"Some Problems of Securities Act Administration"

ADDRESS

of

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It was a pleasure to get your kind invitation to come up to Philadelphia to chat with you. The Philadelphia area was my home during the war and while I am not a lawyer, I have been associated with lawyers throughout my professional career with the SEC. It needed only your gracious hospitality to make me feel throughly at home.

I am going to talk about law today - about a special law; and I am going to talk about it as an administrator. To some extent the approach of the practicing attorney and of the administrator to legislative problems must necessarily coincide. But there are significant differences, and if I may be allowed to use a rather elaborate analogy, I would like to dwell for a moment on those differences.

In a sense, the practicing lawyer sees a statute as a sort of system of red and green lights and one-way streets. In conference with his client the lawyer tries to map the client's course in such a way that he gets to his destination without crossing against lights or going in the wrong direction on a one-way street. In court lawyers argue over which way the arrow of the statute points and what was the color of the light at a given intersection.

As an administrator, I must view the law as a storehouse of traffic signs, lights, highway markers, and other regulatory equipment. Some of it - in fact a good deal of it - has to be used the way the Congress specifically directs. But as to the use of some of it I have been granted considerable discretion. The Congress knew that it

could not anticipate all of the traffic conditions and that changes in traffic regulations would be necessary. For that reason I am permitted to put up "stop" signs, or "slow" signs, depending on what my observation of the traffic tells me is necessary within a given area and within limited conditions.

The traffic which I am supposed to regulate is, in general, traffic in securities. In some way or other everyone of the seven pieces of legislation under which the Commission works is designed to protect the pedestrian (or investor) on his way through the traffic in securities. The particular subject matter I want to discuss today is the Securities Act of 1933 and I want, if I can, to tell you something of the problems faced in the administration of that law. In a sense, I want to give you some idea of what the traffic problems were before the Act was passed and what has been done and needs to be done to facilitate the flow of that traffic and to make it safe.

Justice Frankfurter once said in talking of the Act: "Legislation is not anticipation. It is a response, too often a laggard response, to a serious need. The new Federal Securities Act is a belated and conservative attempt to curb the recurrence of old abuses which, through failure of adequate legislation, had attained disastrous proportions."

Justice Frankfurter was right. But one would miss the full meaning and importance of the Act if the Act were regarded solely as a "depression baby." The legislative process being what it is,

we may never have had the Act if we had not first suffered the crash of October 1929 and the deep and penetrating doubts and uncertainties of the ensuing depression. But the basic principle of the Act is a principle applicable to all phases of the economic cycle. Informing the investor, changing securities buying from an activity based on hunch, tip and rumor, into an informed activity based on reliable data is a goal which has universal relevance. It has most relevance, I might add, to a period of prosperity such as we have today. One need only look back to realize that the lemons and the heartaches of 1933 were the sky-rocketing wonders of 1928. And no one, whatever his theory of the depression may be, can deny that the unrealistic prices of 1928 and early 1929 were due in large part to the eargerness of uninformed investors.

I want to make it clear at the outset that the Securities Act doe not authorize the S.E.C. to tell anybody what securities he may sell or what securities he should buy. It does no more than require disclosure in connection with sale of securities of any grade or quality.

The Securities Act is no enemy of speculation. Neither the Act nor the Commission in administering the Act, makes a distinction between securities of high investment quality and those of speculative character. The choice of investments is solely that of the investor. The concern of the Act and of our administration of the Act is to make that choice an informed one.

The Securities Act is no enemy of venture capital. Under the law a new, unseasoned enterprise has the same access to the capital

markets as does an old and seasoned venture. Every year millions of dollars of securities in new promotions - some hopeful and some hopeless - are registered with the Commission and are sold to investors.

Those of you who are familiar with the history of securities distribution know that American underwriting has always put its accent on two factors - speed and risk avoidance. In essence these two factors are related. Speed in distribution is one of the ways in which risk is avoided. The shorter the time between the making of a commitment and the disposition of a commitment, the shorter is the period of hazard during which the distributor is vulnerable to adverse market changes.

In the early days this accent on speed had very direct consequences. A syndicate formed to underwrite an issue would invite dealers' participation in order to help distribute the issue to retail buyers. If, by good chance, the issuer was well known, if it used consistent and adequate accounting methods and published information about itself, dealers would have some access to the data they needed. However, this was far from usual, and dealers were rarely given either adequate information or any leisure in which to appraise an issue and to make their decision whether or not to buy. The time for performance was short; and in many cases it was a command performance. A dealer who had some doubts about an offering being made by a large underwriting firm did not dare to express those doubts for fear that he would be cut out of future desirable business.

In a rising market the underwriter could always find another dealer, and every dealer could find a willing customer. On the broad backs of the investing public were laid the burdens of speed and risk avoidance. The back broke in 1929.

In terms of these considerations it is clear that the success which the Securities Act has had in meeting the problems it was designed to correct can be measured by its success in getting information to the buyer. How much or how little information is provided, the brevity and clarity with which it is stated and - importantly - when it is given to the investor all bear on the effectiveness of the statute. In the course of this discussion I will emphasize particularly the timing of information, for it has become one of the classical problems in administration of the Act.

In order to appraise the effectiveness of the Act we will have to review briefly the mechanics of registration and of prospectus distribution.

Under the Act no issuer, underwriter or dealer can make a public offering of securities by use of the mails or facilities of transportation or communication in interstate commerce unless the securities have been registered with the Commission. The registration process is begun by the filing of a statement containing prescribed information about the company, the security, and the offering. Within twenty days, or within a shorter period - if the Commission "accelerates" the statement - it becomes effective. Between the time of filing and the day of effectiveness the statement is carefully examined by a

team of staff members including lawyers, accountants, analysts and - if necessary - specialists in such fields as oil and gas. Inadequacies in the statement are brought to the registrant's attention and, in the vast majority of cases, the statement is corrected without resort to formal procedures to delay or stop effectiveness.

The Congress realized that the mere act of filing a statement in Washington would do little to assure information to investors scattered throughout the country. It provided therefore, that in sales of registered and newly distributed securities the seller must provide the buyer with a prospectus which contains the salient information needed by the buyer.

The language used in prescribing this requirement was far from fortunate. Section 5 (b) (2) makes it unlawful

> "To carry or to cause to be carried through the mails or in interstate commerce any ... security /subject to the registration requirements/ for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus . . . /that meets the requirements of the Act/".

Because of this language the delivery of a prospectus may be postponed until the sale is, to all intents and purposes, over. The buyer may become psychologically and financially committed before he sees the very document which - under the pattern of this Act - is intended to be the primary selling vehicle. In fact, the withholding of the prospectus until delivery of the security has become the custom of the securities industry. Because of the fact that an oral communication is excluded from the definition of a prospectus it is possible to offer and sell a security <u>after the effective date</u> through the use of the local or long distance telephone and delay delivery of

the prospectus until the mails are used to send a written conformation.

The existence of this anomalous situation is a fundamental problem in Securities Act administration. Resolving it has for a long time been job number 1 in adjusting the Act to meet the practical needs of investors and securities distributors.

It has not been the only problem. As I indicated, many large distributions of securities are accomplished by the creation of fairly complex organizations of underwriters (or "syndicate" members) and retail dealers (sometimes called "selling group" members). Under the Act it is unlawful before the effective date of the registration statement to use the mails or facilities of communication or transportation in interstate commerce to invite dealers' participations or, indeed, to undertake any selling effort whatever. Yet the creation of a full scale selling organization is a difficult task and the speed with which an issue can be distributed may depend on whether such an organization can be formed and ready for the task on the effective date of the registration statement.

It is apparent, therefore, that there have been two stresses toward adjustment of the Securities Act. One is for making reliable information available to investors in time to be of use in the process of investment decision. Another, is the stress of securities distributors toward facilitating the organization of distributing groups.

These aims are by no means in conflict. In fact, early in the history of our attempts at statutory revision, it became clear that they could both be achieved by the same type of adjustment. That adjustment would be to require that an investor be given a

prospectus before he could be committed to the sale. If that were done, it would be completely within the spirit and purpose of this law to permit offers (as distinguished from sales) to be made before the registration becomes effective.

Under the proposal underwriters would be permitted to invite dealers to participate in a distribution and dealers in turn could solicit the interest of investors before effectiveness of registration by oral or written offers (provided the first written offer was made by use of the proposed prospectus). These offers could be made through the use of the mails or the facilities of interstate commerce. On the other hand the buyer of the security would be assured of a minimum advance period during which he could read the prospectus before committing himself.

Like many answers to complex questions, this one was no means as simple as it appeared. Weeks and months of wrangling with the

securities industry were spend (in my opinion they were wasted) over a detail of this proposal known as the "out-clause." Ironically enough, the "out-clause" was originally proposed by the securities industry itself in the early phases of the revision program in 1940 and 1941. Its reappearance in suggestions made by our staff was due to the fact that they wished, as far as possible to achieve a joint program. In essence the "out-clause" would have provided that if a sale were effected before a prospectus was delivered the buyer would have a maximum period within which to rescind the sale after getting the prospectus. The "out-clause" was widely misunderstood and it resulted in disputes about detail which helped to befog the main purposes of the revision program. To may mind the main purposes could be achieved without it.

Other criticisms of the proposal for advance delivery were made by securities distributors. They boiled down, in essence, to the claim

that advance delivery would complicate the mechanics of prospectus distribution. Let us inspect, for a moment, those mechanics. Under the proposal, sales could be made legally by underwriters to dealers and by dealers to ultimate investors as soon as the registration statement becomes effective, provided such information as price, spread, etc., is furnished at that time and provided underwriters had provided dealers, and dealers had provided investors, with the conventional red-herring prospectus at least 48 hours prior to the effective date.

In many cases - in most cases in fact - this would not be difficult. It would represent only an extension of a present practice in securities distribution. For many years the Commission has encouraged (and within recent years has in fact required) the dissemination of information to dealers during the waiting period through the medium of the red-herring prospectus. The red-herring is nothing more or less than the prospectus filed with the Commission, containing all the pertinent information except for price, spread, and related final data. It is marked prominently with a legend in red ink to the effect that it is not an offering, and from this legend derives its name.

I have always felt that the scheme envisioned in a system of advance delivery of prospectuses is workable. Of its desirability I have no doubt - for it is the most straightforward answer possible to one of the most fundamental problems of the Act - timely information to the investor. The problems on which I have commented and many others like them are only collateral to the main issue of the revision program -

getting information to the investor in time for it to be of real use to him. With willingness and a good faith effort to make such a system work, the details could be ironed out by flexible rules and regulations.

Throughout the years in which we have considered these proposals we worked in close contact with industry representatives. Although we have made considerable progress and there has been a lot of give and take on both sides we have not been able to work out a joint program with the industry to bring to the Congress. I sincerely hope such a joint program can be worked out.

Furthermore, the process of improvement has by no means stopped. We seem to be in a lull at the present in our efforts to make basic revisions in the statute. But during the lull we reinspected the program in the light of our rule-making power to see how much of the objective could be obtained by revisions in our rules.

Earlier this month we promulgated two proposed rules designed to stimulate the dissemination of information to dealers and investors during the waiting period. One of these provides for a so-called "identifying statement," the other aims at cutting down the duplication now involved in sending a full, final prospectus to people who had previously received the red-herring prospectus.

The "identifying statement" as set forth in proposed Rule 132 would identify, to the extent that the data are available, the security, the issuer, its business, price, yield, and spreads, conversion or redemption rights. It would tell the investor whether the issue is to be listed or traded over the counter. It would state whether the

issue is on behalf of the company or on behalf of stockholders. The statement may set forth whether the security is a legal investment for banks, insurance companies or other regulated purchasers. It may state whether the issuer has undertaken to pay any taxes with respect to the security or income on the security.

The identifying statement could be used either before or after effectiveness. It is intended as a screening, not a selling device. When properly used it should help the dealer to ascertain what investors are sufficiently interested in the type of security in question to warrant supplying the more detailed information contained in the red-herring.

The identifying statement as proposed at this stage, would carry a tear-off request for a prospectus which an interested investor could fill out and send back to the dealer. If the request were made before the registration statement is effective and before a final prospectus is available, the dealer could send the proposed or red-herring prospectus in response to this request. Thus, if the identifying statement is to work out as intended, some means must be devised of getting a sufficient number of prospectuses to dealers so that they can comply with tear-off requests.

To meet this problem the Commission decided to use a technique which has been a part of the scheme of regulation for several years. Today, under current practice, the Commission requires that underwriters make a distribution of red-herring prospectuses to dealers during the waiting period as a condition of accelerating the effectiveness of the registration statement.

Under today's practice it is sufficient for the underwriter to give one red-herring prospectus to a dealer. In order to make the identifying statement an effective screening device we have included, in our statement accompanying the new rule, a proposal to revise our acceleration practice. Under the revised practice it would not be enough to give each dealer only one copy of the red-herring prospectus. The dealer would have to be provided with enough copies to enable him to fill customers' requests for red-herring prospectuses. If reasonable compliance with this policy is not demonstrated, acceleration will not be granted under the proposed practice.

We did not wish, through this requirement, to make the securities distribution process more burdensome and more expensive. In the second rule which we have sent out for comment, an amendment to rule 431, we have provided the means whereby an adequate distribution of pre-effective prospectuses could be made without increase in the complexity or expense of underwriting. In amending rule 431 we would make generally applicable a practice which we now permit only in connection with offerings to stockholders. Under that practice the complete final prospectus could consist of the red-herring prospectus previously distributed and a supplemental sheet furnished at or after the effective date giving price, data, and other information properly permitted to be excluded from the red-herring prospectus.

We hope, by making this practice generally applicable, to encourage the widespread use of red-herring prospectuses during the waiting period. It will no longer be necessary to send a complete new

final prospectus to people who had received the red-herring, thereby duplicating information already sent out and increasing expense.

Adoption of these rules, from the administrative point of view, would involve some hazard. The tear-off which is provided for in the proposed identifying statement can be a force for good or evil depending on the extent to which red-herring prospectuses are available and the willingness of dealers to comply with tear-off requests. Unless interested investors who ask for prospectuses actually get them, the tear-off system amounts to little more than what might be colloquially called "a ready made sucker list."

It is sometimes difficult for responsible members of the underwriting profession to realize that the Commission must take into account the possibility that certain dealers might resort to submarginal practices. However, even if we assumed a complete willingness of dealers to comply with tear-off requests, the success of the proposal depends upon assuring that the dealers themselves are provided with the prospectuses they need in order to honor requests.

The Commission intends to observe very carfully the actual operation of the rules if they are adopted. Unless they serve the intended purpose they will be reconsidered.

I urged the consideration of this proposal and I support it wholeheartedly. If it works as it is intended, it should go a long way toward accomplishing the primary objectives of the statute. It does not, however, fully meet the needs for revising the law and I have not given up hope that we will be able to do the full scale revision job that has to be done.

It is a high hope, for it would vindicate the belief of many of us that the system of free enterprise, open channels of investment, and a high level of public interest in our securities markets are better achieved by information than by ignorance.