

INVESTMENT BANKERS ASSOCIATION OF AMERICA

Hollywood Beach, Florida

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Chairman
Securities and Exchange Commission

November 28, 1961

I want to express my delight in meeting with you and in speaking for the first time before the Investment Bankers of America. My last visit to Florida was more arduous: it was while in uniform, for one day during the war.

As you may know, ours is a newly constituted Commission. Four Commissioners have been appointed in 1961, and one in 1960. Under these circumstances, I am sure you might seek some notion of our point of view. I might say that our backgrounds are varied. One of us is a former United States Senator and Chairman of the Subcommittee of the Banking and Currency Committee which has jurisdiction over the S.E.C.; two are outstanding past members of the Commission's staff; the fourth was a practicing lawyer with heavy experience in corporate finance. I am a former professor and part-time practitioner.

In general, I venture that I speak for my colleagues; though I would assure you, and them, that my views are in no way binding upon them. We function as a true Commission, with five voters, always independent, occasionally differing from one another, but at the same time operating in a general atmosphere of harmony and respect.

First of all, let me make it clear that our position is not anti-Wall Street or any other street. Such a point of view is doctrinaire, totally

undiscriminating and irresponsible. The financial centers of this country, and indeed of the world, have within them all elements and are an integral segment of American life. Personally, having spent my life in the practice and teaching of corporate law, with an address at No. 1 Wall Street, I would find it hard suddenly to regard all my past associations with rancor.

Secondly, you are the responsible leaders in the industry who -- happily -- are evolving the standards of a true profession. With you we may have occasional differences in point of view. But in essence I firmly believe that we both are aiming for the same ends, and that cooperation can and should be anticipated.

Thirdly, we believe in strong enforcement of the securities laws as they stand. It is commonplace to note that this is an era of economic "good times." The Wall Street Journal, with which some of you may be remotely familiar, had a story about some Southern Pacific Railroad detectives following a wire out to a box car and finding there a hobo sleeping under an electric blanket. Times indeed have changed when even panhandlers are not totally impecunious.

The crescendo of registration statements with which the Commission is daily confronted is testimony to the lively state of the underwriting

business. This output has been coupled with very active market conditions. These factors create a greater opportunity for the development of fraudulent and manipulative practices. As responsible members of your industry, I believe you recognize the potential problems now present in our securities markets and agree with me that the climate calls for vigorous enforcement. Over and over again in New York, before I came down to Washington, I had eminent leaders in your industry take me aside and tell me that certain corrections are needed. I emphasize that action, both legislative and enforcement, will be selective, and not a broadside.

Fourthly and finally, I believe that ethical standards must move upward. Today anyone would be shocked with a comment attributed to a 19th Century railroad buccaneer: "Why buy the shares, if we can buy the directors." Thanks in substantial part to the securities laws -- accounting rules, disclosure standards, and principles of fair dealing have developed almost by a process of accretion. While in law school during the early thirties I remember the overwhelming fears expressed over the 1933, 1934 and the 1935 Acts. I wonder how many today are still opposed to the disclosure philosophy -- which is now gaining ground on the Continent? How many accountants and analysts would like to return to the accounting

rules of the twenties? And how many people in the utility industry -- comparing the jigsaw of a utility empire then with their corporate structures today -- would feel that their industry is worse off? Some would say in fact that the Holding Company Act may well have saved them from wider governmental ownership.

This does not mean, however, that everyone in the financial community is benevolent. Furthermore, should we adopt an attitude of satisfaction with the status quo? In the past 6 months I have had a chance to observe the resourcefulness of the securities industry in adopting new forms of financing. Why is there not room for growth and improvement in standards as well? Ethics too, can, and should be, dynamic. As a practical as well as a theoretical matter, the basic principle underlying securities regulation is that of fiduciary responsibility. Mr. Chief Justice Stone -- himself a corporate lawyer -- phrased this thought some 33 years ago:

"I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'" More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle . . ."

As you all well know, laws are often enacted to remedy the abuses of the fringe elements of society -- in our case the ethically marginal securities operator. To avoid increasing regulation, you share with us the responsibility for maintaining and indeed for raising standards of conduct.

While we are enjoying this current prosperity, we must recognize, as the President has pointed out, that we are destined to live out most, if not all, of our lifetime in uncertainty, challenge and peril; that our very system with all its virtues of freedom is at stake. Interestingly enough, only a few days ago a Polish Marxist philosopher brought to the attention of his own people that the strongest propaganda against communism today in the capitalistic world is the concept of freedom of the individual. He argued that more of it should exist within a Marxist socialist system.

At the same time we must likewise recognize that freedom can survive only if coupled with responsibility. The public interest cannot permit abuse to become rampant under the guise of freedom. We can and must do our utmost to raise ethical standards in a world where all values are being questioned, lest we deteriorate to the level of our adversary. This then is competition of another kind -- in the ethics of business conduct as well as in economic systems. Here is an area in which complacency may not be permitted to flourish in the glow of economic well-being.

Now, how can we carry these general principles concretely over to the study of the securities markets which Congress has commissioned us to undertake? Before going to substance, let me make a few comments on procedure. At the outset, let me assure you that this is not a publicity venture. There will be no midget perched upon anyone's lap. This study will be responsible, as evidenced by the choice of its director -- a highly responsible lawyer. Anyone who has seen Milton H. Cohen in action is aware of his broad grasp of the securities field, both as a governmental official and active private practitioner. At the same time, even though the investigation will not be flamboyant, I would add that in our opinion some public hearings should in all probability be held.

Finally, with respect to procedure, I want to emphasize that this study will not be divorced from the continuing work of the Commission. We shall not sit and wait for the report in January 1963 if weaknesses come to light in our own administration of existing laws or in current industry practice. There is something anti-climactic about awaiting a protracted study and delaying all action till its ultimate submission and digestion. Therefore, where the need of change is demonstrated, action will be taken as soon as possible through amendment of our rules or early legislative proposals.

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Turning now to substance, let me point out this is the first major study of securities practices and the market in 30 years. Much has happened in that interim in terms of the growth of the markets, proliferation in stock ownership, and changes in distribution and selling methods. The time is ripe for a new appraisal.

The study will be broad and inclusive in scope. Breadth of approach is clearly the dictate and intention of the Congress. As Senator Williams of New Jersey said on the Senate floor: "It is intended that this study and investigation be wide in scope; otherwise the resulting information will not enable Congress to examine the broad spectrum of the securities industry." The Commission has already been developing areas of inquiry. Lines have not been rigidly fixed as yet, but we do have some definite ideas on subject matter. I should like at this time to spend a few minutes on some of the areas which the Commission contemplates examining in this study.

An orderly and informed securities market depends to a great extent on the knowledgeability and integrity of broker-dealers and their salesmen. It is the salesmen who have immediate contact with the public. It is they who advise customers on the proper selection of securities. It is they who must fulfill the duty to know their customers imposed by exchange and NASD rules. It is the broker-dealers, employing these salesmen, who must bear a responsibility of maintaining the necessary standards by adequate supervision. Responsible conduct on the part of broker-dealers and their salesmen can, and should be, our keystone.

Certain factors may lead to a deterioration of standards in the marketing area. I cite by way of illustration the following:

1. Part-time salesmen, who may operate from door-to-door and be remote from experienced supervisors.
2. The growth of branch offices which may lead again to the potential separation of salesmen from supervisory officials.
3. The growth of the base of stock ownership which has undoubtedly injected into the market less experienced investors and speculators.
4. The sheer volume of activity on the market.

I do not say that any of these factors in and of themselves will erode standards.

Part-time salesmen may be the most competent and ethical individuals.

Professionalism, however, is harder to develop on a part-time basis.

The Commission is encouraged by the efforts of the industry to improve the standards of salesmen and broker-dealers -- by any steps taken to inject a higher degree of professionalism into the securities business. We welcome the establishment of more rigorous tests as a condition to registration of salesmen. In furtherance of this goal of professionalism, we expect to determine what might be developed to improve the training, sense of responsibility, and general quality of broker-dealers and salesmen.

A second broad area of inquiry in the market study will be an examination of the over-the-counter market. This will encompass both distribution and trading in that market and regulatory jurisdiction over issuers. The latter poses the problem of the extent to which reporting requirements, proxy regulation, and restrictions on insider trading should be applicable to issuers whose securities are traded in the over-the-counter market. This problem has already been extensively analyzed and we do not intend to retrace our steps. On the basis of prior studies, it is difficult to avoid the conclusion that, in principle, investors in over-the-counter securities should be protected by the same type of measures governing listed securities. I believe informed judgment is the basis of a free and responsive securities market and that stockholders, investors, and securities analysts must have current information of material events affecting a company to be able to make intelligent investment decisions. Information about an issuer should not be sealed off once a company has offered its securities to the public. Nor should it be limited to officers, directors, and controlling persons, that class denominated as insiders.

Beyond disclosure there are other questions to consider. For example, should not the ethic of the office impose restrictions on short-swing trading

as now imposed on insiders in companies having listed securities? Again, the argument is advanced that broker-dealers must both be represented on the board of directors and maintain a market in a company's stock. Our job is to find out whether this argument is soundly based. Thus further studies may be needed to settle some of the more controversial questions involving concrete application of the provisions of the Exchange Act.

We shall also review current underwriting practices. We have noted with interest the increasing use of various forms of special underwriting compensation, such as cheap stock and options. We have seen in a few cases extraordinarily high commissions in cash or stock and wonder whether the taking of such compensation is consistent with just and equitable principles of trade. Also, in a few instances -- but a few is too many -- we have noted public offerings of the securities of companies whose only business seems to be the manufacture of its securities. A distinguished engineer and board chairman told me that he asked a president what his company made, and the reply was \$2 a share. What are the responsibilities of the underwriter who participates in a public distribution of securities? I know that many of you require far more information from an issuer prior to underwriting its securities than will be presented in a prospectus. Should not this type of careful

inquiry be the standard for the industry? Does anything less satisfy the objectives of the Securities Act and the Securities Exchange Act? Just as you must "know your customer," should you not "know your issuer?"

In connection with our analysis of the distribution process, we shall study in depth the distribution and "after market" trading pattern of issues offered to the public for the first time. Particular attention will be paid to issues in which the first trading price of a security represents a substantial premium over its public offering price. The staff will attempt to determine what is the cause of this premium, whether it results wholly from supply and demand or from practices which are intended to generate a certain type of market reaction. Among the practices which will be analyzed are those whose effect might be to restrict artificially the floating supply of stock in an initial distribution, such as sales to insiders or preferred customers who agree not to resell for a given period and sales to discretionary accounts where the customer has no immediate knowledge of the transaction. Furthermore, after market activities which might tend to maintain or inflate prices will be reviewed. These include the requirement that a customer who buys at the offering price purchase additional shares at higher prices in the after market; open market purchases by insiders, underwriters and others for

the purpose of maintaining a market; and the use of bids in the "pink sheets" to give the appearance of after market activity. The Commission will have to determine which of the foregoing activities actually are occurring with frequency and the extent to which they operate as fraudulent or deceptive practices.

The staff of the Commission is nearing completion of its investigation of the rules, policies and procedures of the American Stock Exchange relating to the conduct of specialists and other members. It is anticipated that the staff report in that investigation will be coordinated with a general inquiry into exchange problems. In this area, it is anticipated that we will take a new and comprehensive look, in light of past experience and present conditions, at certain basic questions that have been the subject of continuing concern, such as the specialist's role, trading by members, block distributions on and off the exchange, and the like.

Another very important area for inquiry deals with credit restrictions on the purchase of securities. There are at present numerous gaps and inconsistencies in the margin requirements. We shall attempt to determine if there is a rational or necessary basis for allowing these to continue. At present the credit problem has gained prominence because of the insolvency of a large factoring concern which allegedly was lending substantial amounts of money to customers for the purchase of securities.

Finally, I should like to comment briefly on investment companies. Although some of you may not be directly involved in this aspect of the industry, I am sure you recognize the growing impact of the mutual fund on the economy. At the outset I should like to make quite clear that the Commission does not in any way desire to impair the effective and proper operation of mutual funds, or to question the mutual fund as an important medium for public investment. We do, however, believe that certain practices, patterns, and policies in the investment company area warrant close examination. The fifty-odd law suits involving mutual funds and their affiliates focus attention inevitably on certain ways of doing business. In the course of the market study we shall analyze selling practices of mutual fund salesmen. Independent of this study, the Commission itself has been undertaking a review of investment company relations with their investment advisers, brokers and underwriters; the participation by underwriters and dealers in investment advisory fees; joint transactions between the investment company and affiliated persons; and other practices such as "reciprocal business." The Investment Company Size Study undertaken at the request of the Commission by the Wharton School of Finance of the University of Pennsylvania is nearing completion and should provide useful data. The Commission will review and study all pertinent information with a view towards formulating a sound program in the investment company area.

In conclusion, I want to reemphasize the anticipation and desire of the Commission for continuing and full industry cooperation on all the problems jointly facing us. We have a common goal -- to raise the standards of the securities business.