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COOPERATIVE REGULATION

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COOPERATIVE REGULATION

I might begin by explaining the title of my paper. By cooperative regulation, I mean the process whereby the Securities and Exchange Commission, in conjunction with the stock exchanges and the National Association of Securities Dealers, regulates the securities markets. The exchanges and the NASD are self-regulatory bodies since they regulate their own members. However, they act under the oversight of the Commission which has, and exercises where necessary, its own direct rulemaking and other powers. The extent of this sharing of essential governmental power with industry is unique to the securities business.

Since I have determined to restrict my remarks to developments on the federal scene, I shall not discuss the role of the states in the regulation of the securities markets. The states preceded by many years the federal government's entry into this area. The Congress has always recognized the importance of state regulation by expressly saving it in all of the federal securities acts. The states have made, and continue to make, important contributions to the public interest and the protection of investors. We maintain close liaison with them.

Nor shall I, for the purpose of our discussion tonight, include bodies such as the Investment Bankers Association, the Association of Stock Exchange Firms and the Investment Company Institute within the term "cooperative regulation." In contrast to the exchanges and the NASD, they are not the recipients of delegated governmental powers. I think it important to state, however, that these, and other industry organizations, have played an important role, and undoubtedly will assume an even greater one, in the cooperative effort between the Commission and industry to achieve our common objective -- higher standards of conduct in the securities industry.

Without doubt, the most important recent development in the regulation of the securities industry has been publication of the Report of the Special Study of the Securities Markets. The Report is important in the context of my remarks tonight for a number of reasons.

It examines and evaluates the structure and performance of cooperative regulation. Most of its 175 recommendations are for changes in the substantive rules, the programs, or the organization of the self-regulatory bodies. During the preparation of the Report, many of the improvements effected by the self-regulatory bodies and by others were, at least in part, stimulated by the existence of the Study. Since release of the Report, self-regulatory groups have implemented several of the recommendations and have been active in their evaluation of others. Finally, and most important, I believe that implementation of these recommendations provides the most demanding test to date of the effectiveness of the basic scheme of cooperative regulation.

We can plow only a part of this broad and fertile field tonight. Accordingly, I shall concentrate on the Commission's views of the importance of prompt implementation of the Study recommendations.

Since a major part of the job of implementing the Study is ahead of us, it may be useful to discuss the Commission's views on the principles it will employ, and the principles it hopes the self-regulators and others in the industry will employ, in accomplishing this task. While much of what I will say tonight has already been stated before a Subcommittee of the House Interstate and Foreign Commerce Committee and elsewhere, a re-statement here of the Commission's point of view may contribute to a wider understanding by the public, the industry, and other interested parties. Understanding does not automatically lead to agreement, but it does help. Certainly, without it, agreement can never be achieved. If industry and the Commission understand each other, we will, at the very least, get to the point more quickly.

A review of the philosophy underlying federal regulation of the securities business and of the Study's evaluation of its structure and effectiveness may also be useful. We, at the Commission, and you, in industry, are well aware of the activities of the self-regulators. Nevertheless, we become so involved in our everyday tasks that we tend to lose sight of the reasons for the grand design by which we share a joint responsibility. Such a review may be helpful for another reason. A significant recommendation -- for increased reliance upon joint regulation -- cannot be justified unless we can demonstrate that the process has worked and that it has the capacity to provide protection of investors in the future.

The Philosophy and Purposes of Cooperative Regulation

The briefest outline of the pattern of regulation provided by the Securities Exchange Act will reveal its basic philosophy and purpose.

> First: Congress vested the Commission with primary responsibility for effectuating the purposes of the law. This requires the Commission to act directly in many areas. But unlike other federal regulatory agencies, the Commission discharges only a portion of this responsibility directly.
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> Second: A major part of this responsibility is delegated to the self-regulatory agencies. They are to enforce compliance by their members not only with legal standards but with ethical concepts as well. They are

authorized to fix standards and control practices of their members, within such concepts as the "promotion of just and equitable principles of trade" which obviously allow a wide range of activity. In some respects these powers are broader than the Commission's authority.

Third: To discharge these responsibilities, the self-regulatory agencies are vested with governmental powers which are to be exercised in the public interest and for the protection of investors. This is perhaps the key difference between a self-regulatory body and a trade association, which is not the recipient of delegated governmental powers.

Fourth: To aid in assuring that they perform effectively in the public interest and that they do not misuse their powers the Commission has certain oversight responsibilities. The Commission is empowered to act on its own, directly or through authority with respect to the rules of the self-regulators, when the latter do not or cannot act.

These are the essential ingredients. Merely listing them demonstrates the cooperative character of the system.

This carefully developed system fortunately operates not behind wraps in some ivory tower but in the fishbowl of public scrutiny and criticism. And there are two other important participants in the overall scheme. The Courts review Commission action to ascertain whether it conforms to constitutional and statutory standards. Congress exercises an even broader power. It not only reviews the performance of both the self-regulators and the Commission but, of course, can alter the whole regulatory structure or balance at any time. As the ultimate delegator of the governmental power, it is appropriate and desirable for Congress to review continuously the performance of the system of cooperative regulation which it created.

We who work in Washington are ever mindful of this beneficent influence. Those who work and live elsewhere tend to forget that both the self-regulators and the Commission are accountable to Congress, and that Congress will duly note and take appropriate corrective action when any one of us falls down on the job. While the stimuli provided by such Congressional and court oversight can, on occasion, be painful to the recipient, they are integral and desirable parts of cooperative regulation in the securities industry.

The Study Report contains a thorough discussion of the advantages and disadvantages of cooperative regulation. Briefly, the advantages are: Self-regulators -- members of the affected business -- can bring to bear on certain problems of regulation a greater degree of expertness and expedition than can the Commission, a necessarily more remote governmental agency. The self-regulatory agencies can act in the realm of ethical standards and practices, some of which may not be within the reach of the broad antifraud provisions of the securities acts. Third, participation in the regulatory process by members of the affected business gives them better understanding of the aims and problems of regulation and therefore encourages voluntary obedience. Finally, the costs of self-regulation are borne by those regulated, thus relieving, at least in part, the burden on the general taxpayer.

But like most good things in life, these benefits are obtained at the price of certain risks. Self-regulators may not always exercise optimum diligence and may, indeed, use self-regulation as a device to avoid or mitigate regulation. Self-regulators may be parochial in adjusting and accommodating competing aims and policies. Furthermore, since self-regulatory bodies are composed of disparate subsidiary groups, the legitimate interests of a particular group may be overridden, or the tugging and pulling may result in inaction or impasse. Self-regulatory agencies may find it difficult to strike the proper balance in delegating authority to staff employees. And, as the Study discussed in some detail, there may be duplication of effort among the self-regulatory bodies and between these bodies and the Commission. Finally, the self-regulatory bodies necessarily lack subpoena power without which thorough investigation may be difficult or impossible.

The Study evaluated cooperative regulation in terms of its effectiveness in serving the interests of investors only after a thorough and objective look at the record -- by far the most reliable indicator.

The Study's Evaluation

The Study's overall conclusion was that the basic statutory decision to place substantial reliance upon cooperative regulation appears to have stood the test of time and that it has worked effectively in most areas. Stating the matter another way, the Study concluded that the demonstrated strengths and benefits of the system outweigh its disclosed weaknesses. The Study, of course, recommended that these inadequacies be corrected.

This conclusion was reached after an exhaustive review and an evaluation of the performance of the system in many different areas of the securities markets. I need not remind you that the Study performed its job with a critical eye and did not hesitate to point to needed improvements -- as evidenced by at least 175 recommendations. Perhaps the most striking, yet most ignored, feature of these recommendations is that they evidence a considerable amount of faith in the self-regulatory agencies, since more of them call for action by the self-regulators than for action by the Commission. This is fully consistent with the traditional attitude of the Commission, not only in regard to the work of the statutory self-regulatory institutions, but also in other areas where the Commission has relied upon bodies subject to its jurisdiction to develop policies, procedures and substantive rules consistent with statutory purposes. The development of standards of accounting and auditing by the professional accounting societies is but one example.

The Commission agrees that cooperative regulation has, on balance, worked well and that its role should be strengthened and expanded, although necessarily under increased Commission oversight. At the same time, we also agree with the Study that revealed weaknesses must be corrected and that the Commission's powers in reserve must be exercised when the self-regulators cannot or do not take reasonable and needed action.

A fair number of the inadequacies described in the Report relate to performance by the Commission. The Study personnel were instructed to examine and report upon the Commission's performance thoroughly and objectively. The Study did just that. Expressly, and by implication, they found the Commission deficient in several respects. Needless to say, we have dealt with some of these inadequacies and are taking steps to remedy the remainder as soon as possible.

Many of the recommendations call for greater Commission oversight. This is a necessary corollary to, and not inconsistent with, recommendations for increased activity by the self-regulators. I know that oversight is not always welcome. But it must not be misinterpreted as a grasp for power. If the Commission were "power-hungry," it could, in many of the areas where increased activity by the self-regulators is recommended, regulate the whole activity itself under its existing statutory authority.

Viewed in perspective, the Commission's oversight powers must be understood as an indispensable element of cooperative regulation. For this system to operate in the public interest, the statutory pattern not only requires the self-regulatory agencies to meet their responsibilities but the Commission, as a wholly governmental instrumentality,

to assure their effective performance. The alternative to adequate oversight is not inadequate or no oversight; it is direct Commission action. With respect to many activities, this is not the statutory objective, and it is not the Commission's. We urgently desire cooperative regulation in the securities industry to work and, indeed, to work better. We believe this necessarily means increased activity by the self-regulatory agencies and increased oversight by the Commission in some areas. But it also means that the self-regulators must be permitted to enjoy such autonomy as will enable them to act as responsible partners in a cooperative enterprise and that the Commission's direct and oversight powers are to be used with restraint.

At this juncture I should like to point out the significance of the Supreme Court's recent decision in the Silver case. In light of that case, self-regulators -- particularly the exchanges -- may have cause, in some situations at least, to welcome more direct Commission oversight. As you know, one of the factors pointed to by the Supreme Court in reaching its decision was that the specific action taken by the Exchange which affected Mr. Silver was not subject to Commission review. The Court also suggested that the fact that exchange actions are not subject to specific Commission review may leave the exchanges on uncharted seas. Many within and outside the Commission agree with the Study that if self-regulation is to function effectively and with due regard for all aspects of the public interest -- including the public interest in vigorous self-regulation -- the forum for review of self-regulatory action should be the agency already established as the official guardian of the public interest in the securities field -- the Commission -- and not the anti-trust courts. A threat of antitrust liability is not encouraging to self-regulators who, by definition, are required to be vigorous and to take effective action with respect to their members and others. At the same time, it would be unrealistic to assume that the courts or the Congress will lightly grant any kind of general immunity without appropriate governmental oversight to assure that self-regulators' action is proper within the framework of all relevant public policies.

Implementation of the Report

As I have said, the Report of the Special Study presents a formidable challenge to cooperative regulation. This is due not only to the number and importance of the recommendations, but to the complex and controversial nature of many of the problems which they reach. No one has expected the implementation process to be an easy one, but complexity and controversy cannot excuse or unduly delay the execution of necessary tasks. We are all required -- Commission, self-regulators, and industry -- to address ourselves to the important implementation

responsibility with reasonable dispatch. At this point, I should like to outline the basic principles which the Commission is pursuing in the implementation program.

The Study Report is a thorough, thoughtful, and highly responsible document. In most instances the Commission has accepted and endorsed its conclusions and recommendations. In some cases the Commission felt that further study or consideration would be required, and so notified Congress. However, this desire for more intensive analysis is not to be understood to reflect a conclusion by the Commission that problems do not exist in these areas or that attention should not be given to them as promptly as possible.

As a practical matter, it was impossible to attempt to implement all the Study's recommendations at one time. A priority list has been established. At the top of this list are matters deemed to merit immediate attention. The setting of priorities was not designed to detract from the importance of those items held for later action. Such items are not being "relegated to the shelf," discarded, or neglected. Considerable work has already been done on a number of them; all will receive full consideration in a reasonable time.

Before the Commission acts, it will secure the views of the financial community. Solicitation of these views is required by law with respect to our rulemaking activities. However, even where it is not required, an interchange of ideas is necessary to an effective program. This seems all the more important since the Study did not have the benefit of industry's comments on its specific recommendations.

In view of the quality and thoroughness of the Study, the Commission believes its recommendations and conclusions are entitled to the greatest weight. But it would have been naive to expect that all its proposals would be greeted with unanimity. They were not. Where the industry feels a conclusion is incorrect, we are requiring it to document its assertion in detail. Where alternative solutions are offered, the Commission will not hesitate to accept them if they are as effective and desirable as those proposed by the Study. We are not wed to precise formulae; we are interested in the best solutions -- those that are fair, reasonable, and responsible. We are convinced that such solutions can result from constructive discussions with the industry and the self-regulatory bodies.

However, our attitude of careful study and of prior consultation should not be confused with a lack of diligence and zeal. Thoughtfulness is compatible with progress, even prerequisite to it. In the same

way, where implementation is to be undertaken by a self-regulatory agency, we expect that agency to move thoughtfully and reasonably -- but to move. The problems discussed by the Study cannot be swept under the rug. The agencies must exercise initiative in taking constructive and open-minded action. Established practices are not necessarily the best practices. Upon thorough consideration, suggested changes may not be as disruptive as first considered. I might even suggest that they may prove to be beneficial.

It would be less than honest to assert a belief that the Commission and the self-regulatory bodies will agree on all matters. In the eventuality of a disagreement, a popular metaphor would have us solve the problem by resorting to the shotgun -- our reserve powers. The shotgun metaphor was obviously intended to be more colorful than precise. A new rule must not have a shotgun effect. Rather, the approach must be affirmative and selective. It will involve, even at this stage, the cooperation of the industry. Therefore, all valid arguments should be raised and thoroughly considered. Though groups in the industry may not believe a rule is necessary, their comments and suggestions concerning it and how best to frame it will be valuable to the Commission and to those to be affected by it. In any event, neither the Commission nor the industry can allow a disagreement to lead to a breakdown in the lines of communication or to a failure of cooperation in other tasks.

Such a breakdown does not appear imminent. Much has already been accomplished. The Commission and industry are currently engaged in a number of important projects. In his testimony before the House Subcommittee, Chairman Cary detailed the progress that has been made and the items to be considered in the immediate future. The coming months will witness final or interim consideration of many significant problems.

These remarks have necessarily been general. They have dealt with some fundamental aspects of a relationship between government and industry which exists nowhere else in our economy. I should now like to be more specific and relate these obversations directly to you. After all, you have chosen careers in an industry which bears a heavy public responsibility. What does cooperative regulation mean to you who are already so important a part of this industry and soon to be occupying its posts of top leadership?

Most vital is your need to understand your own role in helping to meet the industry's obligations. Cooperative regulation, like other lofty concepts, is ultimately likely to be only as good as the people involved in it. Nor is such involvement a matter of altruism; it is good business. Leadership within a firm can realize its maximum potential

only to the extent that its voice is heard within the industry. Laxness and abuse by any segment of the industry bring discredit to all of it. The aim must be one of raising the standards of all firms to those of the best and most responsible.

The character of cooperative regulation points, in my opinion, to a need for you, the industry's emerging leaders, to display a lively interest, and to participate as actively as possible in the work of the self-regulatory agencies and other important industry groups. These groups are expected to represent all their members. As responsible leaders, you should make certain that they reflect the attitude which you consider important for this industry. Once again, it is the age-old story of direct personal participation -- in cooperative regulation in the securities industry, as in politics, charitable causes or other group activity. You can sit on the sidelines and let others do the work. Or you can get on the field yourself and actively do your part.

Lest there be any doubts, let me make clear that this encouragement of participation by volunteers in the affairs of the self-regulatory agencies is not inconsistent with the Study Report's recommendations for improved staff organization in these groups. Both are needed. Industry leaders will be making their maximum contribution when they set overall policy and direct the efforts of capable, efficient staff organizations. Each is indispensable to the other.

I believe I can close on a note of optimism. For the most part, the self-regulatory agencies have taken their obligations seriously and are proceeding in due course to consider and, in many cases, to implement many of the Study's recommendations. The interchange of views between industry and the Commission has been thoughtful and thorough. Initial exploration has revealed sharp differences of opinion in some areas, but as I stated earlier, the interchange of ideas can be fruitful even when there are disagreements. I can assure you that the Commission is anxious to utilize to the fullest the advice, the expertise and the criticisms of industry. The momentum already achieved must be maintained until every problem discussed by the Study is dealt with and satisfactorily resolved.

Gentlemen, we are all in this together.