good just don’t work out, and should

be dropped. Some experiments, by way of rule or otherwise, prove unfortunate - - that is the nature of experiments. Of greatest importance, of course, is the proclivity for change of the underlying facts of our economy and business practices. Some ideas, that seem timely and exciting when conceived, become stale and irrelevant before final action can be taken. In part because of the deliberate pace of our rule-making processes, we run a continuing danger of spending too much attention on yesterday's problems rather than today's, to say nothing of tomorrow's. Matters that seem of burning urgency when markets are up and rising and hot issues are popping up all over seem somewhat less pressing after a year of depressed markets and a glaring absence of public offerings of equities, hot or cold.

Nevertheless, we intend to proceed with such projects as a rule on the use of projections and other forward-looking information. We intend to propose guidelines for corporate directors and on the use of non-public information. Last fall I expressed some doubt as to our ability to do a useful job on the latter of these guidelines, and this spread consternation in certain quarters. Hopefully, we can do some good in contributing to clarity and certainty, and we will surely try. But I am afraid that there are unreasonable expectations abroad. Such concepts as materiality cannot be reduced to rules of mathematical precision without doing more harm than good. The same is true with respect to a director's due care.

We have also accepted the program for the development of a central market system embodied most recently and comprehensively in the Commission's paper on the subject published last March. When combined with a coordinated, nationwide system for the clearing of transactions, and a similar system of depositories for stock certificates, the

result should be a substantial reduction of costs for securities transactions - - which is certainly important - - and improved efficiency in the process of bringing together the maximum number of buyers and sellers so as to give the investor, especially for the smaller trade, the best possible chance to find the best price for his trade.

We are trying to steer a steady course toward desirable objectives, while remaining responsive to new information, better ideas and changed conditions as they may occur. We must also remain responsive to proposed changes in the laws we administer and by which we are bound. There are pending in the Congress an unusual number of bills affecting the federal securities laws and markets. Still more are said to be coming. While the diversity of the proposed legislation sometimes makes it difficult, we are trying to construct and adhere to a consistent policy, bending occasionally to the realities of what is possible.

But is this enough? Is continuity with our own past and the completion of projects already underway going to be adequate for the needs of tomorrow?

The other day I was interviewed by a very attractive young lady who writes for a financial magazine. She asked me if I would describe our capital markets five years from now. The circumstances and company were such that I wanted very much to give some sort of intelligent, or at least intelligent-sounding answer. But I demurred. In fact, I chickened out. I answered with questions of my own. What will happen to interest rates? Will inflation be curbed? What will be the role of our commercial banks and trust companies? Will there be a free flow of capital among nations or will a sort of financial protectionism become dominant? What will happen to tax provisions? If I knew the answers to these questions and some more, I said helpfully, then I might hazard a guess at

her question. Actually I could have been more helpful. Instead of evading the thrust of the question by referring to market factors largely beyond our authority or responsibility, I could at least have said something about those factors that are within our sphere of influence.

I do, for example, expect a central market system well-established along the general lines of our program described last March. I expect the cost, at least the relative cost, of securities transactions to be sharply reduced. I expect stock certificates of actively traded stocks to be largely immobilized. There are, as you know, serious proposals to abolish the stock certificate altogether. I have not yet become personally convinced that it is necessary to go so far, but it is clearly necessary to eliminate the costly shuffling and shipping of paper in the trading process, and this will be achieved. I expect us to be adhering to the basic disclosure philosophy that has governed the federal approach for forty years - - eschewing both the classic radicalism that says it is all a lot of expensive nonsense and the paternalism that says that investors must be protected from themselves, although I must admit that the astounding resourcefulness of the kind of promoters who enjoy fleecing widows poses a continuing temptation to lose the faith and cause the federal government to exercise a heavier hand. I would also like to say that I expect the Federal Securities Code to be law and, as a matter of fact, I do. In my present capacity, however, I suppose I must refrain from declaring myself on the merits of any particular provisions.

I could have said these things then. Saying them now provokes inquiry into the adequacy of our approach. We all recognize that our capital markets are in poor shape, both as to security prices and the securities industry. May the SEC properly disclaim any

responsibility for the state of the markets? Can we cop out by blaming it all on inflation and taxes?

Last September, I referred in a talk to a remark which I read in Alan Abelson's column in Barron's, to the effect the merging and combining going on among broker-dealers was like rearranging the deck chairs on the Titanic. Later, at our SEC Executive Conference in Bedford Springs, our Executive Director, Alan Blanchard, in a deliberate attempt to be irritating, and thus stimulating, carried the figure a step further. Perhaps, he said, much of our fussing at, and with, the securities industry is like the officers on the bridge of the Titanic devoting their attention to whether the roulette wheels in the ship's casino were honest.

Feelings are so sensitive and defensive these days that I suppose I must hasten to add, for the benefit of literal-minded and insecure persons, that Alan did not really mean that our securities markets are like gambling devices, or that our capital markets are necessarily headed for disaster. He was simply extending a simile for colorful effect. His point, however, is well taken. It is not enough for our capital markets to operate fairly; they must also operate efficiently, by which I mean not just that they operate smoothly and at low cost but that they perform adequately their economic role of capital formation.

Historically, the SEC has concentrated its efforts on promoting fairness. We have been diligent and fairly effective protectors and promoters of what one commentator has dubbed the equitable factor. We do not appear to have given anything close to equal time to the efficient factors. There are those within our own community who think that this is as it should be. They argue that Congress sent the Commission forth to save investors

from being mistreated, not to foster the financial well-being of broker-dealers or to worry about stock prices, or try to influence the sources of new equity capital or the terms on which it is furnished. The prevalence of thoughts of this sort in the Commission's ranks has been instrumental in leading some thinkers on the industry side to conclude that perhaps we need a new commission or official body to take over nurturing of the efficient factor in our capital markets.

We have not yet expressed any views on the merits of the proposals for a new commission. We are still trying to understand them and how they might work. We are also trying to understand as clearly as we can the basis for this inadequacy that these persons feel in Commission attitudes toward the capital markets and the effects of our regulatory efforts. Inasmuch as most of the Commissioners and so many key staff personnel have been and are lawyers, is our approach too legalistic, with too little regard shown for the economic results of the positions we take? Could we do more to help restore our capital markets to health? Could we do more to further the economic welfare of members of the securities industry? Are these objectives relevant to the public interest and the protection of investors, as that phrase is used throughout our laws?

Reflection on these questions - - which I shall not try to answer categorically this afternoon - - suggests that the Commission has not been so indifferent to efficient factors as may appear. Perhaps in explaining and justifying our position we have emphasized legalistic and equitable considerations and obscured economic and efficient factors out of habit or because we think that these considerations are more clearly within our statutory mandate. Certainly the positions we are taking on problems of market structure are intended to promote healthy capital markets and enable members of the securities

industry to achieve reasonable profitability and attract sufficient capital to perform their vital economic function in the years ahead.

The central market system as we envision it is intended to promote more efficient capital markets, preserve and encourage auction markets, make the markets more attractive to individual investors, and overall improve the access of companies to new equity capital. Our adoption of this program and our position on related matters such as fixed commissions, nationwide clearing, nationwide depositories and portfolio disclosure by institutional investors, as well as our position on improved disclosures in annual reports and in financial statements are not viewed or intended by us to reflect legalistic views unrelated to economic consequences.

In fact, confidence in our capital markets is essential to their efficiency. While it would be a distortion to suggest that lack of confidence has been the sole or even the major factor in keeping individuals away from the securities markets, it clearly has been an important factor. Confidence in the integrity, financial and otherwise, of his broker, confidence in the quality, completeness and timeliness of information available to him confidence that his order, though small compared to institutional orders, will be fairly handled for his benefit, and confidence that his cost for the transaction is reasonable and not made unnecessarily high because of antiquated procedures and equipment or artificially pegged because of considerations unrelated to the value of the service sought and received - - confidence in these matters is surely important to the individual if he is to put his savings back into corporate equities. Hence I submit that confidence is an efficient factor of top magnitude.

But there may well be more that the Commission can and should do, alone or in conjunction with other branches and agencies of the government. We are studying all proposals to this end as carefully as we can. We fully accept the fact that the health of our capital markets is of the greatest possible importance to the health of our economy. The present state of poor and failing health is a severe challenge to the industry and the government. We intend to do our part in meeting this challenge.