

## A Call for a New Special Study of the Securities and Financial Markets

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# Commentary

## A CALL FOR A NEW SPECIAL STUDY OF THE SECURITIES AND FINANCIAL MARKETS

THE HONORABLE STANLEY SPORKIN\*

We are now entering a new era in the regulation of our financial markets with the appointment of a new SEC chairman. We owe a deep debt of gratitude to Chairman Shad, who, as you know, has presided over the SEC for almost six years. I believe this is a record-setting term for an SEC chairman. I also believe that the Chairman should be congratulated for running a Commission that has accomplished much and has reduced the tension between the regulators and the regulated. He has made sure that our securities markets continue to be the best in the world. Chairman Shad can be particularly proud of the markets' continued high level of integrity and investor confidence. I am prepared to say this despite the recent rash of insider trading abuses and the presence of other trading market concerns.

EDGAR<sup>1</sup> is a most worthwhile project and a great monument to Chairman Shad. The Chairman is also to be congratulated for the Commission's superb enforcement program and particularly applauded for the tremendous strides it has made in ridding our marketplace of insider trading abuses. The Levine and Boesky cases are of a magnitude that have truly enormous implications.

That is the good news. Although our markets are still flourishing and continue to be the best in the world, the securities industry is beset with a myriad of problems that, if not solved, could have a severe impact on the continued viability of our financial marketplace. Of particular concern is the way we are attempting to deal or not to deal with them. In many instances, we seem to be just watch-

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\* United States District Judge, District of the District of Columbia. B.A., Pennsylvania State University, 1953; LL.B., Yale Law School, 1957. This is a revised version of an address delivered on November 21, 1986, before the ABA Federal Regulation of Securities Subcommittee.

1. EDGAR, which stands for electronic data-gathering analysis and retrieval, is the computer system that the SEC plans to use for information filing. The use of EDGAR is expected to reduce dramatically the amount of time necessary for the dissemination of time-sensitive corporate information. Victor, *Will EDGAR Pass Legal Muster?*, Nat'l L.J., Mar. 16, 1987, at 3, col. 1.

ing these problems as they erode the confidence of investors and the integrity of our great system. In other instances, we are dealing with Band-Aid solutions. Much more is required.

I believe the time has come to convene another special study of the securities markets, like the one of some twenty-five years ago that was headed by Milton Cohen. That comprehensive review, which was entitled *The Special Study of the Securities Markets*,<sup>2</sup> has had a tremendous impact during the past twenty-five years in the shaping of our securities markets. But because of the tremendous impact of deregulation and the advent of a host of new problems, we can no longer rely entirely on the solutions offered by the Special Study.

A major part of the Special Study dealt with bread-and-butter issues. Indeed, one of the great accomplishments of the Special Study was to take the first step in integrating the '33 and '34 Act disclosure standards. Issues that were addressed by the Special Study largely included the internal workings of our market system. They pertained generally to our domestic marketplace. The new set of problems is largely external.

At this stage, we are observing the development of a securities market that is truly global in dimension. We are seeing the emergence of competitive markets in both Europe and the Far East. With the communications revolution, it is going to be more and more difficult for the United States to maintain its worldwide monopoly to the degree that it has in the past. We must meet these new challenges in a direct way.

We saw the almost disastrous results experienced by some of this nation's major industries when they failed to recognize the nature and extent of the challenge from abroad. As a result, such basic domestic industries as motors and steel have been ousted from their preeminent global leadership roles. If we don't wake up, a similar fate awaits the securities industry. We are particularly vulnerable since, up to this point, we have been dealing with these global problems on an ad hoc basis and have not been trying to solve them on a broad-range, integrated basis.

The problems are manifold. They range from serious differential disclosure problems to the uneven ability to obtain trading data necessary to assure the market's continued integrity. Without financial and disclosure integrity, our market system cannot continue to command the investor confidence that a properly functioning mar-

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2. *Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (5 vols. 1963).

ket system must have. We also have made little, if any, progress in establishing the necessary investor redress mechanism that a global securities marketplace must have to survive. Investors must be able to redress disputes and grievances promptly and effectively if the market system is to be viable.

We have also taken virtually no action with respect to foreign acquisition and takeovers of major domestic concerns. Indeed, little has been done even to assure the continued domestic ownership of entities necessary to our national defense. These international problems are only a part of the external pressures that our securities markets face.

Back in the Special Study days, many thought that the Glass-Steagall Act<sup>3</sup> meant that brokers were to be brokers and bankers were to be bankers. With the deregulation tidal wave that has been with us over the past six years, we are seeing that competition among markets and players is greater than ever. Here, of course, there have been certain legislative solutions proposed and designed to deal with the relationships among the various financial sectors. I fear, however, that the proposed solutions might be too narrow to deal with the very broad problems that exist.

Just as we can no longer look at our domestic securities markets in isolation, we cannot define the financial marketplace as being comprised only of brokers and dealers. The special study I propose would take a wide-ranging look at our domestic securities markets to determine what the necessary interplay between markets and players should be. The solutions sought must be flexible. We know from experience that rigid standards are no match for those bent upon overriding a strict regulatory system. I am not critical of the tremendous innovation that we have seen over the past five years. To the contrary, I think it demonstrates the great strength of our free market system. But just as we need innovation in the private sector, we need creative thinking from our public officials.

While some take the position that the marketplace should be regulated solely by competition and that complete deregulation is the ultimate solution, I am not prepared to subscribe to that view, at least at this time. It may well be that an additional dosage of deregulation is the answer, but we will not know that until we have the kind of far-reaching exploration of the issues that I am proposing.

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3. 12 U.S.C. § 377 (1982). The Glass-Steagall Act prohibits banks that are members of the Federal Reserve System from owning any entity that is engaged principally in retail securities brokerage. *Id.*

One point, however, is clear: It is going to be difficult to integrate the various worldwide systems as they now exist.

While brokers were lamenting the intrusion of banks into the brokerage business, it now appears that the shoe may be on the other foot. *The Washington Post*, in a recent article referring to the new record high of post-depression bank failures, reported the following:

L. William Seidman, chairman of the Federal Deposit Insurance Corp., which insures bank deposits, also said that deregulation of the banking industry and the invasion of insurance companies, securities firms and others into what used to be the sole preserve of banks will cause more failures in the future.<sup>4</sup>

A number of other pressing problems need to be addressed in a thoughtful fashion. The method of financing takeovers through the issuance of debt securities of less than investment grade needs to be dealt with in order to avoid serious trauma to the system. Whether we describe this phenomenon as mirror or junk bond financing, it needs to be carefully studied. In addition, we are seeing new methods of financing on virtually a daily basis. Now broker-dealers seem to be abandoning their customary, traditional advisory role; they are becoming principals in the takeover battle by providing the financing and, in some instances, taking an equity position. Such activities create only a small part of the many issues arising out of corporate changes in control. Moreover, unlike the past, all corporate enterprises are vulnerable. The Business Roundtable is very concerned over the current trend of more and bigger takeover battles and is considering steps to make our major corporations virtually impregnable to a takeover assault. Some suggest that the proposed cure might be worse than the disease. In any event, where all this will end is unclear.

A new, broad assessment of this entire area is increasingly becoming an absolute necessity. The Commission's Study on Takeovers<sup>5</sup> was fine as far as it went. A broader review, however, is necessary to establish a regulatory mechanism that is able to adjust itself as new problems emerge—problems such as the silent takeover, which is epitomized by what recently happened at one major

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4. Rowe, Jr., *Four Added Bank Failures Set Post-Depression Record*, Wash. Post, Nov. 7, 1986, at A1, col. 3.

5. ADVISORY COMMITTEE ON TENDER OFFERS, U.S. SEC. REPORT OF RECOMMENDATIONS (1983).

concern and which looms on the horizon for other companies. I am not advocating any one particular solution. But I am saying we need to look at the entire takeover mechanism to see what, if anything, is necessary to make the process more equitable.

The study I propose should also take a new look at the entire corporate governance issue. The impetus for reform is no longer being driven exclusively by academia, but is coming, in part, from the corporate community itself. Indeed, the most renowned takeover merchants are rationalizing their existence on the bases that the existing system is malfunctioning and that without any meaningful oversight of their activities, poor managements continue to make poor decisions. In this regard, I invite your attention to a recent *Newsweek* interview with Carl Icahn, the new head of TWA, where the following appears: "In theory, corporate boards of directors are supposed to ensure that management is working in the best interests of the shareholders. But Icahn believes that boards rarely act as a check on poor managers."<sup>6</sup> Quoting Icahn, the article continues:

I was on the board of one company and really it's a frightening thing. I won't say which because I made a lot of money with it. They used to have board meetings at 8 in the morning out in Cleveland. Here's what goes on. Literally, half the board is dozing off. The other half is reading *The Wall Street Journal*. And then they put slides up a lot and nobody can understand the slides and when it gets dark they all doze off.<sup>7</sup>

"Bloated, risk-averse, inefficient and unimaginative" are recent words used to describe American business management.<sup>8</sup> Many would think that these are the words of a Ralph Nader—they are not. They were the comments of the Deputy Secretary of the Treasury.<sup>9</sup> And recently a news account of a speech by the late Malcolm Baldrige, Secretary of Commerce, reported:

American industries have "lost ground to foreign competitors because of shortsighted management."

"We were simply outmanaged," said [Secretary] Baldrige . . . "Most of all, we lost our reputation for quality when we had been the world's leader. There is no excuse for that and there is no one to blame but American man-

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6. *Confessions of a Raider*, NEWSWEEK, Oct. 20, 1986, at 54.

7. *Id.*

8. Rowen, *U.S. Official Raps Business Executives*, Wash. Post, Nov. 8, 1986, at G1, col.

2.

9. *Id.*

agement—not labor, not the government, but management.”<sup>10</sup>

In the corporate governance area, we must also carefully study whether abandoning the one-share, one-vote principle might not be a regressive step. There has been much discussion as to whether we are so interested in short-term performance that we have squandered the future of many of our outstanding industrial concerns. We need to examine closely this extremely important issue and, if true, to come up with curative measures. The professional liability insurance crisis brought about by the continued explosion of corporate litigation and suits against accountants and other professionals is another issue that requires thoughtful consideration.

The internal mechanism of the marketplace certainly needs a fresh look after twenty-five years. Especially is this so now that we are on the verge of inaugurating twenty-four hour trading markets.

We are now seeing the emergence of new products on almost a daily basis. Years ago many market experts were somewhat leery about the advent of trading in options on securities. Now we have not only trading in options on securities, but we have trading in all kinds of variations of options. Indeed, we even have trading in options on stock indexes without an underlying security for sale. The distinction between trading in commodities and trading in securities is thus becoming blurred. Program trading is another new phenomenon that needs careful study. These various new trading vehicles have had a tremendous impact on the marketplace. Whether they serve investor interests in any meaningful way has not been determined. Some believe the marginal benefits they produce are far outweighed by the detrimental impact they have on the marketplace.

We must obtain more knowledge of the entire marketplace and what the market system of the Twenty-First Century should encompass. Is it better to have trading markets that are unencumbered by all these satellite markets, or should we continue with the present virtually unorganized markets? In other words, do we continue with a system in which, as they are invented, new trading vehicles continue to be appended to the present trading market apparatus?

One of the virtues of our free enterprise system is the innovation that it spawns. Sometimes, however, an inordinate price must be paid in order to realize the full potential of our free market system. For example, virtually every time a new product is introduced,

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10. Auerbach, *Baldrige Joins Attack on U.S. Firms*, Wash. Post, Nov. 13, 1986, at E1, col. 2.

the so-called pack syndrome comes into play, and we soon find ourselves surrounded with untold numbers of variations of the same product. This leads to an oversaturation of the marketplace, with attendant adverse consequences.

Another important area that needs to be examined is the relationship between our national market system and state regulation of securities. While I have always believed the states have a meaningful role to play in the regulation of our securities markets, the time has come to determine precisely what that role should be and how we can remove from our capital-raising mechanisms unnecessary regulatory impediments. Duplicative regulation can have a severe impact on our ability to raise new capital efficiently.

The tension between securities and futures trading is on the increase. The regulatory oversight of the interplay of these two markets is inconsistent and, in some instances, nonexistent. There is a real need to reexamine the respective roles of the SEC and CFTC in this important area.

The proposed study should also look at certain enforcement issues, such as the appropriate resource level for the enforcement program and the allocation of the enforcement workload among the self-regulatory bodies, the states, and the SEC. In addition to looking at how we can better deal with insider trading abuses, the proposed study should also review the various financial debacles that have taken place over the past decade in order to see what lessons we can learn from them and what new enforcement weapons are needed to prevent their recurrence. The better use of automation in market surveillance and in disseminating corporate information should also be a key part of the proposed study.

The appropriate role of risk arbitrage in the marketplace has not been fully circumscribed. Indeed, some have questioned the propriety of the methods and techniques used in this process. In any event, a close examination of this important market function is long overdue. This is particularly so in view of the recent events as they pertain to the market game *du jour*, which I call GreedGate.

New forms of credit extensions and expansions of existing techniques need examination. This would encompass a close look at the expanded use of repurchase agreements, the explosion of new offerings of mortgage-backed securities, and the distribution of other wrap-around debt instruments.

A broad-based study of the financial markets, as proposed, can be an extraordinarily exciting and immensely worthwhile project. The main purpose of such a study would not necessarily be geared

to finding solutions for all of these problems. Rather, the study would be considered a tremendous success if it merely disclosed how the markets are affected by the internal and external factors now in operation. I would hope that this proposal would be well received by both the Commission and its Oversight Congressional Committees. We all learned a great deal from the 1962 Study. It was a great effort and has proved to be of tremendous assistance both to regulators and market participants. A new study, at this time, should have a similar impact in shaping the financial markets for the next twenty-five years.