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THE SECURITIES AND EXCHANGE COMMISSION AND THE CALIFORNIA SECURITIES MARKETS

Address

by

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Effects of Federal Supervision of Securities Markets

For nearly 25 years the Securities and Exchange Commission has acted as the sentinel of the nation's securities markets. The expanding demands for additional capital to build new productive facilities have underscored the important role of the Commission to the investing public and to the economy. Of the projected 35½ billion dollars required by American businesses for new plant and equipment and working capital during 1958 more than one-third must be raised through the flotation of new securities issues.

The administration of the securities laws by the Commission has contributed to the economic and social development of the nation in three important respects. First, the auditing and accounting principles prescribed by the Commission have elevated the managerial standards of American business. Second, the enforcement by the Commission of just and equitable principles of trade to be observed by broker-dealers and national securities exchanges has enhanced the generally honest repute of the securities industry. Third, the Commission's registration and reporting requirements have created an informed climate for public investors.

These achievements have produced a sound basis for maintaining a dynamic free enterprise system. Confidence of the American public in the integrity of our industrial and financial institutions has been fostered. Individual savings have been channelled into corporate investment. Capital formation has been facilitated.

Importance of California as a Financial Area

The impact of the securities laws extends beyond the investment community and the companies seeking to raise capital from the public. The Commission's work has particular meaning to the people of California. Judged by various statistical criteria, California ranks second among the great financial states in the nation. With New York leading in most categories of financial indexes, California generally surpasses its closest competitors - Pennsylvania and Illinois.

California residents comprise nearly 12% of the total number of American shareholders in publicly-owned corporations, compared with about 20% from New York and approximately 8% each from Pennsylvania and Illinois. 1/ California residents receive 10% of the total personal

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1/ Source: 1956 Census of Stock Ownership, N.Y.S.E.

income in the United States, contrasted with 12% for New York. Pennsylvania and Illinois each account for approximately 7% of the total personal income. [2] California ranks first in the amount of dividends and interest received by individuals [3] and first in total value of open-end investment company shares purchased. [4]

Objectives and Enforcement Techniques of the Commission

The broad objective of the securities laws is to prevent exploitation of the investing public through misrepresentation in the sale and trading of securities. This protection is effected by three principal techniques: First is the procedure for obtaining fair and adequate disclosure of all pertinent business and financial facts in new offerings of securities to the public and by the companies required to file various types of reports with the Commission. The second method involves the investigation and prosecution of unscrupulous promoters and securities salesmen. The third technique requires the registration of, and supervision over, broker-dealers and national securities exchanges.

Registration of Securities

A significant standard for judging the importance of California in financial affairs is the volume of new securities offerings registered with the Commission by California companies. During the past fiscal year, the expanding industries in California accounted for over 6% of the dollar volume of all registered offerings. A total of 59 registration statements, offering approximately 900 million dollars of new securities, emanated from companies whose principal business was located in California. The aggregate number of registration statements filed by all companies throughout the country amounted to 943, offering in excess of 14.6 billion dollars of corporate securities. The electric, gas and telephone companies located in California accounted for approximately two-thirds of the total California financing achieved through the registration process. The next largest California group were the airplane and electronic equipment companies, followed by the oil and gas extractive industry.

The heart of the Commission's authority to shield the public from abuse in the purchase and sale of corporate securities is the registration process. Unless some exemption is available, issuers and controlling persons who intend to sell their securities to the public must file a registration statement with the Commission prior to any public offering. The registration statement discloses the pertinent business and financial facts about the issuer and the securities being offered for sale. The registrant and underwriters are responsible for its contents.

2/ Source: Department of Commerce, Survey of Current Business, August, 1957.

3/ Source: Statistics of Income, 1955, Internal Revenue Service, U. S. Treasury Department.

4/ Source: National Association of Investment Companies 1956.

The Commission reviews the material contained in the registration statement to determine compliance with prescribed informational standards. Upon correction by the issuer of any deficiencies appearing in the documents, the Commission permits the registration statement to become effective. In selling securities subject to an effective registration statement, a prospectus, which discloses the basic facts about the issuer and the offering contained in the registration statement, must be delivered to prospective investors before consummation of sales. The requirement for using a prospectus in connection with all registered distributions affords an opportunity to the public to purchase securities on the basis of an informed judgment rather than on guesswork.

Fundamental to the administration of the disclosure requirements is the principle that the Commission does not, and is not permitted to, pass upon the merits of or approve the securities registered for public sale. While the registration process effectively reduces the area of uninformed risk-taking, it does not prevent unwise speculation or the exercise of poor judgment by individual investors.

A recent registration statement filed by a company organized to explore for uranium and other minerals illustrates the operation of this concept. Its first registration statement was so defective that the Commission instituted an administrative proceeding to prevent it from becoming effective and to determine the accuracy and adequacy of its representations. The Commission found that the geological reports were essentially misleading. Inadequate methods had been used to sample potential uranium prospects and to ascertain their proximity to neighboring mineral regions. The Commission held that use of the information contained in the reports would be deceptive to investors. The company then filed a second registration statement correcting all of the deficiencies referred to in the Commission's opinion.

Acting in conformity with the concept that the Commission's function is limited to securing full disclosure and the statutory mandate to lift the stop-order upon the filing of proper amendments, the Commission permitted the second registration statement to become effective. Among other matters, the second registration statement included the following: "In connection with prior sales of the Corporation's securities false and misleading information was circulated . . representations were made concerning the presence in large amounts of high-grade uranium ore which were false (since no body of commercial ore was known to exist) and high assays were used from both non-representative vein material and from samples taken from properties not owned by the Corporation." The Commission, of course, will continue to scrutinize closely the methods used in attempting to sell these securities.

The problems of the Commission in enforcing the registration provisions fall into three categories. The first area involves the arduous work of detecting and requiring the correction of misstatements and material omissions contained in registration statements. A recent filing by another promotional mining company involved a comical example

of an omission to state a material fact. The offering circular had stated that on the basis of estimates by a professional driller, the company claimed 30 million tons of proven ore and 200 million tons of probable ore. While it was true that the ore estimates had been made by a professional "driller," the Commission discovered that his drilling experience had been acquired as a dentist rather than as a mining engineer. The Commission's own geologist took 65 samples from the properties and found that the company could not claim any significant ore deposits.

The second type of problem in enforcing the registration provisions arises in connection with the distribution of large blocks of unregistered securities through unjustified reliance upon some exemption from registration. The exemptions that are most commonly misunderstood relate to transactions not purporting to be a public offering and to distributions following the issuance of securities in certain statutory reorganizations and exempt exchanges.

As a matter of administrative convenience, the Commission often considers that an offering of securities is not public where the number of offerees is limited to possibly 25 persons. However, the basic determination for invoking the registration requirements does not turn upon the number of offerees but rather upon the knowledge of the offerees, or their access to information about the offering, that would be provided in a registration statement. In merger and exchange transactions which are exempt from registration, resales of the securities may require registration if the securities were obtained by shareholders with a view to their distribution. The perplexing problems of statutory interpretation that are presented in these situations make the administration of the securities laws an inexact, though interesting, art.

The practice of so-called "gun-jumping" creates the third class of registration problem. One aspect of gun-jumping involves the illegal dissemination of information about an issuer before the effective date of a proposed offering. There has been an increasing tendency by issuers and underwriters to publicize the affairs of prospective issuers in a manner which exceeds the statutory mandate that offers of securities must be made only on the basis of the financial and business information contained in a statutory prospectus. The Commission does not permit the circulation of brochures, letters or speech material during the pre-effective period, and even prior to the filing of a registration statement, if the publications are designed to condition, or have the effect of conditioning, the market or of facilitating the sale of a securities issue. 5/

Within the past month a firm named as one of the principal underwriters in a major offering violated this restriction by mailing a letter

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5/ See Securities Act Release No. 3844, dated October 8, 1957.

during the pre-effective period to many of its clients containing information about the issuer that could not be legally included in the registration statement. The Commission informed the syndicate manager that this violation might cause the Commission to withhold its order accelerating the effective date of the registration statement. The offering became effective with the offender excluded from the underwriting and selling groups.

The policy of the Commission respecting this form of gun-jumping has been clarified in another recent administrative decision. The question involved a proposed publication by an underwriting house, which traditionally had been a managing underwriter for an issuer, of information concerning current developments in the business of that issuer. This firm, which had a wide clientele owning investments in the securities of the issuer, believed that it had an obligation to keep its customers advised concerning a number of important events which would have a material bearing on the issuer's operations by publishing an objective report of these events. Although the financing plans of the issuer indicated that it would probably be in the securities market for new money later in the year, no immediate or specific date had been fixed for any future offering. The Commission expressed agreement with the objectives of the firm and concurred that the publication of such a report under these circumstances would appear to raise no question as to possible premature sales efforts in relation to the marketing of a new securities offering.

Financing Problems of Small Business

The difficulties which are often encountered by small business in raising needed capital in the public markets has, from time to time, been related to the disclosure requirements of the Commission. It would appear, however, that the application of the securities laws does not adversely affect small business. On the contrary, the dissemination of dependable and pertinent information about the securities of small issuers increases public interest in, and the marketability of, their securities.

In the administration of its rules providing simplified procedures for offerings of less than $300,000, the Commission has attempted to reach a fair balance between affording adequate investor protection and reducing the burden and expense to small issuers in raising capital through public offerings. As part of its legislative program, the Commission has recommended to the Congress that the limitation on the size of issues that may be exempted from the registration requirements be raised to $500,000.

There are several possible reasons which account for the financing troubles of small business. First, many small business firms, especially closely-held companies, appear to be reluctant to offer securities that would be attractive to a substantial number of investors. The

unwillingness to share control on an appealing basis often dampens public investor interest. Second, the untested quality of the securities of many small business firms makes their distribution difficult, uncertain and expensive. Third, small businessmen are often unfamiliar with the potential sources of capital funds, the methods of arranging financing terms, and the Commission's disclosure requirements.

In an effort to assist small business to become more familiar with the procedures under the federal securities laws and to reach the reservoir of funds in local capital markets, the Commission is participating in a series of educational conferences, jointly organized by the Commission, the Investment Bankers Association and the Small Business Administration. The first of these conferences on the financing problems of small business was held last week in Denver. Another will be held in Cleveland in March. If local investment, business or legal groups will take the initiative in making arrangements, the Commission will be glad to participate in a similar program in California.

Prevention and Prosecution of Fraud

The enforcement work of the Commission is generally carried on in its 14 regional and branch offices. The Commission is currently investigating approximately 1,000 matters that appear to involve violations of the securities laws. The San Francisco Regional Office, with jurisdiction over California, Arizona, Nevada and the Hawaiian Islands, is responsible for approximately 75 of these cases.

During the fiscal year 1957 the Commission referred a total of 26 cases involving 132 defendants to the Department of Justice for criminal prosecution compared with 17 cases and 43 defendants during the previous fiscal year. A total of 71 proceedings were instituted in the federal courts during that fiscal year to enjoin illegal activities in the securities markets compared with 35 injunctive actions during the previous fiscal year. The enforcement record for the fiscal year 1957 further shows that the Commission issued 132 denial or suspension orders for non-compliance with the small offerings exemption, revoked 29 broker-dealer registrations, denied 6 applications for registration as broker-dealers, and instituted 10 stop-order proceedings to prevent registration statements of securities from becoming effective.

The acceleration of the Commission's enforcement program has been caused primarily by the record volume of capital formation required by American industry. The public appetite for corporate securities as a medium for investing individual savings has expanded with the increasing tempo of the economy. The intensified activity in the financial markets has attracted to the securities industry a fringe element of stockateering promoters and securities salesmen. These persons are the principal subjects of the Commission's investigative attention.

The types of violations that the Commission encounters run the gamut from unconscionable misrepresentations respecting the nature of securities offered for sale to technical non-compliance with the registration requirements and the bookkeeping rules for broker-dealers.

Many Californians have probably been importuned by boiler-room dynamiters, through long distance telephone calls and deceptive brochures, to buy unregistered securities in unknown companies of dubious value. The term boiler-room is used to describe a breed of securities houses - often conducting their activities from hotel rooms or beyond the jurisdiction of the Commission in Canada or Cuba - which use high pressure selling techniques and make fraudulent representations to prospective investors. The stockateering salesmen who employ these illegal methods to break down investor resistance are known as dynamiters. This type of illegal operations constitutes a small but dangerous segment of the securities industry.

The schemes of some fraudulent promoters are bizarre. Within recent years the Commission has developed and successfully prosecuted a variety of securities fraud cases, involving such ingenious devices as perpetual motion machines, an atomic water treating machine - purporting to be a cure-all for cancer, arthritis, and high and low blood pressure - and a "magnetic logger" claimed to be capable of detecting oil fields.

One of the most whimsical promotions ever suppressed by the Commission was carried on in California. In March of last year the promoter of a company representing to own a patent for a wingless aircraft that was capable of carrying 4,000 persons a distance of 25,000 miles non-stop at half the cost of any other plane was convicted of securities fraud and sentenced to three years imprisonment. 6/ More than 800 stockholders lost approximately $200,000 in this fraudulent venture. In selling the securities, the promoter claimed that the development of this wingless airplane was comparable to the achievements of the Wright Brothers, Leonardo da Vinci, Sikorsky, Billy Mitchell and Charles Lindbergh and that this plane was the greatest advance in aviation since the advent of flying. However, he omitted to disclose, among other things, that he had previously assigned the patent to another company, that the prototype consisted simply of a remodelled small standard airplane from which he had sheared all but eight feet of each wing, that it was less efficient than existing types of planes, and that it had not been successfully test flown.

In the spring of 1957 the Commission successfully concluded in the United States District Court for the Eastern District of New York a landmark fraud case. 7/ For two reasons, the conviction and sentencing of Walter F. Tellier to four and a half years imprisonment in connection

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6/ U.S. v. Wm. E. Horton, et al., U.S.D.C. S.D. Calif. C.R.No. 24615.

7/ U.S. v. Walter F. Tellier, et al., U.S.D.C. E.D.N.Y. Cr. No. 44203.

with the debenture financing of Alaska Telephone Company has given significant momentum throughout the country to the Commission's enforcement program. First, as the archetype of illegal securities dealer, his conviction has served as an example for other operators who employ the long distance telephone to high-pressure innocent investors into buying speculative securities of unknown companies by fraudulent representations. Second, his conviction has destroyed one of the largest distribution sources for the securities of stock-jobbing schemes.

In the Alaska Telephone case the trial court found that Tellier and his salesmen had fraudulently represented the financial condition of the company in the sale of four series of its debentures. Through printed flyers and the telephone representations made by his salesmen, the defendant emphasized the absolute safety of the investment; that the 6% interest, payable monthly, was guaranteed; that the debentures were gilt-edged and comparable to savings accounts, government bonds, and other blue chip securities; and that the net proceeds of the issues would be used for expansion, new equipment and working capital.

Contrary to these representations, the financial condition of the company was, in fact, so impaired that the proceeds obtained from the sale of the various series of debentures were used to pay the interest charges on the earlier series. This Ponzi operation, which involved the payment of alleged profits out of capital contributed by investors, proceeded according to plan. Until stopped by the Commission's investigation, the victims, being impressed by the immediate high return on their investments, were reloaded with debentures as each successive series was issued.

Supervision of Brokers and Dealers

Another significant indicium in determining the standing of California as a financial state is the number of its registered brokers and dealers. California's 342 registered broker-dealers comprise 7% of the total number of broker-dealers registered with the Commission and is the largest state group next to New York.

The authority of the Commission to make and enforce rules governing the operations of registered broker-dealers is extensive. Certified financial statements are required to be filed annually. The form and content of books and records are prescribed. Inspections are made to determine compliance with applicable legal requirements.

The Commission inspectors determine whether the prescribed books and records are maintained in an adequate and current condition; whether prospectuses and confirmations have been delivered promptly; whether the margin rules established by the Federal Reserve Board are being observed; whether the Commission's net capital rule limiting the broker-dealer's aggregate indebtedness to not more than 20 times his net capital is being followed.

These inspections also include a careful examination of the dealings with customers. The inspectors look for evidence of high-pressure sales tactics and illegal selling of unregistered securities. Records are checked for misuse of customers' funds, hypothecation of customers' securities, taking secret profits in agency transactions, purchases and sales to customers at prices having no reasonable relation to the market price, and abuses of trust and confidence, such as the practice of churning, that is, inducing excessive trading in the account of a confiding customer in order to reap an illegal harvest of commissions and markups.

An extensive broker-dealer inspection program is a basic enforcement technique for the protection of the investing public. Accordingly, over the past three years of increasing market activity the Commission has more than doubled its output of broker-dealer inspections. In the calendar year 1957 an all-time record of 1340 inspections was achieved.

Supervision of National Securities Exchanges

Of the 14 national securities exchanges registered with the Commission, the Pacific Coast Stock Exchange, with divisions located in San Francisco and Los Angeles, is the second largest in terms of value of stock traded and the largest in terms of the number of shares traded. In the calendar year 1957 the total value of stocks traded on the Pacific Coast Stock Exchange was approximately $650,000,000, and an aggregate of about 32,000,000 shares were traded.

The position of the regional exchanges in the financial system of the nation has changed considerably over the years. Originally, stock exchanges were essentially places where local brokers and financiers met to trade in local securities, and such exchanges developed in most cities of any financial importance. With the growth of large corporations, whose securities were nationally traded, and the development of modern means of communication, exchange trading has tended to concentrate in national markets, particularly the New York Stock Exchange, which during 1957 accounted for approximately 86% of the volume of stocks traded on all exchanges in the United States.

Notwithstanding the development of the national market in New York, the major regional exchanges, such as the Pacific Coast Stock Exchange, continue to play an important role. They provide an exchange market for issues of primarily local interest, as well as a local market for issues of national importance. On June 30, 1957 about 544 stock issues were available for trading on the Pacific Coast Stock Exchange, which amounted to approximately 18% of the total number of issues available on all exchanges. Of these 544 issues, 97, comprising about 140,000,000 shares and $750,000,000 of market value, are not traded on either of the two New York exchanges. Approximately one-half of the share-volume of trading on the Pacific Coast Stock Exchange is accounted for by these local issues. The consolidation at the end of 1956 of the

San Francisco Stock Exchange and the Los Angeles Stock Exchange to form the Pacific Coast Stock Exchange is a significant example to forward-looking regional exchanges of a way to increase their facilities and usefulness.

The supervision by the Commission of the operations of registered national securities exchanges extends to approving their form of organization; their rules of procedure, which must insure fair dealing and investor protection; and their rules for membership, which must provide for disciplining members for conduct inconsistent with just and equitable principles of trade. Furthermore, securities may not be listed for exchange trading unless specified information about the issuer is publicly disclosed in an application and in periodic reports filed with the Commission and the exchange. Their officers and large stockholders are required to file stock ownership reports.

Companies listed on national securities exchanges are also subject to the Commission's proxy rules. Although the Commission has no authority to require listed companies to solicit security holders for their proxies, compliance with the proxy rules is required if they do so. Over the years there has been a slow, steady growth in the number of companies which solicit security holders for proxies or consents with respect to various corporate activities. During the past fiscal year, 76.4 per cent of the 2,004 companies having voting securities listed and registered on national securities exchanges solicited proxies under the Commission's rules for the election of directors. By far the largest number of these solicitations, of course, related to elections of directors. Approximately one-third of the proxy solicitations referred to other matters of importance to security holders and to their corporations in the development of business programs and financial plans, such as mergers and acquisitions of assets, issuance of new securities or modification of the terms of existing securities, pension and retirement plans, profit-sharing and various compensation plans, and charter and by-law changes.

The Commission's function under the proxy rules is concerned with the maintenance of uniform standards of objective description, fair explanation and adequate disclosure of corporate information for the benefit of security holders, who are often remote from management and out of touch with the affairs of their companies. The dissemination of this information concerning proposed corporate activities through proxy material complements the financial data filed with the exchanges and the Commission pursuant to the reporting requirements and contributes to creating informed investor opinion.

Since these reporting and proxy provisions are not applicable to most unlisted securities, many large corporations with substantial public investor interest are not required to observe certain basic standards of corporate disclosure. The Fulbright Bill, [8/] which the Commission supports, would extend the coverage of the reporting requirements and

8/ S. 1168, 85th Cong., 1st Sess.

the proxy rules to large corporations not listed on national securities exchanges which have at least 10 million dollars in assets and 1,000 shareholders. If the bill is passed, a total of 669 companies would be affected. The 49 California companies subject to the provisions of the bill would constitute the third largest state group.

Conclusion

The tremendous economic growth of this state, with its abundant natural resources and enterprising, rapidly increasing population, has made California one of the most important industrial and agricultural states in the Union. It has also nutured its financial markets to maturity and established California as the second most important financial community in the nation, exceeded only by New York. By reason of these developments, Californians should not consider the Securities and Exchange Commission as a remote agency in the national capital riding herd only on Wall Street bulls and bears. Its effective, enlightened and vigorous administration of the federal securities laws has a direct and important impact upon the economic development of California, the integrity and vitality of its capital markets, and its investing public.

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