

REMARKS OF RICHARD B. SMITH, COMMISSIONER,
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
AT THE CENTER FOR RESEARCH IN SECURITY PRICES,
GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO,
MAY 16, 1968

EQUITY AND EFFICIENCY IN THE SECURITIES MARKETS

I want to thank the Center for Research in Security Prices here at the University of Chicago for this opportunity to talk to your Seminar group this evening.

The fact is I have been ruminating for some time about beginning to speak to what I see as a very compelling need, for greater inter-disciplinary efforts among economists and lawyers in the analysis of problems facing the securities industry. I thought this might be an audience interested in that thesis. I should say at the outset that these are my own reflections, born of a year now on the Commission and a number of years before that as a legal practitioner. They should not be construed necessarily as the views of anyone else.

I would like to pose this evening as interrelated, but separate and distinguishable, considerations in the securities markets two principles which for want of better words I will call Equity and Efficiency. Equity is a typically lawyer's consideration; Efficiency, that of an economist. And perhaps they are the different lens through which each of us look at and judge the securities markets as an analytic matter. They are not antitheses but neither are they the same thing.

By Equity I mean the insistence on fairness and fair dealing to the individual that is at the heart of our jurisprudence. By Efficiency I mean in general the aggregate cost effectiveness with which an aspect of the economy performs its function. I am sure no economist wants the markets to be inequitable or does not wish fraud prevented. I am equally sure no lawyer seeks an inefficient market or would countenance waste. Yet I suggest there is more than semantic difference in the two desiderata. The variance in final criteria as well as in professional terminology produces a gap in real communication between us.

Professor Manning talked to this point recently by commenting that each man, the economist and the lawyer, has his own theology, what he believes is ultimate. I think it interesting to consider these general foci of our respective professions and how they may have affected our respective approaches to the securities markets.

Professor Robbins has compared the ways a lawyer and an economist approach the securities markets in this way:

"The lawyer tends to draw conclusions from the evidence of cases and from hearings that often probe into cases more deeply by amassing the testimony of participating individuals. The economist relies for his evidence more heavily on masses of data and attempts to ascertain the trends, relationships, characteristics, and probabilities embodied in large quantities of statistics. When revealed deficiencies call for a cure, the lawyer tends to seek his remedy by the issuance of a corrective rule; when the studies of the economist disclose deficiencies, he prefers to find his cure in the development of a theory which may lead to institutional changes. The lawyer is more concerned with standards of conduct of the participants in an industry; the economist with the economic impact of their actions. The lawyer may be more disposed to view the action of the securities business as it influences private property; the economist may see its role tied more closely to its function as an allocator of capital."

The latter comparison, I believe, is especially significant.

I am not an economist and so I will not presume to define to you the various and sophisticated levels of efficiency by which economists now are, or could be, testing the results, operations, institutions and regulations of the securities markets. Professor Baumol puts it that securities markets must be judged on how effective or optimal they are as an allocator of the nation's financial resources, and further, on how disciplining, directly or indirectly, the markets are upon the productive utilization

of the allocated capital. Related to the effectiveness of these allocational efficiencies, of course, is the element of operational efficiencies in the markets, the mechanical and cost effectiveness with which issuances and exchanges of securities are carried out.

At least with respect to this latter aspect of market efficiency, Professor Stigler has pointedly said:

"So far as the efficiency and growth of the American economy are concerned, efficient capital markets are even more important than the protection of investors -- in fact efficient capital markets are the major protection of investors."

Professor Stigler's statement, I think, dramatizes the aggregative end of the spectrum on which economists, quite naturally, concentrate. I would assume, without a thorough reading, that even less market-oriented and more organization-oriented economists, such as Professor Galbraith, would not disagree with this aggregative approach characteristic of your discipline. My point is not to quarrel with the statement, but only to illustrate the almost professional bent it represents.

The other bent can perhaps be illustrated in the presidential message that accompanied the first piece of federal securities legislation back in 1933. It said in part:

"In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

"...[The legislation] should give impetus to honest dealing in securities and thereby bring back public confidence.

"The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

"This is but one step in our broad purpose of protecting investors. ..."

Here, it is in effect bring said that investor protection is the essential to effective capital markets.

My own sense of the matter is that to achieve mass public involvement in the securities markets, to attract the capital at all, the public must feel -- and I emphasize feel -- as well as reason two things. One, that true, meaningful information is available about the bulk of securities in the marketplace upon the basis of which informed choice and trading takes place, not necessarily their own informed trading, but also not informed trading limited to insiders. Second, that the financial intermediaries and the trading mechanisms of the marketplace are essentially fair and not overreaching. Without these two elements of belief, I don't see how there can be public confidence in the securities markets, and without confidence I don't believe many people would part with their money, at least in the form of long-term financial claims.

The situation in Europe, I believe, confirms this. The equities markets in Continental Europe have been almost rudimentary. Investors, particularly small investors, have been extremely reluctant to commit funds to an enterprise on a long-term basis such as equity investment. The markets do not have sufficient depth and liquidity to give such investors any confidence in realizing cash by resale when they wish. Those who do invest, because they can learn so little about the enterprise and because there is no strong secondary market, insist on high earnings payouts, thus depriving industry of the most efficient means of funding new plant by plowback of earnings. There are apparently strong movements within Europe now to improve their capital markets. They feel that increased information is essential to this purpose. Let me read from two recent studies.

First is the Segre report of the European Economic Community Commission titled "The Development of a European Capital Market" and published in 1966:

"The problem of ensuring that full information is available to investors is a particularly important aspect of the development of a European securities market. Measures designed to familiarize the public with investment in securities and with the stock exchange mechanisms appear to be necessary; so also is the laying down of rules to ensure -- apart from the annual

publication of accounts -- a continuous flow of information on company operations. More detailed information should be published when securities are issued or quoted on a stock exchange. Although it has been noted in recent years that the information supplied by companies has improved, entirely voluntary arrangements will probably not be sufficient to ensure further progress in this direction: for this reason several reform schemes, already adopted or still under study, seek to lay down prescribed standards in this field."

At a later point, and with more particular reference to the role of increased information, the EEC study concluded as follows -- and because it is important I shall quote at some length:

"In all Member States an essential factor in the expansion of the capital market is that the public be given better information on securities and familiarized with the machinery of the stock exchange. Looked at from the point or view of the development of a European capital market, these problems assume a new aspect and added urgency.

"In most cases, the problem of making information on securities available to the public has been approached in Member States from the angle of protecting savers. But publicity is important also for an expansion of capital supply on the security market, and this aspect seems to have been neglected.

"In the first place, for lack of sufficient information on the operations and prospects of companies some investors are inclined to tread warily on equity markets. By contrast, it is the wide range of information available -- among other things -- that explains why the leading international securities are so popular with investors. Another consequence of deficient information is that the public tends to attach more importance to political or tax aspects than

to the basic facts showing a company's development and its prospects; this explains the often speculative bent of European stock markets and the public's lack of selectivity as between different securities.

"These defects are apt to discourage many classes of potential investor from placing their money in equities. Another point is that changes in the distribution of national income to the benefit of wage-earners have diminished the savings capacity of social groups used to equity investment and increased that of groups with little experience of the stock exchange.

....

"Lack of information by which the comparative merits of different types of investment can be assessed, especially from the point of view of their yield and soundness, induces savers to stick to the simplest forms, like sight deposits and savings deposits, because they are not in a position to assess the advantages of other forms of investment, such as securities.

"All this means that the economic and financial objectives of fostering the supply of entrepreneurial capital, combined with the need to protect the savings of the public, together create a strong case -- despite differences between the two requirements -- for the provision of fuller information for the public. ..."

The EEC study spoke to the necessity of imposing standard disclosure requirements. This gets to the question of the need for regulation to enforce disclosure in a free market, where some feel voluntary disclosure would be more appropriate and where market forces would themselves impel

that degree of disclosure sufficient for its needs. Let me read you the conclusion of this group of economic experts, who have lived in a non-disclosure enforced environment and who looked at the American experience with presumably objective eyes.

"The Group is, of course, aware that the development of such permanent and more detailed information may raise certain problems for companies in relation to shareholders, employees, competitors and the tax authorities, given current European practices in this respect. It will therefore be necessary to proceed with some caution, and it will no doubt be indispensable to harmonize legal requirements so that all European firms are placed on an equal footing. However, experience in the United States testifies to the fact that fuller publicity requirements have done no harm to companies but have in fact redounded to their benefit as regards both sources of finance and relations with the public in general.

"Although the practice of providing a continuous flow of information has been spreading in recent years, it is doubtful whether it will do so sufficiently unless it is made compulsory. This suggests, and the French example confirms, that the law will have to step in if current customs and usages are to be radically altered. Given the fears of business firms that more exhaustive disclosure of their affairs would weaken their competitive position unless their rivals were obliged to be equally forthcoming, the pertinent requirements need to be equivalent in all the countries of the Community and there must be no discrimination on grounds of nationality."

Last year the Organization for Economic Cooperation and Development published its own "Capital Markets Study" which in this respect reaches much the same conclusion as the EEC study the year before. Let me read you a portion of this OECD report:

"There is little doubt that for the countries concerned a renewed and continuous demand for shares would be desirable in the long-term, not only so as to preserve the value of large invested financial savings, but mainly in order to stimulate the supply of more equity capital.

"The emergence of such demand will depend partly on general factors like larger financial savings by households, business prospects, tax systems, etc., but the present enquiry shows that it also requires systematic efforts to improve the efficiency of the security markets in the broadest sense, that is, including on the one hand the trust which investors place in shares as long-term financial assets and the expectations they have of them, and on the other hand the way in which savings are channelled to the market for investment in bonds as well as shares. These are basic projects which it will take a long time to accomplish. ..."

And further, as to disclosure of information, the study says:

"Issuers of listed securities should regularly publish full and easily understandable information on their activities and prospects. Such general information, as well as past and current data concerning each issue, should be accessible to potential investors. In this latter context the members of the stock exchanges should, moreover, conscientiously discharge the responsibility of unprejudiced interpretation and advice which as experts they have towards the general public.

"The United States is well advanced in these respects, and this is due not only to regulations but to an enlightened attitude of the business and financial community. The United Kingdom too is in a more advanced position concerning information than most Continental European countries; actual practice

is in general in advance of the law which itself is now in the process of being improved, inter alia through new measures concerning disclosure of information. Several Continental European countries have recently taken official steps in this connection, and a number of private groups are working to this end. In France the disclosure requirements were extended in 1965 for companies which have issued listed securities; in Germany there is the Stock Corporation Law of 1965 and legislation is being prepared that would oblige all enterprises above a certain size to make regular disclosures on their financial position; in Italy new legislation is being prepared on the operation of the stock exchanges, which will deal especially with the question of information. ..."

Thus you see that Europeans, who are trying to emulate the massivity and strength of our American capital markets, have analyzed as a highly important ingredient in their efficiency the fine attention here which has been given to the protection of investors and their equities. And protection of investors was the basic purpose behind the disclosure requirements. That it built confidence and participation in depth in the stock markets, and hence contributed to their efficiency does not seem to me to be a mere coincidence. Is it not justifiable to say that equity to the individual investor is a necessary element in our public capital markets and may, as a principle, contribute to the market's efficiency?

Requiring to the extent feasible that all investors have equal access to adequate information, imposing professional and fiduciary responsibilities on brokers, investment advisers and financial intermediaries dealing with investors, designing the market structure to provide by and on behalf of public investors fair, non-manipulative, non-overreaching trading in the markets -- these are objectives of equity that seem to me to serve efficiency.

Thus, in juxtaposing the lawyer and the economist, equity and efficiency, I don't want to give the impression that I believe the economists' concern for efficiency and the lawyer's for equity are irreconcilable viewpoints, or really in conflict. I do believe they require more explicit, more mutually informed reconciliation. I submit we each have much to learn and to comprehend from the other. And, as a lawyer, I am quite willing to concede that many things can be done in the name of Equity that are better not done, or done differently.

For that reason I applaud the attention being given to the economics of the securities markets by the University of Chicago. While our Commission economists are generally familiar with the work being done here, I hope that reasonably soon there can be greater chance for contact. I understand that a good deal of the work here has been in the area of securities pricing, and because of that and the prevalence of exchanges of securities in conglomerate acquisitions I thought I might recount a story to you.

A family had an extra puppy in the home. The son announced to his father one evening that he intended to sell the puppy. The father thought this would be a good way to give his son some concept of how a business transaction was conducted. He told the boy that he first would have to establish a price at which he was prepared to sell the puppy. The son said that he had already decided that. He was going to charge \$10,000. The father remarked that he thought this might be a bit high for a mongrel dog. He suggested his son start at \$5 and be willing to settle at \$2.50. The boy insisted that his price would be \$10,000. The next evening the father asked his son what progress he had made on selling the dog. The son said that he had sold it. The father asked "Well, how much did you get for the puppy?" The son said "\$10,000." "\$10,000!" the father said incredulously, "Whatever do you intend to do with all that money?" The son said that he didn't get money -- that he had exchanged the dog for two \$5,000 cats.

I don't think that story will require too much analytic time by price theorists. But perhaps it has a certain pertinence to our day.

Let me go on to say that I strongly believe greater emphasis should be placed upon economic analysis of the securities markets both in their structural and in their operational aspects. This I would think should go beyond work on stock price forecasting and portfolio valuations, important as these are to those engaged in the securities business and to a testing of the ultimate efficiency of the securities markets. I would welcome a great deal more empirical testing of regulatory concepts and economic measuring of the impacts of regulatory decisions and processes. This would be more directly relevant, of course, to our functions and needs at the Commission. Deeper analysis, as free from ideological premises as possible, might lead to the

discovery of new equitable principles in the marketplace and to the discarding or revamping of present ones. I would suggest that in theoretical inquiries recognition should be given to the practical necessities of the securities industry and the practical problems with which regulatory administrators are required daily to deal.

Nevertheless, any regulation aimed at protecting investors should be measured against its impact on market efficiency, so that the true cost of such regulation becomes apparent both to the regulator and to the regulated. Such analysis, I believe, should become a more integral part of the preparation and basis for administrative action. That action requires a careful weighing of both equity and efficiency factors, so as to achieve an integration of the two in order for both to serve the interests of our society.

Indeed, the time is propitious for a greater coordination of effort between economist and lawyer, each bringing his respective tools to the securities markets. With the phenomenal growth in the role of financial intermediaries in the securities markets within the last decade or so, basic changes are occurring in market structure and conceivably in market performance. The participation by institutions in the stock markets is a most significant and basic development with which our Commission presently has to deal.

This is not to say that the development of conglomerate companies and their implications, or the effects of automation on the conduct of the securities business, to mention two, are not also important and significant developments to which we and the industry must give attention. But the growing institutionalization of the market and the resulting impact this is having on the operation, conduct and structure of the securities industry has more than anything else raised new considerations, and some old ones with which we must deal anew. We are presently deep in consideration of stock exchange commission structure questions, which will be a major area of the Commission's attention in the coming months, but it is the institutions which have forced the structure questions to the forefront.

The Chairman of the Commission testified today in Washington on a pending legislative proposal for the SEC to institute a major economic study of the role and impact of institutions in the securities markets. This is a particularly important resolution on which hearings were held in the Senate. A companion resolution is pending in the House and we are hopeful that the study will be authorized soon. The securities industry has indicated its full support of and pledged its full cooperation with such a study.

It has been estimated that approximately one-third of the total amount of stock outstanding in the United States is now held by institutional investors. Institutions account for at least one-third and probably more of the dollar volume of transactions currently on the New York Stock Exchange. For some time now institutions have been substantial net buyers and individuals net sellers of stock. Every indication is that the trend will continue or even accelerate. While we have fairly complete information with respect to mutual funds, we need a good deal more information covering investments by corporate and union pension funds, personal trusts, insurance companies and banks, foundations and college endowment funds.

The proposed study would gather and compile the necessary data and would focus primary attention in several areas where both complex and important policy questions exist. There is the impact of institutional investment upon the securities markets, the securities industry and the investing public. There is the effect of institutional investment on sources and allocation of capital, the amount and nature of savings and the level of stock prices. There is the relationship of institutional investors with the companies in whose stocks they invest, and the proper role of financial institutions as stockholders. There is a basic question of why institutional investment is growing so rapidly, whether it will continue to grow and if so at what pace and what the consequence of this will be.

It is fundamental to this study that it will be an economic inquiry. That is, the study will approach institutional investment as a long-term economic phenomenon to be understood and analyzed as such. In the Commission's view such a study is necessary now to the continuing healthy functioning of our securities markets and to the full understanding of our economy. There is nothing more vital to our private enterprise system than its processes of capital formation and the assurance that these processes are operating both efficiently and equitably.

If the Congress sees fit to authorize and fund the study, we shall of course draw primarily on economists for the competence and analysis that will be needed. I hope that growing out of such a study would be a more effective utilization of the qualities which the economist can bring to the securities business and its regulation. I would look for that involvement -- I would welcome it.

Now, I have said tonight that I believe all of us must look at the securities markets in terms of both Equity and Efficiency. I have urged both lawyers and economists in this field not out-of-hand to dismiss the other's viewpoint or without attention being paid to assume the other is simply missing the point. I have referred to current developments in Europe as both confirming the viability of our system and putting us on notice that the field will not long remain America's alone. Finally, I have pointed to the forthcoming institutional study as offering real hope both that a meaningful inter-disciplinary effort relating economics and law will evolve and that a better and improved understanding and regulatory approach to the securities markets will result.

Thank you.