CONTINUING ROLE OF THE STATES
IN REGULATING SALES OF SECURITIES

Address by

RALPH H. DEMMLER

Chairman

Securities and Exchange Commission

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Last year when I had the pleasure of addressing your luncheon in Miami, I talked about the role of securities regulation generally and its relation to the process of capital formation. Today I would like to speak for a moment about the separate roles of the states and of the Federal Government in the matter of securities regulation.

The subject, of course, lends itself alike to platitudinous observations and to brisk and controversial discussion. I would like to be a little livelier than the former but to avoid the high blood pressure generated by the latter.

I have chosen the subject not only because you happen to be state administrators and I a Federal administrator, but because I am convinced that in order to do an effective job of administering the securities laws or any other laws, we must all keep reexamining our major premises or, putting it another way, keep asking ourselves: "Why do we do what we are doing?" We can't answer that question without looking at our jobs in their proper perspective.

Now let me get a little more specific. The states were the pioneers in the regulation of the sale of securities. They took different approaches. Some depended on broker-dealer registration; others depended upon fraud statutes; most had and still have statutes requiring the qualification of the particular securities offered. Because the subject matter of such legislation was difficult and complex and because conditions varied, the state blue sky laws were a long way from uniform. Moreover, jurisdictional questions with respect to offerings made in interstate commerce created enforcement problems which were staggering in respect of national offerings. Had the 20's been less roaring than they were, perhaps the problem of securities regulation would have been solved by a gradual approach to uniform state law. But the 20's did roar. The processes of capital formation and the practices of the market place got out of hand. A large segment of the public was infected with a speculative germ. All of that in part caused, and in part coincided with, a general economic debacle, and the result was the enactment in 1933 and 1934 of the Federal Securities Act and the Federal Securities Exchange Act.

The idea of a more significant role for the Federal Government in the regulation of corporate enterprise was not, however, born of the depression. There had been a lot of thinking done on the subject over a period of years. Discussions of Federal licensing and incorporation of companies in interstate commerce antedated the 30's by almost 50 years. In the early part of the century an Industrial Commission created by the Congress recommended Federal incorporation and suggested that corporations should be required to publish information about themselves and their promoters in the raising of capital and to furnish financial reports to their stockholders. When the conditions of the 30's brought about Federal action in the securities field, the Congress had three choices: (1) a fraud statute like that of some states; (2) a qualification statute like that of other states; or (3) a disclosure statute.

The pattern chosen was a combination of a fraud statute and a disclosure statute.

The Federal statute, of course, leaves an investor free to part with his money like the proverbial fool. It is based on a relatively non-paternalistic doctrine that the role of Government in policing the sale of securities is fulfilled when the investor is assured of a legal right to get the facts and a remedy in case of fraud.

Is that an adequate protection of investors? No one contends that every investor reads the prospectus any more than the millions of people covered by life insurance read their policies. Nevertheless a disclosure statute accomplishes two things in addition to getting through, at least to some investors, the information set forth in the registration statement. First, the very fact that transactions of a suspect character must be disclosed probably prevents many such transactions from ever taking place. Second, while the prospectuses may not be read by individual purchasers generally, they are read by analysts, bankers, and other specialists through whom the information is disseminated and whose appraisal contributes to the fixing of a market price more nearly fair than could be fixed if the information were not available.

The 1954 amendments to the Securities Act of 1933 are designed to get information about the issue and the issuer out to more members of the public than has been customary under existing practice, in other words, to increase the efficacy of disclosure.

I said a moment ago that the sufficiency of disclosure and anti-fraud provisions alone as the bases of effective security regulation is debatable.

The Federal statute, however, is not a qualification statute. Section 23 makes it clear that the Securities and Exchange Commission does not approve and may not approve issues and that it is unlawful for anyone to represent that it has approved any issues. This does not seem to be realized by many members of the public, so I say it again in the hope that you and your staffs will help to disseminate a public appreciation of the fact.

There is a school of thought, however, to which many people belong which urges the necessity of imposing qualification standards as a condition for the marketing of securities. This, as I indicated, is the approach of many states. The effect, therefore, of our present dual system of regulating the sale of securities is, in many areas of the country, to add the qualification standards of the state act to the disclosure and fraud provisions of the Federal act. At first blush this might look like unnecessary duplication but in fact it is not. Section 18 of the Securities Act says categorically "nothing in this title shall affect the jurisdiction of the securities commission . . . of any state, of any security or any person." Moreover, in the absence of any exclusive preemption of Federal control of interstate offerings, the states have a reserved power under the Federal Constitution to impose their own standards.

However, qualitative standards for securities, legislatively framed, are hard to frame and hard to keep up to date. Qualification standards not prescribed by legislation but left to administrative determination involve a degree of administrative wisdom that is hard to find. Qualification standards or exemptions based on rating manuals or listing on exchanges involve problems of delegating legislative power to private agencies. In other words, a good qualification statute is hard to write and hard to administer.

Yet the fact that we have had such statutes since the original Kansas Act of 1911 indicates that the qualification approach is still highly regarded in some areas. Justice Holmes repeatedly expounded the philosophy that the states are laboratories in which economic ideas can be tried and proved or tried and found wanting. I suggest

that this trial process is just what has been going on in the states over the years in respect of the offering of securities and particularly in respect of the imposition of qualification standards.

By way of illustration, there has been much written and said during the past several months on the subject of uranium issues, particularly the so-called penny shares. In some states some of such issues have been refused registration. We have done our best to get adequate disclosure into registration statements and offering circulars relating to uranium securities. We have compelled the high-lighting in sales material of such items as (1) options to promoters and underwriters, the exercise of which would result in the public investor's share in the enterprise being disproportionately small when compared with the share acquired for nominal consideration by the optionees; (2) "best efforts" underwriting arrangements which indicate that a sufficient amount of proceeds may never get through to provide for the development of the enterprise; (3) questions of title, quality and price of ore, availability of market and of refining facilities. Doubtless many of the offering circulars and prospectuses which our Commission processes are less optimistic documents than the promoters desire. On the other hand, it has been urged that people who dream of fortunes are discouraged by nothing that is said in the cold print of a prospectus. They are said to see the word "uranium" and buy. You can't prove mathematically which view is correct.

Now I suggest that in this area there is justification for trying it both ways. Let those states whose authorities have determined to erect higher safeguards against the improvidence of their own citizens refuse qualification to uranium issues which do not meet the standards of such states. Let other states having different types of statute rely upon the disclosure provisions of their own laws and the disclosure required by the Federal Act.

That approach may result in different consequences to the citizens of one state than to the citizens of another, but until we find the ideal solution, different approaches to the same problem represent the way mankind has learned.

The role that the states have historically played in regulating the sale of securities is important not only because it represents certain approaches different from that of the Federal approach, but because it fills gaps in the Federal statutory plan - for one example,

intrastate issues. Many small businesses are locally financed. Many sound enterprises are turning to the Government for loans to raise capital when they should be financing themselves by equity money rather than debt. The adaptability of your state laws to the meeting of this problem is vitally important to the national economy.

I have far from exhausted the list of reasons for the importance of effective state securities laws and efficient administration thereof, but I think the reasons I have given are sound.

Since these laws and their administration are important, it is a matter of concern both to the nation and to the particular states that there should be no withering away of your functions as a result of insufficient financial support. The Federal Government doesn't do the whole job and I am not a defeatist when I say that I doubt if it could. Consequently, while it is none of my business, I venture to express the hope that your legislatures will see fit to provide you with the necessary sinews of battle.

In addition, since your work is important, it becomes a part of your task to eliminate some of the things which may stand in the way of effective state participation in the process of securities regulation, particularly the confusion resulting from the great diversity of state law. While state statutes fall into patterns, there are many variations within the same pattern, variations of words, variations of concept. The great progress made through your Association in the adoption of uniform forms, convention examinations of investment companies, naturally leads one to the hope that progress can be made toward greater uniformity in state securities statutes themselves.

It does not seem unduly optimistic to think that basic definitions can be made uniform, that broker-dealer registration provisions can be made uniform, and that qualification provisions can be made uniform. In other words, states could be in position to select and adopt such portions of a uniform statute as fitted its own statutory scheme.

It may be a long while until a millennium of uniformity will be attained. But whatever progress we make, the ideal solution will always be in the future. People when they invest money are in effect hiring other people to work for them. The whole process of investment is in effect just one of human relationships. Human relationships have never accommodated themselves to any ideal formula and until the real millennium of the Scriptures comes to pass, they never will.

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