RESUMÉ OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS AND THE COMMISSION'S LEGISLATIVE PROPOSALS

Address by

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It is nice to be with you again. As I have told some of you in person, I have always enjoyed working with the Secretaries, although I'm sorry to say I've lost touch in the last few years. We at the Commission continue to look to you for your views and advice in many matters. We have been grateful for your help, always cheerfully offered, in our efforts to seek solutions to problems which arise in administering the securities laws. We and the business community have profited from your efforts. Now that you are seventeen, going on eighteen, you can be justifiably proud of your growth and achievements as an organization. We join you in the expectation that a program so well-conceived will continue to enjoy the confidence and enthusiastic support of your member companies.

On September 5, 1961, a new subsection was added to Section 19 of the Securities Exchange Act of 1934. This amendment 1/ directed the Commission to make a study and investigation of the adequacy of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension or disciplining of a member for conduct inconsistent with just and equitable principles of trade. In the words of the House Report, 2/ " . . . the Congress, by enacting subsection 19(d), is directing the Commission to bring up to date and enlarge upon the study which, by subsection 19(c), it directed the Commission to make some 27 years ago." The Report went on to state that while the language of the resolution is specific, its scope is very broad. Clearly, a sweeping study of the rules, practices and problems of the securities business and the securities markets was contemplated.

Thus was born what has come to be known as the Special Study of Securities Markets. The first installment of the Report of the Study was transmitted to the Congress on April 3 of this year.

A brief explanation of the organization of the Study group, the techniques employed and the sweep of the subject matter of the entire Report will convey some impression of the prodigious effort devoted to produce a well-conceived, thorough, responsible, objective and fascinating addition to our financial literature. It was apparent from the beginning that the Commission must occupy a dual role in carrying out the Congressional directive. As you know, the Commission has certain supervisory or residual powers with respect to the rules of the exchanges and the National Association of Securities Dealers--the only registered association in the business. Fair and objective consideration of the adequacies or inadequacies of the rules and regulations of these organizations would necessarily involve scrutiny of the action or nonaction of

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1/ Public Law 87-196, 87th Congress, H.J. Res. 438 - September 5, 1961.

2/ H.R. Rep. No. 882, 87th Cong., 1st Sess. 4 - (1961).

the Commission itself as an institution in relation to those rules. It was also clear that the Commission and its staff could not simultaneously engage in the essentially incompatible functions of day-to-day operations and the time-consuming research and analysis demanded by the Congressional directive.

A Special Study group of about 65 persons was established therefore as a separate unit under the direction of Milton Cohen 3/, staffed in part from Commission ranks but principally by attorneys, economists and others employed for the purpose. This group proceeded without trumpeting and with full awareness of our desire for thoroughness and objectivity to develop a comprehensive Study program and assemble the necessary raw materials.

In the course of this latter process, approximately 35 questionnaires or letters of inquiry were mailed to thousands of persons and companies, all of whom were most cooperative in their responses. These included broker-dealers, issuers of securities, members of the exchanges, financial analysts, investment advisers, public-relations firms, customers of broker-dealer firms, purchasers of the shares of investment companies, and various categories of financial institutions. In addition to the information secured by these means, the Study group employed the other customary devices for establishing a comprehensive and adequate foundation of statistics, facts and informed opinion for its work. Individuals and groups were interviewed. Public and private hearings were held. The records and files of firms and associations were examined. Data accumulated in the records of the Commission, including earlier staff studies as well as the results of prior research by other organizations, were analyzed. The hundreds of charts and tables appearing in the various volumes of the Report, themselves a distillation of a vast mass of data, contain a wealth of material, useful in many ways to industry and Government alike. We have learned a great deal about our financial system and the operations of the securities industry. We think that industry, too, will have learned much it didn't know about itself--and will profit from that knowledge.

It is expected that the Report in its final form will consist of thirteen chapters. As I mentioned earlier, the first five of these have been transmitted to the Congress. Unfortunately, printing was delayed and it was not until the first week of June that printed copies became available.

Chapter I is introductory in nature and deals with the structure and growth of the securities industry in this country. The substantive chapters begin where regulation must begin--the point of

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3/ Mr. Cohen was born in 1911 and received his A.B. and LL.B. from Harvard University, where he was an Editor of the Law Review. He served on the staff of the Commission for eleven years and was Director of the Public Utilities Division when he resigned in December, 1946, to enter private practice in Chicago.

entry into the business. Chapter II is concerned with the qualifications of broker-dealers, salesmen, supervisors and persons providing investment advice and the controls relating to entry into and removal from the business of persons and firms engaged in the securities industry. Chapter III examines the business practices and activities of broker-dealers, their responsibilities to their customers, the various regulatory controls to which they are subject and the manner in which these operate.

The Special Study afforded the Commission a long-desired opportunity to make searching inquiries as to the procedures by which various types of offerings are originated and the securities sold in primary and secondary distributions. The timing of this aspect of the Study was particularly appropriate in that the phenomenon of the "hot issue" was still fresh in the recollections of the public and the industry, and it was possible to trace the profiles of a number of these. Chapter IV accordingly provides the results of the Special Study's review of the growth in the public sale of corporate securities, the workings of the distribution process, activities of various persons in the after-market and the effectiveness of existing governmental and self-regulatory controls.

The fifth volume of the first installment, Chapter IX, contrasts the obligations of issuers of securities listed on exchanges arising from the Exchange Act or the special arrangements between companies and the exchanges, with the lack of similar protections for public holders of securities of over-the-counter issuers. It also contains an interesting section dealing with corporate publicity and public-relations techniques in this field.

The second installment of four chapters, dealing with the trading markets, probably will be transmitted near the end of this month. Chapter V is introductory in character, Chapter VI deals with the exchange markets--with special attention to the New York Stock Exchange. It reviews the functions and activities of various aspects of the auction markets, including the roles of the specialists, odd-lot dealers and floor traders. This chapter also includes a discussion of short selling and the history and operation of the commission rate structure.

Chapter VII discusses the ramifications of over-the-counter markets, wholesale as well as retail, quotations and the marked contrasts with the exchange markets in virtually all aspects of their operations. Chapter VIII examines the relationship among trading markets, including patterns of distribution of securities among exchanges, over-the-counter trading in listed securities and the regional exchanges as dual and primary markets.

The final segment of the Report, which we hope will be completed by mid-July, will contain the last three chapters envisaged by the original Study plan--Chapter X, which discusses the problems of securities credit and margin regulations, Chapter XI relating to various aspects of mutual funds, and Chapter XII, which evaluates the unique self-regulatory aspects of the securities industry. About a year ago, following what the New York Stock Exchange 4/ termed a period of "stress" and after scores of corporate asteroids achieved spectacular re-entries, it was decided to expand the Study. The market break of late May, 1962, was viewed by the Study group both as an added burden and an opportunity. Some of the subjects first studied in the context of conditions prevailing in 1961 or early 1962 were reviewed in the circumstances prevailing immediately before, during and after the May decline in securities prices. The results of this work are reflected in the final chapter of the Report.

It might be well at this point to publicize our answer to a question unkindly asked at times since April 3. There has been no holding-back of any part of the Report. Originally, we were expected to transmit the complete Report on January 3, 1963. As 1962 progressed, the magnitude of the task seemed overwhelming. We asked for and received an extension to April 3. Despite the added months, it became impossible to meet this new objective. It so happened that the material for the chapters already delivered permitted early completion. The scope, complexity and difficulty of subject matter inevitably delayed the remainder.

I am not at liberty to discuss the contents of unpublished chapters or conclusions and recommendations not yet transmitted to the Congress. This does not, however, preclude emphasizing four or five fundamental proprositions which should not be overlooked during debate and comment upon subsidiary themes.

Our system of fostering public participation in industry through ownership of corporate securities and the complex financial mechanisms which have evolved to facilitate the growth and effectiveness of that system are unique. The Special Study recognized the strength and vitality of this system and calls for action to improve it--not to weaken it or to detract from its accomplishments.

The regulatory scheme reflected in our securities laws also is unique. The Special Study confirms the wisdom of the basic legislative pattern reflected in the original securities acts. These rely upon an unusual admixture of somewhat limited direct and, to a much greater

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4/ The Stock Market Under Stress; The Events of May 28-29 and 31, 1962--A Research Report by The New York Stock Exchange.

degree, indirect or residual Government controls and the appeal to the conscience of industry (with an assist from the coercion of disclosure) for effective self-control.

The perimeter of governmental power in relation to industry under the Acts has been well-explored and tested by administrative and judicial pronouncements in the course of almost thirty years. The Special Study has proposed no striking alterations in the lines thus drawn nor proposed opening any extensive areas likely to stimulate new or enduring conflicts.

The theme of the Study is no shrill call for greater intrusion by Government into the operations and conduct of business. Rather, it is a modulated reminder that there is work to be done by Government and industry, largely a matter of using the administrative tools at hand. In the words of Milton Cohen 5/, the task is to "raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved." Again in his words 6/, "A basic objective of the Special Study was an evaluation, in the light of . . . changes, of the theories and mechanics of direct governmental regulation and industry self-regulation . . . envisaged by" the securities laws. The Study and the Report indicate that under the stresses of its expanded role, the framework of regulation needs considerable adjusting and strengthening, but its basic design appears to have stood the test of time and to have worked effectively in most areas.

It is not surprising, in view of these observations by the Director of the Study, that no sweeping changes in the laws have been recommended.

The Commission's current legislative proposals are now before the Congress. These do not deal with two legislative recommendations, mentioned in our letter transmitting the Report, which have been deferred. One relates to registration and regulation of private systems publishing quotations for securities traded in the over-the-counter markets. It is likely that these would follow existing patterns applicable to broker-dealers and self-regulatory associations. The other probably will relate to certain aspects of security-credit regulation. The work of the Special Study with respect to these has not progressed sufficiently for the Commission to make definitive proposals, and of course the interested industry groups have had no opportunity to consider the Study material. Any proposals with reference to security credit will be made only after consultation with the Federal Reserve Board.

5/ Letter of Transmittal to Commission.

6/ Ibid.

Stated in terms of a broad, ultimate objective, our program is intended to strengthen and improve the over-the-counter market. The means by which this objective is sought involve no new legislative concepts; they leave virtually unchanged the industry-Government relationships established in the mid-thirties.

It occurred to me that this audience might well react to our efforts with a long ho-hum. Many of you represent companies already subject to the Exchange Act. You have long familiarity with Form 10-K, the proxy rules and stockholder proposals. Section 16(b) has been anathema for as long as you've been secretaries, and who would wish that on anyone? Furthermore, since the securities of many of your companies are listed on a major exchange, your reaction to proposals directed at the over-the-counter market might initially be one of considerable indifference. I would urge that such a reaction is one which corporate management--listed or unlisted--in their own self-interest cannot afford.

If mention is made of the stock market, the reflexes behind one's bifocals automatically project the image of a ticker, or perhaps a montage of ticker, and the facade of Eleven Wall. Mention the over-the-counter market, and the reflexes of the sophisticated might project the image of a telephone. More than likely they won't flex at all. A stock exchange is tangible--it stays in one place--you can observe the activity on the floor--it is an institution which works hard at proclaiming its qualities and its role. There is a public awareness of the importance of the exchanges to the economy and, perhaps to a lesser extent, of the importance of the exchange membership to the functioning of our financial system.

The over-the-counter market, on the other hand, defies easy definition. It calls to mind no familiar symbol--or spokesman--or credo. There is no market place. You can't find the counter. There is no report of transactions. There is no report of volume. There is no post or clock. It is a vast, dispersed, heterogeneous, faceless crowd busily engaged in transactions in securities, the identity, amounts and prices of which are not revealed in any public way. For some of its functions it depends on an elaborate and expensive system of instantaneous communication between broker-dealers. For others it relies upon the most highly developed and efficient system of merchandising and distributing securities found anywhere.

As might be expected in view of these characteristics, public attention tends toward the exchanges rather than toward that which is hard to identify or difficult to understand.

There are two aspects of this market, however, which business cannot afford to ignore. First, it is of tremendous size in the aggregate--it is essential to our system and it is growing. Secondly, you need it--sooner or later whether you are listed or unlisted, you will

turn to it, perhaps as a buyer--more likely as a seller--not infrequently as both. From it you will seek and secure your capital. You will hope for a market place of stability and fair prices. You will expect service efficiently, intelligently and economically performed. It is important to you and to the country that those expectations be fulfilled. For many of you--even though you are listed--the over-the-counter market will mirror the public reaction to some class of your securities. You have an interest in the quality and fairness of that market as a trading market.

The Special Study collected data from which some educated estimates could be made as to activity in the over-the-counter market. The Study estimates that during 1961, over-the-counter sales of outstanding stocks totaled 2.5 billion shares valued at $38.9 billion, excluding sales of mutual-fund shares and syndicated distributions. During the same period, two billion shares worth $63.8 billion were sold on all exchanges in the United States. The Study observes, however, that these figures are not strictly comparable and, by various adjustments, concluded that over-the-counter transactions for 1961 probably amounted to about 75 per cent of exchange transactions in shares and 35 per cent in dollars. It can be assumed, therefore, for that year that over-the-counter dollar volume in stocks probably fell within a range of something more than 22 billion and something less than 38 billion. If you assume the 38.9 billion figure, it is of considerable interest to note that the annual dollar volume of trading on all exchanges for the 27 years, 1935-1961 inclusive, did not reach this amount until 1959 and exceeded it only in the years 1959-60-61. If you assume the 22 billion figure, the annual dollar volume of trading on all exchanges exceeding this amount slightly in 1936, did not reach it again until 1954 and exceeded it in only 9 of the 27 years. 7/

In short, the over-the-counter market has achieved a stature in the last few years in terms of public interest, public participation and a place in the financial scheme of things as significant, at least in terms of volume, as the exchange markets when the Exchange Act was first passed and in fact for many years thereafter. Although it may be conceded that 1961 was an unusual year in the securities business, it is reasonable to conclude that this market will grow and with that growth, public participation will increase.

American business and the public investor, no less than the S.E.C., have an abiding interest in the experience, training and competence of the people on whose activities the very existence and the quality of our over-the-counter markets exist. The establishment of sensible controls over entry into the securities business and over the right to continue in that business is one of three major objectives of our legislative program.

7/ S.E.C. 1962 annual report, p. 190.

The basic approach regarding entry into the securities business, reflected in the Securities Exchange Act of 1934, the Maloney Act of 1938 (establishing the N.A.S.D.) and the Investment Advisers Act of 1940, was to permit free access and unlimited entry by anyone against whom the Commission had not previously acted and who had not violated certain securities laws. To be free to engage in the securities business (so far as Federal law is concerned), a broker-dealer need only observe the formality of registration with the Commission. Essentially the same philosophy of establishing unlimited access to the business has historically determined the admissions procedures of the N.A.S.D. The statutory grant of authority to the Association to establish economic distinctions between members and nonmembers has been interpreted by the Commission to be conditioned upon the Association's leaving its door open to most broker-dealers who register with the Commission. Thus the Association may not adopt the exclusionary policies or the philosophy of limited access represented by the exchanges. 8/

Until 1956, the N.A.S.D. consistently followed an open-door membership policy--with the exception of its unsuccessful proposal in 1942 to establish a minimum-capital requirement. 9/ The Commission disapproved that proposal on the ground that it was not an appropriate basis for determination of membership under the Exchange Act. 10/ In 1955, the Association undertook the beginning of a program designed to elevate the standards of entry into the securities business. As part of this program, an experience requirement for proprietors of broker-dealer firms was established and an examination prescribed for those who did not meet that requirement. In 1962, development of a new examination for proprietors, partners and officers of broker-dealer firms was authorized. The leadership of the Association has recognized the limitations of the present system as developed under the existing statutory framework and increasingly has been concerned with the ease of access to the business by the reckless, irresponsible and ill-equipped.

The Special Study strongly urged that all broker-dealers and investment advisers be required to join a self-regulatory body as a prerequisite to Federal registration, that the statutory bars to Federal registration be extended, and that the obligations and power of the self-regulatory groups under the statute be strengthened. 11/

8/ H.R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. 48 (1963).

9/ Id. at 73.

10/ Id. at 86-87.

11/ Id. at 159.

It concluded that more than a generation of experience with the Federal securities laws has demonstrated that it is impossible to regulate effectively the conduct of those in the securities business unless would-be members are adequately screened at the point of entry. The steady growth in the numbers of investors and participants has made obsolete the concept that entry into the industry should be the right of anyone, regardless of fitness or capability, except those guilty of recent securities violations.

It was urged that greater recognition be given to the functions performed by various classes of persons in the business and that controls over entry appropriately recognize the distinction between the qualifications needed for a salesman, a supervisor, a branch manager, a broker-dealer as an entrepreneur and an investment adviser. Further, it was considered preferable as an extension of and further support for the notion of self-regulation that the N.A.S.D. (or any other registered association) rather than the Federal Government should in the first instance establish the criteria and the machinery for their application.

We believe that this country can no longer tolerate a system under which yesterday's paperhanger can become a registered broker-dealer by filing an application with the Commission, and, without more, so far as Federal law is concerned, engage in business as a manufacturer of "wallpaper." We believe that a dozen salesmen, trained in the ways of a boiler room, should not overnight become registered broker-dealers when their boiler-room employer is put out of business after expensive, time-consuming revocation proceedings by the Commission. During the past few years, numbers of unknown, inexperienced firms suddenly appeared on the scene and as amateur "investment bankers" proceeded to act as underwriters or distributors for numbers of theretofore unheard-of issuers. Without any sense of responsibility to either the issuer or the public, they dumped on the public many an issue which should never have been sold. They contributed in no small way to whipping up the public appetite for the so-called glamour issues by deceptive publicity and by manipulating after-market prices in a way which fostered the notion that a price premium was a sure reward to the purchaser of any "first" issue.

We do not wish to be misunderstood. We are not in any sense urging that the Federal Government should decide what securities should be sold or who should be eligible to sell them. We have no desire to get into the business of passing on the merits of securities or the qualities or abilities of broker-dealers.

We are merely urging that the law should be amended to make it clear that a registered association such as the N.A.S.D. has statutory authority permitting its leadership to respond appropriately to an appeal such as that voiced by its Committee No. 12 in New York in a formal resolution in January, 1962. 12/ This resolution stated in part:

12/ Id. at 67.

> " . . . We have had to deal with an increasingly high rate of influx of proprietors, officers, partners and other personnel who are unqualified by reason of lack of proper moral attitudes, inadequate training and experience and insufficient capital funds; . . . the Business Conduct Committee in this District has found it increasingly difficult within the present framework to enforce high standards of commercial honor and just and equitable principles of trade in such manner as to adequately protect the public interest . . . this . . . Committee strongly urges the Board of Governors . . . to provide for the establishment of a more rigid set of qualification standards in the area of character, experience and financial responsibility, preferably as a prerequisite to membership and/or registration."

We think the proposed amendment will make it possible for the N.A.S.D., in collaboration with the Commission, to adopt regulations which, with proper safeguards pertaining to due process, establish realistic and appropriate standards.

This proposal should not of course be regarded as a reflection on the broker-dealer population as a whole. Rather, it should be viewed as an effort on the part of Government to aid in bringing to maturity the concepts of responsible self-regulation. The undesirable elements in the business, though a minority, have demonstrated a capacity for injury entirely disproportionate to their numbers. The leaders of the industry are well aware that the activities of this predatory portion of the population undermine the goodwill, slowly and expensively developed by the better firms, bring the entire market and its mechanisms into disrepute and accentuate tides of opinion which contribute to the here-today, gone-tomorrow characteristics of the over-the-counter market in so many securities.

We have no illusions that enactment of this portion of our program will solve all the problems of qualification or provide a cure-all in the disciplinary field. It seems almost self-evident, however, there will be powerful forces interested in seeing that the proposed amendments contribute significantly to the achievement of the first requisite for a quality market--trained, competent, adequately capitalized professionals concerned with the integrity of a market the characteristics of which, in the final analysis, so largely depend upon them.

But this alone will not be enough. What of the scope and quality of the information about the merchandise? The New York Stock Exchange 13/ tells us that since 1899--thirty-five years before the Exchange Act--companies making applications for listing their securities

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13/ New York Stock Exchange Company Manual.

have as a regular part of the listing procedure entered into a listing agreement with the Exchange by which they commit themselves to a code of performance, after listing in respect of matters dealt with by the agreement. Initially there were only three of these, two of which related to the mechanics of the market place. The third item, in the words of the Exchange, "represented the Exchange's effort to satisfy, by a formal requirement, a public need which it had long recognized, but which its previous unsupported efforts had been unable to fill--the need of investors for regular financial reports by the companies whose securities they held." A primary objective of the agreement was, again in the words of the Exchange, "Timely disclosure, to the public and to the Exchange, of information which may affect security values or influence investment decisions . . ."

The Exchange Act not only endorsed the principle underlying this policy of the Stock Exchange; it gave statutory definition and authority to the requirement of fair, adequate and timely disclosures by listed companies. It further articulated other requirements or prohibitions which, in general, were designed to foster fair and orderly markets, but it emphasized, as the Exchange had years before, that a flow of reliable and timely information about the companies is an essential ingredient to proper performance of the skilled professional in the securities markets. And this, remember, is in the context of a market where there is not free access for securities. Companies whose securities are listed are carefully screened. Listing requirements having to do with size, earnings, number of shareholders, the record of management must be met. Management must agree to abide by rules of the Exchange which, in some instances, go far beyond any statutory requirement--for example, compulsory solicitation of proxies--prompt publicity to dispel or correct rumors, requirements for voting stock.

In the listed market there is an institution constantly alert to the conduct of its membership and to the activities of the companies admitted to trading, from the point of view of the quality of the market--fairness, orderliness, continuity, stability of price, absence of manipulation; in short, the public interest.

In the unlisted market--where there is no bar to access--no standards of eligibility for admission of securities to the market, there exists the same public interest--and the term "public" embraces the interests of all legitimate and responsible business enterprise--in the existence of a quality market as a market. The public has a right to expect that within this market, too, there should be forces operating to produce fairness, orderliness, continuity, stability of price, absence of manipulation--a market which fairly serves the public interest.

But here there is no institution continuously observing merchant and merchandise alike. Here the quality of the market, in fact at times its very existence, depends not only upon the competence and integrity of

the professional but also upon the action or nonaction of management. Here management is uncommitted to any contractual or other discipline compelling active attention to the type of personal and corporate conduct which contributes to this necessary attribute. In fact, the absence of the latter frequently frustrates the efforts of the former.

The second major thrust of our legislative program therefore we view as a necessary, concomitant of the first. We think a competent, skillful securities industry and the public have a right to expect conformity by those issuers representing a major segment of the over-the-counter market, with at least minimal standards of conduct from the point of view of the market place.

The current proposal, in brief, would require every issuer having assets exceeding $1,000,000 to register with the Commission any security held of record by 500 or more persons. The registration process would be phased, however, to require registration initially of companies meeting this asset test having issues held by 750 or more persons, with the other companies coming in at a later time. The provisions of Section 13 relating to periodic reporting, Section 14 relating to the solicitation of proxies, and Section 16 relating to insider transactions would thus be made applicable to approximately 3,100 companies (initially) (later 3,900) which in the aggregate constitute a significant portion of the over-the-counter market.

It hardly seems necessary--but it is always a pleasure to compliment the accounting profession upon their growth in stature and the progress made in corporate accounting during the past thirty years. It seems strange that any responsible management of a publicly owned company would not recognize the value of the services and guidance of the independent certified public accountant. Sound accounting consistently applied becomes more than a financial tool for progressive management. It produces reliable public reports of sufficient uniformity and comparability (or with explanation of the reason or basis for the lack of it) to permit intelligent comparison of companies in the market place. The statute in this respect calls for no more than intelligent management should insist upon in their own interest.

Every segment of the financial community testifies to the value and the necessity of timely reporting of significant corporate developments and reliable annual and periodic reports. Experience teaches, however, that absent a statutory requirement with appropriate implementing rules, one cannot be sure of corporate reporting meeting all the tests of timeliness, sound accounting, reliability, comparability or consistency. Too frequently in this area there are great temptations to manage the news, to delay publication of the unpleasant or to resort to the no-comment technique. These temptations probably cannot be removed, but it's time pursuit of them be made expensive.

The attitude of a business toward the proxy rules is very likely to mirror its attitude toward stockholders, although there have been a number of instances in which unlisted companies have listed very quickly when it appeared that the operation of the proxy rules would compel an opposition group to reveal its background and associations. Regardless of whether management belongs to the stockholders-are-a-nuisance school or to the stockholder-go-away school or to the developing group which views stockholders as potential promoters of the corporate product and the corporate reputation, the proxy rules serve a unique double purpose from the point of view of the market place. They round out and supplement the periodic reporting requirements. They have long been recognized as one of the Commission's most effective means of achieving timely disclosures; i.e., prior to the time shareholders are to vote on some significant development in the company's affairs. Also, it is through them that stockholders are afforded an opportunity to exercise intelligently that franchise which, as I have mentioned, the stock exchange insists that holders of a listed stock must have. It is through the proxy rules that the Commission is able to require transmittal to stockholders of an adequate annual report reflecting an issuer's financial condition and operations. The proxy rules provide the market with an opportunity to assess coming events, whereas the other instruments of disclosure I have mentioned report events after the fact. Our legislative proposal would not compel solicitation of proxies, but it would compel the furnishing of equivalent information to stockholders if management elects not to solicit. I might add that this latter provision would apply to listed companies also.

Before leaving the subject of reporting, I should mention two other items which are of interest to you. We are proposing a change in Section 12 of the Act to authorize the Commission to require by rule that registered companies file copies of material contracts. The effect of this change is to bring the Exchange Act provision into line with its counterpart in the Securities Act. This would permit us to call for more adequate and, I might say, realistic backup for the financial statements and the description of significant business developments in the annual report filed with the Commission. It would seem to me that such an approach would be more appropriate than one which follows the Form 8-K pattern of current reporting. Experience with this new provision may eventually lead to some further integration of the '33 Act and '34 Act requirements, with a view to simplifying the '33 Act process. The other item is an amendment to the Securities Act extending to ninety days the period during which prospectuses must be delivered for first issues registered under the Securities Act. When the Act was amended in 1954 to reduce the period during which a prospectus must be delivered from one year to forty days, we did not foresee the problems which would arise from the flood of offerings by unknown issuers during the last few years. While we agree with representatives of the investment bankers that lengthening the prospectus period from forty to ninety days will not cure the "hot issue" problem, we do believe that circulation of the

prospectus for a longer period, thus exposing the basic facts to public scrutiny during the earlier stages of the so-called after-market trading, will be beneficial. The amendment will also authorize shortening this period as well as the 40-day period by appropriate Commission action. Thus, for the first time, the Commission will have freedom of movement to provide more flexible arrangements for delivery of prospectuses.

And now we come to Section 16. Subsection (a) requires reporting of transactions by insiders, i.e., officers, directors and beneficial owners of more than 10 per cent of a registered equity security, in all equity securities of the issuer of which he is the beneficial owner. Subsection (b) provides that profits from short-swing trading by these persons in the equity securities of the issuer shall inure to and be recoverable by the issuer. Subsection (c), in brief, prohibits short sales by these persons.

The effect of the legislative proposal would be to bring the insiders of companies registering securities under the amended Act within the reach of these provisions. A new subsection (d) provides that the profit-recovery provisions would not apply to transactions by a broker-dealer in a security in the ordinary course of his business and incident to the establishment or maintenance of a primary or secondary market for such security. The latter exception, not present in prior proposals, recognizes the importance in many situations of the investment banker-sponsor to the maintenance of a market in the security and therefore does not subject his operations for this purpose to the profit-recovery provisions of subsection (b), even though he might be a director or principal stockholder of the issuer.

Section 16 by its terms is aimed at the use by corporate officials of "inside" information for the purpose of speculating in the stock of their corporations. In addition to requiring public disclosure of transactions through periodic reporting to the Commission, Congress provided for the recovery by or on behalf of the corporation of all profits realized by the insider from a purchase and sale within any period of less than six months.

"The short-swing period, a six-months limitation, was referred to by its chief proponent as a 'crude rule of thumb.' That period was declared 'off limits' for insiders. At best it reflected a realistic judgment as to how to achieve the objectives of the law to discourage short-swing trading by depriving insiders of their profit on the transactions. Thus, it eliminated the difficult problem of proof if intention to 'get out on a short-swing' or if actual use of inside information was to be the standard upon which liability rested." 14/

14/ Kornfeld v. Eaton, CCH Fed. Sec. L. Rep. ¶91,225.

The corporate official and director has his problems and they are not just problems of his business. He has to worry about his responsibilities as a fiduciary--at times he has been called a trustee. He must conduct his business under complex rules in many areas which require nice judgments and subtle distinctions as to appropriate or inappropriate action. As to short-term trading, however, Section 16(b) relieves him of that worry. There is little need to make judgments. Section 16(b) is about as subtle as a sledge hammer, and perhaps this is why people tend to get a little emotional about it. It doesn't leave much room for argument. Therein, in part, lies its virtue. The clamor for certainty is pretty well satisfied in this section of the law. It does not make short-swing trading illegal. It does not prohibit. It merely says that if you trade, pay over the profit. It speaks with an eloquence not often misunderstood.

But I think too much attention centers on the word "profit" and that not enough thoughtful consideration is given to aspects of Section 16(b) which are not spelled out in plain words in the statute. The section begins--"For the purpose of preventing the unfair use of information which may have been obtained . . ." These words convey the impression that perhaps the principal thrust of the statute is to prevent a species of gun jumping--of insiders trading against the public on the basis of advance knowledge of internal events not yet materialized or publicly disclosed. If the Act had been worded to recite more fully what it intended to accomplish and does accomplish, perhaps the wisdom of the Congress in 1934 would be better appreciated and in fact more widely applauded.

The purpose expressly stated in the statute is of course important. Another purpose--you will find comment on it in court decisions--was to remove the profit potential for the various types of pool operations in which officers, directors and others engaged as disclosed by the investigations preceding the passage of the 1934 Act. Some of these were notorious and demonstrated a type of market manipulation which the Congress intended to prohibit. The choice of method reflected recognition of the difficult problems of proof and the after-the-fact character of other techniques which might have been employed.

A third purpose relates to a technique clearly more subtle but no less manipulative. It is but a short step from taking advantage of advance knowledge of internal corporate developments as a basis for short-term trading. Effecting actual transactions in securities at certain times and under certain circumstances is clearly recognized as manipulation and as such is prohibited by the statute or Commission rule. Frequently the public statement, the press release, the publicized speech or the well-planned "leak" are far more effective as instruments to manage prices and far more difficult to detect or prevent as manipulative devices. The ease of manipulation of security prices by public-relations techniques is well documented in Chapter IX of the Report of the Special

Study. Section 16(b) therefore operates not only to prevent insiders from taking advantage of inside information for purposes of short-term trading of bona fide developments in a business--it operates just as effectively to prevent the unscrupulous from profiting from the movement of securities prices produced by publishing or leaking false or deceptive information.

A fourth effect of Section 16(b) is one which every responsible management must favor. Every person charged with the responsibility of making important decisions affecting the policies and practices of an organization, whether in business or government, must have confidence in the opinions, recommendations and advice of colleagues, associates, and superiors. There must be belief that problems are considered on their merits from the point of view of the best interests of the organization. Congress has written a rule of conduct for corporate management more effective than management could have written for itself and devised a more effective means of enforcing it. In doing so, management has been afforded a reasonable basis for assurance that decision-making and planning probably are not influenced by prospects of short-swing profits turning upon those events or the press releases announcing them.

These are the things Section 16(b) stands for. You can't be in favor of the evils sought to be reached or indifferent to them. No responsible management of any public company can take such a position. It is difficult to believe that anyone who understood the reach of the section would like to think of the consequences to our listed markets were it not on the books. Its application to the over-the-counter market is overdue.

There is a third aspect of our legislative program which I will merely mention. The Act would be amended to provide for more flexible procedures in handling broker-dealer disciplinary actions by the Commission and the N.A.S.D., and I won't burden you with any discussion of them.

We live in a price economy. Price becomes the ultimate interest of those concerned with markets. Buyers and sellers hope that forces operating in a market place produce fair prices and a measure of stability. In the long run, security prices reflect the judgments of the professionals. Investment bankers, broker-dealers, investment advisers, financial analysts, institutional buyers, sellers and lenders act upon, or recommend that others act upon, their judgments of the worth of your securities. Give the qualified professional honest, adequate and timely information about over-the-counter securities, and the over-the-counter market and the public are bound to benefit.

The proposals being made have been tested and proven in their application to the listed markets. The over-the-counter market in corporate stocks is no longer the relatively unknown and little understood operation of the early thirties. It has become increasingly

important as a part of our financial system. We think we have demonstrated that the principles we have been talking about should be extended in their application and allowed to serve their purposes as usefully in the over-the-counter market as they have in aid of the auction markets. We are not trying to make the entire securities markets over in the image of the stock exchange and its methods of operations. Nor are we in any way ignoring characteristics peculiar to the over-the-counter market which necessarily distinguish it from the exchange market. Recognizing these essential differences, we think that there can be no justification for lower standards in the former of qualifications for entry into the business or lower quality of information about the securities traded.

There is one final point I wish to make and we think it well worth reflection. You can't afford to have responsible leaders in the N.A.S.D. or the S.E.C. spending so much time on the petty crooks and chiselers who so freely come and go in this business, or on disciplinary proceedings which reliable information might have made unnecessary. We have more important things to do.

We are well aware of the arguments likely to be advanced in opposition to one or more aspects of the program. We are well aware of the attack likely to be made by some industry groups. Most of the arguments as to the merits were made thirty years ago, when the original legislation was being considered. Time and experience have demonstrated that most fears and worries as to dire consequences either were more fancied than real or that flexibility in administration and a little ingenuity relieved them. We think that by proper use of our powers to classify, to define, to exempt and to adjust, we can continue to reach decisions and adopt procedures which will reasonably accommodate any business problem likely to arise. Further, our rules and regulations are always worked out with full discussion of their implications and impact with the interested groups, as you well know.

So you see we are engaged in a membership drive for the 8-K Club. If any of you who do not belong are eligible, we invite you to join up. There is no initiation fee. And if by any chance the banks feel left out or not welcome, we will make a particular effort to provide special membership privileges.