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MANAGING TODAY'S CAPITAL MARKET SYSTEM: AN OVERVIEW

An Address By

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Good evening and welcome to Washington. I am pleased to have the opportunity to speak to this impressive group. The Sloan programs at Stanford and MIT are widely known and respected. These programs represent a commitment on your part to excellence which is in the finest tradition of the capital system of this country and indeed of the western world. I was particularly happy to learn that within your group are a number of members from western European countries, representatives from Australia, Nigeria, South America and as far away as Japan.

In addition, I note that there is a happy blend of representation from within and without the private sector.

The eastern field trip which you began on Monday certainly is an ambitious undertaking. While I note that your meetings of Monday, Tuesday and Wednesday were primarily with those in the private sector in New York City, Thursday and Friday seem to be reserved for those of us in the public sector. While I cannot speak for all of my colleagues in the public sector, I, as a former practicing lawyer, am always mindful of the advantage one has in getting in the last word. I note that earlier this week you met with one of my friends in the brokerage business, Bill Donaldson. I am sure he conveyed to you the securities industry's concerns and its evaluation of the Commission's effectiveness in improving our capital market structure which is one of this nation's most important assets.

We at the U. S. Securities and Exchange Commission concern ourselves with the capital market system. The securities markets of this country are an important national asset. They are the heart of our economy. Two hundred million Americans depend on the ability of our securities markets properly to direct and propel our economic progress. Half of that number, some one hundred million Americans, have a direct stake in the values established and the liquidity offered by our securities markets. Thirty-one million of them own stocks directly and the balance are involved through pension and other employee funds, investment companies and life insurance. The SEC is 1,500 strong with approximately 29 million dollars to spend. We are a very small band to protect the interests of 100 million Americans. We are a small band to supervise the disclosure practices of 6,000 American corporations listed on exchanges and the transactions in the securities of another 40,000 corporations which are during the course of a year traded in the over-the-counter market. This can be accomplished only because the SEC stands at the center of an information and regulatory network. What is perhaps most challenging is that the nature of the industry is changing rapidly. We are witnessing an institutionalization of the securities market. The SEC recently spent one million dollars and produced ten volumes analyzing this phenomenon. While we find that almost 75 percent of all stock is owned by individuals and a little over 25 percent is owned by institutions, nevertheless, institutions now account for over 60 percent of the buying and selling in our securities markets. Whereas ten years ago a trade of 10,000 shares or more occurred about four or five times a day, today a block of 10,000 shares or more is sold and bought every three minutes, mostly by institutions.

These changes can radically alter our markets and economy if steps are not taken to insure the continuation of individuals in the marketplace. If individuals are to remain, they must have the assurance that institutions do not have an inside track in the markets and in the information and advice available to them.

An important Commission objective is to establish a market structure in which all investors can be confident that they are receiving professional advice from financially sound brokerage firms, that their trades are executed efficiently and at the best price and that there is a maximum disclosure of corporate information. It may be useful to list just a few of the steps which the Commission has taken recently in these areas. We supported the enactment by Congress in December 1970 of the Securities Investor Protection Act whose purpose is to insure up to specified limits, cash and securities in accounts of broker-dealer customers; we have put into effect new regulations which require brokerage firms to maintain reserves for customers' free credit balances, to segregate securities and keep customers' assets separated from their business operations, this represents a considerable reform in practices which had grown-up in the brokerage business; we have made capital requirements for broker-dealers more stringent and are in the process of considering whether to adopt a uniform capital requirement for exchange and non-exchange members; we have strengthened the control over brokers' possession of securities by requiring a quarterly physical examination and count of firm and customer securities; we have required brokers to furnish information concerning their financial condition to their customers; we have required entrants into the securities business to disclose details concerning their personnel, facilities and financing; we have taken measures to provide the Commission and self-regulatory authorities with more effective early earning systems so as to anticipate brokerage firm difficulties; and we have increased our personnel to permit more frequent and intensive inspections of broker-dealers. These steps are aimed at protecting customers' securities and cash balances held by brokers and to make brokers more financially responsible. We have taken steps in order to encourage automation in the handling of stock transactions and the use of depositories which will speed the immobilized stock certificate and reduce brokerage costs; we have enacted an institutional membership rule for stock exchanges designed to encourage institutions to contribute new capital and to perform brokerage services for the public but to eliminate the kind of institutional membership which merely gives institutions the ability to use the exchanges without paying commissions and to enjoy other special privileges without undertaking to contribute to the purpose of the exchange, which is to serve customers who require brokerage services; and we constantly wage war to require companies to make prompt public disclosure of all developments relevant to a decision to buy, sell or hold their stock. All of this has been done or is in process.

What lies ahead? Our task is not unlike the one which you as managers face. We must improve the product and improve the system within which it is distributed. We must bolster confidence in securities as an investment product and in the market system which makes securities available for investment.

As I view the task with which the Commission is presently faced, a natural division of activity suggests itself. The Commission's attention will be focused in two areas essentially. First, the Commission is moving to encourage the development of a new central market system which will build upon the good features of the existing system. We expect to make the new central market system an operational reality within two years. The details of this system are spelled out in great length in a position paper that the Commission released today. While the securities markets of this country are recognized as the strongest and best in the world, recently they have been taking new form at an incredible pace. There has been a surge in institutional trading, there has been an emergence of new markets to handle big blocks of stock, there have been sudden and sweeping shifts in the pattern of securities trading and indeed there has been an upheaval in the economics of the securities business itself. The result is that today for many securities there are now many markets both on the exchanges and off the exchanges in the offices of broker-dealers. At any given time the public investor sees only part of this picture. He is looking at a goldfish bowl while really living in the middle of an aquarium. There is no communications link really tying all our markets together. The major problem with all of this is that there is no way an investor can be certain that the investment process is working for him all the time, there is no way he can be sure that his interests are protected all the time, and that his order can be represented in all of these markets all of the time. This means that the public investor has no assurance that his broker is getting him the best available price on his order wherever that may be. The central market system will give the investor's order constant protection and representation in all of these markets at the same time. We view it as a communications and regulatory system with three parts: first, a network for reporting prices and volume as trades occur so that all the action in a given security can be viewed through a central source; second, a quotation system to capture and display all the bids and offers in these securities so the broker can see where the best price is available and direct the investors order to it; and third, a regulatory framework to insure that the purposes and goals of the system are met. Three basic working principles must be incorporated into the system as soon as possible: first, preference and protection for public orders; second, direct and open competition between all markets; and third, system integrity, that is guarding against manipulation of prices and other potential abuses. These working principles for the emerging central market are both necessary and practical.

The Commission’s position paper is not a biblical entombment written in stone. We contemplate evolution after a procedure of comment and deliberation, not revolution merely for the sake of change.

We must also improve the product. The best execution in the world is of little value if the investment judgment which triggered the order is not an informed one based on professional analysis of comprehensive and reliable information. The central market is only part of an improved investment process. Of equal or greater importance is the concept spelled out in February 2, 1972 policy statement, of making professional investment services broadly available as economically as possible, without diluting standards of service and responsibility. The Commission has taken at least five distinct steps in recent months to insure that investors are provided with the best possible available information. First, we have urged greater uniformity in accounting standards, second, it is essential that there be established standards for minimum analytical work before producing a public report on a security, and a minimum body of knowledge necessary for professional accreditation of analysts. The analytical community cannot afford to permit the casual passing out of hearsay as a substitute for research. Third, disclosure documents must be clearer, simpler to read and must provide information which investors will be able to use. Investor protection and confidence will be improved by converting much of the boiler-plate and other meaningless language contained in prospectuses and other documents into meaningful disclosure. We have taken steps to insure that the needed changes occur in this area. Fourth, and perhaps our most publicized activity in the area of increased public information has been our recent statement on earnings forecasting. The major thrust of our policy is one of disclosure. In essence the Commission has said that management should be left with the choice of whether or not publicly to forecast earnings and economic results. In doing this we rejected for now the view of some that management should be required to publicly disclose its projections. At the same time we said that once a company elects to project earnings to anyone outside the corporation, it must immediately inform the investing public. I believe that this policy takes into account some well recognized practices going on today which have the effect of shrouding the whole business of management forecasts in a cloak of informal procedure which is not in the best interests of the investing public, the corporations or the investment professionals involved.

Finally, and perhaps most importantly, we intend to move forcefully to eliminate the use of inside information. Any securities market system that is fair requires that both buyer and seller exercise informed judgment. The use of inside information erodes the system by destroying public confidence in our capital markets. It also causes the investor to question the professionalism which is an intrinsic part of any sound investment process. The Commission intends to pursue the crucial problem of inside information on two fronts. First, over the next several months we will be completing a detailed report which will trace the legislative history and the intent of the law in this area, provide an analysis of what has taken place in the courts, present the Commission’s view of the law, and finally set forth a series of guidelines for financial analysts, corporate management, investors, lawyers and the industry as a whole. This clarification of responsibilities in the area of inside information represents a regulatory approach that we believe is preferable to allowing matters in this area to proceed fortuitously on a case-by-case basis in the courts. Our second approach will be one of vigorous enforcement of the securities laws on inside information. By clarifying the professional responsibilities of those concerned we are moving to prevent misuse of inside information. But where misuse is prevalent we will not hesitate to exercise our enforcement muscle. In this regard the Commission will be looking in the future toward more criminal references to the Department of Justice in inside information misuse cases.

I hope this brief survey has provided you with some understanding of the challenges facing the Commission at this time and the approaches being used by the Commission to meet those challenges. We at the Commission believe that we have come a long way in analyzing the strengths and weaknesses of the present system and in projecting a course for the evolution of a new and better system. We intend to move with a prudent gradualism encouraging the needed developments and changes. We expect to be assisted by the Congress and all components of the industry. We know that the securities business is at this time in a difficult period of transition. However, the industry has a rich resource of creative and talented individuals, tough people who get going when the going gets tough. The system has survived worse dislocations. I am confident that with its fine leadership, the industry and our capital markets will emerge stronger than before.