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DEMOCRACY IN THE MARKETS

An Address By

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Because I have the opportunity tonight to address businessmen and women who manage corporations, as well as people from the securities industry and attorneys and accountants who advise these two groups, I would like to talk about something which affects all of you: The participation of the individual investor in the securities markets.

We at the Securities and Exchange Commission are very concerned over the declining role of the individual in our capital markets. We are convinced that the vacuum being created by the growing absence of the individual investor is already having a strong and visible adverse effect on the liquidity and the pricing mechanism for hundreds of stocks. And there are strong indications that the unique ability of this country's capital market system to raise new capital for many thousands of corporations throughout the country is beginning to be affected as well.

Tonight I would like to give you my views on some of the causes and effects of this widening problem, tell you what we at the Commission are doing about it, and indicate some of the areas of possible action by the Congress and by you -- the corporations and the securities industry. The potential erosion of investor confidence and participation in the securities markets is national in scope, and so are the causes of this problem. I do not believe I am overstating the question or being dramatic. The answers to the questions can come only through a concerted effort on a national scale to preserve and strengthen the public character of the markets -- to bring the individual investor back.

We've seen an ever-growing indifference to common stock on the part of the individual investor for some months now. The ratio of trades of 200 shares and under, to take one example, to the total volume on the New York Stock Exchange is half of what it was five years ago. Until recently, the usual explanation was that investor activity was being channeled into mutual funds, but for the last 14 months the funds have experienced net redemptions -- more cashing in of fund shares than new sales, month after month. The static level of stock prices outside the world of the popular averages may also be telling us a story about individual investor interest -- or the lack of it. While the Dow

Jones industrial average, for example, dropped from over 955 in November, 1968 to below 700 in 1970 and then recovered to break 1,000 in November, 1972, an unweighted index of 1,400 stocks is still almost 50% below its 1968 peak. The result has been described as a "two-tiered" market, with the large, internationally established growth stocks -- which some have referred to as the "religion" stocks -- commanding all the attention and exhibiting high price-earnings ratios while smaller, less established companies sell at ratios well below the levels of the past, despite record earnings gains.

The current stock market doldrums may also be pointing up this divergence. For example, share volume on the New York Stock Exchange for the first quarter of 1973 declined about 9% from the same period in 1972. However, American Exchange volume declined 42% a factor which may well indicate the greater lack of interest in smaller companies. Moreover, the number of transactions declined 14% on the New York Stock Exchange and 45% on the American.

The effects of this behavior by the individual investor are becoming painfully evident to the investment community. Financial institutions generally concentrate their activity in a relatively narrow range of these religion stocks. It is the activity of the individual investor that brings trading interest and liquidity to the broad range of other stocks on the New York Stock Exchange, as well as to those on the AMEX, the regional exchanges and to the thousands of small, over-the-counter stocks. Today, we are increasingly seeing what happens -- in the form of abrupt price swings and widening spreads between the bids and offers for many securities -- when the flow of individual orders begins to dry up. In a sense, we have a vicious circle: without the orders of the individual investor, the market lacks liquidity, a situation which leads institutions to concentrate on the "most liquid" stocks, those with the largest number of shares outstanding. Of course, this concentration reduces liquidity as well, resulting in sharp price movements when institutions buy or sell. These price swings and the steady decline

in prices of smaller companies in themselves discourage the individual investor and further aggravate the situation.

The brokerage industry is the group most directly hit by a decline in individual market participation. This decline, combined with lower commissions on larger institutional trades, has produced a severe profit squeeze in the industry. In January, 37% of New York Stock Exchange firms reported losses; in February, 57% reported losses, and the overall loss for the NYSE firms doing a public commission business that month was \$41 million. Since these firms provide much of the capital for market-making in thousands of small, over-the-counter companies, the profit squeeze puts additional pressure on the market mechanism for these stocks. If the market-making capital for these stocks continues to run dry for a long time, the effects on the over-the-counter market will hinder the ability of smaller and newer companies to raise new capital.

The ultimate effect on the ability of smaller companies to raise capital must be of concern at this point. Clearly, even many large companies without an institutional following could suffer if this environment continues, but they generally can finance their requirements from commercial banks, insurance companies or other "private" investors. However, the smaller, regional companies will be severely restricted and our broad-based capitalist system will be threatened by the institutionalization of the equity market.

The broader implications of the decline in individual market activity are equally disturbing and should not be lost on public corporations. The public character of the nation's securities markets is a unique national resource one that gives our population broad participation in companies and provides for a market pricing system that represents the effect of thousands of decisions made by individuals and institutions alike. An increasing number of corporations are becoming concerned about the alternative to this system: a market dominated, as in many European countries, by the relatively few decisions of financial institutions and professional broker-dealers -- a market in which the public is represented only indirectly through the activity of pension funds, investment

companies, banks and the like. In my opinion, to really work, the corporate enterprise system must attract the interest and involvement of the public investor -- the backbone of this country's capital raising mechanism -- and a mechanism that represents one of the few remaining advantages we retain in world competition. It is an advantage we dare not risk losing. Also, as direct ownership declines, or ownership becomes indirect and impersonal through institutions -- what will the effect be on our concept of people's capitalism?

What are the reasons for this problem? Well, the standard explanations have been put forward for so long that they already sound repetitive: The individual investor thinks brokerage commissions are too high, or he took a licking in the market decline of 1970 and wants no more. Some people cite a fear of insolvency in brokerage firms or annoyance over the industry's paperwork foul-up of 1968 and 1969. More frequently expressed is the feeling that the cards are stacked against the individual in the market -- that institutions get all the good research, the best prices, and -- sometimes -- inside information. These and other reasons certainly do indicate a need for basic changes in the structure and operations of the securities markets -- changes the Commission in recent years has been seeking to bring about. In my opinion, however, there are other, perhaps more basic economic reasons for investor disenchantment, which I will discuss in a few minutes.

As I've indicated, at the Commission we are dealing with the structural problems, the nuts-and-bolts issues affecting the operation of securities firms and the regulation and efficiency of the markets. The purpose of our efforts is to create a welcome environment for the individual investor. He should demand and receive the respect of the market, but frankly I do not believe he has received his full share of respect in the past. There has been a lot of talk about the interests of the individual investor. Despite all the concern, there is still a great deal to be done to assure him that the market truly operates in his interest.

Our proposed central market system is such a vital and needed step in behalf of the individual investor. Many of you are already familiar with the Commission's proposed restructuring of the present system for the trading of listed securities into an integrated network of exchange markets and other market-makers operating under comparable standards and regulation. It is my hope that we will have such a system in this country within two years.

For the individual investor, the central market system will provide assurance that his buy or sell order will be executed at the best available price -- no matter where that price exists in the system. The central market system will create new competition between market-makers from New York to California and that competition will be seen "live" in the quotation display systems in the offices of thousands of broker-dealers. With the new system, the broker will not only have the means but the obligation to direct the investor's order for a listed stock to the best market for that stock.

Two rules of this proposed system emphasize the public order and I want to touch on them briefly. The first will have the effect of seeking to have the maximum number of public orders matched with other public orders -- without the intervention of a professional dealer. This rule will require that no dealer can fill a public order unless his quotation is better than the best available public order in the system. In other words, the professional dealer must do better than the existing price -- he must improve the market -- before he can participate in a trade within the system. In effect what this means is that the professional must surrender his present right of priority -- based on time of entry and size -- so that public orders can meet more often. The second trading rule will have the effect of allowing individual investors to participate in some of the premium and discounts available to institutions in trades away from the current market. The central market system will achieve this by giving representation in all markets to limit orders -- orders to buy or sell at prices that are different than current prices on the tape -- left by customers with their brokers.

Obviously, the best and fairest price for a security is of little value to an investor if he is selling or buying a security from someone who is trading on inside information. The cynical misuse of non-public information in the marketplace -- where material information is coin of the realm in dealings between some corporations, securities analysts and favored investors -- mocks the concept of a public securities market. I recently announced that the Commission would attack the problem of misuse of inside information on two fronts. First, we hope to have by mid-year a series of guidelines for public comment on the use of inside information for corporations, the securities industry, the legal profession and others. We will spell out in detail the Commission's views and attempt to provide greater clarity for those who wish to operate in good faith. Secondly, for those who don't, we offer a continually tougher enforcement program on inside information cases, with referrals of some of these cases to the Justice Department for criminal prosecution. I think the prospect of a federal grand jury and potential jail terms for securities trading fraud will prove to be an increasingly effective deterrent. The Commission's policy on the central market envisions a marketplace manned by a professional corps of brokers advising and acting on information that is publicly available to all investors. Trading on inside information -- so called "heresay research" -- has no place in such a plan.

Professionalism goes far beyond the question of inside information. Individuals and institutions should have equal access to non-insider, research information which would be material to their investment goals. Part of this question relates to who gets the first phone call when an analyst determines a fact or changes his opinion about a company. There is no way to make a registered representative or an analyst call one person before another. However, we should see to it that the registered representatives handling individual accounts in a firm get the research information at the same time the institutional representative do. We could then rely on the good faith and professional responsibility of the brokerage community as to when and to whom the information calls

are made. Such an arrangement will stop the practice of firms feeding the institutions all information first and letting the small investor scramble for it afterwards. There should not be a staggered start in this kind of race, since there are hopefully no curves around the track.

Other recent Commission actions which will affect investor confidence include our changes in disclosure for prospectuses and other filings and our new rules on financial responsibility of broker-dealers. It isn't much good for the individual investor if the disclosure document he gets can only be interpreted with the assistance of an investment professional. We have attempted to cut through a lot of the gobbledegook and force companies to really disclose in their disclosure documents -- not really an unfair concept, if I say so myself, as an old boilerplate pusher from private practice.

Our broker-dealer reforms stem from the Commission's Study on Unsafe and Unsound Practices, delivered to Congress in December of 1971. Since then we have put into effect a rule requiring that broker-dealers segregate their customers' cash and securities under specified circumstances so that in the event of failure, the customers will be made whole. As well, we have proposed a new uniform net capital rule for comment. By these and other measures, we hope to restore the confidence of the individual investor in the financial integrity of the brokerage community -- that he will not be supplying risk capital or making an investment unwittingly to his broker and that he will be preserved safe if his broker gets into financial difficulties.

The Commission's recent efforts on use of exchange memberships perhaps point up most dramatically our continued concern for the individual investor in today's markets. During our extensive four-year hearing procedures on market structure, commission rates and the utilization of exchange memberships, the one point that continually was driven home to us was the dissatisfaction of individual investors with the increased institutionalization of the marketplace.

As many of you know, in adopting Securities Exchange Act Rule 19b-2, we took steps to insure that exchange memberships are not discriminatorily denied to otherwise qualified persons or entities, provided only that all members utilize their exchange memberships to compete for public business.

As a result, our rule should equalize, to a large extent, the role of the individual investor and the institution in our markets. Under Rule 19b-2, the public investor should be the subject of increasing attention and competition. Since the rule would open membership to any qualified organization wanting to carry on a public brokerage business, we may well see new capital flowing into the securities industry -- a welcome and wholesome development.

I've talked about a lot of things the Commission has done, but our actions have not been, and cannot be, sufficient in themselves. Other agencies, Congress, the financial community and the corporations depending on the capital market must focus on a number of broad policy matters which raise questions beyond the scope of SEC jurisdiction. In some senses, these questions are economic in nature which makes this forum a particularly appropriate place to raise them.

I am not thinking so much about commission rates since they are clearly under SEC jurisdiction, although in a sense they are also an economic factor. We recognize that the lower commissions charged institutions, reflecting economies of scale, give them an opportunity to trade profitably at a price differential which the smaller investor finds inadequate. Although this may be a factor in keeping out the individual, I believe that an equitable marketplace and good service are far more important than the commission rate, particularly when one notes that the market vehicles which have caught investor enthusiasm recently have been bond funds, REIT's and tax shelter partnerships, all of which typically carry a much higher commission charge or spread than a typical stock exchange transaction. Perhaps we need to provide more rate flexibility, enabling the

investor to pay for the services he wants and the broker to offer a sliding scale of services with different charges for each.

The appeal of closed-end bond funds reflects an important economic consideration -- that of the impact of inflation on the small investor. I suspect there is a substantial body of investors who worry primarily about current return from dividends or interest -- and only secondarily about the possible supplementary return from capital gains. Perhaps the individual -- who has, after all, been a net seller for some years -- reinvested the proceeds from his sales partly in mutual funds, at least during the 1950's and 1960's. However, disappointing fund performance combined with high returns in the bond market, may have led the individual of the 1970's into other investment vehicles and out of the equity market. I recognize everyone is anxious to end inflation and the accompanying high interest rates; and that an easy solution is not available. However, I think it important to recognize that a possible side-effect of inflation is the aggravation of the current difficulties in our equity market. These effects may be accentuated by the current ceiling on dividends and the use of monetary policy to stem inflation, which results in higher interest rates. I suggest that we explore removing this ceiling so that equities can compete more fairly with debt.

At the risk of contradiction for my forewardness as a lawyer in suggesting economic alternatives, I would like to mention possible ramifications of tax policy on the equity market. A number of observers have suggested that increasing the capital gains tax -- and the speculation about elimination of the preference rate on capital gains entirely -- has caused many investors to liquidate investments with built-in gains as rapidly as possible. Reducing or eliminating this preferential treatment may discriminate particularly against the less well-established company which pays no dividends, offering only future growth as an investment inducement. I am not supporting the suggestion that each taxpayer be allowed a one-time capital gains tax exemption similar to the one-time

gift tax exemption. However, I do believe tax reformers must consider the benefits of an incentive to investment in small, young companies.

The tax incentives granted in connection with private pension funds may have a less obvious but important impact on the equity market, and thus also deserve the attention of tax reformers. Pensions are generally receiving a great deal of attention today, and the managers of these funds are among the institutional investors I discussed earlier, who concentrate their investments in the blue chip growth stocks. Before dealing with this point, however, I'd like to speculate on how the participant or ultimate beneficiary views his share in a pension fund. Does he believe that his shares are an alternative to his own direct market participation or does he view the pension fund more as a form of social security?

Concessions such as those allowing deferral of taxes on pension fund participation until the benefits are paid out, and then providing for capital gains treatment on the income and appreciation, may well encourage a participant to rely on his pension and avoid making direct market investments.

But regardless of what the pension fund beneficiary does with his savings, it is apparent that the pension funds themselves have grown dramatically in recent years and an increasing proportion of these funds is being invested in the equity market, a factor which has led some observers to conclude that pension fund managers are the most important influence in the stock market today.

These managers, often bank trust departments, appear to have emphasized quality growth stocks and are accused of being the principal creators of the "two-tiered" market I discussed earlier. Critics also contend that these institutions suddenly -- sometimes overnight -- liquidate positions acquired over a long period, causing sudden price drops even in the largest stocks. In reaction, we have heard calls for restrictions on the percentage of a company's outstanding stock which can be held or on the amount which can be sold in a given time period.

The Commission is opposed, at least at present, to any arbitrary impediments. However, as pointed out in our Institutional Investor Study of 1971, we do believe disclosure of institutional holdings and their significant transactions may be desirable, both to inform investors of institutional concentration and to aid the Commission in meeting its responsibility to assure orderly and equitable markets. Not only would all the participants in the future central market system be better informed, but corporations would have a better understanding of the nature of their shareholders. Accordingly, we will ask Congress to pass an Institutional Disclosure Act, which would give us rulemaking power to require all types of institutional investors -- banks, insurance companies, pension funds, and the like -- to disclose holdings and transactions in securities over which they have investment authority.

My preliminary view is that we might require institutions to report holdings as of the end of each quarter and their past quarter's block transactions (one possible definition might be transactions involving 10,000 shares or 1% of the shares outstanding, whichever is less). I believe that institutions will be anxious to provide this information to demonstrate that their market behavior is fair and proper; moreover, the information could be provided without undue burden from the computer records presently maintained by most institutions.

The basic data, of course, would be assembled according to institutional holders, and a substantial collating effort would be required to organize the information according to corporate entities. While the Commission might undertake such an effort, it also seems probable that this data would be of sufficient interest to corporations and market participants that a private collating effort could prove profitable.

But the Congress can and hopefully will do even more. As we painfully learned after the debacle in 1967 to 1970, the "back office" of the securities industry -- the part of the business small investors never see -- has played a large role in driving small investors from the market. Hold-ups in transfer cause a disproportionately large percentage of

customer complaints to the SEC. Regulation of this important aspect of industry operations should serve to restore investor confidence and likely will generate a return of small investors to the market. The Transfer Agent, Depositary and Clearing Agency Bill of 1972 failed to pass on the last day of the Congressional session, but Congressman Moss, in recent proposed legislation, has resuscitated the measure. It is imperative that a meaningful version of it pass both Houses of Congress in the near future.

In the last several years we have witnessed a growing victimization of the small investor and an alarming lack of concern for his continued vitality. In large measure, I suspect this has been the result of policies pursued by some in the industry who are myopic enough to believe they can wholly ignore the future impacts of their immediate follies. They cannot. We are striving to make the markets of the Seventies viable for small investors, and the Congress hopefully will pursue complementary legislation.

But in the end, the problem is as much yours as it is ours. You need the small investor. It is up to you to preserve and enhance the elements of our capital markets that have served American business so well. Much like the curator of the National Zoo, I feel constrained to warn you that the individual investor already has acquired the status of an endangered species. None of us can afford to have him become extinct.