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FEDERAL SECURITIES LAWS

THEIR SUBJECT MATTER AND THEIR ADMINISTRATION

by

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I confess to a sense of humble pride in having been invited to speak at my own legal Alma Mater in place of Mr. Justice Jackson, whose illness forced the cancellation of his undertaking to address you.

When Dean Larson -- I mean, Secretary Larson -- invited me to be with you tonight he said that my remarks should be of a legal nature. Perhaps he was afraid that I would indulge in a little home-town sentimentality or, perchance, a political speech. However, sentimental as I am about Pittsburgh and loyal as I am to the Administration of our truly great President, you are going to get a legal talk. If at times - or all the time - you find it dull, please assess some portion of the blame to the Under Secretary of Labor.

I want to talk tonight about some law that didn't exist when I studied law from 1925 to 1928 and which is administered by an agency all of whose history has been made since 1934.

The Securities and Exchange Commission is possessed of broad jurisdiction over many phases of the process of the formation and administration of capital.

It is inherent in the nature of things that there must be some legal controls imposed on one man who gathers together and administers capital furnished by others. That is true of trust funds. It is true of bank deposits and in its own way it must be true of corporate capital. Corporations are artificial entities, creatures of the state. They are empowered to do only what the law says they may do. Their directors have duties both as to good faith and prudence. Their property must be handled with due regard to the rights of creditors and stockholders. These general principles are incontrovertible, but an effective system of legal controls to implement the principles involves the development of detailed rules and effective techniques.

When we look at the function of the modern corporation in gathering and administering capital, what ends do we desire? What abuses do we seek to prevent?

(1) We want to encourage investment - money in the mattress, jewelry in a vault are static wealth.

(2) We want no foolish, meaningless obstacles to the accumulation of capital.

(3) We want opportunity for initiative and imagination to develop the full economic potential of an enterprise.

But we want some other things too:

(1) The investor should know what he is getting into when he buys securities.

(2) The public owners of an enterprise are entitled to current information.

(3) Financial information should be presented to investors with reasonable completeness and in accordance with generally accepted accounting principles.

(4) The investor should have a remedy against someone who deceived him by misrepresentation or concealment.

(5) A public stockholder should have a chance to vote intelligently at corporate meetings - not blindly.

(6) The markets for securities should be free of manipulation.

(7) People with inside information should not be allowed to make use of such inside information to the disadvantage of their fellow security holders, and transactions between such persons and the corporation should be subjected to careful scrutiny.

(8) People engaged in businesses involving recommendation of investments, sale of securities, handling of other people's money and securities, should be registered and should be required to file publicly available information about themselves.

(9) Trustees for corporate bond and debenture issues should be sufficiently independent to assure conscientious performance of the duties of such a trustee and the trustee should be required to perform its obligations with prudence.

(10) In cases of reorganization of corporations in which there is a large interest of public creditors or public investors, there should be some assurance of administration by an independent trustee, a vigorous inquiry into the true financial status, and a sound, feasible, fair and equitable reorganization plan.

Those are the ends we desire. Now let me give a topical summary of the statutes which the Securities and Exchange Commission administers so that we can see how those ends are sought to be achieved in greater or less degree by the various Federal securities laws.

The Securities Act of 1933, the so-called "truth in securities law", covers requirements relating to the public offering of most types of securities by issuers and controlling persons and also contains fraud provisions relating to the sale of securities generally.

The Securities Exchange Act of 1934 covers the regulation of stock exchanges, the registration of brokers and dealers, the filing of current information by listed companies, the solicitation of proxies for meetings of shareholders of listed companies, the consequences of trading by so-called insiders, and prohibitions against the manipulation of markets. (Incidentally, that Act created the SEC.)

The Public Utility Holding Company Act of 1935 relates to the regulation of public utility holding company systems, the simplification of their capital structure, and transactions between such holding companies and their affiliates and the issues of securities by both.

The Trust Indenture Act of 1939 provides minimum requirements for trust indentures, standards for the eligibility of trustees and for the inclusion in 1933 Act registration statements of evidence of conformity with the Trust Indenture Act.

The Investment Company Act of 1940 prescribes detailed regulations for the original registration of investment companies, for the sale of investment company securities and with respect to non-arms' length transactions involving investment companies. This is the Act which regulates so-called mutual funds.

The Investment Advisers Act of 1940 provides for the registration of persons engaged in the furnishing of investment advice.

Chapter X of the Bankruptcy Act provides for Commission intervention in the case of corporate reorganizations under that Chapter. In addition, the Commission has a right in Chapter XI proceedings to intervene to the point of suggesting to the court that the proceeding should be under Chapter X because of public investor interest.

These Acts are, however, only a part of the substantive law which confronts a practitioner before our Commission. The substantive law is also embodied in rules and regulations of the Commission. For example, the Securities Act gives the Commission power to make rules and regulations granting exemption from registration to issues under $300,000; to provide by rule for informational requirements in registration statements greater or less than those specified in the Act itself; to define terms; to prescribe accounting standards.

The Securities Exchange Act of 1934 provides that a listed company may not use the mails or instrumentalities of interstate commerce to solicit proxies in contravention of rules and regulations of the Commission. It gives the Commission power to prescribe rules as to stabilization of the market in connection with securities offerings. The Commission has power by rule to prescribe exemptions from the civil liabilities for insider trading imposed by Section 16(b) of the Securities Exchange Act.

The Public Utility Holding Company Act and the Investment Company Act are studded with grants of power to adopt rules and regulations appropriate in the public interest and for the protection of investors (and consumers, in the case of the Holding Company Act).

As you can see, these rules and regulations are not in the nature of a set of directions on how to connect an automatic switch to the rails of a child's electric train. They are more than procedural. They are rules which represent an exercise by the Commission of delegated legislative power to prescribe (guided by the general standards of "public interest" and "protection of investors") positive rules of law which define criminal offenses and create civil liabilities. Under each of these Acts and rules there has grown up a body of precedents, some by decision in contested cases and some by administrative interpretation.

The rule-making power was vested in the Commission because in the opinion of the Congress the multiplicity and changing character of the problems involved in policing the capital markets are such that legislation must be phrased in general terms, leaving to the Commission as a quasi-legislature the job of filling in the details to meet changing conditions and particular types of situations.

The existence of this rule-making power, however, creates recurring problems which will never be solved to the satisfaction of all:

(a) There is danger of adding new rules to old rules, a revision here and a revision there, until a literal jungle of regulations has grown.

(b) Rule-making power imposes a duty of restraint, but it also imposes a duty to use the power to strike down abuses as they develop.

(c) There will always be room for argument as to whether or not a specific power is being under-used or abused.

Naturally that substantive law is accompanied by a not inconsiderable amount of adjective law embodied in the Administrative Procedure Act, the Commission's own rules of practice, its rules, forms and releases, and a certain number of what the sociologists call folkways but what lawyers call courthouse customs.

I go into this detail in order to indicate the nature and the sources of the law which the SEC administers. It would not be inaccurate to say that the Acts which I have enumerated, plus the rules

which have been adopted, plus the decisions and plus the interpretations, amount in the aggregate to a whole new field of jurisprudence.

This jurisprudence doesn't exist in a vacuum. It isn't an isolated legal specialty. Any lawyer who does corporate work or bankruptcy work or who numbers any brokers or securities dealers or business enterprises among his clients is bound to be confronted - whether he realizes it or not - with SEC problems. It is a little like the Federal tax laws in that respect. It's not a bad idea to ask yourself: "Is there an SEC question involved?" as soon as you have finished answering the question: "Is there a tax question involved?"

Now that we have gotten practical and begun to talk in terms of the relationship of the securities laws to the practice of a lawyer, I would like to spend a few minutes on the subject of how the Commission works in processing some of the material filed with it.

The most common practice of lawyers before the Commission concerns registration statements and offering circulars under the Securities Act of 1933 and proxy statements under the Securities Exchange Act of 1934. A registration statement is the basic document used in connection with the sale of securities which are being offered for sale to the public. The principal part of a registration statement consists of a prospectus which is distributed to each purchaser of a publicly offered security. In offerings under $300,000 (or in some cases $100,000) - which are entitled to exemption from registration - the seller is required to use an offering circular which is more simple than a registration statement or prospectus but which gives basic information concerning the security, the terms of the offering and the business of the issuer. Proxy statements are required to be circulated to security holders of companies listed on a national securities exchange in connection with any solicitation of proxies for use at meetings of security holders.

If a registration statement (or prospectus or offering circular) contains misrepresentations or half truths, the Commission under the terms of the Act and its rules may issue a stop-order or seek an injunction. In the case of a proxy statement, if proxies are solicited in violation of the Commission's rules (the statute makes solicitation in violation of SEC rules an unlawful act), the Commission

can seek an injunction against further solicitation and against the use of the unlawfully solicited proxies at the corporate meeting. If one were to look at the statute and the rules alone, it would appear that an issuer or the management files a registration statement or offering circular or proxy statement with the Commission, hoping that it is in compliance with the law but realizing that it is subject to an unappraised peril that the Commission may find it otherwise and that the Commission may take after the filer with a stop-order or an injunction. Actually, it doesn't work that way. The processing procedure set up at the Commission provides the filing party with a basis to appraise the likelihood of adversary proceedings.

In order that the Commission may intelligently determine whether to exercise its powers which I have just mentioned, it must necessarily examine each registration statement, offering circular and proxy statement. Since timing is important both in connection with offerings of securities and the solicitation of proxies, formal adversary proceedings would in many cases make the offering of securities or the timely holding of the meeting impossible. Consequently, the Commission's practice provides mechanics by which the issuer of securities or the solicitor of proxies is advised informally of deficiencies and provided with an opportunity to amend so as to avoid the likelihood of formal adversary proceedings.

This type of procedure creates problems. It has given rise to a widespread belief on the part of the public that the Securities and Exchange Commission in effect passes on the merits of securities, or vouches for the accuracy of the information in a registration statement, offering circular or proxy statement. The Securities Act provides and a prospectus or offering circular is required to state that the Commission does not pass on the merits of securities or vouch for the accuracy of statements in a prospectus or offering circular. The idea that it does do these things, however, is hard to kill off. The same kind of misunderstanding characterizes the public's view of proxy soliciting material. Not only is such a view not in accordance with the law; it is not in accordance with good sense. After all, no agency in Washington or elsewhere could have a detailed knowledge of the facts about a business. The Commission does, of course, have certain information on file which it checks in reviewing material filed with it. If such a check reveals information inconsistent with the statements made in the

material filed, such inconsistency is called to the attention of the issuer or other party filing the registration statement or proxy material.

Moreover, the Commission's staff analyzes material carefully in order to determine whether or not material is presented in a misleading manner or whether the material filed omits to state additional facts which should be stated in order to prevent the dissemination of half truths. Basically, the review of material is limited to a determination as to whether on its face the material conforms to the requirements of the law and the Commission's rules.

It is probable that this reviewing process has helped to create the impression that the Commission does approve material filed with it. It is not easy to convince people that an inquiry designed to ascertain whether a representation is true or false, complete or incomplete, or fair or misleading is not in fact an oblique expression of judgment as to merit. This is a risk inherent in the Commission's administrative processes.

The alternative to that kind of administration would be penal or injunctive proceedings, undertaken without affording opportunity to amend, hardly a pleasing prospect to a member of the business community. I think it fair to state that most people who have contact with the Commission believe that our procedure is a fair method of determining what subjects should be added or subtracted or what different methods of presentation should be used in order to avoid the penalties and liabilities imposed by the Act.

To be sure, there are criticisms from time to time that the staff's comments are picayune. There is also occasional ciriticism that some of the requests for additional information are burdensome and unreasonable. Remember, however, that we deal with a complex subject on which there can be many reasonable differences of opinion. Consequently, occasional sharp arguments are hardly to be wondered at. Let me assure you that the Commission is vigilant in trying to limit suggestions to matters of substance. Moreoever, someone dissatisfied with a comment is privileged to argue it out with the staff or the Commission and even to ignore the suggestion, taking the chance, of course, that the Commission may make an issue of the point by appropriate proceedings.

I have discussed this particular subject at length because it is an example of the extent to which an element of government by men necessarily enters into the functioning of an administrative agency. I think that the word "necessarily" is an accurate one. There is no substitute for the human element of individual judgment in administering a statute requiring disclosure of facts about a business enterprise.

There are certain fields, however, in which the Commission can modify its present and past practices so as to provide more of a government of law and less of a government by men.

The Securities Exchange Act of 1934 provides that it is unlawful to stabilize prices of securities in connection with public offerings "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 does not have any published rules governing the normal type of price stabilizing activities by underwriters. Yet stabilization has been going on for years under principles which have been developed on a case-to-case basis through conferences, telephone conversations and the like. The principles on which the Commission's Trading and Exchanges Division operates have become rather well known among experts but there is no place where a stranger to the craft can read the law on the subject. The staff has recently prepared and the Commission has carefully reviewed proposed rules on stabilization which should very soon be circulated pursuant to the provisions of the Administrative Procedure Act for public comment.

Under the Public Utility Holding Company Act of 1935 the Commission may in effect prevent an issue of securities by a public utility holding company or a subsidiary thereof if it makes certain prescribed adverse findings in connection with the financing program. The standards prescribed for such findings are phrased in relatively broad terms, such as adaptability of the security to the capital structure of the companies in the system, the adaptability of the security to the earning power of the issuer, and the like. Consequently in looking at a particular financing, the Commission must necessarily consider the protective provisions of senior securities, such as bonds and preferred stock.

Both indentures and preferred stock provisions include protective covenants which, for example, limit the issue of other securities of the same class or limit the payment of dividends on common stock. When a company files its so-called declaration or application under the Public Utility Holding Company Act in respect of an issue of bonds or preferred stock, the proposed indenture provisions or preferred stock provisions are reviewed by the staff and suggestions are frequently made for modifications. Here again it is difficult to prescribe exact standards since the financial and physical set-ups of companies vary. However, over the years, standards have been developing and have become relatively well known to lawyers and underwriters who have a constant flow of securities work. Here again, however, there is no place where the company official, his lawyer or his financial adviser can find in written form the standards which the Commission considers proper. These standards have varied from time to time and even from staff group to staff group.

About a year ago the Commission, under the chairmanship of my predecessor, Donald C. Cook, formulated a guide for staff use which at long last produced uniformity within our Division of Corporate Regulation. We are now at work on the formulation of a public statement of policy with respect to indenture provisions and preferred stock provisions so that issuers and their lawyers will be able to read what the Commission's standards are and will not be in position to plead surprise to suggestions for modifications in the protective provisions for bonds and preferred stock.

I have perhaps labored this point a little but it seems to me exceedingly important for the country as a whole that the principles on which an administrative agency operates should be publicly known and should not be a matter of folklore known only to the staff and to experts in the larger financial centers.

You may also be interested in another problem with which we are confronted, namely, the matter of quasi-judicial proceedings before the Commission. Hearings are conducted by hearing examiners and the Commission ultimately hears oral argument following written requests for findings and the submission of briefs. The records in many of our cases are much too voluminous. Unfortunately, pre-trial conferences have not been sufficiently employed.

Negotiations for stipulations have been too much on an all or nothing basis. The President's Conference on Administrative Procedures has adopted recommendations for compulsory pre-trial procedure designed to bring about stipulations, agreements on issues, identification of documents and the like. We hope to be able to put into effect practices which will substantially conform to the recommendations of the Conference. This will be a significant accomplishment in the sense that it should save time for the staff and money for the taxpayers and for the litigants.

My remarks have included some exposition, some how-to-do-it instructions, some philosophy and some expression of hope for things to come. You can see that the problems are not easy and that there is no alternative but to attack these problems one by one in a conscientious common sensical kind of way, guided by a philosophy which recognizes both the need for certainty as to what the rules are and the need for flexibility in the administrative process.

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