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December 6, 1961

The Honorable William L. Cary, Chairman
The Securities and Exchange Commission
Washington 25, D.C.

Dear Chairman Cary:

At our meeting on October 3, I promised to send you some suggestions for the conduct of the study authorized under House Joint Resolution 438. Because you may already be familiar with some specific recommendations we have made in the past for revision of the Securities Acts - summarized in the attached Exhibit A - the suggestions of this letter are confined to general topics that we believe should be studied.

The investor safeguards adopted by the securities industry and by the State and Federal Governments in the wake of the 1929 crash can properly be considered to have been experimental in part. As you have testified, the onrush of events has made it difficult for anyone to step back for a careful examination of the objectives or the results of these many experiments. Meanwhile the world has been changing. We believe, therefore, that your study presents a valuable opportunity for weighing how much various regulatory devices contribute to the safety of investors against how much they cost in terms of impediments to the flow of savings into investment.

We do not accept as a foregone conclusion the proposition that more regulation of the securities markets is necessary, because we believe protections afforded the public by free markets can be effective in the securities markets as they are elsewhere. In the securities markets, the investor has a strong incentive to do a good job of investing; the firms of the industry have a strong incentive to help the investor. Consequently, it seems to us that the main task of the study is to find out how we can facilitate the working of these incentives without blunting them through becoming overly paternalistic. One has only to look around to see industries that are over-regulated -- transportation and agriculture for

instance -- to the ultimate disadvantage of the public the regulations are designed to protect.

The securities markets have such a central role in the nation's economic growth that we must be extremely careful to avoid freezing them in accumulated restrictions. We believe, therefore, that further extensions of governmental intervention in the securities markets should not be undertaken without demonstration of clear and present dangers for which there are no other effective remedies.

We firmly believe that the principle of industry self-regulation with SEC review envisioned by the Congress in 1934 has proved in practice to be an extremely good one. We hope you will continue giving it primary weight when considering remedies for those problems of safeguarding investors that you believe to exist.

Our suggestions are organized in three major areas: (1) experience and needs of investors, (2) business access to the capital markets, and (3) rules and procedures of securities market institutions.

Experience and Needs of Investors

The augmenting of safeguards during the 1930's was a response to the losses investors suffered in the preceding decade. Before any extensive remodeling of those safeguards is attempted, we believe you should go directly to investors to find out how well they have fared under the existing system. This examination should be designed to identify sources of risk and to determine whether the actual incidence of injury to investors is so great as to require additional safeguards. Additional information on the following topics should be of great value not only in modifying the regulations but in uncovering opportunities for the industry to provide better service to investors:

1. Investors' performance. It is clear that investors in common stocks during the postwar years have enjoyed large capital appreciation on the average, but the average of course conceals some individual losses. Although some capital losses are a feature of the adjustment processes of a free enterprise system, it would be extremely desirable to know more about who ultimately incurs them, how large they are, and why they occur.

If some chronic losers can be identified, a study similar to those made of business failures should be made to determine some of the major causes of poor investing performance.

2. Injuries from manipulation and fraud. In view of allegations that investors are currently being victimized by manipulation and fraud in the securities markets, a major effort should be made to locate and analyze cases in which investors are believed to have suffered. We suspect that the total of such losses actually is not as large as is generally supposed. Publicity given to the characteristics of investors and investor transactions most vulnerable to fraud should in itself have value as a warning to investors and as a deterrent to would-be perpetrators.

3. Losses from misappropriation and/or failures of brokers and dealers to meet obligations. Like banks and other financial institutions, securities firms make an enormous expenditure of time and effort to prevent misappropriation or other losses of securities or funds held for the public. In fact, we believe the solvency record of Exchange member firms is even superior to that of the nation's banks. A logical base for appraising this protective effort of the securities industry should be provided by analysis of losses actually suffered by investors. If actual losses are small and infrequent, it could be concluded that the safeguards are sufficient. Better information about actual losses, furthermore, would aid in pinpointing the protective effort, as an alternative to a general tightening of the net.

Business Access to the Capital Markets

The public interest would not be well served if the safeguards erected for investors were to impede the flow of savings into investment materially or to impair the usefulness of the securities markets as a device for allocating capital resources. We believe, therefore, that part of the study should be devoted to examination of the securities markets and securities regulation from the viewpoint of businesses trying to obtain funds.

1. Corporate choices between use of the public markets and private placement or internal financing. If, as is

often alleged, securities regulation induces corporations to avoid use of the public market to some extent, is this effect necessary or desirable, and, if not, how could it be minimized?

2. Corporate choices between equity and debt financing. The tendency of tax considerations to induce corporations to rely unduly upon debt financing is often deplored. Does securities regulation have a similar effect? If so, how can this effect be minimized? How can equity financing be facilitated without endangering investors?

3. The costs of complying with the Securities Acts. The costs of preparing and filing registration statements and otherwise complying with securities regulation should be studied to see if they are in fact an unreasonable burden or a significant deterrent to use of the securities markets. How can costs and time delays be minimized?

Rules and Procedures of Securities Market Institutions

We would expect the previously suggested studies to indicate areas in which additional safeguards may be needed and areas in which the existing safeguards are more than adequate and can be relaxed to some degree. In dealing with the industry, many questions of fact and judgment must be faced in order to decide which investor safeguards should be provided by investors themselves and which ones are the responsibility of the firms of the industry, the exchanges, the other industry organizations, and the government. In any case, we believe the final test of the need for changes in rules and procedures ought to be a demonstration of actual injury to investors. Some subjects we believe should be studied are:

1. Overlapping and gaps in the coverage of the securities laws. We understand that one of the objectives of the study is to ascertain where duplication in coverage of the securities laws and other governmental regulation can be reduced or eliminated, and that you also intend to determine where institutional changes have left some parts of the securities industry free of regulations that are applied elsewhere. We, therefore, will merely endorse those objectives here.

2. Price and volume information. Even if the disclosure requirements of the Securities Act of 1934 are applied

to all publicly held corporations, as we have recommended, investors would still have difficulty obtaining reliable information about prices and volumes of sales of unlisted securities. We consider the inadequacy of price-volume information to be a serious problem that deserves study.

3. Clearance facilities. Slowness in clearing transactions in some areas of the market aroused concern in early 1961. How could such problems best be avoided in future?

4. Regulation of security credit. Security credit regulation, as now practiced, discriminates against purchasers of registered securities, broker-dealers in general, and Exchange members. These effects, serious as they are, are so well known as to need little additional verification. There are other questions, however, that we believe do merit study, possibly by the Federal Reserve Board. We would ask whether or not the prevailing levels of margin requirements are higher than necessary. In view of the manner in which the use of consumer credit and real estate credit is being encouraged, we wonder if the use of credit in the securities markets is not being unduly restricted. We would question, furthermore, whether it is imperative to administer margin regulation in a contracyclical manner. The use of margin regulation in stabilizing economic activity appears to be predicated more upon potential repercussions of stock price changes outside the securities markets than upon the direct effects of security credit upon investors. We would ask whether enough is known about the influence of stock price changes upon economic activity to justify the market uncertainty and discrimination in the use of credit facilities that are now a product of margin regulation.

5. Adequacy of facilities for self-regulation. We hope that one of the products of the study will be a plan for deploying forces of the SEC and those of the industry in such a way that maximum effectiveness can be obtained from the resources available. The Exchange Community has demonstrated, we believe, that industry self-regulation is effective and that additional listings on the exchanges would help to make regulation more uniform in application. The ability of the regional exchanges to take on more of the regulatory load might be studied in particular.

6. The SEC. If present facilities for reviewing registration statements and conducting investigations are inadequate, how large should the SEC staff be? Is everything possible being done to assign personnel to the most important problems of protecting the public? Has the point of diminishing returns been reached in some regulatory areas, while other areas are overlooked?

* * *

I am looking forward to an opportunity to discuss the study with you in more detail.

Sincerely yours,

G. Keith Funston

Att.

EXHIBIT A

NEW YORK STOCK EXCHANGE PROPOSALS FOR APPLICATION OR REVISION OF THE SECURITIES ACTS

Securities Act of 1933

1. Sec. 3(a):
   Amend to exempt from registration the additional issuances of securities which have been registered under the Act of 1934 and dealt in for more than three years on a registered national securities exchange.

2. Sec. 3(b):
   Amend to increase the size of offerings which may be exempted from registration from $300,000 to $500,000.

Securities Act of 1934

3. Sec. 3(a)(3):
   Amend to redefine "member" to include the officers and directors, and the general partners, respectively, of a national securities exchange's member corporations and partnerships.

4. Sec. 7(c) and Sec. 8:
   Amend by legislation or by regulation to make restrictions upon security credit apply equally to all securities coming under the 1934 Act (as amended in point 5 below) and to all lenders.

5. Sec. 12, 13, 14, & 16:
   Amend to subject all issuers having assets of $3,000,000 and 300 shareholders to the registration, statutory report, proxy rule and "insider" trading provisions of the 1934 Act.

6. Sec. 14(b):
   Amend to extend to all brokers and dealers registered under the 1934 Act the requirement that a broker must transmit proxies to his customers.

7. Sec. 15(c)(3):
   Amend to authorize the Commission to regulate the trading of when-issued securities by all brokers and dealers registered under the 1934 Act.

8. Sec. 16(a):
   Amend to require "insiders" to report their transactions within 7 days.

9. Sec. 16(b):
   Amend to limit the right of a corporation to recapture an "insider's" profits made through a purchase and sale, or sale and purchase, within a 6-month period, to his actual profits.