BACKGROUND OF PROPOSED RULE CHANGES

Address by

JAMES C. SARGENT

Commissioner
Securities and Exchange Commission
Washington, D. C.

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It is a great pleasure to be your guest this evening at this January meeting of the New York group of the American Society of Corporate Secretaries and I am most honored to follow my other brethren who have been with you in the years past. The primary purpose of my visit here is to discuss briefly the various aspects of, and background for, some of the proposed rule changes which are under active consideration by the Securities and Exchange Commission and which may have a vital effect upon your companies' public financing procedures.

This last year has been a very active one for the Securities and Exchange Commission in its quasi-legislative functions. Our program of rule revision has been necessary in order to keep abreast of the constantly changing techniques and conditions in today's dynamic securities markets. The Commission has promulgated changes in its Form S-1, our most commonly used registration form under the Securities Act of 1933; Form 10, 8-B, and 8-C, which are the principal forms for registration of securities on national securities exchanges; and in the Proxy Regulation X-14. These form amendments complete a program undertaken in 1953 to coordinate and make uniform, so far as possible, the information required in the basic registration for new issues under the Securities Act of 1933 and for securities registered and traded on national securities exchanges and proxy statements under the Securities and Exchange Act of 1934. The program's objective has been the simplification of the forms and the elimination of duplicate filings previously required under the different provisions of the Federal securities laws.

The practical significance of this amendment program has been to permit more extensive incorporation by reference of information already on file into these new amended forms, which reduces costs and the time of preparation of such filings for all concerned. Now, the new Form S-1 contains more detailed instructions to assist you in the preparation of the form. Some of these instructions have been part of the administrative practice followed by our Division of Corporation Finance for years, but have never previously been made part of the form.

Much study has been devoted during 1956 to other changes in the Commission's rules, regulations and forms.

Amongst those rule changes still pending is the proposed

revision of Rule 133, which the Commission is actively considering at this very moment.

I would like to take this opportunity to acknowledge the continuing interest of the American Society of Corporate Secretaries in our work and point out this Commission's appreciation of the informed views and comments relayed to us by your individual members from time to time on this matter and on other proposed rule changes. Your viewpoints are given the most careful consideration, for we recognize your "expertess" in the practical day-to-day problems of corporate management and the value of your opinions as to the impact our rule-making activities may have on your respective companies.

Before getting to the background of Rule 133, I want to bring to your attention the fact that we have had vast problems with our enforcement program as a result of this Rule. With this Rule on the books, attorneys have advised their clients that stock issued as a result of mergers may be resold immediately without registration. Capital structures of companies, some of which are "fly-by-night", highly speculative ventures, have mushroomed to incredible proportions, with American public investors purchasing shares of companies about which there is little or absolutely no reliable information. These activities, with which we are presently being confronted, are very much like those existing in the 1920's which gave rise to Congress' enactment, beginning in 1933, of the Federal securities acts.

Now, for a little history. Our vital concern in administering disclosure statutes is that at all times the public investor be given the necessary and essential facts so that he can exercise an informed judgment when investing. This is what we believe Congress intended.

Section 5 of the Securities Act provides in effect that it shall be unlawful to "sell" securities in interstate commerce without registration.

Section 2(3) of the Securities Act defines a "sale" to include, amongst other things, "every contract of sale or disposition of a security ... for value".

This Commission's Rule 133, as presently in effect, provides in substance that for purposes of Section 5, i.e., registration, certain classes of statutory mergers, reorganization and consolidations

are not "sales" in spite of the definition of "sale" as contained in Section 2(3) of the Securities Act of 1933. Inasmuch as such transactions are not deemed "sales" within the meaning of Section 5 of the Securities Act, the issuance of new securities in consummation of these transactions is not subject to the registration requirements of the Act.

This Rule gave rise to the phrase "no sale theory". At the very outset of securities regulations by the Federal Government, the staff of the Federal Trade Commission, who first administered the Securities Act until this Commission was created in 1934 by the Exchange Act, concluded that a merger was a "sale" within the meaning of that word for purposes of registration. In late 1934, the first General Counsel of the Securities and Exchange Commission reversed this opinion and concluded that no registration was required for mergers. In September 1935, this interpretation of "no sale" was adopted and applied to mergers as a footnote instruction to our Form E-1, at that time one of our registration forms. This, in my opinion, was a rather curious place to put it.

In the now famous National Supply Co. v. Leland Stanford Jr. University case, the Circuit Court of Appeals for the Ninth Circuit, in reversing the District Court, stated, among other things, that it was in accord with this Commission's view expressed in its *amicus curiae* brief that securities issued pursuant to a consolidation of two companies did not constitute a sale. The Supreme Court of the United States denied *certiorari* and there has been no further judicial guidance other than this Circuit Court decision on this matter.

In 1947, the Commission rescinded Form E-1 and the "no sale" Rule contained therein. This theory, however, was applied administratively thereafter, although no rule was promulgated to that effect. Finally, in 1951, the Commission adopted Rule 133, which applied the "no sale" theory to reclassifications of securities as well as mergers, consolidations and transfers of assets.

The Rule in the last two years has presented considerable problems. Where full disclosure is made to stockholders under the proxy rules, there has been a good history of disclosure and investor protection under Rule 133 mergers. However, Rule 133 has recently been employed as a means to evade the full disclosure requirements of the Securities Act.

Millions of dollars of securities have been illegally sold to unwary American investors through the "boiler room" techniques. By "boiler room" I mean those brokerage houses that have recently cropped up and which use the long-distance telephone and high pressure tactics in the sale of securities of questionable value. Large blocks of securities, having little or no value, have been "freed-up" in reliance upon the opinions of attorneys that there was no sale under Rule 133 and that registration was therefore not required. These securities have then been sold through the use of false and fraudulent verbal misrepresentations to investors in every part of this country. We want to stop these tactics before and not after investors have been badly "burned".

The proposed revised rule is not intended to preclude negotiations and consummation of legitimate mergers nor to have any affect upon the availability of a Section 3(a)(9) exchange of securities exemption. If adopted, the Rule will require a disclosure of the basic investing facts to stockholders who are asked to approve of such transactions or to new prospective investors who may wish to purchase the new securities. This disclosure is, in fact, nothing more than what many companies do as a matter of course in terms of giving fair disclosure of the basic merger facts.

Let me give you an illustrative actual case of this evil. Recently, a brokerage firm was touting an oil company's securities, following a "no sale" merger, by allegations that the oil reserves totalled 20 million barrels. When the company subsequently filed a registration statement of new shares, it admitted to only 2 million barrels of oil reserves. The Commission's oil geologist has challenged even this estimate. The vice here is that the old shares that were issued under Rule 133 were admittedly sold on overstated, false oil estimates of at least 18 million barrels. In addition, the old securities were sold on meager financial facts that have never been certified. This, and many other cases are under active investigation by our New York Regional Office and they involve millions of dollars of securities sold to thousands of unwary investors throughout the United States.

Let me be even more specific. Recently, S.E.C. enforcement investigators have discovered that 49 corporate issuers have sold $83,500,000 worth of stock under purported compliance with Rule 133, or pursuant to other claimed exemptions, without making any disclosures to the public investors.

In 6 "boiler room" broker-dealer firms, all located right here in New York City, some 9 million shares of such "freed up" stock of highly questionable value, mostly concentrated in 4 issues, were sold to some 24,000 American public investors solicited by telephone throughout the United States over a period of between 1 and 8 months during 1956. The total proceeds derived from these sales by these 6 houses alone exceeded $30,000,000, indicating a gross profit of nearly $4,500,000. Long-distance telephone bills aggregated $425,000. The losses on these securities at today's market value would approximate at least 75 per cent of the original cost. These facts have caused us real concern because for the first time since the roaring 20's public investors have lost money because of fraud, misrepresentation and high pressure salesmanship.

This course of conduct, using the present Rule 133, if allowed to continue, can, in my opinion, destroy investor confidence. I hardly need to remind you, gentlemen, of the following additional facts:

American industry must raise 10 billion dollars to meet its estimated expansion needs for 1957. Bank loans and real estate financing in today's tight money markets will supply only 2 billion dollars of this amount. New equity and debt securities must, therefore, be the source of the other 8 billion dollars. The use of Rule 133 to facilitate the sale of unregistered securities by "boiler rooms" is shaking investor confidence at this time when American investors are the key in sustaining the tremendous economic activities of this country.

It is the purpose of the proposed Rule to act as a deterrent to bogus mergers employed to circumvent the securities acts. This Commission has been handicapped in its enforcement work due to the absence of knowledge of these mergers until long after the underlying securities have been distributed, at which time no protection, in the practical sense, can be afforded public investors. To repeat: the proposed rule will not preclude the negotiation or consummation of bona fide mergers. I feel that these facts must be taken into consideration in order to evaluate properly the significance of the proposed change in Rule 133.

There are other revisions to rules presently out for comment and one of these concerns the acceleration policy, about

which you all, I am sure, are vitally interested. Section 8(a) of the Securities Act of 1933 was revised in 1940 by Congress to grant this Commission the discretionary authority to accelerate registration to a period shorter than the prescribed 20 days. At the time of the enactment of the Securities Act of 1933, Congress expressed itself strongly about this 20-day "cooling-off period" to eliminate underwriting commitments made "blindly" and which "resulted in the demoralization of ethical standards" as between underwriter and the public purchaser to whom the underwriter had to look to take such commitments off his hands. The relaxation of the "cooling-off period" by the 1940 amendment set forth certain statutory safeguards within which this discretion to accelerate was to be exercised. Amongst these standards are: (1) the extent of information previously available to the public; (2) the ease with which the nature of the securities may be understood; and (3) the ease with which the rights of the security holder may be understood.

It is clear that Congress did not intend this Commission to exercise this authority casually. Acceleration may be granted only where it is in the public interest and consistent with the protection of investors and not as a matter of course or of right.

Rule 460, in its present form, sets forth the steps to be taken in distributing a preliminary prospectus permitted by Rule 433. The proposed note to Rule 460 relative to the Commission's acceleration policy describes situations in which the Commission, as a matter of administrative practice, has not granted acceleration. The additional note would merely state these administrative policies which have been developed since 1940 and adhered to when acceleration is considered. This new addition to Rule 460 applies to the following situations:

(1) Indemnification provisions: Where the registrant, that is the company, agrees to indemnify its officers, directors or controlling persons from liabilities arising under the Securities Act of 1933, acceleration may not be granted. The Commission regards this indemnification as unenforceable because Congress dictated otherwise by Section 11 of the 1933 Act, which imposes liability specifically against these very persons. Acceleration, therefore, may not be granted except where the parties agree that any claims of indemnification would be submitted to a court of appropriate jurisdiction.

(2) Investigation: Where the Commission is investigating the registrant, or its affiliates, acceleration may be denied.

(3) Liquidating preference of preferred stock: Where the liquidating preference exceeds the preferred's par or stated value and no agreement is made to restrict surplus to the point where combined with capital it would at least equal this liquidating preference, there is a basis for not granting acceleration.

(4) Secondary distributions: Where individual stockholders do not pay their proportional shares of expenses, the Commission may not grant acceleration.

(5) Net capital rule violation: Where one or more of the underwriters is in violation of the net capital rule by the underwriting commitment, acceleration may not be granted. The net capital rule is designed to protect investors by providing certain minimal standards of financial responsibility of brokers and dealers, i.e., for each dollar of assets, a broker-dealer cannot have more than $20 of debt.

There are other areas where acceleration may not be granted, such as activities by persons connected with an offering which may tend to raise artificially the market price. This we all call "manipulation". Also, where there is indemnification of the underwriter, there may be a basis for the refusal to grant acceleration.

All but two of these provisions have been standard Commission policy. The two recent innovations are the net capital and the investigation provisions. These acceleration policies we find necessary in order to offer the public greater protection, which, in turn, adds to investor confidence, the keystone to healthy securities markets.

In 1954, the Congress amended Section 10(b) of the Securities Act of 1933 and authorized the Commission to adopt rules and regulations permitting the use of a form of prospectus which summarizes information that must be set forth in a complete Section 10 prospectus. This amendment was urged most strongly by the securities industry.

Since the enactment of the new Section 10(b), the Commission promulgated Rule 434, in November 1955, which permits

certain independent statistical services to distribute on cards or bulletins a fair summary of information contained in a preliminary prospectus as filed with the registration statement.

On November 23, 1956, about 60 days ago, Rule 434A was adopted by the Commission, which further implements Section 10(b). The Rule provides for the use of a summary prospectus by certain issuers under certain conditions. The new Rule, as of necessity, required careful consideration. Particular problems were raised by historical reference to the 1920's when one-page advertisements and brochures were a means used in the distribution of securities. These brief solicitation materials were frequently false and misleading and part of the mechanism of "stampeding" investors to facilitate a quick distribution of securities.

However, we were not unmindful of the desire of industry and the financial community to provide a shorter, summarized document which could be mailed, printed in newspapers, and otherwise distributed to the public during the waiting period and would be more likely to be read and understood by the public. Although these objectives are commendable, the Commission must always be alert to the dangers of over-simplification and omission which must inevitably accompany summarization and consolidation. The Rule is, therefore, limited to registrants filing on Form S-1, or in the case of institutional grade debt securities, on Form S-9; and where at the time of the filing such registrants are required to file reports under Section 15(d) of the Securities Exchange Act of 1934, or as listed companies on a national securities exchange, they are subject to the filing and reporting provisions of Sections 13, 14 and 16 of the Exchange Act.

Rule 434A is on trial, if I may use legal vernacular. If it proves successful, it may be broadened to other classes of issuers. However, any abuse resembling the evils of the 20's in any way would certainly call for consideration of revision or limitation of the Rule.

It is our hope that the summary prospectus will be used to secure that broad diseemination of information about new issues which you and we have always heartily endorsed, and which is consistent with the original policies of the Acts to get information to prospective investors during the waiting period. We hope that the

summary prospectuses prepared will be fair, honest and adequate. Abuse of the Rule must inevitably lead to the use of the suspension power reserved to the Commission in the amendment to the statute. If it becomes necessary for the Commission to exercise the suspension power with any frequency, it will be difficult for the Commission to continue the Rule in effect, so we hope that the investment banking profession and your corporations will do all in their power to make the summary prospectus rule work well in the interest of public investors.

In conclusion, let me leave these final thoughts with you. Congress enacted the truth in securities laws to protect investors against misrepresentation, manipulation and other fraudulent acts and practices in the purchase and sale of securities and to assure to investors free and fair markets in which their securities can be traded. In accordance with the Congressional mandate, this Commission is always attempting to obtain fair disclosure of the material, fundamental facts and figures, both financial and background, of corporations offering or selling securities to the public in interstate commerce so that the purchasing public investors can have an informed judgment at the time of their purchases. But Congress, in my opinion, wisely determined that the S.E.C. should not pass upon the merits of particular securities.

Surely we all recognize that the real stability of our capitalistic economy realistically depends upon the proper functioning of the capital markets and only if the public has confidence in the whole capital formation process can the vast savings of the public be siphoned into American corporations in the needed amounts averaging between $7 to $8 billion dollars annually.

It is my sincere belief that if the confidence and faith of the American public in the capital markets are to be maintained so that the needed supply of capital can be continued at the high rate anticipated by present estimates of industrial production, with the resultant high standard of living for the American people, it is essential that this Commission continue its close supervision of the capital markets in accordance with the Congressional mandate expressed in the Federal securities laws so as to insure integrity and fair dealings, and thus to contribute to the success of our free enterprise system and the welfare of all our people.