

POLICING THE

SECURITIES

INDUSTRY:

*More Regulation—
Or More Responsibility?*

*Remarks by G. Keith Funston, President,
New York Stock Exchange, before the
New England Council, Boston, Mass.,
Friday afternoon, November 17, 1961*

QUOTATIONS FROM THE TEXT

Some 15 million people today are venturing part of their savings in the shares of America's corporate enterprises. The securities industry cannot, of course, eliminate the risks, or take responsibility for the individual decisions of these millions of people. But our industry is obviously concerned with the manner in which these investors are approached.

Self-regulation is continuously being tested. And the industry well realizes the necessity for increased vigilance as market activity expands and market facilities are utilized by additional millions of people.

As our economy grows, we can anticipate a boom in shareownership. With it will come, on an even larger scale, many of the problems we faced earlier this year. We must gear our industry now to handle tomorrow's business if that boom is to be a healthy one.

Surely, it is an anomaly that of the roughly 25,000 corporations whose shares are traded in America today, only about 2,200 are listed on any stock exchange and thereby come under the disclosure provisions of the Securities Exchange Act of 1934. Yet, of the approximately 23,000 corporations remaining, another 3,600 may be widely enough held to be considered "publicly-owned." These companies are generally under no obligation to report on their activities.

For many years, the New York Stock Exchange has urged that this double standard be ended.

The answer for the immediate future might well lie in voluntary listing, by publicly-held companies, on one of the nation's 13 registered stock exchanges.

Their capacities are being only partially used today. Yet they offer machinery for effective self-regulation—machinery that could solve some of the securities industry's most important current problems.

(Listing) would help provide price and volume information on additional securities, since the exchanges have developed methods of disseminating data on their transactions. And it would help ease clearance and related problems by making available the existing facilities which the regional exchanges have established.

A long step forward can be taken if the latent abilities of the several regional exchanges are used more fully. This can be made possible, as a practical matter, only if Congress ends the double standard of disclosure for unlisted publicly-held companies.

Remarks by G. Keith Funston, President, New York Stock Exchange, before the New England Council, Boston, Mass., Friday afternoon, November 17, 1961

I CAN HARDLY IMAGINE a more fitting historic locale than Boston, or a more appropriate audience than the New England Council, for the thoughts I wish to express today. For the subject of my speech has deep associations both for this city and for this group of New England's leaders. That subject is responsibility—perhaps the most profoundly searching and crucially important problem of every free society.

I do not speak of responsibility in its legal sense—in which it may be confused with legal liability. By responsibility, I mean that intense spirit of self-reliance which is characteristically American and which recognizes that, in a free society, every individual—and every institution—must be aware of, must understand, and must respect the interests of his fellow-citizens.

A well-known writer—Arthur Miller—once summed up the problem by asking: Who's in charge around here?

A free society has more trouble answering that question than does a controlled society. Sometimes the answer is "the Government." Some-

times it is "Industry." Sometimes it is "the People." And sometimes the answer is "Nobody."

There are large and important areas of our society where Nobody is in charge and where we want no one to be in charge. We do not brook control over our right to speak, or to worship, or to engage in lawful economic activity. One of the aims of a free society is to see that no one takes charge of these fundamental areas of our social, political and economic life.

But there are also areas of our national existence where Nobody is not the right person to be in charge. In those areas the exercise of responsibility—not its absence—is the bulwark of freedom.

I feel this question very keenly since I am in an industry which deals, more intimately than most, with the public. Some 15 million people today are venturing part of their savings in the shares of America's corporate enterprises. The securities industry cannot, of course, eliminate the risks, or take responsibility for the individual decisions of these millions of people. But our industry is obviously concerned with the manner in which these investors are approached, with the reliability and scope of the information available to them, and with the efficiency with which their transactions are handled.

To be more specific, for many years now, the New York Stock Exchange has sought, in the interests of its own Community, to foster a climate in which its members could effectively discharge their duties in serving the public. And because our procedures have implications far beyond the Exchange Community, I would like to tell you something about them. For many of you, I expect, this will be a first glimpse into a relatively unpublicized area of the Stock Exchange's activities.

The Anatomy of Self-Regulation

The concept of self-regulation - and its practical application - has played an important part

throughout the Exchange's history. The men who founded the Exchange were devoted to a concept which has been expressed as "just and equitable principles of trade." In the intervening 170 years, and in the process of evolving one of the most stringent codes of self-regulatory standards ever developed, the Exchange Community has done much to breathe life into that phrase.

However, I would be less than candid if I did not acknowledge that at least a part of today's framework of self-regulation was initially placed upon the entire securities industry by the Federal government a quarter of a century ago. At that time, the industry recognized that if it were to grow in stature as well as in size, it would have to exercise increased authority. Twenty-five years later, I think we can look with considerable satisfaction at what this decision has meant - in the self-regulatory activities of the National Association of Securities Dealers, of individual brokerage firms, and of the nation's stock exchanges.

In this latter connection I should point out that each member firm of the New York Stock Exchange bears sole legal responsibility for its obligations to its customers and the Exchange bears none. The Exchange does, nonetheless, without assuming liability itself, try to assist the firms in defining and carrying out certain of their duties.

Let me highlight some of the ways in which we do this.

The job begins for us with the critical question of listing. Is a company which applies for listing of the standing that we think should characterize a stock on the Big Board? Are its assets, its earning power, its stock distribution up to the standards prescribed by our Board of Governors? If not, we must decline to lend our facilities to that company. Let me point out too, that once a company has met our initial listing requirements we expect it to meet certain lesser criteria for con-

tinued listing. Equally important, we insist that all common stock traded on our exchange must have voting rights, so that no stockholder will be disenfranchised. We insist on proxy solicitation, so that we will not have corporate government by default. We insist on timely disclosure of important corporate developments which may affect stock values, so that our market will not become a private preserve for "insiders."

When I say "we insist" I am not speaking of polite representations. I mean that we will not open our facilities to a business which does not agree to what we call a Stockholder's Bill of Rights, and that we will consider withdrawing our facilities from any corporation which does not live up to it.

Supervision of Member Firms

The reach of our activities, moreover, does not end with exacting listing requirements. Just as vital is our concern for the operations of our member firms in their day-to-day business with their customers. This involves a process of such complexity that it requires over 200 people throughout the Exchange, including an entire Exchange Department, to carry it out. I could easily spend hours telling you about its details; but let me touch on a few points of special interest.

We believe that each firm must have adequate capital to conduct its business.

Once a year, for example, *without warning*, and in accordance with Exchange regulations, a surprise audit of the books of each firm carrying customers' accounts is conducted by independent public accountants, who then reply to a searching financial questionnaire from the Exchange. Each of these firms is required, also without warning, to answer similar questionnaires on two other occasions during the year. The response to each questionnaire is scrutinized by our staff of 27 examiners. Once a year, one or more of our exam-

iners calls unannounced upon each member firm, to spot check its activities.

And each week, those firms engaged in underwriting activities must report their underwriting positions to the Exchange.

A specific object of all these examinations is to see that every firm meets the Exchange's capital requirements. As a firm's business grows, it must, of course, provide more capital. In addition, a mandatory fidelity insurance program covers all personnel of member firms which deal with the public.

All these procedures are expensive and time-consuming. But we consider them indispensable to the self-interest of our Exchange Community. Incidentally, I think it is a fair measure of success that our members' solvency record is superior even to that of the nation's banks.

One of our continuing areas of interest is the investigation of customer complaints. Happily, there are not many of them. Last year, out of the millions of orders placed through Exchange member firms—not only on the Big Board, but on other exchanges and in over-the-counter and commodities markets as well—we received less than 600 queries from customers who felt that their accounts or orders had not been properly handled. The vast majority of these involved technical misunderstandings and were easily cleared up. And in the few more involved cases—38 of them—the Exchange's arbitration facilities, or settlement through the courts, were available to customers.

I hardly need emphasize that our concept of good performance goes beyond the investigation of complaints. In fact, we think it begins in seeking to *prevent* complaints in the first place. For example, there is a two-way flow of information between each customer and his firm. We expect our member firms to know who their customers are, and we think it proper for customers to be able to find out what their brokers' financial

condition is, as well. In addition, we subject all member firm advertising to review to see that it conforms with standards of truthfulness and good taste, and we spot check the firms' market letters and other literature.

Finally, there is that most delicate and vulnerable of all customer relationships—selling. In many ways, the problem of responsible selling lies at the heart of a responsible securities industry. We have constantly sought to raise the standards for all member firm registered representatives. We do not permit part-time employees to handle customer accounts. We require that a trainee serve a six-month apprenticeship with a member firm. And before he can be registered he must pass a stiff Stock Exchange examination—or its equivalent. After he has demonstrated his technical qualifications, and the Exchange has inquired searchingly into his background and reputation, every representative—and every partner and officer, too, I might point out—is subject to disciplinary action if we find that his dealings with customers have been in any way improper.

It is perhaps inevitable that occasional violations of the regulations occur. Most breaches of the rules are technical in nature and unintentional; but they may be subject to disciplinary action nonetheless. When a member or allied member is found to have violated the Exchange's rules, he may be censured, fined, suspended or expelled from the Exchange by the Board of Governors.

The Board moves swiftly and decisively in these cases. In nearly a quarter of a century, however, the Board has found it necessary to judge relatively few cases resulting from formal charges of misconduct.

Two other areas of the Exchange's self-regulatory activities may interest you. The first concerns the specialist.

More than anyone else, he is the key to a smooth-flowing, fair and orderly market. In the

stocks in which he specializes, he serves as a broker's broker, executing orders left with him, and as a dealer, buying and selling for his own account. His central aim is to try to keep the spread between transactions and between bids and offers as narrow as reasonably practicable. In the process, he contributes immeasurably to the market's liquidity. To guide him and to test how effectively he does his job, we have set up a few policies—in fact, 30 pages of them, single-spaced. May I remark, parenthetically, that the record of our specialists has been extraordinary—not only for technical virtuosity, but for integrity as well.

Stock-Watchers

Another important Exchange activity concerns our vigilance over unusual situations in individual stocks. We call this operation Stock-Watching. Every day, a computer runs over the price and volume movements of the 1,500-odd stocks listed on the Exchange. Far more accurately than the human eye, it notices any unusual variations in individual stocks, and it sets these aside for more careful, human investigation. When a stock "acts up" we want to know why. Most of the time, events in the news readily explain these movements. But not always. Sometimes a rumor will affect a stock. Is it true? If not, we make it our business to try to have it scotched; if true, to have it aired. This may mean asking listed companies to help clarify the facts and release them to the public immediately. Perhaps the stock-watching operation may turn up an attempt at possible illegal manipulation. If that happens, we track it down to the limit of our authority and then turn the case over to—and work with—the Securities and Exchange Commission.

As I review the ground I have covered, I think the time has come to stop citing facts and to state the moral of my argument. It is this: if you were to ask people in the New York Stock Exchange

Community, "Who's in charge around here?" there would be no doubt that the answer would be: "The Exchange Community is."

The Need for a Widening of Responsibility

Allow me to emphasize that, in answering that question, the Exchange Community can, of course, speak only for itself. Our authority is limited to our members and allied members and their employees, who comprise less than half the securities industry's total personnel. One of the reasons I stress this is that the public does not always distinguish among the various segments of the securities industry, as our mail so often attests. At the same time, however, it is certainly true that while each sector of the industry has problems of its own, these problems often overlap. And because they are inter-related, they stimulate the entire industry to cooperate in solving them.

It is clear, for example, that during the past year we have all seen a number of disturbing signs. There has been a number of widely-publicized infractions of securities laws and the rules of exchanges and other regulatory bodies. There have been excesses in unregulated credit areas. But these infractions have been the infrequent exception rather than the rule. While any infraction is one too many, any industry whose personnel totals nearly two hundred thousand—and which deals with people and their money—is bound to have violations. Self-regulation, in other words, is continuously being tested. And the industry well realizes the necessity for increased vigilance as market activity expands and market facilities are utilized by additional millions of people.

A continuing problem, against a background of soaring securities trading volume, is that brokerage firm customers have no way of obtaining definitive price and volume data on certain securities—data which might alter their actions.

Continuing information about publicly-owned unlisted securities which are traded over-the-counter is not easy to come by. Reports of transactions by corporate insiders in unlisted companies are not available. And last spring, having made a purchase, a customer often had to wait weeks and, on occasion, literally months, before his stock was actually delivered. In the over-the-counter markets, this situation was aggravated because, among other things, no centralized clearing facilities were available.

Now it is possible, of course, to shrug off such problems as being typical of a "boom" in investing. But as our economy grows, today's "boom" becomes tomorrow's norm. We can anticipate a boom in shareownership in the years ahead. With it will come, on an even larger scale, many of the problems we faced earlier this year. That means we must gear our industry now to handle tomorrow's business if that boom is to be a healthy one.

Today the SEC is looking into the broad aspects of the securities industry's operation. This is entirely proper and healthy. Quite possibly, the SEC will recommend that, in certain areas, standards of performance and disclosure should be improved. I cannot, of course, either predict or prejudge the recommendations that may be made. But should Congress decide on legislative changes, one very real question, it seems to me, would be: who can best exercise increased responsibility—the government—or the industry?

Who Should Be In Charge?

Let me begin by saying that there is an important job that only the government can do. It involves ending the curious and thoroughly unjust double standard with which an investor must cope in today's securities markets. When he buys the securities of a corporation listed on a stock exchange, he can be assured that the company is required to file an annual report describing its

operations and financial position. Information about securities transactions by officers, directors and 10 per cent holders will be made public. When proxy material is furnished to him, it will contain the information essential to making a sound voting decision.

But when the same investor buys the securities of a corporation which is not listed on a stock exchange, he can count on no such intelligence — *although the unlisted corporation may be as large, or have as many shareowners, as its listed counterpart!* This in no way reflects on the financial quality of unlisted securities, many of which are excellent. Nor does it imply that *all* unlisted companies are deficient in supplying information to their shareowners, which is not the case.

But, surely, it is an anomaly that of the roughly 25,000 corporations whose shares are traded in America today, only about 2,200 are listed on any exchange and thereby come under the disclosure provisions of the Securities Exchange Act of 1934. Yet, of the approximately 23,000 corporations remaining, another 3,600 may be widely enough held to be considered "publicly-owned." That is, they have at least 300 stockholders—a criterion widely accepted as the mark of a "public" company. These 3,600 publicly-owned companies are generally under no obligation to report on their activities.

For many years, the New York Stock Exchange has urged that this double standard be ended by bringing unlisted publicly-held companies under the disclosure requirements of the 1934 Act. There is no reason why investors in these companies should not automatically be entitled to the periodic reporting of corporate financial data, or why information about insider transactions should not be made public. There is no reason why proxies should not fully inform shareowners as to the corporate matters that must be voted on. There is no reason why all securities, and those who extend or maintain

credit for purchasing or carrying them, should not be under the same credit regulations. In short, there is no reason why corporations large and important enough to have 300 shareowners should be reluctant or find it inconvenient to provide in their reports and their proxies, the information investors need to arrive at sound decisions.

The Next Important Step

I most emphatically do not want to give the impression that ending the double standard—which only the government can do—will put an end to the problems of clearance and inadequate price and volume information evident in the securities industry earlier in the year. However, when I suggest that the government require more companies to meet *basic disclosure requirements*, I do so as a means to an end—and that end, as I think you can anticipate, is wider self-regulation by the securities industry itself.

How can we best achieve this? In the long run, the answer might well lie in setting up, through a going organization like the National Association of Securities Dealers, a nationwide system for clearing trades in unlisted securities and for reporting price and volume data. The NASD is, in fact, now studying this possibility. Such a plan, however, might prove to be economically unfeasible; and, as a practical matter, it might be unrealistic to expect the NASD to provide, within the foreseeable future, facilities on the scale that would be required. The geographical problem of covering 50 states and thousands and thousands of companies is, in itself, immense.

For the immediate future, there is, however, another alternative—one that is immediately available and practical. It lies in voluntary listing, by publicly-held companies, on one of the nation's 13 registered stock exchanges. Many companies today avoid listing on a regional exchange because they do not wish to assume the

disclosure obligations imposed by Federal law. Once disclosure requirements are made mandatory by Congressional action for all publicly-held companies of a certain stockholder size, many presently timid attitudes toward listing will disappear, and the desire to list will concomitantly receive great impetus. Most important, the smaller, publicly-held companies are well-suited to listing on the regional exchanges which, in turn, have the potential to play an increasingly vital role in the nation's securities industry. I might note—to avoid any possible misinterpretation of self-seeking—that few presently unlisted corporations would qualify for listing on the New York Stock Exchange.

But let's see what listing on the regional exchanges would accomplish in addition to broadening materially the flow of corporate data.

First, it would help provide price and volume information on additional securities, since the exchanges have developed methods of disseminating data on their transactions—either instantly or at the close of the day. *Second*, it would help ease clearance and related problems by making available the existing facilities which the regional exchanges have established.

These regional exchanges exist in major population centers from coast to coast. Their capacities are being only partially used today. Yet they offer machinery for effective self-regulation—machinery that could solve some of the securities industry's most important current problems.

To be sure, not all the regional exchanges have identical listing and disclosure requirements, or comparable facilities for reporting and clearing transactions. But the basic machinery generally does exist, and surely a broadened base for listing would provide a powerful incentive to push forward. Ultimately, it would pave the way for higher standards for sales people, for continued strengthening of brokerage firm financial standards and, most important, for the faster and

sounder growth of shareownership itself.

Let me briefly sum up my thoughts:

The Exchange Community has demonstrated that self-regulation can be hard-hitting. The entire securities industry has shown that self-regulation can be effective. The industry faces important problems which are likely to become more pressing as shareownership expands. A long step forward can be taken toward solving these problems if the latent facilities and abilities of the several regional exchanges located across the country are used more fully. This can be made possible, as a practical matter, only if the Congress ends the double standard of disclosure for unlisted publicly-held companies.

The Wider Issue

The wider issue, of course, is one of fuller assertion of responsibility by the securities industry itself. Returning to Arthur Miller's blunt phrase, the ultimate question we must face is: Who is to be in charge around here? I believe the right "person" to be in charge of the securities industry is the industry itself. The whole thrust of my proposal is to make the industry's self-regulatory operations more effective.

In a free society, we prefer, whenever possible, to stimulate the private sector of our economy to expand its activities and services. Each time we do so, each time private enterprise soundly enlarges the scope of its operations, a free society is always the gainer.

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