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"SELF-REGULATION IN THE SECURITIES INDUSTRY"

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REGULATION OF THE SECURITIES INDUSTRY IS FUNDAMENTALLY DIFFERENT FROM REGULATION OF OTHER BUSINESSES BY FEDERAL INDEPENDENT ADMINISTRATIVE AGENCIES. THE SECURITIES AND EXCHANGE COMMISSION IS NOT ONLY A DIRECT REGULATOR, BUT ALSO AN OVERSEER OF SELF-REGULATORY ORGANIZATIONS. THESE ORGANIZATIONS INCLUDE THE EXCHANGES AND THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. ("NASD").

WHEN CONGRESS PASSED THE SECURITIES EXCHANGE ACT OF 1934, IT ESTABLISHED A REGULATORY PATTERN WHICH INCLUDED SELF-REGULATION IN ORDER TO AVOID THE UNDUE BURDEN ON BUSINESS WHICH EXCLUSIVE DIRECT GOVERNMENT REGULATION WOULD BE. THE LEGISLATIVE HISTORY EXPLAINS:

> IN FRAMING A REGULATORY MEASURE, THE PRACTICAL PROBLEM OF ADMINISTRATION HAS ALWAYS TO BE FACED AND WHEN REGULATION GETS BEYOND A CERTAIN POINT THE SHEER INEFFECTIVENESS OF ATTEMPTING TO EXERCISE IT DIRECTLY THROUGH GOVERNMENT ON A WIDE SCALE COUNTERBALANCES THE FACT THAT POSSIBLY THE EXCHANGES MIGHT NOT BE AS DILIGENT AS WE WOULD WISH THEM TO BE ABOUT REGULATING THEMSELVES OR AS DILIGENT AS THE GOVERNMENT WOULD BE IF THE TASK WERE COMPACT ENOUGH TO FALL WITHIN THE LIMITS OF EFFECTIVE GOVERNMENTAL PERFORMANCE.

IN ADDITION TO THE PRACTICALITY OF SELF-REGULATION FROM THE STANDPOINT OF GOVERNMENT EFFICIENCY, CONGRESS HAS RECOGNIZED THAT SELF-REGULATION MAKES PEOPLE WHO ARE SUBJECT TO REGULATION ACTUAL PARTICIPANTS IN THE REGULATORY PROCESS. THIS NOT ONLY BRINGS EXPERTISE AND UNDERSTANDING INTO THE REGULATORY PROCESS, BUT MAKES THE IMPOSITION OF REGULATORY CONTROLS MORE PALATABLE.

Mr. Justice Douglas referred to the potential which self-regulation has for establishing and enforcing "ethical standards beyond those any law can establish." He stated:

> Self-regulation...can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government alone, can effectively reach.

Another positive aspect of self-regulation is that the exchanges and the NASD have traditionally played a strong promotional role for the securities industry. This has relieved the SEC from undertaking many promotional responsibilities. As pointed out in a recent study on Federal Regulation by the Senate Committee on Government Affairs, promotional and regulatory programs do not comfortably coexist in the same agency. "Experience has demonstrated that when both functions are assigned to a single agency, there is a general tendency for the agency's promotional mission to predominate."

Last week I spoke to the Securities Industry Association about the difficulties I perceive in the assumption of significant new promotional responsibilities by the SEC. I was disappointed that coverage of my speech stressed possible adverse effects of that promotional role in the Commission's prosecutorial role, rather than my concerns about the shifting of promotional responsibilities from the self-regulatory organizations to the Commission.

I DECIDED TO SPEAK TO YOU THIS AFTERNOON ON SELF-REGULATION IN THE SECURITIES INDUSTRY BECAUSE I BELIEVE THAT SELF-REGULATION IS A MEANINGFUL ALTERNATIVE TO INCREASED GOVERNMENT REGULATION OF OUR FINANCIAL INSTITUTIONS AND FINANCIAL MARKETS. AND DESPITE THE PRESSURES FOR, AND IN CERTAIN AREAS, GOOD POLICY REASONS JUSTIFYING INCREASED GOVERNMENT INTERVENTION IN THE ECONOMY, I DO NOT BELIEVE THAT INCREASED GOVERNMENT REGULATION OF THE SECURITIES INDUSTRY IS NECESSARY OR APPROPRIATE. IN AN AGE OF CONSUMERISM, WE SOMETIMES FORGET THAT OUR ECONOMY IS BUILT UPON PRODUCTION AND NOT MERELY CONSUMPTION. IN THE 1930'S THE FEDERAL GOVERNMENT CREATED A NUMBER OF NEW INDEPENDENT REGULATORY AGENCIES TO STIMULATE THE ECONOMY AND TO CREATE JOBS DURING A DEPRESSION. THE SEC WAS ONE OF THOSE AGENCIES, ALTHOUGH THE COMMISSION'S ROLE WAS SEEN BY CONGRESS AS PREVENTING ANOTHER DEPRESSION BY AVOIDING ABUSES WHICH LED TO THE 1929 STOCK MARKET CRASH.

THE SEC IS CHARGED WITH INVESTOR PROTECTION AND THE MAINTENANCE OF FAIR AND EQUITABLE TRADING MARKETS. WE SOMETIMES FORGET THAT, AS LAUDABLE AS THESE OBJECTIVES ARE, THEY ARE NOT ENDS IN THEMSELVES. INVESTOR PROTECTION AND GOOD TRADING MARKETS ARE IMPORTANT BECAUSE THEY ARE NECESSARY INGREDIENTS FOR CONFIDENCE IN OUR SECURITIES MARKETS. THE FEDERAL GOVERNMENT'S EFFORTS TO ENGENDER SUCH CONFIDENCE ARE BASED ON THE ASSUMPTION THAT INVESTOR CONFIDENCE CREATES A FAVORABLE CLIMATE FOR THE CAPITAL FORMATION NEEDS OF THE GENERAL ECONOMY.

In my opinion, the success of the SEC as an effective regulator should be measured by whether the scheme for securities regulation which we pursue, on balance, encourages rather than discourages healthy capital formation. Clearly, the rate of capital formation by the private sector today is inadequate to solve our urgent national problems. Much of the lag in capital formation is due to basic economic ills which the SEC has neither the mandate nor the expertise to cure. However, there are some developments which directly relate to the securities industry which concern me because the SEC may be in a position to affect some of the economic factors involved.

I am concerned about the extent to which private capital is being invested in vehicles other than corporate securities. The dollar value of securities registered by corporations under the Securities Act of 1933 for sale to the general public decreased from $42 billion in the Commission's fiscal year ended June 30, 1975 to $36 billion in the year ended June 30, 1976 and $31.8 billion during the 12 months ended September 30, 1977. During the past few years, real estate, commodities and municipal securities have all been more attractive to investors than corporate stocks or bonds. I am also concerned about the declining profitability, shrinking population, and unmet capital needs of our broker-dealer community.

I AM NOT CERTAIN WHAT THE SEC CAN DO TO REVERSE THESE TRENDS, ALTHOUGH I WOULD WELCOME ANY SUGGESTIONS YOU MAY HAVE. BUT I DO FEEL THAT INCREASED REGULATORY RESTRAINTS ON THE SECURITIES INDUSTRY WILL NOT BE HELPFUL.

NOT LONG AFTER I WAS APPOINTED AS A COMMISSIONER OF THE SEC, AN OBSERVER OF THE SEC'S ACTIVITIES TOLD ME THAT I SEEMED TO BELIEVE IN ZERO-BASED REGULATION. AT FIRST, I WAS NOT SURE IF THAT REMARK WAS COMPLIMENTARY OR DEROGATORY. EVENTUALLY, IN KEEPING WITH THE WAY IN WHICH MOST OF OUR EGOS OPERATE, I DECIDED THAT I HAD BEEN COMPLIMENTED. NOW THAT I HAVE SPENT SOME TIME IN WASHINGTON, I BELIEVE THAT AMERICANS MUST START TAKING SUNSET LEGISLATION SERIOUSLY, AND PUBLIC OFFICIALS LIKE MYSELF SHOULD START RECEIVING PLAUDITS FOR DEREGULATION RATHER THAN ADDING TO THE AMOUNT OF LAW OUTSTANDING.

DESPITE THE GENERALLY HELD VIEW THAT GOVERNMENT HA BECOME TOO BIG AND REGULATION HAS GONE OUT OF CONTROL, THE FEDERAL GOVERNMENT CONTINUES TO GROW. COMPARED TO NEW YORK, WASHINGTON IS A BOOM TOWN. IT DOES NOT SEEM RIGHT TO ME THAT THE GOVERNMENT IS FLOURISHING WHEN THE PRIVATE SECTOR IS FALTERING. IT DOES NOT SEEM RIGHT TO ME THAT THE SEC IS STABLE WHEN THE SECURITIES INDUSTRY IS SHRINKING.

On the other hand, although the SEC has taken on increased responsibilities over the years, it has not grown greatly in size. It may surprise you to learn that in the 1930's the SEC had about 1800 employees, and the agency still has less than 2000 employees. In these days of burgeoning bureaucracies, that is a growth rate of which I am proud. I would like to maintain it.

I believe that one of the most effective ways to curtail the growth of the SEC, without unduly sacrificing investor protection and good trading markets, is to rely upon self-regulation in the securities industry. Self-regulation has been an integral part of the statutory scheme for the federal regulation of the securities markets since 1934, when Congress preserved the securities exchanges as self regulatory organizations, expressing the hope that the exchanges would effect needed reforms so that direct action by the SEC would not be necessary.

Then in 1938 Congress extended the concept of self-regulation to the regulation of over-the-counter brokers and dealers, by enacting the Maloney Act which led to the formation of the NASD. The legislative history of the Maloney Act indicates the belief of a supporter of the Act that many of the abuses in the securities industry were more a matter of ethics than illegality. Even if the funds and staff for regulation of the markets were provided by Congress, in his view, ethical practices were not a task which the government could perform.

THEREFORE, SELF-REGULATION WAS CONSIDERED PREFERABLE TO THE BUREAUCRATIC EVILS WHICH WOULD RESULT FROM A DETAILED AND RIGID REGULATION OF BUSINESS BY THE GOVERNMENT.

IN 1963, THE COMMISSION'S SPECIAL STUDY OF SECURITIES MARKETS UNDERTOOK A COMPREHENSIVE EXAMINATION OF THE EFFECTIVENESS OF SELF-REGULATION. THE SPECIAL STUDY FOUND MUCH TO PRAISE ABOUT THE SELF-REGULATORY PROCESS AND CONCLUDED THAT REGULATION OF THE SECURITIES MARKETS SHOULD CONTINUE TO BE BASED ON THE PRINCIPLE OF GIVING MAXIMUM SCOPE TO SELF-REGULATION. HOWEVER, THE SPECIAL STUDY ALSO WARNED OF THE DANGERS OF THE ANTI-COMPETITIVE TENDENCIES OF SELF-REGULATION, AND STRESSED THE NEED FOR EFFECTIVE GOVERNMENTAL CONTROL:

> /S/ELF-REGULATION BY A MEMBER ORGANIZATION INVOLVES SOME DEGREE OF IMPAIRMENT OF COMPETITION AND PUBLIC CONTROL IS NECESSARY NOT ONLY TO INSURE THAT SUCH IMPAIRMENT IS COMPENSATED FOR BY EFFECTIVE REGULATION, BUT ALSO TO INSURE THAT THE KINDS AND EXTENT OF IMPAIRMENT ARE ONLY SUCH AND NO GREATER THAN REQUIRED BY THE EXIGENCIES OF REGULATION. INHERENT IN SELF-REGULATION IS THE "PRIVATE" FORMULATION OF RESTRICTIVE STANDARDS OF BUSINESS CONDUCT AND THEIR ENFORCEMENT BY, AT THE VERY LEAST, EXCLUSIONARY PRACTICES.

THE NOTION THAT ONE OF THE UNDESIRABLE ASPECTS OF SELF-REGULATION WAS ITS ANTI-COMPETITIVE TENDENCY WAS REITERATED DURING THE CONGRESSIONAL HEARINGS AND STUDIES OF THE 1970'S WHICH EVENTUALLY LED TO THE SECURITIES ACT AMENDMENTS OF 1975.

THIS CRITICISM WAS EXPRESSED VERY WELL IN THE 1973 STUDY BY THE SENATE SUBCOMMITTEE ON SECURITIES AS FOLLWS:

> REGULATION, BY GOVERNMENT AND BY INDUSTRY GROUPS, IS AN ESSENTIAL ELEMENT IN PROTECTION OF INVESTORS, BUT IS NOT AN EFFECTIVE SUBSTITUTE FOR COMPETITION IN ASSURING A FLEXIBLE AND HEALTHY INDUSTRY.
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> THE CONCEPT OF INDUSTRY SELF-REGULATION, SUBJECT TO SEC OVERSIGHT, IS WELL-ADAPTED TO DEALING WITH PROBLEMS OF CONDUCT AND ETHICS, BUT IS NOT WELL-ADAPTED TO DEALING WITH GENERAL ECONOMIC QUESTIONS INVOLVING COMPETITIVE INTERRELATIONSHIPS AMONG FIRMS WITHIN THE INDUSTRY.

THE 1975 AMENDMENTS WERE DESIGNED IN PART TO REMEDY SELF-REGULATORY DEFICIENCIES. THE MAJOR CHANGES THAT THE 1975 AMENDMENTS MADE IN THE SELF-REGULATORY PROCESS CONCERN SELF-REGULATORY RULEMAKING, MEMBERSHIP, RULE ENFORCEMENT, AND DISCIPLINARY ACTIONS. THE LEGISLATIVE HISTORY OF THE STATUTE INDICATES THAT CONGRESS INTENDED TO STRENGTHEN THE TOTAL REGULATORY FABRIC, RATHER THAN TO DIMINISH THE ROLE OF SELF-REGULATION. I HOPE THIS LEGISLATIVE INTENT CAN BE REALIZED.

CONGRESS HAS CONSISTENTLY RECOGNIZED THAT SELF-REGULATION IN THE SECURITIES INDUSTRY HAS MADE IT POSSIBLE FOR THE SEC TO REMAIN A SMALL, FLEXIBLE AND PROFESSIONAL AGENCY. BOTH THE INDUSTRY AND THE COMMISSION HAVE THUS FAR BEEN ABLE TO AVOID THE STULTIFYING EFFECT OF DETAILED BUREAUCRATIC REGULATION OF DAY TO DAY BUSINESS ACTIVITIES. CONGRESS HAS ALSO RECOGNIZED THE ANTI-COMPETITIVE INSTINCTS OF THE SELF-REGULATORY ORGANIZATIONS AND HAS ATTEMPTED TO COMPENSATE FOR THIS WEAKNESS IN THE REGULATORY STRUCTURE BY MANDATING MORE REGULAR AND MORE AGGRESSIVE OVERSIGHT BY THE SEC.

I HOPE THIS NEW OVERSIGHT WILL NOT RESULT IN SO MANY NEW REGULATORY RESPONSIBILITIES THAT THE SEC AND THE INDUSTRY ARE BURDENED BY UNNECESSARY AND UNECONOMIC RESTRAINTS.

THE IMPORTANCE THAT BOTH CONGRESS AND THE COMMISSION HAVE CONTINUED TO PLACE ON SELF-REGULATION WAS EVIDENCED BY THE CREATION OF THE MUNICIPAL SECURITIES RULEMAKING BOARD BY AMENDMENTS TO THE EXCHANGE ACT IN 1975. IN COMMENTING ON LEGISLATION DESIGNED TO BRING THE TRADING OF MUNICIPAL SECURITIES ACTIVITIES UNDER SEC CONTROL, THE COMMISSION SUPPORTED THE CREATION OF THE RULEMAKING BOARD BECAUSE

> ...THE EFFICIENT FORMULATION OF RATIONAL RULES TO REGULATE THE MUNICIPAL SECURITIES INDUSTRY CAN ONLY BE ACHIEVED WITH THE ASSISTANCE AND BROAD PARTICIPATION OF REPRESENTATIVES OF THAT INDUSTRY.

SIMILARLY, THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS CONCLUDED, IN ITS REPORT ON S. 249, THAT THE HISTORICAL REASONS WHICH PERSUADED THE CONGRESS TO DELEGATE GOVERNMENTAL AUTHORITY TO NATIONAL SECURITIES EXCHANGES AND ASSOCIATIONS REMAINED VALID AND JUSTIFIED THE ESTABLISHMENT OF A SELF-REGULATORY STRUCTURE FOR THE MUNICIPAL SECURITIES INDUSTRY.

> UNDER THE FEDERAL SECURITIES LAWS SINCE 1934 AND 1938, SELF-REGULATION HAS PLAYED AND WILL CONTINUE TO PLAY AN ESSENTIAL ROLE IN REGULATING CORPORATE SECURITIES MARKETS. THE BILL WOULD SIMPLY EXTEND THIS PRINCIPLE TO THE MUNICIPAL SECURITIES MARKET.

I HOPE THAT THE CONGRESS AND THE PUBLIC WILL CONTINUE TO HAVE SUFFICIENT CONFIDENCE IN THE EFFICACY OF SELF-REGULATION TO ENDORSE ITS USE AS AN ALTERNATIVE TO INCREASED GOVERNMENT REGULATION. THE PRESENT CHAIRMAN OF THE SEC, HAROLD M. WILLIAMS, HAS SUGGESTED THAT SOME DEREGULATION OF INVESTMENT COMPANIES COULD BE ACCOMPLISHED BY THE FORMATION OF A SELF-REGULATORY ORGANIZATION FOR THAT INDUSTRY.

IN A SPEECH THIS WEEK TO THE INVESTMENT COMPANY INSTITUTE THE CHAIRMAN INVITED THE INDUSTRY TO GIVE THIS MATTER SERIOUS THOUGHT AND TO LET THE COMMISSION HAVE THE BENEFIT OF THE INDUSTRY'S IDEAS. I WOULD LIKE TO REPEAT THAT INVITATION BECAUSE I ALSO BELIEVE THAT A SELF-REGULATORY ORGANIZATION FOR INVESTMENT COMPANIES COULD RELIEVE THE SEC OF AT LEAST SOME OF THE REGULATORY BURDEN WHICH WEIGHS HEAVILY ON BOTH THE AGENCY AND THE FUND INDUSTRY.

SELF-REGULATION BY THE ACCOUNTING PROFESSION HAS ALSO BEEN ENDORSED BY THE SEC IN THE PAST AND CONTINUES TO BE ENDORSED BY THE PRESENT COMMISSION. DESPITE THE PRESSURES FOR GREATER GOVERNMENT REGULATION OF THE ACCOUNTING PROFESSION IN CONGRESS, THE COMMISSION HAS RECOMMENDED, AS RECENTLY AS IN TESTIMONY BY CHAIRMAN WILLIAMS ON MARCH 3, 1978 BEFORE THE HOUSE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, THAT THE ACCOUNTING PROFESSION HAVE A REASONABLE OPPORTUNITY TO ACHIEVE EFFECTIVE SELF-REGULATION ON ITS OWN.

I HAVE A STRONG PREFERENCE FOR SELF-REGULATION OVER GOVERNMENT REGULATION TO THE EXTENT SUCH A REGULATORY STRUCTURE IS CONSISTENT WITH THE PUBLIC INTEREST. SELF-REGULATION PLACES RESPONSIBILITY AND ACCOUNTABILITY WITH THE PEOPLE WHO HAVE THE GREATEST STAKE IN WEIGHING THE COSTS OF REGULATION AGAINST THE BENEFITS ACHIEVED. THE EXPLOSION IN GOVERNMENT WHICH HAS OCCURRED IN THE PAST SEVERAL DECADES HAS INVOLVED THE FEDERAL GOVERNMENT IN DAY TO DAY CONTROL OVER THE ECONOMY. BUT THIS CONTROL HAS NOT SOLVED THE SERIOUS ECONOMIC PROBLEMS THE NATION FACES, AND SOME OF THE SIDE EFFECTS OF EXTENSIVE GOVERNMENT REGULATION ARE UNDESIRABLE.

ALTHOUGH THE COUNTRY SEEMS TO BE IN REVOLT AGAINST GOVERNMENT REGULATION, THE CONSUMER MENTALITY OF THE GENERAL PUBLIC TENDS TO ENGENDER MORE REGULATION. BUT EVEN THE BEST INTENTIONED AND MOST COMPETENT PUBLIC OFFICIALS -- LIKE THE COMMISSIONERS AND STAFF OF THE SEC -- CANNOT PURSUE A COURSE OF LESSENED INTERFERENCE AND REGULATION BY GOVERNMENT IN THE SECURITIES INDUSTRY, WITHOUT THE RISK OF SOME LESSENING OF INVESTOR PROTECTION, AT LEAST IN THE SHORT RUN. AS A COMMISSIONER, I BELIEVE THAT THE SEC MUST BALANCE THE LONG TERM NEEDS OF INVESTORS AGAINST SHORT TERM POLICY OBJECTIVES. IN THE LONG TERM INVESTORS NEED A SOUND AND STABLE ECONOMY AND A SECURITIES MARKET WITH POTENTIAL FOR REAL GROWTH.

FREQUENTLY, THE SEC ENGAGES IN RULEMAKING AND LITIGATION TO REDRESS DAMAGE WHICH HAS BEEN DONE TO PARTICULAR INVESTORS. IF THE LONG TERM COSTS OF SUCH ACTIONS IS AN UNDUE REGULATORY BURDEN ON BUSINESS, THE LONG TERM HARM TO ALL INVESTORS OUTWEIGHS THE IMMEDIATE BENEFITS OF SUCH ACTIONS. BUT THESE ARE DIFFICULT DECISIONS, AND NONE OF US ARE AS WISE AS WE WOULD LIKE TO BE IN UNDERSTANDING THE FUTURE IMPLICATIONS OF CURRENT ACTIONS.

I DO NOT REGARD SELF-REGULATION AS A PANACEA FOR THE PROBLEMS OF TODAY'S POLICY MAKERS. SELF-REGULATION CAN BE AN AVOIDANCE OF EFFECTIVE REGULATION; IT ALSO CAN RESULT IN GREATER RESTRICTIONS ON BUSINESS INNOVATION THAN GOVERNMENT REGULATION. BUT IF THE SECURITIES INDUSTRY IS OVER-REGULATED, THAT IS AS MUCH THE FAULT OF THE INDUSTRY AS ANYONE ELSE. IN MY OPINION THE BEST WAY FOR THE SECURITIES INDUSTRY TO CONTROL ITS OWN FUTURE IS TO REGULATE ITSELF WISELY AND EFFECTIVELY IN THE PUBLIC INTEREST. THE CONCEPT OF SELF-REGULATION HAS BEEN SUPPORTED BY CONGRESS AND THE COMMISSION. THE MECHANISMS FOR SELF-REGULATION EXIST. USE THEM WELL.