

THE LISTED AND UNLISTED SECURITIES MARKETS

Address of

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I am very happy to be here this evening to talk with you briefly about some matters which deeply concern us both. Last year my friend and associate, Commissioner Sargent, described to you some of the rule changes proposed by the Securities and Exchange Commission. He is here again with me tonight, and I am sure will be glad to make his knowledge available to any of you who may wish to discuss your problems with him. Those of you who do not already know Ray Garrett, our Associate Executive Director, who is also here with me, should meet him and get to know him. He is the former Director of the Division of Corporate Regulation, and is an expert in practically any field of our statutes.

During 1957, two of the amendments to the rules mentioned by Commissioner Sargent were adopted by the Commission. The note to Rule 460, which codified existing administrative practices governing acceleration of the effective date of a registration statement, seems to have resulted in clearing the air for everyone. The other rule he mentioned and which was adopted, is Rule 434A. As you know, this rule permits the use of a summary prospectus. Commissioner Sargent then referred to this rule as being "on trial". After more than a year's

trial, this provision seems to be clearly feasible and is doubtless now a permanent part of our procedures. The proposed revision of Rule 133 to which he also alluded was, so to speak, referred back to committee for further study and consideration, and no further action has as yet been officially indicated.

I think, before I expand upon today's topic, I should remind you of some few axioms that those who deal with the Securities and Exchange Commission on a day-to-day basis are sometimes inclined to forget. The first and most basic concept is that the rule making power of the Securities and Exchange Commission is not without its limits. The Commission may legislate by adoption of rules only within the scope of the rule making power entrusted to it by the Congress. It may not add to the statutes by rule, although it may implement them within their respective frameworks. The remedy in case of an inadequate statutory delegation of power is not through the adoption of rules, but by amendment of the statute.

Except for matters of internal management and certain other matters here immaterial, the Administrative Procedure Act requires publication of notice of rule making and an opportunity for submission of views by interested persons. In addition, the Commission as a matter of practice, very often directs individual notices to persons

such as yourselves who have previously indicated an interest in such matters or who we may feel will be so interested. The corporate secretaries have invariably been quick to file with the Commission their comments on such proposed rules. Since you must work with many of these rules as part of your daily responsibilities, you are uniquely qualified to predict the effect of any proposed revision. We are appreciative of this assistance, and your opinion is given great weight when we come to determine whether a particular proposal is in the public interest.

I might add, too, that it is not necessary for you to limit yourselves to commenting upon Commission suggestions. As you know, the rules, regulations and forms of the Commission are continuously under study. Members of the staff scrutinize each rule or regulation from time to time and reassess it in the light of changing patterns of securities distribution. In the very nature of things, however, men who are applying the existing rules to concrete situations in the course of their daily work can give us the benefit of a practical experience available from no other source. We would like to feel that you are participants with us in this process of review and revision, and that you will freely forward to us any critical comment which experience may dictate.

Rule changes are extremely important. But, as I have said, they must be based in each instance upon the legislative policy embodied in the statutes. Accordingly, any change in the basic legislation is of special importance to us and we must follow very closely the course of all such proposals.

At this point, I would ask you to stop and cast an eye over some not too remote history. Those of you who are even a little younger than I were spared the agony of trying to deal with the unfettered markets of pre-S.E.C. days. The gigantic losses resulting from the 1929 debacle cruelly exposed the sham, the pretense, the downright fraud on the basis of which many of those securities had been issued and sold. The inevitable result was a public loss of confidence in the capital markets and in the value of all corporate securities. This was by no means the sole cause nor even the major cause of the economic doldrums of the 1930's, but I think it is generally conceded to have been an important contributing element.

With the establishment of the S.E.C., with the gradual acceptance of its philosophy and the far-seeing policies in its administration laid down by my able and illustrious predecessors and their colleagues and staff, came a gradual reappraisal, a reacceptance by the public of the functions of corporate finance and the place of the securities

market. I do not think I exaggerate when I say that the willingness of the American people again to participate in private corporate investment was based in large part on the feeling of security engendered by this legislation. The results, you know. The number of new issues of corporate securities and the dollar amount thereof during 1957 were at an all-time high, and the number of individual holders of such paper has increased by leaps and bounds.

But the salutary provisions of the 1934 Act which have contributed to informed stockholders and a more intelligent corporate electorate were, by their terms, applicable only to listed securities or to certain corporations which had floated issues under the 1933 Act. Such companies represent a relatively small fraction of all business corporations, and do not include many concerns substantially larger than many whose practices are so regulated. Yet, as is perfectly natural, the confidence reestablished by the disclosure provisions of the Securities Acts was extended to all corporate securities. An interesting collateral conjecture relates to the possible relationship between this phenomenon and the increasing investor gullibility apparently reflected in the renewed success of the "boiler room" technique.

From the point of view of these problems, one of the most

significant proposed additions to the Securities Acts is that contained in a pending bill known officially as S. 1168, and more generally as the Fulbright Bill. This bill in its present form would impose, upon every unlisted company having \$10,000,000 of assets and over 1,000 stockholders, approximately the same disclosure requirements as are now imposed upon a company listed on a national securities exchange. It has been reported out of committee and is currently awaiting action in the Senate.

This proposal is not a new idea. When the Securities Exchange Act was enacted in 1934, the Congress recognized the need for some statutory provision in this area, but left the question open. At that time, the over-the-counter market was one of the mysteries of our financial system. Authentic data was lacking with respect to its nature, its function, its size, and the technique of its operation. Congress thought to solve the problem by authorizing the Commission to adopt rules and regulations "to insure to investors protection comparable to that provided by" the detailed safeguards enacted for investors in securities traded on the exchanges, but this was to be done by Commission regulation of brokers and dealers. As early as 1936, however, it was recognized by the Commission and the Congress that it was impracticable to establish requirements for issuers by the indirect means

of imposing sanctions on brokers and dealers, and the search was on for some other method.

Shortly after the end of World War II, the Commission submitted to Congress a report which it called a "Proposal to Safeguard Investors in Unregistered Securities." This report gave instances in which harm to investors had resulted from the failure of the Securities Exchange Act to apply its key provisions to unlisted securities. The report compared the policies as to financial reporting followed by registered companies with those followed by unregistered companies, and their respective proxy soliciting practices. It called attention to instances where insiders were able to traffic in securities of their companies at the expense of the public for lack of controls over insider trading of unlisted securities. The remedy for these abuses, the Commission said, was legislation which would apply to the unlisted market the same protections for investors as existed in the listed market. However, a bill based upon the Commission's recommendations was introduced too late in the session for any action to be taken upon it.

In 1950, the Commission revived the proposal by sending to Congress a "supplemental report" to the "Proposal to Safeguard

Investors in Unregistered Securities." This report examined data relating to a new group of unregistered companies and came to the conclusion that the problems which the proposal had been designed to meet not only remained unsolved, but had even been accentuated by economic developments. Various bills incorporating the Commission's suggestions were introduced in both the House and the Senate. But then came the Korean war and Senator Frear, the sponsor of the Senate bill, issued a statement explaining that the urgent need for legislation dealing with the war had forced the Banking and Currency Committee to defer consideration.

In 1955, this Committee held a series of hearings devoted to a study of the stock market. The majority report of the Committee stated: ". . . that as a general policy, it is in the public interest that companies whose stocks are traded over the counter be required to comply with the same statutory provisions and the same rules and regulations as companies whose stocks are listed on national securities exchanges." A predecessor to the now pending Fulbright Bill was then introduced.

The bill followed the same general lines as the prior suggestions for legislation dealing with this problem, and the Commission again reported to Congress that it found serious abuses in the unlisted market

which would indicate the desirability of extending to those securities the same controls as were exercised over those in the listed market. Both the report of the Commission and the testimony of the then Chairman of the Commission, Mr. Armstrong, indicated support for the general principles of the bill. Again, it was found that the time was too short to permit any final action to be taken upon the bill before Congress adjourned.

This legislation was reintroduced by Senator Fulbright in the first session of the 85th Congress, and since the matter had been fully explored, further hearings were omitted. If enacted, it will represent the first major addition in twenty years to the protections afforded investors under the Securities Exchange Act. In its present form it extends the disclosure philosophy of the Act to these securities in three major respects.

First, it would make available to the holders of such securities the same financial information that is now received by investors in listed securities by making the registration and periodic reporting requirements of the Securities Exchange Act applicable to all corporations covered by the bill. This is a perfectly natural extension of the law. There is no reason why two corporations in the same industry, of the same size and with approximately the same public interest in

terms of number of stockholders should not make public the same financial information. Yet today, if one of those corporations is listed and the other is not, the former is compelled to file the complete financial reports which you know as Forms 8-K, 9-K and 10-K, while the other may shroud its entire financial operations in a cloak of secrecy. Not only must the listed company disclose such information as might have a bearing upon the value of the security as an investment, but also it must have the financial statements contained in those reports certified by an independent accountant. The unlisted company, however, in publishing financial reports, is not required to follow these standards and is not required to publish certified financial statements. Investors in unlisted securities receive no more information than the company is willing to give them. A series of surveys made in 1946, 1950 and 1956 of the annual reports of sample groups of the unlisted companies indicated that they were often seriously inadequate and sometimes misleading.

The second major area in which this bill is designed to operate involves the proxy soliciting practices of unregistered companies. I know that all of you are more or less familiar with Regulation X-14. We have been through a number of well publicized proxy battles in the past few years and we find that this regulation is workable and

serves its purpose. There have been some rough spots which the Commission has tried to smooth out as they become evident. Some day, I hope to be able to say that this difficult area is completely in hand. There is no doubt in the mind of any sophisticated observer that some form of supervision over these activities is a sine qua non to an informed corporate electorate and fair practices in solicitations. Yet, in spite of this rather axiomatic observation, there are a great many companies having a large public ownership in which the nature of the information supplied security holders in connection with solicitation of proxies is in the uncontrolled discretion of the management. These are the companies whose stocks are sold on the over-the-counter market and who do not come under any of the statutes requiring proxy materials to be filed with the Commission. Our studies show that some of these corporations in their proxy soliciting material fail to disclose the names or affiliations of the nominees for directors. In some instances, the proxy material does not even name the current officers and directors. The owners of many of these companies are asked to approve so-called independent auditors, whose name is not mentioned. Oftentimes, the stockholders are asked to ratify all acts of management since the preceding meeting and they are given no indication of what management has done. And in one instance, the proxy

was written on the back of a dividend check, with the result that the stockholder gave management his proxy when he indorsed it.

It is often stated that the American corporations are developing a conscience in their dealings with their stockholders. Our informed, if somewhat cynical conclusion is that this conscience is likely to flourish far more readily under the publicity requirements of the Securities Acts than when nurtured only by the cold winds of management's untrammelled self-interest.

The third major area to which the proposed bill extends the existing law involves trading by corporate officers, directors and large stockholders in equity securities of their own companies. The Congressional investigations which led up to the enactment of present laws disclosed unconscionable abuses in this field. Officers and directors participated in "pools", sold their companies' securities short, and otherwise traded in the market upon the basis of inside information, and even manipulated the declaration or passing of dividends and the release or withholding of corporate information with an eye to reaping profits at the expense of stockholders for whom they were fiduciaries. While such activities conflict with basic morals, dealing with them by legislation and regulation presents difficult

problems. The solution adopted by the Congress in 1934 for listed companies was three fold: First, such officers and directors are required to publicly disclose all of their transactions in equity securities of their companies; secondly, profits realized by them from so-called "short swing" transactions in their company's securities inure automatically to the company, it being deemed impractical to enforce a standard based upon proof of knowledge and motives concerning inside information; and thirdly, to ameliorate the occasional harshness of this automatic standard, the Commission is given power by rules and regulations to exempt transactions which it finds are "not comprehended within the purpose" of the automatic forfeiture. In addition, short sales by such persons are prohibited.

This statutory scheme has on occasion posed difficult problems, both for the courts in identifying transactions which fall within the statutory prescription, and particularly for the Commission in the exercise of the rule-making power granted. There are, for example, intricate technical problems in defining the extent of the statute's application to various forms of indirect or incomplete ownership, such as those involving trustees, beneficiaries, wives, children and partners, general and limited. Similarly, in the exercise of the Commission's exemptive power, we have had to wrestle over the years with close

questions of judgment in identifying and defining transactions falling within the extremely general standard of "not comprehended within the purpose" in a way which will carry out the Congressional objective of permitting legitimate and harmless transactions without opening loopholes through which the statute may be evaded. This has proved a particularly difficult task in the case of the various plans involving the use of equity securities for the purpose of executive compensation, or for stimulating incentive, such as stock option plans, bonus plans, retirement plans, savings plans, and others. These plans have assumed increasing importance in view of present tax rates and the favorable treatment given them under the Revenue laws. Recently our conclusions with respect to stock option plans were questioned by the Court of Appeals for the Second Circuit in Greene v. Deitz, where the Court intimated that plans exempted by our rule might, under some circumstances, be used as a vehicle for the abuse of inside information and that consequently the rule appeared to be beyond our statutory power. Although the situation may be clarified in other pending cases, we are necessarily re-examining and re-evaluating the rule in the light of its present operation and the comments of the Court.

Notwithstanding these and other technical problems, the existing statute has been generally successful in accomplishing its major purposes

of preventing short term speculation by insiders at the expense of those for whom they are fiduciaries, and the question consequently arises as to why security holders of unlisted corporations should be denied a similar protection against such misuses of trust.

On the other hand, given the manner in which the over-the-counter market functions, considerable apprehension has been expressed for fear the automatic forfeiture of profits from short swing transactions by so-called "insiders" might disrupt the operation of that market and thereby deprive security holders of an orderly and liquid market for their securities. Particularly troublesome is the problem of so-called "sponsorship" by brokers and dealers who maintain the market in unlisted securities and who may feel called upon to assume a place upon the board of a company in order to represent investors to whom they have sold the company's securities, and the fact that officers, directors and large stockholders may indirectly perform in the over-the-counter market a function somewhat similar to that of a specialist on an exchange by providing an outlet which can either absorb or supply shares where this is necessary to maintain a continuous and orderly market.

In its report to the Congress the Commission has accordingly

recommended that the bill make applicable to officers and directors of corporations to which it applies the disclosure requirements of Section 16(a) and that the application of Section 16(b) dealing with short-term profits be deferred pending a Commission study of the problems presented by its operation in the over-the-counter market. Reports under 16(a) would in the meantime not only operate as a powerful deterrent to improper practices but would also make available for the first time the essential data upon which the Commission's study could be based.

I would hasten to add that this recommendation in no way means we have made up our minds as to the ultimate desirability or undesirability of applying Section 16(b) but only that this problem merits further study, in the light of the information which enactment of the bill would make available, in order that whatever decision is reached may be informed and reasonable.

The Fulbright Bill differs from the others I have referred to most significantly, perhaps, in the standards used to determine the issuers to be subject to the new legislation. In 1946 and again in 1950, the Commission recommended that all corporations be included which had more than \$3,000,000 in assets and at least either 300 stockholders or \$1,000,000 in outstanding indebtedness. The descriptive limits of legislation of this nature must necessarily be more or less arbitrary.

The aim of the legislation should be to identify in a reasonable way, those corporations in which there is a significant investor interest and which can reasonably be asked to assume the obligations of a substantial publicly owned enterprise. The asset test was suggested in order to eliminate small businesses, and the number of security holders and the public indebtedness test was proposed as a gauge of the extent of the public investment. There is no magic in three million and three hundred, or five million and five hundred, or ten million and one thousand, or fifty million and five thousand. Obviously, the higher the dollar amount of assets stated and the number of stockholders, the fewer the number of issuers that would be subject to the bill. As it now stands, the bill entirely omits the public indebtedness test and is made applicable only to corporations with more than \$10,000,000 in assets and 1,000 stockholders of record. Whether this represents a fair dividing line between substantial publicly held corporations and those which are not, is a matter of judgment. The practical effect of the presently proposed standard on the other hand, can be readily estimated.

The number of issues and the market value of stocks traded in over-the-counter have increased each year. In 1935, there were about 1,800 stocks quoted daily in a prominent over-the-counter

quotation service. Today, the same publication quotes prices on over 6,000 equity securities. In whatever form it may eventually be enacted, the bill will cover only a small fraction of these companies. It is estimated that there are 633 corporations in the United States having both more than \$10,000,000 in assets and 1,000 stockholders which are not now listed, and which would be subject to the bill as presently drafted. Of these, 380 already file periodic financial reports with the SEC pursuant to other provisions of the Securities Exchange Act. That means that 253 corporations would have new obligations to file financial reports if the bill was passed. All 633 companies would be subject for the first time to the proxy soliciting and insider trading provisions of the Securities Exchange Act and the appropriate rules. As might be expected, a large number of companies which would be affected by the bill are located here in New York. Of the 633 corporations, 72 have their main office in this city. Of these, 43 do not at present file financial statements with the Commission. Some of these companies are among the largest in America. They constitute a group of companies with almost a billion dollars of assets and many thousands of stockholders.

If time and experience show that some other measure of coverage would be preferable, the change can easily be made, once

the principle is legislatively established that public interest in these basic corporate policies does not depend upon the accident of listing on a stock exchange. Our economy is firmly based upon the concept that risk capital is necessary in order to initiate and expand business ventures. The number of Americans who own corporate securities and who have thus become partners, in a very real sense, in our industrial, utility and other enterprises, both large and small, has, as I have pointed out, increased enormously, and probably has reached over 10,000,000. Any influence which tends to interfere with this process must be discouraged. It seems to me that management has been short-sighted when it has failed voluntarily to adopt the fundamental policies of the Securities Exchange Act as a matter of sound business judgment. Since our studies show that most unlisted corporations have not, I believe legislation to compel such policies at least for the larger and more widely held companies is greatly in the public interest. I believe further that the corporations affected will come to see that these policies are to their own best interests as well. It is only through furnishing the investing public with full, frank and accurate information about its business that corporate management can gain the confidence of investors and attract the risk capital which is so essential to our economy.

One other aspect of the Fulbright Bill and the proposition it embodies has recently come to my attention. Our staff, among many other honors, has had offered to three of its top men an opportunity to study in Europe under the auspices of the Rockefeller Foundation. Some of the comments which these men have made on their return are very enlightening to us who have become inured to our Securities Acts. Corporate management in many areas of Europe simply has no conception of the fair disclosure policies embodied in this legislation. The directors consider that the stockholders who, to be sure, are not nearly so numerous as in this country, are not entitled to even the most elementary reports as to corporate finance and affairs.

In addition, European laws and practices with respect to accounting standards, corporate elections, management organization and compensation, and other matters are naturally very different from ours. These conditions, I may say, have caused us some concern from time to time when international corporations have sought to enter our capital markets either for new money or for exchange listing. It does not increase international good will for us to attempt to say that foreign corporations must do everything exactly our way, even though we are satisfied that our way is the best way. Some accommodation to foreign ways and foreign standards

seems necessary in our increasingly interdependent world, but essential standards of investor protection must still be insisted upon. I trust that none of you will feel that occasional minor concessions to foreign ways of doing things and to the problems these corporations encounter at home constitute unfair discrimination against domestic corporations.

I might also suggest that there is some lack of candor when we cry "holier than thou" to foreign corporations while maintaining a distinction as to these matters in our own laws based solely upon whether the corporate security happens to be listed on one of our national security exchanges.

In conclusion, let me remind you of the outstanding role which public financing has played in the recent growth of our economy. Capital expenditures for new plant and equipment in all types of business rose from \$28 billion seven hundred million in 1955 to \$37 billion in 1957, as contrasted with an average of \$19 billion during the years immediately following World War II. Something over one-fourth of this has been financed by the public sale of securities for cash. The fact that public investors have been willing to come forward with this kind of money for industrial expansion is a great tribute to our free economic system. It is

more than a tribute, of course, because it is absolutely essential that such new capital be available if our free institutions are going to meet the unprecedented demands which our country faces.

We all know that many factors contribute to making our system work, but I also know you will agree that one essential factor is the individual investor's confidence in his being adequately informed and fairly treated. The ability of industry to grow and prosper depends upon its ability to obtain capital. Access to capital, in turn, is dependent to a large extent upon the confidence which the investing public has in securities as a safe and profitable future investment of their savings. This confidence is in large measure a function of the extent to which all relevant corporate financial and related information is disclosed to investors. We feel that it is our job to extend and preserve this confidence, and we believe the pending legislation will go far toward improving our effectiveness. With or without the Fulbright Bill, however, we solicit your cooperation and support in achieving capital markets and corporate processes which are open and fair to the general benefit of us all.