THE SECURITIES ACTS AMENDMENTS AND RESPONSIBILITIES OF COUNSEL

Address by

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This Institute is, to my knowledge, the first of its kind ever to be held in Oklahoma, but I would hope that it will not be the last. Oklahoma has experienced continual economic growth in recent years, resulting in a substantial increase in the number of local enterprises wishing to finance their endeavors through the public issuance of securities. This economic growth inevitably carries with it a degree of affluence and sophistication on the part of the people, causing non-resident issuers to look increasingly to Oklahoma for purchasers of their securities. The increased interest in securities has required the practicing attorney to add the securities laws, state and Federal, to his already crowded sphere of knowledge. This is, of course, especially true of the attorney with corporate clients, who demand both immediate and accurate advice on topics of concern to corporate management.

I will attempt to provide you with a general picture of the changes in the Federal administrative picture as provided in the Securities Acts Amendments of 1964.

The basis for the Amendments is contained in the Special Study of Securities Markets, which was conducted pursuant to the 1961 mandate of Congress. After almost two years of exhaustive work in all phases of the securities markets, the scholarly and dedicated Special Study group issued its report, which was submitted to Congress by the Commission in three segments during the spring and summer of 1963. This report provided by far the most comprehensive examination and analysis of prevalent conditions in the securities markets of this country since the Congressional inquiries of the 1930s. The report is itself ample justification of the time, effort and money spent on its accomplishment. The Special Study group did not unearth the pervasive fraudulent activity which was so apparent in the earlier inquiries. Its report, however, does make clear that the phenomenal growth of the securities markets in the 30 intervening years had, as the Commission stated in its letter of transmittal to Congress, "imposed strains on the regulatory system and revealed structural weaknesses."

The Special Study Report made both specific and general recommendations for Commission rule-making action, Congressional amendatory action and action by the self-regulatory entities such as the National Association of Securities Dealers and the national securities exchanges. Many of these recommendations have been carried out in their entirety. Others have been modified in varying degrees by the Commission, after extensive conferences with industry representatives, and brought to fruition. Still other recommendations are under continuing study by the Commission and its staff in recognition of the fact that there can be precious few questions of policy which are wholly black or white. We deal in numberless shades of gray, and all effects of our actions must be carefully weighed.

A great many of the Special Study recommendations are found in the Amendments which President Johnson signed into law on August 20, 1964. At the signing ceremony, which I was privileged to attend, the President said:

> "The law signed today should further strengthen the securities markets and public confidence in them. Industry and government have worked together in the writing of these laws. Industry and government will work together in making these measures succeed."

I not only heartily subscribe to this statement but can unhesitatingly say that its theme has been the basic tenet of my administrative philosophy for the past six years.

Many of you undoubtedly have been through these Amendments with the proverbial "fine-tooth comb." You will appreciate, I am sure, that my treatment of them here must be of a less detailed nature.

The broad purposes of the 1964 Amendments are stated, in a masterpiece of over-simplification, in the title of the Act: "To extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes." It will be seen from this that we have, on the one hand, the application of a proven administrative tool; namely, disclosure, to an area of the securities markets heretofore virtually unregulated. On the other hand, we have the application of new and improved regulatory tools to an area which has been subject to regulation since 1934. These two approaches complement each other admirably in achieving the ends primarily sought; namely, consistency in disclosures to investors and prospective investors, and quality in securities firms and their personnel.

On the theory that those persons and firms who have had little or no previous contact with Federal securities laws will be in greater need of advice and counsel, I shall concentrate upon the first of these objectives while treating of the latter in less detail.

Chapter IX of the Special Study Report pointed out that there was no longer a logical basis for the distinction made by the Exchange Act between listed and unlisted securities. Issuers of securities listed on national securities exchanges must register these securities with the Securities and Exchange Commission and keep the registration statement current by periodic financial reports and by current reports upon the happening of significant corporate events. They must also comply with the proxy and insider trading requirements of the Act, which I shall discuss in some detail in a few moments.

It is clear to everyone who has observed the progress and growth of the securities markets that the quality of disclosure in the over-the-counter markets has shown a marked improvement during the past 20 to 30 years. This is especially true of the issues which are widely held, and therefore more actively traded. I believe that this improvement is a reflection of, and a tribute to, the effectiveness of the Exchange Act requirements. By requiring that specific standards of disclosure be met by all listed companies, the Act has served to develop in the public investor an awareness of the inadequacies of disclosures made by other issuers. Many over-the-counter issuers have become cognizant of the necessity and desirability of seeing to it that investors, and prospective investors, are kept completely informed. Despite this noteworthy progress, however, the Special Study found that the disclosures voluntarily made by unlisted companies left a great deal to be desired. While many instances existed wherein full and complete information was disseminated to shareholders, nevertheless, the public investor in unlisted securities was being given, on the whole, substantially less information than the person who invested in listed securities. Not only did the volume of information delivered to shareholders fluctuate considerably, but the candor with which it was presented was highly variable.

Prior to the enactment of the 1964 Amendments, the only successful, albeit limited, effort to extend the reporting requirements of the Exchange Act into the over-the-counter markets was

Section 15(d), which has been in effect since 1936. This provision brings companies filing registration statements pursuant to the Securities Act of 1933 under the reporting requirements of Section 13 of the Exchange Act. The application is limited, however, since it pertains only to classes of securities for which a registration statement has been filed, and since only the reporting requirements are imposed. By contrast, the 1964 Amendments impose upon certain issuers the full range of Exchange Act requirements previously applicable only to issuers of listed securities. Further, the new provisions may be applicable whether or not a 1933 Act registration statement has ever been filed by the issuer.

The keystone of the new provisions is Section 12(g), the registration requirement. If an over-the-counter issuer has total assets of more than one million dollars and has a class of equity securities held of record by 750 or more persons, it must file a registration statement relative to that class. The shareholder requirement will be reduced to 500 after July 1, 1966. An issuer may also register other classes of its securities, whether or not the prerequisites are met. This, of course, is entirely optional with the issuer. A decision to register other classes might be prompted by the protections afforded by our proxy rules, which are applicable only to registered securities. Further, the insider trading rules are applicable to <u>all</u> equity securities of the issuer if <u>any</u> class is registered.

Two weeks ago today was the deadline (perhaps that is an unfortunate choice of words) for the filing of Section 12(g) registration statements, except for those companies whose fiscal year ends during the first half of the calendar year. We have, however, granted several temporary extensions in cases where good cause was shown. We have received approximately 1,100 filings to date, and we estimate that many more will be forthcoming over the next few months. As we used to say in the Navy, there are always a few who don't get the word.

Detailed examination of each of these registration statements, and correction of deficiencies within the 60 days prior to automatic effectiveness, will be, quite frankly, a physical impossibility. As we have advised the Congress, our staff is working night and day, but even this will not be enough. This being the case, counsel should be aware that Section 18 of the Exchange Act provides civil liability against any person making a false or misleading statement in any document filed with the Commission pursuant to that Act. Damages may be recovered by any person who did not know of the false or misleading nature of the statement and who purchased or sold a security at a price which was affected by the statement. This provision is automatically applicable to registrants under Section 12(g) upon effectiveness of the registration statement. It is clear, therefore, that special care must be taken in the preparation of these registration statements. Our examination process is merely an assistance to management which, in the final analysis, must bear the ultimate responsibility for all material filed, whether or not thoroughly examined by our staff. I cannot emphasize too strongly the vital importance of completeness and accuracy from the very beginning.

Our preliminary studies indicate that approximately 900 additional issuers will be subject to the registration requirement after July 1966 when the shareholder requirement is reduced to 500. This makes it apparent that there will be numerous borderline cases. In order to assist issuers and their counsel, we adopted rules defining "total assets" and "held of record" as those terms are used in Section 12(g). Without going into great detail, "total assets" is defined as meaning just what it says, <u>and</u> <u>not</u> net worth. The total of balance sheet assets, prepared in conformity with our Regulation S-X, is the test. As to "held of record," our rule goes somewhat beyond the traditional definition of that term. This is in accordance with Congressional intent--that we define terms so that there can be no deliberate circumvention of the registration requirement by issuers otherwise subject to it.

We have also defined "equity security" basically as it is defined elsewhere in the Exchange Act. This term is <u>not</u> limited to common stock, or even to corporate securities. It includes a multitude of interests, from chinchilla contracts to limited partnership profit-sharing arrangements. The majority of these hybrid securities will probably not meet all the prerequisites of Section 12(g) registration. Most will either have less than one million dollars in total assets, or will have less than 750 "shareholders." It is important, however, that counsel be aware that the new provisions are applicable to securities and issuers which may not necessarily fit into traditional definitions.

The registration statements do not become effective until 60 days after filing, or such shorter time as the Commission may direct. It should be noted here that the legislative history of this provision makes it clear that acceleration of the effective date should occur only at the request of the applicant. The reasoning behind this unwritten limitation is seen in the fact that the reporting, proxy and insider provisions are applicable when the securities become registered.

In order to clarify the terms employed here, and at certain other points in the Exchange Act, we have adopted a rule which provides, in effect, that securities are "registered" only when a Section 12 application or registration statement becomes effective.

As I have stated, registration under Section 12 carries with it the full range of Exchange Act requirements heretofore applicable only to listed companies. The first of these is Section 13, which requires the filing of periodic financial reports and reports of significant corporate happenings. These requirements are thoroughly spelled out in our rules and forms, complete with "who, what, when and how" guidelines. Counsel should understand these requirements, especially those related to the reporting of significant corporate events. Most of the required filings, however, will be prepared by the bookkeeping or accounting department of the issuer, and reviewed by the issuer's independent certifying accountants. With this in mind, I would like to pass on to the proxy and insider trading provisions, where the responsibility of counsel is primary, and where thorough understanding is an absolute necessity.

Our proxy rules will not be applicable to most 12(g) companies until at least June 30, 1965, due to the 60-day waiting period between filing and effectiveness. This is well after what our staff painfully refers to as the "proxy season." The same component of our staff (with some, but not enough, additions) is now laboring over the deluge of 12(g) filings, and has just passed the peak of the normal flow of proxy statements from listed companies. Unlike most of us, therefore, the coming of spring was greeted in their offices with something less than unqualified joy. Next spring they may look forward to yet another deluge--the first proxy statements from 12(g) companies.

Section 14 of the Exchange Act contains the proxy requirements. Section 14(a) is general in its scope, and it was not changed by the 1964 Amendments. The rules which have been adopted under this provision make up in comprehensiveness what they lack in simplicity. They describe in detail all information which must be provided to shareholders in any solicitation, including the form and content of the proxy itself. They cover almost every eventuality without being inflexible. While the rules are somewhat complex, though unavoidably so, they do accomplish their primary purpose; namely, that shareholders be provided the most complete and accurate current information in order that they may exercise an informed judgment as to how their shares should be voted. Further, shareholders must be allowed a choice in proper cases so that they are not required to choose between voting "aye" or not voting at all.

An amendment to Section 14(b) allows the Commission to promulgate rules governing the conduct of registered broker-dealers concerning the giving, or refraining from giving, proxies with respect to any security registered under Section 12 and carried in "street name" for the account of a customer. Section 14(b) will now apply to all registered broker-dealers rather than merely to those who are members of a national securities exchange. Previously, we had the power to _prohibit_ the giving of proxies in contravention of our rules, but lacked power to _require_ that proxy materials be transmitted to the beneficial owner--nor could we require that a proxy be executed by the broker-dealer in accordance with the owner's wishes.

The New York Stock Exchange and certain other exchanges have rules which regulate the giving of proxies by members. These rules require the forwarding of proxy solicitation material received by the record owner if the solicitor pays the expenses. The record owner may either request voting instructions or enclose a proxy which the beneficial owner may or may not execute, as he sees fit. While these rules afford considerable protection for a "street name" shareholder whose broker is a member of these exchanges, they would be of no benefit to the same shareholder if his broker were not an exchange member. Section 14(b) was expanded by the 1964 Amendments so that _all_ owners of registered securities would be afforded equivalent protections in this area. We have not as yet published rule proposals under this provision. It may be assumed, however, that such rules, when published, will be at least comparable to the exchange rules which I have mentioned, and that they will accomplish the purpose for which the provision was designed.

Section 14(c) is new, having been added by the 1964 Amendments. At present, the New York and American Stock Exchanges require that listed companies solicit proxies for all meetings of shareholders. Unlisted companies and those listed on some other exchanges are not subject to this requirement. The result, therefore, has been that any company which could count on having a quorum present at meetings, in the persons of management and those friendly to management, could avoid furnishing the valuable information required by the proxy rules by simply not soliciting proxies. When proxies are not solicited by or on behalf of management, Section 14(c) requires that all holders of both listed securities and over-the-counter securities registered under Section 12 be provided with "such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made . . ." We have published for comment proposed extensive rules under this provision. These rules, except for solicitation and contest provisions, are virtually identical with those issued under Section 14(a). Therefore, upon adoption of these rules, all shareholders, whether or not their proxy is required by management, will be provided basically the same information. In the event of a contest, Section 14(a) will, of course, come into play since this would undoubtedly result in a "solicitation."

All proxy solicitation materials, and all 14(c) materials, must be filed with the Commission at least 10 days prior to their proposed use. This allows our staff time within which to examine the proposed materials and to call any deficiencies to the attention of management and counsel for correction before use. This process is an aid to compliance with these rules.

While the extension of the proxy requirements to unlisted issuers will impose added responsibilities upon management and counsel, it will also provide the protection of the same requirements and the same high standards of disclosure in the event of a contest.

As I have stated, an understanding of, and compliance with, the proxy rules is an absolute necessity for counsel. This becomes vividly apparent when one considers recent judicial decisions which in some instances imply, and in others enforce, private rights of action for non-compliance with the proxy rules. These decisions indicate that non-compliance with these rules may invalidate corporate action which was otherwise valid under the applicable state law. Furthermore, in such circumstances, independent claims for damages may arise.

Another area of vital importance, now applicable to Section 12(g) companies, is that of the so-called "insider trading" provisions of Section 16. Any officer or director of an issuer whose equity securities are registered under Section 12, and any person holding directly or indirectly the beneficial ownership of more than 10% of that class of security, is an "insider" for purposes of these provisions. Section 16(a) requires that each insider file a report at the time of registration of the security, or at the time he becomes an insider, and reveal the amount of <u>all</u> equity securities of the issuer of which he is the beneficial owner. He must also report all changes in such ownership within 10 days following the end of the month in which they occur. Notice that these reports encompass <u>all</u> equity securities of the issuer, and not merely the class which is registered.

Section 16(b) allows the issuer to recover, directly or through derivative action, any profits made by an insider in a purchase and sale (or a sale and purchase) of an equity security within any six-month period. The terms "purchase" and "sale" have been very liberally construed by the courts in order to give full effect to the purposes for which the provision was enacted. Applicability of this provision is in no way dependent upon a determination that inside information <u>was</u>, in fact, the basis for the purchase or sale, or even that the insider possessed information which could have been its basis. Moreover, it is of no consequence that the transaction was motivated by altruistic objectives. If the transactions occurred and an insider was the beneficiary, liability is virtually absolute. An experienced practitioner has recently said that, in view of the applicability of this provision to persons and firms who may be completely unaware of its consequences, the best advice he could give would be as follows: No insider should buy or sell a share, exercise an option or conversion privilege, or take any action related to the securities of the issuer, without consulting counsel before the fact. With the short-swing profits provision now of almost universal application, it would seem that any attorney would be well advised to give such advice to his clients, and all "insiders" would clearly be well advised to give it heed.

The courts have ruled that a purchase (or sale) by an officer or director, before he became subject to Section 16(b), may be matched with a sale (or purchase) afterwards. So long as the two transactions occur within six months of one another, Section 16(b) liability will attach. This result has come as quite a shock to several insiders in recent years. Counsel for many 12(g) companies may not be sufficiently familiar with the intricacies of Section 16(b) to protect against unwitting violations. We have adopted, therefore, a rule which will give some relief by exempting from the operation of Section 16(b) any transaction which took place prior to the issuer's first 12(g) registration. This exemption is limited to 12(g) companies and will not exempt those voluntarily seeking exchange listing for their securities. The rule is scheduled to expire by its own terms on October 31, 1967, so that this relief will be provided to the companies which will be brought under Section 12(g) when the shareholder requirement is reduced to 500 from the present 750. This rule will have no effect on liability incurred when the matching transactions both occur after the insider becomes subject to Section 16.

Section 16(c) makes it unlawful for any insider to make any short sale or "sale against the box" as to any equity securities of the issuer.

The only substantive change in the Section 16 structure pertains to market-making in over-the-counter securities. It is not uncommon for a market-maker to be represented on the Board of Directors of the issuer in whose securities he is making a market. Further, the market-maker may, at some time, become the owner of more than 10% of the class of securities in which he is interested. Of course, the application of Section 16(b) would severely inhibit the market-making function in these circumstances, since any profits made by the insider in his market-making capacity would be recoverable by or for the issuer. The Commission recommended, and the new Section 16(d) provides, an exemption for such situations, subject to the power to define all key terms and to prescribe conditions limiting the exemption. These rule-making powers and the Section 16(a) ownership reports, when employed in conjunction with the disciplinary powers of the Commission, should provide a surveillance tool sufficient to prevent abuses in this area. The exemption is limited to securities not then or theretofore held in an investment account, and to securities held in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market for the security. The exemption does not affect the insider reporting requirements of Section 16(a).

Rules under this provision will be published in the near future to make the scope of the exemption more definite and to ensure that this limited exemption may not be employed for conscious circumvention of Section 16(b), thus defeating the salutary purposes for which the provision was enacted.

The 1964 Amendments were enacted for one broad purpose; namely, to strengthen the securities markets of this country. The registration requirement, and the reporting, proxy and insider trading provisions which are imposed by it, will ensure a degree of quality and uniformity in corporate information which has never before been present in the over-the-counter markets. This alone should greatly increase public confidence in these markets, thereby increasing their stability and encouraging further growth.

Operating in tandem, so to speak, with the registration requirement, are the various provisions directed toward strengthening regulation of brokers, dealers and their employees by the Commission, and by the Commission's regulatory "right hand," the NASD.

For the first time, the Commission is given the power to proceed administratively against individuals. Previously, individual employees of broker-dealers could be disciplined administratively only through proceedings which also disciplined the employer. For obvious reasons, this procedure could not produce just and desirable results in many cases. We are also, for the first time, provided with intermediate sanctions, so that we need not choose between a slap on the wrist and the ultimate sanction of revocation.

The standards for entry into the securities business are appreciably raised by the Amendments, and the importance of employee supervision by broker-dealers is brought into sharp focus. A firm, and its supervisory personnel, may be disciplined specifically for failure to supervise employees adequately. The Congress provided a statutory exception in this area, which, to say the very least, encourages broker-dealers to establish and enforce comprehensive supervision procedures. If such procedures can reasonably be expected to detect and prevent violations, and if they are properly implemented by both the firm and its supervisory personnel, no findings of failure to supervise may be made. Of course, many firms now have such procedures, and they are enforced wisely and well. Those who do not, however, would do well to follow these leaders. As the President of the NASD recently said: "Supervision is now the name of the game."

Another feature of the Amendments is the requirement that broker-dealers who are not members of the NASD must establish their qualifications to enter the securities business under procedures to be established by the Commission. Previously, non-NASD members merely registered with us and, absent any statutory disqualifications, the philosophy was one of "free entry." The NASD, on the other hand, requires registered representatives to pass an examination, and makes other inquiries into the training and experience of prospective members and their employees. To provide a degree of equivalence as to all broker-dealers, substantially similar powers are now lodged in the Commission for application to those who do not choose to join the NASD. The Commission's administration of these provisions will not be identical to that of the NASD, but it may be expected to be similar. We have just completed our review of the first rule proposal under these provisions. It concerns qualification standards and should be published in the very near future. Other rules are now in the final stages of preparation, and conferences with industry representatives are now being held to obtain pre-publication comments. When these rules become effective, and have been put into general operation, the qualifications of all persons engaged in the securities business will be examined prior to their entry into that business.

The Amendments give the NASD specific authority to make rules relating to the financial responsibility of members. Along these lines, the Commission has recently adopted amendments to its net capital rule, which for the first time requires maintenance of a minimum net capital. The Special Study strongly recommended such a requirement. It hypothesized that, where management has little or nothing "at risk" in the way of committed capital, it could be, and often was, less mindful of its responsibilities under the securities laws and of its obligations to customers and other broker-dealers. The rule now requires that broker-dealers engaged generally in the securities business have, at all times, at least $5,000 in net capital, computed in accordance with the rule. The requirement is $2,500 for broker-dealers who engage in the business in only a limited manner, as described in the rule. Previously, a broker-dealer could have little or no committed capital, so long as its aggregate indebtedness was no more than 20 times the net capital. Continuous study of the operation and impact of this rule is being conducted in order that we may determine whether any further action is appropriate in this area.

Investors, and prospective investors, should be the prime beneficiaries of the elevated standards now effective in the securities industry. Persons who lack the basic qualifications to deal with public investors will be prevented from doing so, at least through broker-dealers registered with the Commission. In addition, the Commission is now empowered to discipline more appropriately those who would deal unfairly with their customers, or otherwise violate the provisions of the securities laws. These benefits, when coupled with the increased quality and uniformity of disclosure which will flow from registration, should give the over-the-counter markets a stature in the eyes of the public which they have never before achieved. Such a result is fervently to be desired and sought by all concerned.

We at the SEC do not consider these Amendments to be a panacea for all problems which face the securities industry. As in any other vital industry, there will always be problems. No statutes or rules can be written which would wholly preclude abuses. Even if that could be done, such requirements would necessarily be so restrictive that the industry would smother under the weight of its own safeguards.

Our function, and that of management and its counsel, is to operate within the framework of the existing securities laws. This framework has as a major portion of its basis the philosophy that self-regulation and cooperation are not only workable in the national scheme of things, but are superior to any alternatives which may present themselves. The NASD and the national securities exchanges have demonstrated over the years that this philosophy is correct.

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