

WHAT IS THE SEC DOING TO PROTECT THE PUBLIC
FROM SECURITIES FRAUDS?

An Address

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at

TOWN HALL

Los Angeles, California

November 13, 1956

WHAT IS THE SEC DOING TO PROTECT THE PUBLIC FROM SECURITIES FRAUDS?

The Securities and Exchange Commission was established in 1934 to protect the investing public from fraud and manipulation in the purchase and sale of securities. In regulating the distribution of securities to the public and the brokers and dealers and stock exchanges of the securities industry, the Commission relies primarily on the full disclosure requirements of registration. With certain exceptions specifically mentioned in the statute, all public offerings of securities must be registered with the Commission and prescribed financial and business information about the issuer must be provided to persons who are offered the securities prior to sale.

Vigorous enforcement of the disclosure provisions so as to maintain public confidence in honest and orderly securities markets is essential for the continued economic growth of this country. Nearly eight billion dollars of investment capital must be obtained annually from the savings of the American public in the capital markets. Protecting these hard-earned savings from the fraudulent schemes of stockateers is the primary reason for securities regulation. You -- the public -- are therefore justified in asking -- How is the Commission carrying out its public trust? What is the Commission doing to protect the public from securities frauds?

A good starting point is to ask the fundamental corollary question -- What are principal enforcement problems being encountered by the Commission? There are three. The first involves the sale of securities by swindlers on the basis of the fantastic big lie. The big lie technique is used to sell securities in companies which are purportedly developing such imaginary assets as secret processes, inventions and precious mineral discoveries. The second troublesome enforcement problem arises from the sale of corporate securities to the public in violation of the registration requirements. The third enforcement problem is created by the substantial increase in the number of brokers and dealers recently registered with the Commission who lack adequate capital and are inexperienced in handling financial matters for the public.

You would think that the public would easily detect the fraudulent schemes underlying the big lie. Victims of securities frauds, however, have warned our investigators after they realized that they had been swindled -- "If you don't want to be taken by him, you'd better not listen to his sales talk."

Fraudulent promoters frequently introduce a religious aura to their operations for the purpose of impressing victims with their piety and integrity. A few months ago two confidence men were convicted of a securities fraud in connection with a large scale oil promotion conducted by mail out of Fort Worth, Texas. Almost a million dollars was obtained from the public. The promoters told the investors that they had found the

world's greatest undrilled oil field which was even bigger than the colossal oil deposits of the Near East. They represented that outstanding geologists supported this opinion and that the oil was flowing out of the well until the flat in which the well was located had become "an oil-sodden mess." Unwilling to stop at such extravagant statements, these stockateers climaxed their touting with this prayerful statement: "Again thanks to Him from Whom all the joyful things of the earth flow forth; a Divine Guidance without which this exceedingly great joy could not now be ours." Upon the basis of combining the big lie with a religious appeal, these swindlers were able to sell leases, which they had acquired for as little as ten to fifty cents an acre, for as much as \$100 an acre. Instead of having the "world's richest undrilled oil field," they, of course, had no commercial oil field at all. They were convicted and are serving jail sentences.

In another Texas case a promoter was convicted of peddling stock in a company which he claimed had perfected a fuelless, self-energizing power unit - in effect, a perpetual motion machine. Simultaneously, he was selling an "atomic water treating machine," which was purported to be a cure-all for cancer, arthritis, low and high blood pressure, and other dread diseases. Our investigation revealed that this perpetual motion power unit consisted only of a small metal kitchen cabinet containing a Mazda sun lamp, whose rays penetrated a piece of colored church glass, which supposedly had been blessed. Although he was one of the most notorious confidence men in the securities field, many victims of this fraud were hostile to our investigation because they had apparently been influenced by his pretensions as a scientific, medical and religious leader.

The ageless confidence game in which the victim is induced to place bets on horse races and athletic contests which allegedly have been fixed, was successfully used not long ago as part of a securities fraud device. The original scheme involved betting on volley ball games in the Hawaiian Islands, which had been fixed by the promoters. Having swindled the Hawaiian plantation laborers with this fraud, they then embellished their trick with the "Spanish prisoner" type of fraud. The promoters held themselves out to be controlling stockholders and executives of a large shipbuilding company on the mainland. This company was represented as having a six million dollar fund to be distributed to its stockholders. These fraud artists solicited investments on the basis of using the proceeds to enable them to travel to the mainland where they would conduct litigation for the release of the fictitious six million dollar fund in the non-existent company. It is estimated that these crooks obtained more than two million dollars from this scheme before being convicted and sentenced.

The Commission obtained the conviction of another promoter within the last few years for defrauding investors in an oil promotion based upon a so-called "magnetic logger" device. The promoter claimed that

it could tell him where oil fields were located, the exact depth at which the oil could be found and even the total number of barrels of oil which could be recovered from the field. Despite his fantastic claims as to its infallibility for locating oil fields, the defendant admitted at the trial that he personally had never been able to drill anything but a dry hole. The so-called invention was simply a "doodle-bug" contrivance consisting of a stick with a spring attachment.

Swindlers also use the big lie technique in more subtle forms. Securities of mining promotions are sold upon oral representations that engineering tests have disclosed the presence of specified large quantities of ore when no real tests have been made - someone has simply dug a hole in the ground and found a trace of some mineral. Salesmen talk glowingly of dividends and stock splits by unseasoned companies which, in fact, are losing money. They fail to mention such interesting facts as the insolvency of the company. Assets are written up and manipulated. Securities are represented as being blue chip investments or that they will soon be listed on national securities exchanges. Investors are told that they are providing capital for a promising enterprise when in fact they are buying promoters' stock, and their money goes straight into the promoters' pockets and not to develop the company.

A favorite motif in securities fraud cases is the Ponzi scheme, which involves the payment of alleged profits out of the capital contributed by victims. Such payments are made to induce additional contributions to the venture. Being impressed with the immediate high return on their investments, the victims are susceptible to being reloaded with more securities of the same company. Expert confidence men are seldom satisfied until they have depleted their dupes of all of their assets.

In prospectuses and offering circulars that are required to be filed with the Commission and delivered to prospective purchasers before the consummation of a sale of securities as part of an interstate distribution, the Commission often discovers material misstatements or omissions.

A recent offering circular stated that the principal promoter of the issuer had been engaged in the securities business and was president of a concern specializing in "corporate formations and management." However, the circular omitted to state that this firm had never promoted a successful business venture and that it was simply a corporate front for promoting his own business interests. This same circular also stated that the promoter had been associated with a large oil company in the "field of finance and collections." This was also false and misleading in omitting to point out that the only association of the promoter with a large oil company was in the capacity of a filling station operator.

A promotional mining company claimed in its offering circular that on the basis of estimates by a professional driller, it had 30 million tons of proven ore and 200 million tons of probable ore. It was true that the ore estimates had been made by a professional driller but his drilling

experience had been acquired as a dentist rather than as a mining engineer. The Commission's mining engineer took 65 samples from the properties and found that the company could not claim any significant ore deposits.

The big lie technique has been used by a ring of boiler-rooms which recently commenced large scale operations in New York City. In the jargon of the securities industry, a boiler-room refers to an organization employing high pressure and dishonest tactics to sell securities through long distance telephone calls. Its name is derived from the clatter of numerous telephones, resembling the noise made by an old-fashioned boiler, that are used by the salesmen. The securities handled by these boiler-rooms often consist of domestic and Canadian penny stocks of uranium and oil companies traded on the over-the-counter market, but the securities of industrial companies registered on national securities exchanges are also sold and manipulated by the boiler-rooms.

Who operates these houses? How do they function? And, more importantly, what is the Commission doing to stop the boiler-room operations? Many of the salesmen are ex-convicts who are refugees from the vicious home improvement rackets and other confidence games. Many sport criminal records in such activities as narcotic traffic, bootlegging and gambling. They include carnival pitchmen, circus barkers and a variety of veteran fraud artists.

The typical boiler-room is located in a shabby back office and usually employs about thirty salesmen. The pitchmen operate from small cubicles containing several telephones, a list of prospective victims and a three-minute egg-timer. The list of prospects includes the names of moneyed widows and relatives obtained from undertakers or it may consist of stockholders of record in some large, well-known corporation. The egg-timer is used to limit telephone calls to three minutes unless the prospect shows some interest in the offering. The work production requirements of one boiler-room demanded that salesmen must complete sales with one third of the prospects called to keep their jobs.

In making their pitches, these slick-talking crooks promise the chance of a lifetime in some "special situation" security and guarantee to double or treble the victim's money within a few weeks or months. The prices of penny stocks are arbitrarily stepped up at frequent intervals. By pointing to this steady rapid increase in the market, these fraud artists successfully reload their victims at the artificially advanced prices. The rub comes when the victims want to sell. There is no buyer's market for their securities.

The size of the business conducted by one boiler-room which the Commission recently closed down was staggering. Over a period of a few months it had grossed commissions of nearly two million dollars from selling the securities of only four companies. The long distance telephone bill amounted to about \$200,000. The salesmen's commissions amounted to \$600,000.

A few months ago the Commission dispatched special task forces composed of lawyers, accountants and investigators to a number of these boiler-rooms located in New York City. During this fiscal year, injunctions have been obtained against more than twenty broker-dealers for Securities Act violations. Our various regional offices are now interrogating thousands of defrauded investors in all parts of the United States in preparation for taking appropriate legal proceedings against these stockateers. While this intensive investigation and the injunctive actions have unquestionably smothered much of the boiler-room activities, it is apparent that the destruction of this ring of securities swindlers depends on criminal prosecution.

Why is the technique of the big lie, and especially its mass production application through boiler-rooms, a by-product of the times? The unprecedented high-level of the economic activity enjoyed throughout the country has resulted in giving the public more money to spend than ever before. Employment averages nearly 67 million. Individual personal income after taxes has risen to an annual rate of 285 billion dollars. The gross national product has been surging at an annual rate of 409 billion dollars. People have become accustomed to witnessing the miraculous growth of new communities and industries. For example, in 1955 140,000 new business enterprises were commenced compared with 93,000 in 1952. The public is eager to participate in and profit personally from this expansion.

In the expectation of realizing huge profits on small initial investments, persons with a little extra money are attracted by the romantic appeal of uranium development and Canadian stocks that are represented to be growth issues. Through nearly all the known media of advertising, the stock exchanges, brokers and dealers, investment advisers and investment trusts have been urging the public to invest in the burgeoning enterprises of American business. With increased individual savings, with visible evidence of wealth being created and with encouragement and opportunity to invest, a vast new segment of the public has become investment-minded. What is the result? A vast and fertile field for the operations of slick stockateers and a dangerous climate for unwary investors has been produced.

The second pressing enforcement problem encountered by the Commission involves the distribution of securities in interstate commerce without complying with the statutory registration requirements. An indeterminately large volume of securities is being sold in fictitious and unjustified reliance upon various exemptions from the registration, such as the intrastate exemption, the private offering and exchange of securities. Where registration is illegally avoided, public investors are deprived of receiving the pertinent business and financial information about the issuer and its securities to which they are entitled for making an informed investment judgment. Since adequate public disclosure is the essence of the securities laws, its avoidance creates a vital enforcement problem.

What are the schemes used by dishonest promoters and unscrupulous broker-dealers and underwriters to avoid the full disclosure requirements? One device involves the purported sale of large blocks of securities to foreign financial institutions, which are usually located in Switzerland, Lichtenstein or Canada. The securities, however, are neither transferred to nor held for investment by the foreign interests. Instead, they are almost immediately distributed to the public in the United States without registration. The transaction with the foreign bank is a mere sham to conceal an illegal distribution.

Another scheme for avoiding the disclosure of investment facts to the public is based upon an unwarranted reliance upon the intrastate exemption. Many distributions of large blocks of securities, particularly of insurance companies in the southern states and penny uranium stocks of companies located in the Colorado Plateau, are purportedly made wholly within one state. However, these securities are frequently distributed across state lines and sold to persons in states other than where the issuer is incorporated and doing business.

Another method of avoiding registration involves distributions of securities under the so-called "no-sale" principle enunciated in Rule 133. This provides, in substance, that a corporate merger or similar consolidation involving an exchange of securities and effected by vote of stockholders is not a sale requiring registration of the securities. This exception from registration is difficult to justify considering the broad definition of "sale" or "offer of sale" in the Securities Act. It has frequently been abused by companies effecting mergers and consolidations for the primary purpose of making a public distribution of securities. In these cases the merging company has acted simply as a conduit to distribute to the public the stock it has received from the surviving company. Thus, a large block of newly issued stock finds the protection of interstate commerce without affording public investors the protection of registration. The Commission is presently considering the advisability of repealing this rule so that public investors will not be denied this protection in the numerous transactions involving corporate mergers.

The third enforcement problem is created by the rapidly growing number of brokers and dealers registered with the Commission. In 1953 there were approximately 4,100; today there are more than 4,600 - an increase of more than 12%. Many persons have been attracted to the securities business in the hope of making quick profits during the present strong and active market period rather than with the intention of establishing sound business reputations through ethical dealing. The New York boiler-rooms constitute one facet of this problem. Inexperienced, newly registered broker-dealers, especially those in the Colorado Plateau area dealing in low-priced speculative penny stocks, is another.

In order to protect the public from the fraudulent activities of boiler-rooms, on the one hand, and unbusinesslike practices of new registrants, on the other, the Commission has greatly accelerated its program of inspecting brokers and dealers. These inspections have two basic purposes: first, to determine whether or not broker-dealers are conducting their business in accordance with the regulations of the Commission that are designed to insure compliance with established and orderly practices in the industry and in conformity with applicable legal requirements, and, secondly, whether they are dealing honestly and fairly with customers.

Included under the first heading are such matters as the maintenance of adequate and current books and records, the prompt delivery of confirmations and of prospectuses, where required, observance of the margin rules of the Federal Reserve Board, and compliance with the Commission's net capital rule. These requirements are not mere "red tape"; they are essential to the proper conduct of a business which involves the handling of other people's money and property.

Our inspections, however, consist of more than a review of books and records. Dealings with customers are also carefully examined. Our inspectors look for evidence of high-pressure illegal sales tactics and illegal selling of unregistered securities. Records are checked for misuse of customers' funds, hypothecation of customers' securities, taking secret profits in agency transactions, purchases and sales to customers at prices having no reasonable relation to the market, and abuses of trust and confidence, such as the practice of churning, that is, excessive trading the account of a confiding customer in order to reap an illegal harvest of commissions and markups.

The primary objective of the Commission is to enforce, with all its statutory powers and all its available manpower, the laws which are designed to protect the investing public from securities frauds. What is the enforcement record of the Commission?

1. We promptly issue stop orders to prevent securities offerings from becoming effective where registration statements appear to contain a scheme to defraud, or where there appears to have been no bona fide effort to comply with the registration requirements. During fiscal 1956, 3 stop orders were issued; since July of this year, 5 stop orders have been issued.
2. We promptly issue suspension orders against small offerings under Regulation A (which involve issues of \$300,000 and less) where the terms and conditions of the regulation are not strictly complied with. 101 suspension orders were issued during the past fiscal year compared with a total of 18 issued during the previous fiscal year.

3. We promptly institute injunctive actions or administrative proceedings against brokers and dealers who fail to comply with the prescribed statutory standards. 7 injunctions and 44 administrative proceedings were instituted during the past fiscal year. Since July of this year more than 20 injunctions have been authorized against brokers and dealers, and 17 administrative proceedings to deny or revoke their registration with the Commission have been instituted.

4. We have increased the tempo of the broker-dealer inspection program from about 700 a year in fiscal 1953 to a projected 1,400 in fiscal 1957.

5. We have instituted a new program to conduct periodic inspections of investment companies.

6. We have recently proposed for public comment two important rule changes which are designed to reinforce the disclosure requirements of the Securities Acts. One is the proposed summary prospectus rule to facilitate the dissemination of information about companies bringing new issues of securities to market. The second is the revised statement of policy governing the use of sales literature of investment companies. The objective of the latter proposal is to clarify the portrayal of operating results of investment companies by requiring that charts and tables shall show separately the three elements involved in their performance, namely, investment income, capital gains distributions, and asset value reflecting unrealized appreciation or depreciation.

The vigorous enforcement by the Commission of the disclosure and anti-fraud provisions of the Securities Acts has resulted in curtailing the free wheeling operations of crooked promoters and swindling securities salesmen. The area of uninformed risk taking by a "get-rich-quick" minded public gambling in untested promotional ventures has been reduced. However, the Commission cannot prevent the popular pasttime of speculation or the exercise of poor judgment by individual investors. Operating within the American system of free enterprise and limited by the full disclosure theory, the Commission does not, and should not, guarantee the quality or approve the merits of publicly distributed and publicly traded securities. The fundamental protection against securities frauds, lies with the individual investor or speculator. What advice can be given to the investing public to protect the individual and his savings from unscrupulous stock pushers?

1. Don't buy securities from any person who is unknown to you, especially if the offer is made over the telephone.

2. Request any unknown salesmen to put in writing and mail to you any representations he makes about the securities being offered.
3. Demand to see and then read the prospectus or offering circular describing the company and the securities being offered before you buy.
4. Contact one of the Commission's offices before parting with your money if you suspect that a salesman is attempting to defraud you.

The public trust to protect the interests of investors is being vigorously administered by the Commission on a broad front. However, the assurance of maximum protection to the public can only be obtained through industry cooperation and investor participation with the Commission in enforcing the securities laws. An expanding dynamic America, which requires an ever increasing amount of investment capital from individual savings, relies upon the preservation of honest and orderly securities markets. All of us - the Commission, industry and the public - can contribute to securing this objective.

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