REMARKS OF RICHARD B. SMITH, COMMISSIONER,
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Some Current Considerations Relating to Federal Securities Regulation

I am especially pleased to have been asked to speak here in Philadelphia to a group of lawyers such as you. I have the utmost respect for Philadelphia lawyers as many of you probably know -- in part I suppose because I am something of a Philadelphia lawyer myself. We alumni of the University of Pennsylvania Law School and our good Dean are vigorously at work (and I believe successfully) to project Penn into a truly national law school. Nevertheless, there is no one of us who does not want to retain the law school's residence in Philadelphia. For one thing, all of us who attended it have some pleasure in vicariously considering ourselves Philadelphia lawyers.

I have another reason to be so pleased to speak to Pennsylvania lawyers. While I am not admitted to the bar in Pennsylvania, because I never completed a clerkship here, I did have a preceptor at the Pennsylvania bar for some three years. I know there are many who dismiss the preceptorship system as an anachronism, or a formality, or even some form of economic constraint. I myself am an admirer of the system, and, indeed, I think it worthy of adoption in other states. My attitude, I am sure, reflects the quality of the experience I had with my preceptor in Lancaster. My senior in years and experience, his mind was in many ways younger and more agile than mine was then, or I believe has been since. He spent hours with me, while I was home over law school vacations, discussing his views of and experiences in the practice of law and imparting to me something of the humanity, the decency and the moral fiber that is so much a part of the law. It was an education in the broad sense of that word that I could never have obtained merely in law school, or as an associate in a busy law firm, or for that matter in government. A preceptor who takes his role as seriously as did mine, cannot help but be a healthy and abiding influence on a young man aspiring to the law.

Not only my preceptor, but every good lawyer -- whether in Philadelphia, New York or elsewhere -- must have a directness, a

candor, a capacity to cut through the bramble bush. This is as true in the securities law as it is in other fields of the law. It was rather convincingly demonstrated to me in an exchange of correspondence between the Commission's staff and a lawyer in Kentucky several years ago. So that you won't become too elated with your knowledge of the intricacies and involutions of securities laws acquired this morning and this afternoon, I would like to read you two of this Kentucky lawyer's letters. They are addressed to the Commission's Chicago Regional Office.

"Dear Sirs:

"Mr. John Smith, president of Pond City Auto Auctions, has handed me your letter of January 12 to which please refer.

"Now I set up the corporation for these fellows. They have bought themselves a lot and are aiming to put up a place where used cars are auctioned off.

"The boys' intentions were to sell stock only to used car dealers. I know this for a fact, because I set in on several of their meetings when they started the corporation last September. Of course, I suppose they could sell stock to the public if they took a mind to. There is nothing in their charter forbidding it.

"Now I frankly tell you that I am a country lawyer. There are a dozen lawyers in this town, and I would not give two cents for what all of us put together know about Federal law. The reason is that each one of the regulatory or administrative agencies of the govt. has got its own books of rules and regulations and if a lawyer here had them he would be needing a barn to put them in, and he would be bankrupt from buying them. So, most of us gave up on Federal law long ago. All I've got is a $3 book on bankruptcy. If some poor fellow comes in with a Federal problem, I tell him to write his Congressman. There may be a copy of the Securities Act of 1933 in this town, but I don't know who would have it, and I sure don't.

"So, if the Pond City Auto Auction boys are doing something you don't like, you let me know what it is and I will tell them to quit it.

"I can't figure how you ever even heard of this outfit. I think their competitors must have written to you. Maybe you could also check on their competitors.

"Yours,

______"

There is a second letter dated about a month and a half later --

"Dear Sirs:

"I thank you for your letter of January 29.

"It <u>does</u> appear that the stock offering might not have been entirely intrastate, and that therefore registration is required. I have wended my way through all the material you sent me, and I think I fairly comprehend the substance of Release Nos. 4434, 4554, 4450, 4470, and the Securities Act of 1933. However, I must confess that the 'General Rules and Regulations' is the most incomprehensible document that has ever come to my hand. When I graduated from law school, I got the highest grade on the state bar exam. I have an I.Q. of 137, and I still can't read this damned thing and make any sense out of it. Couldn't you just send me some blank forms to fill out? Then we could do business.

"Yours,

______"

Now there was a lawyer who saw things clearly, despite -- or maybe because of -- his lack of knowledge of securities laws. It is with that simple and inquiring spirit that I would like to discuss with you today some very old considerations concerning the federal securities laws that I believe are deserving of renewed attention.

Judging from the Seminar's schedule, you are receiving today some extensive instructions from a very talented panel in the world of registration statements and exemptions from registration. The idea of federal registration of securities is to obtain disclosure for investors.

Disclosure of what?

It has been expressed in various ways. President Roosevelt's message to Congress recommending the enactment of the Securities Act of 1933 expressed it this way:

> "There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."

Speaker Rayburn, the acknowledged legislative father of the SEC, said in the House debate on the 1933 Act:

> "Let me repeat that what we seek to attain by this enactment is to make available to the prospective purchaser, if he is wise enough to use it, all information that is pertinent that would put him on notice and on guard, and then let him beware."

Statements of this type were repeated in the Congress and in the literature of the early 1930's concerning the Securities Act. Disclosure is sought of every "essentially important element attending the issue" and "all information that is pertinent" to the prospective purchaser.

Now what essentially important elements of pertinent information should an investor have?

One could classify such essential information into two categories: information concerning the issuer of the securities (including the nature of the securities themselves -- whether common, preferred, convertible, debt or whatever), and information concerning the market for the securities.

The whole thrust of the 1933 Act is to require disclosure concerning the issuer. The Act itself, in Schedule A, specifies certain categories of information concerning the company whose securities are being offered. The various registration forms developed by the Commission over the years have amplified these requirements. The 1933 Act prospectus has become a fountain of information concerning the issuer. It describes in considerable detail the company's capitalization and the securities it proposes to offer, its business and properties, its management and the

compensation arrangements for the management, as well as transactions with the company in which management has a material interest, the earnings history and current financial condition of the company. It also describes in some detail the rights and obligations of the prospective security holders.

All these considerations, of course, are directed at the intrinsic worth of the company and its securities, and in this sense the 1933 Act reflects the investment theory of those sound investment analysts, such as Graham and Dodd, who believe that analysis of intrinsic worth factors is the really sound basis for investment.

Even those who do proceed on the basis of intrinsic worth recognize that marketability of the security and the quality of the market are relevant, though they consider secondary, factors. The assumption, which is undoubtedly more often fact than not, is that a good company will attract a good market, and that any period of lag will be quickly corrected at least within the time requirements of the typical small investor. To the extent that it is not, the assumption would seem to be that this would result from some manipulative or fraudulent activity in the market itself for which disclosure is neither an appropriate nor effective remedy or preventative. (Hence, the essentially regulatory approach to the securities markets reflected in the Securities Exchange Act of 1934.)

Presumably it is for this reason that disclosure given in the prospectus concerning market factors is surprisingly limited, although there is some.

For example, the underwriting arrangements, which represent the first step in introducing the security to the market place, are described in some detail. The managing underwriter is identified as well as each participating underwriter. Dealers in the selling group are not identified, but the terms upon which the underwriters and dealers will be offering the securities are set forth. The selling group agreement, as well as the agreement among underwriters and the underwriting agreement with the issuer are filed as exhibits to the registration statement. Part II of the registration statement calls for disclosure of any marketing arrangements or limitations that are not set forth in the agreements.

The name of the market (the stock exchange or over-the-counter) in which the security will be traded is generally set forth. If the issue is of additional securities of a class already outstanding, the market in which the outstanding securities have been traded is generally set forth, together with market price ranges over a period of time. If the issuer intends to apply for listing on a stock exchange, this is generally stated.

The number of shares that supposedly constitute the floating market supply -- that is the number of shares outstanding and to be outstanding in the hands of the public as distinct from the shares held by management, controlling stockholders and insiders -- can be deduced for the most part from information in the prospectus. You will remember that the prospectus requires disclosure of 10% stockholders as well as the shares held by the management and any shares being offered to special groups. This information as presented, however, is really directed at disclosing to the prospective investor those persons in actual control of the company, rather than at attempting to describe the quality of the market for the security. The registration statement does not necessarily include information on all restricted transfer stock that would reduce the public float. Some information as to this, it is true, is set forth in Part II of the registration statement in connection with reporting unregistered sales of securities within the past two years.

With that I believe I have described everything in most prospectuses that relates to marketability and the quality of the market. As you see, it is rudimentary, especially when compared to the fulsome detail with which the issuer is described.

The only contributions of the 1934 Act reporting requirements in the area of market information are twofold: one is the requirement in Form 10-K (the annual financial statements filed with the Commission) that the number of record holders be stated. While 10-K's are in the Commission's public files and the financial services pick that information up, so far as I know nothing further comes of it. Second is the requirement that a Form 8-K report disclose increases or decreases in excess of 5% in the outstanding number of shares and that all such changes, regardless of amount, be disclosed in the 10-K report. Of course, the proxy rules under the 1934 Act also require that the number of shares entitled to vote at the meetings be stated, and that any holder of in excess of 10% of the outstanding shares be disclosed.

I wish to make it clear that when I describe the market factor as an element in the investment decision, I am not speaking about it in the narrow terms of simply tracing price movements, nor am I suggesting at all that looking to various market factors without seeking information concerning the business and financial results of the issuer is an appropriate method of investment.

There are those I suppose who would disregard any information about an issuer other than its name and look only to the security's activity in the market. The Commission's attitude toward that kind of basis for investment is reflected, I believe, in the Commission's rule concerning advertisements by investment advisers, under the Investment Advisers Act of 1940. That rule labels as fraudulent, deceptive or manipulative an advertisement by an investment adviser which represents, directly or indirectly, that any graph, chart, formula or other device can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them. Indeed, it is fraudulent under the rule if the adviser represents that any graph, chart or formula will assist any person in making his own decisions as to which securities to buy or sell without prominently disclosing "the limitations thereof and the difficulties with respect to its use."

I am speaking about the market factor in a much broader sense.

There is little doubt that an informed investment decision to purchase or sell a security involves not only an evaluation of the business affairs of the company but also an evaluation of the environment in which the securities are traded. Securities do not trade in a vacuum; they trade in a market place where buyers and sellers arrange for contracts, either directly or through intermediaries, which will provide for the buyer the lowest possible acquisition price and for the seller the greatest possible proceeds. While I cannot discuss at any length here the very complex operations of our securities markets, it should be apparent that the characteristics of the market place may be as important a subject for the investor as the business affairs of the company.

Though securities are either traded on an exchange or in the over-the-counter market, the market price for particular securities are not set by these abstract entities; rather, they are set by individuals like you and me or perhaps by institutions whose judgment as to what the price should be is controlling. Neither the New York Stock Exchange nor the Securities and Exchange Commission nor the economists, who sometimes like to talk about

"fundamental values," set the prices. Rather, a buyer must be found for the seller and a seller must be found for the buyer. Sometimes, of course, the professional broker-dealer community must fill the gap and buy or sell for its own account when the public does not or cannot maintain the liquidity which is demanded by certain investors and which cannot be supplied by other public investors.

Many informed investors know it is important to find out the extent of institutional, as distinct from private investor, interest in a security. If, for example, there is a substantial amount of institutional holdings, it is possible that a number of these institutions will increase their holdings or sell the security at or about the same time. If this happens, there can be a substantial impact on the market. Conversely, if a security is held primarily in the hands of thousands of small investors with little or no institutional interest, there is a greater likelihood that the dealer system on an exchange or in the over-the-counter market can absorb the relatively random imbalances of purchases and sales. The significance of this can be measured by recent estimates which indicate that about one-third of the trading on the New York Stock Exchange is accounted for by institutions such as mutual funds, pension plans, bank trusts, and the like. In some securities institutional participation is estimated as high as 50% to 60%. Since institutions tend to trade in much larger blocks, the trading pattern in such securities can be very different from a security widely held by many small investors.

It is also relevant to be aware of the number of shares outstanding for a particular class of securities and, further, the extent to which the shares are held by few or many owners and their availability in the market. For, as the float for a security decreases, the decisions of relatively few people can affect the price of the security quite substantially and can place substantial strains on the market place. The significance of this consideration can be measured by the fact that it is a primary criterion for listing on or delisting from the major exchanges. It is, of course, quite difficult to evaluate whether a market place can absorb 100 shares, 1,000 shares, or 10,000 shares without substantial price movement. On an even more technical basis it is meaningful to determine the historical turn-over of a security for particular classes of holders of that security. If it turns out that the holders are mainly institutions who rarely sell and who

can be expected to be increasing buyers as compared to institutions whose historical pattern is to liquidate quite quickly after short profit taking (or loss taking), this, too, can be of significant interest to the public investor.

Even the market place where the security trades can be important to a potential investor.

Let's look at the exchange market first. The exchange market is centralized. That is, all the orders go to one place and a tape reports each transaction, the price and volume. Second, there are rules of precedence and priority which set forth orderly procedures for the execution of retail and professional orders. Third, there are regulations concerning the specialists who make a market in the security.

These rules impose on the specialist certain affirmative obligations and also restrict his activities to those designed to make a fair and orderly market. If the specialist has substantial capital or significant borrowing power which has not been used to any major extent, he can provide tremendous depth and liquidity in the auction market by absorbing or supplying substantial amounts of stock. On the other hand, if his financial position or inventory commitments do not permit him to perform such a function the market can be somewhat erratic and subject to constant price fluctuations. This can be a troublesome problem, particularly for companies whose earnings history is somewhat erratic.

In an exchange market it is reasonable to expect that a vast network of member firms will be involved in selling and recommending a security to a wide variety of customers, dispersed over a wide geographic area. Thus, the market will be made up essentially by the flow of orders -- both buyers and sellers, and to the extent that they are not in balance either because of their timing or because of the amount of shares involved, the specialist and the capital available to him will be expected within reason to take up, absorb and even out the imbalance. Exchanges also provide various kinds of plans, some formalized and some not formalized, which will assist a potential buyer or seller in being able to obtain or dispose of a large block of securities.

The over-the-counter market is quite different. What are the characteristics of that market? Unlike the exchange, it is a decentralized market. There are few formal obligations placed on the market-makers to remain as market-makers or to absorb supply and demand imbalances in a manner which assures a fair and orderly market. However, particularly in the case of high-grade securities, it can be an exceedingly competitive market place in which the market-makers must service their customers with fair prices or else expect to lose them.

It is a market place which does not report volume or prices of trades and while it reports daily what the market place is willing to buy and sell the security for, this is given for an unknown point in time. The lack of volume information makes it quite difficult to make any informed judgment as to the thinness of the market and the ability of the dealers who make markets to absorb imbalances of buying and selling. There is no tape which would permit an informed observer to examine and evaluate price changes in different kinds of volume environments.

There are no rules in the over-the-counter market (except business practicalities, which can be quite persuasive) which require that a market-maker continue to make a market in a particular security. His own evaluation of the security, his own needs to diversify or be liquid, may make it unwise, as a business matter, for him to continue to make a market. And, there are, of course, substantial differences in the quality of the markets made by various over-the-counter dealers. The over-the-counter market, however, does have some firms, including the largest New York Stock Exchange member firms as well as large non-member firms, with enormous capital that can absorb substantial blocks of higher grade securities and hold them in inventory.

The problem of evaluating the market place is made even more complex by the fact that there are shifting patterns of public and professional desires in the kinds of securities in which they want to invest. Savings may be attracted to underwritings, pension funds, listed securities, over-the-counter securities, variable annuities and mutual funds in bewildering shifts of public opinion. And, as the public temper changes as to what kind of equity or debt investment is attractive, the market place for certain securities can change dramatically. Again, people have to make markets, and as their investment objectives shift because of economic, tax, or even psychological factors, markets become more or less liquid, depending upon the nature and extent of shifting opinions.

Certainly all these intangible aspects of investment risk could not profitably be incorporated into a prospectus. For one thing, a well prepared prospectus should, to the extent possible, hew that line, known to pleaders, that runs between conclusions or value judgments and detailed evidentiary facts. Yet certain base data concerning volume of trading, public float and block holdings are available. This is information that the exchanges use in determining listing and it is information which many professional investors utilize. If one of the objectives of the prospectus is to seek to put the relatively amateur investor on an information parity with the professional, is it not possible that some degree of market information should be provided to all investors in a new offering?

It might be argued that this information can be understood and interpreted only by a professional and therefore it would be meaningless to the average small investor. This, of course, might be said about much that is in the modern prospectus. Certainly the amount of disclosure given by many diversified companies with complex financial structures and transactions must leave unsophisticated investors gasping and in a quandary as to intrinsic worth. Without denying that much more can be done to further simplify prospectus disclosure concerning the issuer, I don't think anyone who has worked through the registration process can help but be persuaded about the prophylactic value of requiring fairly detailed disclosure about the issuer, particularly on its first public issue. Is it fair to ask what effect greater disclosure concerning the market would have upon the market?

It might also be argued that any information concerning the market would have to be so generalized that it would make a prospectus into a text book, and would be impracticable for that reason. However, it seems to me that the Commission has developed prospectus disclosure concerning the issuer into a meaningful body of information without getting into general economic or industrial theory, which is a necessary premise for understanding much of the prospectus. By a parity of reasoning, would it not be possible to provide meaningful information concerning market risks without getting into general market theories? It seems to me it is at least worth exploring.

Some slight step in the direction of market information disclosure I hope will be made shortly by the Commission in revising guidelines for the preparation of the registration statement. You will remember that several years ago the Commission issued Release 4666 containing some 32 guidelines. This has now been revised and expanded to some 53 items to permit more practitioners to know the practices and criteria followed by the Commission's staff in processing registration statements. It should be released for comment next week. It has been proposed that additional information concerning the number of holders, float and market-makers with respect to over-the-counter issues be provided to the staff as supplemental information to assist the Commission in forming some further views concerning disclosure in this area. We are also considering further utilization of our computer runs on over-the-counter securities and possible utilization of clearance information from the American Stock Exchange service to over-the-counter firms in New York to provide more data on the over-the-counter market.

By suggesting that consideration should be given to additional disclosure to investors concerning market factors I am not suggesting that there is anything wrong with those markets. Although there are some problems (and what industry doesn't have some problems?), the American public capital markets are amazingly sturdy, viable and productive. They can become more so through even more informed investing, and that is what I am speaking about today.

It may be that a prospectus is not the only or the best vehicle for providing such disclosure. As many of you know, there has been a substantial body of comment developing among students of the Federal securities laws strongly suggesting that more emphasis be placed upon the 1934 Act continuous reporting requirements and less upon the 1933 Act prospectus requirements. Last week (again as many of you know) the Commission adopted the long-awaited Form S-7. The Form provides for modified prospectus disclosure with respect to established publicly-held companies that have published annual reports, distributed proxy statements and provided periodic filings over the preceding 5 years, and have had sizeable sales and earnings during that period that would suggest relative stability and general availability of information concerning the issuer. The Commission felt that a company in that status warranted a more abbreviated, and hopefully more expedited,

registration process. This is an experiment and reflects some movement in the direction of integration of the 1933 Act and 1934 Act requirements. More can be done, particularly in upgrading the 1934 Act requirements. Perhaps reliance for more market data could be placed on sources of information other than the prospectus but in a coordinated manner as was essentially done in Form S-7.

The Commission announced last week the formation of a special study group within the Commission, directly under the charge of a Commissioner, that will proceed with intensive study of further coordinating and improving corporate disclosure. I am sure that some of the considerations on market disclosure about which I have spoken today will be part of the grist with which that group will deal. As the Chairman stated in his announcement, the study group will look

> "into the efficacy of present disclosure requirements in the light of changing trends in corporate finance and in the pattern of public stock ownership and trading activity, as well as technological advances in the means for dissemination of information to the public. The Study Group expects to work closely with the various segments of the securities industry and members of the professions and will welcome the cooperation and suggestions of all persons interested in or affected by the disclosure provisions of the federal securities laws."

My good friend and colleague, Frank Wheat, will have overall supervision of this study group. He is a man for whom I have acquired the utmost respect (although we do not always agree -- after all who could expect a Californian and a New Yorker to always agree), and we all look forward to the results of that study with great anticipation.

I am talking today about the market environment for investment. I referred earlier to the growing impact of institutions on the markets. This is a profound development that has reached truly substantial proportions only over the past ten years or so. Holdings of financial institutions of stocks listed on the New York Stock Exchange have nearly doubled in the 1960's alone, going from about $53 billion at the end of 1959 to $101 billion at the end of 1966. At the latter date bank administered personal trust funds held an additional $56 billion. If you include bank

trust funds, institutional holdings at the end of 1966 amounted to some 33% of all the stocks listed on the New York Stock Exchange which in turn amounts to some 90% of the value of all publicly-held stock in the country.

Institutional trading of course has also been growing rapidly and in pace with the holdings. In fact, a limited group of mutual funds have accentuated the trading volume proportion by increasing their turnover rates markedly. But the effect on the securities markets of relatively short-term trading practices by some institutional investors, as well as the many broader implications of institutional holdings, is a subject requiring a great deal more systematic study than it has been given to date.

On December 4 Congressmen John Moss and Hastings Keith, the Chairman and ranking minority member respectively, of the House Subcommittee on Commerce and Finance, introduced a joint resolution directing the SEC to make a study and investigation of the purchase, sale and holding of securities by institutional investors of all types. I hope that resolution and the necessary appropriation receives the support of the full Congress. Indeed, until such a study is made, I confess it would be difficult to indicate precisely what the implications of institutional holdings in a particular security would be, what particular risks, if any, an investor should be alerted to as a result of that fact. Yet we know that such holdings and trading do have an effect, in some circumstances good, in some bad, in terms of price to the public investor.

I am sure I have raised more questions for you than anything else. In large part I suppose that is what I intended. We must all think afresh about disclosure, without compromising the substantial accomplishments in this area, and about the markets, without jeopardizing their fundamental health, and about the relationship between the two. They are the kind of matters that are occupying the Commission today. I need not emphasize of course that what I said today reflects my own views and questions which may or may not be shared by my colleagues.

You know when you are discussing such massive considerations as the role of institutional investors in the securities markets, it is sometimes necessary to bring yourself back to earth and remember that the markets are in the end dependent not only upon

the capital that comes into them but upon the businesses that issue the securities, and that even our largest enterprises at some point came from small businessmen with large visions. I have an enormous respect and admiration for that entrepreneurial spirit. I was not shaken in it by a letter which the Commission received just this week. Let me read it to you:

"Dear Sir:

"Would you please forward to me the Federal Statutes and laws relating to the Promotion of a Multi-Million Dollar Corporation?

"At the moment, I am only interested in the laws with respect to the PROMOTION of a corporation. However, if they are not too voluminous, and can be conveniently transmitted through the mails without being too bulky, I would also like to have the laws relating to the formation of a corporation and the sale of its stock, etc.

"The Multi-Million Dollar concern which I am presently considering the initiation of, will operate on a world-wide basis when successfully in operation.

"Therefore, if you have information which I should have relating to international trade as controlled by the SEC of IF, SEC does indeed exercise such controls, I would appreciate same.

"Thanking you in advance, I am

"Sincerely,

____

Envelope, Stationary & Postage $ .07
Charge to: (Organizational Cost)"

I will leave it to your imagination from what state, where they think big, this letter came!

Thank you.