# RECENT DEVELOPMENTS IN RULE MAKING AT THE SECURITIES AND EXCHANGE COMMISSION

Address of

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It is, I think, significant in any analysis of the functions of the Securities and Exchange Commission to observe the professional affiliations of its staff. From this point of view, I was very much interested to observe, while glancing over a directory of your membership, that some nine members of our staff belong to your organization. This large representation is apparently greater than that of any other governmental agency or of any private firm. I believe that we may conclude from this fact that securities analysts and our organization have very substantial interests in common, and that you would be interested in a discussion of some of our problems in the field of rule making.

My principal remarks this noon will be directed towards some recent developments in this field of administrative legislation, with particular reference to three particular rules, to wit, Rules 133, N-22D-1 and N-10F-3. The latter two, if adopted by the Commission, would have considerable impact in the field of investment companies.

First, however, I should like to spend a few minutes in discussing the recently enacted Small Business Investment Act of 1958, with which I know that you are all familiar, and the manner in which companies organized or qualified under that Act may be affected by the statutes which we administer.

The stated policy of the Small Business Investment Act is to improve and stimulate the national economy in general, and the small business segment thereof in particular, by establishing a program to stimulate and supplement the flow of private equity capital and long term borrowings requisite for the sound financing of the operations of small business concerns and for their growth, expansion and modernization. In enacting this legislation, Congress started from the premise that it is not the function of commercial banks to furnish equity capital or long term loans for industrial growth and development, and that the cost of the public sale of relatively small issues of securities is disproportionately high. This legislation is thus designed to meet a very real and urgent need of the man who is running a business of modest size.

The Small Business Investment Act sets forth only certain basic and broad provisions, leaving to the Small Business Administration the

duty to implement these provisions by promulgating rules setting forth the necessary details and establishing suitable procedures. The Act contemplates that this financing will be accomplished largely through investment companies organized for this purpose, and the Small Business Administration has been charged with the duty of approving such investment companies and with a substantial measure of responsibility in regulating and examining such companies to make sure that they comply with the purposes and provisions of the Act.

In enacting this legislation, however, Congress clearly had in mind that these small business investment companies should be subject to the provisions of the Investment Company Act of 1940, with certain exceptions. This law is, of course, administered by the Securities and Exchange Commission. Such companies are specifically exempted from the provisions of Section 18(a) of the 1940 Act, which requires a three to one ratio of assets to borrowings, and they are also excused from complying with the limitations on the declaration of dividends or other distributions on capital stock unless certain coverage on publicly distributed indebtedness is maintained. In all other respects these small business investment companies are subject to the 1940 Act, and to regulation thereunder by the Commission in accordance with the standards prescribed by it as necessary to protect the interest of investors and the public.

The Small Business Investment Act also adds a new Section 3(c) to the Securities Act of 1933 under which the Commission may from time to time by rule exempt from registration under that Act any class of securities issued by a small investment company, if it finds that the enforcement of the Securities Act with respect to such securities is not necessary in the public interest and for the protection of investors. It also adds a new provision to the Trust Indenture Act which authorizes the Commission to exempt from regulation under that Act any class of securities issued by a small business investment company, subject to such terms and conditions as may be prescribed. Our staff is giving consideration to the need for, and possible extent of, exemptive regulations under the authority of these two provisions.

The Securities and Exchange Commission intends to operate under the Small Business Investment Act as nearly as possible in accordance with the purposes and aims of this legislation. At the same time, we feel that we must still act so as to preserve the integrity of the salutary provisions of the Acts which we administer. We are now working with the Small Business Administration to conform so far as we can the pertinent rules, regulations and forms under the Securities Act which would apply

to small business investment companies with those which would be applicable under the Investment Company Act and also with the requirements of the Small Business Administration. We are attempting to arrange matters so that, insofar as is practicable, there will be common forms for use by these companies under both the Securities Act and the Investment Company Act. Thus a registration statement under the Securities Act might also serve as the registration statement under the Investment Company Act. Similarly, the annual and other periodic reports required by virtue of an offering under the Securities Act might be received as adequate filings under the Investment Company Act.

It is our hope that, by streamlining our own procedures as well as through cooperation with the Small Business Administration, we will simplify the task which will face these investment companies when they are formed and will expedite the accomplishment of the aims of the Congress as set forth in the Small Business Investment Act.

Turning more specifically to the subject of rule making by the Commission, I would like first to direct your attention to the concept of a "single offering price" referred to in Section 22(d) of the Investment Company Act as it relates to the question of permissible variations in sales loads imposed on purchasers of investment company shares. In this connection the Commission issued a notice last May of a proposal to adopt a new rule (Rule N-22D-1) which would clarify and codify its existing practices of permitting varying sales loads either through administrative interpretation of Section 22(d) or through orders of exemptions from the provisions of that section granted under Section 6(c).

You will recall that Section 22(d) of the Investment Company Act prohibits the sale of its shares by a registered investment company, its principal underwriter or a dealer to "any person" except "at a current public offering price described in the prospectus." The plain words, as well as the legislative history of this section, show its purpose to be to prevent discrimination among purchasers and to insure an orderly distribution of such shares by preventing their sale at a price less than that fixed in the prospectus. In an opinion of the Commission's General Counsel issued in 1941, Section 22(d) was construed as permitting continuance of a long standing practice of the industry under which graduated reductions in the sales load had been granted, depending upon the quantity of shares purchased provided that such quantity discounts were clearly described in the prospectus and were available to any

members of the public on a non-discriminatory basis. Pursuant to this interpretation, the Commission has permitted quantity discounts to be quoted on purchases by an individual at one time of a dollar volume of shares in excess of a fixed amount, say $25,000. It has also allowed quantity discounts on volumes computed on the basis of the aggregate of the shares previously acquired and then owned plus the shares being purchased, and also on the basis of so-called "letters of intent," in which the purchaser undertakes to purchase the required amount over a limited period of time in order to qualify for the reduced sales load. It has further permitted the aggregating of purchases by related individuals, such as members of a family, in order to make available the quantity discount. Questions have arisen under these arrangements as to the propriety of permitting quantity discounts to a trustee or other fiduciary or agent who purchases for more than one account. Such quantity discounts have also from time to time been extended to a representative acting on behalf of a group of individuals such as the members of a medical society or of a college faculty. In rationalizing its decisions in these situations, the Commission has regarded the fiduciary or other representative making the purchases as a single purchaser and thus as "any person" as the term appears in the statutory language, provided that the grouping of purchasers was voluntarily arranged without inducement by the issuer or its sales representative.

It has appeared necessary, however, to reconsider these determinations and to review existing industry practices in view of some complaints made to us in connection with such groupings of purchases. It has been found in many instances that the grouping has been solicited or encouraged by dealers or salesmen. It has become increasingly evident that reduced prices are not being granted to a single member of the public based upon the quantity of the shares being purchased, but rather to the aggregate purchases of several or numerous individuals comprising selected "classes" of persons, contrary to the spirit and intent of Section 22(d). An important consideration in this situation is the possibility, if not the probability, that prospectuses will not be furnished to all of the individuals comprising the group, in violation of the disclosure requirements of the Investment Company Act and the Securities Act.

As I mentioned, the proposed Rule N-22D-1 was drafted and circularized for comment among the industry in May 1958. Comments were received from some 45 persons, including several state regulatory authorities, representatives of various trade groups, investment companies, dealers and attorneys. Some ten appearances were entered at the oral argument held on the proposal before the Commission on July 23rd,

including representatives of the National Association of Securities Dealers, the National Association of Investment Companies, various funds, management companies and other associations.

The proposed rule provides in part that quantity discounts will be permissible only when granted in accordance with a scale of reducing sales load varying with the quantity of securities purchased by any person and based on (1) the aggregate quantity of securities being purchased at any one time or (2) the aggregate quantity of securities previously acquired and then owned plus the securities being purchased. The term "any person" is defined in the rule to include (1) an individual purchasing securities with his own funds for himself and members of his immediate family and (2) a trustee or other fiduciary purchasing securities for a single trust estate but regardless of the number of beneficiaries. The proposed rule expressly provides "the term shall not include a group of individuals, acting jointly or through a trustee, agent, custodian or other representative." It also draws the line at the granting of special discounts to officers and employees of the issuer or the sponsor.

In the written comments and at the oral argument, objections to the proposed rule were raised by some of those present regarding the contemplated elimination of quantity discounts based on the so-called "letters of intent." It was pointed out that as a practical matter it would be impossible in most instances for a dealer or broker selling shares of a mutual fund to grant a quantity discount on the aggregate of the shares already purchased and then owned plus the amount being purchased, since there would be no way of ascertaining the total number held by the prospective purchaser. Aside from the few companies which have direct sales organizations and maintain complete records in their home offices of all sales and redemptions made by purchasers of their shares, there would be no source from which the broker-dealer could readily obtain information to verify the present holdings of a prospective purchaser. On the other hand, most of the representatives of the industry felt that the practice of making purchases pursuant to a "letter of intent," if properly safeguarded, is the most practical and effective method of offering a discount based on purchase of a certain quantity of shares. They argued that the additional shares to which the purchaser might be entitled by reason of the saving resulting from the quantity discount could be held in escrow until the entire program had been completed, or if the full sales load was to be charged on each purchase,

the difference between the standard sales load and the lesser amount to which the purchaser would be entitled as a quantity discount could be held in escrow to be delivered to the purchaser on the completion of the program. In such event, it was felt that there would be no possibility of the purchaser receiving a discount to which he might not be entitled. In addition, it was suggested that the period to be covered by such letters of intent should be limited to some definite period, such as 13 months. It was also forcibly argued that the term "any person" should be defined so as to include the spouse and minor child or children of the purchaser so that the discount might be based on the total number of shares held by the entire family unit. Some criticisms were also advanced as to other parts of the proposed rule emphasizing the considerations which had led to the existing practices, and some further restrictions were urged, such as a limitation upon special treatment of purchases by tax-exempt charitable organizations.

The proposed rule is now under active reconsideration by the Division of Corporate Regulation in the light of the comments so received, and it is probable that, after further consideration by the full Commission a rule of the general nature of that submitted will issue in the near future, though possibly with some modifications to meet the more reasonable of the criticisms which have been made. In such event, it will no longer be necessary to petition for special orders in order to legalize special discounts in certain cases, as has been done repeatedly under the existing situation.

The Commission also has before it for consideration the adoption of a proposed exemptive rule under Section 10(f) of the Investment Company Act, Rule N-10F-3, which would permit registered investment companies under certain definite prescribed conditions and with certain limitations to purchase securities during the existence of an underwriting despite affiliation through common directors between the investment company and a member of the underwriting group. Although Section 10(f) prohibits such purchases, the Commission by rules and regulations upon its own motion or by order upon application may conditionally or unconditionally exempt any transaction or classes of transactions from those provisions if it is satisfied that the exemption is consistent with the public interest and the protection of investors.

The purpose of Section 10(f) is to prevent underwriters from unloading underwritten securities onto registered investment companies with which one or more of the underwriting syndicate has an affiliation.

In reviewing requests for exemption under this Section of the Act, the Commission does not pass upon the investment merits of the security proposed to be purchased. The wisdom of the decision to buy is the responsibility of the company. The Commission simply grants exemptions in those cases where it is satisfied that there is no indication that the proposed acquisition is being made with a view to benefit the underwriter, and where the acquisition appears to be in conformity with the company's investment policies and purposes.

The Commission is seeking through the proposed rule, to alleviate the problems and administrative burdens involved in processing Section 10(f) applications. It is designed to benefit the industry since these applications are usually required to be filed with very tight time schedules because of the period required for notice of filing and opportunity for hearing. Such a tight schedule often forces the purchases to be made, if at all, subject to the condition that an exemptive order will be obtained from the Commission at the end of the notice period, even though it is not possible to obtain such order until some time after the date of the public offering. Obviously, this sort of a conditional purchase is an awkward and impractical solution to the problem.

The experience gained by the Commission in exercising its exemptive authority under Section 10(f) indicates that the protection of investors can be adequately assured by an exemptive rule with carefully worked out safeguards. Such an exemption would, of course, require that the securities to be acquired must be registered under the Securities Act and must be purchased by the investment company immediately after the effective date of the offering in order to assure investment motivation for the purchase. Other protective measures include limitations with respect to the amount of the purchase and the amount of the underwriting commission involved. Thus, under the proposed rule, the consideration to be paid may not exceed either 3% of the total assets of the investment company or $1,000,000, except that the amount may exceed $1,000,000 if it is not more than 1% of total assets. Nor may the amount of securities to be purchased exceed 3% of the amount of the offering. The limitations as to underwriting commissions are related to the type of security offered and range from 1-1/4% for securities such as bonds to 3-1/4% if the security is a preferred stock and 7% if it is a common stock. The issuer of the security to be purchased must have been in operation not less than three years.

Another condition specifies that the purchase must be authorized by a resolution of the board of directors or an investment committee of the board. A full statement of the transaction is required to be filed with the Commission after the transaction is consummated. Comments

received by the Commission have suggested some modifications in the proposed rule, particularly respecting the percentage limitations. These comments will be given thorough consideration before any such rule is adopted.

A review of past cases shows that a large majority of the purchases heretofore permitted by order would have satisfied the proposed limitations of the new rule. Generally, we believe that these limitations will restrict the operation of the rule to investment grade offerings. Of course, it is clear that where a proposed purchase does not meet all of the strict conditions of the rule, it may nevertheless, where the statutory standards are satisfied, be exempted by order upon application as in the past. On the whole, we feel that the rule will prove to be beneficial to the industry, will protect investors and will enable many companies to take advantage of offerings which had to be foregone in the past because of lack of time within which to process an exemption application.

I would also like to refer briefly to the proposed amendments to Rule 133 under the Securities Act of 1933 which the Commission now has under consideration. This rule, as it now reads, provides that the issuance of securities to stockholders in connection with certain mergers, consolidations, reclassifications of securities or transfers of assets does not involve a sale of such securities to the stockholders of the corporations concerned and consequently that it is unnecessary to register such securities under the Act. The problem presented by the issuance of securities in such transactions arose almost as soon as the Act was adopted. The Commission concluded at that time that the issuance of securities in these transactions did not involve a sale of the securities to the voting stockholders for the purposes of registration, and a statement to that effect was included in a note to the form covering the registration of securities issued in a "reorganization." In 1947, the use of this particular form was abandoned, and for several years thereafter the interpretation was continued administratively. In order to allay any doubts that the interpretation was still being followed it was promulgated as Rule 133 in 1951, and has continued without substantial amendment to the present time.

Because of what it deemed to be abuses of the rule, the Commission published in October 1956 an invitation for comments on a proposal to rescind the rule which would have had the effect of compelling the registration of securities issued in connection with such corporate activities, in

the absence of an otherwise available exemption from such registration. Numerous comments were received in regard to this proposal and a public hearing was held on the matter in January 1957, at which some grave legal and practical difficulties were pointed out. Thereafter, in March 1957, the Commission announced that it was deferring action on the matter pending further study.

The limitations which the Commission considered to be inherent in the applicability of Rule 133 were discussed in the findings and opinion in the Great Sweet Grass Oils Limited and Kroy Oils Limited cases, issued in April 1957, and in Release No. 3846, published in October 1957. In substance, the Commission there indicated that Rule 133, where applicable, merely provides that registration of the securities and presentation of a prospectus to the security holders is not required in connection with the submission of a plan of merger or other transaction specified in the rule and the receipt of securities in consummation of the plan. It pointed out that the securities issued in such a plan are by no means "free" securities, which need not be registered in connection with subsequent offers and sales of such securities by stockholders of the merged corporation. Registration would be required for any subsequent offer and sale unless such activity were limited to casual sales by security holders not in a control relationship with the issuer of the securities which transactions might fairly be described as trading transactions not involving a distribution or unless another exemption were available. Thus, Rule 133 provides no exemption from the registration and prospectus requirements of the Act with respect to any public distribution of the securities received by security holders who might be deemed to be statutory underwriters.

The staff, at the direction of the Commission, has made a comprehensive review and re-examination of all pertinent legislative and other statutory materials and the prior actions taken at both the Commission and staff levels. The views expressed as to the 1956 proposal, both in writing and at the public hearing, were carefully studied. On the basis of the conclusions reached by the staff, their recommendations and the Commission's consideration of the matter, proposed amendments to Rule 133 were issued on September 15th of this year, and public comments were invited.

These proposed amendments would retain the existing rule but would incorporate into the rule certain additional provisions which would make clear that registration is required in certain cases where a public distribution of securities initially acquired in transactions exempted by the rule is subsequently made by a person defined as a statutory underwriter in the proposed amendments.

The definition of a statutory underwriter as used in this Rule appears in two new sections of the proposal. The first section defines as an underwriter a person who makes arrangements with the surviving corporation in a Rule 133 transaction, or with a person in a control relationship with that corporation, to resell to the public the surviving corporation's securities on behalf of any stockholder of the merged corporation who has received such securities. The second section provides that where any constituent corporation or any person in a control relationship with it at the time of the transaction acquires securities of the issuer in a Rule 133 transaction with a view to the distribution of such securities the constituent corporation or the person in a control relationship with it, as the case may be, is to be deemed to be an underwriter. The proposed amendments do not deal with distribution through an underwriter by persons who, after the merger or other transaction, are in a control relationship with the surviving issuer. Registration in such cases is clearly required in the absence of an exemption.

In order to make clear that registration is not required in connection with any and all transactions by persons who would be deemed underwriters under the proposed amendments, provisions have been included which make such registration unnecessary in the case of subsequent transactions which answer the description of unsolicited brokerage transactions within the purview of Section 4(2), essentially trading transactions.

In order that registration may be effected as expeditiously and economically as possible where it would be required by the amended rule, the Commission has under consideration a registration form which would, in effect, permit an issuer to use as the prospectus, the proxy statement which will have been used in soliciting the vote of stockholders for the Rule 133 transaction. Of course, it would be necessary to add supplementary data in regard to the underwriting and distribution of the securities. This procedure has been followed in similar situations in the past and appears to be feasible and to accomplish the disclosure purposes of the Act.

I regret that time does not permit me to describe in any greater particularity the details and the effect of the proposed amendments to Rule 133. However, I think I should add that all interested persons are invited to submit their views and comments on the proposals to the Commission on or before November 14, 1958. For your information,

the notice of these proposed amendments is covered in Release 3965, Securities Act of 1933, dated September 15, 1958.

The final matter which I would like to discuss with you does not, strictly speaking, involve exercise of our rule making power. I think that you, as securities analysts, might be interested in the problems with which we have been faced concerning the manner in which accruals of deferred income taxes are presented on corporate balance sheets. The question is presented to the Commission in sharply defined form when it is called on to determine the debt ratios of utility companies which are subject to the Public Utility Holding Company Act of 1935. These accruals represent the difference between the taxes on net income resulting from depreciation charges computed on a straight line basis and the taxes which would be payable on net income computed according to one of the available methods for accelerated depreciation. The utilities are inclined to argue, with some heat, that such accruals should be considered as earned surplus and so carried on the balance sheet, although placed in a special restricted category. Naturally, this would serve to make the debt ratio of the utility so much the more favorable. The alternative treatment is to carry such accrual strictly as a reserve, separate and apart from the surplus account.

The treatment of this question by the various regulatory authorities is extremely confused. The Federal Power Commission in its Order No. 204, Docket No. R-159, issued on May 29, 1958, added a new balance sheet classification in its Uniform System of Accounts which requires the use of the reserve treatment. The State Commissions are in hopeless and irreconcilable conflict with each other in this regard. When the SEC was recently faced with the necessity for deciding this question, it tentatively adopted the position of the Federal Power Commission. I describe this position as tentative, since the particular utility affected being most unhappy over the result because it will materially affect the debt ratio shown on its balance sheet as included in a pending registration statement covering a proposed issue of its securities, it has asked for a conference, and I most certainly do not want to be in the position of taking a final stand before such opportunity has been given to it.

There is, of course, much to be said for the contention that these accruals are properly to be considered as items of restricted surplus. It is perfectly clear that Congress, when it enacted the Revenue Act of 1954 containing the optional provisions for accelerated depreciation, had

in mind that the cash so generated would be used to supply capital needs in part, and there is little doubt but that the companies which are taking advantage of these provisions are actually using the money for just this purpose. Nevertheless, such accruals bear little or no resemblance to the ordinary capital item, particularly since they are subject to offsetting credits when, as must eventually be the case in connection with a relatively static plant account, the annual adjusted tax accrual is less than the straight line accrual.

The Federal Power Commission, in its Order No. 204, after pointing out the accounting difficulties, observed with very considerable justification that the establishment of special reserves to represent these accruals, while it prevented the unwary layman from being led astray as to the nature of the item, did not prevent a sophisticated investor or analyst from adding such reserves to the equity capital for the purpose of computing a debt ratio. The cogency of this reasoning is one of the factors which has, at least up to the present, influenced our own Commission to come to the same conclusion. We have still not made a final determination as to whether we should compute a debt ratio for our own purposes in this manner, and I frankly do not know what the answer would be if we were. Furthermore, I am not at all sure how much weight is or should be given by an analyst to any decision of the Securities and Exchange Commission in this regard. I do not pretend to any particular competence in the analysis of corporate securities, but I am inclined to feel that, regardless of the actual book entries which may be used, the analyst would at the very least be justified in giving substantial weight to the existence of a heavy tax accrual of this nature.

I may not and probably have not dealt with all the aspects of the current business of the Commission in which you may be interested. I assure you, however, that I shall be very happy to try to answer any questions you may have either on the material I covered or any other matters relating to our work.