S.E.C. RULEMAKING--THE SUBSTANCE NOT THE FORM

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In recent weeks there have come to my attention remarks of a number of men prominent in your business which could only have been prompted by a concern or worry on their part about some aspect of the way the Commission conducts its business. The first question which has been put to us is a very basic one: in effect the question is why the securities business has been singled out for the character and extent of regulation which is provided by the 1933 and 1934 Acts, the Investment Company Act and the amendments contained in the legislative program which we now have before the Congress. Why is it that the merchandiser of securities is subjected to a degree of regulation not imposed on the seller of other media of savings and investment, such as insurance, S & L shares, bank deposits, etc.?

A frivolous answer to this question would simply be another question and a very short one at that: "Where have you been for the last 30 years?" But the question was meant seriously, and therefore a serious answer is called for. This year marks the 30th anniversary of the passage of the Securities Exchange Act of 1934, that one of the statutes administered by the Commission which most directly affects the people and institutions that make up the securities business, as contrasted with the securities with which they deal. Today, when we are trying to find solutions to the problems set out by the Special Study, it is appropriate to quote the legislative father of the Exchange Act, the late Speaker Sam Rayburn of Texas. [Parenthetically, it is fair to note that nobody to my knowledge has suggested that Mr. Rayburn

was a wild-eyed radical.] This is what he said:

> "The Exchange Act is conceived in a spirit of the truest conservatism. It attempts to change the practices of exchanges and the relationships between listed corporations and the investing public to fit modern conditions, for the very purpose that they may endure as essential elements of our economic system. If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. 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 a maturing 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. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting."

Just about a year ago the present Chairman of the Commission made the same point in fewer words:

> ". . . the functions of this report [of the Special Study] and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence."

In deciding what these two gentlemen were trying to tell us, we should bear in mind that almost all legislation is developed with the benefit of 20-20 hindsight. No one, either in the Special Study or in the Commission, has ever suggested that the problems which were laid out by the Special Study, and with which the Commission, the Congress and the self-regulatory agencies of your business are now attempting to deal, are of the same character as were faced by the Congress in the aftermath of the market crash of the late '20's. Nevertheless, it is a fact that investor confidence was shaken by events occurring in the securities markets in the late '50's and the early '60's. The market

break in May 1962, which served as a dramatic climax, was a consequence, not a cause. Of course, there are persons and firms whose standards of business conduct have been and are such as to strengthen investor confidence. Unfortunately, however, there have been, particularly in the decade ended in May 1962, many whose conduct has served to undermine that confidence. Wherever the responsibility rests, it is perfectly clear that the Congress and the American investing public expect the Commission and the self-regulatory agencies of the industry to see to it, to paraphrase Mr. Rayburn, that the law so advances as to strengthen investor confidence in the exchange and over-the-counter market alike. (Congress has made its position abundantly clear. In every year since 1954, one or another of the committees of the House and Senate has made it its business to assess the Commission's performance of its statutory responsibilities. These inquiries culminated in the Mack Resolution of 1961 which authorized the Special Study. There is no realistic basis to support any notion that Congressional interest in the securities markets and investor protection will diminish in the foreseeable future. Also, it must be pointed out that Congress expects the Commission to assess critically its own past record.)

There are a number of ways by which such an advance in the law is to be achieved. First, there is legislation to be enacted by the Congress. We have a good Bill up there, and we think it will be passed. We have been heartened by the support it has received from the industry. I don't think I need to elaborate on that today, but I will have occasion to refer to it later in discussing the Commission's rule-making activity.

Second, the Commission can write new law in the form of rules. Many of our rules are precisely legislative in nature. The Congress, time and again, has specifically authorized or directed the Commission to deal with a subject matter in the industry by rule, and has delegated to the Commission the necessary authority. In some instances, the directive to the Commission has been stated in the broadest of terms, as for example, in Section 14 of the Exchange Act, which authorizes the Commission to regulate proxy solicitation "in the public interest or for the protection of investors." In others, the grant of power is broad, but somewhat more specific standards have been prescribed by Congress for the Commission to follow. For example, in adopting rules permitting a specialist to act as a dealer on a national exchange, Congress has directed the Commission to restrict specialist dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market.

These legislative rules have the force of law and, as long as they are not unreasonable, the courts will uphold them. Under the Exchange Act, for example, the Commission has adopted 22 rules relating to selling practices, which are of this general character. (I hope it is not unreasonable to point out that 22 is a small handful, compared to the number to which you are subject if your firm is a member both of one or more of the principal exchanges and of the NASD.) All of these rules, adopted pursuant to Sections 10 and 15 of the Act, are so-called anti-fraud rules. Congress told the SEC to define manipulative, deceptive, or otherwise fraudulent devices or contrivances which might be used in the securities markets, and to prescribe rules

to prevent their use. Now while "fraud," as that term is used in the securities laws, covers a greater range of activities than common law fraud, it is nevertheless true that the Commission does not have a blank check to forbid just any activity which, in the exercise of arbitrary or irresponsible judgment, it might find to be detrimental to the securities markets or public investors.

At this point, another public remark comes to mind. While the speaker was principally concerned with the action of the Commission in breaking off discussions on proposed Exchange rules governing floor trading, his statement also suggests that the Commission is no longer encouraging self-regulation. Now it so happens that, again 30 years ago, Congress did not say to the Commission "You may regulate this subject matter if you find it necessary so to do for the protection of investors and in the public interest." Rather, Congress said to the Commission "You shall regulate." Period, end of sentence. The Commission thinks that the difference is expressed in plain English, and that Congress meant what it said. In our release of April 9, 1964, proposing a rule to regulate and restrict floor trading on national exchanges, we said ". . . the Commission regards this provision of the Exchange Act as a mandate to attempt regulation of floor trading; but if such regulation does not accomplish the statutory purposes, the alternative, expressly provided by Congress, is prohibition." By contrast, in a number of areas where either the NASD or the stock exchanges have responsibilities, the Commission has not been given such an imperative mandate, and in the legislation which is now before the Congress the Commission is not asking either for such a mandate

or for the authority which would be essential to its discharge. Thus, so far as the NASD is concerned, while the Commission can disapprove any proposed NASD rule or revoke any NASD rule, it is only in a few limited areas that the Commission has authority to order the NASD to adopt a rule, willy-nilly. So far as the stock exchanges are concerned, the Commission has a broader area in which to exercise its power to direct an exchange to adopt a rule. But, on the other hand, it has no power to prevent an exchange from putting into effect a proposed rule even though the Commission thinks it undesirable. It should be emphasized that no changes in the relationship of the Commission to the NASD or to the exchanges are being sought or provided for in the pending legislation.

So Congress has given the Commission different types of directives, sometimes authorizing it to do something, and sometimes directing it to do something. It has also given it varied powers to deal with different subject matters with which the self-regulatory agencies are also concerned. So when you talk about self-regulation, you have to be pretty specific in defining the context in which you use the term.

Self-regulation by an exchange has one definition in the area of floor trading. But it has quite a different definition when used in the area of the exchange's responsibility, for example, for the fixing of reasonable rates of commission. As I have said, in the former case the Commission is under a mandate to resolve the problems presented by floor trading. The Commission is certainly not doing violence to the theory or practice of self-regulation when it decides to adopt its own rule on the subject, after a 30-year

history which the Commission summarized in its release of April 9 as follows: "One salient fact emerges from this history. Notwithstanding its reliance upon exchange rules, there has been no time in the past thirty years when the Commission, which has the statutory responsibility, has been in a position to make a finding that exchange regulation had satisfactorily resolved the problems of floor trading." (In the light of my reference to the use of 20-20 hindsight, I think it is only fair for me to make it clear that, in arriving at its judgment on this floor trading matter, the Commission was also applying that kind of hindsight to the Commission's own record over the thirty-year period. I can't tell you why the Commission changed its mind on floor trading in 1945. I can only tell you that the Commission, as presently constituted, having available to it facts and information which were not available to the Commission in 1945, has reached a different conclusion. Call it hindsight, second guessing or what you will, you should not be surprised if from time to time an imperfect human institution changes its mind and does it within the limits of its authority and responsibility.) By contrast, if the subject matter is the rate structure of a stock exchange, the Commission's role is that of a second-guesser, and self-regulation as provided in the statutory framework contemplates a primary role for the exchange concerned, rather than for the Commission.

Let us now return to rule making in the area of selling practices, which has also stirred up controversy in recent weeks. The NASD has authority under the statute to impose on its members standards of conduct which go above and beyond the level of the law. So do the

exchanges. Here I refer to standards which are sometimes characterized as ethical practices or, in the words of the statute, "just and equitable principles of trade." In this area, which is indeed a wide one, it is to be expected that the Commission, even as a second guesser, would seldom have occasion to disapprove or abrogate a rule proposed or adopted by the NASD. On the contrary, to the extent the self-regulator organizes its policies into a framework consistent with the Exchange Act, it receives the wholehearted support and endorsement of the Commission. This is self-regulation at its best. Furthermore, in this area, the Commission does not have the power to order the adoption of a rule. As noted above, however, in the area of selling practices the Commission does have the statutory power under Sections 10 and 15 of the Exchange Act to prescribe anti-fraud rules of its own, but the Commission has exercised this power sparingly.

One of the most important of the Commission's "legislative" rules is Rule 15c3-1, the Net Capital Rule. When you consider that there is not yet any uniform minimum national standard of financial responsibility for firms seeking to enter the business, you can appreciate the importance that this, the so-called 20 to 1 rule, has had in the protection of public investors who have entrusted either their funds or their securities to the custody of securities dealers. We expect to be discussing shortly proposed amendments to this rule which would require that those proposing to enter the business have, and maintain, a minimum amount of net capital and maintain a minimum degree of liquidity in their assets. I would hazard a guess that the

industry will consider our proposals fairly modest. One reason for this is that we do have to take account of the fact that the rule will apply uniformly across the board and across the nation.

We have already formally proposed a rule which would supplement the present net capital rule. This is our proposed Rule 15c3-2 which would require that customers be informed periodically of the status of their funds held as free credit balances by broker-dealers. The industry reaction to this proposal has been, to say the least, mixed. This rule is designed to implement recommendations of the Report of the Special Study. In accordance with our consistent practice, the staff of the Commission developed a tentative draft of a rule, and the Commission authorized the staff to discuss that draft informally with industry representatives. Staff personnel had a number of meetings with those representatives, and some of the suggestions and constructive criticisms submitted by industry were reflected in a revision of the rule which was formally proposed by the Commission for adoption on March 12. This brings me to another question posed to me. One industry representative took serious exception to the rule as formally proposed by the Commission, and wondered audibly whether the Commission was in fact informed of the comments which he and other industry representatives had made in these preliminary discussions with the staff. I assured him in a personal conversation that indeed the Commission had received what I consider a fair summary of the industry comments and criticisms. This produced his question: "Don't you believe us?"

My answer to him and my answer to you is that of course we believe that the industry spokesmen are giving the Commission the benefit of their honest and well-considered judgments. But, obviously, that is not the same thing as to say that the Commission will at all events accept all or any of those judgments. Rather, the Commission must, as it does, assess and weigh the conflicting arguments and viewpoints urged upon it and arrive at its own best judgment. It is perfectly clear, from the written and oral comments that the Commission has received on this proposal, that reasonable men may differ on the precise content of the rule. There is less reason to conclude that there is a basic opposition to the objective which the rule is designed to achieve. I trust that when a rule in this area is finally adopted it will not produce in the industry a universal reaction of frustration and disapproval.

This calls to mind the very strong and critical adjectives which have been publicly applied to unnamed members of the Commission's staff. It is always a matter of personal judgment and taste as to how a person chooses to express a strong emotional or intellectual reaction. I do not wish therefore to be understood as criticizing the speaker or substituting my judgment for his. I do think it is fair to say that his remarks represent an exercise in the use of invective in a discussion of a matter with which he was and is properly concerned. Invective can be an effective instrument in public debate. I still vividly remember Cicero's orations against Catiline which I had to translate in third-year high school Latin 30 years ago. Cicero had his

case against Catiline and could document it in chapter and verse. I am satisfied that such a case can't be made against our staff. Rather, I take these remarks as a spur of the moment, off-the-cuff expression of frustration and even dismay in response to the course which the discussions on proposed Rule 15c3-2 and some other topics had taken. You know from your own experience that frustration sometimes produces a search for a scapegoat. I can only urge spokesmen for the industry as forcefully as I can not to seek scapegoats, during the course of the informal and formal processes by which the Commission finally arrives at a decision in the rule-making area. The Commission is a human institution, and therefore its batting average is going to be less than perfect. It is not possible to expect that its conclusions will satisfy all of the people--industry, Congress, public investors, the press, or indeed, each member of the Commission itself. I am convinced, however, that whatever its record, the Commission in making it is not being deceived or misled and does understand, as nearly as humanly possible, the consequences of its decisions and the facts on which they rest. We have sought and we have thus far in large measure received the conscientious and intelligent comment and advice of many people in your business on many matters of concern to you and to us. The need for this kind of assistance is not going to diminish. If we do not get it, we will have more serious things to worry about than a scapegoat.

With that assistance to supplement the conscientious efforts of the Commission's own staff, the Commission is going to continue on

the same basic trail it has been blazing for many years. When it is faced with a problem in the securities markets which appears to call for a solution, whether that problem comes to its attention through a Congressionally-sponsored Special Study or in the ordinary course of discharging its regulatory and surveillance responsibilities, it is going to attempt to provide another link in that "constant extension" of the practice of "straight shooting," as Mr. Rayburn expressed it. In so doing it will, as it must, define the boundaries of the problem, assess the need for its solution and, whenever it arrives at a solution, make a choice as to who should be the prime activator, be it the individual businessman, a self-regulatory body, or the Commission itself, in putting that solution into effect.