"The Joint Responsibility of the Federal and State Commissions in the Prevention of Securities Fraud"

ADDRESS

of

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before the

NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS

Dallas, Texas

Tuesday, October 8, 1940, 2:30 P.M., C.S.T.

When your president, Kirk Gunby, asked me to be one of the speakers on your convention program, he said that he wanted me to give the Association something of a constructive nature; something that would improve the relations between the state and federal authorities; something that would give you State Commissioners some tangible suggestions to think about, take home with you, and put into effect long after this meeting has become history.

I could talk for hours about how we should cooperate with you and you cooperate with us; this has been said in varying forms many times before, and I suppose that it cannot be too often repeated, but without some concrete suggestions it means so very little. Furthermore, it seems to me that cooperation is such a comfortable word, we fall into the habit of using it without quite realizing what it stands for. We are not going to the root of the matter. That which is behind all of this cooperation is that we are charged with joint responsibility in policing the securities markets, and that in this activity we each serve a necessary and complementary purpose. Now that there is a strong Federal Commission, many State authorities are too prone to feel that their responsibility has been somehow lessened and that they can relax their vigilance.

Again, I feel there are cases where our Commission has not been called upon to supplement the state function to the fullest possible extent. Even where the state enforcement has been vigorous, the state action could have been made more effective if the more sweeping exercise of the federal function had carried it forward into other localities to which the perpetrators of the fraud had fled. Quite often violators in a particular area are part of a larger scheme spreading into many localities. A state agency, unable to cross state lines, either in its search for information or in effecting its control, is powerless to cope with such a situation. Only the Federal government, with its power to control the mails and the facilities of interstate commerce, can deal with it.

I have therefore decided to address you on the joint responsibility of the Federal and State Commissions in the prevention of securities frauds. In addition to the reasons already given I feel it is an appropriate subject, because it is the keynote to which the Federal Securities Act is attuned, and because it is the motif to which those charged with the enforcement of the Act should cling in its administration.

Let me review with you briefly the situation with regard to state control which existed just prior to the enactment of the Securities Act of 1933. Commencing with the Kansas blue-sky law in 1911, all of the states but one had enacted some form of securities legislation. Congress had not seen fit to exercise such control in the Territories or the District of Columbia, or to regulate the sale of securities in interstate commerce. The use of the mails to perpetrate frauds had long been outlawed, but the mail fraud statute did not emphasize securities frauds, nor was any agency specifically charged with their prevention.

The statutes which the forty-seven legislatures had enacted approached the problem of regulation from different angles, and set up varied means of control.

The state legislation fell into three general patterns:

The *Martin Act*, which became a part of the statute laws of New York in 1921, was the first of those state statutes which were modeled on the theory that securities frauds could best be controlled by effective enforcement after the fraudulent scheme had been initiated. This act authorized the Attorney General of the State to commence an investigation whenever it appeared to him that any person had engaged or was about to engage in fraudulent practices in connection with the sale of securities. He was authorized to seek an injunction against the continued sale of such securities. Criminal proceedings might also be instituted. Peculiar characteristics of this type of statute were the centralization of the authority in the Attorney General of the State rather than in the local prosecutor; and more importantly, power to prevent the continuation of the fraud through the use of the injunctive process.

The second general pattern on which state statutes have been modeled, and the one prevalent in thirty-four states, is that which regulates the sale of specific security issues. Under such statutes, before a security may be offered for sale within the state, it must be registered and qualified with the state regulatory agency, subject of course to certain exemptions. Although similar in type, there is a wide variance in the requirements of these statutes as to information to be supplied, exemptions, and applicable remedies.

The third type of statute is that which seeks to control brokers and dealers engaged in the sale of securities within the state. A licensing system is set up, and a broker or dealer, once licensed, can sell securities without the necessity of qualifying each issue. Of course, such statutes provide for proceedings for revocation of the broker-dealer license, should he abuse the privilege.

Quite often various states have adopted a combination of these types, having the licensing of brokers and dealers combined with the qualifying of securities, or perhaps with the injunctive and prosecutive remedies. The unfortunate thing is that there is no uniformity in state requirements. Although Delaware, the forty-seventh state to adopt securities legislation, enacted its statute in 1923, there has been very little progress made in unifying the state laws, the first proposal for a uniform sale of securities act not coming until 1930. Even today this uniform Act has only been enacted in three states and the territory of Hawaii.

Without necessarily sponsoring the act which has already been proposed by the Commissioners on Uniform State Laws, I think that this convention should renew its interest in seeking a unification of state statutes. If we accept the premise that state regulation has a real place in effective securities enforcement, there could be no more constructive move for this Convention than to see to it that state laws providing for such enforcement are as comprehensively drawn as possible and as nearly alike as the requirements of each particular state can make them. As has already been done in Massachusetts and South Carolina, consideration should be given to harmonizing the state requirements with the Federal statute. The more uniform the treatment of fraud by the several states and by the Federal government under their respective powers, the more effective will be the control of that fraud.

But let us return to the situation existing in 1933, before any Federal Securities legislation had been adopted. It was apparent, despite the excellent results which had been obtained by the enforcement of the varying state statutes, that there was still a large area of securities frauds which could not be reached by state enforcement alone.

During the post-war decade some fifty billions of new securities had been floated in the United States, fully half of which had been proved to be worthless.

This was the period of active stock promotion and a rising market, with everyone from elevator boy to corporate president widely speculating. Stocks rose to nebulous heights bearing no relation to their real value. Huge paper profits were made. Anything was possible. A credulous public provided victims for fantastic get-rich-quick schemes with monotonous regularity.

You remember what happened in October, 1929, when thousands who had placed their faith and their life savings in securities found themselves with nothing but handsome stock certificates. Those who still had assets sought to recoup their losses by further investments and again were victimized by unscrupulous promoters.

Inevitably the question is asked, why was it that the securities statutes of forty-seven states were indadequate to stem the flood of twenty-five billions of worthless securities? One answer, of course, lies in the question itself. There could be no complete and effective control unless there were regulatory laws in all of the states, in the District of Columbia, and in the Territories. So long as any area remained without a securities law, it was inevitable that persons desiring to engage in security swindles should flock to it. A Senate sub-committee, considering a blue-sky law for the District of Columbia, reported that there had been sold in the District more than $100,000,000 of real estate and mortgage bonds, a substantial part of which were worthless.

But even had the securities legislative program been extended to every state and territory, it is unlikely that any appreciable part of these losses to investors would have been eliminated.

The state regulations themselves had certain deficiencies. I have already suggested the lack of uniformity in the various state laws. There was even greater variance in their administration. This was probably due largely to a lack of interest on the part of some states, predominatly rural in character, and far removed from the centers of finance and business activity so characteristic of our metropolitan areas. They were more concerned with the problems of the farm than with high finance. As a result their money went for crop improvement, good roads, rural electrification, and the like, not for setting up an adequate staff to enforce their securities laws. Some states even yet are appropriating a ridiculously insignificant sum. They are forgetting that as distant as they are from the centers of urban activity which generate these securities issues, their people are not so far removed that they cannot be approached and swindled by unscrupulous securities salesmen. In some of the far flung schemes emanating from cities such as New York or Chicago, hordes of securities salesmen were sent throughout the country to contact the credulous persons residing in small communities.

The mails and the telephone were also extensively used. In the storeroom of one confidence house I found hundreds of rural telephone directories, with the names of the victims carefully checked and carded to that of the salesman who was responsible for their seduction.

A suggestion which I should like to give this convention is that it put its full weight behind a movement to persuade the legislatures of those states in which appropriations are inadequate to make available to their securities commissions sufficient funds to protect their citizens from being swindled out of their savings. If there are state commissioners here who feel that they are not being furnished with sufficient funds with which to operate adequately, and I am sure that there are many, I think that they should call their situation to the attention of this Convention, and ways and means should be devised to bring the importance of it home to the Governors, Legislators and other officials of the States concerned.

Another difficulty of state administration has been that, with the exception of a few states like New York, the burden of prosecuting offenders has not been centered in a state agency, but has been left to county prosecuting officials, along with more colorful crimes, such as murder, arson and rape. As a result, no continuity of policy has been developed - and far too frequently all prosecution has been dropped upon the making of restitution, thus permitting the offender to go free and seek new victims.

By far the greatest defect in the system existing before 1933, however, was the inability of the states to control frauds which were effected across state lines, and the failure of Congress to exercise its power with respect to the sale of securities in interstate commerce. Quite often a promoter, apprehended in one state, would make restitution to the few people whom he had swindled in that particular community, and would then be permitted to go free and continue his activities in another locality. A federal law has made the entire nation an unhealthy place for him to carry on his fraudulent activities.

It was against this background that the Federal Government was called upon to take cognizance of its responsibility in this field. This Association had sponsored some form of Federal regulation as early as 1919. Various bills were introduced in Congress but none were successful of enactment until 1933, when the first of the Federal securities statutes was adopted. The 1933 Act sought to emphasize the joint responsibility of the Federal and State governments for securities fraud prevention. This was no attempt on the part of Congress to arrogate to itself control in the field of securities. It was, rather, an attempt to increase the effectiveness of state regulation by complementing it with federal regulation. To emphasize this Congress incorporated into the Act Section 18, which unequivocally provides that nothing in the Act shall affect the jurisdiction of any state securities commission.

This Association did much to further the cooperation between the newly created Federal agency and its counterparts in the several states, when it devoted a large portion of its 1933 convention to a discussion of the problems created by the Act's passage, and invited representatives of the Federal Trade Commission, then charged with its enforcement, to be present. On the occasion of that convention, the President of the United States addressed a message to the Association, in which he said:

"The adoption of the Securities Act of 1933 marks not only an effort by the National Government to exact standards of honesty and truth of our national commerce in securities but presages also the beginning of a movement for close and effective cooperation between the agencies of State and Nation in a mutual effort to give better protection to our investing public."

This concept of dual responsibility has been translated into actuality in such a way as to be a complete refutation of those who have been able to see nothing but the breakdown of the democratic way, and a steady encroachment of the federal government upon the functions of the states. There has been a constant exchange of information in respect of our common field ever since the Commission established its Securities Violation Bureau in response to the suggestion advanced at your 1933 meeting.

Wherever investigations conducted by this Commission have disclosed violations of state laws, the Commission has endeavored to refer the facts to the appropriate state official. Similarly, many of the cases in which the Commission has proceeded are cases which were referred to it by state and local authorities. Greater effort along these lines will undoubtedly produce even more satisfactory results, and I feel we should both keep ever before us the ideal of mutual effort which the President has called upon us to achieve.

On our part it should be constantly remembered that local agencies are better equipped to understand and handle local problems. Hence the justification and reason for the qualifying of securities issues by the states. They are able to look into the business and those concerned with its management, to estimate its worth and appraise their integrity. I doubt if a Federal agency ever could so operate. We are not near enough to the local scene. Accordingly, Congress saw fit to place upon the issuer the responsibility for telling the whole truth relative to securities.

A recent example of how our Commission has felt it to be more effective on occasion to act through the state was in the case of an outfit which was selling vending machines to certain investors in the State of Ohio. There were collateral contracts which appeared to bring the sales within the prohibitions of the Federal statute, and there was some use of the mails, but the gist of the offense was the sale of these machines through fraudulent representations of earning potentialities. This seemed more like good , old-fashoned obtaining money by false pretenses. We developed the facts and turned the evidence over to the State prosecutor. An indictment has resulted. It was fast and it was efficient. We should do it more often.

Particularly through our nine regional offices, located in every section of the country, have we been able to maintain that close personal contact so helpful in establishing good relations between the state and federal officials.

Mr. Allred, the regional administrator for this great southwest section, is with me today. In addition, the Commission has been sufficiently interested in the problems of this Association to send one of its own members, Mr. Sumner T. Pike, to represent it at this convention, and to observe personally that which comes before you for discussion. It connotes a strong desire to be understanding and helpful.

The Securities Act incorporated two of the three patterns which had been expressed earlier in the state statutes - the so-called fraud provisions exemplified by the Martin Act, and the registration requirements for specific issues.

We have recently had an example of the efficacy of the provisions making it a criminal offense to make a false declaration in a registration statement filed with the Commission. A short time ago the public was electrified by the disclosure that the president of the huge McKesson & Robbins Corporation was a former convict, who had completely concealed his identity and had achieved an enviable reputation as a business executive. Investigation revealed that he had set up on the books of McKesson & Robbins many millions of dollars of assets which actually had no existence. While the principal actor in this drama removed himself from the judgment of our courts by suicide, numerous associates, without whose assistance this fraud could not have been perpetrated, were indicted by a Federal Grand Jury. Such action was made possible by reason of the fact that the securities of this corporation were listed and registered on the New York Stock Exchange, and it was necessary to file financial statements with the Exchange and with our Commission. It is interesting to note that, although the defendants were indicted on charges of conspiracy and mail fraud as well as filing false information in such registration statements, the only count on which the jury returned a verdict of guilty was that of making such false statements.

The third pattern - registry of brokers and dealers engaging in interstate transactions in securities through the use of the mails or other instrumentalities of interstate commerce - was added to the Commission's enforcement mechanism by the Securities Exchange Act of 1934. This was amplified by a new concept of self regulation of over-the-counter dealers through the enactment of the Maloney Act in 1938. This provided for the setting up of associations of over-the-counter broker dealers which were to be largely self governing, under certain regulatory supervision by the Commission.

Returning again to the fraud control type of securities legislation, exemplified by the Martin Act, I should like to emphasize the value of the injunctive process in the prevention of securities fraud. Law enforcement, you will agree, consists largely of two functions - prosecution and prevention. I do not want to underestimate the value of vigorous prosecutive action, or to suggest that there should be any lessening of our efforts to seek adequate punishment of those who have violated our laws. There is no question but that a program of effective prosecution acts as a deterrent to law violation. All of you are familiar, however, with situations where, for varying reasons, criminal prosecution is not justified; but the investing public must be protected from a recurrence of the unlawful practices. In such situations the injunction is a complete remedy.

In other cases, of course, the injunctive process can be utilized as a quick way of putting a stop to the conduct complained of, while continuing to develop the case with a view to criminal prosecution. In the field of securities fraud, the injunction has had great value as a prophylactic. We have made use of it extensively. Up until the close of the fiscal year just ended, we have obtained injunctions against 775 persons in connection with the enforcement of the several statutes we administer.

There is an added advantage. Once an injunction has been obtained, those within its terms are subject to the short, quick remedy of contempt should they dare to employ again their fraudulent devices. Too often, even where a case has been carried to indictment and conviction, the ultimate result is a suspended sentence, a fine, or at most a short prison sentence. After he has gotten off - or out - there is nothing to prevent the wrongdoer from re-engaging in his nefarious practices, except the fear of the law again catching up with him, with all the resultant delay of another presentation and trial, and with a very good chance, because of the protection which the law throws about defendants, of getting out of the net altogether.

How much better to have available the more direct remedy of contempt, where the court alone can determine if its decree has been violated, and can summarily impose an adequate punishment. The Commission has instituted several such contempt proceedings with gratifying results.

Unfortunately the injunctive technique in dealing with securities frauds is available in less than two-thirds of the states. It would be a definite move in the right direction if the legislatures of other states were urged to furnish this weapon to their state regulatory agencies. I should also like to urge that those states which have the injunctive process, combined with other methods of regulation, make more extensive use of it. It will bring immediate and effective results.

Our Commission has been vitally concerned with the problem of keeping the capital markets open and enabling the investor to place his funds in securities with the knowledge that he is doing so on the basis of honest information. Likewise, we have been sensitive to the problems of those business concerns who must tap the capital markets for their business needs.

In policing the channels through which savings flow into business, we have run into one of the most vicious schemes so far devised - the so-called "front money racket", in the operating of which unscrupulous promoters approach small business men needing capital with the suggestion that their requirements can best be satisifed through the flotation of new securities.

The front money operator offers to do everything necessary to raise additional capital, to incorporate the company, to provide a registrar and transfer agent, to prepare a prospectus and the necessary registration papers for the SEC and the various state commissions, to find a broker who will be interested in underwriting the issue, even to take a block of the securities himself -- the company to lend its name and business reputation and he to do the rest. Unfortunately, he has no intention of going through with this program. All he is interested in is obtaining the advance fee. Should he go so far as to file a prospectus, it is so woefully inadequate that it cannot possibly meet the necessary requirements.

Both we of the SEC and you State Commissioners should be vitally interested in the destruction of this advance fee racket. Its very operation casts some reflection in the public mind upon all law enforcement agencies. Its very existence depends upon an artificially stimulated impression of the complexity and difficulty of the registration requirements, and its unchecked progress leads the layman to an unwarranted criticism of the efficiency of all law enforcement bodies.

In conjunction with the Department of Justice and the Post Office we are making a vigorous effort to eradicate this evil. Certain operators, united in a scheme which encompassed the entire country, have been indicted in Cleveland and Detroit. Other indictments may follow. If such a situation comes to your attention it would be well for you to report it to our Commission, as well as deal with it as vigorously as possible through your local prosecutors, as it may tie into some of the schemes on which we are already working.

We cannot be too alert in our detection and punishment of violators of the law. When the investing public realizes that we are all on guard, there cannot help but be a restoration of that public confidence in business investment which was so unfortunately destroyed in the disaster of 1929.

Particularly in this period of national emergency must we be on the alert. The public interest in those industries relating to national preparedness has been stimulated, and there is afloat a feeling that investment in such companies is not only good patriotism but good business as well. Much of the capital needs of such industries is being provided for through public financing. A large part, however, will have to be obtained from private sources. While it is, of course, the primary duty of all of us to expedite and to facilitate the meeting of business and capital in such circumstances, we must recognize that we are also charged with another responsibility. At the same time that we assist those who have legitimately and honorably come to the money markets, we must sort out those scavengers who follow in their wake to take advantage of the reawakened public interest to unload their worthless securities which, while they may look like sound and patriotic media of investment, are in reality more akin to those illusory issues which were absorbed by the billions in the recent twenties. By so doing, we will insure that funds available for investment are harnessed to the national effort, and not diverted into purely promotional adventures.

You of the state commissions will undoubtedly have numerous "war" issues presented to you for qualification. Each will claim that it is an integral part in the national defense program. Individuals, some of whom you have long suspected of law violation, will now claim that they are important cogs in the new defense machinery. It is a difficult problem to know what to do. We all want to do what we can for our country in this time of emergency. At the same time we do not want to abandon those great social reforms which have become so important a part of our organic laws. We in Washington are perhaps in a little better position to determine the validity of these patriotic claims and assertions. We can get some information from other departments who are actively engaged in the defense program. May I suggest that when such a problem is presented to you and you do not know the answer, you ask us to give what assistance we can.

It is the purpose of the Commission, and it should be our common purpose, to remove those frictions which deter the investment of private capital in legitimate business enterprise.

The Commission is always ready to do anything that will aid business, consistent with the fundamental purposes of the securities legislation. It had found, as a result of its experience, many instances where, because of certain factors, such as the amount of accurate information already available

to the public, or the simplicity of the issue, that the full twenty day waiting period before a registration could become effective under the Securities Act was not necessary. In recognition of this, it joined in a recommendation to Congress that it be given discretion to shorten the waiting period. Such an amendment has just been enacted.

Similarly, in an effort to throw as few obstacles in the way of the legitimate financing of small business as possible, the Commission has been considering, and has sent to all state commissioners and numerous other interested persons and organizations for their consideration and comment a proposed revision of Regulation A. This would liberalize the conditions of exemption for issues up to $100,000. The exemption would become effective immediately upon a letter of notification containing only information necessary to identify the issuer, the underwriter, and the issue to be sold. There is no requirement that a prospectus be used, but copies of any selling literature would have to be filed. The conditions of exemption and the requirements of what is to be filed have been simplified as much as possible.

Your comments have been solicited as to whether there should be included in the minimum conditions of exemption the provision that no securities should be sold in any state unless the laws relative to registration, qualification and licensing of that state have been complied with.

Other possible conditions, not included in the present draft, would be a limitation upon the underwriting costs, and disclosure of whether the security was being offered for the account of the issuer or for the account of certain security holders. Since the theory of the proposed exemption is to cast the burden of enforcing the statute upon its fraud provisions, there is some discussion as to whether it would be appropriate to require the filing of any selling literature, and if such literature were to be filed, how much inspection and comment would be appropriate on the part of the Commission. It has also been thought that perhaps a form letter of notification for permissive use by the issuer would be helpful. Responses to our letter have been rather slow in coming in. We urge that you state commissioners give it your immediate consideration, and furnish us as soon as possible with the benefit of your thoughts.

And so, I have tried to sketch for you some of the things which we can all do to eliminate the fraudulent schemes and practices which have been all too rampant in the past, and to make the securities field appreciably safer for the investing public. I have tried to indicate that it is a joint responsibility, something which you could not do alone without the aid of Federal legislation, and something which the Federal authorities cannot accomplish unless the state agencies continue to exercise their full functions. The Securities and Exchange Commission is anxious to do its part, and, I am sure that you state Commissioners, both individually and as a group, will want to do yours. Each has a definite part in the work. It is just one big job to do together.

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