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February 1, 1978

Mr. Harold M. Williams
Chairman of the Board
Securities and Exchange Commission
Washington, D. C. 20549

Dear Mr. Williams:

I have your letter of January 10, 1978, also the transcript of your speech given at Boca Raton. Both in your letter and in the speech, you ask those in the Securities business to "voluntarily" express further thoughts on the problems extant.

In my letter of September 1, 1977 (copy enclosed) I paraphrased my views on Rule 390. If the rule is cancelled, there will be provided one more profit center for dealers acting as principals. This will supplement the options, non-security loans, insurance, tax shelters, commodities and real estate, none of which, when handled by non-experts, is in the public's interest.

How sad it is that legislation promulgated in the public's interest so frequently brings forth results 180° off target. John Moss was the champion of negotiated rates. For years before he ever led the House Committee into the securities arena, he sat periodically with small groups of us in San Francisco "learning" our business. At that time, and without securities' experience, he expressed disapproval of the NYSE as a "gentlemen's club" and he advocated negotiated rates as a means of providing competition within the securities business. It has become destructive competition. You have called it "predatory and destructive."

I have a snapshot taken of myself and Moss, face to face at the St. Francis Hotel, where, in advance of the passing of legislation including negotiated rates, he spoke to several securities groups on that subject. I told him then that he was opening Pandora's box. That is exactly what he has done and it is a pity that he intends to retire before he finds out the full consequence of what I call sociological legislation (effecting social changes, ignoring economics.)

Moss contended that after negotiated rates, all the little old ladies who bought 100 shares of PG&E would pay less commission. As a matter of fact, within two weeks following May 1, 1975, Merrill Lynch advanced their rate on small orders by 8%, while the discounting at the bank and institutional level increased steadily. As I write these lines, I am informed that several of the big firms have just increased small order rates another 7%. This is in the face of 4 1/2¢ to 7¢ per share for institutional large orders. Since

May 1, 1975, the major financial streets have been strewn with the remains of some 145 firms (not 100 as referred to by yourself.)

I believe that one of the causes of legislation producing a reverse result is that it is prepared by men who do not know the business being legislated. They obtain information by calling in contenders for all sides, most of whom have an axe to grind. The hearings are frequently influenced by views related to the offensiveness of a "gentlemen's club," while the economics of retaining a system for raising capital and providing liquidity are not premeditated or understood.

May I take you back to the 30's and explain how constructive legislation was formed.

The 1929/1932 period was followed by the usual government investigation. Pecora, a prosecuting attorney in New York City government, conducted the hearings for the Committee. Most of those subpoenaed were bankers, since they were, at that time, the majority underwriters and retailers of securities. Among those who appeared were J. P. Morgan of the J. P. Morgan Bank, and Charles Mitchell of the National City Bank. One witness, a female midget, was called. She was one who, reportedly, had been hurt financially by a Morgan underwriting. Because of her diminutive size, Pecora put her on J. P. Morgan's knee to give her testimony. There is a famous photograph of that incident.

The outcome of that investigation was not very conclusive. Securities issues (stocks) bought in 1929 had been purchased largely on 10% margin, only a small decline in market value could, and did, wipe out the speculative customer's equity. Attempted liquidation of securities brokers' collateral loans by banks, wiped out first the broker and, later, the banks.

Detail which went into the '33 and '34 Acts carried very little of what came out of the Pecora Committee's investigation. Truth in Securities (1933 Act) called for complete disclosure. The 1934 Act covered all the no-no's related to manipulative practices so typical of the times.

The two Acts were written by two young lawyers, nicknamed "the Frankfurter Hot Dogs." Their names were Cohen and Corcoran; both were law students just out of Frankfurter's class at Harvard. Their work was done well except that they forgot, and omitted from the 1934 Act, any reference to the over-the-counter market.

As originally completed, the 1934 Act related only to the listed market (some 1,500 issues), whereas many thousands of OTC issues were outstanding. This is where the securities industry came in to assist in preparing legislation.

One of the early post-depression regulations of the Roosevelt administration was the National Recovery Act (NRA). It required every industry to have on

file with government a code of business ethics. The Investment Bankers Association (now the SIA) called in fifty member broker-dealers from all parts of the country, to convene in Chicago, where they prepared a code for the securities business. Its long-term importance was that although the NRA, after only a few months of existence, was declared unconstitutional by the Supreme Court, the Securities Dealers Code continued to be used as the practical working rules of the industry. Paragraph after paragraph was inserted, without change, into the By-laws of what later became the NASD.

The securities industry also was responsible for the passage of Section 15A which was added to the '34 Act. This brought all over-the-counter securities under the Act. We had the full cooperation of the SEC, as they had, at that time, a limited staff and were anxious to get the over-the-counter issues under the Act to be supervised by a self-regulatory body. Lastly, to give administrative authority to the NASD, they passed rules which required all broker-dealers to be members of the NASD if they expected to get price concessions, underwritings, etc.

Other practical contributions were made to the public by the securities industry. It was the NASD which evolved the 5% Philosophy to control excessive profits. Here are some of the background details.

From the 20's into the 30's, the securities industry, which included banks and broker-dealers, underwrote and retailed issues as principals, and took profits of from 3 to 7 points, occasionally 10. In the Code days, the NRA had eliminated "boiler shops" but, for years after the passing of the Code, securities firms and banks took big profits. The 5% philosophy brought profits into line.

It was not uncommon for a frozen loan in a bank to be transposed into a bond issue. Some of the bonds never paid the first coupon. It also was common practice for bank underwritten securities, carrying 5 points' profit, to be confirmed to their own Trust accounts, from which they were already collecting trustees' fees. Prior to the Code days, practically all dealers billed their sales of inventory bonds carrying a profit at a price of, say, 98, with a commission of $5.00 added. This was a decorative inference to an agency transaction.

In the late 20's, the public became interested in stocks. Margin requirements of only 10% were inviting. All new underwritings were marginable - and bankable. Gradually, to accommodate customers who wanted to buy stocks, firms began to buy exchange memberships. Even the banks carried associate memberships (half memberships) and that only because they were not qualified for regular membership without being partnerships.

Dealer firms sought Exchange memberships to broaden their profit base; also to dignify their position. Membership was a hallmark of control and quality. The rules applicable to capital and even direction of salesmen converted many a firm from "shop" to a business.

I do not know, to date, when 390 became a rule. I am certain that it was not passed solely for the purpose of benefitting Exchange members. This is the view of many who, like Moss, have worked on securities' regulations. I think they go too far. There is great credit due 390. It is one of the most protective rules in the book. Its genesis was like dozens of other rules which were passed to offset industry problems. Rule 390 was created as a competitive offset to the abnormal profits being charged on dealer transactions. It created an area in which the public could buy listed issues, backed with statistical data required by the Exchange, for a fraction of the OTC cost.

Rule 390 was, and is, the great discipline which made the NYSE the envy of non-members. Moreover, it is the great contributor to confidence among the public. Should 390 be cancelled, it is certain that the standing and volume of Exchanges would shrink. As I write these lines, I look across the street to the San Francisco division of the Pacific Stock Exchange. Here is a literal can of worms; seats now at $300 to $500, and the paid President resigning, a Board hopelessly divided on the subject of moving virtually the entire operation to Los Angeles. Their computer system is in disarray. Inside, behind the nine Corinthian columns which support the building, it is being proposed that only the options market will be left to operate in San Francisco, this without a red light hanging over the entry. And now the demise of 390, the big firms will turn to dealer business as of a generation ago, and the small firms will follow. One facet of the securities business which the legislators have never experienced or known is the hazard of inventory. To carry inventory with capital partly borrowed from a bank, in order to make a fraction of a point of profit, is the basis for the next crop of failures.

As to the National Market System: you are in a difficult position. You have certain Congressmen nudging you to do something. You also have a fragmented industry which cannot do anything. You ask, "Where is the leadership?" It ceased to exist on May 1, 1975. It was then that the industry splintered into many parts. No better example ever crossed my desk than the "reports" of the National Market Securities Board; their scattered views represented the agony of men in business areas ranging from third market to specialists struggling for their survival.

You summarize the dire consequences of legislation which called for negotiated rates and a National Market System. The failure of firms and the weakening of the capital raising system is not what the Congressman expected. I would be less than frank if I commented upon the National Market without emphasizing my skepticism. I do not believe that the Congress-

men who reviewed the conditions of the late 60's and early 70's came up with the right answers. I fear that views of a computerized market came to them as they did to many of your staff, who, as you have referred to the subject, became convinced as far back as 1971 that markets could be balanced off by IBM computers. I heard that same routine in 1969 from the same IBM salesmen. They came to an IBA convention with IBM cards which were to be substitutes for stock certificates. There would be no transfer agents or registrars. All outstanding shares would be held in a central depository and the cards would designate what each person owned. I showed a sample to several San Francisco bankers. Loss of transfer fees, as well as loss of sale of stock certificates, created negatives, while their lawyers said that a man's estate should contain only actual stock certificates.

I cannot see any improvement in liquidity or terms from a National Market System over what has been provided for years by Exchanges. There has been much said in Washington re the evils of the specialist. But, in order to get his franchise to deal in designated securities, he had to make the book and provide an orderly market. Change this, to the point of having many market makers, and there is no exaction put upon them to take stock in a declining market. They have no concern as to losing the stock for non-performance in market making. During any economic crisis there will not be liquidity to which we have been accustomed, because amateur market makers will run to cover.

If, after all, the National Market should confirm accurate legislative judgment, what are the costs of putting it together? I commend the Commission for putting 390 in the offing until someone finds a number. I might add that Stock Exchange firms like ours, which have seen seats go from $300,000 to $45,000 (local seats from $225,000 to $300 at $500) are not financially oriented to participate in a high cost, electronic mechanism. We are concerned, too, over the detail of handling odd lots. As of today, they are held in-house by big firms acting already as dealers, who buy on the bid and sell at the asked. Also, we wonder about the client who asks for size of the bid and who tries to get in between bid and asked.

Even more concerned are we as to the position of Exchanges. I have been in most of the Exchanges in the world. Some have operated for ages. I have related above the sad state of affairs at PCSE and I can see New York side-tracked by the so-called National Market System. It was New York which set the qualifications for listing corporate securities. The most important item was publicity as to corporate financial stability and earnings, all of which made it desirable for corporations to list, thus to provide stockholders with information and prices. Our Number One sales resistance point is the client query, "Is it listed? Where do I see it in the paper?" It will be difficult under a National System. I wonder, too, if the corporations relish the prospect of having the market for their

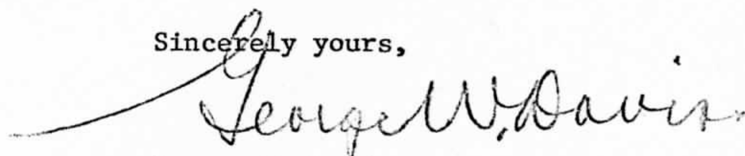
shares scattered across the country. What of the banks? Can the laws under which we work be made applicable to them, too? Or do they continue to "bundle" securities, postpone executions to build size and then press the brokers for 4 1/2¢ rates? Will the Fourth Market, operating in size, find any alternative to selling big blocks to another big buyer? Can the Fourth Market accommodate a 100 share buyer? Will they be bothered to feed out stock as in a secondary?

As to central clearing - a legislative dream. This, if highly concentrated, is dangerous. We are more impressed by clearing operations spread into geographical areas, just for safety. One national back office experience is enough.

I do not reject change. I have not only accepted it, I have worked for it in every securities industry crisis of the past 55 years. I have watched the proceedings since May 1, 1975. It has been a catastrophy for 145 firms (plus mergers). I see further deterioration imminent because a National System will have to destroy more organizations and exclude more distributors of securities (salesmen), in order to meet the legislative objective. This is exactly what holds back the leadership which you seek. Those who confer on this subject now deal for themselves. They deplore the prospect of cutting out some segment of the industry in order to meet the mandate. And the public? If all that has gone on since May 1975 is in their interest, the Security Acts should have a new preamble. So far, what has occurred has been counter productive for them.

You were kind to direct your letter to me. I have responded by sharing with you some bit of history and a few observations. If any part of what has been set forth should provoke your further enquiry, I may be reached at the other end of your line: 415 392-7700.

Sincerely yours,



George W. Davis

GWD:ies

Encls.

cc: Mr. Robert H. B. Baldwin, SIA