SOME CONTEMPORARY

PROBLEMS IN SECURITY REGULATION

Address of

Edward N. Gadsby
Chairman
Securities and Exchange Commission
Washington, D. C.

before the

National Security Traders Association, Inc.

Hot Springs, Virginia
November 6, 1957

SOME CONTEMPORARY PROBLEMS IN SECURITY REGULATION

It is a great pleasure for me to appear before you tonight and to participate in your annual convention. I know that being visited and addressed by a chairman of the Securities and Exchange Commission is not a novel experience for you. But, as you know, I am still fairly new at the job, and the experience of being with you is to me novel as well as pleasant.

Since you are all professionals in your particular phase of the securities business, I imagine that you know our Commission and have some knowledge of the laws which we are required to administer, at least of the Securities Act of 1933 and the Securities Exchange Act of 1934. I do not feel that we are necessarily on opposite sides of the fence under these statutes. For, while on the one hand, the Commission is charged by law with the duty of safeguarding the interests of investors and consumers along certain designated lines, on the other hand, the Commission recognizes that it must not frustrate or thwart the beneficial and wholesome operation of the mechanism of the capital market which it is so authorized to regulate. In fact, we conceive it to be our duty to foster and encourage the investment of funds in industry. If regulation of the capital markets is to be effective, it must achieve a harmony that will permit the full development of those

markets which lie at the very foundation of this country's economy and future. At the same time, such regulation must prevent recurrence of those activities which have in the past resulted in abuse of and loss to investors. The fulfillment of this dual objective can be realized only through a mutual understanding of the problems involved, both those we have as regulators, and those you have as an important part of the regulated market.

I know that a person who has been caused trouble or inconvenience by our statutes or rules, or who has been prevented from doing something he wanted to do has, at least temporarily, no love for us. And I am familiar from long experience on the private as well as the governmental side with some of the methods of expressing that lack of love. It is obviously impossible to please everyone, and especially those who at the moment are feeling acutely the restrictions of our statutes or rules or enforcement activities.

However, Congress has declared that securities transactions must be regulated in order to protect our national economy. This has come to be an accepted axiom in our economic thinking. There may be some honest difference of opinion as to methods and limitations, but I think it can safely be said that no one who has any interest in the public

welfare or in the securities industry wants to go back to the good old days of the bucket shop, the boiler room and the water-soaked balance sheet. Full disclosure, fairness, and honesty in the securities business are not only principles of morality and justice. They are also essential for the continued effective operation of our economic system.

Today, all responsible persons believe that the thrifty American who is asked to put his savings into the securities market should feel confident that the brokers, dealers and salesmen who are offering the securities to him for sale are following reasonable standards of honesty and disclosure. Furthermore, he is entitled to expect that, once he has bought them, the market value of these securities will not be jeopardized by overreaching or manipulative practices in the securities markets.

Our interests along this line do not conflict in any true sense of the word with your own. The Commission is dedicated to the preservation of an effective, honest and open functioning of the capital markets. You are interested in the same thing. Both your job and ours are concerned with making the free enterprise system work for the benefit of all.

Since we have this fundamental similarity in viewpoint, I would like to call your attention to certain problems which have currently been giving us a lot of concern. Some of these will not

affect you directly as traders, but I think they will be of general interest to you as persons engaged in the industry.

The first of these relates to the somewhat paradoxial conflict between the efforts of an issuer's management, its public relations men, and sometimes its underwriters, to get as much favorable information as possible to stockholders and the requirements of the Securities Act prescribing the prospectus and its use. A press release or letter to stockholders which ordinarily might be regarded as a smart move for improving public or stockholder relations can suddenly become illegal where closely followed by a public offering of securities. The press release then appears as an offer to sell the securities and so a "prospectus" which would fall far short of meeting the requirements of Section 5 of the Act.

Last month we issued a release discussing this question. You may be interested in some of the observations made.

Under Section 5 of the Act, it is against the law to offer a security prior to the filing of a registration statement. A security may be offered legally after filing and before the effective date of a registration statement, provided that any prospectus employed for this purpose meets the standards of Section 10 of the Act. Thus,

in general during this period - after the filing and before the effective date - no written communication offering a security may be transmitted through the mails or in interstate commerce other than a prospectus authorized or permitted by the statute or the relevant rules. After the effective date, sales literature in addition to the prospectus may be employed legally, provided the statutory prospectus precedes or accompanies the supplemental literature.

These provisions with respect to the time and manner of offering and selling securities apply during the period of distribution of the security. Consequently, the prospectus required by the statute must be used by an underwriter or a dealer participating in the distribution so long as he is offering any part of an unsold allotment. In addition, all underwriters and dealers must use the prospectus during the 40-day period following the effective date of a registration statement or the commencement of the public offering, whichever occurs later.

It is clear from the express language and the legislative history of the Securities Act that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. Although not couched in terms of an express offer, the publication of information

and statements, and publicity efforts generally, made in advance of a proposed financing may in fact so contribute to conditioning the public mind or arousing public interest in an issuer or its securities as to raise a serious question whether the publicity is not in fact part of the selling effort. The line is often very difficult to draw between legitimate publicity and a sales campaign, and the burden is on the issuer to draw this line.

Similarly, the release of publicity and the publication of information between the filing date and the effective date of a registration statement may result in a determination that the publicity is in fact a selling effort by an illegal means; that is, other than by means of the statutory prospectus. Similar problems will arise from publicity and the release of information after the effective date but before the completion of distribution.

Instances have come to our attention in which information of a misleading character, gross exaggeration and outright falsehood have been published by various means for the purpose of conveying to the public a message designed to stimulate an appetite for securities. This material, needless to say, could not properly have been included in a statutory prospectus conforming to the standards of integrity established by the statute. Some of the cases have reflected a

deliberate disregard of the law. Others have indicated that the parties were unaware of the problems involved or else failed to exercise a proper control over research and public relations activities pending the distribution of an issue of securities.

Let me point out to you a couple of examples of the sort of situation of this character with which we meet.

In one relatively recent case, a company negotiating with a prospective underwriter for a public offering of common stock supplied the underwriter with financial information concerning its operations for the first quarter of the fiscal year. The underwriter incorporated this material in a brochure containing other information concerning the company and its prospects. The brochure was distributed widely among the membership of the N.A.S.D. at the time when a registration statement was being prepared but prior to its filing. When the registration statement was filed it was discovered that the financial statements included therein reflected a financial history and a current position much less favorable than suggested by the first quarter figures shown in the brochure.

The Securities and Exchange Commission considered that the distribution of the brochure violated the registration provisions of the Act and also raised questions under the anti-fraud provisions of the

statute. It was also held that the underwriter's activities justified postponement of the effective date of the registration statement until the offering prospectus had been circulated among those to whom the brochure had been made available. I have no doubt but that the relations between the company and the underwriter were seriously strained by this result, which could have been avoided by the exercise of even reasonable foresight.

In another case, immediately preceding the filing of a registration statement for an issue of securities of a large industrial company, the research department of an investment banking firm distributed to a substantial number of the firm's institutional customers a brochure which referred specifically to the proposed issue and described the business and prospects of the parent company of the prospective issuer. The business of the prospective issuer represented the principal part of the over-all operations of the total enterprise. The banking firm had been a principal underwriter of prior issues of securities by the parent and in accordance with its policy had from time to time distributed reports to its clients concerning securities of issuers which the firm had financed. It appeared, in this particular case, that the research department of the banking firm had prepared and distributed such a report to its clients without being fully aware of the activities of the

underwriting department or the timing of the forthcoming offering.

We advised the representatives of the issuer and the prospective underwriter that under all the circumstances, including the content, timing and distribution given to the brochure, participation of the firm in the distribution of the securities would pose difficulties from the point of view of the enforcement of the registration provisions of the Act. In order to avoid any question as to violation, the banking firm did not participate in the distribution. Hence, a failure of the various departments of the banker to coordinate their activities resulted in the loss of a very attractive and profitable piece of business.

Ordinarily we have no great difficulty in these registration matters. The great bulk of the securities industry and their legal advisers appear to be fully reconciled to the statutes and after some twenty-four years of experience, can operate under them deftly and adequately. But in any industry of such complexity and ubiquity and which offers golden opportunities for fraud in its lower reaches, there is bound to be a margin of operations which shade from gray to black. Or, in a less sinister area, there may be some reason based on economy or simple impatience why a given corporation feels, rightly or wrongly, that it does not care to file the papers necessary for registration. When Congress drafted the Securities Act, it provided

for certain exemptions, and it is in such exemptions that many of these concerns take refuge. One of these exemptions is for "transactions by an issuer not involving a public offering," sometimes characterized as the private offering exemption.

When we speak of an offering as public in nature, it does not mean necessarily that it must be an offer to the whole world. One Court has aptly pointed out that "an offering of securities to all redheaded men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation . . . is no less 'public' in every realistic sense of the word, than an unrestricted offering to the world at large."[1/] The Supreme Court in the Ralston Purina case laid down an even stricter test. It there held that whether the number of offerees is few or many, if they are persons who do not have access to the information which would be given to them by the filings under registration proceedings, the offering is a public one. Consequently, even an offering to key employees of the issuer might be a public offering.[2/]

There have been many attempts to evade the registration requirements of the Act by means of devices calculated to give the appearance

---

1/ Securities and Exchange Commission v. Sunbeam Gold Mines, 95 F. 2d 699 (C.A. 9, 1938).

2/ Securities and Exchange Commission v. Ralston Purina Company, 346 U.S. 119 (1953).

that a public offering is not involved. The Commission, however, has insisted that if the net effect of the transactions is a public distribution, no technical devices can change its basic character. Last summer in a public release the Commission made it clear that one may not isolate a part of a series of related transactions and try to establish that this portion is a private transaction where admittedly the whole business involves a public sale. In the case there referred to, a company issued debentures which were immediately convertible into stock. The debentures were sold privately and the issuer was given so-called "investment letters" by the purchasers. However, the purchasers converted the debentures into stock very shortly thereafter, and sold the stock widely to the public. This was held to be a public offering subject to the Act. [3/]

An issuer may not establish an exemption merely by collecting so-called "investment representations" from a limited group of purchasers if in fact a distribution by these persons is intended. A representation by a purchaser that he is taking for "investment" when in fact he is concurrently dividing a participation among others or

---

3/ Crowell-Collier Publishing Co., Securities Act Release No. 3825 (August 12, 1957).

reselling a portion of a commitment to others is worthless as grounds for such a claim. Issuers and underwriters cannot claim that a transaction does not involve a public offering if they do not know the identity and number of initial offerees or purchasers or whether the purchasers offer and sell to others. The Congress and the Courts have placed the burden of proof upon the person claiming an exemption. It is his responsibility to assure the existence and continuance of the conditions on which the exemption is claimed. Holding for the six months' capital gains period of the tax statutes, holding in an "investment account" rather than a "trading account," holding for a deferred sale, holding for a market rise, holding for sale if the market does not rise, or holding for a year, none of these necessarily affords an automatic basis for exemption. There must be a genuine investment intention. One cannot safely rely on formalistic devices and ignore the actual intent. And if the issue is not exempt, it is dynamite to handle. Its sale may impose substantial liabilities on the company and on the original purchaser, may result in injunctive proceedings which could seriously effect the market in the security, and could involve criminal liability as well. As in the case of most Federal statutes, it does not pay to flout the Securities Act.

Another exemption often resorted to is the so-called intra-state exemption. This exemption is predicated on the constitutional background of the Securities Act, since that statute was based on the Commerce Clause of the Constitution, and on the Congressional concept that in matters of a purely local nature, it is inappropriate for the Federal Government to impose the disclosure provisions of the Federal Securities Act. Accordingly, any security is exempted from registration which is part of an issue of a corporation organized under the laws of a state and sold only to persons resident in that state. This exemption is designed to apply only to such types of distribution as are genuinely local in character. It exempts "only issues which in reality represent local financing by local industries, carried out purely through local purchasing." 5/

In the first place, it should be noted that the exemption is available only if all of the issue is sold to residents of the state. If any part is sold to a non-resident, directly or indirectly, the entire exemption is lost and all of the sales, even those to residents, become unlawful. Likewise, if within a short period one or more of the purchasers should resell to a non-resident, the purchaser might

---

5/ Opinion of General Counsel (Securities Act Release No. 1459, May 29, 1937).

be considered an underwriter within the definition of the Act and the exemption would be destroyed. This could entail serious consequences to the issuer and to those who participate in the offering. Even if the sale to the non-resident is inadvertent and even if it should not warrant criminal action, nevertheless, should the stock decline in value, all who participated in the sale would be subject to civil liability at the suit of each of the investors. Moreover, if the issuer finds that it cannot raise the desired amount from residents of the state, it cannot change horses in midstream and shift to Regulation A or some other exemption, for the intrastate exemption will then be lost as to the part of the issue earlier sold in reliance upon it.

To turn, now, to another problem, there has been a great deal of publicity recently concerning the boiler room operators. As has been pointed out in the published articles on this subject, one of the favorite vehicles used by these gentry, is the so-called Rule 133 of the Commission which excludes from the definition of a sale the issue of certain corporate securities resulting from a merger or consolidation. There is grave doubt of the legality of Rule 133, and the Commission proposed last spring to delete

it entirely, but was met with such a chorus of dissent from the industry and its lawyers that it took the matter back for another and perhaps more intensive study. That study is in process and should result in another proposal regarding this rule in the not too distant future.

I don't suppose any of my audience has ever dealt with one of these boiler rooms, since I would not suppose their sucker lists would normally include such highly sophisticated markets. However, in some cases, the securities have been listed on the Board, or have been widely distributed through the over-the-counter market before the acquisition by the boiler room operator of the block of stock which he is peddling. The result is that his operations have resulted in an artificial market followed, in some cases, by de-listing of the security, to the loss of previous innocent investors. From this standpoint, you, as representatives of legitimate dealers and as persons called on to trade in any security, are affected by these operators, even though you or, for that matter, your customers may not purchase a share of stock from them. Again, you may be very certain that the Securities and Exchange Commission will continue its investigatory and enforcement activities to the fullest extent possible. There is nothing which gives our staff more real pleasure, I am sure, than to see the prison doors shut behind one of these salesmen or his principal.

I would like to point out one more difficulty which we have struck in the course of our activities. In order to make clear how these things develop, let me recall to your attention the stupendous increase in the facilities for interstate commerce since the Federal Constitution was written in 1789. This increased ease of communication has forced the Congress and the Courts to broaden the meaning of the Commerce Clause of our fundamental law far beyond the meaning imputed to it by Madison, Jefferson and Hamilton, and was one of the principal factors that brought on the adoption of the various laws under which the Securities and Exchange Commission operates. But at the same time, the facilities for intercourse with foreign nations have correspondingly improved to where such a realist as Wendell Wilkie could accurately describe this globe as constituting one world.

Now, those to whom I have referred as being interested in evading the salutary provisions of the Securities Laws have not been slow to discover that the facility of communication with foreign nations applies as much to them as to anyone else. It only requires a few hours' flight to deliver a parcel of securities to Montreal, and only a day or so to deliver them to Switzerland or some other place in Europe where the long arms of the Securities and Exchange

Commission and the Department of Justice cannot reach, and from which points it is relatively easy to carry on operations which would result in immediate indictment if they were performed from a base in this country. It is no reflection upon the foreign countries involved, who have their own problems, when I say that the same dislike of stock jobbing is not always met in those jurisdictions, and the Commission is sometimes forced to contend with very considerable obstacles in its attempts to follow such transactions through the ramification which a resourceful crook and his counsel can so establish.

For example, the Swiss law prevents a bank from revealing the name of a client who directs that it not be revealed. Consequently, the real ownership of a block of stock may be successfully hidden by recourse to such a device. For another example, a Canadian court, at least temporarily, has in effect invalidated a treaty arrangement with this country, and unless and until we get a more favorable decision, we cannot extradite one who violates the Securities Act from Canada for trial in this country.

I am sure that many of you have had occasion from time to time to deal with the various types of organizations classed as Investment Companies, whether in transactions involving the securities of such concerns, or in purchases and sales of securities

for their account. Such organizations are, as you know, subject to the jurisdiction of the Commission under the Investment Company Act of 1940. Due, in some measure, at least, to the rising market which reached its then peak in July of this year, as well as to very effective sales methods, the asset value and the importance in the securities markets of these concerns have multiplied manyfold since the adoption of the Act. In 1942, the aggregate stated value of the securities in the portfolios of the then 407 companies under our jurisdiction was $2,400,000,000. In 1957, this figure has increased to $15,000,000,000, though the number of companies included had increased only to 432. How much of this increase represents new money and how much is capital gains, could, I suppose, be computed. However, I only allude to this growth as showing the increasing importance of these funds in our economy.

Naturally, this tremendous growth is accompanied by growing pains of various descriptions. The growth phenomenon itself was evidently of concern to Congress when it inserted Section 14(b) into the statute in 1940, which authorized the Securities and Exchange Commission to investigate the effects of the size of these companies on our economy. This and many allied problems are by no means insubstantial, and have been given all the attention permitted by budgetary limitations.

Many of the newer mutual funds have sought to compete with the older funds by adopting spicy names implying an intention to concentrate portfolio investments in some special and romantic field. In such case, we have insisted that the fund tie itself down in some degree to live up to the implications of its name by a suitable statement of investment policy in its registration statement. Such a policy can only be changed by a vote of stockholders. This is irritating to promoters and management. But after all we believe that if the natural implication of a fund's name is that it is invested, for example, in the automobile industry, then it should be invested in that industry to a substantial extent. Otherwise, the name is deceptive.

This situation sometimes brings up the question as to whether a particular investment conforms to the applicable investment policy. The modern diversification policy which has been adopted by many corporations makes it increasingly difficult to tell just what industry is represented by a given issuer. We would just as soon not have to decide such questions. But so long as mutual funds continue to hold themselves out as representing a particular investment policy, by name or otherwise, we must do our best to see that the fund lives up to its undertaking.

While discussing the Investment Company Act, I should mention to you what we call the "inadvertent investment company." It often happens in these days of rapid corporate change, that an industrial corporation sells its assets to a competitor, very often for a substantial cash consideration. Being human, the management of the selling corporation which finds itself in possession of a large amount of cash and does not take kindly to being done out of a job by liquidation and distribution, turns to the market and starts acquiring investment securities. It apparently comes as a distinct shock to them some time thereafter when we catch up with them to discover that they have suddenly become managers of an Investment Company and are subject to very substantial regulation in their activities, a phenomenon to which they are unaccustomed and by instinct resent and deplore.

I mention the Investment Company situation particularly, since it is rapidly becoming one of the great sources of outside equity capital. The other great pools of credit, such as the pension trusts and institutional investors, go in far more heavily for debt securities, leaving the risk capital for others. Hence, it is important that the Investment Company Act be administered sympathetically, so as not to discourage such capital while still with a view to the policies embodied in the statute by the Congress. I mention these problems to you in particular, since

you may stumble upon these situations from time to time, and you may be able to warn your customers that perhaps a visit to their lawyers is indicated.

The Securities and Exchange Commission is thus compelled to steer carefully at all times between Scylla and Charybdis. It must live up to its policy of expediting and fostering the flow of capital, but it must do so without weakening itself in its extremely important duty of protecting the public investors from the ingenious snares of the confidence men. And this feat is getting more complicated daily, if for no other reason than the sheer number of transactions which the Commission is called on to police. The total volume of securities effectively registered in the fiscal year ending June 30, 1957 was $14.6 billions of dollars, the largest volume in the history of the Commission, and almost double that filed so recently as 1953. The number of shares admitted to trading as of December 31, 1956 was about 6,334 million, an increase of 850 million, or over 15 per cent in one year. Many other indices point up the increased volume of work we necessarily handle. For example, the number of ownership reports under the various statutes has increased from 22,333 five years ago to 34,443 in the last year. There were 1214 broker-dealer inspections

completed during the fiscal year ending June 30, 1957 representing an increase of 25% over fiscal 1956. The number of securities salesmen increased from 48,566 to 57,103 during the same period, and the number of investment advisers registered under the 1940 Act increased from 1,309 to 1,431, or almost 10 per cent.

I do not want to be accused of simply stating these problems and then running for shelter. The apparent dilemma I have described is by no means impossible to avoid, and we intend manfully to attempt to avoid it. We have introduced or supported legislation in Congress designed to facilitate processing of matters before the Commission, to enlarge the scope of the Section 3b, i.e., Regulation A exemptions and in any way that seems possible to us to assist the financial community. At the same time, legislation is under consideration to extend civil and criminal liability to documents filed with the Commission in connection with exempt offerings such as those made under Regulation A; to clarify and strengthen the provisions relating to manipulation and to financial responsibility of brokers and dealers; to grant to the Commission authority to adopt rules regulating the segregation of customers' securities and excess collateral held by brokers and dealers; and to make the status of a person as an exchange member or registered broker or dealer a basis for federal jurisdiction without the necessity of proving use of the mails or interstate facilities.

I think you may be interested, also, in the status of the so-called Fulbright Bill which has been pending in Congress for the last couple of sessions and which is designed to amend the Securities Exchange Act of 1934 to extend some of its provisions to unlisted securities. This amendment would compel certain corporations whose securities are outstanding in the hands of the public but who have not qualified them for listing on a recognized stock exchange to comply with certain provisions of the Act as they now affect corporations whose securities are listed. Under this proposal such companies would be required to file financial statements and proxy material and their officers, directors and large stockholders would be required to report short swing trading, would be prevented from making short sales and would be required to observe the margin rules of the Federal Reserve System. This Bill was reported out of the Senate Committee on Banking and Currency to the floor of the Senate in the last session. In its present form, it applies to about 650 of the larger corporations whose securities are traded over-the-counter except banks, insurance companies and certain other institutions. No further action was taken in the first session of the 85th Congress

but it probably will come up on the calendar some time next year. This Bill will doubtless have the effect of tending to increase the number of listed securities, since there would be apparently little to be gained by these companies staying off the Board if it becomes law.

In addition to legislative changes designed to meet some of the problems I have outlined, the Commission has under consideration far-reaching amendments to some of its rules, and is actively studying the situation involving foreign jurisdictions to see whether there is any legislative or other answer to the problems it has been meeting in that field. It also has under consideration a study of the field of permanent financing for small business, involving a re-appraisal of Regulation A and consideration of steps which might be taken to create a broader investor interest in this field.

The obverse side of this program includes a continuing program of strict enforcement, by civil and criminal actions in the courts where indicated, but in large measure through administrative sanctions. The stepping up of our enforcement activities is clearly reflected in some of the internal statistics for last year. In the fiscal year ending June 30, 1957, the Commission referred 26 new cases to the Department of Justice for criminal action as

compared with 17 cases during the previous year. Similarly, the Division of Corporation Finance reports a total of 176 investigations and administrative proceedings under the 1933 and 1934 Acts during the fiscal year 1957 as compared with 115 such actions during the previous year. Comparable increases in the workload of the Division of Trading and Exchanges are reported, and substantial increases in the enforcement activities of this Division are contemplated for the coming year.

The Securities and Exchange Commission feels a deep sense of responsibility in performing the duties which are assigned to it by the various statutes under which it operates. While we cannot condone and must prevent violations of the rules of the game as laid down by the statutes, we feel that we must use every resource within our power to assist the legitimate activities of the securities business. The particular part of the business which you gentlemen conduct is of unique importance and of very great interest to our organization. Your activities in stabilizing the market in connection with new issues is critical in its importance to the investor and to the public as well as to the issuing corporations. I am anxious to see a closer working relationship

between our Division of Trading and Exchanges and your organization in order to accomplish some of the aims which I have pointed out here tonight. If I have been able in any way to further this program by the few and rather superficial observations which I have been able to make in view of my relative inexperience, I shall be very happy indeed and shall consider that I have in some small measure repaid the superb hospitality with which your organization has treated me.

572930