DEVELOPMENTS IN RULE MAKING AND LEGISLATION

Address by

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before the

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One of the greatest pleasures that I enjoy as a Commissioner is the opportunity to visit our regional offices. I have just spent two days in our Fort Worth office and have observed the fine work which our staff is doing here in the Southwest. Ever since I accepted your invitation I have been looking forward to talking to you at this monthly luncheon of the Houston Chapter of the American Society of Corporate Secretaries. Let me say to you that we at the S.E.C. deeply appreciate the fact that your organization continuously expresses its views and offers constructive assistance to us at the Commission. In recent hearings as to proposed rule changes, you were very well represented by one of the members of your New York Regional Group. In fact, he and I both had to scurry down to Washington during the night following a dinner-meeting talk I gave on January 16 before the New York Regional Group so that we could continue our discussions in the formal hearings scheduled on January 17, the following morning.

I would like, in the first instance, to urge your organization to continue to afford us the benefit of your views, for your opinions are most helpful to us and play a vital part in the function of our agency. You gentlemen are conversant with the day-to-day problems of corporate management and your "expertise" in the field of corporate management helps to direct us in our legislative duties.

This afternoon I would like to discuss for a few minutes the present state of the securities markets and the capital requirements of industry. Our Section of Economic Research estimates that the expenditures of American business for plant and equipment additions and improvements will reach about $38 billion for the year 1957. This can be compared to the $35 billion actually required in 1956, which in turn was 22 per cent more than the requirements of industry in 1955, the previous record year. These figures seem almost astronomical and yet they are the realistic reflection of the actual success of the American capital system.

Of the money that must supply the $38 billion, much of it will be raised internally through such sources as depreciation accruals, retained earnings, short-term bank loans, mortgage financing, and from other similar sources.

In light of the firm inflationary curbs taken by the Federal Reserve System, bank loans and mortgage financing probably cannot be looked at too hopefully for the $3 billion of additional money required in 1957 over 1956. Certainly a good portion of this increase must come from the savings of the American public who will invest in new securities to be offered in 1957. This is one of the areas of the capital markets in which this Commission is vitally interested.

In 1956, of the $35 billion required for industry's needs, $11 billion of new securities were offered for cash. Of the $11 billion, only $8.7 billion was directed towards plant and equipment uses, the remainder being used to retire securities previously issued. We have, therefore, estimated that the public securities markets will provide about one-fourth of the necessary funds required for plant expenditures. In the past, industrial concerns and railroads as a general rule tend to raise the major portion of their capital requirements from internal sources. Public utilities, on the other hand, have had to obtain well over half of their requirements from the securities markets. American industry must compete with others in seeking funds through the capital market formation process. States, municipalities, and other principalities accounted for $5.4 billion of bonds offered in 1956, while the agencies of the Federal Government raised about $5.7 billion in this manner. I offer these figures to illustrate that the American capital system is everyone's business. Each and every American investor must partake in this contribution towards the improvement of our living standards. We, at the Commission, have been directing our efforts to the maintenance of the integrity of the capital markets so that no forces of evil can threaten the confidence of American investors or slow down the flow of capital which must be continuously ready and available for corporate needs.

At the same time, we have a reciprocal responsibility to assure the investor of the availability of facts, without which an informed judgment is impossible. Confidence of investors, on one hand, and assurances of availability of capital markets, on the other hand, are corollaries to each other in the proper functioning of this nation's economy.

To further illustrate the function of our capital system, we need only to compare it with the figures available of stocks and bonds offered by private business organizations in the other leading capital formation countries of the world. Industry in the West German Republic issued stocks and bonds for cash to the extent of $820.6 million in 1956. In Great Britain, $626.3 million in stocks and bonds were sold for the year of 1956 to the public for cash. Our figures for 1956, as I noted above, indicated that private business sold $11 billion of securities for cash during the same period of time, indicating the outstanding accomplishments of the people who make up our capital markets. One corporate issuer alone, The American Telephone and Telegraph Company, sold three issues in the period from January 1, 1952 to March 4, 1957, in amounts ranging from just under $500 million to more than $600 million. These three issues were convertible debentures sold by the marketing of non-underwritten rights offerings to the company's shareholders.

During this period, of approximately five years, there were 26 other large corporate offerings sold through conventional banking channels. I think these figures speak for themselves and serve to illustrate the tremendous importance of capital formation to the economy of our country. There is nothing in the Federal Securities Acts laws designed to impede the process. These laws, as administered, help -- do not hurt -- capital formation. Capital is formed only by the voluntary cooperation of the investing public, and the work of the Commission is one of the important factors giving the public confidence in the integrity of our capital markets.

In the last twelve months, certain forces of evil have crept into our securities markets. These elements have preyed upon public investors. Influenced by the unprecedented activities in the securities markets, unwary investors have been sold millions of dollars of highly speculative securities by fraudulent misrepresentations in many cases.

To illustrate the problem, let me point out that our investigation of six broker-dealer firms located in New York City indicates that during six months in 1956, 9 million shares of securities were sold in four issues to some 24,000 American public investors throughout the United States. The long-distance telephone has been the key weapon in this campaign by these firms which we call "boiler rooms". Telephone bills alone aggregated $425,000 for these firms, and profits in the form of brokerage commissions were in excess of $4,500,000. The value of these securities at today's market prices approximates thirty cents on the dollar. These facts have caused us real concern. I need not say that such large losses may well irreparably damage investor confidence.

We have recently directed our efforts to proposing legislation and rule revisions aimed at tightening our enforcement powers so as to prevent this weakening of investor confidence. Only if public investors continue to believe in the capital formation process can the required capital be forthcoming from the savings of the American people.

Some of these abuses have stemmed from the fraudulent use of our Rule 133. As you know, the Rule is an interpretive expression by the Commission that for the purposes of registration of new securities, "no sale" is involved in the issuance of securities pursuant to certain types of statutory mergers, reorganizations, consolidations, and reclassifications of securities. Inasmuch as the securities issued -- pursuant to the Rule -- are deemed not to be a "sale", as that word is defined by Section 2(3) of the Securities Act, the registration requirements of the Act are not applicable. The Rule has been abused and the securities sold by the "boiler rooms" were "freed up", in reliance on

the Rule, and resold to American investors without benefit of the fair disclosure registration requirements of the Securities Acts.

On December 7, 1956, we issued a proposed revision of the Rule which, in effect, would have reversed our present position and would have required registration of securities issued in such mergers, consolidations, reorganizations and reclassifications. Public hearings were held on January 17, 1957. We have reviewed the record of these hearings and the written material submitted by all segments of the industry and the Bar with regard to this proposal.

The Commission, this week, announced that it does not presently contemplate adopting the revision of Rule 133 as announced in Release No. 3698 until further study of the problem. This announcement is made so as to remove any uncertainty that may exist as to contemplated action by companies in the area covered by the Rule. In a letter to Mr. Chester T. Lane, Chairman, Committee on Administrative Law of The Association of the Bar of the City of New York, the Commission has expressed the view that it is in the public interest to reappraise the so-called "no sale" doctrine underlying Rule 133 "in light of our administrative and enforcement experience, and to seek a solution more consistent with the fundamental disclosure and antifraud principles of the statutes which we administer". In this letter we have taken the position that a change in the Rule may be worked out which would effectively deal with the problem. Consideration as to a statutory amendment to deal with the problem is another approach the Commission is presently exploring. The Commission will welcome any rule or statutory amendments which might be submitted by interested persons.

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 twenty days. 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 intended that acceleration 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 in cases where acceleration has been denied. 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: 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.

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

(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.

(4) Secondary distributions: Where individual stockholders do not pay their proportional shares of expenses.

(5) Net capital rule violation: Where one or more of the underwriters is in violation of the net capital rule by the underwriting commitment.

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, 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 were 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 dissemination 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.

The Commission recently published its 1957 legislative recommendations for comment. Discussions between industry and the Commission were conducted on February 25 and 26, 1957. One of the proposed amendments is a proposed Section 10(f), of the Securities Act, which would require the filing of supplemental sales literature. This is presently required of investment companies. As the statute presently is written, the use of supplemental literature is subject to possible charges of omissions to state material facts and must be accompanied by a prospectus. To eliminate this danger and inconsistency, the amendment has sought to require the filing thereof with the Commission.

Although no present legislation is proposed in this direction, consideration is being given to closing up the use of "foreign devices" to circumvent the Securities Acts. We have been very limited, and, I may say, frustrated by the use of Swiss, Liechtenstein, and foreign trusts accounts in Canadian brokerage firms maintained in street names and anonymous Swiss bank accounts. It is my considered belief that the registration and antifraud provisions are being violated in cases where we have been unable to act because the evidence is beyond our reach.

On March 4 and 5 we appeared before the Subcommittee on Securities, of the Senate Committee on Banking and Currency, to report on this problem. I want to assure you of the Commission's continuing study of this problem with a view to closing out any abuses through the use of these evasive techniques.

I want to thank you all for your invitation. As I stated earlier, I want to again solicit your assistance and constructive criticism in our rule making.