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CURRENT ADMINISTRATIVE PROBLEMS UNDER THE SECURITIES ACTS

Address of

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Commissioner

SECURITIES AND EXCHANGE COMMISSION

before the

NEW YORK CHAPTER

of the

AMERICAN SOCIETY OF CORPORATE SECRETARIES

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At the outset I wish to express my thanks for the opportunity afforded me tonight to discuss with you some of our current administrative problems and to solicit your cooperation in their solution.

I intend to touch upon some of the rules our staff is now formulating for our consideration to implement further the recent revision of Section 5 of the Securities Act of 1933 (and related sections); some of the "ground rules" which have developed over the years from our experience with proxy contests for control of some of our larger corporate enterprises; and, finally, the proposal recently circulated for comment, to adopt a semi-annual reporting requirement of certain information by companies now filing reports with the Commission pursuant to provisions of the Securities Exchange Act of 1934.

Before mentioning the rules under the Securities Act which are now in process of formulation, I believe it would be helpful, and serve to give more meaning to our present efforts, if I discuss briefly the considerations which led to the revision of Section 5 of the Act by the 83rd Congress.

As you know, prior to the recent amendments to the Securities Act of 1933, which became effective on October 10, 1954, it was unlawful to offer or to sell a security to the public by mail or instrumentalities of interstate commerce, until a registration statement with respect to the security had been filed and had become effective. Thus, while no offering could legally be made during the period between the filing date of a registration statement and the effective date, which averages about 20 days,

it was clear from the legislative history and Section 8(a) of the Act that the Congress intended that the public would become informed of the essential facts relating to a proposed issue during this period. The importance of this cardinal objective of the statute was emphasized by the practice prevailing prior to the adoption of the Act of completing sales of an entire issue sometimes within a matter of hours after the offering was announced. Dealers and the public were compelled to make commitments blindly.

While passage of the Securities Act provided for the filing of information with the Commission and for a waiting period during which such information could be studied, the Act did not provide mechanics for the widespread dissemination of this information to dealers and investors prior to sale. The securities industry contended that the free flow of information concerning a new issue during the waiting period was restricted because of the fear by underwriters and dealers that the communication of information to prospective investors before the effective date of the registration statement might be construed to involve illegal "offers." Concerned with this variance between statutory purpose and actual practice and recognizing that the distinction between "offer" and dissemination of information is difficult to draw, the Commission took early administrative action designed to encourage the dissemination of information during the waiting period.

In 1946 the Commission adopted a rule (former Rule 131, now 433) which provided that distribution of a preliminary prospectus before the

effective date of a registration statement would not in itself constitute an offer, if it bore a legend, printed in red, to the effect that no offering was being made. At the same time the Commission announced that acceleration of a registration statement would be conditioned upon a showing that there had been an adequate and timely distribution of such prospectus. This so-called "red-herring" prospectus found its origin in a release (No. 70) of the Federal Trade Commission published in 1933 which recognized the propriety and desirability of giving publication to information contained in the registration statement prior to the effective date. Again, in 1935 and 1936, the Commission published two opinions by its General Counsel which extended the "red herring" theory to certain types of summaries. (Releases 464 and 802).

In 1952, the Commission took another step designed to assist dealers to communicate with customers for the purpose of determining who might be interested in receiving a prospectus concerning a new issue. A rule (Rule 132) was adopted providing for a short notice of a proposed public offering called an "identifying statement" containing prescribed general information concerning a new issue. This rule provides that the use of the identifying statement does not constitute an offer of a security for the purposes of Section 5.

While these rules and the related acceleration policies of the Commission compelled a wider communication of the information in the registration statement to dealers and, indirectly, to investors, the Commission felt that an appropriate amendment of the Act was required

to achieve more fully the basic objective of informing investors quickly and effectively before they make purchase commitments.

The recent revisions of the Securities Act support expressly the practices which the Commission had permitted and, indeed, had required the industry to follow. Basically, the amendments now permit oral and written offers to sell and solicitations of offers to buy during the waiting period. However, the prohibition against the making of an actual sale, contract to sell or contract of sale prior to the effective date continues in full force. Specifically, Section 5 now prohibits the use of the mails or the facilities of interstate commerce for

(1) sale or delivery after sale prior to effective registration;

(2) the transmission of a prospectus which does not meet the standards of Section 10 and the delivery of a security without such a prospectus; and

(3) the offer of a security prior to the filing of a registration statement or as to which administrative bars have been imposed or public proceedings therefor commenced.

As I have noted, oral offers are now permitted by Section 5 after the filing of a registration statement. Written offers are also permitted, limited however, by Section 10 to the prospectus included in the registration statement or such summary prospectuses as may be permitted by rules or regulations of the Commission. Any such offer, whether oral or written, is subject to the civil liabilities and criminal sanctions of the anti-fraud provisions of Sections 12 and 17 of the Act.

I think it must be apparent from what I have said that the amendment does not work any fundamental change and may fairly be said to give more specific authority for the continuance of practices which have developed over the years, and to make these practices specifically subject to the sanctions provided by the Act.

Some confusion appears to exist, however, as to what written material may be disseminated during the waiting period. At the present time the only written offering material which has been authorized for use during the waiting period is the preliminary prospectus described in Rule 433. This is a complete prospectus but for price and related data and replaces the former "red herring" prospectus authorized by Rule 131 which was repealed last fall. Rule 132 which authorizes the use of an identifying statement has been retained pending a clarification of problems as to the use of preliminary and summary prospectuses under the laws of certain states. While no "summary prospectus" has as yet been authorized for use in the preeffective period, our staff is presently drafting rules to permit the use of a summary prospectus under certain circumstances.

A related problem, the use of summaries prepared by independent financial publishing companies, is under study. This would permit the continued use of such summaries as the well-known "yellow cards" within the framework of the statute. Consideration is also being given to the conditions under which the machinery for the solicitation of competitive bids for securities may be put in motion in the period prior to the effectiveness of the registration statement. Finally, I should mention that we are drafting a rule which will expand beyond the traditional

"tombstone" advertisement the scope of preliminary communications between issuers, underwriters, dealers and investors. The recent amendment of Section 2(10) of the Statute was designed to vest in the Commission a measure of discretion to prescribe the information which may be included in such communications and advertisements. We anticipate the publication of rules in these areas for your comment in the near future.

It is hoped by such rules, and the adoption of related acceleration and other administrative policies and practices, to implement the recent amendments to the end of encouraging wider dissemination of relevant information regarding new issues. A word of caution is necessary, however.

If there is any one proposal that was carefully and fully considered last year and expressly rejected by the Commission and by the Congress, it was the suggestion that issuers, underwriters and dealers be permitted to engage in "free writing" in the offering of securities in the period between the filing and the effectiveness of a registration statement. We at the Commission had thought that this was very generally known and understood by the securities industry. Members of the Commission have discussed this problem publicly since the effective date of the amendments. Despite this and the wide publicity otherwise given to the basic prohibition against such "free writing" by the Commission and through financial publications and services, several cases have come to the attention of the Commission recently in which "free writing" and similar or related activities in violation of this basic prohibition were found to have taken place.

The dangers inherent in the dissemination of supplementary material to the public pending effectiveness of a registration statement was emphasized in the case of a recent registration statement, filed by an exploratory mining company. The information released was seriously at odds with statements made in the filed prospectus. The prospectus referred to ore which might be recovered as "not considered high grade." The information released to the public referred to the company's "very righ" deposits, "deep surface deposits of workable . . . ore," mines which "possess the richest . . . deposits in the world." Whereas the prospectus indicated the purpose of the financing to be to obtain funds with which to seek ore, the company released information referring to "this vast deposit," and stated that "the company plans to start building a mill." In another case a letter was sent, prior to the effective date, to some 3,200 dealers discussing in some detail a proposed offering. So far as the proposed offering was concerned, the Commission refused to grant acceleration in both cases. In the Commission's view it was particularly important, in the case of the mining company, to allow sufficient time for the information contained in the prospectus to become disseminated so as to offset the misinformation released to the public.

In yet another case, after a registration statement had been filed but prior to its effectiveness, we learned that one of the underwriters had mailed about 300 letters discussing the proposed offering. These letters stated that the common stock which was about to be issued would "yield" 6.6%. This was arrived at by including in the "yield" the market value of a stock dividend. I believe I do not need to dwell upon the proprieties

of such a presentation. We also learned that other underwriters had also mailed letters to customers discussing the offering. The Commission determined to defer acceleration until correcting letters had been sent.

Another problem with which we hope to deal by an exercise of our new rule-making powers, stems from the obligation or desire of management to advise stockholders as to matters which may affect their interests in the corporation. A similar obligation arises from listing agreements with stock exchanges which require prompt notice to stockholders and to the exchanges of rights to subscribe to new issues and the allowance of a proper period of time to exercise such rights. Additionally, the exchanges also require the publication of certain information by issuers to guard against the circulation of false rumors as to proposed corporate actions.

In an effort to coordinate the requirements of the Securities Act with this obligation to disclose coming events, no question has been raised concerning bare announcements to stockholders regarding proposed securities offerings, before or after the filing of a registration statement, which do not attempt to lay the groundwork for the offering to follow and which contain appropriate caveats as to the nature and purpose of the announcement. Stockholders may thus be alerted to the impending offering so that they may consider promptly the prospectus when delivered to them.

In a recent case a registrant, prior to filing a registration statement for a proposed rights offering of common stock, had made a change in its fiscal policy which had the effect of substantially revising reported net income. It desired to issue a press release and to send a letter to stockholders furnishing information of the aforementioned revision of net income

accompanied

by an additional announcement discussing the change in the company's fiscal policy. After discussions with the registrant an acceptable form of release which limited the scope of the letter was agreed upon. The dangers inherent in "free writing" in paving the way for a coming securities offering were avoided by the registrant in this case by discussions with the staff. A similar problem with respect to communications in advance of the filing of proxy soliciting material arises under the proxy rules adopted by the Commission pursuant to Section 14 of the Securities Exchange Act of 1934 which I shall discuss next.

As you know, Section 14(a) of the Securities Exchange Act of 1934 in general prohibits the solicitation of proxies with respect to securities registered on national securities exchanges in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. The Commission has promulgated rules under this section, known as Regulation X-14, which seek to protect investors by requiring disclosure to them at the time their proxies are solicited of certain basic information calculated to enable the investor to act intelligently upon each separate matter with respect to which his vote or consent is sought.

Regulation X-14, however, contains no special requirements designed to deal specifically with problems presented by proxy contests of various types. I think it would be difficult to prescribe specific rules on this subject although this matter has received serious consideration by the staff. Still, I have often thought that much time could be saved for the Commission and its staff, as well as for the parties involved, if prospective participants

in proxy contests understood from the outset some of the standards we apply to material which is intended to be sent to stockholders. In accordance with this belief, it might be helpful if I discuss "ground rules" which my experience at the Commission indicates are of general application.

Difficulties usually arise in connection with information, argumentation or advocacy employed in addition to the information required in the proxy statement or in supplemental soliciting material. These are subject to the general standards outlined in Rule X-14A-9 which states in substance that no solicitation subject to the regulation, written or oral, shall be made which at the time or in the light of the circumstances is false or misleading with respect to any material facts or which omits to state any material fact necessary to make the statements made not misleading, or necessary to correct any statement in any earlier communication which has become false or misleading

In the administration of the rules with reference to proxy contests, particularly those relating to efforts on the part of an opposition group to unseat management, a number of basic principles have evolved. I'll highlight these principles by reciting certain practices as to which the staff or the Commission, or both, have objected in the processing of proxy material over a period of many years. These are:

(a) Distortion of and other improper use of business or financial facts.

(b) Expressions of opinion or conclusions concerning the operations of a business which can not be supported by the facts or information called for to substantiate or establish a basis for the statements made.

(c) Use of statements by individuals, organizations, courts, Congressional Committees and administrative agencies out of context.

(d) Statements of conclusions and opinion as established facts rather than as opinions.

(e) Claims, promises or projections as to future earnings, dividends, sales, and increases in value of assets or stock.

(f) "Smear" tactics generally, including such devices as -

(1) Guilt by association with criminals, communists, illegal acts, or events generally regarded as contrary to the public interest.

(2) Reprints or extracts from newspapers, periodicals of a derogatory nature not supported by facts.

(3) Use of material reflecting the opinions of others having no special competence to judge or know the facts.

(4) Use of libelous or defamatory material.

(5) Use of material attacking the racial, religious or political background or belief of a person.

(6) Efforts in the nature of character assassinations.

(7) Use of allegations or testimony in investigations or administrative proceedings where no conclusions or findings have been reached or published.

(g) Re-publication of material prepared by others without applying the same tests to such material as would be applied were it published in the first instance by the contestant. Also involved are questions of consents and interest.

(h) Use of supplemental material prior to filing with the Commission.

If this were a general group and not a special one of skilled and experienced corporate secretaries I'd summarize with the shorthand advice KEEP IT CLEAN!!

I hope this brief review of some of our experience in the administration of Regulation X-14 as applied to proxy contests will help eliminate unnecessary delays and other impediments to the processing of soliciting material by the Commission's staff and to the dissemination of relevant and truthful material to security holders. I shall now turn to a discussion of the proposed semi-annual reporting requirement under the Exchange Act which we recently circulated for comment.

It may be useful at this point to review briefly the history of the Commission's efforts to prescribe an appropriate quarterly reporting requirement. In Section 2 of the Securities Exchange Act of 1934, Congress stated that the lack of appropriate accurate financial information is detrimental to the public interest and the interests of investors. Section 13 of the Act requires every issuer of a security registered on a national securities exchange to file such annual reports and such quarterly reports as the Commission may prescribe. Rules prescribing annual reports were adopted shortly after the effective date of the Act. Reports were later adopted calling for current reports on Form 8-K whenever any of certain special events occurred during the year. Since that time the problems involved in the requiring of regular quarterly operating reports, the usefulness of such reports to investors, and their feasibility in the light of contemporary business and accounting practices have been under study.

During the war the Commission adopted rules requiring quarterly reports of sales and certain information as to war business. When the war was over and this latter information had largely lost its significance the situation was reviewed to determine whether this requirement should be revised and included as a permanent part of our reporting system. There was considerable difference of opinion among the staff regarding the amount of information which should be reported and as to the desirability and usefulness of such information. The Chief Accountant of the Commission recommended the adoption of a requirement for quarterly reporting of net sales only because, in his view, (a) the best indication of the general course of business was probably the net sales figure; (b) requiring net sales only had the great advantage of ease of computation and definiteness; and (c) such requirement would provide a link between the current wartime quarterly reporting and such permanent program as might seem desirable after extended study. He pointed out, however, that the net sales were not necessarily an indication of profitableness and in fact might in particular cases be misleading.

The Commission accepted the recommendation and released the proposed rule for comment. On March 28, 1946 the Commission announced the adoption of Rule X-13A-6B, and the revision of Item 11 of Form 8-K to require quarterly reporting of sales or other gross revenue during the fiscal quarter for which filed. At the same time the Commission rescinded a requirement for the reporting of changes in dollar volume of war business handled by listed

companies. On November 2, 1949, Form 9-K, requiring the same information was adopted to supersede Item 11 of Form 8-K. In its release announcing adoption of Form 9-K, the Commission stated:

> "As a result of extended study of the problem and of the comments received from those to whom preliminary drafts of the program were sent, we are of the opinion that companies should furnish investors and the public with regular interim information as to their operations. We are inclined to believe, moreover, that it would be desirable to obtain at quarterly intervals a condensed income statement showing not only gross revenues but also net income before and after Federal income taxes together with any non-recurring items of income or costs and losses of an unusual size even though certain of the items could only be arrived at by the use of reasonable estimates or on the basis of certain assumptions. It appears, however, that a substantial number of listed companies do not now have their accounting and reporting practices so organized as to be in a position to make the determinations necessary to furnish reasonably reliable data of this character on a quarterly basis. Accordingly, we have determined for the present merely to require information as to sales or other gross revenues."

On October 10, 1952, after considerable study the Commission released for comment a proposed revision of Form 9-K and related rules. This proposal would have required the filing after the close of each fiscal quarter of a report containing a profit and loss statement and a related statement

of earned surplus for the quarter and for the current fiscal year through the close of such quarter, to be prepared in accordance with Regulation S-X. Schedules would not have been required and the report would not have had to be certified. Exemptions were provided for certain classes of issuers, including banks, insurance companies, investment companies, common carriers, public utilities, single crop agricultural companies, and companies in the promotional or development stage.

Of the 381 letters of comment received, 13 expressed qualified or unqualified approval, 357 expressed disapproval, and 11 were of a miscellaneous nature. In the main, the objectors expressed grave concern over the burden of preparing quarterly information comparable to that furnished in annual financial statements. They likewise feared that liability might be incurred under Section 18 for the reliability of information which, it was urged, must of necessity be less reliable than such information furnished on an annual basis. It was also argued that the preparation of formal statements purporting to meet the requirements of S-X would lead to misleading implications of adequacy and accuracy. After considerable study of the matter, the Commission announced in March, 1953 that it had determined not to adopt the proposal at that time.

Thereafter, in the light of personnel and other restrictions induced by budgetary limitations, a study of the quarterly reporting requirements was initiated by the Commission in connection with a review of its activities, procedures and requirements to determine the extent to which these might be eliminated, revised or modified without material adverse effect upon the public interest. The study revealed that during the fiscal year ended

June 30, 1953, a little more than 2,000 companies filed 8,297 quarterly reports of gross sales on Form 9-K. Probably as many as 600 letters were sent out by the staff in connection with these reports -- about 400 to get the reports filed and about 200 to get them filed correctly. To handle and process so many thousands of documents is estimated to have taken an aggregate of time of the Commission's staff of 6 man years.

On August 6, 1953, the SEC asked all interested persons to submit their comments with regard to a proposal to rescind Form 9-K. We received over 340 replies expressing approval of discontinuance of quarterly reporting and only 46 expressing a desire that it be continued. In view of the reaction to this proposal and to the earlier proposal for additional information and in the interests of economy, the Commission adopted a staff recommendation and, on October 9, 1953, rescinded Form 9-K.

From time to time we have received various requests for the reinstatement of a quarterly reporting requirement. Some months ago the Commission directed its staff to review the various factors previously considered and to confer with representative professional groups regarding the feasibility of reinstating an interim reporting requirement and as to the content of any such report. After an exhaustive study of the previous proposals made, the Commission's experience with the quarterly reporting requirements previously in effect, and detailed discussions with various professional groups, our staff recommended that the Commission release for comment a proposal which would require companies subject to the reporting requirements of Sections 13 and 15 of the Act (with certain exceptions) to file with the

Commission one semi-annual report containing specified information with respect to sales, net income before and after income taxes, extraordinary and special items, and charges and credits to earned surplus.

It was suggested that such a report might not be subject to the possible misleading implications of accuracy which might arise from a formal profit and loss statement for a short period. Because such reports would not be complete profit and loss statements, because they would necessarily be subject to certain assumptions as to taxes, inventories and other items which are ordinarily finally determined only at the close of the year, our staff also recommended that such reports not be subject to the civil liability provisions of Section 18. The Commission determined that the proposals were worthy of serious consideration by all persons and companies affected. Accordingly, on January 27, 1955, the Commission published for comment (Securities Exchange Act Release No. 5129) a proposed Form 9-K for midyear reporting which would be filed only once a year and would contain certain specified information with respect to sales, net income before and after income taxes, extraordinary and special items and charges and credits to earned surplus. Comments on this proposal already received are being studied by the staff and will continue to be received until February 28. In addition, the Commission announced that a public hearing would be held on March 9, 1955, to afford all interested parties an opportunity to express their views. It is perhaps unnecessary for me to point out that the Commission has not made up its mind about the proposal.

I said at the beginning of these remarks that I was here to solicit your cooperation in the solution of the Commission's problems in these areas. I want to impress you with the earnestness of that request. If the Commission's administration of these statutes is to be effective it must be consistent with the practicalities of present-day corporate life. Probably, nowhere else does there reside the volume of knowledge or experience bearing upon many of such matters as in the minds of the members of your organization. Bringing this knowledge and experience to bear upon these problems, in the form of comments and suggestions regarding proposed rules and regulations, will greatly assist the Commission in reaching proper decisions.