SOME PROBLEMS CONFRONTING THE SEC

An Address By

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Mr. President, members of the Association and friends:

It is a pleasure for me to be with you once again and an honor to have the opportunity to speak to you on this your 38th Annual Convention. This is indeed an historic occasion for it is the first time since the Association was organized in 1918 that the Annual Convention has been held outside the United States.

The first Convention I attended was the one in New Orleans in 1934. I have been present at most of the sessions since that time and, as some of you know, I had the great privilege and honor to serve as your President in 1945. Each time I am with you, I am deeply impressed with the wonderful and constructive medium that this Association provides for the interchange of ideas on both the Federal and State level, the promotion of understanding, and the solution of many of the common problems that confront us. Many of these problems are not easily settled. The path to their solution often is marked by great obstacles, and achievement of the desired ends may be slowed by temporary setbacks. But here, at these meetings, where ideas are freely expressed and exchanged in the best tradition of our Western way of life - where we can meet informally and know personally those with whom we must deal if our problems are to be solved - the seeds can be and are sown which eventually will blossom into the fruit of progress. With this thought in mind, I should like to place before you some of the problems that face us today.

Securities Administrators are always confronted with the problem of how best to protect those who invest in new and speculative business ventures without unduly hampering the raising of the necessary funds for such ventures. The rise of the United States to industrial greatness was due in large measure to the ability of new business enterprises to obtain funds from venturesome investors willing to speculate on the development of the country's abundant natural resources. Today it is apparent that, while the old geographical frontier has disappeared, we stand on the threshold of new scientific frontiers the breadth or depth of which no one can foresee. Many of the developments in these new areas will continue to be made from small beginnings which will need to be nurtured along with limited amounts of capital raised from public investors. The Securities and Exchange Commission is most concerned that such capital shall be forthcoming, but, at the same time, that those who are asked to furnish it shall be given an adequate description of the risks involved so as to provide the means for reaching an informed judgment as to the probabilities of reward for taking such risks, and that those who do invest shall do so in issues where they will get a fair run for their money.

The Commission's function in the raising of capital is essentially one of preventing frauds in the sale of securities and of seeing to it that full and fair disclosure is made to prospective investors. Once such disclosure is made the investor must evaluate the facts and make his own investment decision. The Commission has no authority to

pass upon the merits of proposed financing and therefore possesses no veto power over proposed offerings.

In general, a public offering of securities cannot be made by use of the mails or in interstate and foreign commerce unless they are registered with the Commission under the Securities Act of 1933 or are exempt from registration. The Commission is empowered under Section 3(b) of the 1933 Act to adopt regulations exempting from registration offerings not in excess of $300,000 on such terms and conditions as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Pursuant to this authority, the Commission has adopted several regulations, including Regulation A for securities of domestic commercial and industrial companies and Regulation D for Canadian securities. Most small scale public financing is done under these regulations.

The Commission has been particularly concerned for some time with the problem arising out of the willingness of some to take unfair advantage of the speculative enthusiasm evident with respect to new securities issues offered to the public by new business ventures of all types. The stock of newly organized uranium companies has especially caught and held the public imagination. Many of these offerings have been made under Regulation A and few under Regulation D.

We have not been alone in this concern. The May 26, 1955 majority report "Stock Market Study" of the Senate Committee on Banking and Currency stated:

> "During the hearings, evidence was offered of considerable speculative fever in small issues. This was particularly evident in the sales of uranium stocks, which today comprise approximately 50 percent of all offerings of $300,000 or less. The abuses uncovered ranged from misleading and irresponsible advertising to instances in which the promoters appropriated for themselves most of the money paid to finance the venture, and left for the public practically worthless securities.
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> "Prompt and vigorous action should be taken by the SEC to curb these abuses."

The growth of speculative activity in uranium stocks is illustrated by the increase in the number of brokers and dealers who do business in such stocks. In June 1953, there were registered with the Commission 147 brokers and dealers located in the seven principal western mining states, the area serviced by our Denver Regional Office. By June 1955, the number had increased to 258. Many of the newly registered brokers and dealers were persons who had no previous experience in the securities business and apparently were induced to enter it because

of the existing speculative fever. This development, coupled with an increase of approximately 300 per cent since 1952 in the number of filings under Regulation A experienced by that office, has impelled the Commission to intensify its efforts to protect public investors. As a part of its investigation and enforcement program, the Commission has sent a team of broker-dealer inspectors and attorneys to the Denver Office for a few months to conduct an intensive inspection program primarily directed to broker-dealer's registered with the Commission who have not been inspected recently or who have just registered.

From the beginning of April 1953, when the presently existing Regulation A became effective, to the end of October 1954, letters of notification were filed under the regulation by 355 mining companies covering proposed offerings of 358 issues of securities aggregating $64,400,000. Of this latter number 224 were for companies engaged in the mining of uranium ore and represented $46,500,000 of proposed gross proceeds. The average for the uranium issues was $208,000 each while other mining issues averaged $133,000. It is apparent that financing under the Commission's exemptive regulations, considered in the aggregate, is substantial and important. It is also quite clear that careful consideration should be given to investor protection afforded by the regulation. It was with this thought in mind that the Commission in the Fall of 1954 initiated an over-all study of filings made under the existing regulations since their adoption in the Spring of 1953.

Since the passage of the 1933 Act the Commission has adopted a variety of types of regulations under Section 3(b). For example, some have required varying degrees of disclosure to prospective investors, others have required the escrowing of promoters' securities, and still others have required compliance with state statutes as a condition for the availability of the exemption.

The principal features of the presently existing Regulation A are as follows: A notification must be filed with the appropriate regional office of the Commission. An offering circular containing certain specified information is required to be used, except in the case of offerings not exceeding $50,000. The Regulation also provides administrative machinery whereby the exemption can be denied or suspended if the Commission finds that the exemption is not available to the company in question, that the terms of the exemption have not been complied with, or that fraud is being practiced in connection with the offering. Regulation D in the main contains the same requirements.

These regulations represent a great improvement over those in effect prior to 1953 in terms of investor protection. However, the recent Commission study of the operation of these regulations has revealed certain glaring inequities in connection with offerings made thereunder, particularly by newly organized uranium and other mining ventures. Issues have been sold to the public on a capitalization basis that reflects a promotional participation heavily weighted against the public investor who furnishes the initial cash capital. Others are sold under terms which grant promoters and underwriters options and warrants

which, even if the venture is successful, provide the insiders and underwriters with riskless and potential profits at the expense of the public stockholders by diluting their investment and share of profits. The great majority of the offerings are on a "best efforts" basis and there is no assurance that enough money will be raised to explore or drill; moreover, there has been no undertaking to return the investors' funds even though an amount sufficient to carry out the company's exploration or development program is not obtained. Offerings have been commenced where underwriters would receive a commission plus advances for legal and selling expenses which in the aggregate would amount to almost 1/3 of the total gross proceeds from the offering. Moreover, if the offering was not well received, it might be abandoned with the result that underwriting commissions and expense allowances would absorb virtually all the funds received, leaving little or no funds available for the company's development.

With a view to preventing practices of this sort as well as others which I shall not enumerate, the Commission on July 18, 1955 published for comment a proposed revision and consolidation of Regulation A and D. The proposal contemplates that Regulation A would be available to domestic and Canadian companies on identical terms and conditions. Since the inequities which I have mentioned existed in the main in respect of new ventures, a distinction would be made between promotional and other companies. A "promotional company" would be defined as one which was organized within one year prior to the date on which it filed a letter of notification under Regulation A and which had not had a net income from operations or, if organized more than one year prior to such date of filing, had not had a net income from operations for at least one of its last two fiscal years. The following special requirements would apply to such companies:

1. The securities to be offered would have to be qualified and concurrently offered for sale in the state or province where the company has its principal business operations.

2. No securities could be offered except for the account of the company; secondary offerings, "bail outs", and offerings of underwriters' shares or options would not be permitted under the exemption.

3. Provision would have to be made, by escrow or otherwise, to assure the return to stockholders of the money paid in by them unless at least 85% of the total offering is sold and paid for within six months after the commencement of the offering.

4. In computing the amount of securities which could be offered under the new regulation, there would have to be included the amount of all securities issued or proposed to be issued, for assets or services, or to directors, officers, promoters, underwriters, dealers or security salesmen, except to the extent that such securities are escrowed or otherwise effectively held off the market for one year after the commencement of the offering.

5. No sales literature, other than the prescribed offering circular and limited advertisements specifically permitted by the rules, could be used in connection with the offering of securities of promotional companies.

The proposed amendments represent important improvements in the regulations, based upon the experience of the Commission in their administration since the last revision in April 1953. They should assist and protect the public investor but should not retard the raising of capital for legitimate promotional ventures. In fact, they should provide greater assurance that the bulk of the money sought to be raised for exploration, development, and similar purposes will actually be available for those purposes.

We feel this is one of the most important matters now before the Commission. We will receive public comments on the proposal until September 15, and it was the subject of fruitful discussion yesterday afternoon. The definitive form of the new regulation will not be determined until we have had an opportunity to consider the comments received, including the helpful suggestions made by the State and Provincial Administrators.

One other solution to this problem has been suggested. On April 21 of this year, Congressman Bennett of Michigan introduced in the House of Representatives a bill which would repeal Section 3(b) of the Act which is the statutory basis for these regulations. Public hearings on the bill were held in Washington commencing July 20, 1955. The Committee will hold additional hearings commencing on September 8 in Denver and September 14 in Salt Lake City.

The Commission opposed the Bennett bill before a Subcommittee of the Interstate and Foreign Commerce Committee of the House which is considering it. We pointed out that in the course of the 1953-1954 amendment program relating to the statutes administered by the Commission, the Senate passed an amendment to Section 3(b) which would have raised the permissible limit to $500,000. This amendment was supported by the Commission. However, it was rejected by the house of Representatives and was dropped in conference.

The exemptions provided for in Section 3(b) reflect a long-standing judgment as to legislative and economic policy. Basically, that judgment involves a weighing of the interest of the particular purchaser of securities as against the public interest in providing fairly quick and easy access to the public capital markets for limited amounts of capital by small ventures or unseasoned enterprises. We think the public interest would be better served by promulgation of a more stringent exemptive regulation, which has been proposed by the Commission, than by repeal of the statutory provision which makes the regulation possible.

I should like to mention briefly the so-called Fulbright bill which, if enacted, would greatly enlarge the Commission's jurisdiction in certain respects.

The Securities Exchange Act requires companies whose securities are listed on national securities exchanges to register those securities with the Commission, to file periodic reports, and to comply with the Commission's proxy rules in the event proxies are solicited from the owners of such securities. In addition, the officers, directors, and 10 percent stockholders of those companies are subject to the "insider" trading provisions which require reports of their holdings and transactions and permit the company to recover profits made by those persons on short-swing transactions. These provisions do not generally apply to over-the-counter securities.

In its report "Stock Market Study", the majority of the Senate Committee on Banking and Currency stated:

> "Several of the witnesses questioned the 'double standard' that exists in the regulation of securities on the exchanges and over the counter. An issuer of securities registered on a national securities exchange is subject to one set of regulations, whereas another issuer in the same industry, of the same size, with the same number of securityholders, and with the same degree of public interest whose securities are traded in the over-the-counter market is subject to entirely different regulations...
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> "The committee is of the view that as a general policy, it is in the public interest that companies whose stocks are traded over the counter be required to comply with the same statutory provisions and the same rules and regulations as companies whose stocks are listed on national securities exchanges. There appears to be little valid grounds for exempting companies from filing periodic financial statements with the Securities and Exchange Commission or from conforming to statutory provisions, rules, and regulations governing proxies, and insider trading merely because their securities are not listed for trading on a stock exchange."

On May 24, 1955, Senator Fulbright introduced a bill which would eliminate the so-called "double standard" between listed and unlisted securities and would provide investors in over-the-counter securities with the protections and benefits now afforded investors in listed securities. The bill follows substantially the pattern of

legislation recommended by the Commission in 1946 and 1950, and of bills introduced in the House of Representatives in 1946 and in the Senate in 1949, all of which failed of passage.

The Commission was asked to comment on Senator Fulbright's proposal and expressed the view that the "broad principles and objectives underlying /the bill/ are sound and the Commission supports them." Further, "The fact that there has been no means by which the principles and standards of fair, accurate and adequate financial reporting and disclosures of the Exchange Act could be brought to bear for the benefit of investors in our important over-the-counter markets is of concern to this Commission as it has been to our predecessors."

Since the Commission had not had sufficient time to reach definitive conclusions on certain aspects of the bill in the short elapsed time between its introduction and the Commission's initial appearance before the Subcommittee to which the bill was referred, the Commission was requested to suggest amendments at a later date. A report containing these suggestions was transmitted on July 19, 1955.

As introduced, the bill would require the registration of all securities of any company having 500 or more securityholders and $5 million or more in assets with certain specified exemptions.

In its report, the Commission recommended that the bill be revised to require registration of any class of equity securities the record holders of which numbered more than 750 and that the asset test be abandoned since it would not be a satisfactory measure of a company's significance in terms of earning power and public interest, and would be equally unsatisfactory from the standpoint of administration and enforcement. The Commission feels that the selection of 750 record holders represents a reasonable test of public interest in a trading market in a security and that it would be appropriate to use this test to the exclusion of any other for purposes of requiring registration of an equity issue.

In order to provide against the uncertainties which might arise from the fact that the number of holders of an equity security might vary somewhat above and below 750, the Commission proposed that the bill be amended to provide for automatic termination of registration 90 days after the filing with the Commission of a statement that the number of record holders has been reduced to less than 500.

Record ownership is not ordinarily available with respect to debt securities and, in any event, may not be as suitable a test of public interest as the principal amount of the outstanding class. The Commission proposed, therefore, that any outstanding debt issue exceeding $1 million which has been publicly offered under the Securities Act of 1933 and any issue of debt securities thereafter registered for offering under the Securities Act exceeding $1 million in principal amount also be subject to the bill. It also proposed that the registration of any debt issue terminate automatically if the principal amount outstanding

is reduced to less than $1 million.

Other changes recommended by the Commission include provision for termination of registration by Commission order upon a determination by the Commission, either on its own motion or upon application, that certain statutory standards in the bill have been met; provision for authority in the Commission comparable to that which it has in respect of listed issues to suspend trading for cause; and provision that it shall be unlawful for any broker-dealer to effect transactions in a security as to which a suspension order is in effect.

According to estimates, approximately 1500 companies would be required to register one or more classes of publicly held equity securities. The Commission advised the Subcommittee of its belief that if the bill were amended to reflect the suggested changes and enacted into law, the protection and benefits for the public investor which it provided - all of which are consistent with the principles and provisions of the bill - would not affect adversely companies subject to the statute, the processes of capital formation, the markets in which securities are traded, or small business.

The public hearing on the Fulbright bill developed strong support for its enactment. There was also opposition to its enactment from various industry groups on the basis that there was no public need for such legislation.

On July 26, 1955, the Fulbright bill, revised substantially in accordance with the suggestions made by the Commission, was reported upon favorably by the Subcommittee. However, the Subcommittee did not eliminate entirely the total asset provision in the case of equity securities and those companies having 750 or more record holders and $2 million or more in assets would be subject to its provisions. Any security issued by a bank or any issuer which is an insurance corporation subject to state supervison is specifically exempted.

On August 2, 1955, Congressman Klein of New York introduced a companion bill, H.R. 7845, in the House of Representatives. I think you will hear much more about these proposals during the next session of the Congress.

There has recently been considerable comment in the Press concerning what is oftentimes called the Canadian Problem. Let me say at the outset, however, that the phrase "Canadian Problem" which has come to be applied to this situation does not adequately or fairly describe the activities with which we have been concerned.

From the standpoint of the Commission, the primary problem is to prevent frauds upon our citizens. The problem is created by the efforts of unscrupulous persons, many of them from the United States, who take advantage of the international boundary and the differing regulatory and legal systems of the two countries in order to exploit investors in

the United States from bases in Canada. At one time, the activities of this fringe element were centered in Toronto and later shifted to the Province of Quebec when the Ontario Securities Commission effectively cleaned up the Toronto situation. The ease of communication by mail, telegraph or telephone across the border makes it possible to conduct high pressure selling campaigns as readily from Canada as from within the United States. The basic difficulty of the Commission and other federal and state agencies in dealing with such activities is that we can not directly reach violators in Canada since they are beyond our jurisdiction. Moreover, these persons may not clearly violate any Canadian law where they restrict their offerings to the United States.

Many different methods have been employed over the years in an effort to cope with the problem, including proceedings under Canadian and provincial laws and extradition. One of the difficulties in connection with proceedings under provincial laws has been the feeling on the part of some provincial officials that American securities laws and procedures are unduly complex by Canadian standards and difficult for legitimate Canadian mining and exploration ventures to comply with. Regulation D was adopted by the Commission to provide a simplified procedure by which small Canadian offerings could be made in compliance with our statutes, in the hope that provincial authorities would then require compliance with our laws. This hope has not been realized, owing, among other things, to the limited powers of provincial administrators, differences in the philosophy of securities regulation between the United States and the Canadian provinces, and administrative difficulties which were aggravated by the inexperience of Canadian issuers and underwriters with SEC statutes and procedures. Moreover, issuers and underwriters offering from Canada object to complying with the multiple requirements of the laws of almost all the States, in addition to SEC requirements.

After years of negotiation, the United States and Canada in 1952 concluded a Supplementary Convention for the extradition of fugitive criminals which was specifically designed "to comprehend any and all frauds which are punishable criminally by the laws of both contracting states, particularly those which occur in connection with transactions in securities." We did not conceive this treaty amendment to be a panacea. We had hoped, however, that it would be a significant step toward the eventual elimination of fraudulent securities traffic across the border. This hope has not fully materialized. In the first case brought pursuant to its provisions, extradition was denied. The 1952 treaty amendment was interpreted in a manner which limits its effectiveness, primarily because of the complexity of international extradition law when applied to statutory offenses of this kind as between countries both of which have a federal system, but a differing division of authority between federal and state or provincial governments. The court held that enumeration 11A of the Convention does not reach violations of the fraud provisions of the Securities Act of 1933 because Canada has no sufficiently corresponding statute, and hence the "double criminality" requirement of extradition law as interpreted in the British

Commonwealth is not met. In any event, extradition would be more effective as a weapon in reserve than as a routine instrument of law enforcement.

Although we have not reached the goal of understanding and achievement which all of us would desire, significant cooperative advances have been made. And it is to the credit of this Association that the first steps toward clarification of this subject came about, in large measure, as a consequence of the 1949 Convention in Richmond, Virginia. Prior to that time the problem was surrounded by so many emotional blocks, there was so little understanding of the other fellow's point of view, and there was such an unfortunate lack of personal contact between Canadian and American regulators, that no truly cooperative steps were taken to work out a solution. At that meeting someone - I do not know whether he was a Canadian or American representative - in effect held out his hand and said: "Let's stop the shouting and direct our efforts towards working things out." The persons involved got to know one another, to recognize their respective virtues and faults, and rolled up their sleeves and went to work.

The Dominion and Provincial governments of Canada and the Federal and State governments of the United States have a strong mutual interest in stopping the activities of unscrupulous international operators on both sides of the border. Responsible securities dealers both in Canada and in the United States are equally concerned, for it is essential to the maintenance of the confidence of investors and to the channeling of their savings into legitimate enterprise that abusive practices of the fringe element be eradicated. The scope of the areas of agreement and cooperation is great; and where there may be disagreement, it is with respect to methods and mechanics rather than fundamental differences on objective. We of the Commission pledge ourselves to a renewed effort to find a solution to our common problems which will be both effective and merit the wholehearted support of all concerned.

The public has benefited greatly from what has been accomplished to date. The problem is complicated and of many facets, and there may have been temporary misunderstandings and set backs. But I have been deeply impressed with the great strides forward which have been made. I am confident that we will reach our ultimate mutual goal before too long and that we will do so in a manner that reflects, with credit to all, the common national character and standards of morality of our two great nations.