[Woodside, Byron D]

THE BUREAU OF NATIONAL AFFAIRS, INC.

BRIEFING CONFERENCE
ON
SECURITIES LAWS AND REGULATIONS

SAN FRANCISCO -- SEPTEMBER 7, 1957

Commissioner Sargent,
Former Chairman Demmler,
Gentlemen:

You have heard from Ralph Demmler concerning some of the practical aspects of preparing an issue for market---of the collection and organization of the information to be contained in a registration statement and prospectus---and the preparation of these documents for filing with the Commission.

Mr. Hocker and I will try to explain what happens to a registration statement after it has been filed and to outline briefly the standards and principles employed by the Commission in the discharge of its functions under the Acts.

The reporting and disclosure provisions of the various Acts are administered for the Commission by the Division of Corporation Finance. If the operations of the Division were to be described in terms of ultimate responsibility I would say that we are preoccupied constantly with the same three basic considerations which concerned Mr. Demmler's team in the preparation of his issue for market---time---the requirements of the statute and the rules and regulations---and materiality.

I mention "time" first because the Commission has always recognized the importance of "time" and "timing" to issuers and underwriters in financial transactions. Subject, of course, to the meeting or apparent meeting of requirements, it is our policy to meet any reasonable time schedule if that be possible. We are rather proud of the fact that very rarely does it occur in a well-prepared case an issue fails to meet a market schedule because of

inability of the staff to make deadlines. That is not to say that counsel, corporate executives and underwriters may not be subjected to considerable nervous strain, and sometimes acquire a fine case of jitters in the process, but by and large the system produces.

Approximately 70-80 per cent of all the work done by the Division is performed under some time schedule established by the statutes or the rules or requested by the parties. During the course of a year---when economic activity is at levels experienced in recent years---somewhere between 900 and 1000 registration statements for issues aggregating 13-14 billion dollars are filed under the Securities Act and approximately 2000 proxy statements are filed under Section 14(a) of the Exchange Act. The Commission of course has no control over the flow of its work in these two areas. We have no circuit breakers or expansion tanks to take care of the surges which occur because of swings in market prices, money rates or other business factors. It becomes important to you and to us therefore for me to echo and emphasize the advice given you by Mr. Demmler. When you have determined upon the time schedule you or your underwriters wish to follow, communicate that information to the Commission's staff as promptly as possible. It will help us to help you if we are forewarned and given an opportunity to adjust our schedules to meet yours.

Another aspect of the time problem should be mentioned as a matter of administrative practice and procedure, knowledge of which may be of assistance to you. We are not equipped to give prefiling examinations of proposed registration statements, proxy statements or other proposed filings. We have neither the time nor personnel to spare from the cases actually before

us to review material in advance of filing. We are, however, prepared to consider, and encourage issuers, counsel and accountants to submit, in advance of filing, specific problems of accounting---law or disclosure, the resolution of which in advance may avoid last-minute disruption of schedules. The chief counsel and chief accountant of the Division spend a great deal of their time in prefiling conferences concerning specific problems recognized as potential obstacles to expeditious disposition of a case. Not infrequently these problems require consideration by the Chief Accountant or General Counsel of the Commission or the Commission itself. Obviously it is better to have such a problem explored, defined and if possible resolved before you become involved in the final stages of preparing an issue for market. We make one exception to this policy of refusing prefiling examinations. In situations involving foreign issues where time, distance and translation and communication problems complicate the normal amendment process, we try to assist counsel and the accountants by prefiling reviews.

It seems to me that there is little to be said in a conference such as this as to the specific informational requirements of the statutes. They outline the broad sweep of the Congressional intent. The Commission's rules and forms spell out in more detail refinements for various types of disclosure problems. Over the years they have been revised and reworked in a fairly continuous process for the purpose of providing the maximum guidance to the practitioner and the staff as to the Commission's views concerning the subjects or factors required to be disclosed. Under our practice and procedure, no rule or form can be adopted without Commission action. It rarely occurs that any rule or form is adopted or amended without first submitting the proposed action

for public comment and criticism. Frequently, public hearings are held by the Commission as an aid to thorough consideration of the policy problems and practical considerations concerned.

In this field of disclosure the basic problem always has been and doubtless always will be "materiality." Materiality of required information---materiality of facts not specifically required but essential to an understanding of required facts---materiality of facts as to which the requirements are silent---materiality in terms of emphasis or manner of disclosure---materiality as it affects the selection of the enforcement procedures to be followed by the Commission.

You are entitled to some explanation how the necessary judgments as to materiality in the processing of documents are evolved, who makes them, what guides are there for you and us to follow.

In the two principal areas of our work---registration statements and proxy statements---there are two quite different powers available to the Commission to compel enforcement of the statutory standards. Under the Securities Act the Commission is authorized to hold administrative proceedings and to issue stop orders under Section 8(d) if the circumstances warrant. The published opinions of the Commission under Section 8(d) contain a wealth of information for the guidance of those working with this statute.

In the proxy field the Commission has no similar power to hold administrative proceedings and issue administrative orders. On the civil side the ultimate action by the Commission in the proxy field is to seek an injunction.

The basic problem under Section 14(a) of the Exchange Act, as it has been construed and administered by the Commission, is essentially the same as that under the Securities Act. The principles and standards enunciated in the

Commission's opinions under Section 8(d) of the Securities Act should be considered as having equal pertinence and application to the disclosure problems encountered in the proxy area and to the reporting and disclosure problems under Sections 12 and 13 of the Exchange Act.

In March, 1934, the Federal Trade Commission issued its decision in its first proceeding under Section 8(d) of the Securities Act in the matter of Charles A. Howard, et al.* This opinion contains an important declaration of administrative policy as well as a pronouncement of the Commission's philosophy as to meaning of the statutory test of materiality.

"The Commission's jurisdiction to issue a stop order under Section 8(d) relates to deficiencies arising out of statements of material facts contained in the registration statement, or omissions to state material facts required to be stated in the registration statement or necessary to make the statements therein not misleading. It will thus be seen that a condition precedent to the issuance of a stop order is the existence of deficiencies relating to statements or omissions of material facts. Deficiencies not relating to material facts do not give ground for the issuance of a stop order. They may, however, be included in a notice to show cause why a stop order should not be issued, and the stop order may embrace in its terms such deficiencies, although it must have as a basis for its issuance a deficiency relating to a statement or omission of a material fact."

The Commission went on to say that no question had been raised in that proceeding as to whether any of the deficiencies related to a material fact---in other words "a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question."

* 18 F.T.C. 626 and 1 SEC 6

Today you will find in Rule 405 of Regulation C under the Securities Act a definition of the term "material" which reflects this early decision which in turn derives from the case law of England.

"The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." Substantially the same definition is to be found in Rule X-12B-2 of the General Rules and Regulations under the Exchange Act.

In the day-to-day operation of the Division, most cases are handled informally and whatever we have to say concerning them is conveyed by correspondence or by conference. In the informal as well as in the formal procedure it has been our custom to comment on matters which perhaps standing alone would not support a stop order. You as well as others may have questioned the propriety or validity of this procedure.

Our staff has been instructed not to raise immaterial deficiencies, nor to clutter up your files or ours with unimportant or merely technical matters. If, however, there is some point of substance to be made in a case, an effort is made in the interest of the maintenance of some reasonable degree of uniformity in disclosures to bring to your attention other matters which may serve the end result of clarity of presentation or the correction of oversight or error.

The point I wish to make, however, is that this policy and procedure is rooted in a Commission decision as to policy from which it has never wavered. You doubtless are aware of the position---you may not have known of its origin.

In this same case the Federal Trade Commission went on to say with respect to another item---"But the half-truth embodied in the registrant's answer is the very type of untruth to which the language of the Securities Act relating to omissions of material fact has reference. In the language of Mr. Justice Avory, the registrant's statement is 'false in a material particular in that it conveyed a false impression.' Rex v. Kylsant [1932] 1 K. B. 442,448."

A few months later---May, 1934---the opinion of the Federal Trade Commission in the matter of Commonwealth Bond Corporation* was promulgated. In this case the Commission touched on a problem which presents difficulties from time to time and which I mention because a clear holding on the general problem in a stop order case has not yet been written. Some day there will be such a case. The opinion states---The prospectus of the company implied that the cash return to depositing bondholders would be more than that of nondepositing bondholders, when the evidence establishes that no cash would be available for distribution to those who deposited.

In referring to this aspect of the disclosure problem in the case the Commission said---"These statements are rather in the nature of prophecies rather than statements of present fact. But a prophecy known to be untrue as of the time it is made is to be regarded as an untrue statement of fact inasmuch as it misstates the mind of the person making the prophecy." Some day the Commission will be faced with a case in which it must consider whether a prophecy can ever satisfactorily meet the tests of the Securities Act. The prophet can hardly support the burden of showing that the prediction is not untrue or misleading when he cannot know whether it is or is not.

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18 F.T.C. 635, 1 SEC 13

A year later---in September, 1935---the Securities and Exchange Commission published an opinion in a stop order case involving National Educators Mutual Association, Inc.* At that time the Commission's rules required the filing of a registration statement the contents of which were required in part to be restated in a separate prospectus, or summarized in the prospectus. The rules as to the form and content of a registration statement have been changed in the intervening years to eliminate the need for statement and restatement of information, but one of the basic holdings in the Educators case deserves repetition here.

"The registration statement seeks to ascertain certain very definite particulars of a registrant. In many instances, answers to these may be technically adequate when viewed item by item. The combination of these items, especially those required to be set forth in the prospectus, generally reveal the character of the offering being made and the nature of the security the investor is being solicited to buy. But it may frequently be true that the cumulative effect of these individual items is carefully and intentionally concealed by their segregation in the prospectus, with the result that the impression left upon the reader by the prospectus is fundamentally untrue and misleading. The challenge of the Commission can thus under the Act be not only to individual items in the registration statement and prospectus as such, but upon the broad basis that the general effect of the prospectus as an entirety is to create an untrue and misleading picture in the minds of prospective investors." In brief, scatteration, to use a term favored by the statistician, dispersion, footnote qualification of the standard text are to be guarded against.

*1 SEC 208

In June of that same year the Commission concluded as follows in a stop order opinion relating to a registration statement filed by Plymouth Consolidated Gold Mines, Ltd.*:

"It is obvious that the enterprise projected by this registration statement is primarily to extract gold and silver from investors in this country for the benefit of the promoters and only incidentally to extract gold and silver from mines in distant Mexico. The entire corporate structure of this registrant demonstrates that even though the mines should prove in some degree to realize the predictions of their romantic engineers, the return to the investors would still be negligible. So much is siphoned away by the promoters from the money contributed by investors, that an almost negligible equity is the return for the cash contributed by the public. When that situation occurs and is concealed by the way in which promoters, selling property to themselves through the fiction of a corporation, acquire huge blocks of salable stock for property for which they paid little or nothing, the type of full disclosure demanded by the Securities Act calls for an adequate and succinct disclosure of the effects of these strange and curious proceedings to the investor. To insist upon less than this, would be to fail to fulfill the mandate of that Act and to allow it to be perverted to the uses of fraud rather than to its prevention."

This is but another way of saying that although we cannot and should not, as an instrument of Federal Government, pass upon the merits of ventures or the methods being employed by business in its endeavors, we do and must attempt to seek the revelation of material factors which will illuminate the

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*1 SEC 139

merits for the prospective partner remote from the business and whose informatio in most cases can only come from the prospectus.

In the Haddam Distillers Corporation case* in October, 1934, the Federal Trade Commission announced a principle and policy subsequently adopted and followed in many cases by the Securities and Exchange Commission.

Amendments to the company's registration statement had been filed following the stop order hearing which it was contended cured the deficiencies found by the Commission to exist. In commenting upon the amendments it was stated in the opinion---

"The Commission in stop-order proceedings can in its discretion consider the situation as of the time of the issuance of the order and not limit itself to a consideration of the record as of the time of the notice of initiation of the proceeding. But the circumstances attendant upon the present case clearly give no warrant to the Commission to exercise its discretion in order to permit the registrant to escape the consequences of a neglect and folly that approaches fraud. Trusteeship of other people's money, which the registrant in offering its securities to the public seeks to assume, demands under the present Congressional mandate embodied in the Securities Act some warrant of open, fair and careful dealing. The registrant has twice failed to meet that criterion. Now that the deficiencies have been called forcibly to its attention it hopes by curing them to regain its right to sell securities. But it should certainly not acquire that right under these circumstances when this Commission has the power to transmit generally to the public this evidence of the registrant's disregard of fundamental business ethics and this evidence of unconscionable pretense of scientific method by an appraisal company. A nation of investors deserves, at least, this slight protection."

1 SEC 37

The write-up of assets for balance sheet purposes became the subject of a somewhat cautious probing of a troublesome problem in the Consolidated Mines Syndicate case* in May, 1937. After reviewing the facts, the Commission in its opinion stated:

"The above examination of the figures for unrealized appreciation reveals that the figures chosen partake more of the character of a wish than a careful estimate. Unrealized appreciation is essentially an estimate of the difference between the cost of a property and its present real worth. Since it is dependent on valuation, inaccuracy in such valuation will inevitably invalidate the appreciation figure. From the above analysis of registrant's valuation figures it is apparent that the unrealized appreciation claimed by the registrant is without any basis in sound valuation and is, therefore, misleading. We do not find it necessary at this time to decide whether the inclusion in the balance sheet of unrealized appreciation, even if supported by a proper valuation, is proper."

You will note that these six opinions were all published more than twenty years ago. They do not of course begin to deal with all the specific problems of disclosure which have arisen or which may arise. But the Commission in disposing of the particular problems therein involved gave expression to principles of general application and policy which have been applied repeatedly in the intervening years. They are sound and reliable today if heeded.

But why---you ask---do you speak to us of stop orders and injunctions? Those are for the mining and other promotions, the speculative enterprises and those who seek to defraud the public. As reputable members of the bar and the business community we do not have these problems.

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2 SEC 316

Within the month a life insurance company attempted to sell registered securities under circumstances as to which the opinion in the National Educators Mutual case of 1934 could have been issued with little more than a change in the names of the two companies. I was assured by a member of Congress that the people involved were the leaders of their community. I have no doubt that those people did not realize that they were engaging in a practice publicly condemned by the Commission twenty years ago. Fortunately, the matter was corrected before any harm was done.

There is now in progress an administrative proceeding under the Securities Act concerning a company engaged in a course of dealing which investigation indicates borders on fraud. A highly-placed member of the executive department of an Eastern State is a member of its board of directors. I am sure, had he known the full facts concerning the enterprise and its activities, he would not have loaned his name, reputation and prestige to the venture.

The writing-up of assets continues as a problem as it did years ago, but a little more subtly than formerly. Although on occasion a direct attempt will be made to increase the value of an asset on the books of the issuer, more frequently the same effect is sought to be achieved by transfers of the asset from one company to another by way of transfer of securities or the merger of companies.

Concealment or blurring of fact or effect by dispersal, footnote, fine print, prolixity, ambiguity or omission, seem to be continuing never-ending problems in this business of disclosure. These techniques by whomever employed and whether employed deliberately or by inadvertence are a species of thievery. They rob you of the most important factor in securities transactions other than money---time.

They complicate your timing problems whether they are employed by you or whether they are employed by others. They impede the conduct of all business before the Commission. They on occasion threaten your good reputation and the public confidence in and acceptability of corporate securities even though in your own case no particular problem is presented.

We at the Commission have pondered why after twenty-four years of the Securities Act we have more stop order proceedings pending than we have had in many years and we continue to meet the same basic disclosure problems in our handling of cases informally by letter or conferences notwithstanding the public expressions given over the years to the standards to be applied. I suppose all law enforcement agencies at some point are baffled by the same question.

Some years ago a chairman of one of our legislative committees addressed a formal inquiry to the Commission as follows:

"Now that registrants, underwriters, and their counsel have become familiar with the registration procedures and requirements of the 1933 Act, would it not be possible and desirable for the Commission to abandon its reviewing process, looking toward deficiency memoranda, etc., and permitting the statement to stand on its own feet, as originally contemplated, subject, of course, to all the sanctions contained in the Act?"

The answer in brief was that if the Commission is to perform its primary function of preventing fraud in the sale of securities and to prescribe and enforce fair and uniform standards of conduct and disclosure, a pre-effective review was essential. The interesting aspect of the question, however, was the apparent underlying premise. There was an implied assumption of a state of affairs which the Commission has yet to experience.

I can give you a few pointers which if followed ought to minimize the risk of difficulty in particular cases. They are offered as suggestions after observing in many cases the reasons for problems encountered by registrant and the Commission.

A principal cause of trouble in some cases has been a pair of scissors. Many a registration statement and a proxy statement has been put together by tak: an old case---it can be anyone's---or several of them and working them over with scissors and glue tube to construct a new one.

Of course, there have been instances in which the Government Issue version of the scissors has caused considerable embarrassment to us. We have had examiners who have devised a deficiency letter by the same process. The practice is not a good one by whomever practiced.

Then there is the approach, employed too frequently, of filing a registration statement and prospectus with the expectation that the Commission "will tell us what to put in it and fix it up."

Many cases impress upon us the fact that we are growing old. We find a new generation of practitioners and businessmen who never knew or have forgotten the early years of the securities acts and the problems which gave rise to particular rules or the content of registration forms. It is understandable that many should find this a technical, complex and bewildering field and fail to find all of the many aids which would assist them to a solution of their task.

We encounter situations in which counsel finds himself employed to prepare a registration statement or proxy statement and discovers to his chagrin that his client has failed to make available to him or has deliberately withheld basic data essential to the proper discharge of his obligations.

Finally, I should mention that many practitioners approach the securities acts as though they were concerned with a fairly simple legal problem. This approach can be quite a snare. In the usual case I don't believe that the legal questions under the disclosure provisions of the statutes are particularly difficult. Basically, the problem is a financial problem. Reporting---disclosures, whether in the proxy area or in the raising of capital, relate to business and financial transactions. Competence becomes a matter of good, sound financial analysis in most cases. If you fully understand the business and financial events with which you deal, it should be fairly easy to employ the lawyer's art of clear expression and fair description. It would be my observation that it is the practitioner who fails to probe until he fully understands the economic and financial factors with which he deals who creates a legal problem where none should have arisen.

One final word on procedures. The Commission acts on every registration statement as it becomes effective under Section 8. Each Commissioner reviews a memorandum on every case before that case is presented for action. Staff members are expected to know the facts and to explain and comment on problems encountered. Our job at staff level is to dispose of the cases on a day-to-day basis within the limits of Commission policy as that has been determined on a case-by-case basis. You are free to raise with the staff and with the Commission, if you wish, any matter as to which you believe an improper or unfair decision or result is being reached. There's no need for formality in that event---you may request the staff to submit a question to the Commission for a ruling and that will be done or you may request to be heard by the Commission. It has been my experience that the Commission has been most generous in its response to such requests.

This policy and approach in the long run operate for the good of all of us. Generally, the position of the Commission has been that the policies, standards and procedures to be followed should be those which will assist legitimate business to conduct its legitimate affairs with a minimum of unnecessary interference and with full awareness of that factor I first mentioned---time.

In following that policy and approach, we are confronted with the never-ending dilemma faced by every law-enforcement agency---a dilemma which to some extent is of our own creation---how is it possible to prevent the unscrupulous and the negligent from turning to their own advantage a system designed to aid and further the legitimate objectives of those who willingly comply with the statutory requirements?