ADDRESS

of

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Keeping the Investor Informed

Both the Securities Act and the Securities Exchange Act command the disclosure of information about securities so that an investor may act intelligently in buying, selling and holding his securities. It would be an easy but unfair policy to adopt a single requirement for all cases, "State all material information". At the other extreme one might consider each issue of securities separately and after examination, determine the specific information to be furnished. The middle course, foreseen by the statute, is classification. Classification introduces the dilemma of precision and flexibility. On the one hand, it is necessary to be precise, to circumscribe the field of required information by appropriate limits and to require presentation in such manner as will be intelligible to the reader and comparable with information furnished by other similar registrants. On the other hand, the forms must be sufficiently flexible to be adaptable to the needs of any particular registrant.

This problem of classification arises under both Acts. Somewhat different bases result due to the difference in the timing and purpose of reports. Since adoption of recent amendments to the Exchange Act requiring annual reports as to large issuers under the Securities Act, these differences are lessened.

As a first and obvious step we have segregated those registrants as to which the desirable information is not *business* facts. Certain classes of securities present problems so basically different that special forms have been devised to meet their particular needs. Thus certificates of deposit issued by a committee, voting trust certificates and foreign governmental issues, are each given a special form. Such distinctions are obvious.

In considering the general run of issuers, the general manufacturer, the basic capital goods industry, utilities, the retail distributor, the transportation company - two bases of classifications present themselves. First, issuers may be grouped according to the kind of business done. Second, according to the age and condition of the business. About a year and a half ago the Commission, by adopting Form A-2 divided the whole field into two parts: registrants whose past record entitles them to be treated as "seasoned" whether well or badly, and those which have not yet emerged from the promotional stage. The pertinent information as to an old, established company is not the information you want about a new and untried venture. Take the property account. In the absence of earnings reports the method of acquisition and valuation are the heart and core of the new promotion. In an established company the earnings record, properly computed, is the best evidence of value and the early history of the several properties becomes of less and less significance as time passes. Only last month the Commission announced a tentative draft of a form for new mining ventures (Form A-O-1). A casual reading will indicate the difference in the information which is to be required of registrants in the promotional stage. Here there are explored in detail the method of promotion and underwriting; the identity and rewards of the promoters and underwriters and managers; the physical property on which plans for the future depend; and what those plans now are. Contrast these topics with the main heads of information in Form A-2 and you have in fine the basis for separating the issuers. It may be that another form will be necessary in this series specially adapted to obtain information as to

registrants beyond the true promotional stage, but not as yet with a continuous operating history. Or possibly one or the other of the above forms may be modified to meet such an intermediate situation.

Then there is the company which has become involved in, or has but recently emerged from, reorganization proceedings. Nearly anything may be happening or have happened. You may have had a complete overhauling of both the properties and the financial structure or merely a change in the interest rate on a large bond issue. Particular questions must be directed to the details of the plan of reorganization. Under the Securities Act these questions should be designed to elicit information of aid to an investor in determining whether he should vote for the proposed plan and accept the proposed exchange of securities. Again, a nice distinction must be made between cases where the pre-reorganization history is pertinent and where it is not. Take the financial statements. Should the statements prior to the troublous times be required. If so, should changes being effected by the reorganization be noted upon their face. These features will compel the use of special forms for such registrants and assume particular significance under the Exchange Act where annual reports are being filed all through the critical period.

Classifications based on the kind of business done present the more difficult and intriguing problem of classifying *business* enterprises. One of the earliest steps taken was to separate corporations from unincorporated issuers. While this on its face seems valid, at least to a lawyer, our experience has been that with the exception of one or two problems of management and liability the distinction is without meaning. Accordingly, it may be expected that in time the distinction will be abolished or reduced to a question or two added to the forms for corporations.

The business of certain classes of issuers is clearly outside of the current of general business enterprise - the railroads with their annual reports to the I. C. C., the insurance companies with their reports to state insurance commissions, the banks, the investment trusts. Each of these issuers has been given a separate form under the Exchange Act. In the case of a railroad, the form is in principal a condensation of the report to the I. C. C. with some added information.

The specialized investment trust form gives major attention to the two questions of portfolio content and management. Clearly these are the significant features to be dealt with both in the form and in the financial statements. Accordingly, there are special questions in the form as to limitations on the kind of security which may be acquired and in the financial data there are detailed schedules showing the present content and the changes in the portfolio, and much more specific information is required as to book value, market value and cost. Contrary to the practice in the general forms, the balances in the several accounts at the beginning of the period of report may not be "as per books", since the great majority of investment trusts are of recent origin. Therefore, an audit from the beginning is practicable.

The insurance form has special questions concerning the nature of the insurance business done, the effect of policy dividends and the affiliations of the officers and directors. The financial instructions are entirely different, and the usual insurance practices are given special consideration. Such particularization clearly is not possible without the use of special forms.

The larger problem which lies immediately ahead is to obtain adequate information as to the general run of issuers; the utility, the basic manufacturing industry, the retail distributor, the extractive industry and so on. I say "adequate" advisedly since the word has a plethora of meaning and its fullness covers all of the distinctions which must be made between issuers in order that the meat of each investment problem may be presented in succinct and intelligible form.

At present all of the above would register to sell securities on Form A-2, or to exchange their securities on Form E-1, or to list their securities on Form 10. Yet the significant business information is quite different; and the financial statements are cast in different molds.

Much constructive work remains to be done in molding the financial requirements to particular situations. Since certified financial statements are required at most for a period of three years there is the problem of how much, if any, information should be obtained for the period prior to that covered by the financial statements filed. At present this has been solved by an item in the form, not necessarily certified by independent accountants, which picks out of the past ten to fifteen years such significant features as write-ups, write-downs, revaluations of capital stock, and write-offs of bond discount. While this division of financial information is in general applicable, yet if the business is recently formed, certification for the entire period is not impracticable and where there is a universal predecessor, inquiry into its accounts is desirable. In the case of particular types of business, say the utilities, much more specific information as to past managerial policy with respect to write-ups, maintenance and depreciation should be asked.

As to the financial statements themselves, a start has been made toward specialization with investment trusts and insurance companies under the Exchange Act. There you will find special schedules designed to detail the portfolio of investments and to show clearly the changes in content. In the income statement you will find a clear segregation of dividend and interest income from profits and losses on the sale of securities. Such specialization is patently necessary. In the case of utilities the significant problem of the property accounts and the related depreciation, or retirement reserves must be given special consideration. A different handling of the earnings statements of manufacturers from those of the merchandisers likewise suggests itself. The extractive industries, particularly as to companies in the promotional stage, call for special treatment of the problem of valuation. Thus, in the tentative draft of the form for new mining enterprises which was recently sent out for expert criticism, the suggestion was made that property should be valued at not more than the cash cost to the promoters, or if held for a considerable period, at not more than the present fair value.

Examples such as these multiply rapidly as one tackles the problem of getting needed information before the investor. In calling for more and specific data there must always be kept in mind that placing unduly severe burdens on the issuer and invading those areas of privacy which are essential to competitive enterprise cannot be considered in the long run as helpful to the investing public.

A related problem to that of specializing the forms is the question not of obtaining essential data but of bringing it home to the average buyer or seller. In part, this is a question again of presentation in the registration statement. Under the Securities Act, however, there is the further problem of the prospectus. Valuable as may be the contents of the filed statement, it is idle to expect that such statements will be freely or profitably consulted except by the great statistical services, the large distributor, the investment counsel, the exceptional private investor.

The present prospectus has also assumed such length that the small investor will frequently be unable to spare the time necessary for its adequate study, and in many cases he is not equipped to analyze the complex data given. There is present need of such a summary or selection of information included in the registration statement as will clearly reveal striking features of the particular issue and the particular issuer. It might be that with further experience the present prospectus rules could be modified so that a radically smaller document would be delivered in connection with the offering to a prospective investor, and supplemented if the investor requests, by a prospectus in the present longer form.

It must be remembered that while the Commission has the power to issue stop orders preventing or suspending, a deficient registration statement from being effective, yet its chief function is to be an office of registry. Good or bad, information must be placed on file. It is the registrant's duty to furnish required information. The sanctions of the Securities Act penalize both omission and misstatement. It is to be hoped that as registrants become more accustomed to the procedure of filing and to the requirements of the several forms that the Commission will be able to devote more and more of its time and efforts to the problem of what "adequate information" is with respect to various businesses. Specialization in forms for registration will, in the long run, be of more value to investors, as well as registrants, than too detailed and meticulous review of individual statements for the purpose of uncovering deficiencies.

In connection with devising of adequate forms we are constantly faced with the risk that we shall make them so onerous as to result in prohibitive costs. We have had some experience with this matter of cost and I want at this time to discuss certain aspects of it with you. Cost of registration under the Securities Act is a sort of bogey man. The legend still persists that cost of registration under the Securities Act is interfering with the revival of the capital market. The most fantastic stories - and I choose the word deliberately - have been circulated on this account. Let us look at the record. As you know, every registrant includes in the registration statement an estimate of the expenses it expects to incur in connection with the registration. Although we know from various check-ups that registrants tend to over-estimate these expenses, nevertheless we will take the figures supplied in the registration statements at their face value.

We then get the following picture for 305 registration statements effective during the year 1935 which may be regarded as representative for all registration statements filed by seasoned issuers. "Commissions and discounts" paid to underwriters for distribution of the issues averaged 3.3% of total gross proceeds, i. e., the amount paid by investors for the securities. Thus if investors paid par for a $10,000,000 issue, the underwriters' fees would average $330,000. "Other expenses" connected with the issue which include stamp taxes, trustees' charges, listing fees, printing and engraving

expenses, legal fees, accounting fees and appraisal fees, as well as those expenses which are directly connected with registration under the Securities Act, amounted to 0.7% of gross proceeds. Thus if investors paid par for a $10,000,000 issue, these other expenses would average $70,000. "Commission and discounts," therefore, are almost five times as large as "other expenses" and any change in the average rate of commission and discount is five times more important than a proportionate change in "other expenses." It is very difficult to ascertain accurately which part of these "other expenses" is a result of the necessity of registration under the Securities Act of 1933. Of course, there are certain expenses like stamp taxes, trustees' charges, costs of printing and engraving and cost of listing which are not affected at all by the Securities Act. From a smaller sample of registration statements it is estimated that more than one-half of all "other expenses" is made up of the foregoing type of expense and has no relation to our Federal securities legislation. This leaves approximately 0.3%, representing legal, accounting, engineering and similar expenses. It is obvious, however, that only a very small part of the 0.3% represents an increase due to the Act, inasmuch as legal, accounting and engineering expenses were necessary at any time.

If we think a bit further, any increase in cost due to the Act is far from being a net expense from the point of view of our national economy. For one thing, in return for any additional expense, institutional and private investors now have at their disposition, material much more abundant and much more reliable on the basis of which to judge the merits of the securities offered to them. It is obvious that the necessities of disclosure under the Securities Act of 1933, as well as the power of the Commission to issue stop-orders, will prevent, and have prevented, the offering and the sale of certain questionable securities. It can hardly be doubted that the money saved investors is considerably in excess of any additional expenses due to the Securities Act.

The availability of the material required in the registration statements provides bankers and underwriters with a much better basis of judgment and the fact of registration may tend to reduce the sales resistance of customers. Today, the price charged by bankers for their services in the distribution of securities (the so-called underwriting spread or commission) is considerably lower than it was before 1929. Part of this decline is, of course, due to the decline in the level of interest rates and to the fact that the present market for new securities is a sellers' market. Whether or not some of this reduction is also due to the Securities Act, we cannot prove or disprove with incontrovertible statistics. Nevertheless, I am convinced, from all the material which we have accumulated in the Commission, that the Securities Act of 1933 has contributed to the reduction of underwriting spreads. Moreover, since even a small reduction in the average spread, say 1/4 of 1%, would completely wipe out all of the expenses of registration, I feel that the Act has probably brought about a shrinkage in underwriting spreads sufficient to cover any increased expenses of registration.

It is true that possible additional expense attributable to the Securities Act is greater as respects the small issues. "Other expenses," which average 0.7% of gross proceeds for all of the 305 registration statements on which my figures are based, average 1.7% for statements of issues under $1,000,000. But the amount attributable to the Securities Act would still be very small. In some individual cases, it is true, the

proportion may be high, but that is usually because the registrant hitherto has had its accounts and books not in the shape we should expect from anybody who asks investors not acquainted with its record to entrust it with their own money. If the additional expenses of registration are relatively higher for small issues, the indirect benefits - i.e., the reduced underwriting spread - surely are greater. It may be that in the long run it is the small issue which will benefit most from the Securities Act of 1933, because the total cost of distribution - i.e., underwriters' "commission and discount" plus "other expenses" will be materially lower in the years to come than they were in the 20's.

So far, I have drawn my own conclusions from our own statistics; but let me read you the conclusions which Professor Waterman, of the University of Michigan, reached after a thorough investigation of the issues of stocks and bonds of electric utilities registered under the Securities Act:

"..... the writer is satisfied by evidence ..... that registration expenses are not excessively burdensome in connection with large or even moderately sized issues and that expense is seldom a valid excuse for failure to register under the Securities Act as now administered." And further, "It is quite evident that differential registration costs" (i.e., costs not encountered before the Securities Act) "comprise only about 30% of the total expenses of issuing securities and corporate complaints about such amounts seem nonsensical and unjustified ..... It will doubtless continue to be true that the small company will find its registration costs proportionately high - and so they probably were before the passage of the Securities Act of 1933 - and that may be unfortunate, but surely the explicit costs are nothing that can not be readily borne by typical public utility companies," and, finally, "Although we do not yet have a definite answer in fact to the interesting question of whether financial operations under the Securities Act, with its attendant requirements for publicity and rules of conduct will effect material and permanent reductions in underwriting fees, there is legitimate reason for hope. Investment bankers should receive compensation in amounts representing the value of the important functions performed by them, and 1935's low margins may be an indication that competition, publicity and standardization of distribution methods will combine to prevent undue contributions to either the inefficient or the unscrupulous members of the banking fraternity."

But from the view point of the national economy cost cannot properly be considered as an isolated matter. The cost is excessive or fair, judged in the light of the benefits received. If registration requirements were relaxed, so as to make cost nominal, the chances are that we would be back to the easy-going days when truth about securities was more of a myth than a reality. It cannot be denied that the telling of the truth about securities costs money. But insofar as it makes for more discriminating purchases, and deters or prevents the sale of fraudulent or synthetic securities, there is a net gain from the view point of the national economy. This is commonly overlooked or disregarded. Thus, an official of a large investment firm was recently heard to find fault with the stringent regulations embodied in the Securities Act and the rules promulgated by the Commission thereunder, and to complain of the time and expense involved in complying therewith as compared to the old days when Federal regulation was non-existent.

This gentleman had probably never stopped to consider to what extent the present flourishing condition of his business might be due to the fact that his firm no longer has to compete, as it did in the past, with distributors of securities which, if not actually fraudulent, were at least sold on the basis of inadequate, misleading or inaccurate information.

It might have been pointed out to him that between July 7, 1933, the date on which the Securities Act of 1933 became effective, and March 31, 1936, 2,075 registration statements were filed with the Commission, and that approximately 400 of these statements, with respect to issues of securities, an aggregate face amount of over four hundred million dollars, never became effective, for one reason or another.

In this connection, the Commission has, since the summer of 1933, down to June 30, 1936 issued 107 stop orders, involving 62 million dollars of securities. Of these 30 were lifted, involving 19 million dollars, after the registrant had satisfied the requirements of full and complete disclosure. The balance were never lifted, thus placing a barrier to the distribution of 43 millions of dollars of securities, through the use of the mails or other agencies of interstate commerce. Hence insistence on stringent registration requirements cannot be lightly dismissed. The cost may well be small, compared with the net benefits.

Among the benefits which I have mentioned are the increased protection to investors from fraudulent securities and the advantages accruing to security brokers and dealers as a result of progressively greater public confidence in the security markets. But these are by no means all of the benefits flowing from the registration requirements of these statutes. Recently a principal executive officer was in our offices in connection with a new $10,000,000 offering which his company proposed to make. There was much contention on his part that our registration requirements were too severe, and that we should relax them in case of his company in view of its long history of conservatism and respectability, and in view of the additional cost to it, if the particular accounting information had to be furnished. We were, however, adamant and a few weeks later he returned with the required information. And he related a not uncommon story. He said that as a result of our accounting requirements the cost of this financing had been increased by $10,000 or $15,000. But, he added that it was worth many times that amount for him and his directors to discover some things about the company which the investigation made necessary by our requirements had revealed and which prior to that time they had never known.

It is true, however, that this Commission is not satisfied that it has carried its registration requirements to the point of perfection. Quite the contrary, it believes that it has merely made a substantial beginning. Further evolutionary development, based on constant study and experience, doubtless will lead to more discriminating requirements. -

The objective is the development of a large variety of forms for registration, nicely adjusted, not only to the age and degree of seasoning of the particular registrant, but also to the type of business involved: By this method, a larger degree of truth about securities can be obtained, further simplicity may be realized, and costs may be reduced. But in such a program, reduction of costs must always be a secondary, rather than a primary, objective.