FOR RELEASE UPON DELIVERY OF SPEECH

"HOW TO SHORTEN PROSPECTUSES AND REGISTRATION STATEMENTS"

ADDRESS

of

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Before the

AMERICAN MANAGEMENT ASSOCIATION

New York, New York

December 14, 1937 - 10:00 A.M.

HOW TO SHORTEN PROSPECTUSES AND REGISTRATION STATEMENTS

I wish first to express the great pleasure I have in being able to discuss with you some of the problems which are of our common concern.

For some time I have had the responsibility of preparing forms and regulations under both the Securities Act of 1933 and the Securities Exchange Act of 1934. In so doing, I have been deeply impressed with the great help obtained from frank criticism by the persons affected. To obtain such criticism has been the constant policy of the Commission.

I should like to talk with you concerning a question which I believe is very important; namely, how can there be obtained a simpler presentation of securities in registration statements and prospectuses?

What I have to say may contain very little new, but sometimes old things do not suffer from restatement.

As you may be aware, there is at present in preparation a revision of the forms and regulations affecting registrations and prospectuses. These revised forms and regulations, it is hoped, will be sent out for criticism at a very early date, or, in any event, the more important ones. In this revision an effort has been made, so far as consistent with the objectives of the law, to bring about a simplification to the extent it can be done by rules. But in my conviction the causes for the length of prospectuses and registration statements are not the law and the rules. The Commission has asked me to study the means by which these documents could be made more understandable. During a long period of time, I have tried, on that account, to find the reasons for what has often been their incommensurate bulk and illegibility. I thought it might be of some interest to you to have presented what seem to me to be the real causes.

To my mind the first of those causes is the undue prolixity with which simple questions are answered in an involved and legalistic manner. There is nothing in the statute which requires such a mode of presentation. Indeed, the registration statement and the prospectus were designed for persons making business judgments, for whom such a presentation is more of a deterrent than an aid. In order to eliminate such undue prolixity, the Commission has authorized a series of opinions, the purpose of which is to show how meticulousness has served in part to thwart the purposes of the law. In these opinions it has been our attempt to indicate how information may be supplied in a simple and usable manner without violating the statute in any way. In the first opinion we took an item from a typical prospectus in which 2,000 words had been used to describe the basis upon which additional bonds of the class being offered might be issued. If you have an open-end mortgage and the lien is significant, this information is indispensable to a sound investment judgment. Few business men could be expected to struggle through 2,000 words of complex description. Our opinion showed how, for the purposes of the prospectus, the same information could be given in 250 words.

In a second opinion we took another item from a prospectus. In this case the persons drafting the prospectus had taken 1,900 words to describe the conditions upon which property could be released from the lien of the mortgage securing the issue which was to be offered. We indicated that the material information could be conveyed in 200 words.

The question may be asked as to whether there has not been a failure, in preparing some prospectuses, to exercise that judgment as to materiality which is necessary in any business act. The statutes do not impose liability, except for material misrepresentation. An analysis would show, I believe, that the great mass of detail often furnished is not material in the circumstances of the particular issues and does not aid in the formation of a business judgment as to whether the particular securities should be bought or not.

It may be observed in this regard that the habit of legalistic tautology is not new. Some one has graciously sent me an extract from an old English case which shows how an English Chancellor imposed a quaint punishment for undue tautology. The case was decided in 1566, and concerned the great length of a pleading. The Chancellor observed

> "that the said replication (i.e., the pleading) doth amount to six score sheets of paper and yet all the matter thereof which is pertinent might have been well contrived in sixteen sheets of paper . . . '

and gave order

> "that the Warden of the Fleet shall take the said Richard Mylward (the culprit pleader) alias Alexander into his custody and shall bring him into Westminster Hall on Saturday next about 10 of the clock in the forenoon and then and there shall cut a hole in the midst of the same engrossed Replication which is delivered unto him for that purpose, and put the said Richard's head through the same hole, and so let the same Replication hang about his shoulders with the written side hanging outward, and then, the same so hanging, shall lead the said Richard bareheaded and barefaced round about Westminster Hall whilst the Courts are sitting, and shall show him at the Bar of every of the three Courts within the Hall, and then shall take him back again to the Fleet, and keep him prisoner until he shall have paid £10 to her Majesty for a fine and 20 nobles to the defendant for his costs in respect of the aforesaid abuse."

By way of contrast, I should like to call to your attention the simplicity with which a foreign registrant answered a question put in one of the Exchange Act forms. The question was, "State briefly the circumstances of any failure to pay principal, interest or any sinking fund amortization installment". The answer was, "Principal and interest are paid without interruption *until yet*".

It may be hoped that, with the passage of time and the quieting of unwarranted fears induced at the time of the enactment of the law, the legalistic mode of presentation will tend to disappear. Indeed, there are indications such a trend has already set in.

But there is another major cause of complexity which cannot in any way be attributed to the law, namely, the complicated manner in which we create securities.

From time to time the claim has been made that upon the filing of a registration statement a truck was needed to convey the required material to the files of the Commission. People have spoken metaphorically of "tons" of material. The point I wish to make is that the quantity of such material did not come from the requirements for registration, but took its birth, before registration, in tne complications of the enterprise's organization.

Consideration may be given in turn to the nature of several of these complications. In so doing, I realize that I risk placing myself in the position of a certain gentleman who, during the World War, wrote to the British Admiralty that he had a sure method of eliminating German submarines from the ocean. The Admiralty replied, inquiring what it was. He answered, "Heat the ocean and the crews of the submarines will be boiled out". The Admiralty inquired, "How heat the ocean?", and he retorted, "That's your problem".

There may first be mentioned the complexities springing from an interrelated family of companies. Patently the Securities Act had nothing to do with the creation of this form of the ownership of business. It should seem clear, also, that no proper picture of the facts necessary for investment analysis can be made unless the various interests in the interrelated companies are set forth. If, in a given situation, there are a large number of subsidiaries with varying minority interests, certainly the Act would fail if the data pertinent to an understanding of the respective claims were not given. If the rights of a given security can be determined only by knowing the prior claims expressed in, say, fifty different kinds of securities, it is not possible to forego the mass of exhibits which constitute the organic instruments of those divergent claims. Very often the securities registered may be such as to express a claim against only a part of the total enterprise. It would seem manifest that data should be given so that an understanding of such segregation can be obtained. This is particularly true since experience has shown that often a segregation theoretically set up in law has not been followed in fact; for under the normal mode of conducting business things subject to the same will tend to lose their separateness. The Kreuger and Toll reorganization gave an illustration of that phenomenon. Although there was a great variety of different claims against different parts of the enterprise, the business had been so conducted and the relationships were so intertwined that the differentiation upon bankruptcy was a matter of great difficulty.

Another illustration may be given by the mention of a case that arose in the early administration of the Exchange Act. A company requested not to be required to furnish separate financial statements for a subsidiary which had outstanding bonds listed on a national securities exchange, on the ground that it was impossible, in view of the manner in which the business had been conducted, properly to segregate separate financial statements for the subsidiary. Although the bonds represented a distinct legal claim upon only a portion of the assets and business of the total enterprise, it was claimed to be impossible to segregate financial statements for such portion of the business, though organized in the legal form of a separate corporation. There have been other instances in which, through the creation and existence of subsidiaries, the securities registered represented special claims only against a portion of an integrated business. Certainly the difficulties and quantity of statement required to give a description of such complications spring, not from the requirements for registration, but from the nature of the organization of the enterprise.

Independently of the complexities that arise from an interrelated family of companies, many instances could be cited of a complicated capital structure set up for a single corporation. The statement of the division of rights created by such a capital structure, even though it take many words, can hardly be dispensed with, since otherwise an investment understanding cannot be obtained. Let us describe for you, as an example, a complicated capital structure which recently came to my attention.

The securities registered included $2,450,000 First Lien Collateral Trust Bonds, with non-detachable stock purchase warrants attached, 42,104 shares of convertible preferred stock, and 701,120 shares of common stock. Most of these securities were outstanding in the hands of the public, or were held by the underwriter under a former offering. The securities being offered were those held by the registrant and consisted of (a) $4,000 of bonds, 1,548 shares of preferred stock and 4,782-1/3 shares of common stock, and (b) 226,638 shares of common stock unissued but reserved for certain contingencies, including (1) 73,490 for the exercise of non-detachable stock purchase warrants attached to the Collateral Trust Bonds; (2) 25,000 shares for the exercise of options granted to officers and employees; (3) 126,312 for conversion of 42,104 shares of preferred stock; and (4) 1,836 shares declared as dividends on previously outstanding preferred stock held pending exchange of such stock.

The preferred stock was convertible into three shares of common for each share of preferred. It was preferred, in liquidation, to the extent of $50.00 and was redeemable at $55.00. There were attached to each of the Collateral Trust Bonds three warrants, each exercisable from the date of issue of the bonds and expiring on December 15, 1941, or the day after the date designated for redemption of the bond to which attached. Each warrant called for 10 shares of common stock, and could not be exercised for less. One of the warrants was exercisable at $8; another at $12; and another at $16. The outstanding options calling for 25,000 shares of common stock were to expire in 1940, and entitled the holders to purchase the common stock at $12 per share.

I shall not go further into the complexities. However, let us look for a moment at the effect this structure had upon a simple requirement of the form for registration. There is required to be stated on the first page of the prospectus the price at which securities registered are to be offered to the public, to the underwriter, and the spread. In the cited case it required, of course, a great deal of space and a very involuted statement to meet that simple requirement.

The securities issued in reorganization are another example of introduced complexities. We all know that in reorganization, instead of frankly facing the situation, an attempt is often made to create securities which on paper appear to be the old securities. Say there is an old bond for $1,000. There is given a new bond for $1,000 but provisions are added to make it not a bond, such as the paradoxical one of having the interest determined by the income. The reason for such action, of course, is that the holder of the bond, seeing $1,000 engraved, thinks he is getting a bond of a dollar's worth equivalent to the one he had originally bought. The instrument so created then continues to have currency until perhaps the thing has to be done over again. In creating securities thus of mongrel kind, there are bestowed strange names which serve, "partly to conceal and partly to reveal" their true nature. It is apparent that, as to such securities, it is essential that there be set forth a clear presentation of the especial provisions affecting the particular security, if understanding is to be obtained. Here again the complexities and the quantity of words spring, not from the registration requirements, but from the way in which the securities are created.

The corporate indenture may be taken as another example of complexities extraneous to the Act. It is common knowledge that this document has waxed great from decade to decade, as a snowball rolling down the hill of time. Where it will arrive, no one can say. But it may be asked whether, as a financial community, we have to continue to bear this huge incubus. Analysis will disclose, I am certain, that a large part of the indentures presently used consists of words that could be eradicated without any loss either of substantive provision or of real clarity.

A so-called granting clause taken from a modern mortgage reads as follows:

> "NOW, THEREFORE, THIS INDENTURE WITNESSETH, that to secure to the Bondholders the payment of the principal and interest of the Bonds and the performance and observance of the covenants and conditions therein and herein contained, and to charge the mortgaged property with such payment and performance, in consideration of the purchase or acceptance of the Bonds by the Bondholders, and of the acceptance by the Trustees of the trusts herein provided, the Company has granted, bargained, sold, conveyed, aliened, enfeoffed, released, confirmed, assigned, transferred, and set over, and, by these presents, does grant, bargain, sell, convey, alien, enfeoff, release, confirm, assign, transfer, and set over unto the Trustees, their successors and assigns, the following described property:"

Some of these words go back, as is commonly known, to modes of conveyance existing centuries ago, and long since obsolete.

The following story is told about a certain Japanese loan. When there was presented to the Japanese in Tokio a form of indenture for their signature having words such as the above, the Japanese, cautious about words not understood, inquired of the American lawyer as to the precise effect of each one of the words. The lawyer could give no such explanation.

The point I should like to make is that the setting forth in clear terms of the effect of instruments couched in such language must necessarily lead to involved statements; and that the real answer to the desire for simplicity is to set about to obtain a reduction of the size of the instruments. In any event, whatever may be the source, the complications are not due to the Securities Act nor the rules and regulations adopted under the Act.

Other complexities foreign to the Act are those resulting from the difficulty of interpreting, accounting-wise, certain procedures followed in setting up the securities. A good example is that of issuing securities purely on an arbitrary basis for property received from promoters, than having a large part of such securities donated back to the corporation and pretending to create therefrom a capital surplus; indeed, to speak generically, all of the instances of the issuance of securities for other than a real capital contribution. Another instance is that of creating preferred stock having a low par value, say $1.00, but bearing a dividend based on a much higher capital contribution, say $100, and having a liquidating value on dissolution at another figure.

Many more instances could be cited, but it is believed the above show clearly that the complications involved are man-made and can be man-removed. The simplification which everyone desires in registration statements and prospectuses can not be really achieved without their removal, except by renouncing the objective of the law, namely that the investor be informed when he is asked to buy. Because of the inertia against change, I would not be so sanguine as to say that these complications will be removed.

Other markets, however, have solved the problem of having large enterprise and at the same time keeping capital securities relatively simple. In France, for example, the issuance of securities departing strictly from common stock or debt indicates that the company has poor credit; otherwise, in the opinion of the market, the conferment of special rights would not be necessary. The market place is frightened, since it is easy to put a "nigger in a woodpile" of words.

It may be asked why it would not be possible to create capital securities comparable to a negotiable instrument. Capital securities, on other markets, resemble, in form, ordinary negotiable paper. Certainly, capital securities, as instruments evidencing rights, are not inherently necessarily more complicated than bills of exchange. Indeed, the bundle of rights and obligations expressed by the bill of exchange is, it is believed, more complex in the persons, transactions and obligations involved than capital securities.

Do these introduced complications really serve the investor, in the long run? Some one has said that in principle the true rights of a security holder are in inverse proportion to the number of words required to express them. After all, in current practice there are only two basic kinds of securities; namely, common stock and evidences of indebtedness. Upon those two classes of securities we have built an almost infinite number of varieties. We have tried to create securities which partake of the characteristics of both. We have a bond, that as a bond is bad; we therefore try to give it, that it may be sold, the attributes of stock. Or we have a stock, that as stock is bad, and we try to give it, that it may be sold, the attributes of a bond. In so doing, there is created a great series of provisions which make analysis difficult, and which, if trouble ensue, render the determination of rights costly, and the expenses of reorganization consume a large part of whatever corpus in the estate there may be.

As a former chairman of the Commission has stated, the Securities Act and the Securities Exchange Act are democratic statutes. They are predicated upon the investor having the ability to judge what securities should be bought and what securities should be sold. It is clear that the requirements as to registration should get to him information by which judgment can be made. That judgment, however, cannot be truly exercised unless the mode of presentation is such as to enable an investor of ordinary training to understand the facts involved. We are all agreed, I think, that there should be such a presentation. But, to be realistic, how is it possible for the ordinary man (or any other man, indeed) to adjudge a security on the basis of putative earnings in the future projected from earnings in the past, if he is called upon to calculate the effect, upon such supposititious earnings, of the permutations and combinations, including the application of leverage, springing from an intertwined relationship of divergent warrants, options, convertibilities and other mutabilities exercisable at varying price levels?

As a direct aid to simplification, the Commission is considering announcing shortly a new basic form for registration under both the Securities Act and the Securities Exchange Act, applicable to practically all issuers. Any differentiations that may be necessary are to be made as special requirements for the particular categories within the basic form. Any differentiation springing from the necessity of a different presentation of the financial data is to be obtained by placing all accounting rules and regulations in a general regulation applicable to both statutes. This accounting regulation would contain the rules as to breakdown, schedules and other such matters, and would have special requirements for insurance companies, banks, and other such categories necessitating special treatment. This one form would be used by practically all issuers having financial statements, other than newly-formed ones. In establishing these new rules a special effort has been made to improve the selectivity of the information required, to remove burdens of investigation not commensurate with the result obtained, and to get a more lucid presentation. The series of opinions above mentioned, which is to continue, will serve to indicate that, in the opinion of the Commission, legalism is not a canon to apply in building up a prospectus.

More than this cannot be done by the rules and regulations. The remaining part--and to my mind the greater part--to obtain a simple registration statement and a simple prospectus--must be done by those who are creating the securities, so that a simplicity of structure is introduced.

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