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THE STEPCHILD

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COMMISSIONER

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Securities and Exchange Commission

As a result of an endeavor that has gone on for almost 41 years, the United States has built an enviable structure of regulation of securities markets and those who participate in them. Starting with regulation of the disclosures that attended distributions of securities, we have extended this regulation in many directions: by means of the 1934 Act, the activities of the securities industry, the conduct of the exchanges, information in the secondary markets and the conduct of insiders have all been effectively regulated. Through the Investment Company Act of 1940 we have developed an embracive – in the eyes of some, a too embracive – system of regulation for investment companies.

The only area in which our regulatory efforts have been deficient I think is that pertaining to investment advisers. This is an opinion that is shared by an enormous number of people, users of the services of investment advisers as well as providers of those services. Recent figures indicate that there are approximately 3,059 registered investment advisory firms managing approximately $260 billion. Furthermore this part of the securities industry has been growing with speed. As recently as 1969, there were only 1,343 registered investment advisory firms and it was estimated they had under their management about $130 billion. Notwithstanding these impressive figures, the regulation of investment advisers has always been a matter of secondary importance, a stepchild in the whole process of securities regulation.

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In a sense, perhaps, this is the consequence of the origins and administration of the Investment Advisers Act. It came into being on the coattails of the Investment Company Act of 1940: it was Title II of legislation of which the Investment Company Act was Part I and, in Professor Loss' words, "…it followed a brief supplemental report on investment advisers which the Commission had filed as an incident of its investment trust study." The legislative history was singularly more limited and less informative than that which accompanied the Investment Company Act of 1940. It appears that virtually every comma and period in the Investment Company Act was the subject of controversy and discussion, while relatively little attention was lavished upon the Investment Advisers Act. Clearly it was the felt need for better regulation of the investment companies that gave rise to the statute in the first place and it was something of an afterthought that investment advisers were included in the legislation.

This pattern has continued ever since. The statutes have tended to be administered together and most of the endeavor has been directed towards the investment companies. For example, at the present time of the 65 people in the Investment Management Regulation Division of the Commission, only 6 are clearly identifiable as concerned primarily with the administration of the Investment Advisers Act. While it is recognized that the securing of any modifications of securities legislation is a prolonged, uncertain process, it does seem that in the case of the Investment Advisers Act, this tendency has been carried to something of an extreme. In 1945 four proposals were made for amendments to that Act. A mere fifteen years later two of the four were adopted and for the first time there were affirmative requirements that investment advisers maintain certain books and records, the Commission was given the right of inspection, and Section 206 was brought into closer conformity with the conventional antifraud provisions that were in the 1933 and 1934 Acts.

It is not only legislative change that is slow coming; the same can be said of rule changes. Rule 206(4)-3 which would have effected significant changes in the format and content of written recommendations and other communications by investment advisers has lingered on the shelf as a "proposed rule" for some seven years now and has neither been adopted nor withdrawn. After this extended wait the staff is now ready to dust it off and take another look at it. I think it is their intent, due to the long lapse since attention was focussed upoh this and changes that have occurred in the manner of doing business, to recommend that it be put out for further comment.

Perhaps the secondary position of this legislation is best evidenced by the fact that in the second edition of Professor Loss' masterful treatise on securities regulation, out of a total of 2,199 pages, 25 are devoted to the Investment Advisers Act.

There are signs that this relative nonconcern for this area of regulation may be ending. Commissioners at various times have indicated to the staff and public their concern with the relatively weak regulation in this area. In 1973 Commissioner Hugh F. Owens spelled out clearly his concern with the quality of regulation of investment advisers and urged legislative reform that would deal with qualifications, conflicts of interest, financial responsibility and bonding. In November of last year I reiterated these themes publicly in Milwaukee and other Commissioners have also evidenced desire and concern in this area.

The staff has responded to this. Among other things the Commission recently proposed for comment a comprehensive regulation that would establish far-reaching and highly significant standards of disclosure by investment advisers with regard to their qualifications, methods, services and fees. In my estimation this proposal, if adopted, can have tremendous impact upon the manner in which investment advisers' business is run in this country. We have long known that disclosure alone can accomplish great things in upgrading the quality of performance, in deterring unwholesome practices and in bringing about change. I for one am extremely hopeful that if the Commission pursues a course of expanded disclosure, we may find investors responding to this additional information concerning the competence of those who hold themselves out as investment advisers, favoring those who clearly have the edge because of training or experience or methods used.

The Commission's staff has made an extensive survey of its powers under the Investment Advisers Act of 1940 and the limitations on those powers. While amendments which have been made, such as the amendment in 1960 which gave the Commission the power to define, and prescribe means to prohibit, fraudulent, manipulative and deceptive acts and courses of business, provide significantly greater opportunities for action by the Commission than existed previously, nonetheless I think it is evident from this survey that the Commission cannot do all that must be done to accomplish effective regulation without legislative changes.

If the Investment Advisers Act is to be strengthened, it seems to me there is no better time to do it than now. Individual investors have in the last four or five years taken a tremendous shellacking in the market, regardless of the medium through which they made their investments. Investment companies have suffered sharp declines in the value of their portfolios; banks have done no better; even very conservatively managed portfolios have suffered sharp declines. While no accurate figures are available comparing the performance of individually managed portfolios and those managed professionally, I think that any such study would indicate that, disheartening as the performance of professionals has been, it was better than the results achieved by untutored, untrained amateurs who tried in a couple of hours a week to achieve better performance than professionals who made investment analysis a lifetime occupation, who had been trained specially and who had access more readily to literally mountains of information concerning not only individual issuers, but broad economic and industrial trends. I think many of those investors, gazing at the shambles of the portfolios for which they once held high hope, may realize the difficulty, if not the impossibility, of matching wits with professionally managed money in the marketplace.

There are those who would suggest that there is no rational way of investing, that the dartboard approach is as good as any, that the market is essentially erratic and random and no one, regardless of training or skill, can discern better than another what its movements or the movements of any security are likely to be. I totally reject that concept. Perhaps my rejection is based less upon rational considerations than the simple belief that all of the training which investment advisers have enjoyed, all of the efforts that they expend daily in analyzing the course of the world's and the nation's economy, the trends in industries, the performance and future prospects of some 10,000 publicly-held companies, counts for naught and weighs not a wit in the scale of performance. Although theory indicates that in an efficient market the market at any given moment will reflect all of the information in the marketplace, there is also solid evidence that market reactions do not occur immediately but rather there is a time during which the information is filtering into the marketplace and reflecting itself, not in one sharp movement, but in a trend. The time period during which this assimilation occurs may not be long, but nonetheless those who are in a position to receive the information quickly and act upon it promptly, will obviously be advantaged over those who catch up with it two or three days later. The fact that the professionals are in a constant cheek-to-jowl relationship with this abundance of information alone gives them an advantage denied to the average person who cannot have a Dow Jones broad tape in his office or constant telephone contact with innumerable sources of insight and information.

I would suspect that many of those who wish to be participants in the securities markets, but who have suffered severe jolts in the last few years, may return but with a heightened realization of the hazards of investments in equities and a belief that they would be better served by the market if they used the professional resources available to them. Consequently, I believe that the amount of money under professional management will in the years to come continue to grow, if anything, more rapidly than it has in the past. If this prediction is correct, then in my estimation it becomes a matter of some urgency that action be taken promptly to assure that the integrity and the quality of the counsel that is received by American investors as they turn increasingly to professional assistance be considerably higher than it is today.

There is a wide scale realization of the deficiencies of regulation in this area. Professionals in the business recognize the extent to which they are the victims of unfair competition from people who are not qualified, who do not abide by any professional standards, who are more notable for their ability at self-exploitation than they are in giving sound investment advice. Notwithstanding the understandable reluctance that the professional organizations in this area have about the intrusion of the federal government into the regulation of their affairs, nonetheless there are many who increasingly see this as the only salvation, and even among those who do not believe that federal intervention is necessary or desirable at this time, there is a realization that some strengthening of the regulatory process, either through state legislation or self-regulation, is a necessity.

Efforts at reform without further federal involvement have basically taken two forms: efforts at state legislation and efforts at self-regulation.

The New York Society of Security Analysts, a chapter of the Financial Analysts Federation, last year sought to secure the enactment in New York State of legislation which would provide for the voluntary registration of analysts, the establishment of standards of practice and a code of ethics and a mechanism for enforcement. This legislative endeavor had its origins in the fact that a very high proportion of the analysts in this country are employed in the state of New York. The proposed legislation would have contained provisions which would grant reciprocity to analysts operating in other states under certain circumstances.

As might have been expected there was considerable criticism of this approach. To many, including me, it seemed anachronistic, at a time when our economy is increasingly national, even international, to seek effective regulation through the medium of legislation in a single state. Advisory services are used throughout the country; an adviser's conduct may have impact far beyond the boundaries of a single state; many advisers have clients in many states. Why, the critics ask, should we revert to a pattern of regulation that in so many ways has been proven to be inadequate? There has been talk among accountants that there should be national licensing instead of the hodge-podge that presently exists. Through Professor Loss' securities codification effort, progress is being made through a proposal for federal preemption in eliminating some of the duplications in the disclosure area imposed by federal and state regulation. While there is indeed a legitimate role for limited cooperative regulation in the states, nonetheless it strikes many as completely contrary to wholesome trends for one state to set up a pervasive system of regulation in one state with the expectation and hope that it will forestall action at the federal level.

A straw vote was taken among analysts in the state of New York on this proposal and they voted rather strongly against it; however, there are signs that this endeavor is not completely dead and conceivably at some point it may resurface.

The other major effort which has been made to regulate more closely the activities of analysts has been self-regulatory. The Financial Analysts Federation through the Institute for Chartered Financial Analysts has developed an increasingly sophisticated program, including comprehensive and, I am told, difficult examinations which, successfully passed, can lead to the right to place the magic initials "C.F.A." after one's name. In addition, there is developing an increasingly demanding code of ethics and a means of enforcing it. I would not denigrate the earnestness or sincerity or even the effectiveness of these endeavors, but the principal deficiency is clear. The most that this approach can do is regulate the use of the "C.F.A." designation. If an erstwhile adviser is indifferent to those initials and if he is able to divert the attention of clients and would-be clients from them and what they mean, there is no way for this program to upgrade his performance or disadvantage him if he strays from the ethical path. Furthermore it seems to me that there are significant perils in the course that is being pursued by the ICFA. At some point, as it moves to more effective regulation, it appears evident that it will be met by charges of overreaching, unfair discrimination and ultimately antitrust violations. With the only penalty the removal of the initials, and no way to effectively prevent an investment adviser from plying his trade after running afoul of the ethical prescription of the organization, its effectiveness must necessarily be less than for instance, the situation with respect to brokers and employee of brokers who can be effectively removed from <u>any</u> participation in the industry by appropriate Commission or self-regulatory action.

With neither of these a satisfactory solution to this urgent problem, the remaining course available, and the one which I believe should be followed, is clear: a strengthening of federal regulation, albeit perhaps in association with self-regulation.

It is easy to be deluded into thinking that this is a simple or easily accomplished solution. Any significant strengthening of federal legislation concerning investment analysts is studded with problems. For one thing, how far should it reach? Should it go into the offices of banks and compel that bank employees be qualified? What of brokers-dealers? At the present time there is an exemption under the Investment Advisers Act for broker-dealers whose investment advice is incidental to the performance of their tasks as broker dealers and who do not receive any special compensation. Doesn't this express a gross over-simplification, namely, that analysts employed by broker dealers do not need the sort of regulation, limited though it is, that pertains to investment advisers? If a system is developed that involves tests for competence, shouldn't the employees of broker dealers who engage in the business of giving advice be just as susceptible to these judgments as those who operate independently? Similarly, what about the analysts employed by an insurance company who may never have any direct contact whatsoever with anyone other than the portfolio managers of their own companies; should we rely upon the management of the company to determine the competence of its employees, or should these people too be subject to a pervasive and comprehensive system of regulation? Obviously if an effort is made to regulate employees of banks, insurance companies and other entities which are subject to other regulatory bodies, the sort of controversy that has attended the recent legislation in the Congress will reemerge. Quite understandably entities already subject to stringent regulations are reluctant to have not only new regulations, but even more important, a new body regulating them. And in some cases it may appear that the proposed new regulation by a new body may hamper or interfere with or overlap the regulation already existing. Thus a very serious problem of defining jurisdictions and responsibilities lies ahead in developing any legislative program.

On the other hand, if more vigorous regulation were confined to investment analysts who operate apart from entities such as banks, broker-dealer firms, insurance companies and so one, then those subject to the new scheme of regulation might well contend that they were the victims of unequal, inequitable and unfair regulation. For myself, and I say this without being able to prove it empirically, I am convinced that the principal abuses which may exist in the area of investment advice are associated with those who hold themselves out as investment advisers and who have direct relationships with the public; at least it seems to me this is where complaints most frequently originate.

Another difficulty is that no system of regulation can properly or effectively control the exercise of judgment. I have frequently received criticisms of the regulatory scheme pertaining to investment advisers which really faulted not so much the regulatory scheme as it did the judgment of analysts. It may well be that to some extent these lapses of judgment may be reduced in number and severity if more stringent requirements with regard to suitability, reasonable bases for recommendations, and training and experience were adopted and enforced. However, at best the market is a chancey place and as we have seen clearly in the recent past, even the most sophisticated, knowledgeable, best-educated analysts may misjudge the direction of the economy or the future fortunes of a corporation. No effort at regulation is going to stifle complaints of those who may be the victims of the wrong conclusions honestly arrived at.

Then there is the problem deriving from the diversity of approaches taken by analysts. Should we summarily disqualify an analyst whose performance, presumably for fortuitous reasons, has been outstanding, but whose method consists of palm reading, astrology, examining the entrails of animals? What should we do with regard to the chartists who content that the road to riches lies not in fundamental analysis but in careful plotting of the various idiosyncrasies of the Dow Jones average? It seems to me that any sort of regulatory scheme might bar completely irrational but permit a diversity of approaches, provided the methods used are fully disclosed (as they would be under our pending rule proposal) and provided that the user of exotic techniques has at least an awareness and knowledge of the more conventional methods of securities analysis, the manner in which the securities markets function, and such other information as should be part of the equipment of any analyst, regardless of how bizarre his own methods may be.

And then of course there is the question of how any expanded regulation should be managed. Should it be through the mechanisms of self-regulation or should it be by the SEC (which presumably will be the instrumentality for achieving stronger regulation) directly? I favor the former approach. Despite occasional lapses, it seems to me that self-regulation in the securities industry in this country has been successful. It has been the means by which we have availed ourselves most fully of the experience, the knowledge, the interest, and the integrity of the best members of the securities industry in resolving the problems of their industry. Self-regulation must be coupled with effective oversight by a governmental agency. It is this pattern I would suggest should characterize regulation of the advisory industry in the future. The structure of self-regulation might take any of several different forms. It might consist of legislation similar to the Maloney Act under which associations would register upon approval of their constitutions, by-laws and rules by the SEC and would thereafter function subject to the oversight of the Commission. It might well be that more than one self-regulatory organization would register under such a statute; probably it would be better were there but a single entity. This entity might be a new configuration unlike any that presently exists or, on the other hand, it might be simply an extension and expansion of the ICFA. It seems to me that the ICFA has taken significant steps in the direction of effective self-regulation, moving steadily towards the outer point that can be achieved without statutory sanction and government oversight. It may well be that its procedures and its practices could be easily adapted to whatever requirements might be incorporated in a new statute.

Whatever the entities were, obviously it is important that the scope of regulation reach all those engaged in the activity.

The overwhelming majority of firms engaged in the securities business are members of the NASD not because of legal compulsion, but because of the provision of the Maloney Act which exempts from antitrust law the provision of the NASD constitution which prohibits members from giving discounts to non-members. It is difficult to imagine a similar economic device which might be used to push investment analysts into an organization, and there is a certain repugnance to the idea that anyone should be compelled as a matter of law to belong to an organization, even one that is cloaked with quasi-governmental powers and responsibilities. It may be that the solution to this problem is to establish a parallel regulatory structure similar to that which is called "SECO" and which provides for direct regulation by the SEC of those broker dealers who are not members of any self-regulatory organization. Thus under this approach advisers would have the option of either joining an organization cloaked with self-regulatory powers and responsibilities or being subject to direct Commission regulation in a manner comparable to that which would be done by self-regulators.

Another approach is suggested by the legislation which is now in the process of enactment by Congress with respect to the regulation of municipal bond dealers. This legislation provides for the organization of a rulemaking body appointed by the

Commission and representative of the various participants in the municipal bond trading markets. This body will make the rules governing brokers and dealers engaged in the municipal bond business, with the enforcement of those rules left to banking authorities as they pertain to bank dealers and the NASD and SEC as they pertain to non-bank dealers, with concurrent authority in the Commission to investigate and enforce the rules and the law with respect to banking entities.

It would be well if whatever legislative program is developed was the fruit of responsible cooperation between the Commission and leaders of the security analysts profession. The possibility of this kind of collaboration unfortunately is hampered by rivalries and antagonisms that exist between segments of the profession. It strikes an outsider that the origins of these tensions are obscure, muddled and may be even lost in memory, but nonetheless they endure and interfere unduly with efforts to achieve a sensible pattern of regulation. Inability to reach agreement with regard to the form that self-regulation takes may very well cause the proponents of increased regulation to look more favorably upon direct regulation by the Commission. While in my estimation that would be preferable to the lax regulation that exists now, nonetheless I would find it less desirable, and I am sure that in the long run the analyst profession would find it less desirable, than a structure permitting a large measure of self-regulation. I would urge those who are leaders of the factions of this profession to reexamine the reasons for the gap between them and their brethren, explore means of eliminating it, and combine their efforts to bring about what all of them recognize is a necessity at this time, a more responsible pattern of regulation to eliminate the culprits, the stupid, the irresponsible, the charlatans who damage the reputation of this profession perhaps as much s they damage the finances of the public.

I have suggested the time is right. There is significant interest in this subject in Congress. With the omnibus securities legislation that has preoccupied Congressional committees concerned with securities matters for four years now near enactment and

Presidential signature the time is a good one to ask the Congress to focus its attention on this neglected area. Hopefully any regulatory pattern that may be developed for investment advisers will be framed expertly and well because of the experience that we have all had with the regulation of other segments of the securities industry. Much thought has been given to this subject by responsible leaders of the profession. The Financial Analysts Federation has given extensive consideration to the various means and modes of regulation, as has our staff. I would hope that we may all move together toward a mutually shared goal.