

ENFORCEMENT PROBLEMS UNDER THE SECURITIES ACTS

An Address

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The Securities and Exchange Commission has been entrusted by the Congress with the important function of regulating the capital markets of the nation. What is the significance to the American economic system of this role performed by the Commission?

The ultimate objective of our administration of the various securities statutes is to maintain public confidence in the American system of free and private enterprise. This goal is being achieved by making available to the investing public reliable business and financial information concerning corporations whose securities are publicly issued and traded. Over the past 22 years a vast body of corporate financial data has been accumulated as a result of the Commission's registration, reporting and proxy requirements.

In making their investment decisions, investors should assume a greater responsibility for using such information, because it is vitally important to the continued prosperity of our expanding economy that public confidence in corporate securities as a safe and profitable medium for investment of savings of individuals be maintained. Industry must obtain long-term capital for plant expansion, new equipment, and working capital at a rate of over eight billion dollars a year. The principal source of this vitally needed capital is the savings of the American people, which must be attracted to legitimate corporate investments through the channels of the securities markets. Never before in our economic history have individual investors assumed such importance.

One danger that threatens the corporate system of free enterprise is the siphoning away of individual savings from investment in legitimate enterprises. Despite the general honesty of the business community, there are destructive forces operating in the area of corporate financing, which tend to undermine public confidence in the stability of the capital markets. Stockateers are peddling securities of dubious value from boiler-rooms. Speculative securities in unseasoned enterprises are shamelessly touted and manipulated by unscrupulous brokers and dealers. Large numbers of persons are attracted to the securities business in the hope of making quick profits. A considerable volume of securities is being illegally distributed to the public without the basic protection of full disclosure afforded by the registration process.

The most serious peril to the continued health of the capital markets is caused by the activities of boiler-room operations. Who are they and how do they function? The securities salesmen employed in the boiler-rooms are often cons who have criminal records in such activities as bootlegging, gambling, narcotics traffic, home improvement rackets and various types of confidence games. Many have been circus barkers and carnival pitchmen. They sell corporate securities

of dubious value through high pressure and dishonest tactics over the long-distance telephone to unknown prospects located in distant parts of the country.

Boiler-rooms have concentrated in the New York City area, but the impact of their activities extends from coast to coast. The typical shop is located in a garret or shabby back office. It usually employs about thirty salesmen. Their pitchmen operate from small cubicles containing several telephones, a list of prospective victims and a three-minute egg-timer. The list of prospects includes the names of moneyed widows and relatives obtained from undertakers or it may consist of stockholders of record in some large, well-known corporation. The egg-timer is used to limit telephone calls to three minutes unless the prospect shows some interest in the offering.

In making their sales pitches to unsuspecting victims, these fast talking swindlers promise the chance of a lifetime in some "special situation" security, which is usually a promotional mining or oil company. They assure their prospects that they will double or treble their money within a matter of weeks. Simultaneously, the prices of the securities being pushed are manipulated, and by pointing to the steady rapid increase in market price, these fraud artists are able to reload their victims at the artificially advanced prices.

The work production requirements of boiler-rooms usually demand that salesmen complete sales with one third of the prospects called. At this rate of sales, the amount of the commissions of salesmen and the firm's profits are staggering. One boiler room recently closed down by the Commission grossed about \$2,000,000 from a few month's operations. The salesmen's commissions alone amounted to \$600,000. The telephone bill was \$200,000.

Investigations conducted by the Commission of six boiler-rooms located in New York City have revealed that over 9,000,000 shares of unregistered securities of highly questionable value, mostly concentrated in four issues, were recently sold to approximately 24,000 persons solicited by telephone in all parts of the country. The total proceeds derived from sales by these six houses alone exceeded \$30,000,000. The gross profit from the operations was nearly \$4,500,000. Long-distance telephone bills aggregated \$425,000. At today's market values, losses on these securities approximate at least 75% of the original cost. These cases will soon be presented to grand juries.

The issuers of many of the securities touted by boiler-rooms have illegally avoided public disclosure of their business and financial facts. Much of the stock sold by boiler-rooms are speculative mining and oil securities of both domestic and Canadian origin, but some are industrials listed on national securities exchanges. The most pernicious method of evading the registration requirements is reliance on the "no sale" principle and the private offering exemption.

The "no sale" principle enunciated in Rule 133 provides, in substance, that a corporate merger or similar transaction involving an exchange of securities or the issue of securities for the assets of a corporation and effected by vote of stockholders, is not a sale requiring registration of the securities. Companies have effected mergers and consolidations with newly organized corporations which are formed for the primary purpose of serving as a vehicle for a distribution of securities without registration. In these transactions, the merged company acts simply as a conduit to distribute to the public the stock obtained in the exchange from the surviving company. The merged company and its stockholders do not take the new securities for investment but rather for redistribution to the public - usually through the boiler-rooms. Through this fictitious device, large blocks of newly issued stock have entered the channels of interstate commerce without the protection of full disclosure to public investors.

A variation of this technique involves the acquisition by one company of a controlling interest in a second company through a voluntary exchange of securities with a few of the controlling shareholders of the second company. The exchange is made in purported reliance upon the private offering exemption. Soon after the transaction is consummated, the controlling stockholders make a public distribution of the securities received in the exchange.

Corporate empire builders have diversified and enlarged their activities by the simple scheme of increasing authorized capital stock which is then exchanged for assets or securities of other corporations. In many instances, the shareholders concerned are not given adequate business or financial facts concerning the transaction to enable them to vote intelligently on the proposal submitted to them or to determine its fairness. Furthermore, in the subsequent distribution of the securities received in exchange, the public has been denied the protection afforded by the registration requirements.

Since adequate public disclosure is the essence of the securities laws, its avoidance creates a vital enforcement problem. The Commission is considering a variety of approaches to cope with the misuse of the "no sale" rule in merger transactions and the exemption from registration provided for private offerings and exchanges of securities.

The distribution to an unwary public of speculative securities in mining and oil promotions poses a danger to the confidence of the American public in the capital markets. The risks of profit in new, unseasoned, extractive companies are uncertain. The possibility that heavy losses will be suffered by public investors as well as promoters is great. The Commission has uncovered many cases of misrepresentation and unfair dealing with the public in the distribution and trading of securities of these companies. Overreaching by promoters and underwriters, of course, tends to injure the reputation of the entire industry.

Some corporations are formed solely to create a source of securities for distribution to the public. Their securities are manufactured for stock jobbing purposes. Promoters have acquired mining properties having little or no real value for a nominal consideration and then have transferred the properties at grossly inflated prices to the corporations which they have formed. Large blocks of stock are sometimes issued in the names of dummy promoters, officers and directors, which are then sold to the public at unreasonably high prices unrelated to the intrinsic value of the corporation's assets. Insolvent issuers attempt to sell their securities to the public. Salesmen of some mining securities represent that engineering tests have disclosed the presence of specified large quantities of ore when no real tests have been made. They talk glowingly of dividends and stock splits by unseasoned companies which are losing money. Assets are written up and manipulated. Investors are told that they are providing capital for a promising enterprise when they are actually buying promoters' stock, and their money goes straight into the promoters' pockets and not to develop the company.

Investigations of filings made under Regulation A (which exempts from the full registration requirements offerings not in excess of \$300,000) have uncovered a variety of misrepresentations. One promotional mining company claimed in its offering circular that on the basis of estimates by a professional driller, it had 30,000,000 tons of proven ore and 200,000,000 tons of probable ore. The Commission's mining engineer took sixty-five samples from the properties and found that the company could not claim any significant ore deposits. It was true that the ore estimates had been made by a professional driller, but his drilling experience had been acquired as a dentist rather than as a mining engineer.

These abuses in the sale of mining securities to the public creates a problem to the industry in obtaining investment capital. It is evident that public investors will continue to show confidence in the mining and oil industry by contributing their savings for exploration and development only if the promoters and brokers and dealers who distribute and trade in such securities deal fairly with the public.

The existence of a flourishing mining industry is vital to the continued prosperity and security of this country and the free world. The activities of small mining companies are, of course, making a most important contribution to the exploration and development of mineral resources throughout the country. A study of the filings made under Regulation A by uranium companies in the Commission's Denver Office during the period from May 1, 1953 to January 1, 1956, shows that a total of 465 issues became effective. The 1955 AEC list of uranium producers includes 40.2% of these issues. Some qualification must be made regarding the significance of this percentage figure because the list covered all shipments having a uranium content of one-tenth of 1% or better, regardless of the size of the shipment. The point is,

however, that a substantial, tangible effort has already been made by small mining companies in exploring for uranium deposits and developing a uranium industry in this area.

The Commission must be extremely careful not to impose undue restrictions on their ability to obtain investment capital. The raising of venture capital from the public for legitimate mining promotions must not be stifled by unnecessary regulatory burdens. The revisions to Regulation A, which the Commission adopted last summer, were designed to effect greater protection to public investors by attempting to prevent the types of abuses which have been disclosed in our investigations, without hampering small business. They restrict the availability of the exemption from full registration in certain cases and strengthen the Commission's enforcement powers against issuers and underwriters utilizing the Regulation.

The revised Regulation may not be used where any underwriter of the issuer has been convicted of a crime or has been enjoined in a case involving securities transactions, or if the Commission, a national securities dealers association or an exchange has issued a disciplinary order against any underwriter of the issuer, or if any underwriter of the issuer was the underwriter of any other issue which is the subject of a stop order or suspension order or even if such proceeding is pending.

Another material change in revised Regulation A is to make the exemption unavailable to an offering by a security holder of his own securities if the company is newly organized or is one without net income for at least one of the last two fiscal years. The purpose of this provision is to prevent bail-outs by promoters and other insiders in unseasoned companies. Furthermore, unseasoned companies are now required to use an offering circular even if the amount of the offering aggregates less than \$50,000.

The amended regulation provides that the offering circular must be revised every nine months until the offering terminates. Expanded informational reports regarding sales and use of proceeds must be filed by the issuer every six months. An additional ground for suspension of the exemption has been added for failure of the issuer or any of its officers, directors, promoters, or underwriters to cooperate in any investigation by the Commission of an offering under the Regulation.

The Commission has under consideration certain further amendments of Regulation A, which would restrict its use only to seasoned companies with a history of earnings or, in the alternative, to companies which are not issuers of penny stocks.

There are four alternative proposals. Under the first alternative, the exemption afforded by the Regulation would be available only if the issuer had a net income for at least one out of the last five fiscal years. Under the second alternative, the Regulation would be used only if the number of units offered would be limited to 100,000 in the case

of equity securities and 3,000 units for debt securities. The third alternative would make the exemption available only to issuers satisfying the earnings test and the unit limitations on the securities to be offered. Under the fourth alternative, the unit limitation would only apply to issuers which cannot satisfy the earnings requirement.

Through its current program of vigorously enforcing the disclosure and anti-fraud provisions of the various acts that it administers, the Commission is able to curtail many abuses in the sale of securities. The area of uninformed risk-taking by a get-rich-quick-minded public is reduced. However, the public can never be fully protected from its own poor judgment or gullibility. Unscrupulous confidence men continue to be successful in selling to the public millions of dollars of worthless securities in countless fantastic promotions.

A few months ago the Commission obtained the conviction of two promoters selling participating interests in what was claimed to be the world's greatest undrilled oil field. They represented that it was bigger than the colossal oil deposits of the Near East, and that the area round one well was an "oil-sodden mess." Almost a million dollars was obtained from the public by selling leases at \$100 an acre which they had obtained for as little as ten to fifty cents.

Another promoter was convicted for defrauding investors in an oil promotion involving a so-called "magnetic logger" device. He claimed that it could tell him where oil fields were located, the exact depth at which the oil could be found and even the total number of barrels of oil which could be recovered from the field. Despite his fantastic claims as to its infallibility for locating oil fields, the defendant admitted at the trial that he personally had never been able to drill anything but a dry hole. The alleged invention was simply a "doodle-bug" contrivance consisting of a stick with a spring attachment.

Stock in a company which had purportedly perfected a fuelless self-energizing unit - in effect, a perpetual motion machine - was successfully peddled to the public. Our investigation revealed that this perpetual motion power unit consisted only of a small metal kitchen cabinet containing a Mazda sun lamp. Another scheme to defraud innocent investors involved an "atomic water treating machine" which allegedly could cure cancer, arthritis, low and high blood pressure and other dread diseases.

In carrying out its program to secure adequate disclosure for the investing public and to prevent, detect and punish fraud in the sale of securities, the Commission vitally needs a larger staff and additional funds. Our budget request for the coming fiscal year, which has been approved by the President, is \$7,178,000. This sum represents an increase of approximately 25% over the appropriation for the current fiscal year. If this budget is enacted by the Congress, the Commission will be able to employ approximately 150 additional personnel to carry out its important responsibilities in preserving fair and honest securities markets.

The current dynamic growth and productive power of the American economy, which is reflected in a Gross National Product of 412 billion dollars, is sustained by the capital markets. Over the past four years, the dollar amount of securities registered with the Commission has increased 75%, from 7-1/2 billion dollars in fiscal 1953 to over 13 billion dollars in fiscal 1956. We estimate that the number of registration statements to be processed in fiscal 1958 will be 1,190 as compared with a record number of 981 actually filed during the past fiscal year. This unprecedented financial activity has also swollen the number of brokers and dealers registered with the Commission. We estimate that the approximately 4,600 brokers and dealers which were registered in fiscal 1956 will increase to 5,000 in fiscal 1958.

This sharp rise in the volume of corporate financing in recent years has been accompanied by certain abuses. These unhealthy situations must be eliminated if capital investment is to continue to nourish a growing and prosperous America. The attempts of the Commission to protect the interests of the investing public and of honest business from the activities of unscrupulous persons who unfairly compete for the individual's savings is fully justified by sustaining the confidence of the American public in the capital markets. Reasonable regulation of the securities markets neither restricts free enterprise nor prevents the growth of industry. It burdens honest business only so that dishonest business may not thrive.

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