"THE DISSEMINATION OF INFORMATION UNDER THE SECURITIES ACT"

ADDRESS

of

JAMES J. CAFFREY

Chairman, Securities and Exchange Commission

At Dinner in honor of

NATIONAL ASSOCIATION OF SECURITIES ADMINISTRATORS

New York, New York

Friday Evening, September 27, 1946

Mr. Chairman, Ladies and Gentlemen:

I want to say thanks on behalf of myself and my fellow Commissioners for your kind hospitality, the excellent dinner, and this chance to talk over some problems of common interest to all of us. What I have to say tonight is of interest not only to those of us here who are devoted to the regulation of securities practices, but also to members of the financial community and to investors. I am particularly glad tonight to compare notes with those here who administer State securities laws on what I know is a prevalent regulatory problem: getting information to investors.

Sometime ago I saw a cartoon of a woman sitting in her broker's office carefully instructing him on how she wanted her investments handled. She ended by telling him, with commendable caution, "Now, just before the next depression I want you to sell all my stocks and bonds."

The story not only shows how some people expect prophetic vision of the financial community, but it shows also one of the important ways in which disillusion and disrespect with the financial community originates. That woman, utterly uninformed about what she owns and what she buys, expects the impossible of her broker. Of course, while her broker stands ready to give her legitimate services, he is not superhuman. But his failure to call every turn in the market will be regarded by that woman as a breach of his obligations.

Contrast that woman with the informed investor who has exercised his judgment about what to buy. The informed buyer does not expect the impossible, has no illusions about what you can do for him, and is not likely to look for scapegoats in retribution for his investment misfortunes. If I were in the investment business I would pray, for my own protection, if for no other reasons, "Let me have about me customers who are informed."

Now, if a broker undertakes to give investment advice he undertakes the duty to tell his client, to the best of his ability, when to buy and when to sell. As you know, it is our business at the Securities and Exchange Commission to help enforce the policy of Congress that investors shall get the information they need. But it is not our function at the Commission to tell people what to buy or sell or when to buy or sell. Where the free play of buyers and sellers is unaffected by artificial impediments, the Commission has no power or authority to interfere with the operation of the market and price movements. Our job is to help lay the foundation for an informed market free from artifical influences. In other words, our job is to prevent tailor-made fluctuations. That job, I think I may say with pride, we have done to the best of our ability. In passing, as you probably know, the Commission is making a comprehensive study of the recent market decline. What that study will disclose we do not know. Our future course will be determined by the facts revealed.

In choosing a topic for my remarks tonight, there were many things I had to consider. Would our very charming ladies forgive me if I talked shop. Would the gentlemen bear with me if I talked on a subject which would require some pretty precise language. I answered both these questions in the affirmative. I know the ladies will forgive me. I know the State Commissioners, the investment bankers, the dealers and the members of the bar who make up this body, by and large, will bear with me because the subject matter of my remarks has a peculiar, even if different interest, to each of those present.

One of the most important pieces of legislation we administer is the Securities Act of 1933. I want to deal tonight with some problems raised under that Act in our attempt to make a reality of the Congressional policy of getting information to investors.

With certain exceptions, all securities being publicly offered must be effectively registered under the 1933 Act. The Act contains a fairly simple mechanism for the registration of securities. A registration statement is filed on a prescribed form containing the information deemed important. Assuming that the registration statement is not amended, or if amended, that the amendment is pursuant to our order or with our consent, registration becomes effective on the 20th day after the statement is filed. However, the Commission can cut down the 20-day period having due regard, among other things, "to the adequacy of the information respecting the issuer theretofore available to the public." Cutting down the period of registration is known as "accelerating effectiveness of registration."

This lag in time between the filing and effectiveness of registration is known as the "waiting" or "cooling off" period. There is no doubt whatsoever about why Congress provided that waiting period. It was so that high-pressuring would be discouraged and that, during the waiting period, information about the security, available from the filed registration statement, could percolate out to investors before they were called on to buy. I cannot exphasize too strongly the need for using the waiting period in order to get preliminary information out to the public. Although the registration statement is publicly on file during the period, relatively few investors or dealers get to know what is in it. It is a common practice in public distribution of securities to take orders over the telephone as soon as the registration statement is effective and to deliver the prospectus with the confirmation. This can lawfully be done, but unless reliable information is currently available before the order is taken, there is a grave danger that the basic policy of the Act is being frustrated.

In general, full use has not been made of the waiting period in order to disseminate information. It is unfortunate that the Congressional policy has not been put into maximum operation in this regard; and my specific concern tonight is with some of the reasons for this and some of the ways in which it can be remedied. The problem has been apparent to us not only from our own experience within the Commission but as a result of numerous communications we have received from investors, dealers, underwriters and others in the financial community.

The financial community has in the past made some adjustment towards using the waiting period for the dissemination of information; and one of the most widely known methods is through the circulation of "red herring" prospectuses. In general, the Act provides that the first written attempt to sell a security which is required to be registered should be either through a prospectus meeting the requirements of the Act or should be preceded or accompanied by such a prospectus. To comply with the Act a prospectus must contain the most significant information in the registration statement and be up to date within a year of its use. Some underwriters have used the waiting period to disseminate to dealers and investors a document looking something like a prospectus, and setting forth the significant information contained in the registration statement as filed. Remember that this document was sent out in advance of the effective date, while it was unlawful to offer the security. In order to avoid the implication that the securities covered by this document were being offered in violation of the law, a legend in red ink was customarily placed across the top of the first page of the document explaining, in part, that the document was for information only, that it was not an offer to sell or a solicitation of an offer to buy. The name of the document derives from this red ink legend.

While we have never really known to what extent the red herring prospectus has been used, it is clear that, in recent periods, its use has fallen off considerably. Now the red herring prospectus is not an unmixed blessing. It does serve to get information to the public during the waiting period; but that information comes out of a registration statement not yet effective and might well contain inadequately stated or otherwise misleading material. Further, there was always the danger that such a document would not only inform but would also be used to solicit indications of interest. And such solicitation in advance of effective registration is contrary to the policy of the Act. Nevertheless, we have from the earliest days recognized that getting reliable information out to the public during the waiting period was part of the fundamental policy of the law. And we have issued repeated interpretations permitting the use of the red herring prospectus without deeming it an unlawful offer or solicitation where we were satisfied from the circumstances that it was being used for information only.

The tendency to avoid using the avenues of information to get knowledge about securities disseminated during the waiting period is a matter of deep regret and concern to us. The reasons for this tendency are many and complex. I cannot discuss all of them, but I will try to sketch some. One often heard is the paper shortage. Another is the predominance, in the recent past, of the seller's market. But one of the most important reasons for inability to get reliable information around during the waiting period is the inadequacy of registration statements as filed. It does more harm than good to circulate to investors inadequate statements, half facts, shaded truths and sometimes downright, although not fraudulently intended, prevarication. It was because of that danger that the Commission in April of 1945, publicly announced the policy of refusing to accelerate effectiveness of registration in cases where inadequate red herring prospectuses are circulated until we are assured that the material amendments to the registration statement are communicated to those who got the red herring prospectus. Many underwriters have said that this public announcement has acted as a deterrent to the use of red herring prospectuses.

Now you will hear of all sorts of arguments about the registration process. One of them is that there is nothing inherently wrong with most registration statements as filed and that the Commission consists of a group of fly-specking perfectionists who cannot tolerate having any statements go through as filed. Of course the Commission is careful and cautious. You would not want a Commission that was not. And you would be hearing less public criticism of the Commission if we let some of the rotten registration statements we get become effective -- with the consequent odium and expense of a public stop-order proceeding and possible civil liability. Nothing in the law requires us to exercise such care in reviewing registration statements in advance of effectiveness. The care of the staff in processing registration statements in advance of effectiveness has a tendency to protect those filing statements and bearing liability as well as to protect investors. But because of the thoroughness of staff review a feeling has grown up, in some quarters, that the registration statement can be filed in sloppy shape. That wasn't the intention of Congress. Quite to the contrary, Congress intended that the registration statement as filed be a carefully prepared and conservative document so that the information getting out during the waiting period would be fairly reliable.

It should be obvious that we cannot depart from the policy of refusing acceleration when inadequate red herring prospectuses have been used. We cannot compromise with our duty to investors, and a successful program of encouraging the dissemination of information in advance of effectiveness of registration must recognize this as a basic premise. The key to success in achieving the statutory policy is the filing of adequate registration statements and care in the filing of statements will cut down materially the need for repeated amendments.

We want to encourage getting out to investors, during the waiting period, reliable information about the security; it should be done so as not to result in unlawful offering or solicitation; it should be done with as much stress on setting out the standards as clearly as possible; it should be done within the pattern of the Act and within the limitation of our power thereunder, and in a spirit of cooperation between us and those with whom we deal. It cannot be done if wholesale revision is necessary before the information in the statement can be safely disseminated to the public. And we, on our part, will be continuously alert to gear up our practices, hasten our procedures and limit our criticism of registration statements to those matters only which are of material interest to investors.

I would like to sketch for you briefly some of the lines along which we at the Commission have been thinking. Again I want to say that my words will of necessity have to be precise. The decription of a proposed rule is not what might be called a very appetizing cordial but it will, I am sure, be of interest tomorrow and the day after tomorrow. My remarks are to be considered as tentative only. Although I may talk in terms of proposed rules I want it understood that I am merely outlining something which I hope will serve as the basis for fruitful discussion between interested representatives of the public and the Commission.

In general, a program of this kind would contemplate the adoption of two rules. The first would be designed to dispel any lingering fear on the part of those who use a red herring prospectus in compliance with the rule that they would be charged with having made an unlawful offer to sell or solicitation of an offer to buy. The rule would declare that a legitimate red herring prospectus, complying with the rule, is not such an offer or solicitation of an offer. The rule would, of course, require that the red herring prospectus contain reasonably accurate and complete information and that it bear a specific legend limiting the use of the prospectus to informative purposes only. We have tried to set up a standard of what would constitute reasonably accurate and complete information. We expect that a red herring prospectus would be reasonably accurate and complete if it is prepared on the basis of the information contained in the registration statement as amended to correct the inaccuracies and inadequacies pointed out in the Commission's first letter of comment on the registration statement. Except for data as to price, and other underwriting information, it is our hope that such a red herring prospectus would be substantially complete.

The second rule would provide that the lawful final [illegible] prospectus could consist of the red herring prospectus complying with the rules, and a supplemental document containing such additional information as is necessary to correct inaccuracies, and to supplement the information in the red herring prospectus.

Under this rule, any person to whom the red herring prospectus was sent or given prior to the effective date need be sent or given only the correcting and supplementing material. If a registration statement is in fairly decent shape when filed, the supplementary material should be short. In this way the use of a red herring prospectus will not require wastage of effort and material by sending out a full new prospectus duplicating most of the material already sent out.

To encourage the use of this interim method of disseminating information, and to help further the purposes of the rules, the Commission would refuse acceleration of the effective date of registration where it believed that underwriters have not tried to accomplish an adequate dissemination of information during the waiting period. What constitutes an "adequate" dissemination we do not yet know, and we hope that we will be able to formulate some specific standards by the time a rule is finally adopted. At present one of the minimum requirements we might lay down would be that, in an underwriting, all prospective and actual selling group members should have received a red herring prospectus complying with the rules.

Underwriters will be expected to have available red herring prospectuses to be furnished to all who require copies. The Commission, of course, would continue its policy of refusing acceleration where a materially inaccurate or inadequate red herring prospectus had been circulated until corrective information is communicated. However it is our hope that this will no longer be a major problem since the red herring prospectus, in most instances, would not be circulated until after receipt of the Commission's first letter of comment.

The proposed rule which would permit a red herring prospectus to be part of the final prospectus should encourage the printing and use of red herring prospectuses. Under this rule a red herring prospectus which has not been used before the effective date can be made part of the final prospectus by attaching it to the necessary corrective document which, in the usual case, should be relatively short. Further, as I have noted, the requirements of the Act that a prospectus be furnished would be met when a person who had been furnished a red herring prospectus would be given, within the limitation of the law, a relatively short document containing the corrections and supplemental material. Thus, the use of the red herring will not involve underwriters, or others effecting the distribution in duplicate printing.

We have thought of various other methods of meeting the general problem I have been discussing. Among them is the possibility of using summaries of information in registration statements for general circulation. The difficulties involved in the use of summaries are many, and we are not clear that the

proposal for the use of summaries offers a workable solution. However, as the project is thought out further, it might develop that summaries may form a feasible supplement to the red herring prospectus rules. It is easy to envision some of the difficulties we would face. Among them is the question of what constitutes a fair and adequate summary in a particular case. It will not be easy to define the line between fair summary and unlawful stimulation to buy which is the natural result of emphasis on favorable data at the expense of the unfavorable data. And further, the adoption of a procedure regarding summaries may have to involve submitting those summaries to a check by the Commission in advance of their use.

You realize of course that the programs I have sketched out tonight are still tentative. We hope, within the next few days, to set machinery in motion for getting specific proposals sent out to serve as a basis of discussion between the Commission and other interested persons. We will of course welcome the views of those who administer State securities laws and we stand ready to avail ourselves of the benefit that their experience, and the experience of others, can bring to the formulation of a program. And I emphasize again that a successful program depends on cooperation.

I assume it is perfectly clear that our eagerness to accomplish the dissemination of information concerning securities which are the subject of a registration statement does not represent any modification of our rigid policy to prevent the offering and sale of securities before the registration statement becomes effective. Properly administered, dissemination of information on the one hand, and enforcement of the prohibitions against premature sales on the other, can supplement each other. Together they make the period before the effective date of the registration statement one in which prospective purchasers have a real opportunity to become informed about new security issues.

It has almost become fashionable for a newly selected Chairman to state publicly his views as to Commission policy in the future. I have been elected by the votes of my associates and the Commission policy is not what the Chairman thinks or says but what a majority of the Commission decides on the evidence.

So, at the moment, I deem it inappropriate even to suggest policies which purport to bind my colleagues. However, I do believe that the country has a right to know that we are very conscious of our obligation to administer statutes passed by the Congress and that we do not make the law but rather that we are agents to enforce it. We are responsible to the Congress and they, in turn, to the American people.

I know that my colleagues are aware of the importance of making early and clear decisions on disputed matters. While we will not sacrifice justice to a slavish devotion to consistency, as a quasi-judicial body, we hope to establish in the minds of lawyers and business men and all those who are affected by the Commission, that our decisions represent a common sense application of law and that they will constitute precedents on which business men may safely guide their affairs.

It is an unfortunate tendency of many contemporary writers to characterize people in the government service as being "to the right" or "to the left". I assure you we shall carry no ideological banner and if we are to be defined geographically, I am sure that our conduct will show the Commission intent on carrying out the will of Congress "right down the middle" -- in line with the law.

Thank you.