

ADDRESS

of

ROBERT H. O'BRIEN

Assistant General Counsel, Securities and Exchange Commission

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The year which now draws to a close has witnessed many spectacular events in the realm of finance. Richard Whitney's defalcations and his subsequent imprisonment are still touchstones for editorials regarding the need for more comprehensive regulation. And stories of the late Philip Musica, alias F. Donald Coster, may still be found on the front pages of newspapers throughout the world.

Less sensational perhaps, but no less important, are the many instances in which corporate management, acting within the letter of State corporation laws, has stripped helpless security holders of their rights. I propose briefly to consider a few of the situations.

At the outset I wish to emphasize the fact that I am not here as a spokesman on behalf of any particular regulatory scheme. My purpose is mainly informative. But an awareness of present abuses in corporate affairs is the first step in the formulation of a program which will curb those abuses. Accordingly, despite the fact that I offer no "constructive program" which will afford a "sure cure" for the evils I shall hereafter point out, I trust that an indication of such evils will serve a useful purpose.

To indicate that evils still exist is not, of course, to imply that the securities markets and corporate enterprises are completely unregulated. The contrary is true. State statutes now regulate many types of corporate activity, and Federal legislation, administered by the Securities and Exchange Commission, does constitute a partial brake upon limited areas of financial enterprise. But such regulation is not pervasive; and fully to understand the limitations of existing legislation, it is necessary to know what fields that legislation is designed to cover. It may therefore be desirable to consider briefly the scope of the legislation administered by the Securities and Exchange Commission.

The Securities Act of 1933, the first of the Federal statutes, calls for the disclosure of material facts concerning securities offered or sold through the mails or in interstate commerce. The Act is not an "approval" statute. It confers no power upon the Commission to pass upon the merits of any particular security issue or to express any judgment thereon. It simply provides that in the absence of one of the exemptions specifically prescribed by the Act, no public offering of securities shall be made through the mails or in interstate commerce unless a registration statement is in effect as to such securities, and unless a prospectus containing a summary of the information in the registration statement is furnished to each prospective investor. The registration statement must contain such information as experience has shown to be necessary to an intelligent appraisal of the value of securities. The statute further provides that it shall be unlawful to use the mails or channels of interstate commerce to offer or sell securities by any fraudulent means or devices.

Through its power to compel the disclosure of pertinent facts in connection with the sale of securities subject to the Securities Act, the Commission is indirectly enabled to exert a salutary influence upon some corporate practices; the grosser forms of fraud and imposition upon security holders do not long flourish under the light of publicity. And the Commission has not been unaware of the possibilities inherent in this device. Thus the Commission has held, for example, that it will ascertain the actual facts concerning valuation of the issuer's properties, as set forth in a registration statement, despite a state statutory provision that an appraisal made by promoters or directors in good faith is conclusive under State law. By testing valuation statements for truth under objective standards, and compelling

a disclosure of the true facts as so determined, the evils which flow from an assignment of fictitious values to assets are lessened in those cases in which securities are registered under the Act.

But full disclosure of dishonest or deceptive practices cannot take the place of honest and forthright action. If the issuer who registers under the Act discloses the whole truth about itself, the Commission is powerless to go further, and stop oppressive practices. The Commission has no authority to curtail or eliminate excessive powers which management has taken for itself under lax corporation laws. The Commission has no power to supervise the activities of corporate management despite their harmful effect upon some classes of security holders. In short, where a registration statement contains no misstatements or half-truths, the management may continue to exercise broad charter powers despite the harm which may be inflicted upon security holders.

The Securities Exchange Act of 1934, another of the Acts administered by the Commission, was the product of an investigation which exposed the evils of unrestricted speculation and other abuses which lay behind the collapse of 1929. That Act is more complicated and more comprehensive than the Securities Act. Among other things, it subjects the national securities exchanges to a measure of Federal regulation; it contains provisions designed to curb profiteering by insiders; it seeks to prevent excessive and unhealthy speculation; it empowers the Commission to promulgate rules covering the solicitation of proxies in respect of any security registered on a national securities exchange; it outlaws "rigging" of securities markets; and it provides that corporations whose securities are listed on a national securities exchange shall file with the exchange and with the Commission an application containing certain designated information, and such annual, quarterly, and current reports as the Commission may prescribe in the public interest and the interest of investors.

The responsibilities entrusted to the Commission by the Securities Exchange Act are great. Experience attests that the Commission has been alive to its responsibilities. Witness, for example, the reform of the New York Stock Exchange. But beyond the powers conferred upon it by the Act, the Commission may not go. And within the unregulated region lie many corporate abuses.

In addition to the Securities Act and the Securities Exchange Act, the Commission also administers the Public Utility Holding Company Act of 1935, the Maloney Act, and performs certain functions in connection with corporate reorganizations under the new Bankruptcy Act, known as the Chandler Act. The Commission's powers under the Public Utility Holding Company Act go well beyond regulation by mere disclosure. The Act ranges from the administrative supervision of security issues and property acquisitions and of various types of financial practices to a mandatory requirement for the unpyramiding of holding companies, and the unscrambling of utility properties along lines which will assure maximum efficiency and economy in operation. But the pervasive powers vested in the Commission under the Holding Company Act may be exercised only with reference to gas and electric utility holding companies and their subsidiaries. It is, in short, a special statute designed to alleviate certain of the evils which threatened the public interest and the interests of investors and consumers in a limited area of utility enterprise.

The Maloney Act is an amendment to the Securities Exchange Act of 1934, which gives the Commission broader powers over the over-the-counter securities

markets, and permits brokers and dealers, under the supervision of the Commission, to form associations authorized to perform functions in the over-the-counter market similar to those performed by stock exchanges in the exchange markets. The primary purpose of the Act is to place brokers and dealers in the over-the-counter markets on a more highly professionalized plane.

Under the new Bankruptcy Act the Commission's primary function is to render administrative assistance to the Federal courts in connection with the tremendously complicated job of reorganizing corporations. Such expert assistance should enable the courts better to discharge their onerous functions in reorganization proceedings. One other feature of that Act, which the Commission had urged in its Protective Committee Studies to the Congress, deserves notice. Chapter X of the Chandler Act requires the appointment of an independent trustee in all corporate reorganization proceedings. Whereas under the old Bankruptcy Act, the management of a company undergoing reorganization might remain in control or obtain the appointment of a friendly trustee and thereby stifle any thorough analysis and appraisal of its past record, the new Act, by making the appointment of an independent trustee mandatory, assures the public and the stockholders that there will be a complete inquiry into the quality of the corporation's management, and a genuine accounting for past activities. Moreover, the independent trustee, as representative of all security holders, serves as the focal point for the formulation of a plan of reorganization. Better and fairer administration of estates in reorganization and greater democratization of the reorganization process are assured under the new Act. Then, too, knowledge that there will be an accounting for past misdeeds in the event of reorganization may provide a deterrent to irresponsible management.

With this somewhat cursory outline of federal regulation of the financial activities of corporations, we may more intelligently consider some of the pressing problems in the field which remain unsolved.

The Securities Act and the Securities Exchange Act have gone a long way to assure to purchasers of securities and to existing security holders that basic information relating to the issuer shall be available. But the whole field of security issues has not been covered, and many investors still lack any means of obtaining necessary information concerning their securities. It is true that no public offering of a security through the mails or in interstate commerce may be made unless certain information is given. It is likewise true that no new securities may be listed on a national securities exchange unless there has been an appropriate disclosure of necessary facts concerning the issuer. Yet the amount of securities for which no information is required is staggering. Accurate statistics, obviously, are not available, but consider, for example, the amount of securities issued prior to the enactment of the Securities Act, and which are not listed on any national securities exchange. It is evident that mere prohibitions against fraud and deceit in the sale of such securities, even though enforced by criminal sanctions, cannot supplant the investors' need for definite information concerning such securities. Excluding government and municipal bonds, approximately \$60,000,000,000 of securities are outside the disclosure provisions of the Securities Act or the Securities Exchange Act.

Moreover, the provisions of the Securities Act and the Securities Exchange Act do not even assure to stockholders of all corporations complete and accurate annual reports relating to the conduct of the corporation's

business. The capability of the corporate management may best be judged on the basis of its corporate record. If that record is an unfavorable one, indicating, for example, dissipation of the corporate funds, stockholders should be apprised of the true facts, so that they may take appropriate steps to protect their investment. But it is an unusual management which, in the absence of statutory compulsion, will lay bare the true facts to the stockholders, no matter how unfavorable those facts are. The result is scanty reports, which often contain distortions of the facts or even lies.

Remember, too, that the Securities and Exchange Commission has no control whatsoever over State charters. We have no power to outlaw even the plainly unfair types of securities; and we cannot reserve for stockholders even a bare minimum of effective control over the enterprise to which they have entrusted their money. We cannot prevent management from aggrandizing rights which belong to security holders, nor can we prevent management from divesting itself by contract of the duties and responsibilities which in all justice should accompany their position of trust.

High in the list of corporate practices, obviously unfair, but supposedly sanctioned by State law, is that in which a portion of the capital contribution of one class of stock is distributed to another class of stock by way of dividends. The following case illustrates how the process works. Preferred stock is issued with a par value of \$1 per share, a liquidation value of \$5 per share, and a redemption price of the same amount. The stock is offered and sold on the market at \$5 per share. The corporation thereafter sets up the preferred stock in a capital account at \$1 per share, its par value, and credits the balance of \$4 to a surplus account. Dividends may thereafter be paid to common stockholders out of this surplus. In a situation of that sort, it is clear that the preferred stockholders are de-luded as to their investment. They expect their total contribution to be invested in the enterprise; they do not contemplate that a large part of their investment will be returned to other stockholders without their consent. But despite the patent unfairness of permitting common stockholders to enjoy as dividends the capital contribution of preferred stockholders, it is the opinion of many corporation lawyers that that result is legally permissible under many State statutes.

Another practice, apparently condoned by State law, but within which lie the seeds of deception unless appropriately disclosed, is the reduction of depreciation costs by writing down fixed assets on the balance sheet. The practice usually works as follows: The stated capital of the corporation is reduced in accordance with the applicable State statute. This operates to create a capital surplus. At the same time, a fixed asset account is reduced to an arbitrary figure which purports to represent the current value of the asset. The credit against the asset account for the amount of the reduction is offset by a charge to the capital surplus account, which was created by the reduction of stated capital. The net result is a write-down of the fixed assets. By virtue of that write-down, the expense of periodically accounting for the depreciation of the fixed assets of the company is lessened. The resultant diminution in depreciation costs frees current income for the payment of dividends.

It is at once apparent that unless a full disclosure is made, stockholders receiving dividends which in fact are attributable to the reduction of the fixed assets may be misled to believe that the dividends are due to improved efficiency of the management or an improved market for the corporation's commodities or services. In situations of that character which

come within the jurisdiction of the Commission, there is an insistence upon a full disclosure. But many such transactions are effected by corporations which do not come within the ambit of the Commission's powers. As to such corporations, there is no assurance of an adequate disclosure to stockholders.

In England, transactions of that nature may be effected only under the supervision of a court, in a proceeding in which creditors and stockholders are entitled to be heard. This procedure represents a realistic recognition of the need for protection by creditors and preferred stockholders against management plans. So far as I know, except for utility holding companies and their subsidiary companies subject to the Public Utility Holding Company Act of 1935, nothing comparable to the judicial supervision found in England exists in this country in similar situations.

I have earlier alluded to the problem of excessive valuation of assets. Typical is the case where a promoter transfers property of a nominal value to a corporation in return for a designated portion of the corporation's stock, and such property is then set up on the books of the corporation at the par or stated value of the stock. In either event, the figure at which the asset is set up on the balance sheet grossly exceeds the value of the assets. Thereafter, securities are sold and credit is extended on the basis of the inflated asset figure.

In the case of corporations which register their securities under the Securities Act, the Commission insists upon a disclosure of the fictitious bases of any asset valuations. But mere disclosure is often not enough. Moreover, in the case of many corporations not subject to the provisions of the Securities Act or Securities Exchange Act, even the minimum of protection which is afforded by disclosure is lacking.

Experience has shown that we cannot rely upon existing State statutes and the common law rules to cope with this inherently deceptive practice. The only safeguard generally afforded has been civil redress to injured parties. Thus, under the so-called "trust fund" theory or "holding out" theory, which the courts have evolved, or under some statutes, creditors may, in the case of par stock, sue stockholders for the difference between the par value of the stock and the value actually given therefor. But such actions are beset by many legal pitfalls, and the possibilities of recovery are slight. Moreover, the widespread use of no-par stock further reduces the danger of liability to creditors. Nominally, stockholders who purchase their stock in reliance upon misrepresentation of asset values may maintain an action in fraud or deceit against the promoters. But the expense which attends such suits, as well as the difficulty of proving scienter, materiality, causation, and reliance, the elements of the action, tends to restrict the number of such suits. These measures hardly strike at the roots of the problem.

Not unusual today is the situation in which one class of stock enjoys a right to participation in the earnings and management of the corporation out of all proportion to the capital contribution of that class. The following case, taken from the records of the Commission, is illustrative of this type of situation. The corporation, which we shall call "Corporation A", had an authorized capital stock of 100,000 shares of Class A \$4 cumulative stock of a stated value of \$100 per share, and 100,000 shares of Class B stock of a stated value of 2¢ per share. Provision was made for cumulative voting by each issue, the Class B stock, however, being empowered to elect a majority

of the board of directors. Earnings of the company were to be employed first in the payment of the \$4 dividend on the Class A stock, with anything remaining thereafter to be divided equally between the two classes of stock. The Class A stock was to be offered to the public at \$100 a share. The Class B stock, all of which was outstanding, was held by a single corporation, which in turn, was controlled by one person. If this corporation were to pay a dividend of \$600,000, the Class A stock would receive \$500,000 and the Class B stock \$100,000. Translated into terms of a percentage return on investment, the Class A stock would receive 5% on its \$10,000,000 investment, while the Class B stock would receive 5000% on its \$2000 investment.

Such a disparity in rights to earnings is obviously unfair, and unjustified. Little more can be said of the situation in which a very small investment is able to control a huge corporation through the virtual disfranchisement of the great mass of stockholders. For a while, it was the vogue to create common stock carrying no voting rights. One of the better known instances is the non-voting common stock of Dodge Brothers, Inc., issued in 1925. In that case, neither the preferred nor four-fifths of the common stock was entitled to vote in the election of directors. This practice, however, soon met with disfavor. Today, the New York Stock Exchange and the New York Curb Exchange will not list new issues of non-voting common stock. This has tended to discourage the use of non-voting common stock, although it has not, by a long ways, eliminated the practice. The ingenuity of corporate management, however, has overcome that apparent obstruction by giving excessive voting power to one class of stock — usually a stock which the managing group has acquired at a cheap price. For example, a corporation may issue one class of common stock, each share of which is entitled to one vote, and another class of common stock, which carries only 1/20 vote per share. For all practical purposes, this device is as effective from the point of view of those wishing to acquire control with a minimum investment, as the use of non-voting common stock.

Limitation of time prevents my treating many other problems. Before closing, however, I should like to touch upon a few of the problems involved in so-called "voluntary reorganizations", which are effected through charter amendments, mergers, consolidations, and sales of assets. The instances are many in which dominant stockholders in these "voluntary reorganizations" have ridden rough-shod over the rights of other stockholders in the enterprise. Incidents in the history of The Equity Corporation, which was the subject of an intensive investigation by the Commission in its Investment Trust Study for the Congress, clearly reveal some of the existing deficiencies in State laws.

The Equity Corporation was organized under the laws of Delaware in December, 1932, for the purpose of acquiring control of investment trusts and investment trust companies and consolidating them "into one corporation or into a coordinated, controlled group". In 1935, The Equity Corporation acquired or brought under its control by merger or consolidation, net assets of 12 corporations amounting to approximately \$50,000,000. Four of these companies, which were organized in Delaware, were merged into The Equity Corporation. The other 8 corporations were consolidated into the American General Corporation, a Maryland company under the control of Equity.

The merger was consummated pursuant to the Delaware corporation statute. That statute provided that a merger or consolidation may be effected by the vote of "stockholders of each such corporation representing two-thirds of

the total number of shares of its capital stock * * * each share entitling the holder thereof to one vote". Under that provision, the class of stock which carried the most votes was able to wield the greatest power, regardless of the proportion of the corporation's assets that were applicable to it. Equity held control of the common stocks of each of the companies which were merged into it. At the time of the merger, these common stocks were valueless in terms of book value. But through its control of these common stocks, Equity was able to control the managements, which in turn, dictated the terms of the mergers. And in the case of three of the four corporations, Equity's control of the common stock was sufficient to enable it to effectuate the merger without the aid of outside stockholders. As a result of the merger, the preferred stockholders of the merged corporations were forced by the overwhelming vote of the common stock to suffer severe losses. Before the merger these stockholders were entitled to a preference on liquidation of approximately \$9,800,000. After the merger, their preferential liquidation rights were diminished to \$6,200,000. In addition, the asset value of the preferred stock of two of the merged corporations was greatly reduced.

The procedure employed to consolidate the other 8 corporations into the American General Corporation, a subsidiary of Equity, was more circuitous than the merger procedure outlined above, but was equally efficacious from Equity's point of view. As distinguished from the Delaware law which permits a merger or consolidation agreement to be adopted upon the approval of two-thirds of all the capital stock, the Maryland law requires the approval of two-thirds of each class of voting stock. Seven of the 8 companies which were consolidated into American General, had been incorporated in Maryland. Of these, 5 had voting preferred stock outstanding. Equity controlled virtually all the common stock of these corporations, and a small proportion of the preferred stock. But under the Maryland law, the consolidation could not be effected without the concurrence of two-thirds of the preferred stock, and Equity was not certain that it could marshal that number of votes.

In order to obviate this difficulty, Equity availed itself of another section of the Maryland Corporation Law which provided that irrespective of statutory requirements for approval by the holders of two-thirds of each class of stock, "such action shall be effective and valid if taken or authorized by such vote of its stockholders or members as may be required for such action by its charter". While the charters of the 5 Maryland corporations contained no explicit provision on the point, each charter contained a provision authorizing the adoption of charter amendments by a majority of all the outstanding stock entitled to vote. Presumably acting under the latter statutory and charter provisions, amendments to the charters of the 5 companies were proposed which authorized the adoption of a merger or consolidation agreement by two-thirds of "the shares then issued and outstanding and entitled to vote". Equity, by virtue of the common stock which it held, commanded sufficient voting strength to secure the adoption of this amendment. Thereafter, it was able to effect a consolidation along lines which would subserve the interests of the common stock, in which it was predominately interested. It is significant that the favorable vote cast by the preferred stock of each company was far less than two-thirds of that class. Accordingly, had the statutory provision entitling preferred stockholders to a class vote not been suspended by the charter amendment, the consolidation would have been defeated.

The consolidation, of course, drastically affected the preferred stockholders' rights. Annual dividend preferences were reduced in amounts ranging

from \$.25 to \$4.10 per share. Dividend arrearages in the amount of approximately \$4,000,000 were wiped out. Preferential rights upon liquidation were decreased. Equity, whose main interest was in the common stock of these companies, much of which was without any asset value, was the moving spirit behind this whole manoeuvre. Through devious use of statutory tools Equity was thus able to divert to itself huge profits at the expense of a large class of preferred stockholders. Where, as in that case, the common stockholders and the management, in effect, can force the preferred stockholders to accede to a compromise or sacrifice of their contractual rights, it is plain that those contract rights, for which the preferred stockholders paid dearly, are of little value.

I believe it is evident even from this hasty catalog of more obvious abuses that the problem of regulation transcends State lines. So long as a few States retain lax corporate laws, under which corporate promoters and corporate managers may, with impunity, defraud or skillfully mislead investors, the problem will remain unsolved. For if the laws of the State of incorporation prove too stringent for the corporate management, it is a relatively easy task to bring the corporation under the laws of one of the so-called "liberal" States. Thus, where the State of incorporation does not permit a particular transaction, it is not unusual for the corporate management to "shop" about for a more favorable jurisdiction, and finding it, set up a new corporation in that State. Thereafter, if the approval of the requisite number of stockholders is obtained (usually a relatively easy task), the assets of the old corporation are transferred to the new corporation. The activities of the management are then tested under the laws of the more "liberal state" - even though the corporation may still retain its principal place of business in the state in which it was originally incorporated.

Federal legislation, it seems to me, is the only hopeful solution. But whatever the character of that legislation, it will undoubtedly be fiercely opposed by the beneficiaries of existing confusion, and abuse and criticism will be the lot of whoever has the courage to venture a remedy. The proposal will be assailed as an encroachment upon the liberty assured to us by the Constitution. There is solace, however, in the words of Mr. Justice Cardozo who some years ago pointed out that "many an appeal to freedom is the masquerade of privilege or inequality seeking to entrench itself behind the catchword of a principle".