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(202) 272-2650



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DEREGULATION: AN APPROACH AND A PROPOSAL

Stephen J. Friedman, Commissioner

The demand for deregulation has become a rallying point for those who believe that excessive regulatory restrictions are strangling our society, burdening the economy and fueling inflation. The Commission, although not as much under fire as some other agencies, is by no means exempt.

Our web of regulation exacts a toll from those who seek access to the public financial markets in this country, whether as issuer of publicly-traded securities, broker-dealer, investment advisor or otherwise. It is expensive to comply with the sophisticated disclosure, recordkeeping and registration requirements which the Commission administers. Moreover, the involvement of the Commission in reviewing and approving compliance by regulated entities creates indirect costs in delay and impaired efficiency -- costs that carry an unusual sting in these days of unprecedented volatility in the public debt markets.

At the same time, the United States enjoys what are widely acknowledged to be the best and most efficient capital markets in the world. They attracted no less than \$75 billion in foreign portfolio trading to our economy in 1980. Many investors -- particularly foreign investors with the perspective to appreciate the fact -- believe that the fairness and efficiency of the U.S. financial markets are due in large measure to the salutary effects of our securities laws and the Commission's regulatory oversight. Are they wrong? Is it possible that the success of the public securities markets is in spite of, rather than because of, our regulatory efforts? I do not think so. It seems to me plain that regulation is necessary to respond to problems with which market forces cannot cope adequately -- or at least not in the short run in which investment decisions are made. For example,

- The company with serious liquidity problems is easily persuaded that additional financing will somehow be found to resolve its problems and that there is no need to "unduly alarm" the markets with public disclosure.
- The broker-dealer in a capital squeeze will seldom elect to curtail his growth until his financial position is back in balance.
- Managers of closed-end investment trusts in the 1930's ordinarily believed that the conflicts of interest in which they found themselves could be resolved "sensibly," as businessmen, but when push came to shove, it was often the shareholders (holders of beneficial interests) who suffered.

My point is a small one -- obvious in fact -- but it bears reiteration at a time when the pendulum of public sentiment swings far in the direction of deregulation. The onset of regulation in a particular area can seldom be dismissed as the product of a crazed mind or simply government-out-of-control.

The regulatory system administered by the SEC exists to make the public securities markets more efficient, fair and stable. That is both a justification and a limitation on our mandate. When the system becomes a burden without sufficient benefits, it is no longer serving its function.

Moreover, change in the financial markets poses new challenges to the old ways of doing things. We should resist the temptation to conclude that our present system is inviolate and change can only be for the worse. The 1980's will be marked by severe challenges to our regulatory capabilities -- challenges we will be able to meet only with flexible and innovative uses of our limited resources. The time is coming when 150 million shares will trade on the New York Stock Exchange on a single day -- perhaps not as soon as this summer, but just as sure in coming. Money market funds, feeding on inflation-generated historic interest rates, have grown to over \$100 billion in less than a decade.

We see an endless parade of new financial products, from futures on government guaranteed, mortgage-backed securities to double derivative securities, such as options on treasury-bill and foreign currency futures, and even futures and options on the Dow Jones Industrial Average and the S&P 500 Index. Moreover, the massive strains of inflation will continue to push investors to try to recoup their positions with the quick fix of returns too good to be true, and there will always be those willing to extend an alluring fraud to accommodate them.

Thus, in the coming years the Commission will be forced to reevaluate itself and its regulatory structures constantly. With that in mind, I would like to share with you today some thoughts about the source and nature of excessive regulation and an approach to deregulation. Finally, I will discuss a proposal for experimental deregulation in our disclosure system, an experiment which not only holds the promise of lifting some of the regulatory burdens, but may throw light on some areas for further deregulation.

The Source of Excessive Regulation

The need for deregulation is often found in what I will call "regulatory myopia," a contagious disease contracted from extended and close contact with the internal workings

of a sophisticated regulatory system. It is above all a loss of balance and perspective. This disease is by no means confined to regulators. It is shared by many lawyers who administer the system and even those who are subject to it.

Any regulatory system rests upon a set of values -- in our case, for example, the worth of disclosure of material facts to the market place. The rules simply implement those values. When a regulatory system is young, the eyes of those who deal with it are firmly fixed on the values. As it matures, perfection of the regulatory net becomes an independent goal, and the rules sometimes become divorced from the ultimate values that gave rise to them.

It is essential to understand that it is the success of the regulatory system and the aggressiveness, intelligence and innovativeness of the regulators that often generate the problem of excessive regulation. Regulators are engaged in a constant battle with the efforts of thousands of market participants to gain a competitive edge by bypassing some of the rules. Thus the eye of the attentive regulator becomes focussed on the possible bypass routes. The smarter and more experienced the regulator the more escape routes he will identify and try to deal with in advance through prophylactic and sometimes overly rigid rules.

One hallmark of an excellent regulatory system is the ease with which it accommodates new problems. Too much of a good thing, however, is bad for the stomach. As the system evolves, the short-sighted regulator may begin to view his system as having a life of its own and his task as justifying the integrity and utility of the system for all new situations, without regard for the larger consequences of that effort. There comes a time when the environment underlying the regulatory system has itself evolved to such an extent that it no longer resembles the beast that Congress was trying to tame.

At that point, what is needed is a fresh outlook -- a return to basic assumptions and a reexamination of fundamental goals and the means to achieve them. In that category I would place certain aspects of the Glass-Steagall Act and the prohibitions on interstate branching by banks, both of which have been overtaken by events. Almost everyone agrees on the need for reexamination in parts of these areas because of the radical shifting of the financial markets in recent years.

I would place the securities laws somewhere near the middle of this process of maturation. Clearly, we long ago marked out our objectives and our basic approach to the securities markets. Equally clearly, things are not so different from the 1930's that the Commission has become a regulatory

dinosaur. Nevertheless, in part we have become captives of our own conceptual system, and we have sometimes been enticed to step so far to one side that the balance is upset.

I would like to mention briefly three examples of the Commission's regulatory response to new issues which, taken together, illuminate well these problems. They are

- The regulation of money market funds
- The Commission's involvement in private sector pension plans (the Daniels case)
- Disclosures about management remuneration

The Commission's reaction to the emerging phenomenon of money market funds -- today's \$100 billion pre-adolescent -- is to my mind a good example of an effective regulator at work. By applying the Investment Company Act to these new products with flexibility and a sense of proportion, the Commission has accommodated powerful economic forces in the financial markets and helped to ensure that public investors are presented with a fair and safe investment alternative. This was done without infringing on the jurisdiction of other regulators and with a minimum of interference with the free play of market forces.

In my judgment, the Commission's role in the Daniels case is a situation in which more weight may have been given to technical application of the system than to the larger result. There the SEC asserted that an employee's interest in his non-contributory pension plan was a security, and that the antifraud rules of the Securities Exchange Act were applicable to disclosures about the terms and conditions of his pension plan. To be sure, the technical argument was not a bad one. The definition of "security" is extremely broad and was intended to reach arrangements that were not necessarily viewed as securities in 1934. But, had we prevailed in the Daniels case, we would have succeeded only in regulating aspects of the employment relationship that are far from our traditional concerns. We would have made no progress in facing other serious questions which are clearly within our areas of expertise -- the regulation of the investment aspects of employee pension plans.

Finally, the Commission recently released a set of regulations detailing the methods for disclosing management compensation. It goes on for pages. The Commission's interest in this general area was intensified by a conviction that there was inadequate disclosure of the full range of compensation, including perks. But the effort took on a life of its own. As you know, management compensation, stock op-

tions, and stock purchase and phantom stock plans have grown dizzyingly complex. If one adopts as a goal uniformity of disclosure among companies to permit meaningful comparisons, then the new rules are superb. They represent a significant advance in the state of the art. But such detailed regulation and disclosure is a high price to pay for uniformity and comparability in an area in which the detail may be of little interest to shareholders.

These experiences teach the need for balance, but not how to find it. How does the regulator maintain his perspective and keep in mind the larger question of whether regulation of new situations is proper as well as possible? As one listens to debates about deregulation, one cannot help but be struck at the usually abstract nature of the arguments on each side. The deregulators call upon economic theory and market forces, while the regulators talk about human nature and the opportunity for abuse. For me the solution must lie in an effort to tie experience into theory.

The Role of Experimentation

In recent years, the Congress and regulators have started to make use of regulatory experiments. Experimentation is one of the most important weapons in the regulator's arsenal. When new issues arise, or deregulation is proposed, pure logic may at best be only a partial answer. It is far easier to predict the effects of a proposed course of action with hands-on experience. Experimentation must be relevant, however, and well-conceived. Random tinkering does no one any good. An experiment should address a number of questions:

- Is it clearly understood what is sought to be learned from the experiment?
- Will the experiment produce useful and reliable information?
- Have adequate measures been taken to evaluate the results of the experiment?
- Is there an adequate understanding of the potential for harmful side effects and a means to identify and control them?

The history of the introduction of NOW accounts is a good example. In 1972, a Worcester, Massachusetts savings bank found a hole in the prohibition against paying interest on demand deposits and introduced the NOW account. In 1973, Congress barred NOW accounts except in New Hampshire and Massa-

chusetts. Other New England states were added in 1976 and New York in 1978. That experience permitted Congress to assess the impact of this innovation on competition among financial institutions and on various classes of depositors. As of the first of this year, there are NOW accounts available nationwide.

Closer to home, the Commission's experience with the National Market System, and particularly our Rule 19c-3 experiment, represents a controlled approach to a particularly difficult issue. A high level of uncertainty attends any major shift in economic ground rules. The complexity of the securities markets makes it extremely difficult to predict the effects on exchanges, issuers, market professionals and investors of removing off-board trading restrictions. The adoption of Rule 19c-3 will give the Commission and others a chance to observe the effects of off-board competition in a variety of circumstances.

Rule 19c-3 has been criticized as an experiment because its sampling of companies is not "statistically valid," and will not provide precise, final answers about the impact of a total removal of restrictions on off-board trading. Those criticisms are true, but beside the point. Perfect experiments do not exist in the real world. But Rule 19c3, combined with an appropriate linkage of systems, will provide useful experience to inform the Commission's judgment at later stages in this evolution.

Market Forces in the Disclosure System

Another area in which experimentation should provide useful and relevant experience is the administration of the disclosure system. The Division of Corporation Finance has made impressive strides in alleviating the disclosure burdens on small business, bringing greater certainty to the exemptions from registration and integrating the disclosure systems of the Securities Act and the Securities Exchange Act. It has proved more difficult to think in a fresh way about the basic question of the kind of information that ought to be disclosed.

The 1977 Report of the Commission's Advisory Committee on Corporate Disclosure considered whether the mandatory disclosure systems of the Securities Act and the Securities Exchange Act were essential to the maintenance of an informed public securities market -- or whether voluntary market pressures could be expected to produce adequate public disclosure. The conclusion of the report, with a strong dissent from Professor Homer Kripke, was that the mandatory disclosure system continues to be necessary. I am prepared to

accept that conclusion, but believe that there would be great value in an experiment in limited but radical change in the disclosure system. I will outline the nature of the proposal, and then explain what I think the benefits from such an experiment might be.

A limited number of large companies with securities that are actively followed might be permitted -- through legislation if necessary -- to elect not to comply with the mandatory Securities Exchange Act filing requirements -- Forms 10-K, 10-Q and 8-K -- subject only to (1) an antifraud rule that would require current disclosure to the securities markets of material facts, and (2) the requirement of sending an annual report to shareholders that includes financial statements complying with Regulation S-X, together with a management commentary on the financials. In a similar vein, the Securities Act registration form for these companies would require simply the financial statements, the management commentary, and "other material information." The existing antifraud rules and Securities Act liabilities would remain in place. Press releases and documents sent to shareholders would also be sent to the Commission.

I should mention that, perhaps even more than in the usual case, this proposal represents my personal views and not those of my fellow commissioners or the staff.

Why should the experiment be confined to large companies when the mandatory disclosure burden falls so heavily on small companies? It is larger companies, which are closely followed by an army of analysts, for which the mandatory disclosure system appears to mean the least. For these companies, the primary forms of transmission of information are, in fact, the press release, meetings with analysts and the annual report, rather than Commission filings. The burden of disclosure does fall heavily on smaller companies. Yet, in my experience, it is precisely these companies for which formal disclosure documents are most useful in conveying information about the nature of the company and its problems. The Commission is looking hard at the possibility of a special set of disclosure rules for smaller companies, and that route, rather than complete exemption, ought to be pursued.

What are the pluses and minuses of this approach?

On the plus side -

- We could explore the feasibility of treating very large companies in a significantly different way.
- Internationalization of the securities markets is progressing, and we are being forced to come to

grips with the concept of minimum acceptable disclosure standards for "world class" securities.

- As the non-mandated disclosure system evolved, we would gain a more clear idea of what the markets really want and what are mere curlicues in the system. It would allow us to focus on those issues with fresh eyes.

On the minus side -

- We would not learn much about the wisdom of a complete elimination of the mandatory disclosure system, since those who choose to elect out will be heavily influenced by the rules applicable to those who do not. That is really a limitation rather than a negative result, and complete elimination is not my objective anyway.
- Many companies may fear the experiment, preferring the safe, if expensive, harbor of the mandatory disclosure system. Or all of those who elect out of the system may simply ape those who do not. I doubt that result will occur. But if it does, nothing is lost.
- Will there be greater opportunity for fraud and overreaching? Possibly. But the heavy market coverage of these companies and the close review of the experiment by the Commission makes the marginal risk a slight one.

Finally, the possibility of failure does not justify abandoning the attempt. If we are faint hearted and pessimistic, we run the risk of standing still in a moving world -- and that is in no-one's interest.