PUBLIC OFFERINGS UNDER THE SECURITIES ACT OF 1933, AS AMENDED

Address by

RALPH H. DEMMLER

Chairman

Securities and Exchange Commission

at the Annual Meeting of the

AMERICAN BAR ASSOCIATION

Chicago, Illinois

August 17, 1954

Since you are lawyers, I ask you to bear with me if I start out with observations as a lawyer rather than as an administrator.

My remarks this morning are directed to the registration of securities under the Securities Act of 1933. The grants of power - particularly quasi legislative power - under that Act are not so broad, sweeping and general as the grants of power under the Securities Exchange Act, the Public Utility Holding Company Act or the Investment Company Act. Nevertheless, the Securities Act does vest in the Commission extensive powers over the process of capital formation. The Congress over a period of many years has not seen fit to withdraw any of those powers.

The existence of a legislatively conferred power imports a duty to exercise that power in those situations in which the Congress intended it to be exercised. No one who undertakes the duty of Commissioner can disavow that responsibility. On the other hand, power imports a duty to exercise self-restraint. Moreover, power must be exercised with a realization of the practicalities of life and with a realization of the inherent limitations of any administrative mechanism operated by human beings.

I want to talk specifically about the registration under the Securities Act of 1933 of securities offered for sale to the public, discussing first, the processing of registration statements and second, the amendments to the Securities Act which were recently enacted to become effective 60 days from August 10, 1954.

I don't propose to make this into a "how to do it" type of legal institute. On that I appreciate the fact that I am hopelessly outclassed by my audience.

I would like rather to discuss the basic philosophy of the Commission's practice in the processing of registration statements. In other words, I am talking about "why we do it."

It is needless to remind you that the Securities Act is based on the requirement of disclosure by the issuer through a prospectus, publicly distributed, reflecting information contained in a registration statement officially filed, and based also on the imposition of liability for misrepresentation and concealment in the registration statement and prospectus or in representations made by the seller.

But the Securities Act of 1933, as amended, goes beyond the mere creation of an obligation to disclose and the imposition of civil and penal liability for failure to disclose. The Act:

1. Provides rather specific rules and standards for disclosure and for a commission to prescribe even more specific rules and standards, including accounting standards;

2. Provides for a waiting period, normally 20 days after filing, before sales may be made;

3. Gives power to the Commission to accelerate the effective date of registration statements - that is, to shorten the waiting period;

4. Gives power to the Commission to issue stop-orders suspending the effectiveness of registration statements until deficiencies are corrected;

5. Gives power to the Commission to seek injunctive relief;

6. Provides power in the Commission by rule and regulation to impose terms and conditions on the exemption of small offerings - not over $300,000 - under Section 3(b).

There are those who argue that the Commission should let the registrant file papers which it thinks follow the rules and forms, sell on the basis of the papers filed and assume responsibility, penal and civil, under the liability provisions of the Act.

From a practical standpoint in the case of offerings of blue chip securities of companies which have gone through the registration process on a number of occasions, such a program might not materially diminish the public protection afforded by our present methods of processing. But recall, if you will, the statutory power of the Commission to suspend effectiveness by stop-order proceedings or to seek injunctions. It is hard to say that such power does not create a correlative duty on the Commission to look at each registration statement to determine whether on its face it shows deficiencies. For a Commission to take any other attitude would be abandonment of its duty.

Now, if our staff looks at a registration statement and finds something which either is not in conformity with the legal requirements or which appears on its face to be a misrepresentation or a half truth, what should we do - should we lie in wait and surprise the issuer by a stop-order proceeding or by an injunction? If any such practice were introduced, I am sure there would be fighting in the streets, at least on Second Street, Washington, and LaSalle Street, Chicago, not to mention a few other well-known streets associated with the raising of capital.

Let me tell you what the Commission does in the processing of a registration statement. We find wide misunderstanding on that subject, certainly among investors, even occasionally among lawyers and people in the securities business. Let me interject parenthetically that lawyers in a peculiar way have a duty not only to know the law in order to advise clients how to achieve favorable results, but also as a learned, licensed profession to interpret to the public generally what the law means and how it is administered.

The Commission's Division of Corporation Finance examines the registration statement filed under the Securities Act of 1933. The Act provides that the registration statement becomes automatically effective after a 20-day waiting period (unless the effective date is accelerated by order of the Commission). However, since timing is important in most offerings and since formal suspension, stop-order or injunctive proceedings would in many cases make the offering forever impossible, the Commission's practice is to advise the issuer informally of deficiencies and to give it the opportunity to amend so as to avoid the necessity of instituting any formal proceeding.

The letter of comment advising the issuer of deficiencies is made after an examination of the registration statement by the staff, including a securities analyst, an accountant, an attorney, and in some cases an engineer. For example, registration statements filed by mining companies are reviewed by a mining engineer for the purpose of determining whether the information given concerning the mining property and the business of the registrant meets the requirements of our registration forms and whether technical information and conclusions are fairly presented.

Uranium issues provide an example of several types of problem. We have had to move in to restrain exuberant misrepresentations as to the price of uranium and the value of production in general areas.

It has been necessary to request issuers to mention uncertainties as to title. We have found on occasion that officers, directors and promoters own claims adjoining the claims of the issuer. That interesting fact, we think, is a legitimate item of comment, since if exploration and development by publicly raised capital in a particular area results in the discovery of ore in that area, the investors of that capital should know that neighboring areas owned by the promoters will benefit from an unearned increment in value based principally on the results of the exploration which the investors paid for.

Some registration statements - and we have found it true in the case of some uranium issues - are inclined to gloss over the exact nature and effect of stock option arrangements with promoters, underwriters, officers and directors. Some of the explanations demonstrate that gobbledegook is not a monopoly of the bureaucracy. The Commission's power of acceleration is geared in part "to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issue and the rights of the holders thereof, can be understood." Our staff is called upon to work over, in connection with some promotions, descriptions of option arrangements, which could be described in biological terms as chaos out of confusion by ambiguity.

I submit that exercise of the power to withhold acceleration or even a threat to exercise the power to institute stop-order or injunctive proceedings is a legitimate weapon against double-talk which

leaves even an intelligent investor uncertain as to the relationship of his securities to the capital structure of the issuer. Multiple threats of dilution through the exercise of options should be clearly set forth in order that an investor or his adviser is in position to prophesy when, if the enterprise becomes profitable, the investor might expect to get a dividend check or realize a capital gain.

In the case of oil and gas issues, the disclosures which should be made will naturally vary dependent upon the character of the company and its assets as well as the stage of its operations. In new ventures it is frequently necessary to request issuers to be more specific in giving the location of their properties. Prospective investors should know where a wildcat or unproven property is located in relation to proven wells and to dry holes. Under certain circumstances disclosure should be made of unusual rental obligations, unusually short leasehold terms. The use of adequate maps is encouraged and is requested where it is difficult to present the facts in any other manner. For producing companies details concerning production and information concerning reserves are material.

The allegation is sometimes made that a zealous staff sometimes compels issuers to say things that drive buyers of securities away. In particular cases that may be true, but if the staff's position is a legitimate application of the statutory standards of fair and adequate disclosure, its approach is justified. Public appreciation of the fact that prospectuses disclose that which repels as well as that which allures creates confidence in the soundness of our processes of capital formation.

We have heard from representatives of both the oil and gas industry and the mining industry that in the processing of registration statements, members of the Commission's staff attempt to impose their own ideas on the subject of reserves. Now, admittedly, both the issuer and the member of the staff are talking about something not conclusively demonstrable. It is easy for the issuer to argue that it is willing to take its chances on civil liability, that after all, it is the issuer's registration statement, not the Commission's.

On the other hand, there are principles in the computation of reserves. The discussions on this subject with our staff are more than mere battles of numbers. Inquiry by the staff into principles

followed by the issuer is wholly legitimate. Relatively forceful suggestions to restrain optimism based on insufficient sampling or based on discredited procedures are not, I submit, abuses of authority.

Let's keep in mind the fact that the Commission's suggestions are "comments." The issuer has the ultimate responsibility. If it desires to go ahead, it may go ahead but subject to the possibility of a stop-order or injunction.

I know you will say that this is not a practical alternative. It isn't. We must depend in large measure on a system of administrative warning. We must have and do have administrative safeguards against over-zealousness by individual staff members.

The individual examiners are checked by a section chief, the section chief by an assistant director, the assistant director by the director of the Division of Corporation Finance. Many doubtful and marginal situations are brought to the attention of the full Commission by the Director on his own motion without request of registrant. Disputes between the registrant and the staff are always submitted to the Commission by the staff if the registrant requests. Moreover, if the registrant asks for an informal conference with the full Commission, that request is always relayed and is granted unless the subject of the dispute is one on which the registrant's position is obviously untenable or is a position which the Commission has previously considered, and consistently rejected.

In addition, during the last year one member of the Commission made a study of all registration statements filed over a period of one month to determine whether or not unfair requirements had been imposed, or harassing or petty demands made. The Commission felt satisfied as a result of that study that the processing procedures were sound, efficient and fair. Furthermore, in almost every instance when a registration statement is brought to the Commission for the order accelerating its effective date, the Commission inquires of the staff as to disagreements, if any, between the staff and the registrant. Considering the large number of registration statements, the number of disagreements is relatively small and the staff position is usually one which the Commission would itself have taken. However, the making of such inquiry probably exercises an influence on the staff and keeps the Commission informed of the administrative process day by day.

It must be recognized that it is impossible to formulate for applicability to every business situation exact standards as to what are the material facts necessary to the making of an investment decision. Consequently, there are bound to be differences of opinion. Let us not deceive ourselves into thinking that any statute requiring fair and adequate disclosure can be administered without differences of opinion between the Commission and registrants. Those of you who work on registration statements know how many arguments take place among the authors of the statement before it is filed.

While in the heat of discussion of disputed positions, registrants may from time to time say harsh things and think harsh things, I think it fair to say that the comments of the Division have frequently resulted in excision from registration statements of material which, if included, might have been a ground for the successful assertion of civil liability.

This processing of registration statements by the Division of Corporation Finance has given rise to a wide-spread public misconception, namely, that the Commission "approves" securities issues. I know I do not need to remind an audience of lawyers that this belief is wrong. Section 23 of the Securities Act spells out the law on the subject so as to negative any inference of such approval. It says:

> "Sec. 23. Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the Commission has in any way passed upon the merits of, or given approval to, such security. It shall be unlawful to make, or cause to be made, to any prospective purchaser any representation contrary to the foregoing provisions of this section."

Nevertheless, many well-informed business people, many non-specializing lawyers and a not inconsiderable number of well-informed people in Government believe that the Commission approves the issue of securities and through exercise of some mystic omniscience, determines that the statements in an effective registration statement

are true. The lack of logic as well as legal foundation for any such belief is obvious. The facts about a company which issues securities cannot be known to the Commission except through:

(a) General knowledge of the staff about the business the company is in;

(b) Published materials on the same subject;

(c) Investment manuals;

(d) Previous registration statements, proxy statements and reports by the same company and its officers and directors and controlling stockholders;

(e) Registration statements of other companies in the same business;

(f) Contracts of the company with departments of the Government;

(g) Contracts of the company filed as exhibits to reports or statements of other companies; and

(h) Miscellaneous external sources of information.

Add the information from all those sources, however, and you still find missing many basic facts about the issuer which lie within the knowledge of its own corporate family. Moreover, in matters of accounting, the Commission makes no audit and certifies no presentation of accounts; that is the responsibility of the issuer and its independent accountants. The Commission requires that accounts follow principles of accounting for which there is substantial authoritative support but the verification of the conclusion that such principles were followed in a particular registration statement is the responsibility of the independent accountant.

Consequently, not only does the law say that the Commission doesn't find that a registration statement is true or accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, but logic makes the same pronouncement.

Will you reaffirm to your brother lawyers and to your interested clients that under the Securities Act of 1933 the Securities and Exchange Commission does not approve securities issues.

I would like to end my prepared remarks with some allusion to the recently adopted amendments to several of the acts administered by the Commission. I will not discuss them in detail since such a discussion would constitute a speech in itself. Excellent summaries and analyses of the amendments are found in the reports of the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce (see Senate Report No. 1036, 83d Congress, 2d Session and House Report No. 1542, 83d Congress, 2d Sesstion). I recommend that you give these reports serious study. The amendment goes into effect sixty days after its enactment, which means that its effective date will be October 10,1954. Some features of the amendment will require implementation by rules of the Commission which should be circulated for comment within the next several weeks. We solicit such comments.

The most important change involves Section 5 of the Securities Act of 1933. Some of the other amendments are necessary to accommodate other sections to the amendment of Section 5. The change in Section 5 and the related changes have to do principally with the mechanics of the distribution of securities, particularly the circulation of so-called red herring prospectuses and identifying statements.

In line with the basic purpose of the Securities Act of 1933 - to provide investors with adequate information concerning securities publicly offered - the act as now amended permits written offers during the waiting period by means of a prospectus filed with the Commission prior to its use. It would remove the difficult concept, inherent in present practice, that it is permissive (obligatory under SEC rules) for an underwriter during the waiting period to disseminate information but illegal to solicit offers. The amended act, however, continues to make unlawful sales, contracts to sell, and contracts of sale before the registration statement becomes effective.

Another amendment relates to the use of prospectuses after the effective date of a registration statement. The Act in its un-amended form requires that any dealer must deliver a prospectus in the initial distribution of a security (regardless of how long the

distribution takes). It further requires the delivery of a prospectus in trading transactions for one year after commencement of an offering. This latter provision is amended to reduce the one-year period to 40 days after the effective date or the commencement of the public offering, whichever expires last. The one-year period for trading transactions (as distinguished from actual distribution) has long been recognized as unrealistically long. Consequently, compliance with the requirement has been burdensome and enforcement difficult.

For certain types of investment companies which continuously offer securities, the Investment Company Act of 1940 is amended so as to provide for mandatory use of prospectuses over a longer period.

I will not go into the other amendments beyond saying that they deal with

(1) the requirements for a prospectus used more than nine months after the effective date of a registration statement;

(2) the limitation contained in the Securities Exchange Act of 1934 on taking into margin accounts securities in the distribution of which a broker-dealer has participated;

(3) a technical change in the same Act relating to "when issued trading";

(4) a modification of the requirement in the Trust Indenture Act for a summary in the prospectus of certain indenture provisions; and

(5) continuous rather than repetitive registration of shares of investment companies which are being continuously offered.

The amendments in no way curtail the issuer's duty to disclose or the liability for non-conformity to the disclosure requirements.

The basic purpose of the laws and the regulations made thereunder is to insure the investor access to the facts about the

enterprise in which he is investing or has invested. The laws do not insure against risk of loss. That kind of insurance can be provided only by the economic soundness of the enterprise in which the investment is made and by the character of its management. Laws however well written and however well administered cannot provide either of those.

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