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STATEMENT OF HAMER H. BUDGE, CHAIRMAN OF THE SECURITIES AND EXCHANGE
COMMISSION, BEFORE THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
HOUSE OF REPRESENTATIVES, ON H.R. 13308

Mr. Chairman and members of the Subcommittee, thank you for inviting me to appear before you again to present more specific views of the Commission on the proposed legislation dealing with the protection of accounts of customers of broker-dealers.

You will recall that when I appeared before you less than two weeks ago on June 4, 1970, I did not discuss the specific provisions of H.R. 13308, but presented to you some of the factors you might wish to consider respecting how the legislation should finally evolve. Among other things, I suggested that consideration should be given to the industry-self-regulatory organizations continuing to have the initial responsibility for overseeing the operations of their members and that existing self-regulatory machinery might be relied upon for the carrying out of an appropriate inspection and examination program, subject to general Commission oversight. I suggested that this might achieve important economies having in mind that self-regulatory organizations presently have considerable personnel ^{and member management} ~~management~~ whose duties relate to investor protection.

For example, the NYSE has over 3,000 employees, the American Stock Exchange has more than 1,000, the Midwest ^{Stock} Exchange about 475, the Pacific Coast Stock Exchange about 450 and the NASD about 350 employees.

Of course not all of these employees are engaged in regulating the conduct of members. *As long as the self-regulatory agencies exist* Nevertheless, it seems *desirable* to preserve and strengthen rather than duplicate *these* the existing self-regulatory structures.

This is in accord with the basic philosophy of the Exchange Act to rely largely on self-regulation with appropriate Commission oversight.

Consistent with that philosophy, I also indicated previously the desire on the Commission's part to give the industry committee, which had undertaken to formulate proposals for the protection of customers, an opportunity to come forward with a specific program before venturing suggestions on our part.

In accordance with our understanding of your Committee's directions, we are prepared to comment upon the proposals of the industry committee which we received last Friday afternoon and to make alternative suggestions where the Commission believes alternative or additional protections are needed. What follows is a summary of the areas of substantive disagreement and of our recommendations. We are also submitting an alternative draft bill which we prepared because of the urgency of legislation in this area before receipt of copies of the industry's draft bill. We did have the benefit of earlier staff discussions with industry representatives, as well as a more definitive outline of industry position, submitted to us last Wednesday in written form. Accordingly, there are substantial areas of agreement between our own and the industry's drafts of the bill, although there are differences both of substance and detail. I will limit my presentation to the outlining of substantial differences.

The industry proposal contemplates the use of a non-governmental corporation separate from the Commission or the self regulatory agencies for the administration of funds for the protection of investors. While we ~~endorse~~ ^{accept} this approach in principle, we believe it is appropriate only if the Commission is directed and empowered to exercise adequate supervision over the industry in order to minimize risks to customers' funds and securities and the costs of insuring against such risks. Here the industry bill appears to be materially lacking. *Unless remedied none prefers a public corporation*

There are three areas in which the Commission should have clear and unambiguous powers to this end: first, direct regulation of broker-dealers; second, supervision over existing self-regulatory authorities; and third, oversight authority with respect to the Corporation.

However, the industry position, as noted in IV(1) of its draft proposal dated June 7, 1970, is ^{that} "there will be no change in or addition to" the existing powers of the Commission over the financial responsibility of exchange members and other broker-dealers. In conformity with this outline, the industry bill contains no provisions clarifying the powers of the Commission to regulate the business of broker-dealers with a view to minimizing the risk that financial difficulties of a broker-dealer will result in loss to customers, loss to the Corporation, and in view of contemplated borrowings of up to \$1 billion from the Secretary of the Treasury, ^{possible} loss to the taxpayers.

We urge that the Commission be empowered, as provided in our bill's proposed Exchange Act section 35(j)(13):

1. To require any self-regulatory organization to alter or supplement its rules, practices, and procedures concerning the frequency and scope of inspections and examinations of its members and to furnish the Corporation and the Commission with reports and records of such examinations;

2. To authorize the Commission to adopt rules, regulations, and orders concerning broker-dealers' acceptance of custody and use of customers' securities and free credit balances as the Commission may consider necessary and appropriate to reduce risks to customers and the expenses of providing against such risks; and

3. To examine and inspect the Corporation and require it to furnish the Commission with such reports and records as the Commission may deem necessary or appropriate.

The industry proposal would also severely limit the Commission's oversight power over the Corporation. It would restrict the Commission's review of bylaws, rules or regulations proposed by the Corporation by providing, in section 35(a)(5), that bylaws of the Corporation and amendments thereto would take effect 30 days after being submitted to the Commission unless the Commission enters an order of disapproval after having given appropriate notice and opportunity for a hearing and making findings--all within 30 days. This cumbersome and

~~time-consuming~~ procedure would effectively hamstring the Commission's too-limited oversight power. Accordingly, we urge that you approve the Commission's proposed section 35(1). It not only avoids these procedures, but would also enable the Commission to require the adoption, amendment or rescission of any bylaw of the Corporation if it deems it necessary or appropriate for the purposes of this legislation.

We also note that the industry proposal does not provide for Commission review of assessments made upon broker-dealers by the Corporation. There is one very limited exception provided in the industry's proposed section 35(c)(5). Where a broker-dealer feels that assessments imposed by the Corporation discriminate against him, he may petition the Commission for a review. Then, after appropriate notice and hearing, if the Commission determines that the assessment upon such members is unfair and inequitable, it may reduce that assessment to such amount as in its judgment is fair and equitable. However, even this limited Commission discretion does not apply, according^{to}/industry proposed section 35(7),

to the extent that an assessment is based upon the broker-dealer's gross revenue from the securities business. We urge that the Commission should have the power to disapprove assessments when initially proposed ^{if} and, /they are found inequitable, to require such revisions as will be fair and will also assure that the Corporation will receive adequate revenues. The industry's proposal would give the Commission a ^{only a} ~~Hobson's~~ choice of reducing an inequitable assessment at the risk of leaving the Corporation with inadequate income.

I ~~am~~ also ^{note} ~~amaze~~ that the industry bill provides for giving credit for amounts contributed to the Corporation by self-regulatory organizations from trust funds by reducing the amount payable in assessments, by members of such self-regulatory organization "all as may be agreed upon between the Corporation and such self-regulatory organization." Since this might involve unfair discrimination in respect to assessments paid by other broker-dealers, we believe the Commission should have the power to disapprove such arrangement between the Corporation and the self-regulatory organization.

Another area of disagreement concerns the discretion to be vested in the Corporation to move for the appointment of a trustee where a broker-dealer appears to be in financial difficulty. Our proposal would vest considerably more discretion in the Corporation than would the industry's. Their proposed section 36(a)(2)(E) would not permit the Corporation to act promptly to reduce risks to investors and to the Corporation's fund by obtaining the appointment of a trustee when it learns that a broker-dealer is in violation of an ^{self reg} exchange's net capital rule. It could not do so unless the exchange also determines and notifies the Corporation that the broker-dealer is "generally unable" to meet demands for reasonably prompt delivery of cash or securities. Even then, the industry proposed section 36(a)(4) would not make it mandatory for the Corporation to apply to a court to initiate the necessary investor protection proceedings. It would only give the Corporation discretion to do so. We submit that action should be expected of the Corporation when a broker-dealer is in such serious financial difficulty. We have not specifically so provided in

our proposal because we would vest the Corporation with much broader discretion and believe that in such circumstances the Corporation surely would act responsibly. But the industry's proposal makes these extreme circumstances a prerequisite to the Corporation having any power to act at all, and implies that even then action might not be taken.

We urge that this Committee adopt the provisions in our proposed section 35(j)(1). It gives the Corporation discretion to apply to a court to take necessary action to protect customers "whenever it shall appear to the Corporation that any broker or dealer is in danger of failing to meet its obligation to customers." We believe the Corporation, rather than the self-regulatory organizations, should have broad discretion to determine when a trustee should be obtained to protect investors and to reduce risks to the Corporation's fund.

Section 35(j)(1) of our proposal differs from the industry's proposal in that it provides that the court shall deem the broker-dealer to be in danger of failing to meet its obligations when the Corporation has asked for the appointment of a trustee if the broker-dealer debtor is not in compliance with requirements under the Act or rules of the Commission or of a self-regulatory agency respecting hypothecation of customer securities or the maintenance or preservation of books or records. These circumstances or that of the broker-dealer being in net capital violation would not make it mandatory for the Corporation to act. However, if it chose to seek the appointment of a trustee, proof of such circumstances would be sufficient to require the court to find the broker-dealer to be in danger of failing to meet its obligation and consequently to grant the Corporation's contemplated relief for the protection of investors.

We also would point out to this Committee that the industry proposal contains two provisions of immunity from liability, neither of which are contained in our proposal. The first of these, proposed section 36(o), provides immunity for the Corporation or any self-regulatory organization from liability for action taken or omitted in good faith by the Corporation or such self-regulatory organization under, or in connection with any matter contemplated by the proposed bill. We do not object to such immunity for the Corporation. We see no need, however, to change existing law respecting the liability of self-regulatory organizations for failure to live up to their responsibilities. The other immunity provision proposed by the industry, in their section 37(c), appears to unacceptably extend immunity to broker-dealers who are members of self-regulatory organizations.

Further, section 37(d), as proposed by the industry, would make it unlawful for the Corporation or Commission to disclose to this Committee or its employees information contained in applications, reports, or documents submitted to or filed with the Corporation by broker-dealers or self-regulatory organizations. Moreover, it would have the effect of prohibiting the Commission from making this information available to the public or to the Congress even though the Commission would have independently obtained information in the documents filed with the Corporation, and even though the Commission obtained this information for purposes apart from the insurance program contemplated in this legislation. We believe this restriction should not be enacted.

There are a number of other items in the Commission's proposal at variance with those contained in the industry's proposal. One is that the industry would have you authorize the Corporation, in Section 36(a)(3), to make a subordinated loan to a broker-dealer who is not in compliance with applicable financial responsibility rules. We have not so recommended because such action might increase the risk to the Corporation's fund by deferring action to obtain the appointment of a trustee. However, if you choose to vest this authority in the Corporation, we urge that you impose limitations requiring that the amount of the loans not exceed more than, say, 10 percent of the fund and that the fund amount to no less than, say, \$150 million at the time of the loan.

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Our proposal also would deny coverage under the program (and consequently the right to do business as a broker-dealer required to be covered) in situations where funds of the Corporation have been disbursed or obligated because of financial difficulties of a broker-dealer, unless the Commission otherwise determines in the public interest. The disqualifications would cover the broker-dealer firm in question, or any officer, director, partner, controlling person or owner of 10% or more of the voting securities of the firm. In consideration of the public interest standards, the Commission, of course, would take into account, among other things, whether the broker-dealer or associated person had made all reasonable efforts to repay the debts or provide for their repayment. The industry proposal does not contain any such provision. We believe such a disqualification, with provision for the Commission to make exceptions upon conditions in the public interest, will provide a desirable warning to broker-dealers that they may not act in a financially irresponsible manner and then re-enter this business after the corporation has bailed out their customers.

Interrelated with the problem of taking action to minimize the risk of customers' losses which would be covered by funds of the Corporation, is how those funds are to be raised: to what extent and at what times by assessments levied upon the industry, or by resort to the Secretary of the Treasury. If Treasury funds are to be advanced, then the question arises: how they are to be repaid?

First there is a question of seed money or a start-up fund. The industry draft contains no provision for the creation of a substantial start-up fund. Its proposed Section 35(a)(7) contemplates that there will be a 120 day lag before broker-dealers become subject to the program and are required to make an initial payment provided for in Section 35(c)(2). This time delay may be no more than a realistic recognition of the time required for setting up the organization, developing a program of assessments and resolving questions of exemptions. Total payments to December 31, 1970 would be 1/8 of 1% of gross securities business revenues for the calendar year 1969, with some exceptions.

We do not have information to compute how much this would yield but estimates of our staff, based on partial figures for prior years, indicate that it is not likely to exceed \$6 million.

Proposed Section 35(c)(9) of the industry draft permits, but does not require, transfer of exchange trust funds with resultant reduction of assessments otherwise payable by members of the contributing exchanges.

Our own draft (Section 35(d)) contemplates the raising of a \$75,000,000 fund within four months -- by assessments or firm lines of credit and a fund of at least \$200,000,000 in five years. No more than 60 percent of these amounts may consist of such lines of credit. It also permits the voluntary

transfer of exchange trust funds. We note in that connection that in the statement presented to you yesterday by Mr. Ralph DeNunzio on behalf of the industry task force there is a suggestion that the industry will be prepared to commit funds and obtain borrowings which would cause the fund to aggregate \$75 million within 120 days of enactment of the bill. If the self-regulatory organizations are able ^{and} ~~to~~ willing to transfer substantial start-up funds, it may be feasible to impose a less drastic program of initial assessments than would otherwise be necessary.

Our proposal sets no express limit upon the rates of assessment which the Corporation may impose with a view to building up its protection fund. On the other hand, the industry proposal fixes an annual limit of 1/4 of 1% of gross securities business revenues if no Treasury loans to the Corporation are outstanding. It establishes a 1/2 of 1% maximum assessment if such loans are outstanding but even in that event, Section 35(c)(10) contemplates that repayment of the Treasury could not be at a rate exceeding 1/4 of 1% of gross securities business revenues so long as obligations to prior private lenders might be outstanding. The other 1/4 of 1% would be subject to a prior pledge to the private lenders.

Having in mind that the maximum Treasury commitment could be up to \$1,000,000⁰⁰⁰ and that interest alone at 6% would be \$60,000,000 a year, it is interesting to note that an assessment at the rate of 1/4 of 1% a year based on figures for the relatively prosperous year 1968 would yield approximately \$ million. The prospect of the Government recovering both principal and interest on a loan of this amount would be very remote indeed. Although we recognize of course that borrowings from the Secretary of the Treasury in this amount would be unlikely, particularly if the Commission has adequate regulatory power to minimize the risk of customer losses, it is understandable that, because of the concern of the Treasury Department, our draft imposes no limit on assessments to repay Treasury loans.

Section 35(h) in the Commission's proposal deals with the matter of loans from the Treasury as follows:

" (h) At the time of application for, and as a condition to, any such loan the Corporation shall file with the Commission a statement with respect to the anticipated use of the proceeds of the loan and a plan providing for the imposition of the minimum additional fees and assessments intended to be collected during the term of the loan. Such additional fees and assessments shall take into account varying practices among brokers and dealers with respect to the method of conduct of their business and consequent risks to their customers in a manner acceptable to the Commission. The Commission shall certify to the Secretary of the Treasury that such loan is necessary for the protection of customers of brokers and dealers and maintenance of confidence in the United States securities markets and that such plan provides as reasonable an assurance of prompt repayment as is feasible and is not unreasonably discriminatory as between persons affected thereby. Notwithstanding the provisions of any such plan, the Commission may, taking into account the ability of the industry to pay and to continue to function effectively at any time during the period when such loan may be outstanding, require the Corporation either to impose such further additional fees and assessments as the Commission may conclude to be reasonable in order to expedite the repayment of such loan or to reduce existing fees and assessments and with the approval of the Secretary of the Treasury, extend the maturities of outstanding indebtedness of the Corporation to the Commission or the Commission to the Secretary of the Treasury as the Commission may conclude to be necessary or appropriate. "

As you can see, rather than have the legislation fix a maximum rate of assessments when money has been borrowed from the Treasury Department, we propose that the Commission be authorized to determine the rates of assessment having due regard for the industry's ability to pay additional fees and to continue to function effectively. For example, it is probable that when the Corporation would have to borrow Treasury moneys, the industry would not be able to pay any, or any substantial increase in assessments. However, when conditions improve, the Commission could appropriately raise the assessments. And, should the industry again fall on bad times before the loan were repaid, the Commission could decrease the assessments and, if necessary, extend the maturity of the loan, with the approval of the Secretary of the Treasury.

The Commission's proposal also does not provide for a maximum limit on Corporation assessments prior to borrowings from the Government. Our proposed Section 35(g) would authorize the Corporation to impose, subject to Commission approval, fees and assessments upon brokers and dealers as the Corporation may deem necessary and appropriate to establish and maintain the fund. It provides that, in imposing such assessments, the Corporation may classify brokers and dealers according to factors such as are mentioned in Section 35(c)(3) of the industry's proposal, with one difference. That difference is that our proposal specifically authorizes the consideration by the Corporation and, in the event of a loan from the Government, by the Commission of the risks to customers of a broker-dealer's activities whether in the securities business or otherwise.

Another difference between our proposal and the industry's is that ours provides that when the Corporation obtains the appointment of a trustee for a broker-dealer in financial difficulty, the trustee shall complete open transactions made in the ordinary course of business on behalf of the debtor broker-dealer's customers and customers of other broker-dealers. (See our proposed Sections 35(j)(2)(A) and 35(j)(6)) However, Section 36(c)(1) of the industry proposal would have the trustee complete all of the debtor's open transactions, including those entered into with the debtor by other broker-dealers for their own trading or investment accounts, unless the Commission shall have determined by rule or regulation that the completion of such open transactions are not in the public interest.

The industry proposal also provides, in Section 36(b)(2), that the trustee shall have no duty to reduce to money any customer securities in the estate of the debtor broker-dealer. However, Section 35(j)(6)(c) of our proposal provides that if the debtor's customer decides to realize a capital gain or loss and so notifies the trustee, then the trustee shall sell such securities if and to the extent the books of the debtor show that the customer has such a claim and securities sufficient to satisfy such a claim are sufficiently identified.

Finally, the industry proposal provides for 12 directors of the Corporation: 5 selected by the New York Stock Exchange; 2 by the National Association of Securities Dealers, Inc.; 1 each by the next three largest stock exchanges (currently the American, Midwest and Pacific Coast); and 1 each by the President and the Secretary of the Treasury. The Chairman of the Board,

who would be the chief executive officer of the Corporation, would be elected by the Board. Our proposal would enlarge the directors to 15. Ten would be selected by self-regulatory organizations as in the industry proposal. The remaining five would be selected from the general public by the President and he also would designate one of these as the Chairman of the Board.

As I stated early in my presentation, there are other differences between our proposal and the industry's which I shall not mention in this statement. As you know, we have had only a limited amount of time to review the industry proposal which was revised as late as yesterday. Accordingly, we have noted the major points where their proposal differs from ours and our primary points of disagreement. We believe that our proposal resolves these differences in a manner consistent with investor protection and contains essential protections against unwarranted risks to the Corporation's and the Government's funds.

In closing, I again express the Commission's unequivocal view that the enactment of adequate legislation in this area at this session of Congress is vital for the protection of investors and the maintenance of confidence in the United States securities markets. The Commission will do all in its power to assist this Committee in the consideration of the proposals before you.