

**SOME CURRENT PROBLEMS OF THE
SECURITIES AND EXCHANGE COMMISSION**

Address of

JAMES C. SARGENT

Commissioner
Securities and Exchange Commission
Washington, D. C.

before the
42nd Annual Convention of the
North American Securities Administrators
Atlantic City
September 10, 1959

ERRATA SHEET

for

Address of JAMES C. SARGENT, Commissioner, Securities and Exchange Commission, before the 42nd Annual Convention of the North American Securities Administrators, Atlantic City, September 10, 1959, entitled, "SOME CURRENT PROBLEMS OF THE SECURITIES AND EXCHANGE COMMISSION."

page 2, 2nd paragraph, 7th line:

delete "promoters agree to place"
substitute "issue is placed"

page 3, 1st paragraph, 3rd line:

insert after "and", "if they are, they"

page 3, 1st paragraph, 7th line:

delete "clear"
substitute "to me"

page 3, 2nd paragraph, 6th line:

delete "seem to be clear"
substitute "may be"

page 4, 3rd paragraph, 18th line:

correct number "4,018" to read "4,918"

The topic which I am scheduled to talk to you about this afternoon is Current Problems before the Securities and Exchange Commission. Before discussing this subject I wish to tell you how very much I appreciate the opportunity of being with you on this the 42nd Annual Convention of the North American Securities Administrators. Although I have been a member of the Securities and Exchange Commission for something over three years, this is the first time I have actively participated with you in your program. This is not to imply that I have not been keenly interested in and aware of what has transpired in your previous meetings, but on past occasions other members of our Commission have addressed you and your meetings were held at points far removed from the SEC's headquarters, posing somewhat of a travel problem. In any case I want to tell you at the outset of my firm belief that the business of protecting the soundness of the expanding financial system in our country is one of great mutual concern and interest for your members and our Commission. But for the fine cooperation and understanding of each others problems and spheres of activities, which exist today, there might have occurred serious consequences in the proper functioning of the capital markets.

In order properly to comprehend many of the problems which at the present time we are facing, it is essential that the significance and implications of the tremendous, dynamic increase in activities in the securities business be understood.

As an illustration of this growth, let's recall for a moment that the value of all stocks listed on the New York Stock Exchange stood at an aggregate value of \$89 billion on September 1, 1929. By the middle of 1932, or some three years later, that aggregate value had fallen to \$15 billion or a loss of \$74 billion dollars. Activities in the market place had by that time come to almost a complete standstill. By comparison to these figures, the value of all stocks listed on the New York Stock Exchange as of June 30, 1959 was \$298.8 billion. If all stocks on all exchanges are included, this total value amounted as of that date to \$337.6 billion.

As of June 30, 1959, there had been 1,226 registration statements filed during the 1959 fiscal year, seeking a total dollar amount of \$16.6 billion. In fiscal 1958 there were 913 such statements filed seeking a total of \$16.9 billion. Thus in that one year there were 313 or some 34% more registration statements filed although the total dollar amount sought was some \$300 million less. These increased filings are significant not only because it is the numerical figure which generally determines the workload of our Corporate Finance Division, but also because it indicates that a greater number of new, small, untried companies, many of which seem to be little more than the products of sheer promoters' exuberance, are coming into the market seeking to raise speculative capital from public investors. These factors have inevitably placed a much greater burden upon our financial analysts who must cull over and ferret out the facts before a registration statement is allowed to become effective.

In the Regulation A field there has been a noticeable increase in the number of filings following a falling off in these filings attendant upon the collapse in the uranium boom in 1956. In 1959, 854 Reg. A filings for a total dollar value of \$170 million dollars were made as against 732 for \$134 million in 1958. As a disclosure device requiring a certain minimal amount of information to be set out in an offering circular, Reg. A, we think, seems to be working fairly well. We are concerned because we believe that perhaps we should develop a program looking towards a more effective follow-up procedure in which we could keep in closer touch with sales techniques and with possible manipulative practices. Perhaps the old adage that "an ounce of prevention is worth a pound of cure" should be followed more closely in this area in the interests of protecting public investors.

One of the really serious problems with which we have lately been faced is what we have dubbed the "hot" issue one, occurring both under Regulation A filings and under full registration. For example, a comparatively new company or one which has always been privately owned decides it wants to go to market. There is obviously no market and the company desires to offer 100,000 shares of its common stock. The ~~promoters agree to place~~ ^{issue is placed} some 78% at the prospectus price with selected purchasers who presumably are expected to hold the stock for the time being at least. The remaining 22% is then allotted to trading houses which are prepared to make a market in the stock. The floating supply has thus been restricted and, where there is great interest in the security, either because it has been generated or because of the inherent nature of the security, there is little question but that immediately following the registration statement's effectiveness, there will occur a trading market substantially higher than the public offering price set forth in the prospectus. Oddly enough the only real public distribution occurs through the trading houses at prices which seem to reflect the highest price the market will bear! Following such a distribution pattern corporate issuers will bring their stock out at a \$5 initial offering price and trading houses to which stock was allotted at the retail price immediately establish a market at between \$10 and \$11. It is our belief that such a distribution pattern encompasses two public offering prices -- one, the prospectus price available to only the selected customers and two, the price or series of prices not disclosed in the prospectus but established by the trading houses, which are not identified in the prospectus, for the remainder of the offering.

Certainly it appears that this whole distribution procedure makes a mockery of the existing prospectus disclosure requirements of the Securities Act of 1933 and of the rules promulgated under the Securities Exchange Act of 1934 and intended to prevent manipulative practices in the over-the-counter market.

Let me elucidate: there is no disclosure in the prospectus to the effect that the prospective offering is to be marketed at two

or more different offering prices in the primary distribution, nor is there any disclosure that the trading houses which bought at the prospectus price actually are performing an underwriting function and should accordingly be identified and named as underwriters in the prospectus. Although these trading houses argue that they are under no obligation to furnish a prospectus before consummating a sale, it seems ^{clear} that they are in fact subject to Section 5 because the distribution has not been completed and the securities being sold have not come to rest in the hands of bona fide members of the public. Furthermore, adequate disclosure would require them to explain in the prospectus how they determined the price at which they proposed to offer the security and the method they propose to use to distribute their allotments. *if they are, the*

I might also point out that the distribution pattern on its face seems to violate Rule 10 B-6 of the 1934 Act which in essence prohibits trading by a person interested in a distribution and Rule 15 C 1-8 which in effect prohibits representations as to market price where that price is made, created or controlled by the broker or dealer. In addition, there seem ^{may be} to be clear violations of the anti-fraud Section 17(a) of the Securities Act and the anti-manipulative Section 10(b) of the Exchange Act and of other rules promulgated thereunder.

An indication of the tremendous workload which we have been experiencing in the last few years is the fact that during the 25 year history of our Commission there have been 15,000 registration statements filed for a total dollar value of \$161 billion, yet 1/3 of these filings and 1/2 of the dollar amount have occurred during the last 6 years.

I suppose it is perfectly natural that, along with this fantastic surge in capital market activities, there have been attracted into the securities business a horde of unscrupulous fraud artists, "con" men and swindlers whose only interest is making a few "bucks" for themselves by any scheme or artifice to defraud that their fertile minds can conjure up.

You would scarcely believe it but we even had to go into a Federal District Court in Oklahoma City to obtain an injunction against a celestially ambitious promoter who was continuing a distribution of securities among credulous public investors in a corporate venture which proposed to be building a flying saucer which was scheduled -- so the prospectus said -- for take-off from Space, Maryland on December 15, 1959 for a trip to the moon! Parenthetically I might tell you that in the prospectus there was mention of a do-it-yourself kit which could be purchased for \$5.

In another case we enjoined a Washington, D.C. promotion which, although never filed with the SEC, was employing a prospectus identical in form with one which had complied completely with our filing requirements, even to the extent of using on its front page the familiar language, "These securities have not been approved or disapproved by the SEC nor has the Commission passed upon the accuracy or adequacy of the Prospectus. Any representation to the contrary is a criminal offense." This company had represented that its Board of Governors consisted of a Member of Congress, who had in fact never heard of the promotion, a retired Major General in the United States Army who had been dead for six months, and the President of the Gettysburg College.

There are, of course, many other cases which I could cite to you to establish the presence within the securities field of unscrupulous promoters. I am sure you are all thoroughly conversant with many of our problems. I am equally certain that you all recognize that the investment banking business has within it many men of the highest integrity and honor. Unfortunately there are others whose moral fiber lacks character and strength and whose basic desire is to serve a personal and greedy interest without any consideration for the effect their conduct may have upon the industry as a whole.

Let me say that this latter type has kept us very busy during the last year. We instituted 111 broker dealer revocation proceedings in fiscal 1959 against 57 in fiscal 1958. In fiscal 1959 we referred to the Department of Justice and United States Attorneys throughout the country 45 new criminal references. This represented the largest number of criminal referrals in the past 17 years and the fifth highest in the entire Commission's history. The 45 referrals also are to be compared with the total referrals in the past two fiscal years which numbered 41. In 1959, while we made 1,471 broker dealer inspections against 1,452 in 1958, we found 2,070 indicated violations of either the SEC statutes or its rules. The Commission's securities violations file contains the names of 69,013 persons against whom Federal or State action has been taken in connection with securities violations. In keeping these latter records current, we added during 1959 items of information concerning 9,576 persons including 3,450 persons not previously identified in these records. As of the end of June, there were ~~4,907~~^{4,907} brokers and dealers registered with our Commission. There are ~~4,018~~ NASD members as against 4,752 last year and 77,917 NASD registered representatives as against 65,314 last year.

In the Investment Company field I might say that the tremendous growth in the investment company industry has continued unabated, and as of the close of the past fiscal year, there were 512 registered investment companies with total assets estimated in excess

of \$20 billion. The rate of growth can be appreciated by comparing this amount with comparable ones representing the total assets of registered investment companies at year end in 1941 of \$2.5 billion, in 1946 of \$3.8 billion, in 1951 of \$5.6 billion, and in 1956 of \$14.0 billion. This phenomenal growth in the industry has resulted primarily from the increase in the size of individual companies, due to the sales of additional shares as well as from appreciation of portfolio securities.

The question of the size of individual investment companies was considered by Congress in enacting the Investment Company Act of 1940. As originally proposed the Act would have provided that investment companies could make no further sales if their assets exceeded \$150,000,000. Today there are some dozen or so companies with assets in excess of this figure. Two open-end companies have assets of over \$1 billion. However, in the final version of the Act specific limitations were replaced by Section 14(b) which provides that the Commission is authorized to make a study and investigation of the effects of size on investment policies of investment companies and on securities markets; on concentration of control of wealth and industry and on companies in which investment companies are interested, to determine whether any further substantial increase in size creates any problem involving the protection of investors or the public interest, and, if so, to make recommendations to the Congress for remedial legislation.

Pursuant to this mandate, about a year ago the Commission arranged to have the Wharton School of Finance and Commerce of the University of Pennsylvania conduct a fact-finding survey in connection with various aspects of this problem. Detailed questionnaires have been sent to 165 open-end companies and 60 closed-end companies, and completed replies have been received from most of them. A progress report has recently been received from the School which indicates that substantial data has been obtained and is being processed. We should have a preliminary report on some phases of the study early this fiscal year. The study will cover such subjects as changes in portfolio distributions, changing rates of growth of the investment company industry, investment companies' market operations, and portfolio turnover rates. Personal interviews with company representatives are being planned to supplement the data obtained from the questionnaires and to make the study more meaningful.

Another major project of the Commission in this field is the investment company inspection program. This program contemplates a periodic inspection of all active management companies for the purpose of ascertaining any deviation from the requirements of the statute. As originally planned, there would be a two-year cycle of inspections. Due to a shortage of personnel and the increased pressure of regular work, it has proved impossible to effect more than a minor number of inspections. This is most unfortunate since our experience, derived from the inspections we have made, indicates a need for review, in the

field, of the operations of these companies to bring them into compliance with requirements of the Act. In some cases, we have found most serious violations. During the last year 14 inspections were made, as compared with 6 for the preceding year. For the current fiscal year 24 inspections are planned, and for 1961-62, which will put the program on an estimated 8-year cycle.

The need for such an inspection program is made crystal clear by the flagrant violation of the Act uncovered in the case of Managed Funds. On the basis of facts which were subsequently more fully developed at a public hearing, a stop order was entered suspending the registration of this company's securities under the Securities Act of 1933. In that case, the sponsors of the Fund had an investment advisory contract with the Fund for which they received compensation of 1/2 of 1% of average net assets per annum. Instead of performing the services required of them, they entered into an arrangement with an analyst associated with a New York Stock Exchange firm under which he managed the portfolio and was compensated by way of commissions on brokerage business in portfolio securities. This arrangement was not disclosed in the prospectus nor was stockholder approval obtained for it as required by Section 15 of the Investment Company Act. The Fund followed the practice of distributing fixed amounts of capital gains quarterly, which resulted in excessive portfolio turnover and represented a deviation from its stated policy of capital growth. The company is presently in the process of reorganizing its management.

Turning now to our Legislative Program which was discussed with you by Chairman Gadsby, last year at Mexico City, I might say that it was introduced into Congress during the current session. Hearings have been held by the Congressional committees concerned and it appears likely that they may take some action on the proposals at the next session.

In general, our proposed amendments to the Securities Act of 1933 are designed to: (1) clarify the jurisdictional basis of the civil liability provisions of the statute; (2) extend civil and criminal liability to documents filed with the Commission pursuant to Commission rules in connection with exempt offerings; (3) increase from \$300,000 to \$500,000 the size of offerings which may be exempted from registration under section 3(b) of the statute (Reg. A); and (4) make it clear that a showing of past violations is a sufficient basis for injunctive relief and that aiders and abettors may be responsible in civil and administrative proceedings.

The proposed amendments to the Securities Exchange Act of 1934 would make comparable changes with respect to injunctive relief and liability of aiders and abettors. In addition, changes are proposed which would: (1) make it a violation of this act to embezzle moneys or securities entrusted to the care of an exchange member or a registered broker or dealer; (2) clarify and strengthen the statutory pro-

visions relating to manipulation and to financial responsibility of brokers and dealers; (3) authorize the Commission by rule to regulate the borrowing, holding and lending of customers' securities by a broker or dealer; (4) make it clear that attempts to purchase or sell securities are covered by the anti-fraud provisions of the statute; (5) revise the provisions relating to broker and dealer registration in several respects; (6) authorize the Commission to suspend or withdraw the registration of a securities exchange when the exchange has ceased to meet the requirements of its original registration; (7) clarify the Commission's authority to suspend a security from exchange trading where there has been a failure to comply with the act and where otherwise necessary in the public interest; (8) prohibit trading in the over-the-counter market for limited periods where the public interest and the protection of investors so requires; (9) provide that an insolvent broker or dealer may be adjudicated a bankrupt in an injunction proceeding instituted by the Commission; (10) provide for a civil monetary forfeiture for each day that any periodic report of registered companies or report of "insiders" of such companies, required to be filed under the act, is delinquent.

The Trust Indenture Act of 1939 requires that debt securities publicly offered for sale to the public must be issued under an indenture meeting certain statutory requirements and standards for investor protection and has been duly qualified with the Commission. The amendments to this act are designed primarily to conform the act to the amendments recommended as to the Securities Act of 1933.

Only three of the amendments proposed by the Commission to the Investment Company Act of 1940 were met with any opposition: one, the amendment which required that an investment company state as a matter of fundamental policy, which cannot be changed without approval of stockholders, its stated investment objective, or characteristic, such as a "growth fund," "income fund", or "balanced fund;" two, the amendment designed to insure that there be on every board of directors of an investment company a certain minimum number of "independent" directors -- that is, persons not connected with the management, investment advisor, or principal underwriter for the fund; and three, the amendment designed to remove the exemption for a company which is subject to the regulation of the Interstate Commerce Commission, which is found to be primarily engaged in the business of an investment company.

The Investment Advisers Act provides for the registration of persons engaged in the business of advising others with respect to securities and prohibits certain activities by registered investment advisers. The proposed changes in this statute would, first, expand the bases of disqualification of a registrant because of prior misconduct; second, authorize the Commission by rule to require the keeping of books and records and the filing of reports; third, permit periodic examinations of registrants' books and records; fourth, empower the Commission by rule to define and prescribe means reasonably designed to prevent

fraudulent practices; fifth, extend criminal liability for a wilful violation of a rule or order of the Commission; and sixth, revise the provisions relating to the postponement of effectiveness and the withdrawal of applications for registration. There has been little or no objection by any segment of the regulated industry to the amendments to the Investment Advisers Act, the Investment Counselors' Association being in entire agreement with these proposed amendments.

There are two other bills presently pending before the House of Representatives which I would like to talk to you about in my concluding remarks. These are the bills which would increase the fees charged for registration of new issues of securities under the 1933 Act and would increase the charges made for sales on the national securities exchanges from 1/500 of 1% to 1/100 of 1% and would apply this charge to sales in the over-the-counter market. The reason for my desiring to mention these two bills to you is because of the serious budgetary problem with which we are presently confronted by reason of the tremendous increase of activities in all areas of the capital markets. Believe me, gentlemen, we have been literally swamped by the tremendous workload pressure under which we have been operating. If we are going to be effective as an Agency in protecting public investors in all areas where we are charged with primary duties by the statutes we administer, it is going to be essential that we seek a substantial increase in our over-all budgetary requirements.

In my judgment, the additional cost problem could be fairly and logically answered if these two bills could be enacted into law. In addition to assisting this Commission in obtaining essential funds, they would for the first time give to the Commission some indication as to the probable size of the over-the-counter market. As of today, no one can actually foretell how many securities either in numbers or in dollar value are being sold in the over-the-counter market. It is our estimate that if these bills were to become law, the percentage of our total budget recoverable by the Treasury would increase from 34.6% to approximately 54%. While these recoverable funds are not usable by the Agency, the fact is that they would reimburse the Treasury for the cost which the Agency has budgeted. I am sure that you all recognize that the SEC is the Agency of the Federal Government which attempts to protect the soundness of our expanding financial system. Unless the integrity and the honesty of the capital market can be preserved so that public investors will continue to have faith and confidence in the functions of these markets, our whole capitalistic economy will not succeed in the cold war which we are facing today. It is the SEC as the "investors' watchdog" and as "Uncle Sam's police force" which is charged with the duty of protecting the financial markets. Unless we can be put in sufficient funds, we cannot hope to do the job in this period of tremendously dynamic and expanding activities.

Now may I say to you how very much I have appreciated this opportunity to be here with you today and to express to you the great appreciation of our Agency for the cordial relationship which exists between you as members of the North American Securities Administrators and the Securities and Exchange Commission.