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OF

CORPORATE SECURITIES

ADDRESS

of

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of the

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During the short span of less than a lifetime there has come about an economic evolution which in its effects amounts to a revolution. As recently as the boyhood days of most of us who are gathered here today, the ownership of property, generally speaking, still retained in combination its orthodox characteristics of possession and control. The present generation, however, has witnessed a tremendous expansion in the use of the corporate form for the conduct of American business. Through merger and consolidation, the corporate form now concentrates to a dominating degree, in hands that are alien from the major ownership, the nation-wide control of many of the most important business activities. Such ownership, resultantly, no longer carries with it the plenary power of management, nor the rights, duties and responsibilities that are inherent in the control of the property.

The most significant aspect of the advance from feudalism to a system of private property was the resulting unity of the three attributes of property, to-wit:--ownership, possession and control. Likewise now the most significant aspect of the current transition toward universality of the corporate form is the resulting disunion of those three attributes into an uneconomic trinity -- into a divorcement of the private rights and the public responsibilities attendant upon the ownership of property that, if left to run its course, threatens to destroy the economic democracy upon which our political democracy is builded.

From its beginnings in the early nineteenth century, which were restricted to enterprises having a direct public interest, the corporate form was progressively extended to banking and insurance, the railroads, manufacturing, the modern public utility, merchandising, urban real estate, and of late to agriculture itself. The investor shareholder has attained vast numerical importance as the nominal owner of enterprise, but inversely with his increasing numbers, the greater diffusion of ownership, and the more and more nearly complete surrender of physical possession, has come decline in his legal as well as practical power to control and manage the property in which he owns an interest. To a revolutionary extent, therefore, the rights and responsibilities that are inherent in the possession and management of property have passed from the beneficial owners into the hands of salaried, and sometimes exploiting, corporate officials, who, by reason of comparatively slight personal ownership, are too often under temptation to seek profit along other avenues than the operation of the enterprise in the best interest of the shareholder.

Every open mind, obviously, that is willing to explore this startling trend, if only as far as was done by Berle and Means in their notable work published in 1932, "The Modern Corporation and Private Property", will concede the need for a stronger medicine than laissez-faire and rugged individualism to correct the economic ills that afflict us now. And no student of the subject will deny that there is in process on the one hand a continuous contraction of the zone of strictly private enterprise wherein so-called individual initiative can be said to have normal sway, and on the other a concomitant widening of the zone of enterprise that is affected by the public interest represented by the investor and the consumer.

From these developments has stemmed the general conviction as well as the supporting fact that investors in corporate securities embody a public interest of the first magnitude which responsible government, both state and national, must protect and conserve.

Undoubtedly it was popular recognition of the metamorphosis I have just described that, to a large degree, inspired the enactment of those laws affecting the issue and distribution of corporate securities which, of one kind and another, we find on the statute books of our state and federal jusisdictions. The pioneering work was done by the states, and 47 of them I understand have adopted so-called Blue Sky Laws. Parenthetically I would pose a query that is provoked by my observation of the capital structure of some of the utility holding companies containing a copious volume of water injected through the hose of generous write-ups. My wonder is why the term "Blue Ocean Laws" hasn't attained common usage as being even more accurately descriptive than the words "Blue Sky".

In speaking to this subject today, I do not lay claim to any extensive personal experience outside the federal field. As a Member of Congress during the period when all of the securities legislation that is now a part of the federal statutes came into being, I acknowledge responsibility with 530 other Members for its drafting and its enactment. At the present time, as one of the five members of the Securities and Exchange Commission, I share the responsibility for its interpretation and administration. My experience with the regulatory laws of the several states consists only of the professional service I was from time to time called upon while in the general practice to render private clients whose business activities brought them within the purview of those laws.

With such a background, therefore, it might reasonably be expected that I should limit myself on this occasion to a discussion of the federal field, that presumptively I know something about. How violent that presumption may be will be left to the charitable judgment of my hearers at the conclusion of my remarks.

Addressing myself as I do, however, to the members of a legal association of a great state, all of them learned in the law and all of them concerned as patriotic American citizens that our dual system of state and federal laws may work the most satisfactorily in the greater public good, I believe it not out of place to implement my review of the federal laws and their administration with some suggestions looking toward the attainment of the sort of team work between the national and state jurisdictions that will promise the greatest possible degree of success in achieving the ultimate objective cherished by all, namely, the protection of investors and the promotion of the general public welfare.

Out of the duality of our form of government spring problems in almost every field of control over human conduct, and the regulation of corporate securities has produced its full share. These problems are present in a variety of forms -- philosophic, constitutional, political, administrative. In my remarks today I am endeavoring to forego any flights into the rarefied, though exhilarating atmosphere of constitutional and political theory, and am considering only some of the concrete, practical questions that arise because of the existence, side by side, of the securities statutes that have been enacted by Congress and the regulating laws that are on the statute books of the several states.

All securities legislation, whether State or Federal, has for its basic purpose, of course, the protection of investors. The State laws, differing considerably in detail, may be classified, according to their basic provisions, into three major types. There is the "fraud" law, which, in essence, provides for the punishment of fraud in the sale of securities. This type of law often fails to lock the barn door until after the horse has been stolen, for it becomes operative only when evidence has been presented that a fraud has been or is about to be committed. Under such a statute a person is free to sell securities without first filing any information or obtaining any permission to sell. A second type of statute is the "disclosure" law, which proceeds on the theory that if the investor is provided with all material information respecting the security he is about to purchase he will then exercise intelligent investment judgment. This type of law calls for the submission of information to an administrative body. Ordinarily, however, it does not require affirmative action by the State prior to sale. Most of the states have adopted still a third type, the so-called "regulatory" law which prohibits the sale of all securities, except such as are expressly exempted or expressly permitted by the state to be sold. Under such a law the state is given an opportunity to pass upon the merits of the security prior to its sale. Thus it may examine the soundness of the enterprise and question the fairness of the terms of the security and of the plan under which it is to be offered to prospective investors. Most of these laws also contain provisions requiring persons engaged in the business of selling securities to obtain a license conditioned upon their honesty and financial integrity. Your law in Illinois is of this class, requiring both the qualification of securities and the licensing of dealers.

Turning now to federal securities legislation, I assume you all know that the SEC administers three statutes, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935, and that it also has been assigned certain non-regulatory functions under the Bankruptcy Act as amended during the last session of Congress. Because of the special fields with which they are concerned, we can eliminate the Bankruptcy Act and the Public Utility Holding Company Act from the present discussion. May I observe in passing, however, that our advisory service to the federal courts in corporate reorganizations under Chapter X of the revised Bankruptcy Act, although initiated only last Fall, is already widely availed of, with quite general satisfaction to the Judges and the investors concerned. The Act of 1935 applying to Utility Holding Companies confers regulatory powers upon our Commission that go far beyond the scope of the issue and distribution of their corporate securities. Later I shall want to say a few words about certain aspects of the Securities Exchange Act of 1934, but for the moment let me confine my remarks to the Securities Act of 1933.

The Securities Act is not, like the Illinois statute, a "regulatory" law in the sense in which I have been using that word. It is rather a combination of the "fraud" and "disclosure" types of statute. The "fraud" provisions of the Act may be loosely described as comprising the law's prohibitions against the use of the mails or of means or instruments of interstate commerce in connection with the sale of securities by fraudulent means. They are in a sense a supplement, in the special activity of the issue and distribution of securities, to the mail fraud statute, albeit somewhat broader in that they apply to the use of instruments of interstate commerce, such as the telephone, the telegraph and the radio, as well as to the use

of the mails. The "disclosure" provisions of the Act, which are probably of more direct interest to lawyers generally, provide for the registration of securities offered, sold or delivered after sale through the mails or in interstate commerce. Registration is effected by filing a registration statement containing certain specified information relating to the securities, their issuer and the manner of distribution contemplated. The Act also requires the use, in connection with each sale through the mails or in interstate commerce, of a prospectus summarizing the information contained i the registration statement. It is well called the "Truth in Securities Act," for its purpose is to make available to the investor not only the truth, but the whole truth, so that he may intelligently appraise the investment risk. The Act does not empower the Commission to approve or disapprove securities; indeed representations that the Commission has done so are expressly forbidden. So far as the Securities Act is concerned, a promoter can peddle, or try to peddle, the most worthless stock in the most fantastic project ever conceived by the mind of man, provided the worthlessness and fantasy are clearly spelled out in the registration statement and prospectus.

It seems odd that an occasional voice should still be heard with the plaint that the Securities Act is interfering with business and is interrupting the flow of investment capital into productive uses. True enough, such voices are becoming more and more occasional and softer and softer spoken. The only impingement of the law is to prevent misrepresentation, whether it be affirmative or negative in character. To the extent that it helps investors acquire confidence that their chance-taking is confined to legitimate business risks, the law should and does operate as a stimulant rather than a sedative. Critics might as well argue that the common law cause of action for fraud or deceit in the sale of shoddy merchandise or other types off-color property retards trade and commerce and should be abolished by statute.

But the fact that our powers under the registration provisions of the Securities Act go no further than to require full and accurate disclosure does not mean that we are engaged in making academic or futile motions. Indeed, it is sometimes ironic to perceive the commotion that can be caused by simply requiring a statement of the truth and the whole truth. You may be interested in two or three examples of the operation of the disclosure principle.

The simplest kind of case is that involving the valuation of property turned over to a corporation by its promoters in exchange for stock in the company. We cannot and do not attempt to prevent the issuance of corporate shares in exchange for property or services. The laws of most states permit this practice; moreover, they commonly provide that a valuation fixed by the directors of the company is conclusive for certain purposes in the absence of fraud. In one of its earliest decisions the SEC held that such a provision of the State law cannot foreclose inquiry by the Commission into the accuracy of the valuation as expressed in the registration statement and prospectus and the accompanying financial statements. 1/ This action by the Commission has unquestionably tended to prevent the issuance of stock to promoters for inadequate consideration, since it has made extremely difficult the sale, except at a discount, of stock thus acquired.

1/ In the Matter of Brandy-Wine Brewing Co., 1 SEC 123.

Another device, reminiscent of the igenious Mr. Ponzi, is the payment of dividends out of paid-in surplus or some similar account not made up of earnings. Unless the source of the so-called dividends is clearly labeled, the investor is likely to get an exaggerated idea of the prosperity of the company. The Commission has no power under the Securities Act to prevent a distribution of capital to stockholders, but if a company is trying to sell its securities to the public, the Commission can and does insist that the source of such distributions be clearly indicated. Many an imposing "dividend" record has been deflated in this manner. 2/

Another particularly pernicious practice is the distribution of part of the capital contribution of one class of stock to another class of stock in the form of dividends. This can be accomplished under the corporation laws of many states in this manner: A preferred stock is sold above its par or stated value; the excess is credited to surplus; and dividends are then paid out of this surplus, to common as well as preferred shareholders. Again we cannot stop the practice, but we can compel disclosure of the proposed allocation of the proceeds of the sale as between capital and surplus accounts, and disclosure of the consequences that may flow from such an allocation. 3/

These examples could be supplemented by many others. You will note that the particular practices I have cited were all made possible by laxity in the State corporation laws. The origin of this laxity, primarily in the competition between States for corporate franchise business, is a story with which I am sure you are all familiar. It is well told in the volume by Berle and Means to which I have already referred. If the time ever comes for a thorough reform of the State corporation laws -- and I hope that time may not be too far distant -- the decisions and experience of our Commission may provide valuable source material.

The device of disclosure under the statutes which we adminster is by no means limited to the Securities Act of 1933. The Securities Exchange Act of 1934, even when a company is not contemplating any new offering of securities, requires the filing of a registration statement before the company is permitted to list any of its securities on a national securities exchange. The information thus filed must be kept up to date by the filing of annual and special reports. In this manner there is spread on the public record a history of every enterprise that is sufficiently large to have its securities listed on an exchange. These Exchange Act registration statements and reports, that are on file with the exchange or exchanges on which the company's securities are listed as well as with the SEC, constitute a source of information of incalculable value.

Under the law the Commission is required to make registration statements and similar public documents that are on file with it available for inspection by members of the public. Provision has also been made for the sale at cost of photostatic copies of any such document or any part thereof. During the fiscal year ended June 30, 1938, over $21,000 was collected

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2/ cf. In the Matter of Golden Conqueror Mines, Inc., 2 SEC 642; In the Matter of Foreman and Company, Inc., Exchange Act Release No. 1560.

3/ Fourth annual report, page 39, paragraph (4).

from the sale of photo-duplications, which means that a minimum of 210,000 pages of information were photostated and distributed to members of the public. Nevertheless, our experience under the proxy rules (adopted pursuant to Section 14(a) of the Securities Exchange Act) indicates that the investors' appetite for information about the companies in which they are interested is far from satiated.

The soliciting material which stockholders have received in connection with the solicitation of their proxies has awakened and vitalized a new interest on their part. This is manifest from the letters the Commission daily receives. The Commission's proxy rules, adopted last August, relate to proxies solicited in respect to securities listed on national securities exchanges and they require disclosure of the facts concerning the matter to be acted upon pursuant to the proxy. In essence, this means that security holders shall be provided with sufficient information to exercise independent judgment in voting. Correspondence from stockholders makes it clear that in many cases they are learning for the first time, through this process, the most rudimentary facts about their companies. That the knowledge they thus obtain should arouse interest and a desire for more active participation is only natural. Although it is too early to appraise the net effect of the rules, it may be fairly concluded that they will inspire correction of many abuses that have existed in the past.

The examples that have been cited I believe to be convincing that these Acts give the investors of the country a substantial amount of protection that has never been afforded under the state Blue Sky laws. The difficulties faced by a state in attempting to protect its citizens from the depredations of unscrupulous promoters operating from another state are well known. Even if the limitations of the state's own statutes and of the commerce clause of the Federal constitution present no obstacle to the prosecution of such a promoter, he is physically outside the state's jurisdiction, and extradition is seldom feasible. Moreover, a single state, unless other states are equally vigilant, cannot often check the more subtle forms of misrepresentation and overselling without taking the responsibility of depriving its citizens of an opportunity to invest in securities which citizens of other states are free to purchase and which may in fact have certain virtues even though they are not as perfect as they are represented to be. In other words, a state is often faced with a dilemma: it must either preven its citizens from making a reasonable speculative investment on the one hand, or on the other, it must let them purchase speculative securities without fully realizing how speculative they are. A federal agency is not subject to these embarrassments. In addition, only a federal agency with a large staff can give the close attention to detail which is necessary if the more subtle forms of misrepresentation are to be detected. The cost of such a staff, when it is compared with the protection afforded investors throughout the nation, is moderate; but the cost of 48 large, expert staffs would probably be prohibitive.

Needless to say, federal securities legislation has its limitations as well as its advantages. The Capitol is remote from many parts of the country. Distance does not present serious obstacles to the administration of a "disclosure" statute like the Securities Act, but it is a factor that would greatly multiply the difficulty, for the Commission as well as for the companies and underwriters involved, of administering a "regulatory"

statute such as you have in Illinois. Moreover, the responsibility of deciding whether or not the merits of a security justify its sale, not merely within the limited area of a single state but throughout the whole United States, would (in my personal opinion) be more than any single group of men should be asked to undertake. This is not to say that disclosure alone gives the investor perfect or even adequate protection. I do say, however, -- and again I am only speaking for myself -- that in my opinion an attempt by the Federal government to pass upon the fiscal or business merits of every security issued by every type of company doing business in the United States would perhaps accomplish more harm than good. Federal scrutiny of the merits of securities, as distinguished from insistence on full disclosure of the surrounding business facts and the erection of minimum standards of contractual protection for the investor, if it is to be effective, must be confined to certain peculiar types of situations, such as reorganizations, or certain peculiar types of securities, such as those issued by railroads and other public utilities, banks, investment trusts and similar moneyed corporations, and other companies having special characteristics.

If what I have said concerning the advantages and disadvantages of federal securities legislation is correct, it would seem to follow that there is a place for both state and federal legislation in this field. That, of course, is what we have today; yet I would be the last to assert that the present system is perfect. You members of the bar are fully conversant with the problems besetting an issuer proposing to sell securities that must be registered under the Securities Act and must also be qualified for sale under the laws of various states. The issuer, or rather its attorney, not only must assemble a large amount of information, but also must present different portions of the information to the different governmental agencies in different terminology and on different forms. The difficulty of meeting these diverse requirements is real and is aggravated by the time element, since all the work must be accomplished within a relatively short period.

The practicing lawyer is not the only person who is plagued by the great diversity of the Blue Sky laws. One of our most troublesome problems at the SEC is the determination of the extent to which small security issues should be exempted from registration under the Securities Act. We have authority, under Section 3 (b) of the Act, to adopt exemptive rules and regulations for issues of $100,000 or less if we find that registration is "not necessary in the public interest and for the protection of investors". One of the bases for exemption which has been suggested from time to time is compliance with the Blue Sky laws of every state in which any portion of the issue is offered, sold or delivered. We have had an exemption of this general character in effect for slightly over a year, known as Rule 210 of Regulation A. A thorough revision of Regulation A is now being considered by the Commission and one of the most elusive of the many problems we have encountered is the unequal operation of Rule 210 by reason of diversity in the state Blue Sky laws. We are not responsible for the diversity, to be sure, and maybe it is both justifiable and sensible for us to disregard it. I am not going to attempt to say what the answer is, but I do know that our job would be appreciably simpler if there were more uniformity in the state statutes.

Prior to the enactment of federal legislation various attempts were made to eliminate the diversity of the state securities laws. The most

conspicuous effort was the preparation of a proposed Uniform Sales of Securities Act, which was approved by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association. To date only two states, Oklahoma and Florida, have adopted this Act. Although this particular uniform law has been the subject of criticism, the principle of uniform state legislation certainly has much to recommend it, and it may be hoped that efforts along this line will not be abandoned.

In the absence of uniform state laws it has sometimes been suggested that uniformity can be achieved by bringing various state requirements into line with the federal statutes. To some degree this is possible, but there are serious objections to carrying such a program too far. For example, the SEC has been reluctant without first giving self regulation a thorough trial to undertake complete and thorough regulation of brokers and dealers operating in the over-the-counter market, as distinguished from those operating on the stock exchanges. When I tell you, that as of April 30, 1939, there were 6,801 brokers and dealers registered with our Commission, you will readily appreciate why our activities in this field to date have been largely confined to obtaining a little basic information about each registrant and to checking the grossest forms of fraud and market manipulation. Most of the cases in which we have revoked the registration of brokers or dealers have involved a violation of state as well as federal law; the language and framework of the Securities Exchange Act of 1934, under which such proceedings are brought, make that almost inevitable. Our present function, so far as the over-the-counter markets are concerned, is in many respects simply that of an additional policeman. If a state statute or Commission requires an over-the-counter broker or dealer to maintain a certain net worth (which is the case, I understand in Illinois), or to keep the free credit balances of customers in a trust account, or to keep spreads within reasonable limits, a conviction or injunction based on a violation of the state requirement enables us to exclude the violator from the use of interstate commerce and the mails; but none of the specific requirements I have mentioned are in the Securities Exchange Act or in our rules and regulations. Consequently, to revise the state laws to meet federal regulations of the over-the-counter market would simply weaken both. The only immediate prospect of sound progress toward uniformity in this field lies in the development of strong national securities associations under the so-called Maloney Act which it was my privilege as a member of the Interstate and Foreign Commerce Committee of the House to sponsor through committee hearings and to final passage. The Maloney Act is an amendment, passed at the last session of Congress, to the Securities Exchange Act of 1934, which added a new section providing for the formation of self-governing associations of over-the-counter brokers and dealers under supervision of, and with certain residual powers in, S. E. C. If these associations eventually develop into the vital institutions we hope to see, we shall have both more effective and more uniform regulation of the over-the-counter markets.

From the subject which is least suited to uniformity by conformance of state to federal requirements let me turn to that which I believe is best suited to such a procedure.

A registration statement filed under the Securities Act of 1933 contains the basic and material information relating to a given issue. Ordinarily, the information contained in such a statement should be sufficiently comprehensive to meet the needs of a state "disclosure" Act. Frankly, I can think

of no sound objection as a matter of policy to the filing of the information with the state administrative body in precisely the same form as in the federal registration statement.

Under the "regulatory" type of state law information is generally furnished to an administrative body in order to permit it to examine the merits of and to pass upon the issue. Essentially, the information required for such purposes is, or should be analogous to that presented in a registration statement. Consequently, I believe such a law readily lends itself to integration with the federal law, particularly with regard to the character and form of the information required to be submitted. Whether the Federal registration statement may not be treated as a basic source of information is a matter which I believe should be given serious consideration in connection with the amendments to your law which I understand are being considered.

This question has been considered by several states which have regulatory laws and the adequacy of information contained in the registration statement for purposes of examination in connection with qualification has been definitely recognized. Thus in Massachusetts, the securities law was recently amended so as to permit an applicant seeking to qualify securities thereunder, to submit the prospectus or offering sheet filed under the Securities Act of 1933 in lieu of the information otherwise required to be submitted by the law. The administrative bodies of certain other states have been able, without amending their statutes, to take definite steps looking toward co-ordinating their requirements with those of the Securities Act. Special forms or regulations relating to qualification of securities have already been adopted in the five states of Texas, Indiana, Nebraska, Ohio and Michigan, all of them treating the federal registration statement as a basic instrument. These forms or regulations permit the filing of that statement, together with the documents that are required to accompany it, in lieu of much of the information that would otherwise be required to be presented.

I am not in a position to say, of course, that any of these statutory provisions or administrative rules I have mentioned would be desirable for you here in Illinois. They are merely illustrative of the means that may be employed, at least in the presentation of information, to coordinate the requirements of our state and federal securities laws. Coordination in this regard can, I am sure, be accomplished without sacrificing the efficiency of the State administrative body or impairing the protection the law affords to investors.

In conclusion, may I acknowledge my own appreciation and that of the other members of the Securities and Exchange Commission of the opportunity your officers have accorded me as a Commissioner to appear before this annual meeting of your distinguished body. Personally, I feel very much at home in this presence, for my school years, both undergraduate and professional, were largely spent at the University of Chicago, and in 1907 I was admitted to practice as a member of the Bar of Illinois. My shingle was hung out, however, across the Mississippi in my home state of Iowa, which frees me from suspicion of unfair competition with any of you Illinois lawyers. Although my visit with you is unavoidably brief, I am enjoying every minute of it, and I thank you all again for the privilege of having had this heart to heart talk with you.

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