<u>NOTES FOR EXCHEQUER CLUB</u>

February 20, 1974

Ladies and Gentlemen:

I would like to take as my text this noon Professor Lorie's statement to the Secretary of the Treasury, published two weeks ago, as "Public Policy for American Capital Markets". In his introduction to the statement, Secretary Shultz has written:

> Deputy Secretary Simon and I have reviewed Professor Lorie's statement and believe that it provides a sound basis for public policy in each of the areas it addresses. While the statement does not represent an official Treasury position, we support its basic conclusions.

The statement grew out of a series of conferences held during the fall with leading representatives from firms and self-regulatory bodies in the investment community and from several major banks. To these Professor Lorie has added his own impressive learning and wisdom and produced a <u>tour de force</u>.

The statement is simple and clear and short - - amazingly so for a document in this field. I commend it to all of you.

OBJECTIVES OF PUBLIC POLICY

What are the desirable characteristics of capital markets?

A. Efficiency in determining prices of securities

Ability to function so that prices react rapidly to new information.

Produce "appropriate" prices in terms of current knowledge.

Fewer "unwise" investment decisions - - fewer extraordinary gains.

"Efficiency makes it difficult to be either a fool or a genius in selecting securities…"

Reduces advantage of institutions over individuals.

B. Efficiency in transferring ownership of securities

"It is desirable that costs of transactions be low"

Three main components - -

Cost of brokerage - - best determined by competition

Cost of using capital and bearing risks

Cost of physically effecting transfers

Lorie urges more efficiency in clearance and depository functions. Rejects a single, national system for competition.

> "The benefits of competition could be preserved, in the form of greater innovation and lower costs in the long run, if competing systems were permitted subject only to the requirement that they interface".

C. Equity in the relationship between investors and their financial agents

Equity has four dimensions:

(1) prices of services - - determined by competition.

(2) provision of information - - reasonably equal access.

(3) execution of orders - - preferences in time and price.

(4) the absence of conflicts of interest.
Eliminate as far as feasible - - and regulate.

D. Public confidence in capital markets

Public confidence requires - -

(1) confidence that returns will be reasonably related to risks,

(2) confidence in the financial integrity of the institutions, and

(3) confidence that the individual investor is not at a serious disadvantage compared with the institutional investor.

Public policy for capital markets cannot deal with the first item.

E. <u>An equitable tax policy consistent with needs for capital formation</u>

Taxes on individuals affecting savings and transactions.

Taxes on broker-dealers, especially affecting ability to accumulate capital.

F. <u>An adequate dispersion of economic power</u>

Concern about growth of institutional investors.

"Bigness per se is not bad; its badness depends on its consequences and must be demonstrated in a factual context."

THE ISSUES

A. <u>Structure and rules of the central market</u>

Lorie generally concurs with SEC policies set out in - -

"Statement on the Structure of a Central Market", Feb. 2, 1972.

"Policy Statement on the Structure of a Central Market System", Mar. 29, 1973.

Lorie thus favors the consolidated tape, composite quotation system, and appropriate rules for preference and priority as proposed.

Strongly favor competitive commission rates.

Some points of divergence - -

(1) "Access" to the central market.

Lorie favors a 100 – 0 standard.

Firms granted access would have to do all, or substantially all, their brokerage business with non-affiliates.

They could act for unaffiliated managed accounts.

They could <u>not</u> act for investment companies that they advise or manage.

This is SEC Rule 19b-2 except for 100 – 0.

"off-broad" trading in listed stocks. NYSE argues that eliminating fixed commissions will destroy the auction market if off-board trading is permitted as it is today.

Lorie is not convinced but adds - -

> "At the same time it must be recognized that uncertainties do exist and should the adverse consequences appear, the SEC should promptly impose effective remedies - - perhaps through the prohibition which the New York Stock Exchange seeks."

B. <u>Governance of the central market</u>

SEC should have equivalent regulatory authority over all participants in the system - - broker-dealers, banks, depositories, non-bank transfer agents, or others, and all self-regulatory bodies.

C. <u>The role and impact of institutional investors</u>

"In summary, institutions cannot reasonably be blamed for the ills which are sometimes attributed to them" So no case made for restricting their investment activities.

As to an institutional investor disclosure act such as SEC supports, Lorie says:

> "little harm and possibly some good could come
> from periodic - - say, quarterly - - disclosures…"

Lorie opposes forced disclosure of intention to trade.

D. <u>The "special problem" of banks</u>

Generally favors retention of Glass-Steagall as presently interpreted.

Competition with investment bankers through larger term lending and arranging private debt financing is good.

Underwriting industrial securities by banks is bad - - conflict.

Managing pension funds etc. and lending to the employer presents conflicts. Should continue to control harmful effect of conflicts by limitations now generally accepted - - the “Chinese Wall”.

“Prudence” - - prudent man standard should be changed to permit greater diversification and investments in smaller companies.

Lorie does <u>not</u> state views on - -

“AIP’s” administered by banks.

Reinvestment of dividends through banks.

E. <u>Tax suggestions for broker-dealers</u>

Personal holding company rules - - modify re income from investments.

Subchapter S rules re income from investments.

Unreasonable accumulation of income - - relax rules to permit building up of capital.

Redemption of subordinated loans and preferred - - treat as return of capital.

Generous loss allowances comparable to other financial institutions.