

**NEWS**

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THE COMMISSION AND THE TRADERS:  
A PUBLIC INTEREST PARTNERSHIP

An Address By

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Securities and Exchange Commission

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NATIONAL SECURITY TRADERS  
ASSOCIATION

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Boca Raton, Florida

Mr. Chairman: Ladies and Gentlemen:

It is a great pleasure to be in Boca Raton, and I am grateful to the Traders Conference for providing the occasion.

I have in fact long been an admirer of traders and our trading mechanisms. You have done much to preserve what is good about our markets. For that reason, this seems like an appropriate time to consider the status of our markets and their future prospects.

We have been experiencing a truly frightening degree of fraud and callous disregard of fiduciary duty in our securities markets and in our corporate life. I am not referring to nit-picking, technical deficiencies in registration statements, or differences of opinion on accounting matters. I am referring to hard core fraud and total disregard of the interests of investors.

Perhaps nothing can match the Equity Funding Corporation case for just plain cheating, but think of the others that have come to light in the last few years. On Friday, the Comptroller of the Currency had to close the U.S. National Bank of San Diego -- the largest bank failure in our history. The facts are not all in on that case, but our own investigation and law suit suggest that disregard of fiduciary duty may have played a major role in creating the bad loans that led to its insolvency.

Investors have lost hundreds of millions of dollars in recent years from this sort of thing. How much more can we endure and still expect to be able to raise capital for private enterprises from individual investors? There is no point in worrying about central market systems and the like if we cannot maintain basic honesty and trust in our business life.

We have enough cynicism now about the quality of corporate financial information because of a growing awareness of the flexibility -- putting it euphemistically -- permitted by generally accepted accounting principles. The accounting profession, the Financial Accounting Standards Board and the Commission are working toward reducing this flexibility. We are working toward making financial statements more informative and more comparable.

We have, for example, just recently moved to force full disclosure of extensive long-term obligations hitherto hiding as leases. Eventually, the FASB will develop more reasonable rules for accounting for leases. Meanwhile we want the investor to know they are there.

We look forward to the day when you can read the financial statements of two companies engaged in the same business and get a fairly good idea of how well each is doing relative to the other.

But what good is all this if we lose faith in the basic numbers? All of the accounting and disclosure rules that ingenious minds can devise will amount to nothing if people cheat. In fact, actual cheating is not necessary to bring about the collapse of our system. It can fall just as surely from widespread suspicion of cheating.

We worry so much about the lack of faith in our private enterprise system on college campuses. You and I know that most businessmen are honest and try to do a good job. But what is a youngster supposed to think when he sees the headlines about Penn Central, National Student Marketing, Equity Funding, and now U.S. National Bank? How do we convince him that these are aberrations -- hated by businessmen themselves -- not typical of the system?

In a way, you traders should know better than anyone else the importance of maintaining faith in the basic honesty of a system. Your profession knows instinctively, and has known for generations, that the whole business rests upon your confidence in the other fellow's integrity. Your market activity would be utterly impossible if you could not rely on the other guy. You do millions of dollars of business by word

of mouth -- relying upon adherence to professional standards by your counterparts -- not upon contracts that are necessarily legally enforceable by conventional rules.

As long as you all retain this confidence, the system can survive an occasional bad apple. You are shocked. You throw him out of the club. And business goes on.

But suppose bad apples became so numerous that your confidence were replaced by suspicion. Suppose you were beset with doubts whether the fellow at the other end of the phone meant what he said. Suppose you had to worry about whether he would have a convenient lapse of memory if the price moved against him.

I once served as an NASD arbitrator in an inter-dealer squabble. The dispute was over which of two companies with similar names had been meant in a trade of stock. One dealer routinely taped all conversations on the trading desk telephone -- without disclosure, of course. But if you really get suspicious, even that does not help much. Very clever things can be done with tapes.

The proximity of securities traders to our markets necessarily means that you can play a key role in preventing the perpetration of fraud. Consider what we refer to as the shell game of recent memory.

During the past several years, the Commission has worked vigorously to retard, if not eliminate, the securities industry's version of the old "shell" game. In the late sixties, with increasing frequency, "shell" companies -- that is, companies with a corporate charter, some greedy promoters, a grand scheme for fraud and little else -- began issuing their shares for nominal consideration to publicly-owned companies, so that the shares of the "shell" could be spun-off to the stockholders of the established companies as a "bonus." The intent, frequently realized, was to create an immediate and active trading market for the securities of the shell company, a result effected when the established company's shareholders promptly resell the worthless securities of the shell. A necessary ingredient in these schemes is the presence of a broker-dealer willing to enter wholly-arbitrary quotes in the "pink sheets" for the stock of the shell company. At the same time, needless to say, little or no information about the issuer is available to the investing public.

Variations on these themes also evolved. Thus, in some cases, promoters would acquire inactive, asset-less corporations which nevertheless previously had effected a fairly wide public

distribution of its shares. Thereafter, the company would be induced to make acquisitions of dubious value, accompanied by a fanfare of publicity. Many times, these so-called "acquisitions" consisted of worthless assets, such as mining claims or patents, transferred to the company by the promoter in return for substantial amounts of stock. All of this activity, of course, is designed to indicate that the company involved is coming to life and, concomitantly, to stimulate public interest in its stock to balloon the market value of the promoter's holdings. Here again, the insertion of the artificial "pink sheet" quotations by some marketmaker was utilized as the primary tool for effecting what often amounted to massive frauds. Unfortunately, in other cases marketmakers were the unknowing pawns of the promoter, rushing in when the fortunes of the shell company seemed to take off.

Now, as you know, it isn't the Commission's function to pass judgment upon the quality of any particular company or the worth of its securities. Instead, our function is to ensure that the investing public has sufficient, accurate and timely information about a company to help them make informed investment decisions. Our approach to the shell game, accordingly,

has been drawn from our enforcement powers -- in the form of some vigorous court actions initiated during the early seventies which successfully challenged these practices as violations of the registration provisions of the Securities Act and the anti-fraud proscriptions contained in the federal securities laws. But we have employed a regulatory approach as well.

We have adopted rules requiring marketmakers to insure that adequate information exists about a company before they may publish quotations for the securities of the company.

I presume that you are all familiar with this rule -- Securities Exchange Act Rule 15c2-11. It requires a trader, desiring to make a market in the securities of a company which is not the subject of current, regular quotations, and which neither reports on a regular basis to the Commission nor has filed a recent registration statement, to have on hand, and make available on request, a broad range of information about the issuer, such as its most recent balance sheet, and profit and loss and retained earnings statements, before quotations may be published.



We recognize that this rule puts a heavy responsibility on you -- the professional trader -- even though the difficulties generated by the shell are primarily the work of unscrupulous promoters. But traders can most effectively put a stop to this debilitating game. Our somewhat limited experience with this rule leaves me quite optimistic. Through the exercise of your professional responsibility and judgment, you -- the professional securities traders -- are playing a major role in restoring and maintaining public confidence in the nation's trading markets.

In that case we hope we have plugged the hole with a rule and your cooperation in following the rule.

We can and will adopt more rules. We can and will inspect, investigate and prosecute and punish. So, too, will the several self-regulatory bodies -- the NASD and the exchanges.

But there are not -- and there never will be -- enough cops to make the system work unless the people participating in the system want it to work and help make it work.

You can put this in terms of morality or of enlightened self-interest. If your mother brought you up right, you believe that it is immoral to cheat and break the law.

But even if you do not fear hell-fire, a man of reason must understand that compliance with necessary rules -- and faith in the other fellow's compliance -- is the basic glue that holds our free enterprise system together. If that glue melts, some other less efficient and more oppressive system is sure to come.

I am not talking this way tonight because of any notion that traders are prime offenders. Not at all. You are, indeed, custodians to a high degree of that honesty and reliance in fair dealing that I am talking about. It is your performance to date and unflinching acceptance of added responsibility in this regard that help maintain the basic honesty participants in the securities industry have generally exhibited.

I urge you not to lose the faith. And do what you can to maintain it among others.