CURRENT SEC PROBLEMS

Address by

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One of the most exciting things about talking before the Federal Bar Association of New York, New Jersey and Connecticut tonight is the feeling I have that I am returning home and that I am talking from a home base. As a member of this organization, and as a member of the New York Bar for the past nineteen years, I hardly need tell you how much I appreciate the invitation which Mr. Jackson extended to me to tell you some of the problems which are facing the Securities and Exchange today. For the last three years, I have been a member of that Commission, having been sworn in in June of 1956. While I am sure that all of you are probably aware of the logical excitement which sitting on the SEC for the past three years has meant to me, nevertheless I am equally certain that you are conversant with the difficulties and problems which maintaining a District of Columbia residence for a wife and two sons and two daughters and, at the same time, maintaining a domiciliary brownstone house in New York means in terms of living within the limitations of a Federal Government salary. Whatever those factors are, I want to tell each of you how very pleased I am to be here tonight.

It is my personal view that any comprehension of the problems of the SEC in today's market can only be understood in terms of conditions as they existed prior to the time when Federal regulation of the capital markets came into being. For that reason, I suggest that in the first instance I would like to tell you a little bit of the demoralized conditions of the capital markets in the period following the crash of the stock market in 1929 and the causes for that breakdown.

On September 1, 1929, the value of all stocks on the New York Stock Exchange aggregated $89 billion. By the middle of 1932, this value had fallen to a total aggregate value of $15 billion, or a loss of $74 billion in the value of common stocks on that exchange. In my view, this falling off in value was the direct result of a complete lack of confidence and faith in the integrity of the capital markets. The American public had been completely disillusioned by the practices and conduct of the investment banking business. They were fed up with the completely speculative atmosphere in which all securities were sold, and with the lack of fairness to stockholders, who were not permitted to see or obtain insider information, which was employed by those close to management to further their own personal gains.

The whole structure of the capital markets was built on a basic concept of sell all that you can and get the highest price the traffic - and I might even say suckers - can bear. There was absolutely little or no disclosure of the basic financial background, the purposes of an offering, or the use of the proceeds of such offering to the public security holders approached to put their money into any particular corporate venture. The whole standards of morality in terms of the sale of securities had broken down. Caveat emptor, as we know it in the law, was the rule of the day.

It is small wonder that public investors had lost faith in the functions of the securities business. Few investors considered corporate securities, whether of the debt or equity type, the proper medium of investment. The public put its money into savings banks or sewed it up in the proverbial mattress. Corporations found it almost impossible to obtain equity financing or to sell debt securities, such as mortgage bonds or debentures, to public purchasers. The capital system in a sense came to a staggering halt.

Into this completely demoralized capital picture came the Securities Act of 1933. As Chairman Gadsby said to you in an address which he gave before this Association and the City Club in February of this year, that Act was the first attempt by the Federal Government to get into the business of regulation of the securities business. The Act itself has two fundamental purposes: (1) the requirement that corporations seeking to raise capital by the sale of securities to the public must disclose basic facts and figures, financial and otherwise, about itself, the reasons it is seeking money, and the purposes to which it wishes to put the money raised; and (2) the prevention of misrepresentation and fraud in the sale of securities.

As I believe he told you, the basic aim of the statute was to require that securities offered for sale to the public be registered with the Federal agency by the filing of a registration statement, which includes two parts: (1) a prospectus; and (2) the formal corporate documents, such as the charter, the by-laws, and the like. The Act sought to have the prospectus employed as a selling document so that the public investor desiring to become a stockholder would have made available to him the necessary facts of corporate life and could make an informed judgment as to whether he should invest in this particular company or not.

The following year the Congress passed the second securities act, known as the Securities Exchange Act of 1934. In contrast to the 1933 Act which sought to govern factors relating to the initial sale of securities, the 1934 Act began regulation of activities having to do with subsequent trading in securities. Thus, this latter Act, for the first time, caused Federal regulation of brokers and dealers seeking to sell securities in interstate commerce, and it required corporations listed on national securities exchanges, of which there are fourteen today, to register both with the exchange and with the SEC, which incidentally was created by the 1934 Act. It also required that corporations listed on these national securities exchanges, and certain other companies, file annual, semi-annual and periodic reports with both the exchange and the SEC. It gave to the Commission supervisory power over securities traded on national securities exchanges, as well as some power over the operations of such exchanges and the rules and regulations adopted by them.

Realistically speaking, these two Acts have given to the SEC a tremendous power to eliminate unfairness, in the broad sense, from activities in the capital markets.

At this point, let me say that there are four other Acts which we administer. In the brief time allotted to me this evening, I will probably not be able to discuss them at any length. They are the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

Now, let us look at conditions as they exist today. We are in the midst of the most dynamic capital market activity that this country has ever seen. As of April 30, 1959, the value of common stocks listed on the New York Stock Exchange stood at a figure of $294.3 billion, up from $280.8 billion as of January 31, 1959. This compares, incidentally, to the figure I gave you earlier of the value of all stocks as of September 1, 1929, which was $89 billion. Note also that there has been an increase in the value between January 31, 1959 and April 30, 1959 of almost $14 billion. From January 1 to March 31, 1959, the New York Stock Exchange saw activity never before equalled when 507 million shares, with a total dollar value of $14.1 billion, were traded. On an annual basis, such trading would approximate two billion shares, with an estimated value of about $56 billion.

What has caused this tremendous activity and what has brought about the change in attitude on the part of investors, which permeated the 30's? In the first place, it seems apparent to me that the securities acts, with their basic disclosure concepts gradually, and to be sure at first very slowly, reactivated and re-stimulated a confidence and a faith on the part of the American investing public in the integrity and honesty of the capital markets. People began to place their trust in the facts required to be disclosed in order to comply with the securities acts. People began to understand corporate activity and corporate financial balance sheets. People began to take faith in debt and in equity securities of corporations generally.

Following World War II, demands for capital goods which were in short supply caused inflationary pressures, caused increases in our standard of living, and caused increases in our everyday costs. Salaries and wages went up and, although costs were higher, people's savings increased. As hedges against inflation, new investors appeared desirous of acquiring equity securities. Between 1940 when the Investment Company Act was passed and today, mutual funds have witnessed a great surge of activity. In 1940, the total value of their assets aggregated $2 billion. Today, it is somewhere around $18 billion. Institutional investors began more and more to get into the equity market. This great pressure on the

buy side of that market inevitably forced securities to increase in value. Ever present in this upsurge, however, has been a feeling of confidence and faith in the functions of the SEC in requiring and forcing companies to disclose the facts of their operations and performance.

Unfortunately, the tremendous financial and economic conditions which we have seen in this nation of recent date has attracted into the capital markets persons who are desirous through evasion, through schemes, through nothing more than ill-conceived gimmicks to thwart the disclosure requirements of the Federal securities laws in order to reap personal gain at the expense of the public. It is in this area that our real problems have developed. Let me tell you of a few of them tonight.

You wouldn't believe it, but a prospectus was recently filed by an Oklahoma company seeking to raise a large amount of capital to produce a flying saucer which would take a group of forward thinking progressives to the moon, departure scheduled for next year from Space, Maryland. Needless to say, we had to obtain first a temporary restraining order, and finally a permanent injunction against the solicitation of sale of the securities involved in this situation. I might say, parenthetically, that the prospectus also talked about the sale of a $5.00 "do-it-yourself" flying saucer kit. This sounds a little bit like the ridiculous in absurdum, but the filing was actually made and therefore had to be processed by the Commission.

In another rather strange situation, we discovered a prospectus floating within the stream of commerce containing the quite famous legend that "These securities have not been approved or disapproved by the SEC nor has the Commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense." Of course, you recognize that this is the language that must appear on the facing page of all prospectuses. The particular issue involved had never been filed with our Commission nor had we ever heard of it. As a matter of fact, the board of directors of this company contained the names of several men of great national prominence, none of whom had ever heard of the company. At the present time, we are not sure to what extent public money was raised by the sale of the company's securities, but we have obtained an injunction and the appointment of a receiver.

To get into more realistic problems, we have been very much concerned about the attempts by some companies to raise money through borrowing of funds at very high monthly interest rates. Such loans are secured by the common stock of the borrowing company or its controlling officers. When a loan requires the payment of interest charges out of all proportion to earnings, there is a time when we must consider that there are no bona fide elements of a loan and that, in fact, the transaction is one looking to the ultimate distribution of the pledged securities. This is but another way of effectively accomplishing a distribution, and thus circumventing completely the disclosure requirements of the 1933 or 1934 Acts.

In a recent case, we discovered, at least prima facie, that there had been a complete abrogation of the investment adviser's duty to advise a broker-dealer, who apparently was not only giving advice but was buying and selling the portfolio securities of the investment fund at a rate indicating a certain amount of churning.

Recently, you may have noticed that the United States Supreme Court, in a 5 to 4 decision, decided that a variable annuity issued by a life insurance company was in fact a security because the ultimate return to the buyer of the contract was varied in accordance with the value of the portfolio common stocks in which the premiums paid in were invested. This is posing a whole new area of regulation by our Commission.

I might also point out that the number of companies which have found themselves in financial difficulties, and have accordingly undertaken proceedings under Chapter X of the Bankruptcy Act, has notably increased. Of course, in cases where the total assets of these corporations exceed $3 million, the Federal District Court is obliged to refer the matter to the SEC for its appraised opinion. We can either make an oral or a written report, in which we make recommendations with respect to reorganization plans, their feasibility and their fairness to the public security holders involved.

Finally, I suppose no talk on problems before the SEC could ever be made without some reference to the problems which our Commission has in the private offering field. I know that there are many of you who feel that the Commission should give some clearcut statement as to what a private offering involves. As you know, Section 4.1 of the 1933 Act talks in terms of an exemption for offerings other than public offerings. In antithesis of a public offering is a private offering.

The Supreme Court, in the Ralston-Purina case, 73 S.Ct. 981, determined in substance that the SEC, in deciding whether a particular offering was public or private, should take into consideration the relationship which the offerees bore to the issuer, and whether the offerees had such a relationship as would permit them to obtain the information otherwise available in a registration statement. The Supreme Court specifically stated that a numbers test would be inappropriate.

By analogy, it would seem perfectly obvious that an offering to the 25 top vice presidents of the First National City Bank here in New York would be a private offering. But, by the same token, an offering to 25 individuals who bore no relationship whatsoever to either the corporation or any of its officers, directors or large stockholders, where each of the 25 persons were located in a different state, might easily constitute a public offering.

The difficulties which we face in this area are that we must make determinations as to the subjective intention of the private offeree as of the time he takes the securities. If, in fact, a person takes securities for a purpose other than distribution and holds them for a period of time consistent with a non-distribution intention, then we may be able to decide that such a taking is one of investment. This is a very complex area and one in which you must proceed with great caution in advising clients.

Let me say to you that it is a great pleasure for me to be here, and, if you have any questions, I will be very pleased to try to answer them.

Thank you very much.