PURSUIT OF TWO OBJECTIVES IN SUPERVISING THE SECURITIES MARKETS

Address by

ANDREW DOWNEY ORRICK
Commissioner
Securities and Exchange Commission

before

THE WASHINGTON SOCIETY OF INVESTMENT ANALYSTS

Washington, D. C.

December 18, 1957

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The regulatory posture of the Securities and Exchange Commission in supervising the securities markets might be described as "objective firmness."

What are the most important manifestations of this attitude? First, it impells the Commission to administer a vigorous and aggressive program to strike down any attempts - particularly by issuers, promoters, broker-dealers, and securities salesmen - to defraud the public. Second, it urges constant vigilance in securing fair and adequate disclosure in all offerings of securities which are not exempt from the registration requirements of the Securities Act and by companies required to file reports under the Securities Exchange Act. And, third, it stimulates the search for realistic solutions to Securities Act problems posed by complex financial transactions.

Prevention and Prosecution of Fraud

An important component of the Commission's program is the prevention and prosecution of fraud in securities transactions. The Commission is currently investigating approximately 1,000 matters that appear to involve violations of the securities laws. During the fiscal year 1957 a total of 26 cases were referred to the Department of Justice for criminal prosecution compared with 17 referrals during the previous year. A total of 71 proceedings were instituted in the federal courts during the fiscal year 1957 to enjoin illegal activities in the securities markets compared with 35 injunctive actions during the previous fiscal year. The enforcement record for 1957 fiscal year further shows that the Commission issued 132 denial or suspension orders for non-compliance with the small offerings exemption, revoked 29 broker-dealer registrations, denied the applications for registration of 6 broker-dealers, and instituted 10 stop order proceedings to prevent registration statements of securities from becoming effective.

This acceleration of the Commission's enforcement program has been caused primarily by the record volume of capital formation required by American industry. The public appetite for corporate securities as a medium for investing individual savings has expanded with the increasing tempo of the economy. The intensified activity in the financial markets has attracted to the securities industry a fringe element of stockateering promoters and securities salesmen. These persons are the principal subjects of the Commission's investigative attention.

The schemes of some stockateers are whimsical. In March of this year the promoter of a company represented to own a patent for a wingless aircraft that was capable of carrying 4,000 persons a distance of 25,000

miles non-stop at half the cost of any other plane. was convicted of securities fraud and sentenced to three years imprisonment. More than 800 stockholders lost approximately $200,000 in this fraudulent venture. In selling the securities, the promoter claimed that the development of this wingless airplane was comparable to the achievements of the Wright Brothers, Leonardo da Vinci, Sikorsky, Billy Mitchell and Charles Lindbergh and that this plane was the greatest advance in aviation since the advent of flying. However, he omitted to disclose, among other things, that the prototype simply consisted of a remodelled small standard airplane from which he had sheared all but eight feet of each wing, that it was less efficient than existing types of planes, and that it had not been successfully test flown.

A few weeks ago an oil promoter was sentenced to seven years imprisonment for fraudulently selling investment contracts in oil and gas interests through making false promises of great wealth to prospective investors. He falsely represented that the lands covered by the leases had already been proved for oil and were highly productive and that there was no risk in making the investment. The promoter represented himself to be a highly qualified and successful oil operator who had never drilled for oil without bringing in a producing well. The indictment alleged, however, that the defendant had never been successful as an oil operator and that his profits had been made wholly as a result of promotional activities.

Securing Fair and Adequate Disclosure

The second principal aspect of the Commission's program is to exercise constant vigilance in securing fair and adequate disclosure of material business and financial facts in reports filed under the Securities Exchange Act and through the registration process in all offerings of securities not exempt from the requirements of registration under the Securities Act. During the fiscal year 1957, 943 registration statements, offering to the public a record volume of 14.6 billion dollars of corporate securities, were processed by the Commission. However, investigations conducted by the Commission have disclosed that a considerable quantity of capital was raised by the sale of unregistered securities in transactions where substantial doubt exists whether the exemptions from registration relied upon by the issuers were available.

In some of these cases the nature of the business transactions raise close legal questions respecting the necessity for registration. Others clearly involved illegal schemes to evade the registration requirements of the Securities Act. The effect, in both instances, has been to place in the channels of commerce large blocks of stocks without providing public investors with adequate business and financial facts on which an informed investment judgment can be predicated.

Regulatory Approach

What fundamental principles should guide the Commission in performing its important function of deciding the necessity for registration of securities issues? In interpreting the various statutory provisions the Commission must, first, carefully adhere to the language of the statutes, supplemented by an analysis of the legislative history in cases where the application of the statute to a particular situation may not be clear; second, give attentive consideration to the growing body of securities jurisprudence - such as court decisions, Commission opinions, orders, rules and administrative determinations - which have evolved over the past 23 years; and third, find reasonable and practical solutions to the disclosure problems involving legitimate business activities, within the framework of the statutory language and financial and administrative precedents.

The Commission has been diligent to require the registration of securities in all transactions brought to its attention where some exemption is not available. Frequently, however, complex interpretative problems are created for the financial bar and the Commission by particular factual situations and by various statutory provisions relating to the registration requirements.

Who is an Underwriter?

The definition of "underwriter" in the Securities Act has far-reaching implications to issuers and purchasers of securities in solving registration problems. In the context of the Act, the term "underwriter" has a scope far broader than its common meaning in financial circles. It is defined to include "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security . . , or participates . . in any such undertaking."1/ This definition is closely related to the exemption from registration afforded by the first and second clauses of Section 4(1) of the Act. These provisions exempt "transactions by any person other than an issuer, underwriter or dealer" and "transactions by an issuer not involving any public offering."

The basic concept of the Securities Act is to require registration of securities offered for sale by the issuer to the public unless some exemption is available. The Commission has long regarded the term "distribution" as used in defining underwriter, to be essentially equivalent to the term "public offering." A "public offering" has been broadly defined by the United States Supreme Court to include transactions in which the purchasers or offerees need the protection afforded by registration.2/

1/ Section 2(11), Securities Act of 1933.

2/ SEC v. Ralston Purina, 346 U.S. 119.

Consequently, a person who buys unregistered securities from an issuer with a view to reselling them, or who participates in the transaction by which the securities move from the issuer to ultimate investors, may, unwittingly, be acting as an underwriter, in the statutory sense, if the resales are deemed to be a public offering.

In order to carry out the registration objectives embodied in the Act, the Commission is compelled to examine the stream of transactions in which securities flow from the issuer to the ultimate purchasers. Thus, where a private sale of securities by an issuer is made to a person who intends to resell them to others, the circumstances involving the resales are included in determining whether or not the whole transaction constitutes a public offering.

The converse of taking securities "with a view to distribution" is purchasing for investment and not for resale. Where a purchase of securities is made from an issuer by a person, or a small group, who takes the securities for investment, no public distribution is involved, and registration is not required. The application of the expression "purchasing for investment" must be ascertained by reference to the intention of the purchaser at the time of acquisition. A person's intent can ordinarily be discovered only by weighing objective evidentiary factors and not by relying on self-serving statements - such as contained in so-called investment letters - that a particular purchase was made for investment. One of the most significant, although not necessarily conclusive, of the relevant evidentiary factors to be considered would be the length of time elapsing between the acquisition and resale of the securities. The longer the period of retention, the stronger might be the inference that the securities had been purchased for investment. The concept of taking for investment does not, of course, preclude for all time the right of the purchaser to resell without becoming an underwriter. However, it does impose a heavy burden on the purchaser to establish that when the securities were acquired, he, in fact, did not have a premeditated plan to make a distribution.

A recent administrative decision of the Commission illustrates the type of case where the existence of a premeditated plan to make a distribution negated the representation of taking for investment. A limited number of large purchasers acquired subordinated debentures and common stock in a company organized to engage in a speculative venture. The securities had been purchased with the intent to hold them until the business would become established. Since the purchasers had the preconceived intention, at the time of acquisition, to liquidate their holdings when this point in the development of the company would be reached, the Commission determined that registration would be required prior to any public offering.

Another significant ruling by the Commission interpreting the phrase "with a view to distribution" involved a sale by a controlling person of a large block of common stock in an unseasoned, highly speculative oil venture to a single purchaser in a private transaction. Some months later,

the financial condition of the purchaser became critical and it desired to make a public offering of its holdings. Although the purchaser represented that the company was unwilling to register the securities to be sold, the Commission denied a request for assurance that it would not take action if the securities were sold without registration. The Commission was not persuaded that the purchaser had not acquired the securities with a view to their distribution. The speculative character of the securities, the nature of the purchaser's business and its precarious financial condition at the time of acquisition were relevant objective facts that negated investment intent.

The Commission recently pointed out the dangers of making or relying on vague representations of investment intent by persons who do not have a clear understanding of the meaning of that term under the Securities Act. An exemption for an alleged private offering originally made to a restricted group of persons may be destroyed and the original purchasers may be transformed into statutory underwriters where the participations are subdivided or resold to others. In the Crowell-Collier Publishing Company 3/ financing of convertible debentures in 1955-56, the issuer had secured commitments from 27 persons who executed investment letters stating they had no present intention of distributing the securities. However, prior to the closing date, approximately one third of these purchasers subdivided and resold their allotments, resulting in at least 79 purchasers. The Commission concluded that the issuer could not rely on the exemption from registration provided for transactions not involving a public offering in the sale of the debentures.

Convertible Securities

From time to time, the issuance of convertible securities becomes a popular medium, with both sellers and buyers, for capital formation and investment. During the fiscal year 1957, $1,273 million of convertible securities were registered with the Commission, compared with $1,361 million in 1956, and $369 million in 1952.

The issuance and sale of convertible securities involves a simultaneous offering of two securities: the convertible security itself and the security into which it is convertible. Where the issuer makes a public offering of the convertible security and the conversion privilege is immediately exercisable, registration of both securities is required.

Upon completion of a public distribution of registered convertible securities, the Commission does not consider that the delivery of an up-to-date prospectus in connection with the issuance of the underlying securities upon exercise of the conversion privilege is required by the statute. The rationale of this position is that where the distribution of the convertible securities has been completed through the public

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3/ Securities Act Release No. 3825, dated August 12, 1957.

offering, the transaction of conversion is exempt as an exchange made "by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." 4/ In this situation the exempt transaction is considered not to be a device to achieve a distribution since that has already occurred.

Difficult problems concerning the statutory requirements for registration are frequently raised, however, where issuers sell convertible securities in transactions which purport not to involve any public offering.5/ In a number of instances coming to the attention of the Commission, purchasers in these transactions have exchanged the convertible securities within a relatively short period after the original take-down and have made a distribution of the underlying securities to the public when no registration has been effected. Even though the initial sale of the convertible securities might have been so limited as to qualify for the exemption afforded for transactions not involving any public offering, as to the convertible securities, an appropriate exemption must be found for the subsequent resales in order to avoid violations of the registration requirements.

One exemption which has been relied upon for the conversion and the subsequent sales of the underlying securities is the exchange exemption. It would seem, however, that the exemption provided for exchanges of securities by an issuer exclusively with its existing security holders where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange is available only for the transaction of conversion. This exemption does not afford a permanent exemption for the securities received upon conversion. It does not clothe such securities with an exempt status in subsequent transactions. It applies only to the transaction of exchange. The rationale of this conclusion is that securities which are issued in exchange for convertible securities do not possess any intrinsic qualities that should cause the extension of the exemption afforded by the transaction of exchange to subsequent resales.

Another theory is relied upon to relieve subsequent sales of the underlying securities from the registration requirements. It has been urged that since the convertible securities were acquired in a private offering transaction, this exemption continues to be available for the securities issuable upon conversion. Reliance on this exemption, however, overlooks the fact that a person who converts a security is, in fact, purchasing a new security from the issuer. If the purchaser's intent, at the time of conversion, is to resell the underlying securities to the public,

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4/ Section 3(a)(9), Securities Act of 1933.

5/ Section 4(1), Securities Act of 1933.

he appears to fall within the statutory definition of underwriter, for the reason that he has purchased the securities from the issuer with a view to distribution.

Not all the perplexing implications of these types of transactions have been satisfactorily resolved. The view that the existence of an exemption for subsequent resales of the underlying securities depends upon the circumstances surrounding the original acquisition of the convertible securities is consistent with the concept that an ordinary investor who acquires securities in an exempt private transaction does not become an underwriter merely because at some future time he disposes of his investment. On the other hand, if the status of exemption is not related to the purchaser's intent at the time of conversion, the private placement of convertible securities might become a medium for publicly distributing, without the protections afforded by registration, the securities into which they are convertible.

Rule 133

During the course of the Commission's administration of the securities statutes a vast volume of unregistered securities have been issued in connection with corporate reorganizations. Under Rule 133 securities issued in mergers, consolidations, recapitalizations and transfers of assets effected pursuant to state statutes providing that a favorable vote by a majority of stockholders will bind all stockholders (with appraisal rights for dissenters) are not subject to the registration provisions. On the other hand, voluntary exchanges made by a person or corporation to the public security holders of another company are subject to registration. Voluntary exchanges, however, have constituted only a small fraction of the total offerings registered under the Securities Act, and are insignificant in relation to the total amount of securities involved in corporate acquisitions and mergers.

From the present time back to the enactment of the Securities Act contrariety of opinion among practitioners, regulators and other students of the securities laws has existed as to the soundness of the legal theory relieving securities issued in these types of statutory reorganizations from the registration requirements.

Rule 133 qualifies the definition of "sale" contained in the Securities Act by stating that, for purposes of registration, the issuance of securities in these statutory reorganizations does not involve a sale. The legal theory supporting this "no sale" interpretation is that the securities transactions in such a reorganization occur through corporate action by stockholders exercising their franchise to vote as members of a corporate body. The voting rights of stockholders to accept or reject, as a class, a proposed reorganization plan are created, and the procedures to consummate the transactions are governed, exclusively by the laws of the interested states. The exercise of voting rights by stockholders, acting as a class, does not have the same legal effect as making a choice as an

individual to accept or reject a security offered in exchange for another security. The prime elements of a contract, namely, mutual assent between the corporation and the individual stockholder, are lacking.

The repeal of Rule 133 has been urged on the ground that the Act broadly defines the term "sale" to include every disposition of a security for value, and that many of these reorganization transactions involve the disposition of a new security for value to at least some of the stockholders of the constituent companies.

This approach, however, oversimplifies the problem. It would appear to be rudimentary that the interpretation of the word "sale," as used in the context of "disposition for value," should follow its historical legal meaning, absent an express Congressional mandate to the contrary. A solicitation of stockholders to vote on a proposed reorganization plan does not have the connotation of an "offer to sell." Furthermore, an equally artificial construction of the term "sale" would be involved by deeming that a sale of securities has occurred when the approval of stockholders to a merger, consolidation, reclassification or transfer of assets is obtained.

The no-sale theory, respecting the inapplicability of the registration provisions to these types of corporate reorganizations, has received 23 years of administrative acceptance by the Commission as well as some judicial sanction. 6/ While the doctrine has been described as "unforgiveably formalistic," the legalistic justification for holding that an offer to sell or a sale of securities is involved where a proxy is solicited or voted is subject to the same criticism. The conclusion that the present structure of the Securities Act was not designed to encompass the registration of securities issued in inter- and intra-corporate transactions of this kind is not unreasonable.

During the past year the courts and the Commission have clarified the legitimate limitations of the no-sale rule. These decisions have reemphasized the interpretation that the rule does not have the effect of "freeing up" from the registration requirements the securities issued in merger transactions, which are merely a maneuver to effect a public distribution of securities. The articulation of this sound proposition should effectively preclude further attempts to use the rule as a loophole to avoid registration.

In SEC v. Micro-Moisture Controls, Inc., 7/ decided early this year by the United States District Court for the Southern District of New York,

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6/ National Supply Co. v. Leland Stanford, Jr. University, 134 F. 2d, 689, (C.A. 9, 1943), cert. denied, 320 U. S. 773.

7/ Civ. No. 116-190 (S.D.N.Y.)

defendant issued more than 2,000,000 shares of its stock in exchange for the assets of another corporation. The shares were distributed as a liquidating dividend to the shareholders of the merging corporation, who signed powers of attorney appointing the largest stockholder of Micro-Moisture as their attorney-in-fact to sell the shares. The shares were sold without having been registered and in purported reliance on Rule 133. In granting the Commission's petition for a preliminary injunction, the Court held that Rule 133 could not be relied upon to exempt the subsequent resales from registration "for the reason that the shareholders of /the merging corporation/ were and are in control of Micro-Moisture and that the 'exchange' of /the merging corporation's/ assets for Micro-Moisture stock was but a step in the major activity of selling the stock." The sellers of the stock were also held to be statutory underwriters.

The Great Sweet Grass Oils Limited and Kroy Oil Limited case, 8/ decided by the Commission in April 1957, was a proceeding to delist the securities of the two companies on the ground that they had filed false and misleading reports with the Commission and a national securities exchange. The Commission found that respondents had issued their stock in exchange for the oil and gas properties of a number of ostensibly independent corporations. These corporations were, in fact, under the common control of respondents. The stock was then sold without registration to the public through the use of flamboyant literature and high pressure sales techniques. The reports filed by respondents stated that registration was not required by reason of Rule 133. In rejecting this claim, the Commission said: "Where there is a preexisting plan . . to use stockholders merely as a conduit for distributing a substantial amount of securities to the public, Rule 133 cannot be relied upon by the issuer . .. In any event, where the persons negotiating an exchange, merger or similar transaction have sufficient control of the voting stock to make a vote of shareholders a mere formality, Rule 133 does not apply."

Just two months ago the Commission rendered a further important interpretation under Rule 133 in a case not involving any of the aspects of fraud, such as were involved in the Micro-Moisture and Great Sweet Grass cases. In a proposed merger transaction, a substantial stockholder of the merging company contemplated selling the shares to be received upon consummation of the merger. The Commission decided that while registration would not be required for the issuance of shares of the surviving company to the security holders of the merging company, the substantial stockholder would be a statutory underwriter if he effected a public distribution of the shares received. Following the receipt of this interpretation, a registration statement was filed to cover the shares to be issued in the merger transaction.

8/ Securities Exchange Act Release No. 5483, dated April 8, 1957.

Conclusion

The Securities and Exchange Commission assumes an important responsibility for preserving public investor confidence in the securities markets. While continuing its diligent policing of the securities industry, the Commission must attempt to clarify further its interpretations of the statutory requirements applicable to the registration of securities. The issuance of convertible securities in private transactions must be adequately controlled so that the practice does not become a subterfuge for the distribution of the underlying securities without registration. Likewise, the Commission should continue to be vigilant to prevent the use of the "no-sale" rule as a means of effecting unregistered public distributions of securities.

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