AN ADDRESS

BY

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Things have been quiet around the Commission this week. Of course this is only Wednesday. Since the commission rate hearings resumed yesterday, I am sure things will pick up again. There are days, however, when I hanker for the time when the SEC was criticized for being a listless middle-aged agency and a captive of the industry.

The subject of widest interest today seems to be inside information. You know, of course, that I cannot discuss the Merrill-Lynch case which is now pending before us. And Texas Gulf Sulphur is still in the courts. While I will not comment on the merits, I will make a few references to the courts' findings in that case. And I can discuss briefly the genesis of our approach and that of the courts to the problems raised by the use, or should I say misuse, of insider information.

There has been a lot of loose talk lately about the wells of corporate information drying up, about the Commission sailing into new and

uncharted seas and a few unflattering remarks suggesting that neither the Commission nor the courts really understand the facts of life, expecially that part which deals with the use and distribution of investment advice. Of course another explanation could be that we do understand it and that, in some cases, we don't like what we see. Nevertheless, a few items may place the matter in context.

Restrictions on the use of corporate information in securities transactions are not new. As early as 1909, the Supreme Court held_/ that a controlling shareholder of a corporation defrauded a minority shareholder by purchasing his stock without disclosing the current status of negotiations for the sale of the corporation's property.

In 1943, when the Commission issued a report of its investigation of the purchases by Ward LaFrance Trucking Corp. of its own stock, the accompanying release_/ noted that the Commission

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_/ Strong v Repide, 213 US 419

_/ SEA Release 3445, June 12, 1943

wished to "call attention" to the existence of Rule 10b-5. That report spelled out the failure to disclose dramatic improvements in the financial and operating conditions of the trucking company, which the Commission found violated the Rule.

In 1951 the same rule was laid down in the famous Speed v Transamerica case. There the majority shareholder neglected to tell the minority holders of a great increase in the value of the Company's tobacco inventory. Judge Leahy said:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers."

In 1961 the Commission, in Cady, Roberts held that brokers, who used material inside information in securities transactions for their own customer's benefit prior to

disclosure to the public, violated Rule 10b-5. The information withheld there was news of a dividend cut. The broker was not itself a corporate insider, but learned of the reduction from an associate who was a director of the corporation. I would suggest that recent developments do not really differ from the principles underlying these earlier cases.

I wonder how many critics of the _Texas Gulf_ decision have read _Cady, Roberts_ lately? I also wonder how many of them have read the opinion of Judge Bonsal in the District Court in _Texas Gulf_. One of the key issues in the District Court was, of course, whether the information concerning the drilling results was "material information". But they might be surprised to learn that the Court held that, if the relevant facts were indeed material, the failure of the insiders to disclose such information when they purchased _Texas Gulf_ stock was a violation of Rule 10b-5. This _is_ the holding of Judge Bonsal and of _all_ nine judges of the Court of Appeals. Another key issue was the time _when_ information

becomes public, that is, what constitutes public disclosure under Rule 10b-5. The issue was whether an announcement at a press conference was sufficient even if the news had not yet been published. The District Court held that it was. The Court of Appeals unanimously ruled that publication was not accomplished merely by the announcement, at least not until the news had been published on the broad tape. The Court did not reach the question of whether publication on the broad tape was itself sufficient to permit an insider to act. I am not going to comment on the particular facts of TGS, nor will I, as I have stated, argue that case here. However, in thinking about the questions which have been raised, one should, at the least, sort out the issues and identify the positions.

The law is clear: insiders in possession of material nonpublic information cannot purchase or sell securities for their own benefit (or for the benefit of their customers or their friends for that matter); before they trade the information must be made public. While we may disagree on what

is or what is not material information, we can probably agree that a substantial dividend cut, not previously suggested, would, in nearly every situation I can think of, be material. The test of materiality set out by Judge Waterman in Texas Gulf is whether a reasonable man would attach importance to the information in determining whether to buy or sell the securities in question. If disclosure may reasonably be expected to have a substantial affect on the market price, the failure to disclose would seem to be material.

We may also disagree on when it is that something is "made public". But not too many of you will seriously argue -- or at least I would hope you would not -- that a corporate officer should be permitted to trade on what is admittedly undisclosed material inside information. I take it that we would agree that a corporate insider should not go into the market and buy up shares of his company if the news is dramatic and good, or sell if the news is awful, without disclosing that information to the public.

This after all is and has been the guts of the federal securities laws -- that the investor can come into the market place and be assured that he is not being taken advantage of by persons

with inside information to which he has no access. A market that is unfair is a market where investor confidence is necessarily lacking -- where the public fears to bring its savings. In recommending the passage of the 1934 Act, the House Committee said:

> Unless constant extension of the legal conception of a fiduciary relationship -- a guarantee of 'straight shooting' -- supports the constant extension of mutual confidence which is the foundation of amaturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

To repeat, I believe the law is clear. Those who support the use of inside information without disclosure by corporate officers and directors and other insiders are, fortunately, few and far

between. A theory held by a very few -- that insider information should be used to reward corporate officers and directors, or other insiders, as additional entrepreneurial incentive -- is nothing more than a reversion to the thinking of the twenties -- the 1820's. It is the "flat earth theory" of securities regulation. A basically unfair market, one in which material information is available only to a select few is a market which, to use a questionable metaphor, operates like Gresham's law and eventually will drive out the general public.

I have been struck, in my visits to Europe, and in my reading on foreign capital markets, with the overriding importance of public confidence in the fairness of the securities markets. Where disclosure is not provided, where the market place is not fair, capital markets remain underdeveloped. It is difficult to fault investors who are reluctant to entrust their savings to a market they feel is unfair.

We cannot accept the jungle approach that markets should provide exclusive advantage to

those who are in the strongest position (because they are in a position to engage in substantial trading) to obtain information of secret corporate developments not available to the general investing public.

I had always supposed that securities analysts and investment advisers would applaud these developments. After all, they provide a premium for analytical talent and avoid unfair competition from those who can traffic in corporate secrets.

The seas are really not as uncharted as some would have you believe. The result in _Texas Gulf_ should not have been a surprise to those who read _Cady, Roberts_. Certainly, if _Cady, Roberts_ was not a sufficient clue, the Supreme Court's opinion in _Capital Gains_, in 1963, should have been a clear indication of things to come.

Now I am _not_ saying that there have been no new developments in the law or that standards of investor protection have not been improved. I _am_ saying that the development has been careful, has been based on tested and accepted principles and recent cases do not reflect a precipitous departure or great expansion that some have made it out to be.

Reference should be made to the publication of materially false and misleading corporate publicity -- the corporate press release denying an imminent dividend cut (which in fact, occurs shortly thereafter) or announcing falsely that the corporation has discovered a foolproof cure for baldness -- now that would really be something!

I would point out that Section 10b-5 refers to material misstatements or omissions in connection with the purchase or sale of securities, not merely with respect to particular insider transactions. Thus the issuance of a materially false press release, that is where the false representation is reasonably certain to affect the market price of the stock -- or as the Court of Appeals said in Texas Gulf, "in a manner reasonably calculated to influence the investing public" -- violates Rule 10b-5. To restate it more fully, the Court said that a materially false public release, which, it is reasonably anticipated, will reach and influence the investing public, is almost necessarily issued by the corporation in connection with the

general trading of securities that occurs daily on the exchanges and over-the-counter and, therefore, within the purview of Rule 10b-5.

This may seem to some to go far, but I think you will agree that corporate publicity is often aimed at the investing public, whether that public consists of existing or prospective investors. It is one of the more obvious ways in which someone could manipulate (or, if you prefer a less pejorative term, influence) the price of the company's stock and to exaggerate, create or reverse a trading trend. The Court of Appears held in _Texas Gulf_ that the 1934 Act makes unlawful corporate publicity which may mislead public investors.

It is important to emphasize, however, despite the most surprising statements reported in the newspapers, that we are really discussing _exceptions_ to accepted standards of corporate conduct. Most corporations do not issue materially false press releases. I don't think most analysts believe that access to material undisclosed corporat information are a _sine qua non_ to the fulfillment

of their professional responsibilities. Indeed, I am told it is contrary to the Code of Ethics of the Financial Analysts Federation to try to extract inside information. Most officers and directors do not rush to buy their corporation's shares on learning or some new and important development before the news is made public. The NYSE requires prompt disclosure of material corporate information because, like the Commission, the Exchange is persuaded that the public demands and is entitled to a fair market place.

I had always thought that this view was generally accepted. But some now seem to say that we ought not carry this fairness business too far. Well, fairness is like another familiar condition -- one either is or is not -- you cannot be half fair. A securities market that seeks and depends upon the confidence of all investors cannot afford to be only partially fair.

I suppose I should turn for a few moments to the mutual fund reform bill. As you are aware the House Committee on Interstate and Foreign Commerce, last week, passed over the mutual fund bill for this session. I need not dwell on our disappointment. A ten-year effort to deal with the important problems raised by the growth of investment companies, and the conflicts of interest inherent in that growth, has been frustrated -- at least so far as this session is concerned.

This does not mean that mutual fund reform efforts will die. The Senate bill, which survived a determined industry effort to kill it -- including a good old fashioned floor fight -- contained a number of significant compromise provisions hammered out by the Senate Committee, with the result that a mild bill was made even more so, a result, which I must confess, we did witness with much glee. The Commission, you will recall, originally recommended, among other things, that the front-end load be abolished completely and that fund sales loads be limited to 5%. You also

know that the Senate bill merely reduced the front-end load but did not abolish it, and authorized the NASD, with Commission oversight, to determine levels of commission charges which are excessive. These were solutions which we considered earlier, but which we had determined not to recommend. The provision relating to management fees was also modified.

Most important, however, is the fact that the uncompromising attitude of some in the industry demonstrates a short-sighted view which will eventually and unfortunately redound to the discredit of those who sponsor, manage and sell mutual fund share. We did not conjure up the problems. In 1940, the Congress anticipated that they might arise and directed us to bring them to the attention of the Congress when they raised important issues in the public interest. The Wharton School, in 1962, pointed to some of them as did the Special Study, in 1964. The Commission's own Study, issued in 1966, discussed them thoroughly. The Senate Banking and Currency Committee, after full hearings, saw them and the Senate acted on them. The Chairman of

the House Committee and Subcommittee and others, including some who did not like this particular bill for one reason or another, agreed that the problems are there, that they will not disappear and that they deserve and will receive prompt attention, presumably in the next session of the Congress. In short, the failure of the bill to survive its test in the House Committee did not solve anything.

One Senator indicated in no uncertain terms, last, week, that he intends to introduce and hold hearings on a stronger bill next session. Others have assured me of similar sentiments. As of this moment, there is every indication that a much stronger bill will be introduced next year.

Conflicts of interests in the present mutual fund structure have deprived mutual fund shareholders of a fair share of the economies of scale made possible by their willingness to buy ever increasing numbers of fund shares. It would seem clear that an industry, which charged a management fee of .5% of average assets when assets managed aggregated $450,000,000 and charges at nearly the same rate where assets amount to

$50 billion, is not sharing equitably with shareholders the savings it realizes in management costs -- savings which accrue in most cases not because of greater skill or efficiency but solely because of the very much larger sums of money managed by essentially the same management. This problem will not disappear; there is every indication that it will become more acute.

The extraordinary protection enjoyed by the industry from free competition in the sale of mutual fund shares because of the retail price maintenance provisions of Section 22(d) of the Investment Company Act has kept the sales load on the sale of shares at a level far in excess of the charges considered appropriate with respect to the acquisition of practically any other type of security. The Chairman of the Council of Economic Advisers, the Deputy Attorney General and others, in and out of Congress, have questioned the propriety of continuing such an anti-competitive device. There is already indication that some members of the Congress will seek revision of Section 22(d) and a re-examination of the unusual price maintenance provisions found in that section.

The front-end load by reason of which an investor may lose 50% of more of his investment if he drops out within the first year, represents a sales charge which affects those investors who are the least sophisticated and least able to bear the loss. It still results in excessive sales charges. Here too, statements have been made for the record that the decision to retain a reduced front-end load rather than to secure its abolition will be re-examined.

We, of course, will do what we can with the authority we now have to provide appropriate protection for fund investors. Although I will be accused -- probably with some justification -- of speaking to some extent from frustration, I also speak from a real concern that the problems will get worse not better, and that they cannot be papered over by a stubborn unwillingness to permit reasonable legislative reform.

To repeat again the element of fairness to all -- the appearance as well as the fact -- is a keystone to the public confidence enjoyed by the securities industry and its institutions. Healthy securities markets are essential to our economic well-being -- not only for the United States but for the entire free world. I hope that the delay before these problems are satisfactorily resolved will not result in any real damage to that confidence.

There are several other things which I hoped to discuss with you today. The time

allowed me today is running out, but I should touch on one other item.

The second round of hearings on the stock exchange commission rate structure began yesterday. The Commission has accepted, as an interim measure, a proposal of the New York Stock Exchange to modify its commission schedule including a prohibition of customer directed give-ups. Since then the NYSE has prohibited certain other practices which the Exchange says violate its anti-rebate rule.

These are but the first steps in meeting some of the basic issues flowing from existing commission structure and levels. Further hearings will be held on the various questions raised in the order. These include issues as to so-called "institutional" membership on and other forms of access to, the exchanges. These issues are fundamental and difficult.

In the Silver case, the Supreme Court made clear that there is no blanket antitrust immunity for the stock exchange. Those practices which seem to be inconsistent with the antitrust laws, but are necessary to make the Exchange Act work

in the interest of investors, present or future, may be immune. I should say, in this connection, that the health and, to use another hackneyed phrase, the economic viability of the securities industry and certain of its institutions are within the ambit of the concept of investor protection. Obviously the key question is: what practices are indeed necessary to fulfill this objective. The Department of Justice has raised a number of difficult but important questions in a provocative brief filed with the Commission. Since the Commission has them under study and the hearings are continuing I will not go into the merits of the arguments at this time. I mention them only to emphasize the importance of these issues and the urgent need to find appropriate solutions.

I have referred to but a few of the problems we are facing. I have not discussed other important issues. These include a variety of accounting problems)such as conglomerate reporting), back-office problems of the securities

industry, the development of rules under the tender-offer bill which was recently passed, the disclosure study I initiated about a year ago, the institutional study authorized by the Congress to study the role of institutions in and their impact upon the securities markets. There are, in addition, many other problems requiring the attention of industry. Again, I think it fair to say that these problems are not of the Commission's making. They reflect the increasing complexity of our markets, the growing participation by the public in those markets, the developing sophistication of many of the participants and the variation and novelty of securitis packages and methods of doing business which characterize our securities markets. But new problems bring new challenges and new opportunities. Certainly life at the Commission has been anything but dull! I hope that you, as persons interested in maintaining healthy and productive capital markets, will assist us in tackling these problems and devising appropriate solutions.

Thank you very much.