QUESTION AND ANSWER: SECURITIES/FUTURES EXCHANGES

CHAIRMAN JAMES: I'd like to open it up for discussion at this time. I'll start down here with Commissioner Bible.

COMMISSIONER BIBLE: For Dr. Ruder, how does the securities industry police its advertising practices to make sure that its advertisements are not marketing to people who may not be financially able to undertake that kind of an investment? I'm thinking of Money magazine being available, all the ads in the Wall Street Journal, things of that nature.

MR. RUDER: The sales literature which goes out from a brokerage firm to its customers is carefully regulated by the NASD. The brokerage firm is required to look at that sales literature to see that it does not contain misleading statements. There are very strong disciplinary actions enforced by the SEC and the NASD against misleading sales literature. There is no general requirement dealing with advertising in that same sense, but again, a brokerage firm would not be advertising in a magazine or newspaper in a way which violated those sales literature requirements.

COMMISSIONER LEONE: Can I just make a comment, that one of the other differences with regards to the regulatory structure is that people can bring action based on having been mislead or not having been fully informed of the risks. And companies, not just individuals, institutions can recover damages and recover money. So the fact that there is a body of law and a recognized procedure provides another deterrent for people who might be inclined to slip something by the SEC or by the
securities dealers or others. These kinds of cases on any given day, I wouldn't guess how many of them are floating around. They're not uncommon. They're common. There are mostly settlements and other things. But in addition there are arbitration procedures so that they don't go to the Courts.

In other words, there are sanctions beyond just those by the organizations or by regulatory authorities. It's a well recognized right the investor has or a speculator even to recover -- actually the speculator is a better example in this context -- if they weren't properly informed of the risks, when those requirements are in place for that particular person, whether it's an individual or an institution.

CHAIRMAN JAMES: Would either of you know of any particular data that exists on how effective disclosures have been in terms of screening out those individuals who may have gotten themselves in trouble?

MR. RUDER: I don't know that there is a set of statistical data justifying the disclosure system. It is so well accepted in the securities industry that the SEC has developed an entire apparatus around it; that is, the disclosure of information regarding companies. Every public company is required to disclose annually practically everything about them.

CHAIRMAN JAMES: Not only that, but disclosing risk, potential risk.

MR. RUDER: I don't know of any statistical analysis of that, although the ad hoc experience is that in the so called penny stock area there has been tremendous over-reaching with the result of both legislative and administrative reform efforts.
MR. HARRIS: I don't know of any statistics. Periodically the disclosure system is subject to review and there have been through modern times severe critics of the entire disclosure system on the simple grounds saying that this kind of information would get out under any circumstances and that it is really unnecessary for government to enforce the kind of disclosure standards that they have. As David points out, the general prevailing wisdom is, I think, that disclosure is beneficial and at least it's not in any way hurtful. Whether in fact, to just look at that pamphlet on the options market, whether in fact investors do read the 35 pages of the risks associated with investing in options or if those that do needed to read it to begin with, I don't know. One has to question whether in fact one needs 35 pages to tell someone of all of the risks that are involved in a particular activity, and if you do, whether that's going to be effective. That's as far as I could go.

CHAIRMAN JAMES: Perhaps just because it's 35 pages ought to send signal enough.

Commissioner Wilhelm and then Commissioner Dobson.

COMMISSIONER WILHELM: I very much appreciate the two of you coming here. I appreciate Commissioner Leone helping arrange this. I have either the advantage or disadvantage of being a complete lay person in all of this. I don't gamble in the markets, nor do I gamble in casinos. But I must say that as a lay person as well as a representative of workers, it seems to me -- I certainly wouldn't argue with your last statement, that at least all this disclosure stuff is not hurtful, or at least I think it wouldn't be. It could be hurtful if it leads people to
believe that everything is kind of protected and it really isn't. But I would think, for some of the reasons you just cited, that there are not a whole lot of people who actually understand the degree of risk to which they are subjecting themselves because the disclosures are so complicated. I wouldn't have gone so far until my expert friend to my left said earlier that on the Brady study they discovered that people in high ranking positions in the securities field didn't understand the risks either. I didn't know that. That's a somewhat stunning statement.

If all of that disclosure works, I would have thought that at least the people running the system would have understood it. I'm not trying to be facetious. When you just look around as a lay person, the people of Orange County are about to pay $2 billion because of derivatives. I bet you there's not 1,000 people in America who can explain derivatives accurately.

CHAIRMAN JAMES: And two of them are here.

COMMISSIONER WILHELM: Well, two of them are probably here. Millions of people in California and probably other states buy things called guaranteed investment contracts to protect their retirement which is not remotely guaranteed. Workers, as Commissioner Leone observed, a lot of the funds in which workers' money is invested trail the indexes all the time.

So I'm puzzled by what it is that disclosure actually accomplishes other than possibly a false sense of security. I would suggest as a lay person the possibility that people who gamble in gambling places, as distinguished from gambling in commodities -- again, I'm stunned when Commissioner Leone says the overwhelming majority of individual investors lose money in a
commodities market. That's an amazing statement. I bet you most of them don't know that, despite the disclosure rules.

I think actually people would go into gambling establishments of the kind where this Commission talks about, probably do have a much better idea of the odds than people in the markets. I think people know that they're probably not going to win. I think most of them don't have a statistical understanding of the odds but I bet you that they have a general idea that they're probably not going to win, at least as much as people who go invest in the kind of markets you're talking about.

With that kind of background, here's my question. Given the enormous amount of mistakes that happen and money that is lost in spite of all of these disclosure rules and given -- if I'm right, and if you disagree please say so -- given that the majority of individual investors probably don't actually understand the risks despite all these securities rules and apparently people that run the business don't either, according to Commissioner Leone, I wonder if a form of regulation that looked into the suitability issue and skill and integrity of the people who run the markets and the investment firms, which is the kind of regulation gambling has, might not be at least as effective.

MR. HARRIS: First, a couple of things to just put this in context. First, I think when Commissioner Leone said that most individual investors lose money, he's talking about the commodities market, not the securities market.

COMMISSIONER WILHELM: Yes, I said that.

MR. HARRIS: So it's important to recognize that when people are in the stock market, when they're buying stock, normal
stocks and bonds, what people have put their pension savings in or their retirement accounts in or invests in, most people don't lose money. Most of the disclosures that we've been talking about with respect to the risk in that market, I think are well understood and have been very effective.

There are what I would call relatively new kind of investment or speculative products which I've been trying to call your attention to, which are the options and futures and these derivative products. I think it's important to recognize that all of those products are relatively new on the scene.

We're trying from a regulatory point of view to get our hands on those. I think that probably people will have to lose money before their risks are fully understood and get out generally known. I think you're right that people understand when they go into a gambling casino, they may not know exactly the odds, but they certainly know the odds are against them.

I think that people generally are beginning to learn the complications and odds that are associated with options or futures or derivatives. But I think it's unfair to suggest that the regulations have been ineffective or not useful, largely because these products are so new and so complicated that we're just learning how to regulate.

MR. RUDER: Could I respond in a slightly different way? The disclosures to investors are effective because this information gets out into the marketplace and financial analysts read it. There is a good system for transmission of valuation of particular stocks that comes through the recommendations made by financial analysts.
What strikes me in the gambling industry is that there is information about the odds of any particular gambling instrument which is available to the people who are selling the product. I heard this morning on the radio as I was coming down that Powerball has a $175 million jackpot and that people all over the area are racing to invest and one of the statements made was do they realize that their chances of winning are one in 80 million. Well, they probably realize the chances are small. To me, if that information is available, it ought to be disclosed to the potential buyer.

If the odds at the craps table are a certain kind or the blackjack table are a certain kind or at any other form, slot machines or any other form of gambling, I don't see why the gambler couldn't be told that the chances of getting a certain amount of money back for every dollar put into one of these gambling areas is such and such, 80 percent or 60 percent or 30 percent, whatever it might be. Then at least those people would have some idea of what they were risking when they were gambling.

COMMISSIONER LEONE: Let me just make a point here to clarify something. There is not decisive but compelling and consistent evidence that small investors over-estimate the risks of the stock market and invest more conservatively than is in their own interest. I won't go into a lot of the factors in that, but I think that there is evidence that the risk in the stock market, in fact, for a variety of reasons, is in people's heads as greater than it is, although it's obviously real. Whether that's a result of disclosure or the rules or whatever, I don't know. And this is why the Treasury Department is interested in our looking at bankruptcy.
There's also some serious thought being given by some serious academics to whether gambling as an alternative to investing is reducing savings and investment, which is paradoxical, because I don't think it's because people don't know that gambling is more risky than the stock market. But it's plausible that if one were confronted by two highly risky investments, one of which paid 80 million to one and the other one might grow ten percent in the next three years, that you might be tempted to take a riskier course with your discretionary money. I don't know.

Anyway, I think that the reason this is important is that we do know that disclosure affects behavior by people in the industry and by their customers, and suitability affects both.

CHAIRMAN JAMES: Commissioner Dobson.

COMMISSIONER DOBSON: Dr. Ruder, I saw that same news story on NBC this morning and was amazed by it. One in 80 million odds and yet people were lined up at 4:30 and 5:00 in the morning to buy a Powerball ticket. It's obvious that disclosure has not had much of an impact on those folks.

But let me make kind of a general statement and ask either of you to comment on it. Maybe I'm stating the obvious from what you said, which I really appreciate and found informative. As the federal government has a responsibility and interest in protecting the uninformed, the unqualified, the ignorant, the mentally deficient, those who might be exploited through inappropriate investment, if that's at one end of the continuum where government takes an interest in protection of individuals, the lottery seems to me at the other end of that continuum where government profits from exploiting those same
people. It's the opposite approach to the individual who is a
sucker perhaps, those not able to sustain that kind of
investment. Is that a correct assumption?

MR. RUDER: I would join your assumption there,
although if you look at the lottery, one is really talking about
a form of taxation. The people who are placing their money in
the lottery are doing so in a situation in which a portion of
that money is going back to the very state who are conducting the
lottery and to the municipalities who are reaping benefits from
it.

But it seems to me that there is some room for
protection at least to disclose to the people what the odds are
that their lottery bet will be successful.

On the other extreme, I just want to point out that
in the securities industry the primary tool is disclosure. The
suitability doctrines have been invoked primarily in situations
in which someone is recommending the purchase of a security, so
that there's no blanket prohibition against people engaging in
risky stock purchasing or even pseudo gambling activities in the
stock market. But what there is, is prohibitions basically
against somebody recommending this activity to somebody who is
not capable of bearing the risk. That's the area that I think
you really ought to be looking at a little bit at least.

COMMISSIONER DOBSON: Is it a stretch to say that
lottery advertising sponsored by the state is in fact a
recommendation?

DR. RUDER: I believe it is. I may be more radical
on this view but I believe that the advertisements for lotteries
in this state, the ones that I hear, are totally one-sided. They advertise all the benefits and none of the risks.

CHAIRMAN JAMES: Commissioner Wilhelm.

COMMISSIONER WILHELM: I had a non-monetary bet with myself, how long it would take Powerball to come up this morning. I must say I do not understand the theory that there's something reprehensible about a person spending a buck on the chance they might get hit by lightning as distinguished from a cup of coffee or a New York Times or something like that. Everyone has their own little ways of spending a buck.

I wish I had time to engage you in more debate here about things, for example, like Orange County which continues to amaze me. We don't. So I wanted to ask you a question that might potentially help us with your experience on the subject we want to look at tomorrow which is Internet gambling which is exploding, gambling of the kind that we're studying, not the kind that you study.

I have read some anecdotal accounts of extraordinary movements in the stock markets, especially the penny stock markets, driven by, quote, "information," unquote, that is broadcast on the Internet in ways that are completely unregulated and come from whoever chooses to put the stuff up there.

I wondered if there's anything that either of you is aware of that relates to the question of regulation and disclosure about market information on the Internet that might have something to do with our concerns as a Commission about gambling on the Internet, either the difficulty of regulating it or some other aspect of it.
MR. RUDER: We both have an answer, but I'll let Al answer first.

MR. HARRIS: Quickly, it is regulated in both the securities and futures area but having said that, I think your last statement is the most important. It is very difficult to regulate it. Just because it's on the Internet doesn't mean that it is subject to different rules with respect to fraud or disclosure or advertising that David mentioned. Those rules are there. What is difficult for both the CFTC and the SEC is to identify who it is that may be responsible for putting things out on the Internet and to finding them, stopping them or otherwise.

The SEC has a very, very active fraud team working on Internet fraud and puffery of stocks and those kinds of issues. I think that new medium is just simply one in which both of those agencies are trying their best to get their hands around. But it's not because they don't have authority or jurisdiction or the rules don't apply.

MR. RUDER: That's exactly right. The SEC has some 20 people scanning the Internet every day to look for fraudulent and misleading advertisement. We're just looking at a different medium for what goes on every day in the country, and that is that there are very, very greedy dishonest people who are trying to take advantage of the citizens. And the SEC and the CFTC are both attempting to protect against that activity.

CHAIRMAN JAMES: COMMISSIONER McCARTHY.

COMMISSIONER McCARTHY: Professor Ruder, could I just quickly go through your three recommendations? We've touched a little bit on the first one regarding disclosure and I was trying to think of what kinds of disclosures might be appropriate.
Certainly the odds. The state run lotteries ought to be at least saying what the odds are on winning or not, although I think everybody has a general sense. In something like the lottery, the odds indeed are very, very long. But it still could be useful.

I was thinking in a casino you could probably hand material to somebody that would say if you play the blackjack table, the odds on this kind of a bet are 50 percent, this kind two percent, whatever it might turn out to be.

Now, what other kinds of disclosures occur to you that might be appropriate for the different forms of gambling?

MR. RUDER: My own view would be that they would be quite general. There would be one quite generalized disclosure that said you should understand that this is a risky business and that the odds are that for every dollar you put in you will receive less than a dollar. Then in cases where that information is known about a particular activity, you include that.

The SEC has a booklet for investors which it recommends be given to investors which contain a lot of general advice about investing and what you should know before you invest. That kind of pamphlet could be prepared and made available in the gambling establishments.

COMMISSIONER McCARTHY: As I understood the earlier conversation, you suggested that good disclosure information has some efficacy. I'm going back now to the exchange between you and my friend John Wilhelm over there. But disclosures also have much more meaning if indeed there is some governmental entity to enforce any kind of serious violation of the disclosure requirements, and that's why the SEC is as I think you both
referred to earlier, is effective. You have some standards. The
disclosure sets some standards for conduct by those running the
gambling, whether it's a race track or lottery or casino,
whatever it might be and if those standards were at least
blatantly infringed, then a lawsuit might be brought. That's
what works coupled with the disclosure. Is that what I heard you
say earlier?

MR. RUDER: I think you need to distinguish between
fraud and misrepresentation, that is, lying which is actionable
under the laws of most states under the general law and the
failure to make a disclosure which is required to be disclosed.
That's usually not something which the private citizen can
enforce. So you need some agency.

I may just point out that we have state securities
regulators who enforce state laws in the securities area as well
as the federal.

COMMISSIONER McCARTHY: Turning to your second
recommendation, don't allow gambling activities to advertise to
prospective gamblers who can't bear financially any kind of
serious loss. How would you define a person who cannot bear a
financial loss? What even general criteria at this point? How
would you get at that? How would the gambling establishments
know that unless of course they have a credit line with the
facility or they often use their credit card facilities?

MR. RUDER: The best I can do in that regard is by
analogy to what we call the intra-state offering in the
securities area in which offerings can only be made lawfully to
residents of a particular state. In those cases the
advertisements say this offer for the security is made only to
the residents, say, of Illinois and not to others. It is to me a very difficult question to figure out who you would advertise to and who you would not, but I could imagine some kind of advertisement that included cautionary language that said this activity is harmful to your financial health and you should be aware of that if you are planning to engage in the activity.

COMMISSIONER McCarthy: Now, the third recommendation you make, consideration should be given to finding ways to protect those who are either financially unsophisticated or unable to bear the risk, such as restricting access to gambling establishments. How would those who manage gambling establishments be able to identify such people?

MR. RUDER: I don't have great detail about this, but the English system requires a membership in the gambling establishment in order for the person to be able to enter the establishment. And presumably there are some criteria for membership which would allow the gambling casinos to screen those people that didn't meet those standards.

COMMISSIONER McCarthy: Thank you. One final question, not about your recommendations, but something that's been concerning me as we went through these meetings is how credit is handled with people. We're studying pathological or problem gamblers, people for whom it's a compulsion or an obsession to gamble. The fact that there are credit card machines just a few feet away from the gambling tables and so on, make it easier, that there are indeed now publicly traded companies dealing in the credit card market with a number of gambling establishments. So it's gone big time.
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Do you have any thoughts about how you would try to control the irresponsible extension of credit? I'm not citing any particular case. I noticed that the Illinois Gaming Board -- we're going to hear this in other testimony -- fined a casino in this state $100,000 for improper extension of credit. Do you have any thoughts about how we get at that? So much gambling is done on credit and we've heard testimony in Atlantic City and I think in Boston that people have gone bankrupt using a number of credit cards. Do you have any thoughts in this area?

MR. RUDER: I don't have any specific thoughts. I will tell you that in the New York Stock Exchange rules they have something called the know your customer rule. The know your customer rule is one form of the suitability doctrine that we've been talking about, but it's also important to know your customer to know his or her credit so that the brokerage firms know their customer in the sense that they know their customer will pay. That's very important for the brokerage industry because we do not want to have a market in which there are great defaults.

I think you're talking about something quite different when you're talking about the credit of those who gamble.

CHAIRMAN JAMES: Commissioner Lanni.

COMMISSIONER LANNI: Thank you very much. A couple of comments actually and observations. One, if I could, Professor Ruder, relative to the United Kingdom, in London there are private clubs and that is a membership requirement. Outside of London, they have a number of larger casinos and there's no requirement for membership. So it's a dual situation for either the private membership in clubs as they call them which are...
casinos, but very small ones in London itself. But outside in other areas of the United Kingdom they have larger casinos which do not require any membership.

One aspect I notice -- and I think disclosure is a very important factor. But unfortunately we're in such a horrifically litigious society it seems to me that disclosures are written by law firms, with maybe 50, 60 different lawyers working together to come up with a 95 page pamphlet. How many people really take the time to read this? Is the purpose of this probably more I would think for the protection of the entities issuing these investments rather than for the protection of the individual? Sometimes a simple one page summary which you then can follow up with detail might be an observation that I would suggest would be a better way of disclosing the risks.

I might add also that on commodity futures, when you take a look at -- regardless of one's position relative to casino gaming or pari-mutuel wagering or lottery purchases, one significant difference between commodity futures and those forms of gaming that I just suggested, the other forms of gaming, whatever you wager is the most that you can lose. There is disclosure. I noticed in Mr. Harris' exhibit C, relative to the fact that you can lose more than your investment in commodity futures.

I'm not so sure that the casual investor is quite aware of that until that unfortunate occurrence may take place when they receive a call saying the $500 that you invested is gone, and by the way, you owe us another $2,000. That can confuse a lot of people.
Another observation that I have and it's something that I have learned over recent years is that a number of companies in the United States cannot find themselves sufficiently capable of being listed on an exchange in the United States, seem to go to an area in Canada called Vancouver. The Vancouver Exchange, at least anecdotally, is an exchange that has less than responsible requirements for participation in that exchange. There're great, at least anecdotally, a lot of allegations that there are sufficient misrepresentations, defaults, game playing, what have you in that exchange.

I am bothered when I notice in the disclosure that the United States regulatory system has no control over these exchanges, whereas individuals representing brokerage firms in the United States have the ability to sell securities on an exchange such as the Vancouver Exchange. Again I say anecdotally, has some very difficult aspects to it that concern people.

Has the United States ever suggested that they would have some ability to cooperate, for example, with the Canadian authorities, the equivalent of the Securities Exchange Commission, to have some form of influence in the regulation or at least exposure of possibly the difficulties that exist there?

MR. RUDER: There is considerable cooperation between the various securities commissions of world -- there's an organization called the International Organization of Securities Commissions in which the regulators meet frequently to discuss what can be done. The United States has, however, decided not to attempt to engage in what might be called extra-territorial regulation. If someone is stupid enough to go an unregulated
area in order to risk their money and that area is outside the
United States, the SEC at least has said, well, we've done all we
can to protect that person. As long as I have a chance, I would
say one of the reasons that our capital markets in the United
States are so wonderful is that we have had this tremendous
disclosure and regulatory system which provides a system in which
our citizens can count on the integrity and honesty of the
system.

MR. HARRIS: Could I just make one point about
Vancouver, whether it is as bad as the anecdotal evidence
indicates or not. If a broker in the United States were to seek
to sell stocks in a Vancouver listed company to a United States
citizen in the United States, all of the same protection would
apply. That is, the suitability rules would be applicable.
There would be questions as to the advertising or otherwise. So
that the standards there, and indeed even the penny stock
requirements that we now have with disclosure would be applicable
to those sales. It's not as though when those securities come
into the United States for sale they are totally unregulated.

COMMISSIONER JAMES: I will let you close out our
time together.

COMMISSIONER LEONE: If I'm closing it, I want to say
this has been superb testimony and I think provocative. I think
it will -- I hope it has some influence over the way we think
about some of these issues. I want to raise two points.

One is that we should come back to the credit issue
because it is significant and it is quite different in the
securities industry, the disclosure statements that people have
to fill out in order to -- and institutions to be in certain
markets require you to have bank references. In addition, even in the futures market you have to put up initial margin beyond, which has to be in the form of treasury bills normally. So you've already put money in place. You have to do that in the stock market. In those markets there is a tremendous pressure on the intermediary to make sure your credit is good because the exchanges have recourse to the clearing members.

In other words, it isn't the individual's credit that will determine whether or not a big move in the market gets settled. The clearing member will have to come up with the money so they have a great interest in knowing their customer for reasons that are self-serving which is often a good way to get the right motives.

And finally in the area of disclosure, although this is a little apart from the testimony, I do want to mention it because I think it's very relevant to the specific example of lotteries we were talking about. Right now, lotteries are not only advertised as a way to get rich quick, they're justified in part as a way to pay for education or to pay for senior citizens, to pay for poor or crippled children. All of the serious studies, and we have a very good one from the Controller of the State of New York, demonstrate that not surprisingly, because money is fungible, there is virtually no evidence that there's increased spending in total on any of these things in any of these states. This tax simply replaces other tax. That would be a fact that ought to be disclosed. That would be a disclaimer to the claim that the money is being spent for these good purposes that in fact, studies show that there's no increased spending.
The second thing is -- and I think this might have an interesting effect in our society on behavior on lotteries. The disclosure of the fact that lottery purchases are taxes at an effective rate of 70 percent, 75 percent, 80 percent, 85 percent depending on what it is state by state, would I think be a jolt to most citizens. I don't think people want to buy too many things that have an 80 percent tax attached to them, and I don't think most people realize is that is how large the effective tax rate is on lotteries.

So when you get into disclosure in these areas, there are other things that it would be useful to have out there that don't necessarily mirror the securities industry. But this has been, as I said, extremely useful and we really appreciate it. Probably we won't have a more distinguished panel no matter where we go and who we talk to.

CHAIRMAN JAMES: That certainly is the case. I'd like to thank both you gentlemen for being here this morning. I assure you that you will see your testimony quoted from vigorously as we go throughout our process. It's been a fascinating discussion and we appreciate you taking your time to be here and share your insights with this Commission this morning.

MR. RUDER: Thank you very much.

MR. HARRIS: Thank you.

CHAIRMAN JAMES: You're more than welcome. The Commission is going to stand in recess for approximately 15 minutes. I think everybody needs it at this point.