

HOLD FOR DELIVERY

BUSINESS, GOVERNMENT AND REGULATION

An Address By

THE HONORABLE MANUEL F. COHEN

Chairman, Securities and Exchange Commission

Before The

National Industrial Conference Board

New York City - February 16, 1967

BUSINESS, GOVERNMENT AND REGULATION

A good deal has been said in recent months about the relationship of business and government--both what it has been and what it should be. This is a good thing. For too many years now, there has been a public image of hostility between the two camps--that the ultimate aims of business and those of government were antithetical. Businessmen are portrayed as the defenders of the free enterprise system and government officials as advocates of a planned society.

This public image has not only been productive of discord; it is an inaccurate picture of what the relationship is. For at least as long as I have been in government--some 25 years--the real relationship between businessmen and the government has consisted principally of the accommodation of different interests and viewpoints in the expectation that such accommodation would promote a healthy, productive and dynamic society. It may be, as Professor Carl Kayser has recently suggested, that the image of hostility plays an important role in reconciling what we really do and our traditional image of what our roles should be. I am sure that a business psychologist could explain this better than I. Whatever the explanation, images and imaginary confrontations are not enough. Only a realistic appraisal of what we are actually doing, and an understanding of what our aims are, as Henry Ford recently pointed out, will enable us to focus our attention on real problems and to find reasonable solutions.

But it is not enough to suggest that business and government are engaged in a joint venture to promote the common welfare. Joint ventures require agreement as to aims and as to the roles of the parties to the venture.

The traditional view is that the function of business is to produce--that is, to assemble the tools, the men and the raw materials and to direct them in making products or providing services--while the function of government is to regulate--that is, to fix codes of behavior or standards of conduct within which the productive activities must be performed. Unfortunately, this simplified description does not correspond to reality. Governments have always produced, and business has always regulated.

Governments build dams, and other public works. They run transportation and communication systems and other productive enterprises that are in many cases indistinguishable from similar enterprises built or run by private businessmen. There can be, and there usually is, a good deal of legitimate disagreement in particular cases whether public or private control of a particular enterprise best serves the common interest. In some cases, there is even confusion whether an enterprise is actually being undertaken by a business or by a government. For example, there is an increasing controversy concerning "industrial revenue bonds"--obligations nominally issued by governmental units to finance plant construction which provide for the payment of principal and interest exclusively out of the rental paid by a private company for the use of the plant. These arrangements have raised questions under the federal tax and securities laws--laws which were drafted on the assumption that there was a good reason for distinguishing government from business securities and that there were workable criteria for making the distinction. And there are situations in which there is a deliberate effort, whether because of the huge initial capital requirements or otherwise, to create a jointly sponsored, if not operated, enterprise. Two somewhat different examples would be the development of COMSAT and the proposed SST.

I do not wish, however, to deal extensively tonight with the question of government involvement in productive or service enterprises, which is a

subject somewhat removed from my principal areas of concern. I would prefer to discuss with you the involvement of business in regulation--indeed in government--because I am not always sure that businessmen have a full awareness of the regulatory functions they perform and of the difficulties and challenges which that role entails.

While businessmen believe in competition, there has always been, in every industry and field of commerce, a tendency for businessmen to get together for the purpose of putting limits on the extent and the manner in which they will compete with one another, or permit others to compete with them. The strength of this tendency has varied greatly, depending on such factors as ease of entry into the business, nature of the product or service, special legislative privilege, and so forth. But it is always there, and it is an important force that can serve or frustrate the common welfare. Statutory solutions to the problems created by this tendency have ranged from outlawing it in some instances to harnessing it for the public good in others.

In the securities business, with which I am most familiar, there was a well-developed structure of regulation by businessmen long before the Securities and Exchange Commission ever entered the field. Not only is it still there--it has been enhanced and strengthened over the years. The stock exchanges, which were the earliest entrants, have greatly strengthened supervision of their members, their standards of conduct and other regulatory activity in the period since their rules became subject to scrutiny by the SEC. When Congress determined to establish a system of regulation for the non-exchange securities markets, it authorized and encouraged the members of the industry to form one or more associations to undertake a portion of the job, subject again to SEC oversight. The National Association of Securities Dealers, which was established in response to this legislation, is charged with a part of the burden of regulation of the diffuse over-the-counter securities markets to ensure that they operate in the public interest.

Regulation has many aspects. Intelligent regulation can greatly benefit the members of the regulated industry as well as the members of the public with whom they deal. Since businessmen are human, it is not surprising that some of the regulations they establish for themselves tend to increase their financial return by limiting the amount or type of competition within the industry. Sometimes, but not always, these restrictions can be justified on the ground that they eliminate practices which are harmful to the public, either directly because those practices encourage overreaching or indirectly because in the long run they damage the health and productivity of the industry and, therefore, the interest of the public in a developing economy.

The problem, though, is that it is difficult for those within the industry, acting alone, to form balanced judgments about the relative weights of the competing arguments--a narrow, albeit sometimes transient, view of self-interest may appear to point only in one direction. The function of government in a joint regulatory pattern is to provide representation for the interests of those who are not privy to the highest councils of the industry--it may be the customers or stockholders or some other relatively unorganized group, or it may be the smaller and less influential members of the industry who do not have an effective voice in industry decisions. In my view, it may be even more important for those who may be privy to these councils but who have a short-range view of their ultimate needs and best interests.

In the securities field, for example, it is the constant duty of the government to ensure that the regulations adopted by the industry do not upset a fair balance between the interests of the businessmen who do the regulating and the interests of the public with whom they deal or the other businessmen with whom they compete.

More generally, the statutory recognition and encouragement given to industry self-regulation has placed on the Commission a particularly heavy burden to ensure that the regulatory system is designed to facilitate, rather than to obstruct, the objectives of economical and efficient allocation of public savings which a flexible capital market is intended to achieve.

While not many other industries have the degree of self-regulation that is found in the securities business, we may soon witness dramatic developments. A recent newsletter, noting increasing business concern with government establishment of safety and performance standards for certain products and restrictions on selling practices, indicated that companies in various industries were making plans to draw up their own codes and standards to "head off" action by the government. While industry self-regulation of this sort has the potential for noteworthy achievement, I would like to suggest, on the basis of my own experience, that it will achieve far more if it is conceived of as a method of cooperating with, rather than excluding, the government and the interests and capabilities which the government represents.

There have been two trends in the development of business enterprise in this country--and indeed in the whole Western world--which have lent added urgency to the respective roles of business and government in regulation and have changed drastically the context in which that regulation must operate. I refer to the increasing size and the increasing diversity of individual business organizations. These two need not go hand in hand in the same enterprise, but they often do.

Increase in size alone can work a drastic change in the impact of an enterprise on our economy and our society. We are now facing this problem in the securities markets. There has been a dramatic acceleration in recent years of the trend toward combination of the savings of many small investors into a relatively few "institutional investors" in each of which a small group of men make a single decision to buy or to sell a particular security on behalf of all participants. Thus, where there were formerly hundreds, or thousands, of independent decisions, there are now relatively few, and these decisions tend to coincide with one another. The growing concentration of our units of decision has been accompanied by a strong trend toward mergers of firms engaged in the securities business. These developments place great burdens on our traditional market concepts and on the mechanisms devised to handle securities transactions. This, of course, is not peculiar to the securities markets. It is occurring in many different industries, and in each it places strains on traditional modes of regulation--whether by business or by government. Businesses which have hundreds of thousands of employees and hundreds of thousands of investors are not simply overgrown individual businessmen. They have become different in quality as well as in quantity, and we must modify our concepts and techniques of regulation to ensure that these businesses serve the common welfare.

Professor Galbraith observed, in his recent series of lectures over the British Broadcasting System, that the needs of our giant business enterprises are so vast that they can no longer rely on trading markets either to supply their needs or to distribute their products. Their activities must be carefully planned and organized over long periods of time--planned and organized on a scale and in a manner that would traditionally have been considered more characteristic of the activities of government than of business. Mutual funds may be viewed as an example of this development in the securities industry. The marketing of the shares of mutual funds generally does not depend on fluctuating supply and demand in a trading market but on a carefully planned and highly organized system of sales efforts. In our recent report on investment companies, we did not, as some have suggested, introduce new concepts of regulation into a heretofore unregulated field.

What we proposed was a modification of the existing regulatory structure to provide a better balance among competing interests and needs, which is an indispensable condition to the continued viability of any industry and the protection of the public interest.

In another context, a recent newsletter referred to the possibility that consideration might be given to limiting the advertising expenditures by the largest corporations, on the ground that the sheer volume of their advertisements could strangle competition and overwhelm smaller competitors. On the other hand, it has been suggested that this proposal might create more serious problems than those it was designed to solve. But, regardless of the merits of the arguments for or against this specific proposal, the fact that such a proposal would have been unthinkable in an era of essentially small business competing in a vast and unorganized market, does not mean that we should dismiss it without careful consideration in the light of current realities. Fortunately, we are making, as I said before, a notable start in realistic discussion of business-government relations. We should do no less in defining the nature and obligations of the units of business and the units of government with which we are concerned.

I do not wish to imply in any way that increases in the size of business enterprises are bad. Indeed, this development may well have been a factor in the growth of many areas of our economy. And continued growth may provide the potential for many additional benefits in the future. What I do wish to emphasize is that we must view today's productive enterprises as what they are, rather than in terms of a nineteenth-century pattern which no longer fits the facts of our business life.

The second trend to which I referred is the increasing diversity of individual business enterprises. Diversity can take many forms, but the two which I believe pose the greatest challenge to our regulatory techniques are diversity of product lines and diversity of location.

Diversity of product can free a business enterprise from some of the "natural" constraints which regulate its conduct. It can free a company from the competitive restraints imposed by any one of the markets in which it operates; even though a company's various lines of business have no functional connection with one another, it can use its income from some of its lines to finance activity in other lines which it could not or would not otherwise undertake.

Diversity of product can also free a company from another important control; the consequences of an informed and sophisticated judgment by investors as to the condition and prospects of the company and the quality of its management. The reluctance of some conglomerate or diversified companies to disclose the relative importance of the sources from which their earnings are derived has made it difficult, if not impossible, in many cases for investors to evaluate a company's performance and prospects in each of the various activities in which it is engaged and their effects on the future course of the enterprise as a whole. This removes or makes less effective an important internal control on management performance which was available when business structures were simpler; a division can be, and, indeed, has been operated inefficiently or at a loss for years without anyone outside the management being aware of it or of the extent of the drain on the results of other operations.

We are making some progress (I hope) in coping with the problem of financial reporting by conglomerate companies. Again we are relying in the first instance on regulation by business and professional groups--in this case the Financial Executives Institute and the American Institute of Certified Public Accountants, as well as the individual companies themselves--to develop standards and to secure compliance with them. We anticipate that they will soon be able to report substantial progress.

We recognize that a broad understanding of the problems of conglomerate enterprises and the development of regulatory techniques required to deal with them are still at an early stage of development. The deep division among the members of a sister agency in a current proceeding involving the merger of two large companies engaged in somewhat different lines of business bears witness to the difficulty sometimes encountered in formulating appropriate standards.

To return to the securities business, several mutual fund management companies are now subsidiaries of diversified industrial companies--a pattern which is likely to become more widespread. The recurrent proposals for public ownership of New York Stock Exchange members raises the long-term possibility of the professionals in the securities business becoming the subsidiaries of the firms in whose securities they deal. These matters raise important public and private policy questions. They require our serious attention now and in the coming years.

JA Just as diversity of product lines frees a business enterprise from the restraints of a particular market, diversity of location frees it from the control of local units of government. Corporation law has traditionally--in this country, at least--been state law, but as corporations have outgrown state boundaries they have also outstripped the power and willingness of the states to deal with them. It is not surprising, then, that the regulatory features of state laws governing corporations have gradually been eroded to the point that those laws are tending to become largely enabling acts, and the principal regulations governing the conduct of corporate managers in their relations with their investors, their employees, their customers and their competitors are to be found in federal law.

Intelligent regulation requires that the regulating agencies, whether business or government, have sufficient authority to deal effectively with the productive units in the industry. It is not in the long-run interest of any industry to attempt to keep regulatory authority in the hands of agencies which do not have the knowledge and the power to make effective use of it. Sometimes it is not in their short-run interest either. Professor Loss has noted that what he calls the "neurosis" of the insurance industry concerning any intrusion of federal regulation, which culminated in the special exceptions for insurance companies engrafted onto the Securities Acts Amendments of 1964, has resulted in a system of state regulation which cannot fail to be more cumbersome and more burdensome than the federal regulation which the industry so assiduously avoided.

As all of you know better than I, the process of diversification of location has taken companies across national boundaries as well. Here, the regulatory problems become even more complex, and the ability of existing organizations or governmental instrumentalities to make binding decisions is limited. (Our Ambassador to the United Nations, in a recent speech, said that the thing he missed most since he had left the Supreme Court was the four words that appear at the end of a Supreme Court opinion--"It is so ordered.") Different countries have different interests in the flow of products and of wealth across their boundaries. Most of them have complicated regulations governing international commerce. It is now well accepted, albeit reluctantly, that some measure of formal or informal relaxation and coordination of this form of regulation is required if international commerce is to flourish.

The international securities markets are an example of an area in which government and business can work together in an effort to encourage the development and growth of healthy capital markets. There have been some beginnings of international cooperation in regulation. And there

is a growing awareness abroad, particularly in European countries, of the need to accelerate this cooperation so as to encourage international portfolio investment and the creation of an international capital market in Europe which can compete effectively with that of the United States.

As more efficient capital markets develop, we will almost certainly see a continuation of the tradition of securities markets in different countries borrowing techniques from one another. The most recent wrinkle in mutual funds--the so-called "leverage" fund--came to this country from England. In the other direction, the convertible debenture has been exported from the United States by American companies seeking to raise capital in Europe to expand their operations abroad without adversely affecting our balance of payments. The recent report, by a group of experts appointed by the European Economic Community under the leadership of Professor Claudio Segrè, argued that if European capital markets were to compete with those of the United States, better developed secondary securities markets were essential. To achieve this, member governments were urged, among other matters, to permit vastly increased institutional participation in equity markets, and to remove the obstacles to free access to the debt markets.

As these "productive" techniques have moved across international boundaries, so have techniques of regulation. Ontario has provided us with imaginative precedents for dealing with problems of takeover bids, and recent revisions, both proposed and actual, of foreign corporation laws and stock exchange requirements, have suggested other provisions and techniques which we may find useful or instructive. For example, in the area of financial reporting by conglomerate companies, to which I referred earlier, we are following with interest the results of the amended rules of the London Stock Exchange and the proposed revision of the English Companies Act.

There are also suggestions that other countries may wish to adopt some of our techniques of securities regulation. In England, where a revision of the Companies Act is being considered by the Parliament, there has been extensive discussion of the limitations on the authority of the Board of Trade, the agency most similar to--but still quite different from--the SEC in terms of its regulatory responsibilities. The recent controversy surrounding Phillips' purchase of Pye shares has led at least one respected financial publication to suggest that a government agency more nearly comparable to the SEC might be useful in dealing with problems in the English securities markets.

I began this evening by discussing the relationship of business and government. I would like to speculate now, in considering the changes occurring in Europe, on how business and government can constructively interact. For many years, as most of you know, many European businesses were owned by family interests, and there was little need for these businesses to raise money from the public. The owners and managers of these companies were loath to disclose information about the companies' operations. The securities markets were dominated by banks and other financial institutions, which were the only investors with reliable and comprehensive information about the operations of the issuing companies, and there was little public participation. The corporate laws reflected the interests of the corporate managers, and required minimal disclosure of financial information. In recent years, however, family corporations have been discovering that it has no longer been possible for them to raise adequate capital for modernization and expansion without wider public participation. They have found the public reluctant to participate so long as the companies are unwilling to make adequate disclosure about their operations and management. The consequence has been that foreign governments have been revising their laws to require an increased volume of disclosure and to introduce other necessary reforms. Foreign stock exchanges have been strengthening listing standards and reporting

requirements. The recent meetings in Paris under the auspices of the Atlantic Institute suggest that some prominent businessmen recognize that it may be in their best long-term interests to provide a fuller disclosure of corporate affairs. While these changes occurred earlier in the United States, we have by no means exhausted the possibilities for improvements in the domestic scene.

I should also make clear that I am not suggesting the imminence of a World Securities Commission, or anything like it; and I am certainly not seeking for myself the job of regulating international securities markets. I am simply pointing out the importance of the maintenance of a regulatory structure adequate to the problems with which we must deal as we grow and our affairs become more complex. Business and government both have important roles to play in regulation. Our efforts must be directed toward discovering how we can best use the particular talents of each.