SOME ASPECTS OF THE SECURITIES AND EXCHANGE COMMISSION'S LEGISLATIVE PROGRAM

ADDRESS

By

LOUIS LOSS

Associate General Counsel

Securities and Exchange Commission

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The general text which was suggested to me when I was invited to talk to you today was "free enterprise" versus a "controlled economy." If the caffein can be taken out of those phrases, I suppose the short answer is that we at the Commission favor both. My firm personal belief -- and the basic philosophy of the several statutes administered by the SEC -- is that only through a proper measure of regulation will our economic system remain free and healthy. That much we take as dogma. If anyone still wants to debate that proposition he may, but not with us.

The SEC itself is not without its critics. In our scheme of things no government agency should be. But it seems to be pretty generally agreed that there is no turning back -- that the half-dozen statutes adopted by successive Congresses in the years 1933 to 1940 are here to stay. Some major legislative action was taken every single year but one during that period. In 1933, after forty-seven states and most foreign countries of any importance in the financial world had found it necessary to enact so-called "blue-sky legislation" of one kind or another, the federal government got around to legislating with respect to "truth in securities." The next year came legislation with respect to the securities markets as distinct from new flotations. The year 1935 brought enactment of the Public-Utility Holding Company Act with its much publicized "death sentence" for holding companies -- a provision which experience has shown was rather a new lease on life for private power under public control. In the next few years there were amendments to the 1934 Act. In 1938 and 1939, following the Protective Committee Study which had been conducted for the Commission by Williom O. Douglas, we got first Chapter X of the Bankruptcy Act, with its interesting experiment in cooperation between court and Commission, and then the Trust Indenture Act. Finally in 1940, as a result of the Commission's Investment Trust Study, a unanimous Congress passed the Investment Company Act and the Investment Advisers Act.

It may not be amiss to point out, particularly to this audience of "the loyal opposition," that these statutes are administered by an independent bi-partisan agency, and indeed that in large measure they were prompted and are supported by both sides of the legislative aisle. The investigation of the Senate Banking and Currency Committee which resulted in the 1933 and 1934 Acts had its genesis in a Senate resolution adopted in 1932 -- although a subsequent resolution of the new Congress did provide a fresh set of teeth with a harder bite. The monumental study of the Federal Trade Commission which produced the Public-Utility Holding Company Act of 1935 dates from another Senate resolution adopted in 1928, the year of the twin chickens and the elastic ticker tape. And, to go back even further, the federal incorporation proposals advocated by Presidents Theodore Roosevelt and Taft make our present-day statutes look mild by comparison.

It would be truly remarkable if a series of statutes adopted in so many different steps and covering so many facets of our financial life were found after ten or fifteen years of experience to be perfectly coordinated, without overlaps or loopholes. And it does not detract

from the tremendous effort and skill which went into their drafting to say that they are by no means perfect. In 1941 the Commission undertook to explore the basic Acts of 1933 and 1934 with representative groups of the securities industry with a view to working out areas of agreement and disagreement and presenting a comprehensive amendment program to the Congress. Virtually every provision of both Acts was carefully reviewed and the program got as far as hearings before the Interstate and Foreign Commerce Committee of the House of Representatives in late 1941 and early 1942. But Pearl Harbor raised more important problems and nothing came of that program.

At the moment there are three separate legislative proposals in which we are vitally interested. One is essentially a continuation of the program interrupted by the War, except that it is our present plan to bite off a little piece at a time rather than to attempt wholesale review of the 1933 and 1934 Acts. Our most immediate concern in this regard is to find a statutory formula which will make for the highest degree of real disclosure to investors in the offering of securities without at the same time hamstringing underwriters and dealers during the period between filing and effectiveness of the Securities Act registration statement. The problems presented by that dual aim are formidable and we are not yet certain that we see their solution, but we believe we are making progress.

Our second set of proposals concerns the Investment Advisers Act of 1940. It has now been four years since we sent to Congress a report on two major cases of embezzlement of clients' securities and funds by investment advisers, together with recommendations for amending the Investment Advisers Act in order to subject registered advisers to the same inspection powers now applicable to registered brokers and dealers.

What I want to talk about today is a third proposal -- first submitted by the Commission to Congress in 1946 in a report entitled "Proposal to Safeguard Investors in Unregistered Securities." That proposal is intended to eliminate a double standard of investor protection which has resulted, more by accident than by design, from the peicemeal adoption of the several statutes now on the books. Our proposal, in a nutshell, is to amend the Securities Exchange Act of 1934 by extending the registration, reporting, proxy and insider-trading provisions of that Act to securities of unregistered corporations having at least $3,000,000 of assets and 300 securityholders. These safeguards have been applied to various categories of companies step by step. There remains a fortuitous but important residuum. At the risk of getting a bit technical, I shall try to explain how this came about and why it is vital that the job begun sixteen years ago should now be finished. If in the telling of this story a moral is drawn about the application of orthodox _laissez-faire_ principles in this field, you may consider it not altogether accidental.

In 1933 Congress subjected most new offerings of securities to the light of full disclosure. Under that Act alone, of course, a company can continue to operate in the dark so long as it manages to avoid going to the public market place for its financing. In 1934 similar disclosure requirements were extended to all companies desiring to list their

securities on an exchange. The 1934 Act, in addition to making registration a condition of exchange listing, provided also for annual and other reports to keep the information up to date; and in a 1936 amendment similar reporting requirements were made applicable to future registrants of substantial size offering securities under the Securities Act of 1933 regardless of whether or not they chose to list on an exchange.

The 1934 Act also introduced two other provisions. One assures holders of listed securities of essential information when their proxies are solicited. The other is designed to protect securityholders against trading abuses by corporate insiders -- that is, officers, directors, and principal stockholders. Such insiders must promptly report any trading in which they engage; they are forbidden to sell short; and their short-term trading profits, resulting from going in and out of the market within a period of six months, are automatically recoverable by the corporation without the necessity of proving any abuse of inside information in the particular case.

In the Public-Utility Holding Company Act of 1935 Congress applied much the same reporting, proxy and insider-trading provisions to registered holding companies and their subsidiaries. And in the Investment Company Act of 1940 it followed suit with respect to registered investment companies, thus bringing still another category of companies under the umbrella.

The situation today, therefore, is that, if you happen to be a stockholder of a listed company or a public-utility holding company or a subsidiary of such a company or an investment company, you have access to current financial statements and other information about the company, you are assured of certain information and rights when your proxy is solicited, and you are protected against the use of corporate information by insiders for their private ends. If you are the holder of a security which does not fall within any of these categories but which has been offered to the public and registered under the Securities Act since 1936, you are likely to have current information, but you do not have the benefit of the proxy and insider-trading provisions. On the other hand, if you hold a security in an industrial corporation which has not done any public financing since 1936, this whole series of statutes might just as well not exist so far as you are concerned except for a few fraud provisions -- never mind how large the corporation or how actively its securities may be traded.

One inevitable result of this illogical disparity has been a dislocation of the old relationship between the exchanges and the over-the-counter market. For, just as surely as water will flow down hill, trading will flow from a regulated into an unregulated market. Why should corporate managements list their securities on stock exchanges and thus voluntarily subject their companies and themselves to the registration and reporting requirements, as well as the proxy rules and the insider-trading provisions?

Prior to 1944 there were actually a number of delistings of securities which were admittedly motivated at least in part by a desire to avoid these provisions. In that year the Commission for the first time required a vote of shareholders as a condition of delisting, and no company has yet seen fit to go to its shareholders with a delisting proposal on the basis of complete disclosure concerning the rights which they would lose if the proposal were to carry. There is still the problem, however, of the deterrent effect of the present statutory scheme upon new listings. Although the effects of the statute may not be as important a factor as the desires or recommendations of the corporation's investment bankers on the question of listing versus over-the-counter trading, the statutory scheme undoubtedly is an important consideration in the minds of corporate managements.

There are, of course, two ways to equalize the situation -- either up or down -- and I am sure you will not be surprised when I say that our studies have persuaded us toward the former direction. Let me tell you briefly what the Commission learned in the studies which formed the basis of its 1946 report to Congress. I shall refer, first, to the lack of available information about unregistered companies; secondly, to the habits of such companies in soliciting proxies; and, thirdly, to the need for applying the insider-trading provisions. It should go without saying that we do not mean to throw all unregistered companies into the same heap. Some follow better practices than others. But we naturally must emphasize the cases of abuse if they occur in substantial number. For it is part of the price of living in a civilized society that all of us must conform to the laws which result from the actions of some, more often than not a minority.

The Commission studied the annual reports of 119 companies with assets of at least $3,000,000 and 300 or more securityholders. Not a single company mentioned whether it had had any material transactions with insiders, or whether insiders had traded in the company's stock. Frequently there was no adequate disclosure of important changes resulting from the transition from a war economy to peacetime operations. Information with respect to bonuses or profit-sharing arrangements and the remuneration of top executives was usually absent. The financial statements were in many cases woefully inadequate. About 13% of the companies furnished no income statement at all, and the income statements of many more were so highly condensed as to be of limited value; in some cases they did not even report whether there had been any earnings during the year. Some 20% of the companies furnished no analysis of surplus. Over half of the balance sheets examined were materially deficient when judged by the accounting standards enforced under the Securities Exchange Act. One company listed 95% of its assets under the single caption, "Property, plant and equipment, including intangibles." In another case a "good will" item amounted to 60% of total stated assets although the company had a substantial accumulated deficit. In still another case dividends on treasury shares were boldly reported as income.

It is apparent that certification by an independent accounting firm does not of itself assure adequate information to the investing public, because 85% of the statements examined had been so certified. This is not intended as a criticism of the accounting profession. It is unfair to the profession itself not to buttress the accountants' standards by making the Commission's accounting regulations uniformly applicable to all companies of certain size and degree of public ownership. The Commission's experience has been that, unless accountants can point to legal requirements of good accounting standards, they are often unwilling or unable to pit their own opinions against the insistence of management as to the degree of disclosure -- and a committee of the British Board of Trade made a similar finding a few years ago in the course of its study leading to the amended Companies Act of 1947.

In the proxy field the possibility of abuse is self-evident. The proxy instrument is an essential device in the modern corporation with its thousands and sometimes hundreds of thousands of scattered stockholders. It is a device which can be used for good or ill. If stockholders are informed of the affairs of their corporations and given an opportunity to cast their proxy votes intelligently, the proxy device may well turn out to have been the salvation of our present-day corporate system. On the other hand, if the proxy instrument is no more than a blank check, the whole device simply makes for self-perpetuation of management and leaves the door open, as the Commission said in its 1946 report, "for executive irresponsibility and outright fraud." A writer in the London Economist put it well when he said on Christmas Day in 1937:

> "Company meeting procedure is a fitting topic for the festival of Christmas. Outwardly, it is a conglomeration of paradoxes whose superb unreason best suits the moment when paper hats are put on and logic leaves by the chimney. * * * No hall in England could possibly contain the 150,000 ordinary shareholders of Imperial Chemical Industries. But no secretary ever lost sleep on that account; for shareholders simply do not come trooping by battalions. Contrary to all theatrical canons, the best shows draw the thinnest houses. Only a passed dividend, a heavy loss or a reconstruction scheme can really pack the hall; a crowded meeting is usually an angry meeting. Shareholders who cannot attend, however, are given special facilities for voting in favour of the chairman's policy before they have heard his speech."

To the extent that the Commission's proxy rules apply, that can no longer be said in this country. We are particularly proud of our proxy rules. We think they are probably the single most effective disclosure device in our whole statutory arsenal. Under the proxy rules holders of listed securities or securities subject to the Holding Company or Investment Company Act are no longer faced with the alternatives of giving a blank check or disfranchising themselves altogether. They must be given prescribed information necessary to an intelligent exercise of their voting rights; they must be given an opportunity to indicate their wishes separately with respect to all matters which will arise at the meeting; and, so that corporate meetings will not resemble political elections in the one-party countries, they must be given a reasonable opportunity to present their own proposals and views to their fellow securityholders.

Contrast this with the proxy soliciting practices of the companies which would be affected by the Commission's proposal. We examined the proxy materials relating to 152 meetings of 76 companies, comprising all the domestic companies with assets of $3,000,000 or more whose voting securities have unlisted trading privileges on the New York Curb Exchange and were traded during 1944 in a volume exceeding 5,000 shares. The materials sent out in connection with 89% of the annual meetings did not even name the persons whom it was proposed to elect as directors. In connection with 42% of the annual meetings one of the items was stated to be the approval and ratification of all the acts of the management since the last meeting, with no specification of the nature of those acts. About 95% of the companies did not afford their stockholders an opportunity for a "yes" or "no" vote on specific items through a convenient ballot-type of proxy. One case has quite recently come to our attention in which a form of proxy appeared on the back of the company's dividend check, so that the stockholder who endorsed the check automatically executed a proxy unless he indicated to the contrary by marking an X in a particular space! Here is free enterprise unbridled. The lawyer who thought that one up -- and I assume only a lawyer would have that vivid an imagination -- well earned his fee.

Let us turn now to the insider-trading problem in connection with unregistered companies. As the Commission said a few years ago in its Tenth Annual Report to Congress, "Prior to the enactment of the Securities Exchange Act, profits from 'sure thing' speculation in the stocks of their corporation were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading." The Senate report on the bill which became the Securities Exchange Act referred to a case -- which it said was one of many instances of misuse of inside information -- where the president of a corporation and his brother, who controlled the company with a little over 10% of the shares, disposed of their holdings for upward of $16,000,000 before the company passed a dividend and later repurchased them for about $7,000,000. Apparently Judge Gary of United States Steel knew what he was doing in making it a practice, whenever his board declared a dividend, of insisting that notice of the dividend should be sent out over the stock ticker before adjournment of the directors' meeting.

Except to the extent that the present statutes have forced a change in the traditional laxity with respect to insider trading, we think it safe to assume that the problem still exists. We do know that most of the cases of market abuses by insiders which have come to the Commission's attention in its fraud work have involved unregistered securities.

These are the considerations, in highly condensed form, which have prompted our proposal that the various protective features I have been talking about be uniformly applied to all companies of certain size and public interest regardless of listing on an exchange or any other fortuity. Surely this is true: that the last persons in the world who should have the determination whether the public interest requires the application of these provisions in a particular case are the managements on whom the burden of compliance would fall.

It is fair to ask what the impact of the Commission's proposal would be quantitatively on the Nation's corporate economy. Naturally we can only estimate, but we believe there are some 3100 companies with assets of $3,000,000 as well as 300 securityholders; this figure excludes banks, which would be exempted. Of these 3100, some 1600 are already registered with the Commission under one act or another and most of them are subject to the proxy and insider-trading provisions. Of the remaining 1500, about 500 are already filing with other government agencies public reports which are basically comparable to those required by the Commission. That leaves roughly a thousand companies which do not now file public reports, and a somewhat larger number which are not subject to the proxy and insider-trading provisions. Of course, while corporations may be able to avoid death, they cannot avoid taxes, and probably 85% of those thousand companies already have certified financial statements, so that it would be no great burden on them to register with the Commission.

Some of these companies play prominent parts in the American scene -- Aluminum Company of America, American Potash & Chemical Corporation, The Great Atlantic & Pacific Tea Company, Pittsburgh & Lake Erie Railroad Company, Technicolor, Inc., American Optical Company, Ideal Cement Company, The Crowell-Collier Publishing Company, Time, Inc., Remington Arms Company, and others I could mention. Some of these have securities traded on an exchange on a so-called unlisted basis, but without any of the statutory safeguards I have been talking about, and the securities of other companies in the list are traded solely over the counter. I have yet to hear a single logical argument for continuing to exempt companies of this stature from the several statutory safeguards which Congress has successively found to be essential in the case of the various categories of corporations now covered by the statutes. One may criticize certain aspects of the present provisions; we do not say they are perfect. Our position is merely this: that whatever provisions do appear on the statute books should apply to all companies of certain size and with a certain number of securityholders regardless of the happenstance of past registration under one of the statutes.

One result of this program if it is enacted will be to put the question of exchange listing back on the plane on which it belongs. Today, as I have indicated, that question is complicated by considerations of the restrictions upon management which are attendant upon exchange listing. Our proposal would put the exchanges and the over-the-counter market on a truly competitive basis and each of the markets would be allowed to develop "in accordance with its natural genius and consistently with the public interest," as one of the congressional committees put it in 1936. Adoption of this proposal may also remove one of the incentives toward private placements and, as a result, toward excessive debt financing with its rigidifying effects on our economy. Although it is problematical to what extent the registration and reporting requirements now applicable to public offerings are responsible for the private placement trend, it cannot be demonstrated that the premium of non-disclosure which the law now places on avoidance of the securities statutes has not been one factor in the situation.

Most important of all, this proposal is an essential capstone in the statutory structure whose foundation was laid sixteen years ago in an effort to make corporate democracy an integral part of our national life. Political democracy has long been taken for granted in this country, and social and labor democracy is rapidly achieving almost the same universal recognition in principle. Corporate democracy is no less important an aspect of our national life. And, just as political democracy is imperfect to the extent that any segment of the population is disfranchised, it seems to me to be equally axiomatic that our free enterprise system is vulnerable to the extent that there are important gaps in our corporate democracy.