

REFLECTIONS ON THE SPECIAL STUDY OF SECURITIES MARKETS

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(from a talk by Mr. Cohen at the Practising Law Institute, New York City)

Head of SEC's mammoth "Special Study" of the securities industry and markets disputes Wall Street's terming of the findings published so far as "mild." Cognizant that a sigh of relief followed disclosure that dealers were not going to be separated from brokers and that the principle of self-regulation was not going to be replaced, Mr. Cohen points out there are, nevertheless, serious, complex faults which must be rectified. Reform, he adds, is no less urgent merely because it was suggested to use a scalpel in 100 separate places rather than a meat axe in three or four. Mr. Cohen points out in his commentary how the Report was put together, what its functions and future are. In so doing, he states that in total scope the Report is neither drastic nor mild, and that the legislative recommendations are but a fraction of the total since much that has to be done requires action outside the legislative area.

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Conducting the Report of the Special Study has taught me many things, some of which may not be found very readily on the face of the Report. Just as I learned from the advance release on the New York Stock Exchange's study of the market break that a certain percentage of public individuals having transactions on the Exchange are males, another percentage are females, and a substantial percentage are "other," so I was interested to find from various of our studies that 85% of all widows purchasing mutual funds are women, that the big New York banks have a relatively small share of loans to farmers as compared to country banks, that companies going bankrupt usually have had poor records of earnings, and that most people investing for the first time are younger than people who have been investing for a long time.

I have learned something, too -- and this more laboriously -- about how to conduct a Special Study of Securities Markets. I suppose that I am right now one of the greatest living authorities on this subject, but unfortunately this is one of the most useless kinds of knowledge that anyone could have. By the time one accumulates the knowledge it is too late to use it for a current study and it is too early for anyone to be interested in it for purposes of the next one. Nevertheless, I would like to discuss a few of the important things that I have learned by experience in the past year and a half, because they have bearing on what the Report is and should mean.

First of all, what subjects do you cover in a broad study of the securities markets? The enabling statute and its legislative history said in effect: "Investigate anything and everything about the securities markets and report your conclusions and recommendations by Jan. 3, 1963" -- later extended to April 3, 1963. I suppose that I started with at least an average lawyer's acquaintance with the workings of the securities markets, and I had enough sense to know that with a staff of 65 -- not yet assembled -- it was impossible to study everything. The early days of the Study were spent in considering what we could and should cover and in rejecting many perfectly sensible suggestions of what it would be worthwhile to cover. I was not wise enough, however, to see how difficult it would be to draw sharp lines around the areas selected for study, because I did not perceive how closely the various subjects were interwoven in an endless web.

### Five Surprising Facts

Let me just mention five facts about the securities markets that, in combination, are of great significance, and some of which may come as a surprise to many in the field. First, the major regional exchanges do most of their business in New York Stock Exchange listed stocks. Second, New York Stock Exchange member firms are the dominant members of the major regional exchanges. Third, the New York Stock Exchange firms also do more than half of the dollar volume of all over-the-counter business in stocks, even though they are numerically in the minority. Fourth, an over-the-counter business of growing proportions is conducted by non-New York Stock Exchange members in New York Stock Exchange listed stocks. And fifth, the institutional share of the market has been increasing even though the number of individual public stockholders has also been increasing.

If you consider the implications of just these facts, and also bear in mind that we were to study the adequacy of rules of the exchanges and that the New York Stock Exchange undertakes to regulate its members in all of their activities you will see how difficult it is to draw sharp boundary lines. If you attempt to say "We will study this subject but not that subject," you may quickly find that the first inevitably draws you into the second. This is just one of the reasons why it is much easier to know at the conclusion of the Study just how the Study should have been planned than it was when we were planning it. If anyone plans to conduct a comprehensive market study in the near future, I shall be glad to point out some of the pitfalls and booby traps.

A wholly different kind of example of the intermeshing of many different subjects may be seen in our discussion of the unhappy USAMCO incident in Chapter III.B. of our Report. This one incident exemplifies, among others, the following practices and problems: distribution of a small new issue of a glamour stock -- this one happened to be vending machines -- in a period of hot issues; the concept of suitability in retail selling; advisory and sales activities in a branch office in relation to research activities in a main office; bullish corporate publicity in sharp contrast to bearish inside information; representation on a corporate board of directors and its significance in retail selling and in market-making; retail selling in relation to personal transactions by members and

salesmen of the broker-dealer firm; and problems of supervision in a multi-branch firm and of surveillance and discipline by self-regulatory agencies. If one is studying rules and practices of the securities markets and the adequacy of regulatory and self-regulatory measures, one could hardly deal with a single facet of this situation without also dealing with all or most of its other facets.

### Report's Major Theme

More broadly, the incident is a good illustration of what I consider to be one of the major themes of our Report – the importance of continuous, reliable corporate disclosure in relation to a good many other specific practices and problems discussed in the Report. Chapter IX of the Report is our presentation on this subject of corporate disclosure, but in many senses the rest of the Report is supporting material for our basic recommendations in Chapter IX. Having reliable and regular corporate disclosures is obviously relevant to the subject of responsible and irresponsible corporate publicity. It is obviously also relevant to the question of research, advisory and selling activities by broker-dealers and others. Less obviously, perhaps, an adequate disclosure program for over-the-counter securities is relevant to some questions of mechanics and costs in the over-the-counter markets as compared with exchange markets. It is also relevant, in an unfortunate way, to decisions of corporate managements as to whether or not to seek listing on an exchange. Again, it is relevant to the question of credit and margin provisions for over-the-counter securities as compared with listed securities. I mention these interrelated subjects not merely to show how difficult it is to draw boundary lines around pre-selected subjects for study but also to emphasize why the Special Study has considered the recommendations in Chapter IX to be among the most fundamental.

Because we did not know all the answers when we started, we have undoubtedly made some mistakes in planning the depth and scope of our coverage. We might wish now that we had devoted a little more attention to some subjects and a little less to others. We might wish that our questionnaires had followed through a little better on some subjects so that we could have rounded out our discussions of these matters more fully in our Report.

At the same time, the very breadth of our coverage, while it may have limited the depth of probing of some individual subjects, has provided the enormous advantage of permitting us to see things in relation to each other. While I would be the first to agree that we have not explored some matters to the depth that they may need exploring, I would also assert that we have gained insights into each subject that would not have been possible without our broad coverage. If the seamless web has led us to extend ourselves broadly, the breadth of our study has enabled us, I believe, to understand and describe some of the components of that seamless web in better perspective.

The full scope of the Study and Report was indicated in our transmittal letter of April 3, covering Chapters I, II, III, IV and IX. Since many may not have seen our listing of chapters at that time and may even share a widespread impression that what we have already issued is the full Report, I will briefly enumerate the chapters here:

## Reviews Chapters

Chapter I, after describing briefly the purposes and methods of study and the general nature of recommendations arrived at, sets forth general data highlighting the growth of the securities industry in the post-war period, which was an important reason for the Study and provides the background for many of the subjects explored. Chapters II and III are concerned with the broad range of persons and business entities engaged in the securities business -- broker-dealers, salesmen, salesmen's supervisors, and persons engaged in giving investment advice. The first of this pair of chapters examines the standards and controls relating to their entry into and removal from the business, and the second their activities and responsibilities in the course of that business and the related controls. Chapter IV deals with primary and secondary distributions of securities to the public, with particular emphasis on new issues and briefer review of other specific areas.

Chapters V, VI, VII and VIII extensively explore the functions, structures and problems of markets in which securities are traded after their distribution. Chapter V is a general introduction to this group of chapters. Chapter VI covers the exchange markets, with special attention to the most important of these, the New York Stock Exchange. The chapter reviews the functions and activities of various specialized categories of members, particularly specialists, odd-lot brokers and dealers, and floor traders, and also deals with the subjects of short selling and commission rate structures. Chapter VII discusses the over-the-counter markets, their wholesale and retail components, the quotations systems, and present controls over all of them. Chapter VIII then examines various interrelationships among trading markets, including patterns of distribution of securities among exchange and over the counter trading in listed securities, and the regional exchanges as "dual" and primary markets. I might say parenthetically that a story in the *New York Times* of May 6 criticizes us for failing to deal with the institutional role, but I think that at least a good deal of what the story finds lacking on this score will be supplied in Chapter VIII and perhaps other chapters still to come.

Chapter IX reviews the legal requirements and standards in respect of reporting, proxy solicitation and "insider" trading which are applicable to issuers of securities in public hands, contrasting those relating to securities listed on exchanges with those relating to over-the-counter securities and emphasizing the need for legislation in the latter area. It also considers problems in the dissemination of corporate publicity by issuers of both kinds of securities. Chapter X deals with the purposes, effects, and enforcement of securities credit and margin regulations and some inconsistencies and anomalies of the present regulatory pattern. Chapter XI is concerned with certain aspects of open-end investment companies. It contains the results of an investor survey and also specifically treats with selling practices, contractual plans, and certain problems in connection with fund portfolio transactions. Chapter XII deals with the self-regulatory pattern which is largely unique to the securities industry. It evaluates the regulatory functioning of the New York Stock Exchange, the American Stock Exchange, the principal regional exchanges, the National Association of Securities Dealers, Inc. and certain quasi-

regulatory agencies, notes the absence of self-regulatory organizations in certain areas, and assesses the role of the Commission in relation to all of them.

The market break of May 1962 was thought to merit separate examination as a major market phenomenon, and also afforded an opportunity to study certain aspects of the securities markets, already studied under more normal conditions, in the circumstances of a precipitous decline. The results of this study are set forth in Chapter XIII, although other chapters dealing with particular topics also reflect the findings of this special inquiry. Chapter XIV, still tentative in nature, is reserved for a few general topics that may fit neither within the scope of any of the previous chapters nor within the limits of a further transmittal letter.

#### Public Hearings Less Than Expected

Let me now turn from the subjects of study to the means of study -- both the personnel and the procedures. I should first point out that, in planning a study, the latter questions are intimately related with the choice of subjects. Depending on your subject matters you may need to put greater or lesser reliance on questionnaires, field investigations, interviews and conferences, or public hearings. Depending on both subject matters and techniques, you may need more or fewer lawyers, economists, statisticians, analysts, investigators and so on. And depending on the experience and capacity of your personnel, both subject matters and procedures must be accordingly adjusted.

Actually the study has been conducted with much more reliance on questionnaires and private inquiries and much less use of public hearings than most people expected or than I would have preferred. Of course, questionnaires and private inquiries certainly would have predominated anyhow, but I firmly believe that it is an important function of this kind of study to reach an audience of public investors, not merely members of the industry or students of the industry, and this can best be accomplished by hearings. I have frequently been asked whether we curtailed our public hearing plans because of feared market impact. The answer is that the actual and only reason for not carrying out our original, more ambitious plans for public hearings was that they simply proved to be too ambitious. We very reluctantly concluded that within the limits of time and personnel under which we were working, we could not afford the great additional burden on our time and manpower that further public hearings would have entailed.

#### Staffing from Outside

As to the staff of the Special Study, the great majority of the professional members, including myself, were recruited from outside and only a minority were transferred from the Commission's regular staff. In selecting those who would take leading parts in the Study, the Commission presumably sought people whose general outlook would not be too far out of line with the Commission's own. I came from private law practice in Chicago, following a long tenure with the Commission devoted mostly to the Holding Company Act. Our Associate Director, Ralph Saul, had been with the Commission for several years, under Republicans and Democrats. Our Chief Counsel, Richard Paul, came

from a major law firm in New York, and our Assistant Director, Herbert Schick, from an important law firm in Philadelphia, after an earlier experience on the Commissions staff. Our Chief Economist, Dr. Sidney Robbins, is from the Graduate School of Business of Columbia University. This group was responsible for selection of the balance of the professional staff, which came from university faculties, law offices, brokerage offices, other governmental departments and elsewhere.

That the staff was selected largely from outside had important reasons and important consequences; indeed I think it is an important aspect of the Study and Report that has been widely overlooked and I would like to dwell on it for a few moments.

The enabling law focuses on the rules of self-regulatory bodies and their disciplinary procedures, but it is obviously impossible to go very far with this subject without meeting the question "What was or should be the Commission's role?" Moreover, even leaving out the Commission itself, the same individuals who had been regularly engaged in day-to-day administration of the law and surveillance of the self-regulatory mechanisms could not possibly be in as advantageous position as newcomers or outsiders to take a fresh look at these very matters.

#### Commission Not Involved

Related to the outside selection of a staff, but also stemming from quite independent considerations, was the decision that the actual text of the full Report including its specific conclusions and recommendations should be those of the Special Study as distinguished from the Commission itself. One of these considerations was simply the practical one that the Commission is an extremely busy group of administrators even when no Special Study is going on. It was inconceivable that they could just add to their other workload the job of personally digging deeply into the facts, analyzing the voluminous data of all kinds that were compiled, and coming to agreement on the exact wording of every specific recommendation to be made on a large variety of subjects. If the Commission members themselves were to have gone as deeply into each of these processes as the Special Study has done, either the scope of the Study would have had to be narrower, or the time longer, or the recommendations very much less specific.

Moreover, you must remember that the five members of the Commission itself, having the ultimate responsibility for action taken by the Commission pursuant to a Special Study or otherwise, could not be put in the position of making final decisions on most important types of matters -- including substantive changes in its own rules or in rules of self-regulatory agencies -- except after opportunity for hearing by parties affected. We have pointed out in Chapter I that, although many subjects have been explored in hearings, interviews and conferences, the ultimate conclusions and recommendations of the Study have not been presented for comment or hearing by members of the industry prior to our expressing them. This we could do but the Commission could not. The Commission could satisfy itself that the people chosen to conduct the Study and express recommendations were responsible people within the Commission's sights and it could and did indicate its broad agreement with the tenor of our recommendations, but it

necessarily had to avoid saying the final word at this time on specific matters that it could pass upon only after opportunity for hearing.

Before I was asked to head the Study, I have been a practicing lawyer in Chicago and for a period I was the lawyer for the Chicago White Sox. My fiftieth birthday came along at this time and it was heralded in lights on the famous and spectacular score board, with the result that when I was appointed to my present job one of the newspapers headed its story "From Score Board to Big Board." I will pick up that theme now in relation to what I consider the function of the Study and Report -- from Score Board to Big Board to Spring Board, because I think that the real purpose and function of a Study and Report such as we have been working on is to serve as a springboard. The Special Study could not hope to produce all the answers, and we ourselves certainly cannot go on to produce all the needed results, but I believe that we have provided a springboard for action by the Congress, by the Commission, by the self-regulatory bodies and by members of the industry.

### Disputes Street's Reaction

A springboard should have some spring, and from this point of view the only adjective applied to our Report so far that bothers me somewhat is "mild." It bothers me because it may imply that we did not have much to say and hence that there is not much to do. I firmly believe that there are many things that need doing -- important things that in the long run will mean the difference between a securities business and securities markets deserving and enjoying public confidence or viewed with distrust or cynicism.

Why has the Report been called mild? I believe it is because we have not sought simple and drastic solutions for complex and subtle problems. It had been widely predicted that we would recommend segregation of functions of brokers and dealers and when we did not do so there was a sigh of relief and the Report was deemed mild. This does not mean that combinations of functions do not present many problems -- they certainly do; but rather that the problems are of many different kinds and degrees and should be examined and dealt with in light of specifics. Likewise, it was apparently thought in some quarters that we would find fault with the concept of self-regulation and would suggest drastically curtailing its role. Instead, our Report points out many respects in which self-regulation has not fulfilled its potential and where its role ought to be enlarged, subject always to necessary residual powers of government. This, too, is mild as compared with the far more drastic alternative of turning away from the concept of self-regulation.

These are some of the more obvious places where the quick answer to a problem, but not necessarily the sound one, might be the simple and drastic one -- "cut it off" or "chop it up" or "put it away." It is as if one were to look at some of the problems besetting our cities today -- housing, schools, water, traffic, smog, and so on -- and come up with the answer "Let the people go back to the farms." There are also many problems in the securities markets today and, singly or collectively, they are important and serious, but most of them are not simple. Our total Report will contain not three or four drastic remedies but 100 or more separate recommendations adding up to a major program of

reform. In my opinion, the reform is needed no less because we suggest applying a scalpel in 100 separate places rather than a meat axe in three or four.

I do not mean to say, on the other hand, that we have necessarily come up with exactly the right answer to everything so that any departure from what we have said will mean that we have studied and reported in vain. On the contrary, even though we are confident of the essential soundness of our conclusions and recommendations, it would be no less than a miracle if the Report were received in all quarters with a unanimous chorus of agreement on everything. We are covering a great deal of ground and dealing with many complicated and controversial subjects. We have applied all of the knowledge and judgment that we could muster to suggest proper answers, in some places quite sweeping or far-reaching and in others quite specific and limited. In total scope the Report is neither drastic nor mild; it is merely our judgment of the most suitable remedies for a variety of disclosed weaknesses and problems of various degrees of seriousness.

In its transmittal letter to Congress dated April 3 the Commission addressed itself largely to the legislative recommendations of the Report. These have, quite naturally, received most attention in the press coverage and industry comments to date. Those who have had occasion to look at the Report itself will know that the legislative recommendations are but a fraction of the total. On subject after subject, including some of the most important, implementation of the Report calls for action quite outside the legislative area. Thus, apart from the legislative program that is receiving the earliest attention, the Report provides a large and urgent agenda for the Commission and the industry in the months immediately ahead, and it also opens up many areas for discussion and planning for the longer future. I cannot hope that everyone will be in complete accord with everything we say, but I hope that the Commission will have the constructive assistance in facing the many questions that need to be faced.