

SELF-REGULATION AT THE CROSSROADS

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Anyone who has ever spoken to a large audience knows that the first few minutes can be crucial. The star of one of my favorite examples was former Governor Al Smith, whose frequent bloopers are still fondly remembered by many old-time New Yorkers.

Early in his career as Governor, he made an inspection visit to Sing Sing prison, and the warden asked if he would give a short inspirational talk to the inmates. With a flourish of old-fashioned campaign oratory, he began, "my fellow-convicts" -- and stopped short as laughter swept through the room.

Gamely, he tried to recover with a less formal approach. "Well, anyway, I'm glad to see so many of you here" -- which brought down the house.

Well, just as Al Smith was not their fellow-convict, I can't claim to be your fellow-auditor. But I am glad to see so many of you here because I'd like to share some thoughts with you about the future of our industry, and particularly about a unique aspect of our industry that every one of you is directly involved in -- self-regulation.

The founding fathers of the New York Stock Exchange --the 24 colonial merchants who signed the historic Buttonwood Agreement back in 1792-- set a self-regulatory tone from the very beginning, when they pledged to observe a common minimum commission rate and to deal only with one another. The modern version of that agreement, of course, is a far cry from the founders' original concept of the Exchange.

The Exchange today is a quasi-public, not-for-profit institution with a broad and diverse ownership base --our members-- and a broad range of public, corporate, institutional, governmental and other constituents who have a strong stake in how efficiently we run our business.

Minimum commission rates are a thing of the past; and members can and do deal not only with one another but with everyone else. Still, our Constitution today defines two major purposes of the Exchange, in valid language that dates back to the early days of this century;

“...to maintain high standards of commercial honor and integrity among its [membership]; and to promote and inculcate just and equitable principles of trade and business.”

### THE MOST IMPORTANT TOOLS

The concept and practice of self-regulation are among the most important tools we have to accomplish those purposes. And over the years, our concept of self-regulation has evolved and broadened far beyond anything the Exchange's founders could have conceived. Indeed, in our own time, society has changed dramatically, and the responsibilities of business and publicly

oriented institutions have undergone continuing evolutionary changes -- as public perceptions and our own understanding of those responsibilities have changed.

What was new and innovative in self-regulation 20 years ago is old hat today -- not only in the securities industry, but throughout the business and financial community. Self-regulatory practices and procedures that were considered more than adequate then would be frowned upon as minimal, or even unacceptable, today. But the underlying concept of self-regulation has not changed. The fact remains that self-imposed discipline is almost always more effective --and certainly more palatable-- than discipline imposed from outside.

In the early days, self-regulation in our industry was essentially self-serving -- sometimes more honored in the breach than in the practice. But by the 1920s, the New York Stock Exchange had begun monitoring the financial condition and sales practices of member firms quite closely. And when a vast new Federal regulatory structure began to emerge from the ashes of the Great Depression in the mid-1930s, the industry could hardly help recognizing that in the absence of a strong, sincere and effective commitment to police itself, government would take over more and more of that task.

#### “COOPERATIVE REGULATION”

Over the past half-century, we have developed a vast and complex system that is sometimes referred to as “cooperative regulation” -- a blend of industry self-regulation and government oversight that is unlike any other system in the world. We’ve all heard many pious-

sounding explanations for why self-regulation works. But what it all comes down to is that it is in any organization's own best interests to manage itself responsibly and efficiently. It is also true, in the securities business or anywhere else, that people will almost always perform best when they know they are responsible to someone else who is auditing their performance. And that certainty also plays a part in making self-regulation work.

In our business, that certainty is determined by a chain of command that begins at home - that is, within each individual securities firm. You ladies and gentlemen, in your capacity as internal auditors, play a fundamental and increasingly influential role at the very heart of this process -- by seeing to it that the necessary accounting, financial, operational and other controls and procedures are in place, are being implemented, and are working properly.

The next link in that chain is the self-regulatory organization that has primary responsibility for monitoring a particular firm's compliance with rules, regulations and procedures that they have, as a condition of membership, agreed to abide by.

And finally, beyond the self-regulatory organizations are the local and state regulatory authorities and the Federal government agencies that oversee the SROs and carry out their respective statutory mandates to administer the securities laws in their individual jurisdictions. Chief among the latter, of course, is the Securities and Exchange Commission, which is directly responsible to Congress.

The Exchange's philosophy of self-regulation has undergone significant changes over the past quarter-century. When I first came into the industry, the Exchange was deeply involved in the self-regulatory process, but very rarely talked about it. In those days, the old-timers in the business agreed that it was necessary and proper for the Exchange to keep a watchful eye on their activities -- but they were rather sensitive about telling the world that we did it. That may have been because they were afraid that outsiders might assume that where there's smoke, there's fire. There was also some nervousness about making public statements that might be construed as increasing a firm's legal liability in those very rare instances in which Exchange standards might be deliberately or unintentionally violated.

#### SELF-REGULATION GOES PUBLIC

But by the early 1960s, the Exchange was actively encouraging public share ownership among millions of people who had never before owned corporate securities. And we gradually came to recognize that it was desirable for securities customers and prospects to be aware of the self-regulatory procedures that provided a measure of protection over and above what the law required -- particularly when the thrust of self-regulation was to help member firms manage their businesses more efficiently, rather than to stave off dishonesty.

Some of the old-timers would probably be horrified by the fact that, for quite a few years now, the Exchange has even been publicizing disciplinary actions where dishonesty is a factor. But far from undermining public confidence in our business, that practice has increased our credibility with the public.

Indeed, we were somewhat surprised --and very gratified-- to learn from a survey of Public Attitudes commissioned by the Exchange several years ago that investors consider surveillance of trading and regulatory oversight of member firm operational and financial activities as among the Exchange's most important functions.

In one of its earliest public statements on self-regulation, the Exchange made the point that while the securities industry obviously cannot eliminate the risks of investing or take responsibility for the individual investment decisions of millions of people, it can and should be concerned with the manner in which investors and prospective investors are approached -- and the integrity of both the marketplace and the broker-agents who handle the funds their customers entrust to them. Some of you may be old enough to remember that, in those days, the major upstairs self-regulatory emphasis was on member firms' financial responsibility and sales practices.

#### A VERY EXPENSIVE LESSON

We still pay very close attention to those areas, of course. But as we approached and entered the '70s, a rapid upsurge of public participation in the market triggered contiguous industry-wide paperwork and financial crises that made it abundantly clear that honesty and integrity were not enough. The industry made the very expensive discovery that honest operational inefficiency and mismanagement could do as much as, or more than, outright dishonesty to jeopardize investors' interests and damage investor confidence.

During that period, the Exchange and the membership committed a total of \$140 million to protect customers' interests against losses stemming from the financial insolvency of firms with which they had been doing business. And if \$140 million was a lot of money in 1970, consider that its equivalent in 1981 would be no less than \$330 million. Many customers of Exchange member firms did suffer inconvenience and aggravation, but our extraordinary measures succeeded in protecting the funds and securities of customers of the troubled firms.

The big losers, of course, were the principals and employees of badly managed firms that collapsed under the weight of their own incompetence or inefficiency. But the entire industry -- including even the best-managed firms-- lost out, in the long run, because millions of large and small investors lost confidence in the ability of the industry, as an industry, to provide the quality of service that they properly believed they were entitled to expect.

The survivors learned a great deal from that experience. And admittedly with some prodding from government, the industry entered a new era of self-regulatory diligence in which the focus on operational efficiency is every bit as intense as our concern with financial integrity. Of course, it is also possible to over-react to an unpleasant experience -- especially where money is involved. And as you probably are aware, the Exchange and the SIA are looking into ways of reducing capital requirements --to make firms' capital more productive-- without increasing risks to firms or customers, consistent with the economic realities of the 1980s.

## COMPETITION FOR SURGING SHARE VOLUME

The market activity that precipitated such vexing problems just a bit more than a decade ago seems like the tiniest drop in the biggest bucket, compared with what we now take in stride as a matter of everyday routine. A quick comparison of numbers is startling. In 1968, the year when the paperwork crisis began building, average daily volume on the New York Stock Exchange was just under 13 million shares and the all-time one-day record, set on June 13th of that year, was 21,351,000 shares.

So far this year, volume is averaging about 47 million shares a day -- more than 3-1/2 times as much as in 1968. The current one-day record, set last January 7th is, as you know, 93 million shares -- and that's between a fourfold and fivefold increase. Moreover, as all of you probably are aware, the Exchange and the industry are rapidly gearing up to handle 150-million-share peak days and sustained daily volume in the range of 90 to 100 million shares.

And perhaps the most important over-all achievement of the past few years is that we've shown the world that we --and by "we," I mean NYSE member firms, as well as the Exchange itself-- can handle that kind of workload without undue stress.

The reasons aren't hard to define. For one thing, all of us have embraced the modern communications and data-processing technology --as well as the sound, modern management techniques-- that are essential to operating a modern securities firm and a modern securities

marketplace. Even a simple laundry list of the innovative changes that have been introduced over the past decade would probably keep us here past midnight.

Equally important, I think, has been the new spirit of enlightened self-interest that began to develop, industry-wide, as the elimination of fixed commissions and the reality of the emerging National Market System focused the entire industry's attention --more closely than ever before-- on the crucial importance of competitive excellence. In today's intensely competitive environment, it is clear that the only real way to gain a significant edge over your competitors --whether you are running a securities firm or a securities marketplace-- is to perform a little better than they do.

At the Exchange, that means providing the facilities, the market-making skills and the trading support systems that make it most efficient and cost-effective for firms that are our customers to send their customers' orders in listed stocks to our trading floor. In terms of the internal auditor's job, performing a little better means seeing to it that his or her firm maintains the systems and procedures that keep the firm a step ahead of its competitors in giving customers the measure and quality of service that they want.

#### SELF-REGULATION TODAY

In terms of effective self-regulation, then, the well-managed securities firm today recognizes that its own self-interest demands a high level of financial competence and operational efficiency -- from which its public customers derive particular benefits. The self-

regulatory organizations recognize that you know that. And so, the primary thrust of our monitoring effort is to help you maintain the standards that the public has once again come to expect of New York Stock Exchange member firms.

At the same time, I think we all must recognize, too, that effective self-regulation is not a universal cure-all. Recent experience suggests that there is no way to regulate a firm into --or back to-- financial good health when and if, for whatever reasons, its business dries up.

The government regulators, in turn, are just as well aware that it is in the best interests of each self-regulatory organization to strive to provide the trading environment, the services to members --and the self-regulatory oversight-- that help them maximize the efficiency of their service to the investing public. To be sure, the regulators and self-regulators often may differ vigorously about specifics -- just as member firms may sometimes disagree with the Exchange. But the basic relationships that exist today are constructive and cooperative --rather than confrontational, as they have sometimes been in the past-- and based on a solid foundation of mutual respect.

Former SEC Chairman Harold Williams summarized his concept of the appropriate roles of the Commission and the industry --at least with respect to the development of a National Market System-- in this significant way, with which it would be difficult to disagree:

“The Congress expected that the securities industry would assume primary responsibility for the design and development of the technical components of the system. The Commission’s role in this process is to monitor progress, to act as a catalyst and, when necessary, to take regulatory action

to achieve a particular goal or eliminate unnecessary or inappropriate barriers to competition.”

And if you were to paraphrase that statement to describe the self-regulatory relationship between the Exchange and its member organizations, it might go something like this: “The Exchange recognizes that its member organizations have primary responsibility for conducting their business and for dealing with securities customers fairly and efficiently. Our role in the self-regulatory process is to monitor the firms’ financial and operational capabilities and their compliance with both the letter and the spirit of Exchange-administered rules and procedures; to act as a catalyst for good business practices; and, when necessary, to take appropriate action to assure that a particular member organization does, in fact, honor and meet the responsibilities of membership.”

One of our major objectives is to find ways to simplify compliance with Exchange rules and procedures without in any way compromising the self-regulatory function. And I think we have made some significant progress.

One area in which those efforts have paid off has been in reducing self-regulatory duplication, through the consolidation of examinations, reports and the dissemination of essential data that can be shared by several self-regulatory organizations and, in some cases, with government. And we are continuing to seek additional ways of accomplishing that.

MORE REGULATION OR MORE SELF-REGULATION?

This is one of the key reasons why the Exchange and virtually every other securities industry organization have expressed serious reservations about the SEC's initiatives toward establishing a Market Oversight and Surveillance System -- or MOSS. As originally envisioned, it appeared that MOSS would have greatly expanded direct government surveillance of the markets. Perhaps more to the point for internal auditors, it would have given the SEC a pervasive, direct, industry-wide regulatory presence that seemed totally at odds with the frequently stated government objective of wide-ranging deregulation.

The original MOSS proposal raised many serious questions. One is the philosophical question of whether government ought to assume direct regulatory powers over every aspect of the activities of securities markets and firms in the absence of any compelling evidence of widespread mismanagement or wrongdoing.

It is equally disturbing to contemplate the huge costs to the taxpayers of creating and operating such a system; and both Congress and the Office of Management and Budget have questioned the justification for that, in the context of budgetary restraint.

There is yet another question about the propriety of creating a far-reaching new mechanism for government intervention that could subvert the entire self-regulatory structure that has developed directly from the Federal securities laws.

Apart from all of these unattractive prospects, the original MOSS concept would have created immense areas of duplicative reporting that promised to impose crushing burdens on the entire industry.

#### TOWARD AN ACCEPTABLE ALTERNATIVE

In identifying areas where it believed changes and improvements were desirable, the Commission also recognized that a satisfactory alternative to MOSS would be for the industry self-regulatory organizations to take cooperative steps to implement appropriate enhancements -- in an intermarket context. And the self-regulatory organizations have been working diligently toward that goal.

Early this year, the Exchange and all the other SROs established an Intermarket Surveillance Group to coordinate the over-all effort for exchanging market data and enhancing inter-market surveillance. That group has identified the data now being exchanged among SROs, either on a routine or "request" basis; the data now being collected by SROs that could be exchanged among them and, where appropriate, with the SEC, at minimum additional cost and effort; and data that are not now being collected but which might help in the future to further refine and improve surveillance techniques.

At the request of the new SEC Chairman, John Shad, we reported at some length, in mid-August, on the progress made by the Intermarket Surveillance Group, and on a Project Plan that includes, among many other things, the development by each SRO of an effective audit trail for

equity securities and presentation by each, by year-end, of its plan for integrating shared data into the over-all intermarket surveillance capability.

Chairman Shad responded to that report within two weeks, commenting favorably on the Intermarket Surveillance Group's serious commitment to fulfilling intermarket self-regulatory surveillance responsibilities. And he added --and I am quoting now-- "An effective program of this type --to which the Commission would have access, as well as an audit capability-- would, in turn, allow the Commission to satisfy its market oversight and enforcement responsibilities, without developing a costly and largely duplicative direct surveillance system." End of quote.

Chairman Shad also said that the Commission will not seek funds for fiscal 1983 to enhance its current direct enforcement program beyond the pilot program now in progress. We have inferred that the thrust of the pilot MOSS program now is to update the Commission's own systems in areas where it now has auditing or direct regulatory responsibilities -- and to defer movement toward additional direct regulation in areas where the industry itself can do the job effectively. And that seems to be a reasonable and proper position for the Commission to take.

#### FORMULA FOR SUCCESS

In effect, then, self-regulation today is at a crossroads. The success of the Intermarket Surveillance Group's effort --like the success of our efforts to reduce capital requirements and duplicative reporting-- will depend very heavily on the cooperation of the entire industry. How

well we all buckle down and cooperate may very well determine the thrust --and even the survival-- of responsible self-regulation in our industry for years to come.

As the elements of the efforts now under way begin taking firm shape, we will be seeking constructive input from everyone who may have something worthwhile to contribute. And while internal auditors may not be directly concerned with market surveillance, your knowledge and proficiency in your own areas of responsibility place you very high on the list of member firm officials whose ideas and suggestions can be very helpful -- even outside those areas.

We are not going to achieve our goals in one great leap forward. Improving self-regulatory efficiency and effectiveness is a continuing process that demands constant diligence and innovation. But if we try to slough off the responsibilities that are properly ours, government will be only too glad to take them on.

Essentially, self-regulation is our form of quality control -- both in the marketplace and at member firms. It is our way of helping to assure that the public can obtain quality products and services from our industry, and that a satisfied public will keep coming back to us for more.

We are all partners in this effort -- the Exchange cannot accomplish all the necessary tasks alone. We can do our job well only if our member firms --and all of their people-- do their job well.

With internal auditors playing a larger and larger self-regulatory role within individual firms, it seems likely that the Exchange should be able to rely on your increasingly sophisticated procedures more than we have in the past. As part of our ongoing effort to improve over-all self-regulatory efficiency, we want to interface more closely with groups like yours to develop and refine methods and procedures that can advance our mutual self-regulatory goals.

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I see that I have been speaking now for about half an hour. And I feel certain that there are some topics that are high on your list of priorities that I haven't even touched on. So, rather than go on talking about some of the other things that are on my mind, it might be a good idea to get a dialogue going.

As the fellow said when he staggered through the front door at 1 a.m., fell flat on his face and looked up at his sternly disapproving wife, that completes my formal presentation -- I'll be glad to take questions from the floor.

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