NEWS

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"EFFECTIVE REGULATION REQUIRES COOPERATION AND COORDINATION"

Address by

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Securities and Exchange Commission

North American Securities
Administrators Association
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I am pleased to be with you at this Spring Meeting which gives us an opportunity to exchange ideas, coordinate activities, and hopefully gain the benefits that come from cooperation between state and federal regulators who have corresponding responsibilities. In order to be effective, we must strengthen and support each other in our efforts to maintain securities markets which engender investor confidence and enable business enterprises and governmental entities to obtain the capital necessary to meet the needs of our people.

We must be ever vigilant against those who, for self-interest reasons, oppose desirable change as well as those whose ethical standards are such that their desire for monetary gain exceeds their sense of fairness and who thus prey upon and take advantage of their fellow men through fraudulent and manipulative schemes. At the same time, we must avoid the sometimes natural tendency of regulators to so emphasize restrictions against improper activities that legitimate business activities are burdened with unnecessary regulations which impede and stifle private initiative and innovation. Our responsibilities are great while our resources

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are limited so we must coordinate our efforts if we are to achieve maximum effectiveness.

I want you to know that all members of the Commission are firmly committed to the dual state-federal system of regulation. We realize that regulation and enforcement at the state and local level is most effective in detecting and dealing with problems quickly. The Commission continues to have the keen interest in the activities of state securities regulators that was evidenced during the tenure of Commissioner Owens, a former State Securities Administrator. You can be assured that we will continue to build on the good relationship that already exists because present members of the Commission desire to maximize the effectiveness of both state and federal regulation.

In a recent letter, Chairman Garrett informed your President that Commissioner Sommer has been designated to act as liaison between your Association and the Commission. In addition, I personally believe that each member of the Commission can be involved and participate with you on a regular basis. Through such a relationship, I feel sure that we will better communicate with each other, increase our understanding of each others problems, and thus be more able to assist each other.

During the past year, considerable progress has been made in coordinating the broker-dealer regulatory programs of the various self-regulatory authorities, State Securities Administrators and the Commission. I am happy to report that your President, Mrs. Thyra Thompson, has designated Hugh Makens, Director of the Securities Division of the Corporation and Securities Bureau of Michigan, to represent State Securities Administrators on a newly-formed SEC Advisory Committee on Reports and Forms. In that capacity, Mr. Makens will work closely with the staff of our Office of Broker-Dealer Examination Program as well as other members of our Division of Market Regulation. The responsibility of this Advisory Committee will be to review all existing and proposed regulatory reports and forms and recommend to the Commission appropriate consolidation or elimination of unnecessary reports and forms.

There are at least three basic areas which will be addressed by the Committee: financial reporting forms, assessment forms, and trading forms. As you know, the Commission has also been working with you and a number of other organizations in the development of uniform forms for the registration of brokers and dealers and the registration of principals and agents. I believe these forms, which the

NASA has designated U-3 and U-4, will be of great significance to the securities industry. I understand that they were a topic of discussion yesterday, and since most of you may be aware of Securities Exchange Act Release No. 10612, you know that the Commission has given both the time of its personnel and its wholehearted support to these efforts. These forms are important not merely because they will lessen the burden both on the regulators and the regulated, but because they evidence a cooperative spirit which I have not always seen in the securities industry. If we are to continue to have a viable and developing national securities market, such cooperation is essential.

In September of 1972, Chairman Casey expressed the hope that we could perfect a system of coordination among self-regulatory entities and participating state regulators to avoid unnecessary and burdensome duplicate examinations and make information developed by one participant available to others. We now have in the SEC headquarters office and in each regional office an industry-wide, composite listing of all broker-dealer firms which appear on the early warning or special surveillance list of self-regulatory authorities, based upon the information submitted by these authorities.

We also have a computerized report which provides information concerning examinations which have been conducted by self-regulatory authorities and the Commission during the past ten months. We have found this information to be useful in our activities and hope that, on a confidential basis, you will also utilize these reports.

In the area of cooperative training, each of you is invited to attend a training program for securities compliance examiners which will be conducted here in Washington on June 4, 5 and 6. The invitational materials, together with a copy of the curriculum which will describe the details of the program, may well reach your office by the time you return. The training course will include a review of the latest rules and regulations governing broker-dealers and will provide a solid foundation in fundamentals for inspectors, thus enhancing their ability to detect compliance problems which may require enforcement action.

The Commission's Enforcement program continues to be most active and effective. At your meeting in San Antonio last year, Commissioner Owens gave you a fairly detailed account of our enforcement program. I will only mention some of the more recent cases and leave it to Stan Sporkin, the new

Director of our Enforcement Division, to pursue these and other enforcement matters in his session which, I am sure, will be very lively, as his sessions usually are. The Commission, as well as the Enforcement Division itself, is extremely pleased with the Division's new director and mentor and we assure you that our vigilant but fair enforcement program will be continued without missing a step. All of us were equally pleased to have Irv Pollack, our former Director of the Enforcement Division, become a Commissioner. He brings with him an in-depth knowledge of the securities laws and the structure of our securities markets, which already has been very helpful.

We have accomplished a real breakthrough with regard to pyramid scheme offerings. We believe the Court of Appeals decision in the Dare to be Great case, together with the consent judgment filed April 2, 1974 in the United States District Court for the Northern District of California against Holiday Magic, the modern originator of the multi-level pyramid promotion, signals the beginning of the end for this type of promotion. Since you brought the pyramid promotions to our attention and at the same time pursued actions at the state level, we believe that this area can be pointed to with pride as a prime example of how the partnership of state and

federal regulation can work together. I only regret that we could not have entered this area earlier because, while we have been quite effective, investors have still lost millions of dollars that will not be recovered.

There are also still questionable activities being engaged in by underwriters and dealers in municipal bonds. We have filed injunctive actions against 50 defendants in this area and have obtained permanent injunctions against nearly half of these, including five retail firms. In addition, the courts have entered preliminary injunctions against virtually all of the other defendants. While these injunctions were primarily by consent, it is significant to note that the Commission has prevailed in seeking disgorgement for the benefit of defrauded investors. In the Charles A. Morris case, the court ordered disgorgement from salesmen and supervisors of a retail bond house. In the Investors Associates case, an interpositioning dealer consented to the entry of a permanent injunction and disgorgement. The court in both of these cases appointed a trustee to administer the disgorged funds.

We are also presently pursuing several cases involving alleged large-scale breaches of fiduciary obligations

by mutual fund managers. We continue to move forward with the IOS case involving the activities of Mr. Vesco. Thus far we have been successful in obtaining preliminary relief against a large number of defendants and we are now seeking to obtain permanent injunctive relief. In addition, we are working closely with our counterparts in Canada and other countries to recoup the far-flung assets of this financial empire and bring the matter to a successful conclusion.

In early March 1974, we filed a significant case against Seaboard Corporation and a number of other defendants, including brokers, investment advisers and mutual funds. This case, like IOS, involves alleged large-scale abuses by persons occupying fiduciary positions. While the litigation is in its very early stages, we have thus far established a fund totaling in excess of $550,000, from which investors may recoup some of their losses. Our case against Delphi Capital Corporation is another instance where we have been successful in establishing a fund for investors who have suffered losses as a result of the alleged misconduct of mutual fund managers.

Following up on the Goldstein Samuelson matter, we have taken further action concerning sales of commodities

options. In one case involving International Commodities Exchange, we alleged that the Newport Beach, California firm was writing these options "naked" and that International was, in effect, conducting a "Ponzi operation" and misappropriating investors' funds. International has consented to an injunction and the court has appointed a receiver who is attempting to marshal the firm's remaining assets.

Only a few weeks ago, in the first phase of a new program to deal with insider trading, we filed an action against Geon Industries, Inc. The object of the program is to bring an action as soon as possible after the misuse of inside information is discovered. In Geon, we assembled a task force that quickly ascertained the facts and we were in court approximately a month after the case was first reported to us.

The last of the enforcement activities I want to mention is our high priority program for dealing with delinquent filings by reporting companies. Fair and honest trading markets cannot be maintained unless there is accurate and timely information concerning the financial condition of our public companies. For this reason, we recently suspended trading in the stock of some 40 companies for being delinquent in filing their annual Form 10-K reports.

As is obvious from my remarks, many of our enforcement activities are based on close cooperation with State Administrators. We in Washington are unable to detect as promptly as necessary all emerging problems, so we must depend on your assistance. You not only detected the problems in the pyramid area, but were also first to detect problems in commodity options, municipal bonds and real estate syndications.

While prudent securities regulation requires vigilant enforcement, it also requires that regulations actually serve the salutary purpose for which they are intended or that they be clarified or removed so that regulatory burdens be kept to the minimum possible, consistent with necessary investor protections. Unfortunately, this is not a clearly defined line, and the proper balance can be achieved only through constantly reviewing our regulations and making appropriate adjustments.

For some time, the Commission has had under consideration proposals advanced by the Investment Company Institute which, if adopted, would permit significant cost savings to mutual funds. These proposals are aimed at relaxing the confirmation rule, the requirements for dividend

statements, proxy delivery and reporting for payroll deduction and individual retirement plans involving small purchases. If these proposals, now in the form of proposed rules, or some reasonable variation of them can be adopted and prove workable, they may in the future provide the track record needed to permit an extension to an even wider segment of fund transactions, thereby permitting further economies without sacrificing necessary investor protections.

On the state level, there are serious questions whether the limitations on permissible mutual fund expenses are serving their intended purpose or whether instead, they result in either reciprocal arrangements whereby services to a fund will not be reflected in the expense ratio or the elimination of the mutual fund as an investment vehicle to small investors. If small investor participation in mutual funds is to be retained, state regulations must be flexible enough to provide reasonable expense controls without resorting to a common denominator which may make it economically impractical for investment vehicles aimed at the small investor to fulfill their original purpose. I understand that state officials in California are in the process of developing a new standard in this area, and it may be

desirable for officials in other states likewise to carefully consider the impact of inflexible expense limitations.

Our 140 Series rules under the Securities Act of 1933 have also attempted to provide a more objective and workable regulatory framework. At least three of the four rules have been aimed at clarifying and removing some of the uncertainty for those who desire to issue securities and engage in securities transactions pursuant to exemptions from the registration requirements. Rule 144, dealing with public resales of securities acquired in private transactions, and Rule 145, dealing with registration of securities issued in connection with mergers, acquisitions and reclassifications, have both been on the books long enough to have been the subject of interpretative releases (Securities Act Rel. 5306, September 26, 1972, and Securities Act Rel. 5463, February 28, 1974) and to have proved their worth. Rule 147 under Section 3(a)(11) of the Act relates to intra-state offerings that are exempt from the registration requirements of the Securities Act.

Because of its relationship to your activities, let me take a minute on Rule 147 which became effective on March 1, 1974. The Rule basically contains standards that

the Commission staff had been applying, particularly as to when an issuer is considered to be a resident and doing business within a state, and when an offeree or purchaser is considered to be a resident. The Rule also relies on the traditional ideas of what makes up an offering or an issue, although it provides a safe harbor for certain offers and sales. We haven't had much experience with Rule 147 yet. We have, however, begun to receive a number of registration statements from companies which, after reading Rule 147, decided that they had better register with us rather than rely on the intra-state exemption.

Both the intra-state and the private placement exemptions have been used extensively to offer and sell traditional real estate syndications. In the last few years, however, we have seen a great increase in "public" syndications in which promoters seek millions of dollars from the public to finance limited partnerships investing in real estate, often on a "blind pool" basis. We at the Commission have been concerned with this mass-merchandising of tax shelter type offerings, partly because of the suspicion that suitability standards may not be closely adhered to, and partly because of the difficulties in

obtaining adequate disclosure in an area so different from traditional corporate offerings. The Commission has recently issued for comment proposed guides for disclosure in registration statements dealing with syndications. If after considering the comments, guidelines are adopted, they should result in useful, and in some cases, theraputic disclosure.

The many forms that real estate investment can take have raised questions under the securities laws as to whether, in certain circumstances, what is being offered and sold is a security, subject to the requirements of the securities laws. Condominiums are probably the most familiar example I could mention, but more recently we have received a number of requests for interpretations and no-action positions with regard to the sale of "vacation licenses" and other forms of specified interests including management and rental services in resort property.

The Commission has been concerned with these requests, not because it thinks that the real estate interests are necessarily securities, but because these offerings are not solely sales of real estate. Because of the complexities and the difficulty of making general interpretations, the Commission has directed its staff not to issue any additional

no-action letters in this area and to advise that no-action letters issued in the past in this area do not extend beyond the particular issue involved and should not be relied upon by any other persons, or by the person receiving the letter in any other fact or subsequent situation.

Now I come to what I consider to be the highlight of my remarks. With great satisfaction I can advise you that today the Commission announced the adoption of the final rule in the 140 Series, Rule 146, which deals with transactions that are exempted from registration under the Act by Section 4(2). This Rule is the result of two public comment periods and at least eighteen months of staff consideration and represents what we believe to be a most reasonable approach under the private offering exemption. It was adopted in a form somewhat revised from that last published for comment but substantively similar in many respects and will become effective June 10, 1974 for offerings commencing on or after that date.

As you know, Section 4(2) of the Securities Act provides an exemption from registration for transactions by an issuer not involving any public offering. From the earliest days of the Securities Act, the "private offering"

exemption, as it is commonly known, has been the subject of interpretation which has not always been consistent. Persons seeking to use the private offering exemption have long searched for a means of assuring the availability of the exemption. In their efforts, they have focused on restrictions such as a limited number of offerees and purchasers, a lack of widespread advertising, offerees and purchasers who can "fend for themselves," controls of resales of the securities, and other restrictions intended to assure that the offering is made only to "sophisticated" persons and to inhibit a distribution such as that discussed by the Commission in the now famous Crowell-Collier matter.

Although some persons have thought they could rely on just one of these factors at a time, such thinking is erroneous because all of these factors may be relevant under various circumstances. This area has been fraught with uncertainty for responsible businessmen seeking capital privately. This uncertainty has been increased by judicial pronouncements resulting from understandable efforts to protect investors and has become an even greater problem today as plaintiffs' lawyers, fresh from victories in other fields, are beginning to discover the fertile fields of the securities

laws. This is indeed an inviting field because the primary remedy for an unregistered sale that is not exempt from registration is rescission, which in effect provides the purchaser with a "put" to the issuer until the statute of limitations runs out.

This uncertainty, which places law abiding issuers in a quandry and gives less law abiding issuers an advantage, led the Commission to consider adoption of a rule in the 140 Series that would attempt to define with some certainty when transactions by an issuer would be deemed to come within the exemption provided by Section 4(2). The Rule as adopted is intended to be nonexclusive. Years of experience with the exemption have shown the Commission that there is no way all the questions can be answered with regard to every type of transaction. We have no doubt that there can be valid 4(2) exemptions without compliance with the Rule, and we really mean it when we say that the Rule is nonexclusive. Of course, as with any exemption from registration, the burden is on the person claiming it to prove its availability and the Rule does not change that. The Rule does, however, provide a safe harbor for those who can prove that they have met all of its conditions.

I am not going to speak in detail about the Rule, as adopted, because any description other than a recitation of the entire Rule might well lead to misunderstanding. I will, however, mention a few of its main provisions and you will have a chance to study it later.

Basically, the Rule is intended to assure that "private offerings" are private in the sense that there is no general advertising or general solicitation and that offers are made only to persons who the issuer has reasonable grounds to believe, and does believe, meet certain standards and who have sufficient information available to make an informed investment decision. The offerees must, themselves or through offeree representatives, have the type of knowledge and experience in business and financial matters required to evaluate the investment, and in all cases, the offeree must be able to bear the economic risk of the investment. The concept of an "offeree representative" which you cannot find in prior judicial or administrative interpretations is new in this Rule. We think that this concept makes sense and reflects the realities of many legitimate private offerings.

Aside from restrictions on the type of people who can be offerees under the Rule, there are also requirements pertaining to the information that must be available to the offerees. The Rule incorporates the traditional concept of "access," in which the offeree, by reason of his own relationship to the issuer either as an insider or because of his economic clout, is able to obtain information necessary to evaluate the transaction. The Rule also allows the information requirement to be met by the actual furnishing of information to the offeree or his representative, and as adopted contains a relatively specific description of the type of information that should be furnished.

Although the restrictions on general advertising, the nature of offeree test, and the information condition provide some limitations on the offering, the Commission felt that it was also necessary to limit the number of persons who purchase securities in a private offering to safeguard against distribution of the securities to the public. This limitation has been retained at 35, as proposed, but the Rule as adopted sets the limit on 35 in any "offering," rather than 35 in any twelve-month period, as proposed. The Rule relies on the traditional integration tests for deciding what

offers and sales constitute an offering. It also requires that the issuer take certain steps to help assure that securities sold under an exemption are not resold without registration or an exemption therefrom.

We hope that the Rule as adopted will be workable and will prove to be of assistance to legitimate business in raising capital in a manner consistent with the protection of investors. We will, of course, watch it carefully to be sure that it is serving its purpose and that it operates in the public interest.

Since most of the states also have a version of the private exemption, we believe that you may want to study this Rule and perhaps adopt its principles in your regulatory structure. One of the great benefits of dual securities regulation in addition to coordination, cooperation, and mutual support is that constructive innovation may occur in 50 states as well as at the federal level. Let us all be willing to accept improvements from wherever they come so that we will be able to meet our goals of achieving and maintaining securities markets which merit investor confidence and provide a means of meeting the ever-growing demand for capital to satisfy our social and economic needs.