NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

THE SECURITIES ACTS AMENDMENTS OF 1975, SELF-REGULATION AND THE NATIONAL MARKET SYSTEM

Address By

Philip A. Loomis, Jr.
Commissioner
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

Joint Securities Conference 1975
Sponsored by the NASD, Boston
Stock Exchange and the SEC
Boston, Massachusetts
November 18, 1975

Since this conference is jointly sponsored by two organizations which, since June 4, 1975, have been officially labeled by the Congress as "self-regulatory organizations" and by the Commission, it seems appropriate for me to discuss today some changes in the process of self-regulation which may be expected to result from the legislation which was enacted that day. This includes, I think, not only the specific changes in procedures and standards which are mandated by the Act, but also the changes in attitude and approach of all of us to this business of self-regulation which seem to be called for by the spirit if not the letter of this legislation.

Some of the changes are very specific. For example, any new rule or change in the rules of a self-regulatory organization must be filed with the Commission, and with minor exceptions, must be approved by the Commission, in accordance with a rather detailed procedural scheme, before it becomes effective. Similarly, the Commission may abrogate or amend any rule of such an organization by the use of a procedure which is specified with unusual detail. Disciplinary actions by exchanges are now subject to review by the Commission. An exchange may deny membership to a broker-dealer only in accordance with specified provisions of the Act.

The Securities and Exchange Commission, as a matter of policy disclaims responsibility for speeches by any of its Commissioners. The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

Other changes are not specific at all. For example, the rules of an exchange or the NASD may not "impose any burden on competition not necessary or appropriate in furtherance of the purposes" of the Act. The Commission is directed to use its authority under the Act "to facilitate the establishment of a national market system for securities" which is not defined except in terms of rather general objectives.

I hasten to assure you that I do not propose to catalogue all of the numerous provisions with respect to self-regulatory bodies which may be found in this long and rather complex statute. Rather I propose to consider how they came to be there and what appears to have been the objective of these changes.

The origins of this legislation can be traced back at least to the distressing events of 1968-1971 when an unexpected surge in trading volume caused the securities industry to almost drown in a sea of paperwork. By ill chance this was immediately followed by a sharp decline in stock prices and volume which produced a financial crisis in an industry already weakened by its paperwork entanglements. This situation made it necessary for the industry and the Commission to request, and for the Congress to pass the Securities Investor Protection Act in 1970. The Congressional Committees which sponsored that legislation felt obligated

to assure their colleagues in Congress that they would do something about the conditions which made the legislation necessary. At the same time they had been observing a developing controversy about such matters as fixed commission rates, institutional membership and the whole impact of institutional trading. They consequently embarked upon elaborate studies of the securities markets. The Report of the House Committee Study was issued in October 1972 and that of the Senate Committee in February 1973.

These studies are notable for several reasons. In the first place they represent the only major independent studies of the securities markets which have been done by the Congress since the early 1930's. A great deal of effort and careful consideration by very able people in and out of Congress went into them. At the same time, I think they were influenced in content and conclusions by the background against which they were made and by their avowed purpose of finding out what went wrong and why. This induced a critical tone and focus. Those of us who were on the receiving end sometimes felt that the emphasis on the failings and mistakes which occurred in an effort to deal with a succession of unexpected crises was a bit unfair, and that here and there the response had some elements of over-reaction. There is a considerable difference between the perspective of someone

analyzing a decision in his study after the fact, and the position of those who had to decide, what, as a practical matter, could be done then and there in the middle of an emergency. Yet it is true that things did go wrong, and that there had been a reluctance to change time-honored ways of doing things when change had become both possible and necessary.

The studies, and the legislation which followed, placed a great deal of emphasis on the concept and process of self-regulation in the securities industry. The ultimate conclusion was that this process is highly desirable if, not essential, but that it required significant changes. Without necessarily agreeing with each of the changes which were made, I agree entirely with the basic conclusion, and it is an important one. They need not have come out that way. The Committees critically examined self-regulation under stress, and in a situation where its limitations were most apparent, and yet they did not decide to eliminate it, on the contrary, they extended it to new applications such as the municipal securities markets and the clearance and settlement function.

Self-regulation is a peculiar process. There was even a debate, which found its way into the Congressional studies, as to what to call it. The House Committee concluded in its

study, that "the phrase 'self-regulation' must be consigned to the past" and that the proper phrase is "cooperative regulation." The Senate Committee, on the other hand, objected in its study to the term "cooperative regulation" upon the ground that it might create a misleading impression as to the relative functions and authority of industry and government. But I guess "self-regulatory organization" is now the official phrase since it is defined in Section 3(a)(26) of the new statute.

There is more than mere semantics to this debate; there is a question of substance as to the proper place and function of these industry bodies. The House Committee objected to the phrase "self-regulation" upon the ground that it implies that industry members should regulate themselves, when in fact what is involved is a single regulatory scheme in which the Commission has a "pervasive" role rather than there being a division of responsibilities with an assigned sphere for the Commission and for the self-regulatory bodies. The Senate Committee did not disagree with this, but wished to emphasize its view that these industry bodies were exercising "delegated governmental powers" from which several conclusions followed: (1) their procedures should be more formal and more open although not subject to the "whole panoply of Government administrative procedure," (2) the Commission should have authority to review all or substantially all

self-regulatory actions, (3) the Commission's oversight should be more formal and pervasive and again more open to public view, and (4) the function of self-regulation should be limited to those areas as to which authority has been delegated to these organizations under the Securities Exchange Act.

All of these concepts with respect to the proper functioning and purposes of self-regulation are reflected in various provisions of the Securities Acts Amendments. I have mentioned the major broadening of SEC authority over the rules of the exchanges and the NASD. Detailed procedures for the adoption, amendment and SEC approval of rules of self-regulatory bodies are spelled out in new Section 19(b) of the Act, including requirements for public notice and comment. Similar detailed procedures for Commission modification of Exchange rules are found in new Section 19(c). Disciplinary actions by self-regulatory bodies are subject to review by the Commission, or in certain instances the bank regulatory agencies, under Section 19(d). Section 21 as amended authorized the Commission to file actions in court to enforce not only the Act and SEC rules but also rules of the exchanges and the NASD. Finally, Sections 6 and 15A are amended to require that the rules

of exchanges and the NASD shall not be designed to "regulate by virtue of any authority conferred by this title matters not related to the purposes of this title" or the administration of the organization.

In all of this, the pre-existing distinctions between the jurisdiction of the Commission over the exchanges and its jurisdiction over the NASD are almost wholly eliminated. This change is commonly regarded as merely rectifying a historical accident, the provisions with respect to the exchanges having been enacted in 1934 while the provisions for the NASD came later, in 1938. It seems to me that something more is involved. The Maloney Act of 1938 was designed to authorize and to govern entirely new organizations whose primary, if not sole, purpose was to provide a mechanism for self-regulation in the over-the-counter market. It is understandable that the Congress gave the Commission fairly pervasive authority over these new organizations, which were in large measure creations of the Congress. By contrast the then existing provisions with respect to the exchanges, which had represented to some degree a compromise as to how much authority over the exchanges should be given to the Commission, were not then conformed to the new provisions for the NASD. That was not to come until 1975 some 37 years later. It seems to me that this represents something more

than the mere correction of an earlier oversight. It reflects first the fact that the NASD has grown and flourished under the 1938 structure and in fact has steadily increased its effectiveness as a self-regulatory body while at the same time taking on new functions, such as the NASDAQ system, whose legal foundations were laid by the quotation provisions added to the NASD's enabling legislation in 1964. Further it reflects the fact that relations between the NASD and the Commission over the years have not been characterized, to anywhere near the same extent as have relations between the Exchanges and the Commission, by disputes over the extent of the Commission's jurisdiction, several of which were critically examined in the Senate Study.

There also runs through the new legislation another major theme and that is an emphasis and reliance upon competition, often as a substitute for regulation. The title of the new Act, in listing its purposes, sets forth first the objective "to remove barriers to competition." I have noted the new requirement that exchange rules impose no unnecessary burden on competition. The same idea appears in numerous other places. Fair competition is stated as one of the primary objectives of the national market system which is to be established. The avoidance of unnecessary burdens on competition is stated as an objective or a

requirement in numerous places in the new Act, which even goes so far as to provide in new Section 19(e)(2) that if a sanction imposed in a disciplinary proceeding by a self-regulatory body is found to impose any unnecessary burden on competition, it shall be modified or set aside. The same idea is implemented by a number of provisions which grant open membership or non-discriminatory access to various organizations and facilities.

It has very recently become fashionable to celebrate the virtues of competition as a substitute for regulation, and this, I think, generally reflects a desirable reaction to the unnecessary elimination or suppression of competition by quite a number of regulatory structures. But securities regulation by the government has never really been characterized by any such bias against competition. It grants no franchises, requires no certificates of public convenience and necessity, and even before the enactment of the new legislation, it managed to largely eliminate the rate fixing which had prevailed on the exchanges for over a century before the regulatory scheme was created. Moreover, the Congressional interest in competition in the securities markets antedates the current public concern with the issue of competition versus regulation in the economy generally.

This interest was very clearly expressed in the House and Senate Studies in 1972 and 1973. It is, I think, a rather different kind of concern. There was not so much a conclusion that the scheme of governmental securities regulation itself suppressed competition but rather that it failed to require competition or to prevent industry organizations from behaving in an anti-competitive way. This is quite a different problem, and I think that nothing but confusion is created by confusing these quite different concerns.

In recent years most of those who have studied the functioning of the securities markets and tried to plan for their future have come up with the idea that we should move towards a central or national market system. The Commission made this a major theme and objective in its letter of March 10, 1971, transmitting the Institutional Investor Study Report and again in its 1972 and 1973 statements on the future structure of the securities markets. The Martin Report to the New York Stock Exchange in 1971 proposed such a system. So did both of the Congressional studies I have discussed.
And finally Congress wrote this objective into law not only in new Section 11A of the Act, which directs the Commission to use its authority under the Act to facilitate the establishment of such a system, but also in many other sections of the

statute where there is added to the traditional standard for Commission actions, the public interest and the protection of investors, a new standard "to remove impediments to and perfect the mechanism of a national market system." Examples are: amended Section 6(b)(5) specifying standards for exchange rules, amended Section 15A(b)(6) specifying standards for the rules of national securities associations, Section 11(b) which provides for the regulation of exchange specialists, Section 11A(h) regarding securities information processors, new Section 12(f)(2) dealing with unlisted trading privileges and new Section 15(b)(9) with respect to the regulation of what is referred to as SECO broker-dealers.

Perhaps the cornerstone of a national market system is the creation of a mechanism by which all, or at least most, of the orders for securities traded in the system are channeled into the system rather than being fragmented and dispersed. This concentration of the order flow has at least two important consequences. It provides a maximum opportunity for such orders to interact and to be matched, and it enables market professionals, particularly market makers, to have access to the entire order flow and this in turn greatly improves their ability to perform their functions effectively and efficiently.

Now it is to be noted that, at one time, the New York Stock Exchange came pretty close to having access to this complete order flow. Yet the New York Stock Exchange has not evolved into a national market system, and its share of the order flow has tended to deteriorate in recent years, although one would expect that the development of modern communications technology would have brought about the opposite result. I suggest that a main reason for this failure has been restraints on competition. The Exchange has sought in many ways to channel orders to its market but it has maintained or erected barriers to competition with, and within, that market.

One principal barrier was the fixed minimum commission. This led to a fragmentation of the order flow as participants in the market sought to avoid paying those fixed commissions, or to recapture them, or to direct them to non-members who provided desired services. This particular barrier has now been lowered. But it sometimes seems that rather than seeking to seize upon the competitive opportunity that this development appears to present, the Exchange has concentrated on retaining other barriers. There are two main ones, the absence of competition in the dealer function, which is sought to be restricted to one specialist in each stock, and the requirement

that all orders be executed by floor brokers on the floor of that exchange. The dealer problem has been aggrevated by the fact that many specialists have neither the capital nor the inclination to handle effectively the large orders that come in from institutions, and thus this function has gravitated to large well-capitalized firms who combine the broker and the dealer function by finding the other side for these orders to the extent possible, and positioning the balance if necessary. Some restrictions prevent these firms from fully competing with the specialist, and prevent him from fully competing with them, thus preserving an uneasy balance. The requirement that orders be executed on the floor restrains competition in the execution function. A good many people have noted that small orders could be executed more efficiently by the maximum use of modern technology. For large orders the floor broker does not have available to him either the facilities or the resources for finding the other side which are available to the block houses.

Thus we do not have the national market system yet, but with the impetus provided by the legislation, that development is inevitable and I believe we should get there as soon as possible. For me, at least, the most difficult

problem along the way is how to open up the system and remove barriers to competition without, at the same time, losing the existing mechanism for concentrating the order flow before we have an adequate substitute. I think this problem requires the best thinking that all of us can muster.

I have tried today to sketch some of the background, and some of the aims and purposes of the Securities Acts Amendments of 1975. I have, of course, not even mentioned many of its major objectives such as providing regulation for the municipal bond market, and perfecting the mechanism for clearance and settlement. Rather I have concentrated on two areas, the changing process of self-regulation and the national market system. When one sits down to read this formidable statute, it is very easy to either give up or get lost. Yet this legislation is a very important and I think essential development in our securities markets, we will have to live with it, and we therefore must try to understand what it means and what it does. I hope I have been of some help in this necessary if difficult task.