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RECENT DEVELOPMENTS IN SECURITIES REGULATION: THE SPECIAL STUDY OF SECURITIES MARKETS

INTRODUCTION

THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION

*William L. Cary**

MOVED perhaps by a certain institutional egoism, the Securities and Exchange Commission welcomes this thorough symposium upon the *Report of Special Study of Securities Markets*.¹ Although the product of a separate study group, this report has nevertheless been the focal point of debate throughout the Commission during the past eighteen months. Representing both an intensive and extensive inquiry into the securities markets, it is unquestionably the most ambitious and comprehensive study since the passage of the securities acts thirty years ago. It is not a sensational document—quite consciously. In our opinion, raising standards in the securities industry could best be achieved by thorough documentation, responsible analysis, and constructive criticism. Upon this premise it warrants thoughtful but critical review.

I. ORIGIN OF THE SPECIAL STUDY

The Study is the result of a resolution introduced in the House of Representatives by Congressman Mack,² strongly supported by the Securities and Exchange Commission, and enacted by the Congress as section 19(d) of the Securities Exchange Act of 1934.³

To appreciate the motivation for the congressional resolution

* Chairman, Securities and Exchange Commission.—Ed. The author wishes to acknowledge the assistance of Arthur Fleischer, Jr., Executive Assistant to the Chairman.

¹ *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as *Special Study*].

² H.R.J. Res. 438, 87th Cong., 1st Sess. (1961).

³ Securities Exchange Act of 1934, § 19(d), 48 Stat. 881, as amended, 75 Stat. 465 (1961), 15 U.S.C. § 78(s)(d) (Supp. IV, 1963).

and the Commission's support, the condition of the securities markets up to June of 1962 must be reviewed. Any analogy to 1929—the prelude to the “great crash”—would be inapt; it can hardly be said that brokers' offices were so crowded that “no one could get a chance to inspect the tape,”⁴ nor had ocean liners installed sea-going boardrooms.⁵ Yet this was a turbulent market in which a record number of companies, many highly speculative, were going to the public for financing. The “hot issue” was prevalent; initial trading markets for many new issues reflected an extravagant premium over the offering price. Price-earnings ratios were at extraordinary levels. Indeed, there was a story current that earnings were being capitalized not only upon the future but on the hereafter. Trading volume was soaring, accompanied by noticeably high “fails” to receive or deliver stock certificates. The Commission's enforcement machinery was overloaded. Criminal references to the Department of Justice and administrative proceedings against brokers were at all-time highs. The most dramatic illustration of breakdown in controls was the SEC investigation of the American Stock Exchange,⁶ prompted by the Commission's expulsion of the leading specialist firm of Re and Re.⁷

The Commission, the self-regulatory agencies, and the industry were overwhelmed with daily administrative problems and forced to meet issues on an *ad hoc* basis. Thus, it seemed a highly propitious time for a thorough re-examination of the state of the securities markets and the adequacy of investor protection.

Even with such a brief background, it is readily understandable why Congress regarded an investigation as timely. The decision to assign responsibility to the SEC rather than leave it in the hands of a congressional committee was not a departure from precedent in the securities field. On several previous occasions, Congress has directed the Commission to examine particular subjects.⁸ This policy undoubtedly reflects a congressional recognition of the extraordinarily complex nature of the markets, which are perhaps better suited for study by an agency with some expertise, rather than a congressional probe which might well cause unanticipated tremors in a sensitive market.

⁴ NOYES, *THE MARKET PLACE* 328 (1938).

⁵ GALBRAITH, *THE GREAT CRASH* 86 (1955).

⁶ SEC, *STAFF REPORT ON ORGANIZATION, MANAGEMENT AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE* (1962).

⁷ Re, Re & Sagarese, SEC Securities Exchange Act Release No. 6551, May 4, 1961, SEC Securities Exchange Act Release No. 6900, Sept. 21, 1962.

⁸ *Hearings on H.R.J. Res. 438 Before a Subcommittee of the House Committee on Internal and Foreign Commerce*, 87th Cong., 1st Sess., vol. 3, at 8-9 (1961).

Naturally the Commission seized upon and endorsed this resolution as a vehicle for re-examination. We said before the House Subcommittee:

“Our present budget . . . and our manpower, will not support a thorough study of the exchanges and over-the-counter markets at this time. . . . [T]he constant danger in our Commission is that with market activities and flotations at an all time high, we become so overwhelmed with immediate problems . . . that we are virtually forced to concentrate all our funds and manpower upon them and cannot do any long-range planning.”⁹

As already noted, we, like the securities industry, had been so engrossed that there was neither time nor personnel nor opportunity to back away and ask where the industry was moving and whether present regulations meet the changes wrought over thirty years. Among the developments noted in the Commission’s statement¹⁰ were the growth in public participation and trading volume, changes in methods of distribution and marketing (particularly the rise in the number of customer’s men and branch offices), and the enormous expansion in the over-the-counter market. There, sales of corporate stocks (excluding sales of mutual fund shares and syndicated distributions) increased almost 700 percent in twelve years—from an estimated \$4.9 billion in 1949 to \$38.9 billion in 1961.¹¹

The bill¹² became law as section 19(d) of the Securities Exchange Act of 1934¹³ on September 5, 1961. It authorized and directed the Commission “to make a study and investigation of the adequacy for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade.” The wording of the law and its legislative history made clear that it contemplated a very broad study of the rules, practices, and problems in the securities business and the securities markets.¹⁴

The remaining step was to obtain the appropriation to carry out the authorization; \$412,500 was appropriated on September 30, 1961, and the remaining \$337,500 on October 3, 1962.

⁹ *Id.* at 8.

¹⁰ *Id.* at 5-6.

¹¹ *Special Study* pt. 2, at 546-47.

¹² H.R.J. Res. 438, 87th Cong., 1st Sess. (1961).

¹³ 48 Stat. 881, as amended, 15 U.S.C. § 78 (1958 & Supp. IV, 1963) [hereinafter cited as Securities Exchange Act of 1934].

¹⁴ *Special Study* pt. 1, at 1.

II. ORGANIZATION OF THE STUDY

The Special Study was carried out by a separate group in the Commission of approximately sixty-five persons. It was staffed by many outside the agency, including lawyers in private practice, economists, university professors, and personnel from other government agencies, and a number from the Commission's regular staff. The organization of the Study presented a special challenge in a matter of principle: how to bring together a strong independent group on the one hand and yet achieve some general consensus on the other. There was constant discussion with the Commission, but the Study was given freedom to express its own views and state its own recommendations. This decision reflected confidence in both the ability and responsibility of the talent assembled—which proved fully justified. In commenting upon the *Report*, *The London Economist* said: "Americans who have long admired the quality of investigations conducted by the British Royal Commission may take heart. It can happen here."¹⁵

The emphasis on independence was deemed necessary for a variety of reasons. First of all, it would be difficult, if not impossible to secure complete agreement of all five Commissioners on each statement and conclusion made in the 3,000-page analysis. The Congress had set a time limit on our efforts which we still missed by almost six months. A final Commission consensus might have produced much longer delay.

Second, independent views are helpful, indeed necessary after thirty years. Professor Galbraith has said that "regulatory bodies, like the people who comprise them, have a marked life cycle. In youth they are vigorous, aggressive, evangelistic, and even intolerant. Later they mellow, and in old age—after a matter of ten or fifteen years—they become, with some exceptions, either an arm of the industry they are regulating or senile."¹⁶ I do not accept the hyperbole, although at times there may be a need for revitalization. In such a case it is obvious that independent views can provide a new and welcome stimulus.

Third, the Commission will be required to act in many cases as a rule-making body on the recommendations of the *Report*. Frequently, the rules of an exchange or the NASD (the self-regulatory agency for the over-the-counter market) are involved. In such situations the Administrative Procedure Act and the Securities Exchange Act preclude the Commission from taking a defini-

¹⁵ 208 LONDON ECONOMIST 587 (1963).

¹⁶ GALBRAITH, *op. cit. supra* note 5, at 171.

tive position on the issues raised until the views of interested persons are solicited or, in certain instances, a record is made.¹⁷

Connected with this point is the fact that firm or hardened positions taken by the Commission would make it difficult to deal generally with the industry. An interchange of ideas with the affected parties, even if it were not required by law, is necessary to an effective program. The Study itself did not have the benefit of industry views on its recommendations. The Commission, on the other hand, should not act without them. We seek industry reaction on the necessity and feasibility of the proposals and alternative recommendations—where appropriate—to the problems presented. We do not have the illusion that every rule can be arrived at with unanimity, but, at the same time, we have the conviction that conversations with the industry and the self-regulatory bodies make for fair, reasonable, and responsible solutions.

Finally, it was anticipated that, while the *Report* would focus on the shortcomings in the industry and in the self-regulatory agencies, in certain respects there would be express or implied criticism of the Commission itself. Institutions—government, quasi-public, or private—all benefit from re-examination. As an independent group the study was free to examine the Commission's own practices and did so. In our transmittal letters to Congress, we recognized that as an institution our performance had not always been satisfactory. The *Report's* examination of the Commission is perhaps not as thorough as its analysis of the self-regulatory institutions, but then the Commission has Congress in turn to provide a continuing form of oversight.

By emphasizing the independence of the Study group, I do not imply that the Commission is in any way divorcing itself from the *Report*. This was not the prevalent technique of arranging for others to produce a report, making it public, and then disavowing it when criticized. Such was not our intention. To the contrary, we carefully reviewed the entire *Report*. There were certain areas where at the time we were not prepared to accept a recommendation as made, and we indicated the need for further examination. Yet we strongly endorsed its soundness and expressed our conviction that it was a thoroughly responsible document.¹⁸

Thus, in summary, independent views were respected and yet Commission participation was achieved.

¹⁷ Administrative Procedure Act § 4, 60 Stat. 237 (1946), 5 U.S.C. § 1003 (1958); Securities Exchange Act of 1934, §§ 15A(j), 15A(k)(2), 19(b).

¹⁸ See *Special Study* pt. 1, at iv-v.

III. THE REPORT AND ITS OUTCOME—TO DATE

It is difficult, to say the least, to summarize 3,000 pages in two paragraphs. As already noted, the *Report* is comprehensive; it covers an extraordinary number of areas, with primary emphasis on the trading markets and problems under the Securities Exchange Act of 1934, rather than the distribution process, and issues arising under the Securities Act of 1933.¹⁹ Its breadth may perhaps be appreciated by a notation of the range of its subject matter: qualification standards for those in the securities industry;²⁰ selling and investment advisory practices;²¹ distributions of securities, including problems of "hot issues";²² intrastate and real estate offerings;²³ the operation of the various securities markets, such as the New York Stock Exchange,²⁴ the regional exchanges,²⁵ the "third market"²⁶ (*i.e.*, trading of listed securities off the Exchanges), and the over-the-counter market,²⁷ and the interrelationship of these markets; the gaps and inconsistencies in securities credit regulation;²⁸ selected aspects of mutual funds;²⁹ and the operation of self-regulation.³⁰

The Commission's judgment on the state of securities regulation was summarized in its last letter of transmittal: "[A]lthough serious problems do exist and additional controls and improvements are much needed, the regulatory pattern of the securities acts does not require dramatic reconstruction."³¹ This is the point and counterpoint—strong-market institutions subject to varying degrees of specific weaknesses. Such a picture is to be contrasted with the gross abuses disclosed in the era prior to the enactment of the securities acts.

What has been achieved by the *Report* thus far? To this inquiry there are at least three different facets: (a) actions already taken by the industry; (b) the legislative program; (c) rule-making proposals. These are quite apart from the long-range effects of the Study, as a base for understanding the problems of the industry. The Study does not offer a one-week or even a one-year program. It will serve as a catalyst for legislation and industry action over an extended period of time. To say that there are at least 175 recommendations is just to begin to appreciate the burden. The problems are complex and interrelated. Some, such

¹⁹ 48 Stat. 74, as amended, 15 U.S.C. § 77 (1958).

²⁰ *Special Study* ch. II.

²¹ *Id.* ch. III.

²² *Id.* ch. IV B-3.

²³ *Id.* ch. IV D, E.

²⁴ *Id.* ch. VI.

²⁵ *Id.* ch. VIII E.

²⁶ *Id.* ch. VIII D.

²⁷ *Id.* ch. VII.

²⁸ *Id.* ch. X.

²⁹ *Id.* ch. XI.

³⁰ *Id.* ch. XII.

³¹ *Id.* ch. XII, at v.

as automation, are only emerging. Others, such as those associated with the commission rate structure of the New York Stock Exchange, call for further study. Only one point is clear: both the recommendations and the indirect results of the Study are focused in a single direction—to raise the standards within the securities industry.

A. Though perhaps unanticipated, one inevitable result of a thorough survey is to produce changes and improvements even before the recommendations have been formally submitted. Subjected to voluminous questionnaires which developed the changes that have taken place, the industry had an opportunity to re-examine itself. Even while the *Report* was in process, the financial community and the self-regulatory agencies took numerous beneficial steps. The former president of the Investment Bankers Association, for example, acknowledged that many firms had tightened controls and supervision over selling practices as a result of the Study.³² The New York Stock Exchange strengthened qualification standards for principals and registered representatives, commenced a program of branch office inspections, and improved its surveillance techniques with regard to the “floor.”³³ Finally, the NASD began a program of rewriting its Rules of Conduct, increased its staff, and toughened its examination for salesmen.³⁴

I do not maintain that all of these changes, and the many more that have taken place, are wholly attributable to the Special Study. Undoubtedly, this is so in many cases, while in others the Study may have merely accelerated consideration of a problem. The important point is that the Study has presented the financial community, as it did the Commission, with an opportunity for re-examination—to make its own special study.

B. The second outcome of the *Report* has been the Commission's legislative program, which has passed the Senate and is now (in late 1963) pending before the House.³⁵ Immediately after transmittal of the first segment of the *Report* to Congress, the Commission drafted its legislative proposals. Intensive conferences were then had with representatives of major industry groups and a bill was developed which was acceptable both to industry and to the Commission.

³² Address by Curtis H. Bingham, President, Investment Bankers Association of America, November, 1962.

³³ *Special Study* pt. 4, at 569-70

³⁴ *Id.* at 671-73.

³⁵ S. 1642, H.R. 6789, H.R. 6793, 88th Cong., 1st Sess. (1963).

In its broadest terms, the bill has two major purposes. The first is to improve investor protection in the over-the-counter market, primarily by extending fundamental disclosure requirements. Disclosures now furnished by listed companies would be required also of companies whose securities are traded in the over-the-counter market, and in which there is a substantial public interest. The second major purpose is to strengthen qualification standards and controls over those in the securities business, again with emphasis on the over-the-counter market. We believe that these purposes are interrelated and have a common goal—the raising of standards in the securities markets. Basic and reliable corporate information, essential for informed investing, is a necessary adjunct to higher qualifications for those who deal in over-the-counter securities. Improved standards in the securities markets are best assured by the combination of better information about securities, on the one hand, and better qualified persons to utilize and evaluate that information, on the other. Each proposal in the bill would be an important advance, but it is the sum of all of them which will produce the maximum benefit in the public interest.

To be specific, the first important aspect of the bill relates to extending the so-called reporting, proxy and insider trading requirements to over-the-counter companies having more than 750 shareholders (after two years, 500 shareholders) and more than one million dollars in assets. The reporting requirements, of course, refer to the obligation of companies to file with the Commission annual and periodic reports containing financial and business information.³⁶ The proxy rules require that information be transmitted to shareholders as a basis for informed voting.³⁷ The insider trading provisions require reports of insider securities transactions and provide for the recapture of short-swing profits.³⁸ At present these provisions are generally applicable only to shareholders in listed companies. The Commission has long endeavored to secure their applicability to over-the-counter companies.³⁹

The Special Study *Report* strongly confirms the need for these safeguards. Investor protection must rely on adequate, reliable and timely information about companies trading in the securities markets. In the absence of this information, the *Report* indicates the flourishing of fraudulent sales practices, irresponsi-

³⁶ Securities Exchange Act of 1934 §§ 12, 13.

³⁷ SEC Reg. 14, 17 C.F.R. § 240.14a-3 (Cum. Supp. 1963).

³⁸ 48 Stat. 881 (1934), as amended, 15 U.S.C. § 78p (1958).

³⁹ Similar legislation, generally known as the Frear-Fulbright bill, had been introduced by the Commission in the past. *Special Study* pt. 3, at 6-7.

ble investment advice, misleading corporate public relations and erratic trading markets.⁴⁰ Thus, this segment of the bill would seek to extend the conservative principle of full disclosure to a market where it does not fully operate.

The second major segment of our legislation relates to the quality of personnel in the securities industry. As far as federal law is concerned, there is almost free entry into the brokerage business.⁴¹ The major exchanges, however, have imposed certain standards in this field.⁴² On the other hand, there is a question as to the authority of the NASD to do the same with respect to brokers in the over-the-counter market.⁴³ Accordingly, the bill would authorize the NASD, under the supervision of the Commission, to establish standards of training, experience and capital. There is a clear need for better qualified people in the securities industry. The *Report* showed boiler-room salesmen "floating" from firm to firm, branch offices headed by inexperienced supervisory personnel, and untrained analysts sending out market letters.⁴⁴ It is thus quite clear that a vital key to improvement in the securities markets is improvement of the qualifications of those entering the business and those assuming particular responsibilities, such as the branch managers.

C. As indicated in our letters of transmittal of the *Report* to Congress, most of the recommendations of the Study that the Commission accepted may be carried out under existing legislation.⁴⁵ For example, in the trading area with regard to exchange markets, the Commission itself has very broad rule-making powers.⁴⁶ As to the over-the-counter market, the Commission's powers are tied in with anti-fraud concepts but are still quite imposing.⁴⁷ The self-regulatory agencies may, of course, operate in the broadest area and prescribe ethical standards. The *Report* proposed many recommendations for change in the Commission's rules and in the rules and practices of the self-regulatory agencies as well as in the industry as a whole. The next step, therefore, is to enter into a more formal process of rule-making.

Action will continue for some time on several fronts. As already indicated, members of the financial community in certain cases

⁴⁰ *Id.* ch. X.

⁴¹ Securities Exchange Act of 1934 § 15(b).

⁴² *Special Study* pt. 1, at 75-81, 120-31, 140-41.

⁴³ *Id.* at 48; Securities Exchange Act of 1934 § 15A(b)(3), (4).

⁴⁴ See generally *Special Study* pt. 1, ch. II.

⁴⁵ *Id.* pt. 2, at vi.

⁴⁶ Securities Exchange Act of 1934 § 11.

⁴⁷ Securities Exchange Act of 1934 §§ 10(b), 15(c)(1), 15(c)(2).

will voluntarily adopt procedures suggested by the *Report*. Self-regulatory agencies are expected to take the initiative in adopting rules and practices to overcome disclosed inadequacies. The Commission has expressed its concurrence with the judgment of the Study that the basic design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas.⁴⁸ We anticipate greater responsibilities will be assumed by these agencies. They must, therefore, raise their entire level of performance to their demonstrated capabilities.

At the same time, the Commission itself, as overseer of the self-regulators, is in the process of revising its rules and operations to meet the problems uncovered by the Study. Prior to releasing publicly the rules themselves for discussion, however, we are following a policy (previously noted) of meeting with the industry, obtaining reactions, and identifying any obstacles to promulgating a particular rule from a business standpoint. Some of the items which have a recognized priority involve selling practices, including controls over salesmen and statements of policy respecting selling literature, exchange matters including floor trading, odd lots, specialists and automation, and the over-the-counter market, including the quotations system, NASD "mark-up" policy, and retail executions. Changes will not be wrought in a day, but on the other hand, after a reasonable time and thorough discussion with the industry, solutions should be reached while a thorough study of the subject is still fresh in mind.

I have, of course, touched only briefly on selected aspects of the *Report of Special Study of Securities Markets*. All of the thirteen chapters raise important questions which are worthy of detailed analysis. The papers presented in this symposium focus on some of these problems. Commissioner Whitney highlights the more vexing problems raised by distributions under Rule 10b-6. Mr. Loomis and Mr. Rotberg study the matter of quotations for the over-the-counter market. Professor Knauss evaluates the current role of disclosure in the securities markets. Professor Painter examines the present status of short-swing profit recovery under section 16(b) of the Exchange Act. The student comment is concerned with four key problem areas presented by the *Special Study Report*. These articles and student contributions, together with the continuing debates on the *Report*, should produce a healthy ferment on the state of securities regulation for the next decade.

⁴⁸ *Special Study* pt. 4, at vi.