

U.S. Securities and Exchange Commission

# SEC 1978

## THIRTY-EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION

for the Fiscal Year Ended June 30th

For sale by the Superintendent of Documents, U.S. Government Printing Office  
Washington, D.C. 20402 - Price \$1.50 (paper cover)

## **SECURITIES AND EXCHANGE COMMISSION**

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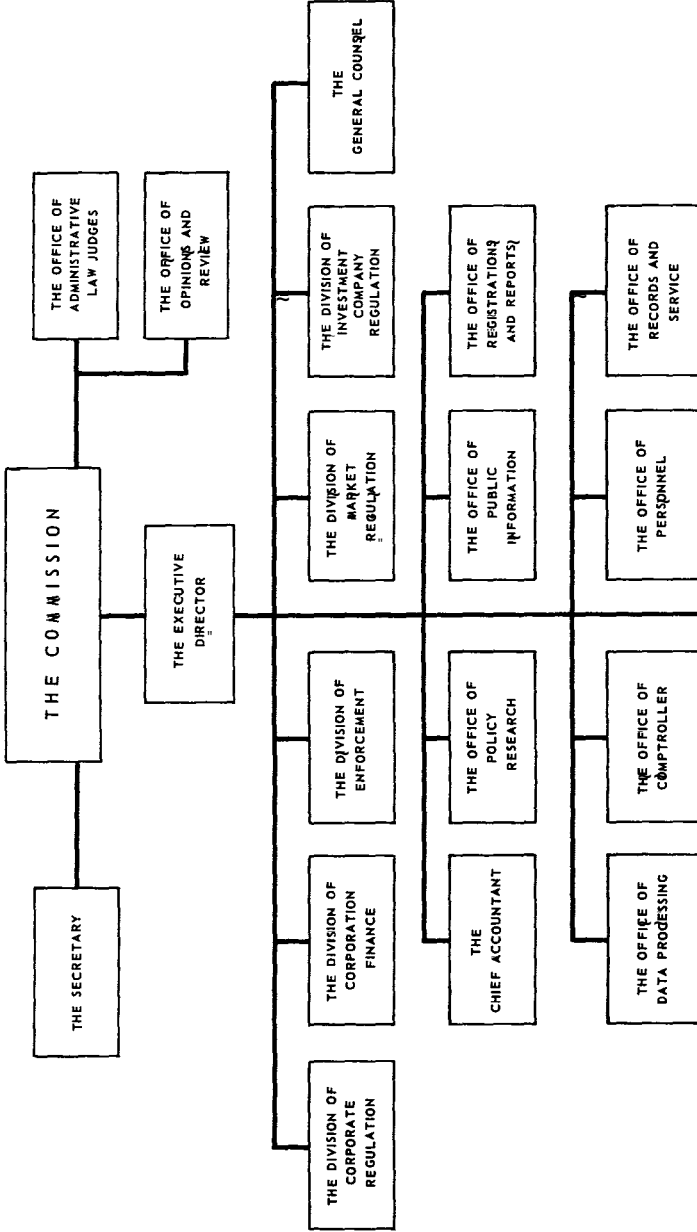
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HUGH F. OWENS  
A. SYDNEY HERLONG, JR.  
PHILIP A. LOOMIS, JR.

RONALD F. HUNT, *Secretary*

\*On November 30, 1972, President Nixon announced the nomination of Chairman Casey as Under Secretary of State for Economic Affairs.

# SECURITIES AND EXCHANGE COMMISSION



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PRINCIPAL STAFF OFFICERS**  
(As of November 1, 1972)

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Term expires  
June 5

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A. SIDNEY HERLONG, JR. of Florida	1976
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Bldg., 120 South State Street.  
San Francisco, California 94102.—450  
Golden Gate Avenue, Box 36042.

## COMMISSIONERS

### **WILLIAM J. CASEY, *Chairman***

Chairman Casey was born in Elmhurst, New York, on March 13, 1913. He received a B.A. degree from Fordham University in 1934 and an LL.B. degree from St. John's University in 1937. At the time of his appointment to the Commission, he was a partner in the New York law firm of Hall, Casey, Dickler & Howley and the Washington law firm of Scribner, Hall, Casey, Thornburg & Thompson. Mr. Casey has authored and edited a broad spectrum of publications on legal, tax, financial and economic subjects, and has served as Chairman of the Board of Editors of the Research Institute of America and Chairman of the Board of Editors of the Institute for Business Planning, a subsidiary of Prentice-Hall. During World War II, he served as Chief of the Secretariat at the European headquarters of the Office of Strategic Services and, subsequently, Chief of O.S.S. intelligence operations in the European Theatre. In 1948, he served on the legal staff of the European headquarters of the Marshall Plan. Subsequently, he served as special tax counsel for the Senate Small Business Committee. He has served as a member of the General Advisory Committee on Arms Control and as a member of the Presidential Task Force on International Development. He has also been President of the International Rescue Committee and of the Long Island Association. He has served as Trustee of Fordham University, of Good Counsel College and of Catholic Charities in the Long Island Diocese. Mr. Casey was sworn in as Chairman of the Securities and Exchange Commission on April 14, 1971.



## **HUGH F. OWENS**

Commissioner Owens was born in Muskogee, Oklahoma, on October 15, 1909, and moved to Oklahoma City in 1918. He graduated from Georgetown Preparatory School, Washington, D.C., in 1927, and received his A.B. degree from the University of Illinois in 1931. In 1934, he received his LL.B. degree from the University of Oklahoma College of Law, and became associated with a Chicago law firm specializing in securities law. He returned to Oklahoma City in January 1936, to become associated with the firm of Rainey, Flynn, Green and Anderson. From 1940 to 1941, he was vice president of the United States Junior Chamber of Commerce. During World War II he attained the rank of Lieutenant Commander, U.S.N.R., and served as Executive Officer of a Pacific Fleet destroyer. In 1948, he became a partner in the firm of Hervey, May and Owens. From 1951 to 1953, he served as counsel for the Superior Oil Company in Midland, Texas, and thereafter returned to Oklahoma City, where he engaged in the general practice of law under his own name. He also served as a part-time faculty member of the School of Law of Oklahoma City University. In October 1959, he was appointed Administrator of the then newly enacted Oklahoma Securities Act and was active in the work of the North American Securities Administrators, serving as vice president and a member of the executive committee of that Association. He took office as a member of the Securities and Exchange Commission on March 23, 1964, for the term expiring June 5, 1965, and was reappointed for the terms expiring June 5, 1970 and 1975. Since June 1964, he has served on the executive committee of the National Association of Regulatory Utility Commissioners.

## **A. SYDNEY HERLONG, JR.**

Commissioner Herlong was born in Manistee, Alabama, on February 14, 1909, and in 1912 moved to Sumter County, Florida, and later to Lake County, Florida, where he attended public schools. He received an LL.B. degree from the University of Florida, Gainesville, Florida, in 1930, and commenced practicing law in his home town of Leesburg, Florida. Commissioner Herlong continued practicing law until 1937 when he was elected County Judge of Lake County, Florida. He continued serving as County Judge until 1948 when he was elected to the U.S. House of Representatives, in which body he served until January 1969, when he voluntarily retired. While serving in Congress, Mr. Herlong was a member of the Post Office and Civil Service Committee, the Agriculture Committee, and, for the last seven terms, the Ways and Means Committee. Upon retirement from Congress, he became a consultant to the Association of Southeastern Railroads. He is a past president of the Florida County Judges Association, the University of Florida Alumni Association and the Florida State Baseball League. Mr. Herlong received the Good

Government Award from the Florida Junior Chamber of Commerce and the Distinguished Alumni Award from the University of Florida. He took office as a member of the Securities and Exchange Commission on October 29, 1969, for the term of office expiring June 5, 1971, and was reappointed for the term expiring June 5, 1976.

#### **PHILIP A. LOOMIS, JR.**

Commissioner Loomis was born in Colorado Springs, Colorado, on June 11, 1915. He received an A.B. degree, with highest honors, from Princeton University in 1938 and an LL.B. degree, cum laude, from Yale Law School in 1941, where he was a Law Journal editor. Prior to joining the staff of the Securities and Exchange Commission, Commissioner Loomis practiced law with the firm of O'Melveny and Myers in Los Angeles, California, except for the period from 1942 to 1944, when he served as an attorney with the Office of Price Administration, and the period from 1944 to 1946, when he was Associate Counsel to Northrop Aircraft, Inc. Commissioner Loomis joined the Commission's staff as a consultant in 1954, and the following year he was appointed Associate Director and then Director of the Division of Trading and Exchanges. In 1963, Commissioner Loomis was appointed General Counsel to the Commission and served in that capacity until his appointment as a member of the Commission. Commissioner Loomis is a member of the American Bar Association, the American Law Institute, the Federal Bar Association, the State Bar of California, and the Los Angeles Bar Association. He received the Career Service Award of the National Civil Service League in 1964, the Securities and Exchange Commission Distinguished Service Award in 1966, and the Justice Tom C. Clark Award of the Federal Bar Association in 1971. He took office as a member of the Securities and Exchange Commission on August 13, 1971, for the term of office expiring June 5, 1972.



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# INTRODUCTION

**By William J. Casey, Chairman  
Securities and Exchange Commission**

## **CHANGE IN THE SECURITIES MARKETS**

As the June 30, 1971 fiscal year came to an end, there were many problems clamoring for attention in the structure and operation both of the securities markets and of the institutions on which these markets depend.

In assigning priorities to these problems, the Commission focused its atten-

tion first on the economic soundness of the firms making up the securities industry, their financial responsibility and the safety of investors' cash and securities left in their custody. During the previous years, the failure of substantial firms had brought about Congressional enactment of the Securities Investor Protection Act potentially committing a billion dollars of public funds to guaranteeing the safety of cash and securities left with brokerage firms by public customers. There was a widespread recognition that brokerage firms needed

more adequate, more liquid and more permanent capital, that their procedures and accountability had to be tightened up and that there had to be closer surveillance over their financial and operational soundness. At the same time, there was a clear need to reshape the structure of the markets themselves to modernize the way securities were both traded and transferred. Thus, going into the fiscal year, the Commission sought to strengthen the industry and its accountability to, and financial protection for, its customers while developing a policy and a framework for modernizing the structure of the markets. To lay the basis for the latter, it scheduled hearings at which investors, members of the industry and all those interested were asked to present their views on the future structure of the securities markets. At the same time, there was strong emphasis on developing greater clarity and certainty in the rules governing the sale of securities and on making financial information on more companies available to the public as well as improving the quality and sensitivity of financial reporting and disclosure. These three concerns—financial responsibility of the industry, the structure of the markets and better disclosure to investors—were the foci of major actions taken by the Commission during the 1972 fiscal year.

Additionally, through staff studies, advisory committees or public hearings, the Commission undertook a thorough review of its policy, rules and practices in these areas:

- (1) unsound and unsafe practices in the securities industry,
- (2) the future structure of the markets,
- (3) enforcement policy and procedures,
- (4) disclosure and marketing practices with respect to hot or new issues,
- (5) rules governing the resale of restricted stock, stock issued in acquisitions, private offerings and intra-state offerings,
- (6) real estate securities,
- (7) use of earnings forecasts in disclosure documents,
- (8) use, coordination and simplification of reports and other requirements imposed on issuers, broker-dealers and investment companies by the Commission and the self-regulatory agencies,
- (9) oil and gas offerings in the course of developing an improved Regulation B and formulation of an Oil and Gas Investment Act pursuant to Congressional request, and
- (10) advertising, sales compensation, pricing and related problems in the economics and marketing of mutual funds.

### **Financial Responsibility and Accountability**

Investor confidence is the cornerstone of public participation in the securities markets. Much was lost in the broker-dealer failures of 1969 and 1970. The lessons of that financial crisis in the securities industry, the creation and operation of the Securities Investor Protection Corporation and new emphasis on early detection and prevention of potential firm failures have led to major new rules to assure financial responsibility and accountability in the securities industry and justify renewed investor confidence.

A major undertaking during the 1972 fiscal year was the working out of basic provisions for a comprehensive rule governing the day-to-day control and protection of customer cash and securities left with brokerage firms. Congress in passing the SIPC legislation in late 1970 gave the Commission specific

powers to develop rules to prevent misuse, improper segregation and loss of control over customer assets.

It was important that this be effected without disrupting the flow of certificates to consummate transactions, and without placing an unnecessary strain on the banking and brokerage system by requiring billions of dollars to lie fallow.

This was substantially accomplished in a rule proposal circulated in May. The new Rule (15c3-3) controls use of customer funds by requiring broker-dealers to set up reserve bank accounts to cover all customer assets not being used in specified, limited, non-risk areas of customer service. The size of the reserve account for each firm is calculated continually through a formula applied to all broker-dealers carrying public accounts. For customer securities left with the firm, broker-dealers have to show actual possession or control of such securities in such locations as banks or certificate depositories. Specific time limits are set for establishing and verifying control or possession of these securities and penalties are imposed for exceeding them.

The many provisions of this rule accomplish the major intent of Congress by isolating customer assets from the risk of the broker-dealer's business in such areas as underwriting or firm trading for its own account. They also prohibit unwarranted expansion of a firm's business which had been accomplished by some broker-dealers through use of customer funds, a major factor in the collapse of many broker-dealers in recent years. The rule penalizes faulty record-keeping by increasing the amount of reserve that must be set aside against customer assets. Finally, these provisions are fully consistent with efforts by the Commission, the industry, and others to bring about a total systems approach to the processing of securities transactions and the changing

of ownership through improved clearance and settlement operations, computerized depositories and eventual elimination of the stock certificate. The rule, with minor modifications and amendments, went into effect around the turn of the 1972 calendar year.

The protection given investors through this rule should be looked at as only part of a total program covering a series of interrelated and comprehensive new requirements. In July, 1971, the Commission required immediate reporting by broker-dealers of any violations of rules governing net capital or any non-current status of books or records. At the same time, any broker-dealer whose aggregate debt was more than 12 times its net capital was required to report in full its operational and financial condition within 15 days after the end of the month in which this ratio occurred. In November, 1971, the Commission passed a rule mandating quarterly box counts by broker-dealers of all securities and certification of securities not in the broker's possession. To increase reporting of financial condition of firms to their customers, the Commission last June passed an amendment to Rule 17a-5 requiring distribution of balance sheets on a quarterly basis to all customers. And to provide for effective screening and regulation of new firms entering the securities business, the Commission in the same month passed amendments to Rules 15c3-1 and 15b1-2, increasing minimum required net capital for new firms entering the securities business and requiring detailed presentations on the firm's facilities, personnel and financing.

These amendments, like many others, were an outgrowth of the Commission's 1971 Study of Unsafe and Unsound Practices detailing the causes of the 1969-70 financial crisis in the securities industry.

Steps to insure financial soundness and operational efficiency in the indus-

try were not limited to rule changes and new requirements. The Commission has also established the Office of Chief Examiner to intensify its inspection of broker-dealers and its oversight over self-regulatory agencies. In March, 1972, the Commission submitted to Congress the draft of a proposed bill to give to the Commission additional authority over the entire paperwork processing mechanism in securities transactions. Two other bills were subsequently introduced, both in the House and Senate. All contemplate that the Commission will set standards for performance, operational compatibility, access to facilities and standards for safety of cash and securities. The thrust of this legislation is to provide coordination and direction for a nation wide system for clearance, settlement and ownership transfer in securities transactions. In addition, to speed the development of new systems for securities processing, the Commission in the 1972 fiscal year created a special operations group composed of former securities industry operations personnel to work closely with the industry on stock depositories, clearing and settlement systems and elimination of the stock certificate.

### **Restructuring of the Markets**

In addition to knowing that the broker he is dealing with is financially sound and operating under close regulatory supervision, the investor should be able to exercise investment judgments in markets that are liquid, free from manipulation, fair to large and small investors and geared to make the best price available to investors in all parts of the country at all times. These factors, plus an emphasis on making available to investors the most professional service possible, are the continuing thrust of the Commission's efforts in the restructuring of the securities markets.

Both the nature of the securities markets and the economics of the securities business have undergone rapid and radical change with increasing institutionalization of the market. Today, while individuals still own most of the stock, institutions do most of the trading. In recent years, the massive flow of large block trades from institutions has required new market mechanisms outside the specialist and the auction market for their absorption. Increased institutional emphasis in brokerage services has led to new research, positioning and execution functions unknown until recently. A commission rate structure often not reflective of the economic realities of the business and pressure from institutions to cut or reallocate commissions has led to a maze of practices which themselves affected the pattern of securities trading. The overall results, on the one hand, have been the creation of substantial new market mechanisms for handling of today's volume and a greater professionalism in brokerage services, particularly in research. On the other hand, these changes had brought a fragmentation of markets, an absence of information on many trades, a directing of transactions to some markets on the basis of commission practices rather than best price, and a growing gap in the quality of investment research services available to individuals as compared with institutions.

The concern of the Commission is that in the future structure of the securities markets competition be made to work for the investor. Our intent is that markets become more publicly oriented, more liquid and that full information on transactions, quotations and the performance of issuers put the individual and the institution on an equal footing in getting information needed for investment decisions and in obtaining the best available price.

Accordingly, in October, 1971, the

Commission began two months of hearings to get the views of all concerned with the structure of the markets and the economics of the securities industry: investors and investor groups, stock exchanges, other self-regulatory agencies, institutions, brokerage firms and securities industry groups. Out of these hearings, we developed our Policy Statement on the Future Structure of the Securities Markets, published in February, 1972.

At the heart of the Commission's market structure policy is a central market system for listed securities. The development of competing markets to handle the increasing number and complexity of securities transactions should be directed so that these markets are part of an all-inclusive system with full disclosure of activity, comparable regulation and standards, and direct competition between market-makers based on performance. The central market would not be one market, but in fact a communications system tying together all competing markets so that investors can see where the best price is available. In this way, trades will flow to the best market, whether it be in New York, California, Chicago and whether it be on the floor of an exchange or in the office of a market-maker. Only in this way can competition be put to work for the investor. Only through centralization of information can the separate capabilities of our markets be combined to strengthen the overall ability of the nation to mobilize and allocate capital.

To implement the development of the central market system and other policy recommendations, the Commission sought to utilize the practical expertise of those most directly involved. Advisory committees comprised of experienced members of the industry and other qualified experts were named to provide the Commission with a full range of options and suggestions. One committee, the Advisory Committee on Market Dis-

closure, has recommended the structure and governance of a reporting system to include last sale and volume information from all markets in a composite presentation, with trades identified by market. This Committee now is at work on recommendations for a system that will provide the heart of the central market: a quotations network that would capture and display current quotations from all competing market makers so brokers can direct investor orders to the best market. Another committee, the Advisory Committee on a Central Market System, is developing recommendations on regulation and operating standards for competing markets in the system, as well as the proper means for providing economic access among such markets. The third group, the Advisory Committee on Block Trading has submitted recommendations relating to the impact of large blocks on securities markets and methods of handling them, which are now under study by the Commission's staff. The staff is also conducting its own analysis of how the central market system should be designed, implemented and regulated.

During the fiscal year the Commission developed two rule proposals as a first step toward a regulatory framework for the central market system. One Rule, 17a-14, requires registered exchanges and the National Association of Securities Dealers to make quotations of listed securities traded by their members available on a continuing basis; the second, 17a-15, requires these agencies to make last sale and volume information available on a current, real-time basis. The next step in this process will be the promulgation of short sale and other rules necessary to make the transaction and quotation disclosure systems not misleading. Once these communications systems are operational, the course toward the development of a truly national central market system will have been set.

The central market system is not an end in itself. It is a crucial part, but only a part, of what should be a totally professional investment service to the public. The system would inform the broker of all markets being made in a security and enable him to achieve the best possible price for his customer. But the best execution in the world is worth little if the investment decision is based on service that is unprofessional and ill-informed. The second critical recommendation of the Commission's policy statement sought to improve the quality of service to all investors by directly addressing the problems of commission rates, investment research and suitability, reciprocal practices in sale of investment company shares, and institutional membership. Together these issues present a complex, interrelated, often jumbled picture that can be clarified only by policies that bring all practices into the open and subject them to the test of public interest.

In the case of brokerage commissions, a drastic overhaul of the rate system clearly is called for and is taking place. In April, 1971, negotiated rates were introduced into the fixed-rate system for the first time, covering portions of orders over \$500,000. In this fiscal year, the negotiated rate sector was expanded to portions of orders over \$300,000. Over the full range of the commission schedule, the Commission reviewed and allowed implementation of a new rate schedule by the New York Stock Exchange which eliminated a temporary surcharge on smaller trades while at the same time it provided rate relief for the industry on these transactions. Because the rate structure bears so closely on the availability of investment services, the policy of the Commission is to weigh the pace of expansion of competitive rates against its economic impact on firms.

The Commission's policy statement described research as an integral and

vital part of any truly professional investment process. In an elaboration of that statement last May, the Commission said that investment managers need not necessarily seek the lowest price for brokerage services in discharging their fiduciary obligations, providing that the quality of research and other brokerage services available at a higher cost can justify that cost difference. Our concern for the quality of service available to investors extends also to creation of new services by broker-dealers and others that will provide individualized investment advisory services, probably computerized, to direct investors with relatively small amounts of money to invest. The Commission after the close of the fiscal year appointed an industry advisory committee to review its rules with a view to encouraging the development of such services and recommending standards for them.

In another area, the Commission has been concerned about reciprocal practices whereby mutual funds reward broker-dealers for the sale of fund shares by directing commission business through them. Aside from the conflict of interest this creates for the broker in recommending fund shares, and the investment manager in seeking best execution, there are very substantial problems of non-disclosure to buyers of the compensation paid to sell to them and of improper cost to fundholders who in effect may pay for the distribution of shares to others through commission dollars. The Commission in its policy statement recommended that these practices be terminated. The NASD at mid-year published for comment [or proposed] a rule barring the directing of brokerage by mutual funds on the basis of the sale of fund shares.

Finally, the question of who should be members of exchanges is closely tied to any consideration of quality of service to the investor. The view of the Commission expressed in its policy

statement was that as the central market system develops it should have at its heart a core of professional brokers and market makers serving investors. The primary purpose of these professionals would be to execute orders for investors. This means that membership on exchanges would depend not on the nature of the brokerage organization but whether it contributes to the purpose of the market by serving investors other than itself. After requesting the advice and recommendations of exchanges, the Commission issued for comment a proposed rule which would allow exchange membership for broker-dealers if at least 80 percent of the value of their exchange securities transactions represents orders from non-affiliated customers.

As a further part of its efforts to implement a policy of maintaining the fundamentally public character of the securities markets, the Commission during the fiscal year sent to Congress a bill that would empower it to further regulate trading by existing exchange members for their own or for affiliated accounts. In essence, it would require that all members, when trading for their own accounts, be required to yield priority, parity and precedence to public customers. This must not be confused with our belief that all exchange members must do a predominantly public business when transacting business on an exchange; we are merely saying that exchange members, when they do trade for their own or for affiliated accounts, even as market makers, must fully recognize their responsibility to the general public and be prepared to yield to public orders.

## Disclosure

American securities markets are the strongest in the world in large measure because the investor in the American market is the best informed investor in the world. Important steps were taken

or started in fiscal 1972 to strengthen this system of disclosure. These changes were based on three concepts: (1) that investor protection and confidence could be improved by converting much of the "boiler plate" and other meaningless language of the new offering prospectus and other documents into meaningful disclosure about the issuer; (2) that greater certainty and clarity was needed in rules governing securities transactions, particularly those involving the securities offering and resale process; and (3) that financial reporting should be made more comparable, more comprehensive, and more meaningful.

Significant new disclosure concepts grew out of hearings held in 1972 by the Commission on new issues. These so-called "hot issue" hearings dealt with the role of the issuer, underwriter and market-makers in the handling of these first-time securities, many of a highly speculative nature. Commission proposals issued last July outlined potential requirements for companies bringing their securities to the public for the first time to discuss business plans, budget projections, plans for use of proceeds, and analysis of expected markets. Equally important, these proposals spoke to the problem of meaningless prospectus language oriented more to considerations of liability than disclosure by requiring specific and direct description of this information and other factors, as well as better organization and presentation of information to highlight and clarify the elements of risk and potential gain.

Commission emphasis on making disclosure more available, significant and meaningful also extended to the volume of information filed by companies whose securities already are publicly held. This involved computerization to speed availability of reports on company insider transactions; introduction of a requirement that companies specifically report



changes in auditors, with more detailed disclosure when the change results from a conflict of views; examination of a potential requirement that companies note items for stockholders that are reported in their annual reports to the Commission but not in their reports to shareholders; and the launching of a major information dissemination program aimed at getting more SEC data to the public through information vendors, public libraries, broker-dealers, news media and Commission publications.

To create greater clarity and certainty in securities transactions, the Commission implemented rules covering sale of restricted stock. Rule 144 is only the first of a series of rules governing troublesome aspects of securities offering and resale. Work was completed in fiscal 1972 which led to drastic revisions of disclosure and resale rules involved in mergers and acquisitions of companies. Work also began on examination of potentially more objective rules in the private placement area. Our objective in these changes is to remove artificial barriers which have been troublesome to issuers in these areas and at the same time create greater disclosure for investors.

The third phase of our disclosure activity involved financial reporting. The Commission is considering acceleration of requirements for supplemental disclosure on the meaning of different accounting policies, the effect of changes in these policies, the nature and significance of accounting choices and the basis for and changes in assumptions and estimates which could be critical to the financial results a company reports.

The independence of auditors and their continuing responsibility was of special concern. As mentioned, we now require notice of auditor changes and special notification if this resulted from difference of views. We issued Accounting Series Release 123 recommending

that corporations establish audit committees composed of outside directors to create a direct channel of communication between auditors and the Board to give greater objectivity to financial statements. In the fall of 1972, we issued another release proposing that auditors report in timely fashion on the fairness of material unusual changes or credits reported to the Commission on Form 8-K, our interim material information report form. At the same time, the Commission proposed amending disclosure forms to require more comprehensive and timely disclosure on write-downs, writeoffs and extraordinary charges. The thrust of this proposal was to discourage arbitrary timing and limited explanations on these often highly significant charges.

The Commission also looked into special problems of financial reporting encountered by companies engaged in defense and other long-term contracts, and cited the need for companies to specifically assess for investors the problems and developments in contracts and programs of a long-term nature. This statement was an outgrowth of a staff study on the severe problems encountered by Lockheed Aircraft Corporation in the C5A contract.

The sale of real estate interests to public investors, a business that has emerged in recent years perhaps as the largest user of public equity funds, was also the subject of Commission disclosure activity. A special advisory committee of professionals was named during the fiscal year to make recommendations for disclosure standards in this complex and growing area. This group completed its work in the fall of 1972 in a report with a principal recommendation calling for uniformity of regulation on real estate offerings among states, self-regulatory agencies and the Commission.

## **Enforcement Policy and Practices**

The Commission undertook a sweeping review of its enforcement operations in fiscal 1972. A special advisory committee on enforcement policies and practices in June issued a series of recommendations to improve, speed and clarify enforcement procedures. The Commission in September outlined, as a result of the report, a policy to clarify informal procedures in effect to provide persons under investigation with the opportunity to present their positions prior to authorization of an enforcement proceeding. The release also expanded the authority of hearing examiners in the conduct of administrative hearings.

## **Reorganization of Commission's Staff**

In its first major reorganization in 30 years, the Commission restructured its staff into five operating divisions instead of three. The overall effect is to concentrate resources by focusing all enforcement and investigative activity in one division, all disclosure activity in another and all regulatory activity into a

third area composed of three divisions, one dealing with markets, another with money management and the third with the Commission's public utility holding company and reorganization responsibilities. This reorganization will enhance the ability to focus our talent and resources and deal effectively with our continuing problems of greatest priority—those concerning the structure and efficiency of the markets, the financial responsibility and professional service of the broker-dealer community, the economics, distribution methods and services of investment companies and investment advisors, corporate disclosure and enforcement in all of these areas. A major assignment of the divisions regulating trading market and money management activity will be education and oversight to foster self-regulation and voluntary compliance. These divisions have developed or are developing inspection manuals and compliance manuals for broker-dealers and investment advisors, guidelines on insider transactions, and a manual of policies and procedures on the oversight of self-regulation.



# **PART 1**

## **IMPORTANT DEVELOPMENTS**



# **PART 1**

## **IMPORTANT DEVELOPMENTS**

### **INVESTOR PROTECTION**

A focus of Commission concern and activity during the 1972 fiscal year was the development of further safeguards for investors in light of the securities industry problems revealed by the 1967–1970 operational and financial crisis. The various steps that were taken by the Commission, together with the investor protection legislation previously enacted by Congress and various measures adopted by the industry itself, were designed to prevent a recurrence of the conditions which then prevailed and to provide a sound basis for renewed investor confidence.

### **Securities Investor Protection Corporation**

The enactment by Congress in December 1970 of the Securities Investor Protection Act ranks high among the measures taken to provide increased protection to investors. The Act created a Securities Investor Protection Corporation (SIPC) to insure, up to specified limits, cash and securities in accounts of broker-dealer customers. While SIPC is funded primarily through assessments on its members (membership consists of all registered broker-dealers and exchange members, with limited exceptions), it has access to emergency

financing of up to \$1 billion from the U.S. Treasury.

As of June 30, 1972, following 18 months of operation, SIPC was involved in the liquidation of 43 broker-dealers in 17 states. It was estimated that over \$7 million of SIPC funds would be required to meet the claims of customers of those firms. One of the major problems encountered in SIPC liquidation proceedings has been that debtor firms had seriously inadequate, inaccurate or even nonexistent books and records. As a result, delays have been encountered in satisfying customers' claims for money and securities.

### **Study of Unsafe and Unsound Practices**

In the SIPC Act, Congress directed the Commission to compile a list of unsafe and unsound practices by broker-dealers and to report to the Congress, within a year, on the corrective steps being taken under existing law and recommendations for additional legislation which might be needed. The Commission's study was submitted to the Congress on December 28, 1971.<sup>1</sup>

In preparing its report, the Commission drew on information in its own files and those of the self-regulatory organizations, including financial reports filed by broker-dealers. The report also referred to case studies of individual firms with financial and operational difficulties, as well as industry surveys and studies in the operational area by management consultant groups. Among the areas analyzed in the report were the 1967 paperwork crisis, the impact of the 1969-1970 market decline, the nature and use of broker-dealer capital, management and operational deficiencies, the use of customers' funds and securities, and stolen securities. The report also documented the need for an early warning system, and included a critique on deficiencies in the self-regulatory scheme.

The report cited the following unsound practices: (1) Inadequacy and impermanence of capital; in some cases, the injudicious employment of capital that did exist. (2) Over-emphasis on sales and trading activities at the expense of operational resources. (3) There was an absence of control of securities traffic to provide assurance of prompt delivery of securities and remittance of payments. The result was a virtual breakdown in the control over the possession, custody, location and delivery of securities, and in the payment of money obligations to customers, exposing customers to risk of loss. The industry, and to an extent the self-regulatory bodies themselves, had not implemented or planned broad-based solutions to the settlement process and the related flow of paper. (4) Inability of self-regulatory organizations to respond to the crisis with meaningful corrective measures. The absence of an effective early warning system caused belated action when the full impact of the crisis was finally ascertained. (5) Lack of experience of principal members of many, principally small, concerns, pointing up problems in entrance requirements to the industry.

The Commission's Study detailed the corrective measures already taken or proposed by the Commission and the industry, and the areas where the Commission deemed further legislation necessary. The most significant of these measures (including several adopted after submission of the Study) and the proposed bills are discussed elsewhere in this annual report. Briefly, capital requirements were made more stringent. Control over securities was strengthened by requiring broker-dealers to make a quarterly physical examination and count of firm and customer securities. Rules were proposed to provide greater protection for customers' free credit balances, and for securities left with brokers. Broker-dealers were required to

furnish information concerning their financial condition to customers. New entrants into the securities business were required to disclose details concerning their personnel, facilities and financing. Measures were taken to provide the Commission and self-regulatory authorities with more effective early warning systems. The staffs of the Commission and the self-regulatory agencies were augmented to permit more frequent and intensive inspections of broker-dealers. Units were established within the Commission and the industry to develop more efficient clearing and settlement procedures, including the anticipated immobilization or elimination of the stock certificate.

## Legislation

During the 1972 fiscal year the Commission submitted to Congress proposed legislation to amend the Securities Exchange Act to increase and unify the Commission's oversight of national securities exchanges and the NASD and to make the self-regulatory pattern of the Act more effective. Generally, the provisions of the bill would have given the Commission more uniform and strengthened review powers over rules of the self-regulatory organizations, and the authority to ensure enforcement of such rules and review disciplinary actions taken by those organizations.

The Commission's present authority over the rulemaking of the self-regulatory bodies is an illogical patchwork of provisions which falls short of giving the Commission authority to act promptly and effectively where a rule, or a proposed rule, is or might be injurious to the public interest. Specifically, the Commission has little power to prevent the adoption of a particular rule by an exchange, nor to abrogate it once it has been adopted. It does have the power to require alterations in exchange rules, but only insofar as the rules re-

late to certain matters, and after following cumbersome procedures. On NASD rules, the Commission has broad powers to block a rule from being put into effect and to abrogate an existing rule, but its power to alter or supplement rules is very limited. The proposed bill would have given the Commission the power to approve or disapprove of any new rule proposal or any proposed amendment, supplement or repeal of an existing rule, as well as the authority to require rule amendments and supplements and to abrogate rules. Action pursuant to such authority would be preceded by appropriate notice and afford an opportunity for comment or hearing.

The Commission is limited in its oversight of self-regulatory bodies in that it cannot directly enforce their rules against their members. The proposed bill would have empowered the Commission to enforce these rules, but only if the self-regulatory body fails to act. The grant of this additional authority to the Commission would not only allow Commission action where there was a breakdown in self-regulation, but would also promote action by the self-regulatory bodies by providing them with greater incentive and by strengthening the hand of these agencies in dealing with members.

The bill would also have expanded the Commission's review authority of disciplinary proceedings to include actions taken by exchanges. Currently, the Commission has such authority only on NASD disciplinary actions, and in those cases it cannot increase the penalty assessed. Under the proposal, the Commission could have increased sanctions other than fines, that are imposed by any of the self-regulatory bodies. Before this could be done, the disciplinary action would have to be referred back to the self-regulatory organization for additional consideration to give it an opportunity to reappraise the sanction in light



of the Commission's indication that it might be inadequate.

In the operations area, the Commission in March 1972 submitted to Congress a draft of a proposed bill to give the Commission additional authority over the handling, processing and settlement of securities transactions, particularly as those functions are performed by securities depositories, clearing agencies, transfer agents, registrars, and broker-dealers. In addition, the proposed bill would have conferred upon the Commission the power to determine the form and format of the stock certificate. The ultimate objective of the bill was to provide a basis for the development of an efficient national system for clearance and settlement of securities transactions. Two similar bills were also introduced, one in the House and one in the Senate.

All three bills were directed at providing a public entity with authority to insure that standardization and automation within the limits of technological feasibility are accomplished as rapidly as possible, and that there be a coordinated systems approach to the clearance and settlement of securities transactions. They contemplated that the Commission set standards and procedures in four principal areas: performance, particularly accuracy and prompt handling and settlement of securities transactions; operational compatibility; policies for reasonably nondiscriminatory access to the facilities; and standards for safety of cash and securities in the custody of these entities.

No legislation on the above matters was enacted by the 92nd Congress. The Commission anticipates that similar legislation will be introduced at the next Congress.

In related action, the Commission in early 1972 established an Industry Operations Technical Staff composed of former securities industry operations personnel. The assignment of this group

is to prepare, in cooperation with the industry, for the elimination or immobilization of the stock certificate, and generally to work on improvement of industry operational methods.

### **National Clearing Corporation**

In the latter part of 1969, the NASD established the National Clearing Corporation (NCC) as a wholly owned subsidiary to provide a nationwide system for clearing and settling over-the-counter transactions. NCC began operations in New York in November, 1970. Clearing facilities were extended on a pilot basis to Boston and Philadelphia in May, 1972. The Philadelphia-Baltimore-Washington and Boston Stock Clearing Corporations provide the operational support required in these two cities. NCC's objective is to be able to clear all trades within and among the three cities by the end of calendar 1972. It believes that such trades account for over 40 percent of total over-the-counter activity by NASD members, now estimated at 50,000 to 60,000 transactions daily. NCC is also operating a pilot inter-regional clearing procedure between several of its New York firms and several Pacific Coast Stock Exchange members on the West Coast.

In connection with the NASD's establishment and operation of the NCC, the Commission, in early 1972, adopted Rule 15Aj-3 under the Exchange Act which prescribes certain requirements for a national association of securities dealers which establishes and operates facilities for clearing and settling securities transactions.<sup>2</sup> These include the requirements that the applicable rules of the association incorporate as guides to interpretation and application certain public interest standards set forth in the Exchange Act, and also that such rules provide a fair procedure with respect to any refusal or limitation of access to such system by a customer, issuer, broker or dealer. The rule also

provides for Commission review of adverse action by the association with respect to such matters. The Commission has determined that the by-laws and operating rules of the NCC, including those relating to access to the system, are consistent with Rule 15Aj-3 and other applicable requirements of the Exchange Act.

## MARKET STRUCTURE

### Policy Statement

During the last fiscal year, the Commission completed another segment of a series of hearings and special studies which began three and a half years ago. Earlier hearings had dealt primarily with questions relating to commission rates and give-up practices. The Commission's Institutional Investor Study Report, submitted to Congress on March 10, 1971, developed extensive data which documented the burgeoning of financial intermediaries such as banks, mutual funds, pension funds and insurance companies, often referred to simply as "institutions", and their increasing impact on the securities markets.

The most recent set of hearings, held between October 12 and December 21, 1971, focused on the structure, operation and regulation of the securities markets and provided the most comprehensive collection of information on market structure since the Commission's Special Study of Securities Markets in 1961-1963. During these hearings, the Commission obtained a broad spectrum of views. A total of 182 persons testified, covering almost 4,000 pages of transcript, in addition to 74 persons who supplied written statements.

Following the hearings, the Commission released its Statement on the Future Structure of the Securities Markets, on February 2, 1972. In this general policy statement, the Commission crystallized and pinpointed many of the

problems and deficiencies existing in the structure, operation and procedures of the securities industry, and presented in comprehensive form its views concerning the appropriate evolution of the securities markets.

The statement called for creation of a central market system for listed securities, in order to maximize the depth and liquidity of the markets. Essentially, such a system would be designed to strengthen competition and to make its operations open and fully comprehensible to the public. The Commission stated that these objectives could best be accomplished by: implementation of a nationwide disclosure, or market information, system; elimination of artificial impediments created by exchange rules or otherwise to dealing in the best available market; establishment of more open economic access to all exchanges by broker-dealers; and integration of third market firms into this comprehensive disclosure, or central market, system. The Commission subsequently proposed rules to make composite information on prices, volume and quotations for all listed securities generally available<sup>3</sup>

The Commission's policy statement also addressed other important questions, such as the impact of block trading, the quality of service to investors, commission rates, research and suitability, reciprocal portfolio brokerage for sales of investment company shares, and membership on national securities exchanges for other than public purposes.

To assist in developing the views it had articulated in its policy statement, the Commission designated three committees comprised of the Commission staff, industry leaders with broad-based expertise in market concepts and functions, and a staff member as secretary to study (1) development of a comprehensive market disclosure system, (2) structure, regulation and governance of

a central market system, and (3) necessary and desirable rules for block trading.

The Commission took other action to increase the portion of institutional-sized orders on which commission rates should be competitively determined, from its prior level of that portion of all orders over \$500,000, to the portion of orders exceeding \$300,000. It also directed the National Association of Securities Dealers to formulate and implement rules to prohibit the practice of using investment company portfolio brokerage to reward broker-dealers for sales of investment company shares.<sup>4</sup> In the area of exchange membership, the Commission requested all registered securities exchanges to adopt rules to exclude from membership any organization whose primary function is to route orders for the purpose of rebating or recapturing commissions, directly or indirectly. It also expressed its intention to exercise appropriate authority to ensure that the exchanges adopt rules requiring that members must conduct a predominant portion of their brokerage commission business with and for nonaffiliated, public customers.

### Commission Rates

On September 24, 1971, the Commission advised the New York Stock Exchange that, with certain stipulations, it would not object to that Exchange's implementation of a new minimum commission rate schedule proposed by the Exchange. Upon agreement by the Exchange, and following clearance by the Price Commission, this new schedule became effective on March 24, 1972. A principal feature of the schedule is the incorporation of a volume discount beginning at 200 shares.

### Nonmember Access to Exchanges

Since 1960, six regional stock exchanges have amended rules to give

NASD-member dealers who were not members of those exchanges a discount from full commission rates. Until recently, however, the New York Stock Exchange did not provide such a discount. This policy created competitive disadvantages for brokers who were not members of the NYSE.

In October, 1970, the Commission requested that the NYSE submit a plan for "reasonable economic access . . . for non-member broker-dealers." And, in September, 1971, the Commission conditioned implementation of the Exchange's new commission rate schedule on adoption of a 40 percent discount for nonmember broker-dealers.<sup>5</sup> The 40 percent discount became effective on all exchanges on March 24, 1972. By permitting qualified nonmember broker-dealers to retain a portion of the amount they would otherwise expend in commission costs, the new rules recognize the costs to such broker-dealers of securing and transacting securities orders. The rules also encourage greater participation by nonmember brokers and their customers in exchange securities markets.

### Exchange Membership

For many years, the fixed commission rate structure maintained by the nation's exchanges failed to reflect economies of scale associated with the large orders of institutional customers. This fact, coupled with the increasing tempo and magnitude of institutional transactions in recent years, combined to produce serious distortions in the existing market system. Large institutions sought to avoid what were regarded as excessively high commission fees, either by devising various rebative and reciprocal dealing practices, or by obtaining exchange membership to avoid the fixed nonmember commission rate entirely. The question of the appropriate utilization of exchange membership took on added significance in light of the Com-

mission's desire to effectuate a central market system.

In reviewing recent trends of the markets, the Commission was concerned about the continued confidence and participation of all investors—including small investors who were found by the Institutional Investor Study to be essential to the proper functioning of the markets. The Commission was further concerned with the pattern of institutional trading and the impact of large block transactions on the functioning of those markets.

The Commission enunciated its broad policy determinations concerning these problems in its market structure statement. Specifically, the Commission stated its view that the rebating, recapturing and redirecting of commissions were to be terminated. As noted above, commission rates gradually will be adjusted to a competitive system which will more properly reflect the costs of handling institutional-sized transactions. Finally, the Commission stated it would request that the exchanges admit or retain in membership only those individuals or organizations which intend to conduct a predominantly public business with nonaffiliated customers.

On April 20, 1972, the Commission issued its White Paper on Institutional Membership which traced in detail the origins of the institutional membership problem and its relationship to the issues of commission rates and market structure, and further specified the Commission's position on the steps it intended to take to implement its policies. On May 5, 1972, the Commission submitted legislation to the Congress to clarify the scope of the Commission's authority to deal with these questions. One proposed bill would amend Section 6 of the Securities Exchange Act to require, in effect, that membership on national securities exchanges contribute to the public nature of the exchange trading markets. A second bill, submitted

on the same day, proposed an amendment to Section 11(a) of the Exchange Act to provide for more effective and comprehensive regulation of trading by all exchange members, either for themselves or those standing in a control relationship with them regardless of whether such trading occurs on or off the exchange floor.

On May 26, 1972, the Commission, pursuant to its existing authority under Section 19(b) of the Exchange Act, sent a letter to the presidents of all national securities exchanges requesting adoption by the exchanges of rules on the appropriate utilization of exchange membership, comparable to a rule suggested by the Commission in its letter.

The Commission's rule suggestion provided that membership in national securities exchanges should be open to any and all persons or organizations, provided that every member or member organization would have, as the principal purpose of its membership, the conduct of a public securities business. For purposes of the Commission's proposed rule, it was stated that an exchange member presumptively would be deemed to have such a public securities business if at least 80 percent of the value of exchange securities transactions effected by the member during the preceding six calendar months were effected for or with customers other than those affiliated with the member or were transactions contributing to the stability and effectiveness of the markets. Conversely, the rule would bar from exchange membership those persons or organizations whose primary function is to rebate, recapture or redirect commissions or otherwise execute portfolio transactions exclusively for the member's own account or for the accounts of persons affiliated with the member.

In August, 1972, the Commission, under authority of the Exchange Act, proposed for comment a rule on mem-

bership on registered securities exchanges for other than public purposes.<sup>6</sup> The rule proposed was substantially the same as that which had been the subject of the Commission's prior request. The initial comment period, after the grant of an extension of time, expired on October 16, 1972. The Commission announced that it also would receive supplemental written comments and oral statements before it concluded its consideration of the appropriateness of its proposed rule.<sup>7</sup>

## OTHER MARKET REGULATION

### NASDAQ

In February, 1971, the NASD formally commenced operations of the NASDAQ automated quotations system with approximately 2,300 over-the-counter securities. The system, which is operated by Bunker-Ramo Corporation for the NASD, has three levels of operating service. Level I service provides a current, representative inter-dealer bid and ask quotation for any security registered in the system for the information of registered representatives and customers of retail firms. Level II is designed to supply upon request of trading rooms a list of market-makers and their current bid and ask quotations for any such security. Level III service is similar to Level II service, but also has input facilities through which authorized NASDAQ market makers enter, change or update bid and ask quotations.

By the end of the 1972 fiscal year, the number of securities quoted on the system had reached approximately 3,350 (including about 90 stocks listed on exchanges) with a total market value of over \$140 billion (excluding the listed stocks). There were about 620 registered NASDAQ market makers, and the system averaged approximately 1,150,000 interrogation requests daily. The NASD also instituted a "stock watch" surveillance program for the

new system, and has been cooperating with the Commission's surveillance staff in looking into unusual market activity in NASDAQ securities.

During the year, the NASD also began to compile price indices for NASDAQ securities and to release them to the news media for public information. To assist the Association in compiling these indices, the Commission adopted Rules 13a-17 and 15d-17 under the Securities Exchange Act and a new reporting form to require the submission of certain information to the Commission and the NASD by issuers of securities quoted on NASDAQ on any aggregate net change exceeding 5 percent or greater in the amount outstanding of a class of securities quoted on the system.<sup>8</sup> Since November 1, 1971, the NASD has also been releasing daily NASDAQ volume to the media for publication. Thus, for the first time, the public was able to obtain daily volume data for many over-the-counter securities.

On March 17, 1972, the Association, on an experimental basis and in response to a request by the PBW Stock Exchange, authorized the inclusion of quotations of exchange specialists in the NASDAQ system.

The NASD also announced its plans to expand the NASDAQ system to allow subscribing firms to report the details of each securities transaction to the NASDAQ central computer. The proposed trade reporting system, which will probably take about a year and a half to put into effect, would make it possible for traders to verify each trade within minutes of its execution and to detect immediately any errors. It is expected that such a reporting system will provide more information to investors and will speed up the clearing and settling of over-the-counter transactions.

### Self-Underwriting

In March, 1970, the New York Stock Exchange amended its rules to permit

public ownership of member firms. Subsequently, the NASD, in view of its members' need for additional capital, abandoned its position that members could not participate in distributions of their own securities and published proposed regulations for public offerings of securities of member firms or their affiliates, whether through an independent underwriter or by the firm itself. The regulations were cleared by the Commission and adopted by the NASD. As a result, numerous broker-dealers were able to register with the Commission offerings of their securities which were self-underwritten in whole or part.

Generally, NASD regulations permit a member to sell its shares to the public if: (1) detailed financial statements are submitted with the registration statement; (2) no more than 25 percent of the equity interest of the owners of the member is offered as part of the issue; (3) the amount of the offering does not exceed three times the member's net worth; and (4) the member's net capital ratio would not exceed 10:1 at the termination of the offering. Also, a member is prohibited from making a subsequent public offering for at least one year and is required to send to each of its shareholders a quarterly statement of its operations and an annual independently audited and certified financial statement. In addition, if the member participates in the distribution of its own securities or those of an affiliate, it must obtain two independent underwriters with at least five years' experience in the securities business, three of which are profitable, to certify to the fairness of the offering and to exercise the usual standards of due diligence in connection with the preparation of the registration statement.

Seasoning and profitability requirements also apply to the member-issuer. In self-underwritings, persons actively engaged in the member's business and their immediate families are prohibited

from selling any portion of their equity interest in the member firm. If the member recommends its securities to a customer, it must have reasonable grounds to believe that the recommendation is suitable and maintain a record showing the basis on which it reached its suitability determination.

During fiscal 1972, the Commission announced a proposal to adopt rules under the Securities Exchange Act for public offerings of their securities by broker-dealers who are not NASD members.<sup>9</sup> These proposed rules are comparable to the NASD regulations.

## DISCLOSURE-RELATED MATTERS

### "Hot" Issues

In February, 1972, the Commission began public, fact-finding investigatory proceedings on "hot issues" securities markets (i.e., markets in which new issues have experienced substantial price rises in their after-markets) to determine adequacy of existing disclosure and regulatory protection for investors.

During the first phase of the hearings, which ended in June, a total of 69 witnesses testified, including representatives of the securities industry, investment banking and state securities commissions, along with a number of professional venture capital investors. These hearings focused on the following questions: (1) Are there viable methods of financing available to new ventures which are more appropriate than the public securities markets? (2) Does information provided to the public of new ventures reflect economic reality and is it in a format which can be easily understood? and (3) Are public markets for new issues subject to methods and patterns of distribution and aftermarket trading which artificially cause such issues to become "hot"?

The second phase of the hearings began in September and focused on dis-

tribution and aftermarket trading. Case studies were selected from among the 64 companies previously identified in the hearings which had first-time public offerings during the hot issues market of 1968-69.

On July 26, 1972, following the first phase of the hearings, the Commission released for public comment proposals for initial steps to curtail hot issues, to provide more meaningful disclosure relating to new issues, and to integrate further the disclosure provisions of the securities laws.<sup>10</sup> The Commission also requested that the National Association of Securities Dealers and the stock exchanges take steps to help alleviate the problems of hot issues markets.

Actions taken or proposed by the Commission included:

1. The Commission stressed the need for underwriters to diligently investigate the disclosure in a registration statement, particularly where the offering involves a high risk venture. The Commission again suggested that the NASD formulate standards for "due diligence" investigations, requested the NASD to establish guidelines specifying what constitutes a bona fide public offering, resulting in an adequate "float" in the hands of public investors, and requested the NASD and national stock exchanges to consider the development of suitability standards for hot issue markets.

2. To provide public investors with meaningful information approaching that received by professional investors, the Commission proposed changes in some registration and reporting forms. These would require improved disclosure of competitive conditions in the industry and the issuer's position. For the first time, descriptions of corporate plans and budgets and market penetration studies would be included. A company filing a first registration statement which has not conducted bona fide operations for at least three years would

be required to describe its plan of operations for the ensuing months, if available. The description would include such matters as a budget of anticipated cash resources and expenditures. Companies which have entered or intend to enter a new line of business, or have introduced or intend to introduce a new product, involving expenditure of a material amount of resources, would have to disclose the results of any market studies and the status of product development in a registration statement or periodic report.

3. To make prospectuses more readable, the Commission revised rules and registration guides and proposed further revision of the guides.

### **Restricted Securities: Rule 144**

In January, 1972, the Commission adopted Rule 144 under the Securities Act dealing with the resale of "restricted" securities and sales by controlling persons, together with related rule and form changes. This represents the culmination of several years of work by the Commission and its staff, arising out of recommendations of the Commission's Disclosure Policy Study.<sup>11</sup> They are designed to provide full disclosure regarding securities sold in trading transactions, and to create greater certainty in the application of registration provisions by replacing subjective standards with more objective ones.

Rule 144 provides that any affiliate (i.e., control person) or other person who sells restricted securities for his own account, or any other person who sells either restricted or other securities for the account of an affiliate of the issuer, shall be deemed not to be engaged in a "distribution" of the securities and therefore not to be an "underwriter" of the securities if all the terms and conditions of the rule are met. The term "restricted securities" is defined to mean securities acquired from their issuer or from an affiliate of

the issuer in a transaction or chain of transactions not involving any public offering.

Before Rule 144 may be utilized, there must be available public information on the issuer. This condition is met if the issuer is subject to the reporting requirements of the Securities Exchange Act and is current in its reporting. If the issuer is not subject to the reporting requirements, there must be publicly available specified information on the issuer.

If the securities sold are restricted securities, Rule 144 requires that they must have been beneficially owned and paid for by the seller for a period of at least two years. The amount of securities which may be sold during any 6-month period may not exceed the lesser of one percent of the class outstanding, or the average weekly volume of trading on all exchanges for a 4-week period, if the securities are traded on an exchange. In sales by affiliates, the amount is computed by aggregating all restricted and other securities sold. For sales by other persons, the amount is based only on restricted securities sold. In certain situations, sales must be aggregated with those made by other persons.

The securities must be sold in "brokers' transactions" within the meaning of the Securities Act. There can be no solicitation of buy orders either by the broker or the seller, and the broker can receive only the usual and customary commission.

Except for transactions during any 6-month period not exceeding 500 shares or \$10,000, a notice of a proposed sale under the rule must be sent to the Commission concurrently with the sale.

In the adoption of Rule 144, the Commission also adopted other rule and form changes.<sup>12</sup> One, new Rule 237, exempts from registration outstanding securities held by persons other than the issuer, control persons or brokers or

dealers, if certain conditions are met. The rule is designed to permit sales in small amounts by non-controlling persons owning securities of issuers which do not satisfy the conditions of Rule 144.

The Commission also issued a release stating its opinion that the anti-fraud provisions of the securities acts are violated when an issuer, a control person, or any other person, in connection with a private placement of securities, fails to inform the purchaser fully as to the circumstances under which he is required to take and hold the securities and the limitations upon their resale.

In September, 1972, the Commission released interpretations of Rule 144 by its Division of Corporation Finance.<sup>13</sup> The interpretations, in question and answer form, were intended to clarify aspects of the rule. At the same time, the Commission amended the rule to require that the notice of proposed sale must also be filed with the principal securities exchange on which the securities are listed.<sup>14</sup>

## Rule 145

The Commission's Disclosure Policy Study in 1969<sup>15</sup> recommended rescission of Rule 133 under the Securities Act, which then exempted from registration securities issued in certain types of business combinations under a "no-sale" theory, and adoption of a special form for registration of securities issued in such transactions. In 1969, the Commission published a proposal to implement these recommendations,<sup>16</sup> but it subsequently deferred action pending final action on Rule 144.

In May, 1972, the Commission published for comment proposed Rule 145 and related proposals,<sup>17</sup> and in early October, 1972, it adopted the proposals in modified form.<sup>18</sup> Rule 145 provides that the submission to a vote of stockholders of a proposal for certain merg-



ers, consolidations, reclassifications of securities or transfers of assets is deemed to involve an "offer" or "sale" of the securities to be issued in the transaction. The effect of the rule is to require registration of such securities unless an exemption is available. Rule 133, being inconsistent with Rule 145, was rescinded.

In order to facilitate the registration of securities issued in transactions of the kind referred to in Rule 145, the Commission revised Form S-14. This form permits the prospectus to be in the format of a proxy or information statement.

### Proxy Revisions

In December, 1971, the Commission invited public comments on proposed amendments to Rules 14a-5 and 14a-8 of its proxy rules, relating to proposals of security holders for inclusion in an issuer's proxy material.<sup>19</sup> These amendments were adopted in modified form in September, 1972.<sup>20</sup> The provisions of Rule 14a-8 relating to the grounds on which management may omit shareholder proposals were amended to substitute objective standards (to the extent feasible) for previously subjective elements. Other changes include an increase from 100 to 200 words in the maximum length of a security holder's statement in support of a proposal.

In related action, the Commission amended its rule on availability of materials for public inspection and copying to extend to materials filed relating to the proposed omission of a security holder's proposal from proxy material and any written staff comments.<sup>21</sup>

### Registration Statements

The Commission published two releases in fiscal year 1972 on procedures used by the Division of Corporation Finance in processing registration statements under the Securities Act. One release,<sup>22</sup> noting the increase in work-

load and need to curtail time in registration, called attention to procedures—some old and some new—for review of registration statements: those which are so poorly prepared or present such serious problems that the use of further staff time cannot be justified are deferred until the issuer takes appropriate corrective action; "Cursory review" or a somewhat more detailed "summary review" is afforded filings (usually repeat filings) which do not present unusual disclosure problems and for which few, if any, comments are necessary; and "customary review" is given those registration statements deemed to warrant a complete accounting, financial and legal review.

The other release<sup>23</sup> stated that the Division would ordinarily defer processing registration statements filed by issuers who are delinquent in their periodic reporting. It pointed out that failure to observe reporting requirements is a serious obstacle to the maintenance of fair and informed trading markets, precludes the use of certain registration forms, and deprives the staff of information necessary for review of registration statements.

### Disclosure by Defense Contractors

In June, 1972, the Commission issued a notice to registrants engaged in defense and other long-term contracts regarding the need for prompt and accurate disclosure of material information.<sup>24</sup> The Commission noted that because of complexities and uncertainties inherent in such contracts, costs to be incurred and ultimate profit are often difficult to estimate. It stressed that registrants nonetheless have an obligation to make every effort to assure that progress on contracts—such as earnings, losses, anticipated losses or material cost overruns—is properly reflected in disclosure documents. The Commission's notice was issued following release of a staff report

on disclosure practices of defense contractors, including case studies of disclosure problems.

The staff report concluded that the Commission's present rules and disclosure forms were generally adequate but that disclosure by some defense contractors could be improved. It noted that differences sometimes appear between disclosures in the annual report filed with the Commission and the annual report to stockholders, which receives wider dissemination. The Commission urged issuers to make every effort to assure that disclosures in annual reports are as complete and accurate as those in filings with the Commission.

### **Broker-Dealer Securities**

Until recently, the great majority of registered broker-dealers were privately financed. During the fiscal year, however, some broker-dealers filed registration statements to offer equity securities to the investing public. Among these registrants were several of the largest firms in the securities industry.

In view of the Commission's limited experience with publicly-held broker-dealers, it determined not to propose a special registration form or disclosure guidelines. However, to minimize delays in the review of broker-dealer registration statements, it published comments and suggestions by its staff to assist those concerned with the preparation of such statements.<sup>25</sup>

### **Form S-16**

As noted in last year's annual report,<sup>26</sup> the Commission in December, 1970, adopted Form S-16, a new short form for the registration of securities under the Securities Act. The form is available only to issuers which have an established record of earnings and continuity of management, and file reports under the Securities Exchange Act. The Form S-16 prospectus consists largely

of the latest annual report and other reports and proxy or information statement filed by the issuer, which are incorporated by reference. At the time it adopted the form, the Commission noted that this was in the nature of an experiment and subject to revision.

In June, 1972, amendments to Form S-16 were adopted.<sup>27</sup> Their primary purpose was to increase the types of transactions for which the form may be used. Before the amendments, the form could be used only for sales of outstanding securities "in the regular way" on a national securities exchange, and for certain other transactions involving convertible securities and warrants. The amendments provide that the form may also be utilized for sales of listed securities in the "third market" or otherwise and for sales of securities quoted on NASDAQ.

### **Regulation B**

In February, 1972, the Commission published for public comment proposed amendments to Regulation B under the Securities Act, which exempts from registration certain offerings of fractional undivided interests in oil and gas rights.<sup>28</sup> The proposed revisions were adopted in October, 1972.<sup>29</sup> This was the first significant change in Regulation B since 1937.

The general structure of the Regulation was retained. The changes include an increase from \$100,000 to \$250,000 in the maximum amount of the offering, and new provisions designed to give prospective purchasers a better opportunity to consider the merits of the offering before a purchase and to curb abuses in the use of sales literature.

## **INVESTMENT COMPANIES**

### **Proposed Oil and Gas Investment Act**

In June, 1972, the Commission submitted to Congress legislation to provide

increased protection for investors in oil and gas drilling funds and programs. The House-Senate Conference Committee on the Investment Company Amendments Act of 1970,<sup>30</sup> in deleting a provision which would have subjected certain oil and gas funds to the regulatory pattern of the Investment Company Act, acted with the understanding that representatives of the oil and gas industry would cooperate with the Commission "in working out a reasonable regulatory statute consistent with the need for protection of investors in this area."<sup>31</sup>

The proposed bill was prepared in cooperation with the Oil Investment Institute, a trade association of oil program sponsors and managers, and, while patterned after the Investment Company Act, is tailored to the specific practices, problems and operating methods of the oil and gas industry.

The legislation is intended to deal only with oil programs which provide flow-through tax treatment to their investors and sell their securities to the public. It does not cover conventional oil companies or financing arrangements used by many small independent oil operators.

Oil programs are generally unincorporated associations which are primarily engaged in the business of holding or investing in oil or gas interests and of exploring, drilling or producing oil or gas. The structure of the programs is generally characterized by externalized management with beneficial ownership separated from control. As a result, management of oil programs may involve self-dealing and other transactions and practices which may be unfair to investors.

The draft bill would provide investor protection by requiring registration of oil programs and subjecting them to comprehensive regulation. It would provide controls designed to prevent conflicts of interest and unfair transactions

between oil programs and their managers, and to insure financial responsibility of program managers; prohibit changes in fundamental policies of an oil program without approval of the participants; and require that a person acting as program manager do so under a written contract which contains certain provisions. Some provisions of the proposed statute would be administered primarily by the National Association of Securities Dealers with Commission oversight. These relate to sales charges, sales literature, suitability of an investment and a classification system for the various forms of management compensation.

### Sale of Investment Adviser

During the year, the Commission also proposed legislation<sup>32</sup> to modify those sections of the Investment Company Act that were affected by the decision of the Court of Appeals for the Second Circuit in *Rosenfeld v. Black*.<sup>33</sup> In that case, the court held that the general principle in equity that a fiduciary cannot sell his office for personal gain is impliedly incorporated into Section 15(a) of the Act requiring shareholder approval of any new investment advisory contract. Consequently, a retiring investment adviser of an investment company violates the Act by receiving compensation which reflects either (1) a payment contingent upon the use of influence to secure approval of a new adviser or (2) an assurance of profits for the successor adviser under a new advisory contract and renewals.

In submitting the proposed legislation, the Commission expressed its view that the principles of equity were appropriately applied to the facts of the case, which involved an outright sale by an investment adviser of its advisory contract with a registered investment company. While the *Rosenfeld* case did not involve the sale of an outgoing investment adviser's assets, the sweep of the

Court's language nevertheless cast doubt on whether an investment adviser could profit when it sold its business in that manner.

In its statement accompanying the legislation, the Commission suggested that it would be in the public interest to remove the uncertainty in the mutual fund industry generated by the *Rosenfeld* decision. Thus, the proposed amendments are intended to permit an investment adviser, or an affiliated person of an adviser, to obtain a profit in connection with a transaction which results in an assignment of the advisory contract if certain conditions are met. These conditions are designed to prevent a retiring investment adviser or an affiliate, in connection with the sale of the adviser's business, from receiving any payment or other benefit which includes any amount reflecting assurance of continuation of the investment advisory contract.

### **Variable Life Insurance**

In the past year, the American Life Convention and the Life Insurance Association of America filed a petition proposing adoption or amendment by the Commission of various rules so as to exempt certain variable life insurance contracts and the issuers of such contracts from the Federal securities laws.

Variable life insurance refers to insurance contracts in which the death benefit, cash surrender value and other benefits vary to reflect the investment experience of a life insurance company's separate account which invests primarily in equity securities. According to the petition, neither the Commission nor the courts had determined the applicability of the securities laws to contracts of that nature. As a result, the petition claimed, life insurance companies had been reluctant to develop and introduce variable life insurance. The proposed rules would exempt from the securities laws variable life insurance

contracts possessing specified characteristics which the petition contended were designed to assure that the basic function of the contracts is to provide protection against death.

On February 15, 1972, the Commission ordered a rulemaking proceeding.<sup>34</sup> It invited interested persons to submit their views in writing and to appear personally in a public hearing on the proposed rules. Hearings began in April and concluded on June 7, 1972.

## **ENFORCEMENT MATTERS**

### **Penn Central Investigation**

In August, 1972, the Commission transmitted the staff report on the "Financial Collapse of the Penn Central Company" to the Chairman of the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce.<sup>35</sup> The report contained the principal findings based on a two-year investigation—one of the largest ever undertaken—into the relationship between the Federal securities laws and the collapse of the Penn Central Company, which was the largest transportation company in the world and one of the largest companies in the United States. Because a principal question was whether adequate and accurate disclosure of the company's condition had been made, an examination into the operations, accounting and finances of the company was necessary. This required the review of hundreds of thousands of pages of documents. Nearly 200 witnesses were called to testify and approximately 25,000 pages of testimony were taken. In the course of the investigation, the roles of approximately 150 financial institutions were reviewed.

The staff report is arranged in four parts. Part I involves the company's possible failure to disclose adverse information to the investing public. Part II relates to possible trading on nonpublic information by individuals and institu-

tions. Part III describes the role of Penn Central's commercial paper dealer and a commercial paper rating service. Part IV involves an examination of a private investment club in which several Penn Central financial officers were members and which raised issues of possible misuse of position by these officers.

Following submission of the report, Subcommittee Chairman Harley O. Staggers was quoted in the Congressional Record at stating:

"I believe one of the immediate lessons taught by the collapse of the Penn Central is that we cannot continue to have one standard of regulation over the securities of rail and motor carriers, and a different standard over the securities of all businesses in America. This has been the result of exceptions which were written into the securities laws many years ago by which the ICC, and not the SEC, regulates the issuance of securities by rail and motor carriers. I have introduced H.R. 12128 to eliminate the distinction and to insure that minimum standards of responsibility are clearly imposed for the protection of the investing public. I think the need for other legislative measures may become apparent once this report has been fully evaluated. I commend the SEC for the job they have done on this report. It is going to be a valuable reference for the public and for the Congress. The Penn Central disaster should not have taken place. We must do everything we can to make sure it does not happen again."

### Pyramid Sales Plans

For some time, the Commission has been concerned with the spread of pyramid sales schemes in the United States. Recently, it was estimated that 150 such schemes were being operated in

the various states and that the public has invested more than \$300 million in them.

In conjunction with the Special Assistant to the President for Consumer Affairs, the Commission in November, 1971, published a release<sup>36</sup> cautioning persons offering multi-level distributorships and other business opportunities through pyramid sales plans that they may be violating the Federal securities laws. Generally, these plans contemplate specified investments in return for the right to recruit and manage other "distributors" or "salesmen."

The release stated that the operation of these plans often involves the offering of an "investment contract" or a "participation in a profit sharing agreement," which are securities as defined in the Securities Act. In such cases, the security—the agreement between the offering company and the investor—must be registered with the Commission unless an exemption is available. In the absence of registration or an exemption, sales of these securities violate the Securities Act. Moreover, a person who participates in the distribution of such securities may be a "broker" as defined in the Securities Exchange Act and, absent an exemption, must register under that Act.

The Commission stated that pyramid sales promotions may be inherently fraudulent. Emphasis is often placed on the allegedly unlimited potential to make money by recruiting others. However, the finite number of potential participants in any geographic area limits the ability of those induced to participate at later stages to recruit others and thus realize a return on their investment. Failure to disclose these factors to prospective investors in a meaningful way would be fraudulent.

The Commission acted to obtain injunctive and other relief against Glenn Turner—the largest promoter of pyramid plans—and some of his enter-

prises, beginning in May, 1972, when it filed a complaint in the United States District Court for the District of Oregon. On August 30, 1972, the court preliminarily enjoined Glenn W. Turner Enterprises, Inc., and its subsidiary Dare To Be Great, Inc. from offering and selling interests or participations in the pyramid promotion of Dare To Be Great, in violation of the registration requirements of the Securities Act or otherwise in violation of the securities laws.<sup>37</sup> The complaint alleged that members of the public had been induced to invest in a common enterprise in which each investor would share in the profits derived from the success of the defendants in inducing other persons, who had been introduced by the investor, to participate in the scheme. The district court agreed with the Commission that this involved the offer and sale of securities. The court declined, however, to appoint a temporary receiver or to order an accounting, as requested by the Commission, although it expressly authorized an application for further preliminary relief should events prove that to be necessary.

The defendants have appealed the district court's decision.<sup>38</sup> That court and the court of appeals denied a stay pending appeal.

On September 13, 1972, the Commission filed a complaint in the United States District Court for the Middle District of Georgia seeking to enjoin Koscot Interplanetary, Inc., its parent corporation Glenn W. Turner Enterprises, Inc., and five individual defendants, including Turner (the founder of both companies), from further violations of the registration and antifraud provisions in connection with the offer and sale of interests in the pyramid promotion of Koscot.<sup>39</sup> In addition to injunctive relief, the Commission requested the court to appoint a temporary receiver for the corporate defendants and to compel an accounting of the proceeds of sales by them.

Because of the pervasive nature of the pyramid plans and doubts raised by the structure of certain of the plans as to whether a security is involved, Chairman Casey, in September, 1972, sent a letter to the Commission's Congressional oversight committees to ask their assistance in obtaining legislation to protect investors in pyramid plans. He urged that at a minimum the securities laws be amended to further clarify the fact that an investment in a pyramid promotion is a security, suggesting that what appears to be needed in this area, however, is a blend of disclosure and regulation—disclosure alone may not be enough.

## COMMISSION REORGANIZATION

In August, 1972, a major reorganization of the Commission's structure was completed, resulting in five operating divisions instead of three. The Division of Trading and Markets was divided into a Division of Enforcement with responsibility for all investigative and enforcement activities, and a Division of Market Regulation to regulate securities markets and broker-dealers, with particular emphasis on the structure and efficiency of the markets and the financial responsibility and professional service of the broker-dealer community. A new Division of Investment Company Regulation was spun off from the Division of Corporate Regulation, which retained responsibility for public-utility holding company and bankruptcy and reorganization matters. The new Division, which will also regulate investment advisers, was assigned the task of concentrating on problems concerning the economics, distribution methods and services of investment companies. Investment company disclosure activity was transferred to the Division of Corporation Finance, which now has responsibility for all disclosure matters.

The Commission took this action in the belief that the new functional struc-

ture will provide a sharper focus on its priority tasks, more effective use of available resources, and the development, through closer supervision and broader avenues of advancement, of effective leadership capabilities for the future.

This separation of disclosure and enforcement activities from the three regulatory divisions should encourage positive, forward-looking supervision and planning in areas of regulatory concern and a co-ordinated and experienced direction of all enforcement and division activities.

## NOTES FOR PART 1

<sup>1</sup> *Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission*. House Doc. No. 92-231, 92d Congress., 1st Sess. (1971).

<sup>2</sup> Securities Exchange Act Release No. 9545 (March 29, 1972).

<sup>3</sup> Securities Exchange Act Releases Nos. 9529 and 9530 (March 8, 1972) and 9731 (August 14, 1972).

<sup>4</sup> In response to this directive, the NASD prepared a proposed rule prohibiting this practice. On July 27, 1972, after approval by the NASD Board of Governors, the proposal was sent to the NASD's membership for comment.

<sup>5</sup> The Exchange had proposed a 30 percent discount. Securities Exchange Act Release No. 9351 (September 24, 1971).

<sup>6</sup> Securities Exchange Act Release No. 9716 (August 3, 1972).

<sup>7</sup> See Securities Exchange Act Release No. 9808 (October 5, 1972).

<sup>8</sup> Securities Exchange Act Release No. 9255 (August 2, 1971).

<sup>9</sup> Securities Exchange Act Release No. 9555 (April 12, 1972).

<sup>10</sup> Securities Act Releases Nos. 5274 through 5279, Securities Exchange Act Release No. 9673 (July 26, 1972).

<sup>11</sup> See 35th Annual Report, pp. 18-22; 36th Annual Report, pp. 9-13; 37th Annual Report, pp. 21-23.

<sup>12</sup> Securities Act Release No. 5224 (January 10, 1972), as revised 37 Federal Register 4327 (March 2, 1972); Securities Act Release No. 5225 and Securities Exchange Act Release Nos. 9442 and 9443 (January 10, 1972).

<sup>13</sup> Securities Act Release No. 5306 (September 26, 1972).

<sup>14</sup> Securities Act Release No. 5307 (September 26, 1972).

<sup>15</sup> See 35th Annual Report, p. 21.

<sup>16</sup> Securities Act Release No. 5012 (October 9, 1969).

<sup>17</sup> Securities Act Release No. 5246 (May 2, 1972).

<sup>18</sup> Securities Act Release No. 5316 (October 6, 1972).

<sup>19</sup> Securities Exchange Act Release No. 9432 (December 22, 1971).

<sup>20</sup> Securities Exchange Act Release No. 9784 (September 22, 1972).

<sup>21</sup> Securities Exchange Act Release No. 9785 (September 22, 1972).

<sup>22</sup> Securities Act Release No. 5231 (February 3, 1972).

<sup>23</sup> Securities Act Release No. 5196 (September 27, 1971).

<sup>24</sup> Securities Act Release No. 5263 (June 22, 1972).

<sup>25</sup> Securities Act Release No. 5222 (January 3, 1972).

<sup>26</sup> 37th Annual Report, pp. 29-31.

<sup>27</sup> Securities Act Releases Nos. 5265 (June 27, 1972) and 5265A (August 8, 1972).

<sup>28</sup> Securities Act Release No. 5233 (February 14, 1972).

<sup>29</sup> Securities Act Release No. 5314 (October 11, 1972).

<sup>30</sup> P.L. 91-547, approved December 14, 1970. See 37th Annual Report, pp. 13-19.

<sup>31</sup> House Rep. 91-1631, 91st Cong., 2d Sess. (1970), p. 27.

<sup>32</sup> S. 3681, H.R. 15304 (92nd Congress, 2d Session)

<sup>33</sup> 445 F.2d 1337 (C.A. 2, 1971).

<sup>34</sup> Securities Act Release No. 5234.

<sup>35</sup> The Report is for sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402, for \$1.50.

<sup>36</sup> Securities Act Release No. 5211 (November 30, 1971).

<sup>37</sup> S.E.C. v. Glenn W. Turner Enterprises, Inc., No. 72-390.

<sup>38</sup> C.A. 9, No. 72-2544.

<sup>39</sup> S.E.C. v. Koscot Interplanetary, Inc., No. 17134.

# **PART 2**

## **THE DISCLOSURE SYSTEM**





# PART 2

## THE DISCLOSURE SYSTEM

A basic purpose of the Federal securities laws is to provide disclosure of material financial and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This aims at enabling investors to evaluate the securities of these companies on an informed and realistic basis.

The Securities Act of 1933 generally requires that before securities may be offered to the public a registration statement must be filed with the Commission disclosing prescribed categories of information. Before the sale of securities can begin, the registration statement must become "effective." In the

sales, investors must be furnished a prospectus containing the most significant information in the registration statement

The Securities Exchange Act of 1934 deals in large part with securities already outstanding and requires the registration of securities listed on a national securities exchange, as well as over-the-counter securities in which there is a substantial public interest. Issuers of registered securities must file annual and other periodic reports designed to provide a public file of current material information. The Exchange Act also requires disclosure of material information to holders of registered securities in solicitations of proxies for the

election of directors or approval of corporate action at a stockholders' meeting, or in attempts to acquire control of a company through a tender offer or other planned stock acquisition. It provides that insiders of companies whose equity securities are registered must report their holdings and transactions in all equity securities of their companies.

## **PUBLIC OFFERING: THE 1933 SECURITIES ACT**

The basic concept underlying the Securities Act's registration requirements is full disclosure. The Commission has no authority to pass on the merits of the securities to be offered or on the fairness of the terms of distribution. If adequate and accurate disclosure is made, it cannot deny registration. The Act makes it unlawful to represent to investors that the Commission has approved or otherwise passed on the merits of registered securities.

### **Information Provided**

While the Securities Act specifies the information to be included in registration statements, the Commission has the authority to prescribe appropriate forms and to vary the particular items of information required to be disclosed. To facilitate the registration of securities by different types of issuers, the Commission has adopted special registration forms which vary in their disclosure requirements so as to provide maximum disclosure of the essential facts pertinent in a given type of offering while at the same time minimizing the burden and expense of compliance with the law. In recent years, it has adopted certain short forms, notably Forms S-7 and S-16, which do not require disclosure of matters covered in reports and proxy material filed or distributed under provisions of the Securities Exchange Act

## **Reviewing Process**

Registration statements filed with the Commission are examined by its Division of Corporation Finance for compliance with the standards of adequate and accurate disclosure. The various review procedures employed by the Division are summarized in Part 1 of the report. While most deficiencies are corrected through an informal letter of comment procedure, where the Commission finds that material representations in a registration statement are misleading, inaccurate, or incomplete, it may, after notice and opportunity for hearing, issue a "stop-order" suspending the effectiveness of the statement.

## **New Registration Guides**

To advise issuers of the policies generally followed by its staff in the review of registration statements and other documents, the Commission from time to time authorizes the publication of guides describing the type of information which may or should be included, and the method of its presentation.

During the past fiscal year, several new guides were published. One covers so-called insurance premium funding programs.<sup>1</sup> These involve the offering of securities, usually mutual fund shares, and the use of such shares as collateral for a loan, the proceeds of which are used to pay the premium on a life insurance policy which is sold to the customer at or about the same time. The Commission has taken the position that such a program involves an investment contract which is a security under the Securities Act. The guide sets forth the staff's position with respect to disclosure, among other things, of risks associated with a decline in value of the fund shares which would require the investor to furnish additional collateral, and the nature of tabular illustrations of program results which may be used.

In an effort to make prospectuses more readable and understandable, the

Commission authorized publication of an amended guide on pictorial or graphic representations in prospectuses.<sup>2</sup> It provides that photographs of members of the management, principal properties or important products are permissible, provided they do not give a misleading impression. The existing policy that artists' or architects' conceptions may not be used was not changed.

The Commission also published guidelines for use in the preparation of Securities Act registration statements by investment companies<sup>3</sup> and a proposed guideline on disclosure regarding an investment company's investment adviser.<sup>4</sup> In addition, as discussed in Part 1, it published suggestions for disclosure in registration statements of broker-dealers proposing to sell their shares to the public.

Printing expenses represent one of the major costs associated with a public offering of securities. The Commission indicated its rules do not require prospectuses to be printed and that less expensive means of reproduction may be used.<sup>5</sup>

## Environment and Civil Rights

In a release issued in July 1971, the Commission called attention to the disclosure requirements in its forms and rules under the Securities Act and the Securities Exchange Act on legal proceedings and description of business involving the environment and civil rights.<sup>6</sup> Compliance with statutory environmental requirements such as anti-pollution laws may require significant capital outlays, materially effect the earning power of the business, or cause material changes in present or future business. The Commission said requirements on legal proceedings call for disclosure of material litigation under environmental laws. The release also stressed the need for disclosure of material proceedings under civil rights leg-

islation which could, for example, result in cancellation of a government contract

The Commission, in a related announcement in February 1972, said it was considering amendments to some registration and report forms.<sup>7</sup> These would require, as a part of the description of an issuer's business, appropriate disclosure of material effects which compliance with environmental laws and regulations could have on capital expenditures, earnings and competitive position of the issuer and its subsidiaries. Information would also be required on pending governmental, private legal, or administrative enforcement proceedings under environmental laws or regulations, and any such proceedings contemplated by governmental authorities.

The Natural Resources Defense Council, Inc. and the Project on Corporate Responsibility had previously requested the Commission to adopt certain changes in its reporting, registration and proxy forms to encompass disclosures concerning environmental and civil rights matters. After the July 1971 release was issued, the Commission advised the petitioners that it would deny the request at that time to study the disclosures brought by the general guidelines. The Commission subsequently proposed to amend certain forms to provide more specifically for environmental disclosures.

The petitioners subsequently filed a petition with the United States Court of Appeals for the District of Columbia Circuit<sup>8</sup> seeking review of what they alleged to be the Commission's "order" denying their request. The Commission moved to dismiss the petition, asserting that it had neither entered any "order" nor taken any action directly reviewable by the court of appeals under the judicial review provisions of the Securities Act or the Securities Exchange Act. In June 1972, the court of appeals referred the Commission's motion to the

panel of the court assigned to hear the case on the merits of the petition.

### Time for Registration

The Commission's staff tries to complete examination of registration statements as quickly as possible. The Securities Act provides that a registration statement shall become effective on the 20th day after it is filed (or on the 20th day after the filing of any amendment). Most registration statements require one or more amendments and do not become effective until some time after the original 20-day period. The period between filing and effective date is intended to give investors opportunity to become familiar with the proposed offering through the dissemination of the preliminary form of prospectus. The Commission can accelerate the effective date to shorten the 20-day waiting period—taking into account, among other things, the adequacy of the information on the issuer already available to the public and the ease with which facts about the offering can be understood.

During the 1972 fiscal year a record 3,716 registration statements became effective. Of these, 231 were amendments filed by investment companies pursuant to Section 24(e) of the Investment Company Act of 1940, which provides for the registration of additional securities through amendment to an effective registration statement rather than the filing of a new registration statement. For the remaining 3,485 statements, the median number of calendar days between the date of the original filing and the effective date was 56, only slightly more than was needed to process a far smaller number of statements in the prior year.

### Organizational Changes

To improve the review of registration statements involving specialized and complex disclosure problems, the Divi-

sion of Corporation Finance made organization and personnel changes.

### Oil and Gas

In April 1971, the Division assigned to its Oil and Gas Section processing responsibility for all oil and gas drilling program filings as well as filings on Form S-10 covering fractional undivided interests in oil and gas rights. This assignment was the first attempt by the Division to concentrate all filings of one industry type in one processing unit. The result has been an improved handling of the registrations and more uniform and complete disclosure. Filed during the fiscal year were 106 registration statements for oil and gas drilling programs, totaling \$940 million, and eight statements covering fractional undivided interests in oil and gas rights, aggregating \$9.8 million.

### Tax Shelters

In February 1972, a branch of the Division was designated to process all registration statements covering tax shelter programs other than oil and gas and real estate investment trusts. These programs include real estate syndications, cattle feeding, cattle breeding, and citrus and pistachio groves and other agri-businesses. During the balance of the fiscal year, 55 tax shelter registration statements were filed, including 10 for cattle offerings. As of the end of the fiscal year, 50 tax shelter filings, aggregating about \$470 million, were pending.

Disclosure generally emphasized in tax shelter filings involving a partnership covers fees and payments by the partnership to the general partner and his affiliates, conflicts of interest, the record of the general partner, and delineation of investment objectives.

In real estate syndications, the trend seems to be strongly in the direction of "blind pool"—i.e., programs which do not as yet have any specific properties

or contracts to acquire specific properties. For such programs, the Division has insisted on an undertaking in the registration statement to file a post-effective amendment and send a report to security holders disclosing information on any material acquisition of property.

### Condominiums

Since May 1972, registration statements for offerings of condominium securities have also been directed to a separate branch within the Division. In fiscal year 1972, a total of 15 registration statements were filed for offerings of condominiums with rental arrangements, aggregating approximately \$134 million.<sup>9</sup>

### Personnel Changes

During the past fiscal year, the Division created and staffed new positions of Chief Financial Analyst and Tax Counsel.

The position of Chief Financial Analyst was created principally to improve anticipation of new developments in financing, provide the Commission with the viewpoint of the investment analyst on disclosure requirements, and improve communications with the professional investment community. The new Chief Financial Analyst is working actively with the accountants on the staff in their efforts to develop consistent and meaningful financial reporting, as well as with staff attorneys and analysts concerned with providing disclosure that reflects economic reality.

The position of Tax Counsel is intended to strengthen the Division's capacity to determine the accuracy and adequacy of tax disclosures, particularly those relating to tax shelter programs, mergers and acquisitions, and the registration of securities for employee stock option, stock purchase, savings or similar plans.

### SMALL ISSUE EXEMPTION

The Commission is authorized under Section 3(b) of the Securities Act to exempt securities from registration if it finds that registration for these securities is not necessary to the public interest because of the small offering amount or limited character of the public offering. The law imposes a maximum limitation of \$500,000 upon the size of the issues which may be exempted by the Commission.

The Commission has adopted the following exemptive rules and regulations

Regulation A: General exemption for U. S. and Canadian issues up to \$500,000.

Regulation B: Exemption for fractional undivided interests in oil or gas rights up to \$100,000.

Regulation F: Exemption for assessments on assessable stock and for assessable stock offered or sold to realize the amount of assessment up to \$300,000

Rules 234-236: Exemptions of first lien notes, securities of cooperative housing corporations, and shares offered in connection with certain transactions.

Under Section 3(c) of the Securities Act, the Commission is authorized to adopt rules and regulations exempting securities issued by a small business investment company under the Small Business Investment Act. The Commission has adopted Regulation E, which conditionally exempts such securities issued by companies registered under the Investment Company Act of 1940 up to a maximum offering price of \$500,000. The regulation is substantially similar to Regulation A, described below.

## Regulation A

Regulation A permits a company to obtain needed capital not in excess of \$500,000 (including underwriting commissions) in any one year from a public offering of its securities without registration, provided specified conditions are met. Among other things, a notification and offering circular supplying basic information about the company and the securities offered must be filed with the Commission and the offering circular must be used in the offering. During the fiscal year, the Commission amended Regulation A so as to permit selling shareholders not in a control relationship with the issuer to offer in the aggregate up to \$300,000 of securities which would not be included in computing the issuer's \$500,000 ceiling.<sup>10</sup>

During the 1972 fiscal year, 1,087 notifications were filed under Regulation A, covering proposed offerings of \$404 million, compared with 836 notifications covering proposed offerings of \$254 million in the prior year. A total of 1,171 reports of sales were filed reporting aggregate sales of \$107 million. Such reports must be filed every six months while an offering is in progress and upon its termination. Sales reported during 1971 had totaled \$63 million. Various features of Regulation A offerings over the past three years are presented in the statistical section of the report.

In fiscal 1972 the Commission temporarily suspended 26 exemptions where it had reason to believe there had been noncompliance with the conditions of the regulation or with disclosure standards, or where the exemption was not available for the securities. Added to 13 cases pending at the beginning of the fiscal year, this resulted in a total of 39 cases for disposition. Of these, the temporary suspension order became permanent in 20 cases: in 15 by lapse of time, in one case after hearings, and in four by acceptance of an

offer of settlement. Nineteen cases were pending at the end of the fiscal year.

## Regulation B

During the 1972 fiscal year, 1,124 offering sheets and 1,359 amendments were filed under Regulation B and examined by the Oil and Gas Section of the Division of Corporation Finance. The number of filings reflects continuation of an upward trend that began in 1965.

A total of 17,998 sales reports were filed during the year, reporting aggregate sales of \$21 million. Sales reported during the preceding year had totaled \$16 million.

Revisions of Regulation B which were proposed during the year are discussed in Part I.

## Regulation E

Two notifications by small business investment companies were filed under Regulation E during the 1972 fiscal year for offerings totaling \$860,000. These were the first Regulation E filings since fiscal year 1969.

## Exempt Offerings Under Regulation F

During the 1972 fiscal year, 17 notifications were filed under Regulation F, covering assessments of stock of \$398,025, compared with 19 notifications covering assessments of \$407,719 in 1971.

## CONTINUING DISCLOSURE: THE 1934 SECURITIES EXCHANGE ACT

The Securities Exchange Act of 1934 contains significant disclosure provisions designed to provide a fund of current material information on companies in whose securities there is a substantial public interest. The Act also seeks to assure that security holders who are solicited to exercise their voting rights, or to sell their securities in response to

a tender offer are furnished pertinent information.

### Registration on Exchanges

Generally speaking, a security cannot be traded on a national securities exchange until it is registered under Section 12(b) of the Exchange Act. If it meets the listing requirements of the particular exchange, an issuer may register a class of securities on the exchange by filing with the Commission and the exchange an application which discloses pertinent information concerning the issuer and its affairs. During fiscal year 1972, a total of 286 issuers listed and registered securities on a national securities exchange for the first time, and a total of 692 registration applications were filed. The registrations of all securities of 129 issuers were terminated. Detailed statistics regarding securities traded on exchanges may be found in the statistical section.

### Over-the-Counter Registration

Section 12(g) of the Exchange Act requires a company with total assets exceeding \$1 million and a class of equity securities held of record by 500 or more persons to register those securities with the Commission, unless one of the exemptions set forth in that section is available, or the Commission issues an exemptive order under Section 12(h). Upon registration, the reporting and other disclosure requirements and the insider trading provisions of the Act apply to these companies to the same extent as to those with securities registered on exchanges.

During the fiscal year, 701 registration statements were filed under Section 12(g). Of these, 431 were filed by issuers already subject to the reporting requirements, either because they had another security registered on an exchange or they had registered securities under the Securities Act.

### Exemptions

Section 12(h) of the Act authorizes the Commission to grant a complete or partial exemption from the registration provisions of Sections 12(g) or from other disclosure and insider trading provisions of the Act where it is not contrary to the public interest or the protection of investors.

At the beginning of the fiscal year, nine exemption applications were pending, and 14 applications were filed during the year. Of these 23 applications, two were withdrawn, three were granted, and one denied. The remaining 17 applications were pending at the end of the fiscal year.

While exemptions are normally sought by issuers of over-the-counter securities, one of the applications on which action was taken during the year involved securities listed on the New York Stock Exchange. Iowa Beef Processors, Inc. sought an exemption from the quarterly financial reporting requirement on the grounds that its business tended to have relatively unpredictable cycles rather than being stable or seasonal in nature and that quarterly results would not provide accurate historical comparisons or valid prognostications for annual results. The company said this might be misleading to the average investor and produce unwarranted fluctuations in the price of its common stock. Following hearings, the hearing officer denied the application. His decision became final when Iowa did not seek Commission review.<sup>11</sup> The officer noted that the company had over 11,000 security holders and that there was active trading interest in its stock. He said quarterly reports would furnish useful financial information. He held that the policy of the Federal securities laws favoring disclosure outweighed the company's speculative fears.



## Periodic Reports

Section 13 of the Securities Exchange Act requires issuers of securities registered pursuant to Section 12(b) and 12(g) to file periodic reports, keeping current the information contained in the registration application or statement. During the fiscal year, the Commission monitored the results of substantial revisions made in the prior year in the annual report form, and through the introduction of quarterly financial reports. Experience to date indicates that these revisions have served to provide more adequate and current disclosure of material information, without imposing undue burdens on issuers. In 1972, 45,671 reports—annual, quarterly and current—were filed.

## Proxy Solicitations

Where proxies are solicited from holders of securities registered under Section 12 or from security holders of registered public-utility holding companies, subsidiaries of holding companies, or registered investment companies, the Commission's proxy regulation requires that disclosure be made of all material facts concerning the matters on which the security holders are asked to vote, and that they be afforded an opportunity to vote "yes" or "no" on any matter other than the election of directors. Where management is soliciting proxies, a security holder desiring to communicate with the other security holders may require management to furnish him with a list of all security holders or to mail his communication for him. A security holder may also, subject to certain limitations, require the management to include in proxy material any appropriate proposal which he wants to submit to a vote of security holders, or he may make an independent proxy solicitation. The rules on security holders' proposals were recently revised, as described in Part 1.

Copies of proposed proxy material must be filed with the Commission in preliminary form prior to the date of the proposed solicitation. Where preliminary material fails to meet the prescribed disclosure standards, the management or other group responsible for its preparation is notified informally and given an opportunity to correct the deficiencies in the preparation of the definitive proxy material to be furnished to security holders.

Issuers of securities registered under Section 12 must transmit an information statement comparable to proxy material to security holders from whom proxies are not solicited with respect to a stockholders' meeting.

During the 1972 fiscal year, 6,556 proxy statements in definitive form were filed, 6,534 by management and 22 by nonmanagement groups or individual stockholders. In addition, 149 information statements were filed. The proxy and information statements related to 6,367 companies, and pertained to 6,328 meetings for the election of directors, 350 special meetings not involving the election of directors, and 27 assets and authorizations.

Aside from the election of directors, the votes of security holders were solicited with respect to a variety of matters, including mergers, consolidations, acquisitions and sales of assets and dissolution of companies (414); authorizations of new or additional securities, modifications of existing securities, and recapitalization plans (1,149); employee pension and retirement plans (48); bonus or profit-sharing plans and deferred compensation arrangements (136); stock option plans (736); approval of the selection by management of independent auditors (2,702) and miscellaneous amendments to charters and by-laws, and other matters (2,013).

During the 1972 fiscal year, 411 proposals submitted by 53 stockholders for action at stockholders' meetings were

included in the proxy statements of 193 companies. Typical of such proposals submitted to a vote of security holders were resolutions on amendments to charters or by-laws to provide for cumulative voting for the election of directors, preemptive rights, limitations on the grant of stock options to and their exercise by key employees and management groups, the sending of a post-meeting report to all stockholders, and limitations on charitable contributions.

A total of 234 additional proposals submitted by 50 stockholders were omitted from the proxy statements of 63 companies in accordance with the provisions of the rule governing such proposals. The most common grounds for omission were that proposals were not a proper subject for security holder action under pertinent state law; were not submitted on time; related to the ordinary business operations of the company; or involved a personal grievance against the company.

The figures do not include 224 proposals submitted to 36 companies by a single individual which were omitted by the managements of those companies because, among other reasons, the proponent appeared to be repeating a pattern of conduct he had engaged in during the previous proxy season which seemed to be contrary to the purpose and intent of the stockholder proposal rule. This pattern involved the purchase of a minimal interest, in many cases one share of stock, in a number of companies, the submission of a multiple number of proposals to such companies accompanied by statements of notice of intention to present the proposals for action at the shareholder meetings, and the subsequent failure to appear at almost all of the meetings.

In fiscal 1972, 23 companies were involved in proxy contests for the election of directors which bring special requirements into play. In these contests, 567 persons, including both management

and nonmanagement, filed detailed statements required of participants under the applicable rule. Control of the board of directors was involved in 16 instances. In 11 of these, management retained control. Of the remainder, two were settled by negotiation, two were won by nonmanagement persons, and one was pending at year end. In the other seven cases, representation on the board of directors was involved. Management retained all places on the board in four contests, opposition candidates won places on the board in two cases; one was pending as of June 30, 1972.

### Litigation on Proxy Rules

*S.E.C. v. Medical Committee for Human Rights.*<sup>12</sup> The United States Supreme Court vacated as moot a decision by the Court of Appeals for the District of Columbia Circuit that when the Commission expresses a determination to take no enforcement action, at least with respect to disputes over the includability of shareholder proposals in management's proxy soliciting materials, that determination is reviewable by an appellate court.

The litigation had arisen out of the refusal by Dow Chemical Company to include in its proxy material a proposal submitted by the Medical Committee. However, Dow included the proposal in its proxy material for the May 1971 annual meeting. At that meeting less than three percent of the votes cast supported the proposal. The Supreme Court ruled that the controversy was moot since, under the Commission's proxy rules, the same or substantially the same proposal could be excluded from Dow's proxy materials for the next three years.

*Kixmiller v. S.E.C.*<sup>13</sup> The petitioner, relying on the court of appeals decision in the *Medical Committee* case, sought review in the Court of Appeals for the District of Columbia Circuit of a staff

decision not to recommend to the Commission that enforcement action be instituted against the Washington Post Company in the event that that company excluded petitioner's proposals from its proxy solicitation materials and of the Commission's determination not to review the staff's position. The Commission has moved to dismiss the petition for review, asserting that it has taken no action that is judicially reviewable.

### Takeover Bids, Large Acquisitions

Sections 13(d) and (e), and 14(d), (e) and (f) of the Securities Exchange Act, enacted in 1968 and amended in 1970, provide for full disclosure in cash tender offers and other stock acquisitions involving changes in ownership or control. These provisions were designed to close gaps in the full disclosure provisions of the securities laws and to safeguard the interests of persons who tender their securities in response to a tender offer.

During the 1972 fiscal year, 1,006 Schedule 13D reports were filed by persons or groups which had made acquisitions resulting in their ownership of more than five percent of a class of securities. Fifty such reports were filed by persons or groups making tender offers, which, if successful, would result in more than five percent ownership. In addition, 16 Schedule 14D reports were filed on solicitations or recommendations in a tender offer by a person other than the maker of the offer. Sixteen statements were filed for the replacement of a majority of the board of directors otherwise than by stockholder vote. One statement was filed under a rule on corporate reacquisitions of securities while an issuer is the target of a cash tender offer.

### Insider Reporting

Section 16 of the Securities Exchange Act and corresponding provisions in the

Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 are designed to provide other stockholders and investors generally with information on insider securities transactions and holdings, and to prevent unfair use of confidential information by insiders to profit from short-term trading in a company's securities.

Section 16(a) of the Exchange Act requires every person who beneficially owns, directly or indirectly, more than 10 percent of any class of equity security which is registered under Section 12, or who is a director or an officer of the issuer of any such security, to file statements with the Commission disclosing the amount of all equity securities of the issuer of which he is the beneficial owner and changes in such ownership. Copies of such statements must be filed with exchanges on which securities are listed. Similar provisions applicable to insiders of registered public-utility holding companies and registered close-end investment companies are contained in the Holding Company Act and Investment Company Act.

During the year, the Commission amended Rule 16a-6 under the Exchange Act to provide that the granting, acquisition, disposition, expiration or cancellation of any presently exercisable put, call, option or other right or obligation to buy securities from, or sell securities to, another person, whether or not it is transferable, shall be deemed a change in the beneficial ownership of the securities to which the right or obligation relates.<sup>14</sup> At the same time, the reporting forms (Forms 3 and 4) were revised to reflect the above amendment and to require certain additional information.<sup>15</sup>

In fiscal 1972, 103,206 ownership reports were filed. These included 19,867 initial statements of ownership on Form 3, 79,339 statements of changes in ownership on Form 4, and 4,000 amendments to previously filed reports, most of which were necessitated by the

form revisions discussed above.

All ownership reports are made available for public inspection when filed at the Commission's office in Washington and at the exchanges where copies are filed. In addition, the information contained in reports filed with the Commission is summarized and published in the monthly "Official Summary of Security Transactions and Holdings," which is distributed by the Government Printing Office to about 10,000 subscribers.

To prevent insiders from making unfair use of information which they may have obtained by reason of their relationship with a company, Section 16(b) of the Exchange Act and corresponding provisions in the Holding Company Act and the Investment Company Act provide for the recovery by or on behalf of the issuer of any profit realized by insiders from trading securities of the company within six months.

### Short-Swing Trading Litigation

*Reliance Electric Co. v. Emerson Electric Co.*<sup>16</sup> A significant decision interpreting Section 16(b) was rendered by the Supreme Court in this case. The Court held, (4 to 3), that profits realized by a beneficial owner are not recoverable on the second sale of an issuer's stock where the first sale had reduced his holdings to 10 percent or less. It relied on a proviso in Section 16(b) which excludes from coverage under that section transactions by a shareholder who was not a more-than-10-percent beneficial owner "both at the time of the purchase and sale . . . of the security involved." Although recognizing that its ruling might be inconsistent with its assessment of the "wholesome purpose" of Section 16(b), and that, where alternative constructions were possible, that section should be given the construction "that best serves the congressional purpose of curbing short-swing speculation by corporate insiders," the Court concluded that the

literal language of the proviso "clearly contemplates that a statutory insider might sell enough shares to bring his holdings below 10 percent, and later—but within six months—sell additional shares free from liability under the statute."<sup>17</sup>

The Court declined to adopt the position urged by the Commission, as *amicus curiae*, which would have both imposed liability on the second sale transaction and preserved the objective quality of Section 16(b) by interpreting the phrase "at the time of the . . . sale" as meaning at any time during the period in which the sale transactions occurred.

The dissenting opinion charged that the result reached by the majority, under "the guise of an 'objective' approach," was a "mutilation" of and "undermines" the statute. Noting that words such as "purchase," "sale" and "at the time of" are not defined words with precise meanings, and reasoning that insiders must not be permitted to circumvent Section 16(b)'s broad mandate if the statute is to have the "optimum prophylactic effect" of deterring unfair use of inside information, the dissenters concluded that the statute should be construed as allowing a rebuttable presumption that any series of sales made by a beneficial owner of more than 10 percent within six months, in which he disposes of a major part of his holdings, will be deemed to be part of a single plan of disposition and treated as a single "sale" for the purposes of Section 16(b).

At the request of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Interstate and Foreign Commerce, the Commission prepared and transmitted to the Congress a draft bill to amend Section 16(b) which is designed to overcome the Court's decision.

*Gold v. Scurlock.*<sup>18</sup> The Commission submitted a brief as *amicus curiae*, urg-

ing the court to rule that the defendants' acquisition of securities of Susquehanna Corporation in a merger between Susquehanna and the company of which they were shareholders, constituted "purchases" of Susquehanna securities within the meaning of Section 16(b). The defendants sold the Susquehanna stock acquired in the merger less than six months later, at a time when they were officers or directors of Susquehanna. The Commission argued that the defendants' receipt of Susquehanna stock in the merger presented them with the opportunity for engaging in the abuses that Section 16(b) was designed to prevent.

## ACCOUNTING

The Securities Acts reflect a recognition by Congress that dependable financial statements are indispensable to informed investment decisions. A major objective of the Commission has been to improve accounting and auditing standards and to assist in the establishment and maintenance of high standards of professional conduct by public accountants. The primary responsibility for this program rests with the Chief Accountant of the Commission

Under the Commission's broad rule-making power, it has adopted a basic accounting regulation (Regulation S-X) which, together with opinions on accounting principles published as "Accounting Series Releases", governs the form and content of financial statements filed under the securities laws. During the fiscal year, Regulation S-X was comprehensively revised. The Commission has also formulated rules on accounting and auditing of broker-dealers and prescribed uniform systems of accounts for companies subject to the Public Utility Holding Company Act of 1935. The accounting rules and opinions of the Commission, and of its decisions in particular cases, have contributed to clarification and wider acceptance of the

accounting principles and practices and auditing standards developed by the profession and generally followed in the preparation of financial statements.

However, the specific accounting rules and regulations—except for the uniform systems of accounts which are regulatory reports—prescribe accounting principles to be followed only in certain limited areas. In the large area of financial reporting not covered by its rules, the Commission's principal means of protecting investors from inadequate or improper financial reporting is by requiring a report of an independent public accountant, based on an audit performed in accordance with generally accepted auditing standards, which expresses an opinion whether the financial statements are presented fairly in conformity with accounting principles and practices that are recognized as sound and have attained general acceptance. The requirement that the opinion be rendered by an independent accountant is designed to secure for the benefit of public investors the detached objectivity and the skill of a knowledgeable professional person not connected with the management.

The accounting staff reviews the financial statements filed with the Commission to insure that the required standards are observed and that the accounting and auditing procedures do not remain static in the face of changes and new developments in financial and economic conditions. New methods of doing business, new types of business, the combining of old businesses, the use of more sophisticated securities, and other innovations create accounting problems which require a constant reappraisal of the procedures. It is anticipated that in fiscal 1973 a program of increased publication of staff interpretations on matters of accounting principles and procedures will be undertaken to better inform the public of the ground rules currently being followed in

the review of financial information filed with the Commission.

### **Relations with the Accounting Profession**

In order to keep abreast of changing conditions and in recognition of the need for a continuous exchange of views and information between the Commission's accounting staff and outside accountants regarding appropriate accounting and auditing policies, procedures and practices for the protection of investors, the staff maintains continuing contact with individual accountants and various professional organizations, including the American Institute of Certified Public Accountants (AICPA), the principal professional organization concerned with development and improvement of accounting and auditing standards and practices. The Chief Accountant also meets regularly with his counterparts in other regulatory agencies to improve coordination on policies and actions between the agencies.

Because of its many foreign registrants and the vast and increasing foreign operations of American companies, the Commission has an interest in the improvement of accounting and auditing principles and procedures on an international basis. In this connection, the Chairman addressed an international meeting on stock exchanges in Milan, Italy, in March, 1972, and a conference on financial reporting, Commission des Operations des Bourse, Paris, France, in May 1972. To promote such improvement, the Chief Accountant in June, 1972, conferred with foreign accountants in London, England, and in October he participated in the Tenth International Congress of Accountants in Sydney, Australia.

### **Accounting and Auditing Standards**

In early 1971, the AICPA appointed two committees to explore ways to improve the Institute's function of estab-

lishing standards of financial reporting. One committee, chaired by former SEC Commissioner Francis M. Wheat, studied the operations of the Accounting Principles Board (APB) and possible alternatives, and made recommendations for a new structure to supplant the APB. The governing council of the AICPA approved the structure in May 1972 and set a target date of January 1, 1973, for establishment of a new board, to be known as the Financial Accounting Standards Board. The seven members of the board, who are to be appointed by a financial accounting foundation which includes representatives from leading professional organizations, will serve on a salaried, full-time basis. The Commission endorsed this new structure, which it feels should provide operational efficiencies and insure an impartial viewpoint in the development of accounting standards on a timely basis.

The other committee appointed in early 1971 was formed to study and refine objectives of financial statements. It is studying the basic questions of who needs financial statements, what information should be provided, how it should be communicated, and how much of it can be provided through the accounting process. The committee's conclusions and recommendations, expected to be ready in early 1973, should also provide valuable guidance to the Financial Accounting Standards Board in determining the direction and the priorities of its efforts in establishing standards.

During the fiscal year, the Accounting Principles Board published five opinions. One, on "Accounting Changes", provides detailed guides for reporting on changes in accounting principles, accounting estimates and reporting entities, and specifies that a company should demonstrate that changes which are made in accounting principles will provide more useful information than the prior method of accounting. Another

opinion, on "Interest on Receivables and Payables," adopted the concept of present value as a basis for accounting valuation and provided needed guides for its use under circumstances when notes which are received or issued bear an interest rate differing materially from the prevailing market rate.

The opinion on "Disclosure of Accounting Policies" requires a description of all significant accounting policies to be included as an integral part of the financial statements when such statements purport to present fairly financial position, changes in financial position, and results of operations in accordance with generally accepted accounting principles. This disclosure should increase the usefulness of financial statements by providing users with more information about accounting policies followed by the company.

Two opinions provide guidance in accounting for income taxes in areas of (1) undistributed earnings of subsidiaries, general reserves of stock savings and loan associations, and amounts designated as policyholders' surplus by stock life insurance companies; and (2) investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures).

## Other Developments

During the fiscal year, the Commission issued six Accounting Series Releases. The first three, described in the 37th Annual Report,<sup>19</sup> related to (1) revisions of annual report Form N-1R for management investment companies;<sup>20</sup> (2) amendments to certain registration and reporting forms and Regulation S-X removing the exemption from certification of financial statements of banks;<sup>21</sup> and (3) an interpretation of the computation of the ratio of earnings to fixed charges which is required to be shown in certain registration statements under the Securities Act and is permitted to

be shown in certain registration and report forms under the Securities Exchange Act.<sup>22</sup>

In an advisory release,<sup>23</sup> the Commission endorsed the establishment of audit committees composed of outside directors by publicly held companies, and urged the business and financial communities and shareholders of companies to lend their support to the implementation of a program to establish such audit committees to afford the greatest possible protection to investors who rely on financial statements.

In another advisory release,<sup>24</sup> on pro rata stock distributions to shareholders, the Commission emphasized that it will deem distributions of shares which are less than 25 percent of the same class outstanding to be misleading if the accounting is improper or disclosure is inadequate; and if there is a question of whether the condition of the business warrants the distribution, a further investigation will be considered to determine whether such distributions may be part of a manipulative or fraudulent scheme. If distributions of more than 25 percent of the same class outstanding appear to be part of a program of recurring distributions designed to mislead shareholders, similar interpretations and considerations may apply.

A release<sup>25</sup> was issued on major amendments to Regulation S-X, consisting of revisions of Articles 1, 2, 3, 4, 5 and 11 and Rules 12-01 to 12-16 (exclusive of 12-06A), and the addition of new Rules 12-42 and 12-43. These are the first general revisions of these parts of the regulation since 1950 and they comprise changes, additions and deletions that have become necessary with changing conditions. After the fiscal year, a general revision of Article 9 of the regulation, pertaining to financial statements of banks and bank holding companies, was also adopted.<sup>26</sup> A comprehensive release was developed to set

forth current guidelines employed in resolving questions of independence of accountants in relation to their clients who are registrants of the Commission. This release<sup>27</sup> was adopted by the Commission after the end of the fiscal year.

Reporting forms were amended to require registrants to furnish additional information regarding any unusual material charges or credits to income; to report a change in the certifying accountants and the reasons for the change and to request that the replaced accountant furnish a letter to the Commission commenting on the reasons stated by the registrant; and to report changes in accounting principles and practices materially affecting the financial statements including a letter from the independent accountants regarding the changes.<sup>28</sup>

After the fiscal year, an amendment to Rule 17a-5 under the Securities Exchange Act was adopted requiring broker-dealers to provide similar notifications of changes in certifying accountants and the reasons for the changes.<sup>29</sup>

## EXEMPTIONS FOR INTERNATIONAL BANKS

Section 15 of the Bretton Woods Agreement Act, as amended, exempts from registration securities issued, or guaranteed as to both principal and interest, by the International Bank for Reconstruction and Development. The Bank is required to file with the Commission such annual and other reports on securities as the Commission determines to be appropriate. The Commission has adopted rules requiring the Bank to file quarterly reports and copies of annual reports of the Bank to its Board of Governors. The Bank is also required to file advance reports of any distribution in the United States of its primary obligations. The Commission, acting in consultation with the National

Advisory Board on International Monetary and Financial Problems, is authorized to suspend the exemption for securities issued or guaranteed by the Bank. The following summary of the Bank's activities reflects information obtained from the Bank. Except where otherwise indicated, all amounts are expressed in U.S. dollar equivalents as of June 30, 1972

Net income for the year was \$183 million, compared with \$212 million the previous year. The decrease was due primarily to higher interest on borrowings, lower yields on short-term investments and lower capital gains. At July 31, 1972, the Bank had taken no action regarding disposition of its net income for fiscal year 1972.

Repayments of principal on loans received by the Bank during the year amounted to \$385 million, and a further \$126 million was repaid to purchasers of portions of loans. Total principal repayments by borrowers through June 30, 1972, aggregated \$4.7 billion, including \$2.8 billion repaid to the Bank and \$1.9 billion repaid to purchasers of borrowers' obligations sold by the Bank.

Outstanding borrowings of the Bank were \$7.0 billion at June 30, 1972. During the year, the bank borrowed \$425 million in the United States market: \$371 million through the issuance of 2-year U.S. dollar bonds to central banks and other governmental agencies in some 60 countries; D.M. 1.3 billion (U.S. \$341 million) in Germany; 54 billion yen (U.S. \$150 million) in Japan; SwF 575 million (U.S. \$141 million) in Switzerland; KD 50 million (U.S. \$140 million) in Kuwait, and the equivalent of U.S. \$176 million in other countries outside the United States. The above U.S. dollar equivalents are based on official exchange rates at the times of the respective borrowings. The Bank also issued \$13 million in bonds that had been sold in previous years under delayed delivery contracts.



These borrowings, in part, refunded maturing issues amounting to the equivalent of \$549 million. After retirement of \$59 million equivalent of obligations through sinking fund and purchase fund operations, the Bank's outstanding borrowings showed an increase of \$1.5 billion from the previous year, of which \$385 million represented appreciation in terms of U.S. dollars of the value of the non-dollar currencies in which the debt was denominated.

The Inter-American Development Bank Act, which authorizes the United States to participate in the Inter-American Development Bank, provides an exemption for certain securities which may be issued or guaranteed by the Bank similar to that provided for securities of the International Bank for Reconstruction and Development. Acting pursuant to this authority, the Commission adopted Regulation IA, which requires the Bank to file with the Commission substantially the same type of information, documents and reports as are required from the International Bank for Reconstruction and Development. The following data reflects information submitted by the Bank to the Commission.

On June 30, 1972, the outstanding funded debt of the Ordinary Capital resources of the Bank was the equivalent of \$1.1 billion, reflecting a net increase in the past year of the equivalent of \$107 million. During the year, the funded debt was increased through public bond issues totaling the equivalent of \$55.6 million as well as private placements for the equivalent of \$68.8 million including, with respect to Japan, \$31.6 million of undrawn commitments at June 30, 1972, and \$5.7 million of drawings under arrangements entered into during the previous year. Additionally, \$32.5 million of two-year bonds were sold in Latin America, essentially representing a roll-over of a maturing borrowing of \$34.3 million. As a result of the world currency realignment in December 1971, the funded debt in-

creased by \$42.5 million due to upward adjustment of the U.S. dollar equivalent of borrowings denominated in non-member currencies, including the equivalent of \$2.6 million relating to borrowings during the last half of 1971 but prior to the December 1971 currency realignment. The funded debt was decreased through the retirement of \$23.5 million from sinking fund purchases and scheduled debt retirement.

The Asian Development Bank Act, adopted in March 1966, authorized United States participation in the Asian Development Bank and provides an exemption for certain securities which may be issued or guaranteed by the Bank, similar to the exemptions accorded the International Bank for Reconstruction and Development and the Inter-American Development Bank. Acting pursuant to this authority, the Commission has adopted Regulation AD which requires the Bank to file with the Commission substantially the same type of information, documents and reports as are required from those banks. The Bank has 37 members with subscriptions totaling \$1 billion. Of the \$502.7 million of paid-up shares subscribed, \$494.6 million had matured by June 30, 1972.

As of June 30, 1972, eight countries had contributed or pledged a total of \$174.6 million to the Bank's Special Funds. In addition to the \$14.6 million set aside from Ordinary Capital in 1969 by the Board of Governors for Special Funds purposes, another \$9.9 million were set aside in April 1971, making a total of \$24.5 million set aside. In addition, the United States Congress has authorized a \$100 million U.S. contribution to the Bank's Special Funds, and is considering the appropriation of these funds in fiscal 1973. There have been indications from four other countries of additional contributions and Japan has pledged an additional \$40 million.

Through June 30, 1972, the Bank's borrowings totalled the equivalent of

\$201 million. In 1971, the Bank sold \$20 million U.S. bonds to regional central banks and borrowed in Switzerland, the United States, Japan, Belgium and Austria. The U.S. borrowing was \$50 million, half in 5-year notes at 6½ percent and half in 25-year bonds at 7¾ percent. Before selling securities in the territory of a country, the Bank must obtain that country's approval.

### **TRUST INDENTURE ACT OF 1939**

This Act requires that bonds, debentures, notes and similar debt securities offered for public sale, except as specifically exempted, be issued under an indenture which meets the requirements of the Act and has been duly qualified with the Commission.

The provisions of the Act are closely integrated with the requirements of the Securities Act. Registration pursuant to the Securities Act of securities to be issued under a trust indenture subject to the Trust Indenture Act is not permitted to become effective unless the indenture conforms to the requirements of the latter Act designed to safeguard the rights and interests of the purchasers. Moreover, specified information about the trustee and the indenture must be included in the registration statement.

The Act was passed after studies by the Commission had revealed the frequency with which trust indentures failed to provide minimum protections for security holders and absolved so-called trustees from minimum obligations in the discharge of their trusts. It requires, among other things, that the indenture trustee be a corporation with a minimum combined capital and surplus and be free of conflicting interests which might interfere with the faithful exercise of its duties in behalf of the purchasers of the securities, and it imposes high standards of conduct and responsibility on the trustee. During fiscal year 1972, 492 trust indentures relating

to securities in the aggregate amount of \$20.2 billion were filed.

### **INFORMATION FOR PUBLIC INSPECTION; FREEDOM OF INFORMATION ACT**

The many thousands of registration statements, applications, declarations, and annual and periodic reports filed with the Commission each year, as well as many other public documents, are available for public inspection and copying at the Commission's public reference room in its principal offices in Washington, D C and, in part, at its regional and branch offices.

The categories of materials available for public inspection and copying and those categories of records that are generally considered to be nonpublic as permitted under the Freedom of Information Act are specified in the Commission's rules concerning records and information (17 CFR 200.80 to 200.82). The Rule adopted by the Commission to implement the provisions of the Freedom of Information Act (5 U.S.C. 552), became effective July 4, 1967 (17 CFR 200.80). Among other things, that rule establishes the procedure to be followed in requesting records or copies, provides a method of administrative appeal from the denial of access to any record, and provides for the imposition of fees when more than one-half man-hour of work is performed by members of the Commission's staff to locate and make available records requested. In addition to the records described, the Commission also makes available for inspection and copying all requests for no action and interpretive letters received after December 31, 1970, and responses (17 CFR 200.81). After the fiscal year, the Commission further provided (Rule 17 CFR 200.82) that after November 1, 1972, it would make available for inspection and copying materials filed under proxy Rule 14a-8(d), which deals with proposals offered by shareholders

for inclusion in management proxy-soliciting materials, and that it would likewise make available related materials submitted to the Commission by any person and written communications prepared by the staff on these materials.

The Commission has special public reference facilities in the New York, Chicago and Los Angeles Regional Offices and some facilities for public use in other regional and branch offices. Each regional office has available for public examination copies of prospectuses used in recent offerings of securities registered under the Securities Act; registration statements and recent annual reports filed under the Securities Exchange Act by companies having their principal office in the region; recent annual reports and quarterly reports filed under the Investment Company Act by management investment companies having their principal office in the region; broker-dealer and investment adviser applications originating in the region; letters of notification under Regulation A filed in the region, and indexes of Commission decisions.

During the 1972 fiscal year, 14,683 persons examined material on file in Washington; several thousand others examined files in New York, Chicago, and other regional offices. More than 36,283 searches were made for information requested by individuals, and approximately 4,198 letters were written on information requested.

The Commission's records do not distinguish between records disclosed under the federal securities laws and those made available under the Freedom of Information Act. During the fiscal year, the Commission in 33 situations, either upon request or on its own motion, considered whether to permit disclosure of records that under its rule implementing the Freedom of Information Act (17 CFR 200.80) would generally not have been disclosed.<sup>30</sup> In 18 cases disclosure was made; in the remaining 13 situations disclosure was

denied. Of the matters considered by the Commission, 9 involved requests for access to the contents of investigatory files compiled for law-enforcement purposes. While the Commission generally declined to permit access to investigatory files, in 3 cases the requesting party was provided with a list of the names and addresses of those persons, other than confidential informants, who provided evidence in the course of the investigation.

The public may make arrangements through the Public Reference Section at the Commission's principal offices to purchase copies of material in the Commission's public files. The copies are produced by a commercial copying company which supplies them to the public at prices established under a contract with the Commission. Current prices begin at 12 cents per page for pages not exceeding 8½" x 14" in size, with a \$2 minimum charge. Under the same contract, the company also makes microfiche and microfilm copies of Commission public documents available on a subscription or individual order basis to persons or firms who have or can obtain viewing facilities. In microfiche services, up to 60 images of document pages are contained on 4" x 6" pieces of film, referred to as "fiche."

Annual microfiche subscriptions are offered in a variety of packages covering all public reports filed on Forms 10-K, 10-Q, 8-K, N-1Q and N-1R under the Securities Exchange Act or the Investment Company Act; annual reports to stockholders; proxy statements; new issue registration statements; and final prospectuses for new issues. The packages offered include various categories of these reports, including those of companies listed on the New York Stock Exchange, the American Stock Exchange, regional stock exchanges, or traded over-the-counter; reports are also available by standard industry classifications. Arrangements also may be made to subscribe to reports of companies of

one's own selection. Over one hundred million pages (microimagery frames) are being distributed annually. The subscription services may be extended to further groups of filings in the future if demand warrants. The company also will supply copies in microfiche or microfilm form of other public records of the Commission desired by a member of the public.

Mircofiche readers and reader-printers have been installed in the public reference areas in the Commission's headquarters office, and the New York and Los Angeles regional offices, and sets of microfiche are available for inspection there. After January 1, 1973, similar facilities will be available in the Chicago Regional Office. Visitors to the public reference room of the Commission's headquarters office may also make immediate reproductions of material in those offices on photostatic-type copying machines. The cost to the public of copies made by use of all customer-operated equipment will be 10 cents per page after January 1, 1973. The charge for an attestation with the Commission seal is \$2. Detailed information concerning copying services available and prices for the various types of service and copies may be obtained from the Public Reference Section of the Commission.

## Publications

In addition to releases concerning Commission action under the securities laws and litigation involving securities violations, the Commission issues a number of other publications, including the following:

### Daily:

News Digest; reporting Commission announcements, decisions, orders, rules and rule proposals, current reports and applications filed, and litigation developments.

### Weekly:

Weekly trading data on New York and American Stock Exchanges; Weekly trading data on New York and American Stock Exchanges (information is also included in the Statistical Bulletin).

### Monthly:

Statistical Bulletin.<sup>a</sup>  
Official Summary of Securities Transactions and Holdings of Officers, Directors and Principal Stockholders.<sup>a</sup>

### Quarterly:

Working Capital of U.S. Corporations  
Stock Transactions of Financial Institutions

### Annually:

Annual Report of the Commission.<sup>a</sup>

Securities Traded on Exchanges under the Securities Exchange Act of 1934

List of Companies Registered under the Investment Company Act of 1940

Classification, Assets and Location of Registered Investment Companies under the Investment Company Act of 1940<sup>b</sup>

Private Noninsured Pension Funds (assets available quarterly in the Statistical Bulletin).

Directory of Companies Filing Annual Reports with the Commission under the Securities Exchange Act of 1934<sup>a</sup>

### Other Publications:

Decisions and Reports of the Commission<sup>a</sup> (Out of print, available only for reference purposes in SEC Washington, D.C. and Regional Offices.)

Securities and Exchange Commission—The Work of the Securities and Exchange Commission

Commission Report on Public Policy Implications of Investment Company Growth <sup>a</sup>

Cost of Flotation of Registered Equity Issues, 1963-1965 <sup>a</sup>

Report of SEC Special Study of Securities Markets, H. Doc. 95 (88th Congress) <sup>a</sup>

Institutional Investor Study Report of the Securities and Exchange Commission, H. Doc. 64 (92nd Congress) <sup>a</sup>

Part 8 of the Institutional Investor Study Report, containing the text of the Summary and Conclusions drawn from each of the fifteen chapters of the report. <sup>a</sup>

Study on Unsafe and Unsound Practices of Broker Dealers, H. Doc. 231 (92nd Congress) <sup>a</sup>

Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets, February 2, 1972.

The Financial Collapse of the Penn Central Company, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, August 1972 <sup>a</sup>

Report of the Real Estate Advisory Committee to the Securities and Exchange Commission <sup>a</sup>

Acts and General Rules and Regulations for all Securities Acts  
Compilation of Releases Dealing with Matters Frequently Arising under the Securities Act of 1933

Compilation of Releases Dealing with Matters Arising under the Securities Exchange Act of 1934 and Investment Advisers Act of 1940

Compilation of Releases, Commission Opinions, and Other Material Dealing with Matters Frequently Arising under the

Investment Company Act of 1940

<sup>a</sup> Must be ordered from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.

<sup>b</sup> This document is available in photocopy form Purchasers are billed by the printing company which prepares the photocopies.

## FREEDOM OF INFORMATION ACT LITIGATION

The meaning of various exemptions from the general disclosure requirements of the Freedom of Information Act, was the subject of litigation involving the Commission during the fiscal year.

*Frankel v. S.E.C.* After the Commission had brought an action which resulted in a court injunction, plaintiffs sought the contents of the investigatory file compiled by the Commission upon which its action had been based. The district court held that the exemption applicable to "investigatory files compiled for law enforcement purposes" was not available because the Commission had not demonstrated that further enforcement action was anticipated.<sup>31</sup> It also rejected the argument that some or all of the records were exempt as matters that are specifically exempted from disclosure by statute by virtue of the Trade Secrets Act, because, in its view, that Act only penalized unauthorized disclosure of non-exempt information. The court ordered the Commission to turn over that portion of the file which was not exempt by virtue of other exemptions which the Commission had asserted. On appeal by the Commission, the Court of Appeals for the Second Circuit reversed the order of the district court and remanded the matter with directions to enter summary judgment for the Commission.<sup>32</sup> It held that the requested records came within the investigatory files exemption which it said was available whether or not further en-

forcement proceedings were contemplated.

*Vinick v. S.E.C.*<sup>33</sup> The plaintiff requested, among other things, the entire investigatory file compiled by the Commission in a non-public investigation of Memorex Corporation which led the Commission to file suit against Memorex and others.<sup>34</sup> The answer filed by the Commission raises issues similar to those in the *Frankel* case. The suit was pending at the close of the fiscal year.

*Commercial Envelope Mfg. Co., Inc. v. S.E.C.*<sup>35</sup> A petition was filed in the Court of Appeals for the Second Circuit to review the Commission's refusal to make public a document obtained from an informant relating to the completeness and accuracy of a registration statement filed under the Securities Act. During the fiscal year this petition was dismissed by the court of appeals for lack of jurisdiction.<sup>36</sup> Commercial Envelope thereafter filed suit in the United States District Court for the Southern District of New York, seeking an order compelling the Commission to turn over the document.<sup>37</sup> In its answer to the complaint, the Commission has again asserted that the document is exempt from disclosure under the Freedom of Information Act because it (1) is part of an investigatory file compiled for law enforcement purposes; (2) is specifically exempted from disclosure by virtue of the Trade Secrets Act; and (3) contains matters which are commercial or financial information obtained from a person and privileged or confidential.

*M. A. Schapiro & Co., Inc. v. S.E.C.*<sup>38</sup> Plaintiff had asked that the Commission be required to make public a staff study on Rule 394 of the New York Stock Exchange and transcripts of testimony taken and other records compiled in the course of the staff investigation of that rule. Before the court had ruled on the issues involving the staff study, the Commission voluntarily made the study public. The district court then directed the Commission to produce for plain-

tiff's inspection and copying the remaining records requested by plaintiff, but allowed the Commission to delete "[a]ll identifying material that would indicate who the individual giving the information was . . . where the person so requested." The court rejected the applicability of each of the exemptions relied upon by the Commission. It held that the records had not been shown to have been compiled for law enforcement purposes, because the Commission proffered no proof that it contemplated a law enforcement proceeding based upon the material sought within the reasonably near future. The records were held not to be matters that are "contained in or related to examination, operating, or condition reports prepared . . . [for the use of] an agency responsible for the regulation or supervision of financial institutions," because the materials were gathered "for the express purpose of changing trading rules and related practices of national securities exchanges." The court further held that the records were not exempt from disclosure as matters that are specifically exempt by statute by virtue of the Trade Secrets Act, or as matters that are "commercial or financial information . . . and privileged or confidential." The Commission determined not to appeal the decision, and it disclosed the records with identifying details deleted.

## NOTES TO PART 2

<sup>1</sup> Securities Act Release No. 5209 (November 8, 1971).

<sup>2</sup> Securities Act Release No. 5171 (July 20, 1971).

<sup>3</sup> Investment Company Act Release No. 7220 (June 9, 1972).

<sup>4</sup> Investment Company Act Release No. 7219 (June 9, 1972).

<sup>5</sup> Securities Act Release No. 5201 (October 12, 1971).

<sup>6</sup> Securities Act Release No. 5170 (July 19, 1971).

<sup>7</sup> Securities Act Release No. 5235 (February 16, 1972).

<sup>8</sup> *Natural Resources Defense Council, Inc. v. S.E.C.*, C.A. D.C., No. 72-1148.

<sup>9</sup> The Division has consistently taken the position that offers of resort condominiums, in conjunction with certain types of rental arrangements, constitute offers of "investment contracts" which must be registered as securities under the Securities Act.

<sup>10</sup> Securities Act Release No. 5225 (January 10, 1972).

<sup>11</sup> Securities Exchange Act Release No. 9348 (September 28, 1971).

<sup>12</sup> 432 F. 2d 659 (C.A. D.C., 1970), vacated as moot, 404 U.S. 403 (1972). Previously discussed in 37th Annual Report, pp. 54-55; 36th Annual Report, pp. 49-50.

<sup>13</sup> C.A. D.C., No. 72-1285.

<sup>14</sup> Securities Exchange Act Release No. 9499 (February 23, 1972).

<sup>15</sup> Securities Exchange Act Release No. 9500 (February 23, 1972).

<sup>16</sup> 404 U.S. 418 (1972).

<sup>17</sup> 404 U.S. at 423. Since the proviso in Section 16(b) relates only to 10 percent beneficial owners, the Court's decision does not affect lower court holdings that Section 16(b) applies to the purchase and sale within six months by an officer or director who is found to be in such statutory insider status either at the time of purchase or at the time of sale. See, e.g., *Feder v. Martin Marietta Corp.*, 406 F. 2d 260 (C.A. 2, 1969), certiorari denied, 396 U.S. 1036 (1970); *Adler v. Klawans*, 267 F. 2d 840 (C.A. 2, 1959).

<sup>18</sup> C.A. 4, Nos. 71-2180, 71-2181 and 71-2182.

<sup>19</sup> See pages 65 and 150-151

<sup>20</sup> Accounting Series Release No. 120 (July 15, 1971).

<sup>21</sup> Accounting Series Release No. 121 (July 19, 1971).

<sup>22</sup> Accounting Series Release No. 122 (August 10, 1971).

<sup>23</sup> Accounting Series Release No. 123 (March 23, 1972).

<sup>24</sup> Accounting Series Release No. 124 (June 1, 1972).

<sup>25</sup> Accounting Series Release No. 125 (June 23, 1972).

<sup>26</sup> Accounting Series Release No. 128 (September 20, 1972).

<sup>27</sup> Accounting Series Release No. 126 (July 5, 1972).

<sup>28</sup> Securities Exchange Act Release No. 9344 (September 27, 1971).

<sup>29</sup> Securities Exchange Act Release No. 9691 (July 27, 1972).

<sup>30</sup> In addition, the Commission provided disclosure of records in substantially all instances where requests were made by the Congress, Federal agencies, state and local government officials, foreign governments and court trustees and receivers.

<sup>31</sup> 336 F. Supp. 675 (S.D. N.Y., 1971). See prior discussion in 37th Annual Report, p. 210.

<sup>32</sup> 460 F. 2d 813 (C.A. 2, 1972), certiorari denied, 41 U.S.L.W. 3188, (No. 72-49) (October 10, 1972).

<sup>33</sup> N.D. Cal., No. C-71-2987.

<sup>34</sup> *S.E.C. v. Memorex Corp.*, S.D.N.Y., 71 Civ. 2812.

<sup>35</sup> C.A. 2, No. 71-1171. Previously discussed in 37th Annual Report, p. 210.

<sup>36</sup> 450 F. 2d 342 (C.A. 2, 1971).

<sup>37</sup> *Commercial Envelope Mfg. Co., Inc. v. S.E.C.*, S.D. N.Y., No. 72 Civ. 1660.

<sup>38</sup> 339 F. Supp. 467 (D.D.C., 1972). Previously discussed in 37th Annual Report, p. 210.

# **PART 3**

## **SECURITIES MARKET REGULATION**





# **PART 3**

## **REGULATION OF SECURITIES MARKETS**

In addition to the disclosure provisions discussed in the preceding chapter, the Securities Exchange Act assigns to the Commission significant regulatory responsibilities for securities markets and persons in the securities business. It requires securities exchanges to register with the Commission and provides for Commission supervision of the self-regulatory responsibilities of registered exchanges. The Act requires registration and regulation of brokers and dealers doing business in the over-the-counter markets, and permits registration of associations of brokers or dealers exercising self-regulation under Commission supervision. The Act also contains provisions designed to prevent fraudulent,

deceptive, and manipulative acts and practices on the exchanges and in the over-the-counter markets. Some recent developments of significance in market regulation are discussed in Part 1.

### **REGULATION OF EXCHANGES**

#### **Registration**

The Securities Exchange Act requires an exchange to register with the Commission as a national securities exchange unless the Commission exempts it from registration because of the limited volume of transactions. As of June 30, 1972, the following 12 stock exchanges were registered:

American Stock Exchange, Inc.  
Boston Stock Exchange

Chicago Board of Trade <sup>1</sup>  
 Cincinnati Stock Exchange  
 Detroit Stock Exchange  
 Midwest Stock Exchange, Inc.  
 National Stock Exchange  
 New York Stock Exchange, Inc.  
 Pacific Coast Stock Exchange, Inc.  
 PBW Stock Exchange, Inc.<sup>2</sup>  
 Intermountain Stock Exchange <sup>3</sup>  
 Spokane Stock Exchange

The Honolulu Stock Exchange and the Richmond Stock Exchange were exempt from registration during the fiscal year. On April 21, 1972, the Richmond Stock Exchange was dissolved by its members, and the Commission thereafter issued an order withdrawing the Exchange's exemption from registration, effective May 10, 1972.

During the fiscal year, two prospective new exchanges, the Chicago Board Options Exchange, Incorporated, and the Southeastern Stock Exchange, Incorporated, submitted informal applications for staff review.

The Chicago Board Options Exchange intends to limit its initial operations to call options <sup>4</sup> in approximately 20 underlying stocks. It intends to increase that number gradually and to extend operations to other types of options as experience is gained and the market and its regulatory arrangements are tested. The Exchange not only would provide a market place for the initial buying and selling of option contracts but also would facilitate the development of a secondary market for the resale of options during their lifetime. Presently, options are initially bought and sold over-the-counter, and there is only a very limited secondary, over-the-counter market.

The Southeastern Stock Exchange, which would be located in Miami, Florida, would serve primarily the southeastern part of the United States as a regional exchange.

### Exchange Rules

The Commission's staff maintains a continuous review of the rules and prac-

tices of the securities exchanges to determine adequacy and effectiveness of self-regulation. To facilitate Commission oversight, each national securities exchange is required to file with the Commission a report of any proposed rule or practice change not less than 3 weeks (or such shorter period as the Commission may authorize) before acting to effectuate the change.

During the 1972 fiscal year, 176 proposed changes in exchange rules and practices were submitted to the Commission. Among the more significant:

1. Since February 1971, when the New York Stock Exchange was incorporated, the American Stock Exchange, Midwest Stock Exchange, Pacific Coast Stock Exchange, and Philadelphia-Baltimore-Washington Stock Exchange have also been incorporated. Like the New York Stock Exchange, the American Stock Exchange was incorporated under the New York Not-for-Profit Corporation Law. The other exchanges were incorporated as membership corporations under the Delaware General Corporation Law. At the request of the Commission's staff, the certificates of incorporation of all the above exchanges permit the payment of dividends only in the event of liquidation. This limitation will assure preservation of exchange assets for the protection of investors and help insure proper functioning of exchanges as self-regulatory bodies by eliminating any incentive to operate as profit-making entities.

In connection with the incorporation of these exchanges, the staff reviewed provisions concerning indemnification of officers, directors and employees. Because indemnification might be against public policy where violations of the Exchange Act are involved, the staff requested each exchange to inform it whenever indemnification is proposed in order to permit review of the particular circumstances.

2. The New York Stock Exchange

amended its rules to permit member firms to sell life insurance. This action was designed to enable members to offer a wider range of financial services to their customers, to diversify their sources of income to help offset cyclical swings in the securities business, and to offer more attractive employment opportunities to qualified salesmen.

3. The New York Stock Exchange adopted a uniform  $\frac{1}{8}$  point per share charge (known as an odd-lot differential) for all stocks purchased or sold in odd-lots. Previously, an odd-lot customer paid  $\frac{1}{8}$  point per share when the stock sold for less than \$55 per share, and  $\frac{1}{4}$  point per share on higher priced stocks. The Pacific Coast Stock Exchange also amended its rules to set a uniform  $\frac{1}{8}$  differential on odd-lot transactions in all securities traded on the Exchange. The Midwest Stock Exchange adopted a  $\frac{1}{8}$  odd-lot differential for all stocks listed on the Exchange, as well as those which are traded on the Exchange and listed on the New York Stock Exchange. The Boston and PBW Stock Exchanges implemented a  $\frac{1}{8}$  odd-lot differential on all stocks traded on those exchanges which are listed on the New York Stock Exchange.

The Midwest, Pacific Coast and PBW Stock Exchanges eliminated the odd-lot differential on odd-lots which are part of an order for one or more round-lots.

4. The New York and American Stock Exchanges revised their governing structures to provide for an increased number of public directors or governors (persons not engaged in the securities business) on their governing boards. Each of these exchanges now has 10 public representatives on its 21-man board, compared to 3 out of 33 before.

### Litigation on Exchange Rules

The past year saw the further proliferation of attacks, under the antitrust laws, on various rules or practices of the New York Stock Exchange (NYSE)

and other self-regulatory organizations. In a number of these cases, the Commission has filed briefs as *amicus curiae* or has intervened. It has taken the position that, to the extent the Commission has regulatory jurisdiction with respect to the rules and practices challenged, they should be tested by the Commission against the standards and by the procedures of the Securities Exchange Act and not by a district court applying antitrust standards. The Commission noted that in the landmark decision in *Silver v. New York Stock Exchange*,<sup>5</sup> the Supreme Court had held that the "guiding principle" to reconciliation of the two statutory schemes is that the antitrust laws must be regarded as having been repealed to the extent "necessary to make the Securities Exchange Act work." And the Commission has pointed out that the Securities Exchange Act cannot be expected to work if district courts may render *ad hoc* decisions which preempt the Commission's judgment in areas of the Commission's basic regulatory responsibilities.<sup>6</sup>

Among more significant cases in this area: *Robert W. Stark, Jr., Inc. v. New York Stock Exchange, Inc.*<sup>7</sup> Stark, Inc. and Robert W. Stark, Jr., its president, and Kansas City Securities Corporation, a brokerage subsidiary of a mutual fund manager and a nonmember of the NYSE, charged the NYSE with having violated the antitrust laws through the promulgation and enforcement of Rule 318, which requires that "[the] primary purpose of every member organization, and any parent of any member corporation, shall be the transaction of business as a broker or dealer in securities." Stark and Stark Inc. sought a preliminary injunction enjoining the NYSE from expelling them for violations of that rule involving the injection of capital by Kansas City into the Stark firm.

The Commission filed a memorandum, *amicus curiae*, urging that the re-

quest for a preliminary injunction be denied. It pointed out that Rule 318 is subject to the Commission's regulatory oversight, and that if a district court were to enjoin the rule it would interfere with the exercise of policy-making functions entrusted to the Commission by the Congress. The district court, in denying injunctive relief, agreed in large part with the Commission's position.<sup>8</sup> The court noted that Rule 318, together with other various rules and customs, was the subject of a pending request by the SEC that NYSE and other exchanges effectuate certain alterations in rules and practices. It concluded that:

"[T]here is adequate power in the SEC to take all steps necessary with respect to the access of institutional investors to the NYSE and . . . this Court should take no step in private litigation which might in any way prejudice the effectiveness of such a scheme, or create any grandfather rights for plaintiffs, or otherwise impair by implication or other[wise] the full and complete right and power of the SEC to do the regulatory work for which it was constituted, in an area of market action which cries out for some rational plan."

The district court's decision was affirmed *per curiam* by the Court of Appeals for the Second Circuit.<sup>9</sup>

*Thill v. New York Stock Exchange*.<sup>10</sup> The Court of Appeals for the Seventh Circuit in 1970 reversed a district court order granting summary judgment to the Exchange.<sup>11</sup> This case is now proceeding toward a trial of the question whether the NYSE's anti-rebate rule is "necessary to make the Securities Exchange Act work." The NYSE moved to refer this question to the Commission on a primary-jurisdiction theory. The district court denied the motion because, in its view, the Securities Exchange Act does not establish a sufficiently pervasive regulatory scheme to

warrant such referral. The NYSE has appealed this ruling.<sup>12</sup> The Commission, as intervenor, filed a brief in the court of appeals in which it argued that the ruling should be affirmed, although not on the theory of the district court. Instead, the Commission pointed out that the current anti-rebate rule, which provides for a 40 percent discount from the fixed minimum commission rate to nonmember broker-dealers, was promulgated by the NYSE at the Commission's request. Implicit in the Commission's request was a preliminary determination that this test rule was "necessary or appropriate" under the standards of Section 19(b) of the Exchange Act. Accordingly, no purpose would be served by referral of a question, the answer to which the Commission had already given—the anti-rebate rule as it currently exists appears proper under the Exchange Act.

*Eisen v. Carlisle & Jacquelin*.<sup>13</sup> In this case, in which the Commission has not participated, the plaintiff filed a class action on behalf of himself and other odd-lot investors against the NYSE and the two major odd-lot dealers on the NYSE, attacking the Exchange's odd-lot trading differential as violative of the anti-trust laws and claiming that the NYSE was required to but had failed to regulate odd-lot transactions. In preliminary rulings, the Federal district court held that the case could be maintained as a class action on behalf of some 6 million investors who had engaged in odd-lot transactions on the Exchange between 1962 and 1966 and that, since the class was more than likely to prevail on its claims, the defendants should bear the major share of the cost of notice to the class.

### Delistings

Under the Securities Exchange Act, securities may be stricken from listing and registration upon application to the Commission by an exchange, or withdrawn from listing and registration upon

application by an issuer, in accordance with the rules of the exchange and upon such terms as the Commission may impose for the protection of investors.

The various exchanges have different delisting standards. However, delisting actions are generally based on one or more of the following factors: the number of publicly held shares or shareholders is insufficient; the market value of outstanding shares or the trading volume is too low; the company does not meet requirements as to earnings or financial condition or has ceased operations; or required reports have not been filed with the exchange.

During the fiscal year ending June 30, 1972, the Commission granted exchange applications for the removal of 77 stock issues and 14 bond issues from listing and registration. The largest number of applications came from the American Stock Exchange (18 stocks and 9 bonds). Other exchanges were represented as follows: National (21 stocks); New York (16 stocks and 3 bonds); Midwest (7 stocks and 2 bonds); Pacific Coast (6 stocks); Detroit and PBW (4 stocks each); and Inter-mountain (1 stock).

The Commission also granted the applications of two issuers to withdraw securities from listing and registration on the National Stock Exchange.

In judicial review of a delisting action, in *Intercontinental Industries, Inc. v. American Stock Exchange*,<sup>14</sup> the Court of Appeals for the Fifth Circuit upheld a Commission decision granting the American Stock Exchange's application to delist the stock of Intercontinental Industries, Inc. (INI). That application was based on INI's dissemination of misleading information in violation of its listing agreement with the Exchange. The court agreed with the Exchange and the Commission that INI failed to take "prompt corrective action". It noted that INI did not make full disclosure until enforcement action was taken

against it some two to three months after it had made misleading announcements. The court also rejected INI's argument that it was denied due process in the delisting procedures.

### Exchange Disciplinary Actions

Although the Exchange Act does not provide for Commission review of disciplinary action by exchanges,<sup>15</sup> each national securities exchange reports to the Commission actions taken against members and member firms and their associated persons for violations of any rule of the exchange or of the Exchange Act or of any rule or regulation under the Act.

During the fiscal year, eight exchanges reported 236 separate actions, including the imposition in 120 cases of fines ranging from \$10 to \$25,000, with total fines aggregating \$266,400; the revocation of 24 member firms and expulsion of 4 individuals; the suspension from membership of 13 member firms and 30 individuals; and censure of 99 member firms. The exchanges also reported the imposition of various other sanctions against 22 registered representatives and other employees of member firms.

### Inspections

Another important aspect of the Commission's supervision of exchange self-regulation is its program of regular inspections of various phases of exchange activity. These inspections enable the Commission to recommend, where appropriate, improvements designed to increase the effectiveness of self-regulation.

In fiscal 1972, the Commission's staff conducted 15 inspections. Two of these were general inspections of the Philadelphia-Baltimore-Washington and Pacific Coast Stock Exchanges. At the New York Stock Exchange, eight separate inspections were made, covering enforcement and interpretation of its net

capital rule, financial surveillance, stock watch and floor surveillance, procedures for compliance with Regulation T of the Federal Reserve Board, arbitration, and the Block Automation System.

Inspections of the American Stock Exchange covered stock watch and floor surveillance procedures, the enforcement and interpretation of its net capital rule and financial surveillance generally, and FACS (a system for monitoring the operational capacity of member firms). In addition, inspections were conducted of the Pacific Coast and Midwest Stock Exchange Stock Clearing Corporations and Service Corporations and the New York Stock Exchange Clearing Corporation.

## **SUPERVISION OF NASD**

The Exchange Act provides for registration with the Commission of national securities associations and establishes standards and requirements for such associations. The Act contemplates that such associations will serve as a medium for self-regulation by over-the-counter brokers and dealers. Their rules must be designed to protect investors and the public interest, to promote just and equitable principles of trade, and to meet other statutory requirements. They are to operate under the general supervision of the Commission, which is authorized to review disciplinary actions taken by them, to disapprove changes in their rules, and to alter or supplement their rules relating to specified matters. The National Association of Securities Dealers, Inc. (NASD) is the only association registered under the Act.

In adopting legislation permitting the formation and registration of national securities associations, Congress provided an incentive to membership by permitting such associations to adopt rules which preclude a member from dealing with a nonmember broker or dealer except on the same terms and conditions as the member affords the

general public. The NASD has adopted such rules. As a result, membership is necessary to profitable participation in underwritings since members may properly grant price concessions, discounts and similar allowances only to other members.

At the close of the fiscal year, the NASD had 4,229 members, reflecting a net loss of 161 members during the year. This loss was the net result of 411 admissions to and 572 terminations of membership. The number of branch offices decreased by 444, to 6,584, as a result of the opening of 1,234 new offices and the closing of 1,678 offices. During the year, the number of registered representatives and principals (these categories include all partners, officers, traders, salesmen and other persons employed by or affiliated with member firms in capacities which require registration) decreased by 2,014 to stand at 197,903 as of June 30, 1972. This decrease was the net result of 23,317 initial registrations, 26,805 re-registrations and 52,136 terminations of registrations during the year.

During the fiscal year, the NASD administered 58,911 qualification examinations of which approximately 34,806 were for NASD qualification and the balance for other agencies, including major exchanges, the Commission and various States.

## **NASD Rules**

Under the Exchange Act, the NASD must file for Commission review, 30 days in advance of their effectiveness, copies of any proposed rules or rule amendments. Any rule change or addition may be disapproved by the Commission if found not to be consistent with the requirements of the Act. The Commission also normally reviews, in advance of publication, general policy statements, directives, and interpretations proposed to be issued by the Association's Board of Governors pursuant

to its powers to administer and interpret NASD rules.

During the fiscal year, numerous changes in or additions to NASD rules, policies and interpretations were submitted to the Commission. Among the more significant which were not disapproved by the Commission:

1. Amendments to the Code of Arbitration Procedure to authorize the Board of Governors to compel a member to arbitrate any dispute, claim or controversy arising out of a securities transaction at the instance of another member or a public customer. Previously, the Code provided only for the voluntary submission of disputes. Further, provision was made for the selection of a representative from the public at large to serve on the National Arbitration Committee.

2. Amendments to Schedule D of the NASD By-laws, which pertains to the NASDAQ system,<sup>16</sup> (a) requiring that NASDAQ market makers' quotations be good for at least one trading unit (usually 100 shares) in securities quoted on the system; (b) requiring NASDAQ market makers to report their volume data on a daily basis; (c) setting subscribers' charges for use of the NASDAQ system; (d) increasing the size of the Association's NASDAQ Committee so as to provide a better geographical representation; and (e) revising procedures and sanctions in connection with alleged NASDAQ violations.

3. Amendments to schedule C of the NASD By-laws to provide for revised qualification examinations for registered representatives of NASD member firms and to create, for the first time, a class of "financial principals" who would be required to pass the entire principal's examination including the

portion relating to financial matters.

4. Amendments to Schedule B of the NASD By-laws realigning the NASD Districts in accordance with the administrative needs of the Association.

5. Amendments to the Association's Uniform Practice Code designed to streamline the procedures relating to the partial delivery of securities.

On May 9, 1972, the NASD Board of Governors submitted to its membership for comment a proposed Rule of Fair Practice to establish a system of regulation for the distribution of tax-sheltered programs. This proposed rule, the result of approximately one year's work by two committees appointed by the Association, would prohibit members from participating in the distribution of tax-sheltered programs which did not meet prescribed standards of fairness and reasonableness. These standards relate to the underwriting or other terms and conditions of the distribution of units of such programs to the public including all elements of compensation to be paid to sponsors or broker-dealers, and concerning the operation, structure, and management of such programs. Suitability standards for investment in such programs and requirements concerning the content and filing with the Association of advertising and supplemental sales literature would be established. At the end of the fiscal year, the comment period for the proposed rule had not yet expired.

### Litigation on NASD Rules

*Harwell v. Growth Programs, Inc.*<sup>17</sup> A class of purchasers of single-payment contractual plans for the accumulation of mutual fund shares sued the sponsor and the underwriter of the plans and the NASD for an alleged conspiracy in violation of the antitrust laws. Plaintiffs sought treble damages from all defen-



dents and resumption of the right to unlimited exercise of the withdrawal-and-reinstatement privilege contained in the plans. The NASD had issued an interpretation of its Rules of Fair Practice, which, in effect, prohibited NASD members, including the sponsor and underwriter of the plans, from continuing to facilitate the unlimited and speculative use of this "in-and-out" privilege. This interpretation had been issued at the Commission's urging.

As reported last year,<sup>18</sup> the district court granted the defendants' motion for summary judgment. On appeal, the Court of Appeals reversed and remanded the case for a trial on the merits. Relying on the *Thill* case, discussed above, the court held that the fact that the NASD "acted under close supervision" of the Commission in adopting its interpretation did not immunize it from antitrust penalty. The court further stated that in any event, the extent of the Commission's supervision was not readily apparent from the record and that the record was barren of what consideration, if any, was given by the Commission to the antitrust effects of the NASD's interpretation.

The NASD sought a rehearing (which the Commission supported in a statement filed with the court) urging that the record did in fact reflect the extent of the Commission's supervision over the issuance of the interpretation and that such supervision distinguished the case from *Thill* where it was held that the "mere possibility" of Commission supervision over the rules of a national securities exchange was not sufficient to immunize the exchange from antitrust attack. The court denied rehearing. It apparently acknowledged that the record did reflect the supervision exercised by the Commission and it deleted the contrary statement from its original opinion, but it reaffirmed its reliance on *Thill*. The NASD thereafter petitioned the Supreme Court for a writ of certiorari.

The Exchange Act authorizes the Commission to abrogate any NASD rule if necessary or appropriate to effectuate the purposes of the Act. During the fiscal year, the Commission, after hearings, abrogated an NASD rule to the extent that it permitted or had been construed to permit the NASD to bar the receipt by its members of commissions, concessions, discounts or other allowances from nonmember brokers or dealers.<sup>19</sup> The NASD's interpretation had in effect precluded members from joining in a distribution with a nonmember where the concession or discount flowed from the nonmember to the member. The Commission held that the rule, as construed and applied, was beyond the scope of the authority granted to the NASD by a provision of the Act authorizing it to adopt rules prohibiting a member from dealing with a nonmember except at the same prices and on the same terms as it accords to the general public. This was the first case in which an NASD rule has been abrogated in whole or in part.

### Inspections

The Commission is charged with the general oversight of national securities associations in the performance of their self-regulatory activities, and the staff conducts periodic inspections of various phases of NASD activity. While in the past budgetary restrictions have severely limited the number of inspections conducted, during this fiscal year, largely as a result of a supplemental appropriation received by the Commission, the staff was able to inspect the overall operations of the Association's district offices in Dallas, Denver, Los Angeles, New York, San Francisco, Seattle, St. Louis and Washington, D.C. In addition, the staff reviewed operations of the National Clearing Corporation which was established by the NASD to provide nationwide clearing and settlement facilities in the over-the-counter market.

## NASD Disciplinary Actions

The Commission receives from the NASD copies of its decisions in all disciplinary actions against members and registered representatives. In general, such actions are based on allegations that the respondents violated specified provisions of the NASD's Rules of Fair Practice. Where violations by a member are found, the NASD may impose sanctions including expulsion, suspension, fine, or censure. If the violator is an individual, his registration with the Association may be suspended or revoked, he may be suspended or barred from being associated with any member, and he may be fined and/or censured.

During the past fiscal year, the NASD reported to the Commission its final disposition of disciplinary complaints against 575 member firms and 486 individuals associated with them, both records.<sup>20</sup> The major factors contributing to the increase in disciplinary actions have been the NASD's expanded examiner force,<sup>21</sup> its increased frequency of inspections of member firms, the adoption of new NASD and Commission rules, and the NASD's quarterly financial reporting form designed to provide the Association with advance warning of impending financial or back office problems.

In the disciplinary actions, complaints against 37 members and 46 individuals were dismissed for failure to establish the alleged violations. The maximum penalty of expulsion from membership was imposed against 38 members, and 36 members were suspended from membership for periods ranging from 1 day to 6 months. In many of these cases, the member was fined as well. In 432 cases, members were fined amounts ranging from \$100 to \$50,000 and in 32 cases, members were censured.

In disciplinary sanctions imposed on individuals associated with member firms, 76 were barred, 26 were revoked,

and 66 had their registrations suspended for periods ranging from 1 day to 5 years. In addition, 272 other individuals were censured and/or fined amounts ranging from \$100 to \$25,000.

## Review of NASD Disciplinary Actions

Disciplinary actions by the NASD are subject to review by the Commission on its own motion or on the timely application of any aggrieved person. In these cases, effectiveness of any penalty imposed by the NASD is automatically stayed pending Commission review, unless the Commission otherwise orders after notice and opportunity for hearing. If the Commission finds, in its review, that the disciplined party committed the acts found by the NASD and violated the rules specified in the determination, the Commission must sustain the NASD's action—unless it finds that the penalties imposed are excessive or oppressive, in which case it must cancel or reduce them.

At the start of the fiscal year, eight proceedings to review NASD disciplinary decisions were pending before the Commission on review. During the year, 25 additional cases were brought up for review.<sup>22</sup> Eight cases were disposed of by the Commission. In two cases, the Commission sustained in full the disciplinary action taken by the NASD.<sup>23</sup> It dismissed the review proceedings in two cases as having been abandoned, and permitted the withdrawal of two other applications. In the remaining two cases, the Commission set aside some of the NASD findings, but sustained the penalties.<sup>24</sup> Twenty-five cases were pending at the end of the year.

One case, *R. Danais Investment Co., Inc.*,<sup>25</sup> involved improper use of the NASD's examination questions in preparing applicants for qualification examinations. The NASD found that the member's president improperly obtained copies of the Association's qualification

examination questions for registered representatives and incorporated those questions into a practice quiz used in preparing the firm's trainees for examination. It expelled the firm and revoked the president's registration.

In sustaining the NASD actions, the Commission referred to a prior holding that:

"In view of the vital importance of examinations in the program of upgrading the level of competence in the securities business, we regard a deception in connection with the taking of those examinations . . . to be so grave that we would not find the extreme sanction of revocation or expulsion to be excessive or oppressive unless the most extraordinary mitigative facts were shown."

The Commission was unable to find that extraordinary mitigative facts had been shown here.

In *Hagen Investments, Inc. v. SEC*,<sup>26</sup> the Court of Appeals for the Tenth Circuit affirmed the Commission's finding that certain Emergency Rules of Fair Practice adopted by the NASD's Board of Governors during the paperwork and financial crises of 1968-1970 had been validly adopted. The court, as had the Commission, rejected the petitioner's argument that the adoption of some rules violated NASD By-laws and that the rules, which petitioner had been found to have violated, were invalid. The court held that the NASD has the authority to promulgate rules of fair practice in an emergency situation without submitting such rules to the full NASD membership for a vote.

In *Benjamin Werner & Co. v. SEC*,<sup>27</sup> the Court of Appeals for the District of Columbia Circuit affirmed *per curiam* and without opinion an order of the Commission dismissing petitioner's application to review disciplinary action taken against him by the NASD. The Court of Appeals necessarily rejected,

as had the Commission, petitioner's argument that the NASD could not impose upon him any penalty except censure since his conduct, while concededly contrary to just and equitable principles of trade and therefore in violation of the NASD's Rules of Fair Practice, was not also found to be illegal.

### **Review of NASD Membership Action**

The Exchange Act and NASD By-laws provide that no broker or dealer can be an NASD member where he or an associate is subject to specified disabilities. These can only be waived under specific findings of the Commission. A Commission order approving or directing admission to, or continuance in Association membership is generally made after initial submission to the NASD by the member or applicant for membership. The NASD in its discretion may then file an application with the Commission on behalf of the petitioner. If the NASD refuses to sponsor, the broker or dealer may apply directly to the Commission for an order directing the NASD to admit or continue him in membership. At the beginning of the fiscal year, 9 applications for approval of admission to or continuance in membership were pending. During the year, 6 additional applications were filed, 4 were approved, and 5 were withdrawn, leaving 6 applications pending at the year's end.

## **BROKER-DEALER REGULATION**

### **Registration**

Brokers and dealers who use the mails or the means of interstate commerce in the conduct of an over-the-counter securities business are required by the Securities Exchange Act to register with the Commission.

As of June 30, 1972, 4,734 broker-dealers were registered, compared with 4,940 a year earlier. The reduction was attributable mainly to the withdrawal of

688 registrations as against only 561 new applications filed. For further comparative statistics, see the statistical section.

### Financial Reports

Registered broker-dealers are required to file annual reports of financial condition with the Commission. In most cases, these reports must be certified by an independent public accountant. The reporting rule was amended significantly during the year to provide more financial data to the Commission and to customers. During the fiscal year, 4,224 broker-dealer financial reports were filed with the Commission, compared to the 1971 total of 4,481.

### Income and Expense Reports

The Commission in June 1968 adopted Rule 17a-10 under the Securities Exchange Act, effective January 1, 1969.<sup>28</sup> This rule requires registered broker-dealers and exchange members to file income and expense reports for each calendar year with the Commission or with a registered self-regulatory organization (an exchange or the NASD) which has qualified a plan under the rule. The self-regulatory organization transmits copies of the reports to the Commission on a confidential basis. During the fiscal year, the Commission deleted the provision of the rule which permitted a self-regulatory organization to omit the names and addresses of members when transmitting reports.<sup>29</sup>

Since 1970, the Commission has approved the plans of the NASD, and the American, Midwest, New York, and Philadelphia-Baltimore-Washington Stock Exchanges.<sup>30</sup> These plans provide that the self-regulatory organization will adopt and implement appropriate internal procedures for review of the reports submitted by members, review all reports filed for reasonableness and accuracy, transmit edited reports to the

Commission, and undertake certain other obligations.

The reports covering calendar year 1971 of SECO broker-dealers<sup>31</sup> and non-NASD members of those exchanges which have not qualified a plan have been received and reviewed by the Commission. The 1971 reports of all NASD members and of non-NASD members of those exchanges which have qualified a plan have been received by the Commission from the respective self-regulatory organization. Information based on these reports is included in the statistical section.

### Broker-Dealer Examinations

A corrective measure taken by the Commission to deal more effectively with problems detailed in its December 1971 "Study of Unsafe and Unsound Practices of Brokers and Dealers" was the establishment in January, 1972, of an Office of Broker-Dealer and Investment Adviser Examinations. In August, 1972, as part of the reorganization of the Commission, the functions of this Office pertaining to investment advisers were assigned to the Division of Investment Company Regulation. The new Office was set up to develop and administer a program for more frequent and intensive examination of broker-dealers, both independently and through improved oversight and coordination with the examination activities of the self-regulatory agencies, as well as to step up and improve the investment adviser examination program.

In March, 1972, shortly after the establishment of the new Office, the rate of examination of broker-dealers and investment advisers increased substantially, in part through enlargement of the Commission's examination staff. The number of broker-dealer examinations increased from 772 in fiscal year 1971 to 893 the past year.

Broker-dealer examinations used in the accelerated program are of three

types: cause, routine and oversight. Cause examinations usually result from complaints received from customers or other broker-dealers, or from other intelligence which indicates a need to review certain aspects of the operations of a particular broker-dealer, and they are generally limited to the subject matter of the complaint. Routine examinations, which cover all aspects of a broker-dealer's operations, are generally restricted to broker-dealers which are not members of any of the self-regulatory organizations (SECO broker-dealers), but members of the self-regulatory organizations are also subject to such examinations. An attempt is made to examine each SECO broker-dealer within 60 days after it becomes registered with the Commission and to schedule routine examinations of that firm annually thereafter. Oversight examinations are explained below.

Broker-dealers are frequently members of more than one self-regulatory organization. A prime concern of the new Office has been to establish an effective system of coordination among the self-regulatory and other regulatory agencies, including state regulators, to utilize more effectively total resources available and to avoid unnecessary and burdensome duplicate examinations. The Office is developing a system whereby each agency concerned will be notified of examinations conducted of its members by other organizations.

The Office has also begun review of examination policies and procedures of the self-regulatory organizations to improve consistency in scope and procedures and has offered to help train examiners of self-regulatory bodies.

The program also contemplates that the Commission staff will on a sample basis (1) examine members of self-regulatory bodies directly to determine if they are in compliance with the securities laws, and (2) examine a member of

a particular self-regulatory organization directly and at the same time review the examination report and working papers of the latest examination by that organization to determine whether its examination program is thorough and effective.

An important function of the new Office is to perfect an early warning system for the detection of financial and operational problems of broker-dealers. This system is also intended to be the vehicle for coordination of the Commission's broker-dealer examination program with the programs of the various self-regulatory organizations. The plan is to organize available information about all broker-dealers registered with the Commission, including their financial and operational condition, into a data bank which would be printed out and distributed regularly to the regional offices of the Commission and to self-regulatory organizations.

One of the first tasks of the new Office was the revision of the Broker-Dealer Examination Manual, which outlines the procedures and policies of the Commission's examination program, and the preparation of a comparable manual for investment adviser examinations. The manuals have been distributed to the Commission's regional offices and are now in use.

In addition, the Office was engaged during the fiscal year in the development of a comprehensive examination training program.

## Rule Changes

The Commission adopted or proposed during the fiscal year a wide range of measures designed to correct the practices which led to or intensified the operational and financial problems of the securities industry during 1967-1970. Among the most significant of these measures were various rule changes or proposed changes for broker-dealers.

## Reserve and Segregation Requirements

Legislation enacted in 1970 creating the Securities Investor Protection Corporation to provide insurance for customer accounts explicitly authorized the Commission to prescribe rules regarding the custody and use of customers' securities and the use of customers' deposits or credit balances. Such rules were to require the maintenance of reserves with respect to such deposits or credit balances. The initial rule proposals were made by the Commission in November 1971.<sup>32</sup>

On May 31, 1972, the Commission released for public comment a revision of these proposed rules, in the form of a proposed new Rule 15c3-3 under the Exchange Act.<sup>33</sup>

The proposed rule deals with the obligation of a broker-dealer to maintain physical possession or control over securities left with it by a customer and to have basic reserves against customer cash and cash realized through utilization of customer securities. It addresses itself to three primary areas of customer protection: (1) the obligation of a broker-dealer to promptly take possession or control of all fully-paid securities and excess margin securities carried for the account of customers; (2) a formula for a cash reserve for all customer funds not used in customer-related transactions; and (3) separation of the brokerage operations of a firm from its other activities.

A number of positive benefits should flow from this approach for the protection of the funds and securities of customers. The restrictions on the use of customers' funds and securities and the requirement that securities be promptly brought under physical possession or control are designed to protect customer assets in liquidation. The rule should also act as a control over the unwarranted expansion of a broker-dealer's business, since it would prohibit

the utilization of customers' funds and customer-derived funds in areas of the firm's business such as underwriting, trading and overhead.

## "Box Count" Rule

In its Study of Unsafe and Unsound Practices, the Commission cited the lack of adequate physical controls over securities during the 1967-1970 period. Under the rules then in effect, that part of the broker-dealer's operations dealing with the movement and location of securities had been subject only to the once-a-year check of the audit required for its annual report of financial condition. In an effort to tighten controls, the Commission adopted Rule 17a-13 under the Exchange Act to require of broker-dealers a quarterly physical examination and count of firm and customers' securities held, and to verify securities subject to firm control or direction but not in their physical possession.<sup>34</sup> In comparing the results of its examination and verification with its records, a broker-dealer must note any differences and must post unresolved differences to its books and records within seven days. At the same time, the Commission made conforming changes in its record-keeping and financial reporting rules.

## Financial and Operational Condition

The Study also noted that an early warning system was needed to identify those brokers and dealers with financial or operational difficulties before they reach a point where liquidation is the only answer. The Commission adopted Rule 17a-11 under the Exchange Act to provide it and the various self-regulatory organizations with an adequate and timely flow of information on the financial and operational condition of broker-dealers.<sup>35</sup>

The rule has four major provisions: (1) Immediate telegraphic notice to the

Commission and to any self-regulatory organization of which it is a member, followed by a financial report within 24 hours, when a broker-dealer's net capital falls below the level required by any capital rule to which it is subject; (2) the filing of special monthly reports until its capital position shows improvement for three successive months when a broker-dealer ascertains that its aggregate indebtedness exceeds 1,200 percent of its net capital—or that its total net capital is less than 120 percent of the minimum net capital required of it by any capital rule to which it is subject; (3) telegraphic notice to the appropriate regulatory authorities, followed by a written report within 48 hours, when a broker-dealer's books and records are not current, and (4) notification to the Commission by a self-regulatory organization when it learns that a member has failed to give notice or file any report required by the rule.

### **New Broker-Dealer Disclosure**

A contributing factor in the failures of broker-dealers in recent years was the lack of adequate resources of persons entering the business. In its Study, the Commission said a number of brokers and dealers who were able to remain in business for only brief periods following their registration had little or no background in the securities field and had little recognition of the need for adequate facilities, personnel and financing. It pointed out that since the Securities Investor Protection Corporation (SIPC) may draw on the United States Treasury up to a billion dollars to reimburse customer losses, "to permit unprepared, irresponsible parties to enter the broker-dealer business without the restraining influence of adequate entry standards would be tantamount to the subsidization of incompetent and irresponsible individuals by SIPC and the United States Treasury."

The Commission amended Rule 15b1-2 under the Exchange Act to re-

quire new broker-dealers to make detailed disclosures on adequacy of personnel, facilities and financing.<sup>36</sup> The former rule merely required applicants for registration to furnish verified statements of their financial condition. As amended, the rule requires a new registrant to file in addition (1) a computation of aggregate indebtedness and net capital; (2) a statement describing the nature and source of his capital and representation that this capital will continue to be devoted to the business; (3) a statement that adequate arrangements exist for facilities and financing required to operate the business, detailing as well the nature of the arrangements; and (4) for the first year of operations a statement specifying arrangements for obtaining funds to operate the business, anticipated expenses, and arrangements to obtain additional financing if needed.

### **Net Capital**

The Commission's Study noted the inadequacy of existing net capital requirements. During the fiscal year, the Commission amended Rule 15c3-1 under the Exchange Act, its net capital rule, to increase the minimum net capital required of most broker-dealers from \$5,000 to \$25,000 and to reduce the maximum net capital ratio (ratio of aggregate indebtedness to net capital) of new broker-dealers for the first year of their operations from 20-to-1 to 8-to-1.<sup>37</sup> For broker-dealers not carrying customer accounts and not holding customers' funds and securities, the \$5,000 minimum was retained.

Another amendment covered treatment of clearing fund deposits under a continuous net settlement (CNS) system for the clearance and settlement of securities transactions. Under CNS, a clearing agency assumes the role of principal party in the clearance and settlement of both the buying and selling sides of a transaction in securities between members of the clearing

agency. Because of the risks assumed by these clearing agencies, they have established clearing funds through deposits by clearing members for use in payment of liabilities of clearing members to CNS or general liabilities of CNS arising from clearing and settling activities. These funds are essential to continued operation and financial security of CNS clearing agencies. Because CNS systems appear to offer substantial reductions in the movement of share certificates, and deposits are available to meet members' current obligations to CNS clearing agencies, the Commission amended Rule 15c3-1 to provide that clearing fund deposits by clearing members of clearing agencies using a CNS system for the clearance and settlement of securities transactions need not be deducted from such members' net worth in the computation of net capital.<sup>38</sup>

Other amendments of the net capital rule were designed to grant necessary relief to underwriters and depositors of contractual plans for the accumulation of investment company shares.<sup>39</sup> They pertained principally to the treatment of funds in segregated trust accounts which must be maintained under the Investment Company Act and rules on possible refund obligations.

### Financial Reports

Rule 17a-5 under the Exchange Act requires registered broker-dealers to file annual reports of financial condition with the Commission. As a result of the back office and operations crisis of 1967-1970, the rule was amended this year to require broker-dealers (other than mutual fund dealers and other broker-dealers who do not carry customers' accounts, or hold customer funds and securities) to file additional information with the Commission annually. Under the amendment, the Commission now receives certified Statements of Income and Statements of Changes in Capital Accounts in addition to the balance sheet information previously required.

In addition, the amended rule now requires broker-dealers not only to file reports with the Commission, but also to send to customers annual and quarterly balance sheets with statements containing current net capital computations. With the annual financial statement, the broker-dealer also must furnish the customer with a statement as to whether the accountants have found material inadequacies in the firm's internal controls and notification that the most recent annual report filed with the Commission is available for examination and copying at the Commission and at the broker-dealer's principal office.<sup>40</sup>

### Clearing Arrangements

In its present form, Rule 17a-3(b) under the Exchange Act in effect prohibits broker-dealers who are not members of a national securities exchange from having their customers' transactions cleared through other broker-dealers on a fully disclosed basis. The Commission believes it no longer necessary to prohibit such clearing arrangements if the clearing broker-dealer has the financial responsibility needed for protection of public customers. By the same token, exchange members who clear for other exchange members should be required to have the same financial responsibility. A proposed amendment of the rule would permit such clearing arrangements if the clearing broker-dealer maintains net capital of not less than \$25,000 and is otherwise in compliance with applicable net capital requirements.<sup>41</sup>

The Commission also proposed to amend the rule to permit a broker-dealer to clear his transactions through a bank, provided the books and records respecting those transactions are kept in accordance with the Commission's record-keeping requirements and the bank files an undertaking with the Commission that such books and records will be available for Commission examination.



### Stabilization Reports

Certain amendments of Rule 17a-2 under the Securities Exchange Act and the related form respecting stabilization reports were proposed during the fiscal year and adopted thereafter.<sup>42</sup> Under the rule, the member of an underwriting syndicate or group which makes stabilizing purchases for the account of the syndicate must file "as manager" reports on syndicate transactions in the stabilized and offered securities. Prior to its amendment, the rule also required other members of the syndicate for whose account stabilizing purchases were made to file "not as manager" reports. Under the amendments, the reports "not as manager" are to be made to the syndicate manager, rather than directly to the Commission. The manager is to file all "not as manager" reports with the Commission.

### SECO Broker-Dealers

Under the Exchange Act, as amended in 1964, the Commission has the responsibility for establishing and administering rules on qualification standards and business conduct of broker-dealers not members of the NASD<sup>43</sup> to provide regulation for these SECO broker-dealers comparable to that provided by the NASD for its members.<sup>44</sup>

During the fiscal year, the number of nonmember broker-dealers decreased from 301 to 294, but the number of associated persons of such firms (i.e., partners, officers, directors and employees not engaged in merely clerical or ministerial functions) increased from 16,060 to approximately 20,600.<sup>45</sup>

During the fiscal year, the Commission released a statement of policy and guidelines on the comparability of NASD and SECO regulation and the relevance of published NASD standards and rules of conduct to nonmember broker-dealers and their associated persons.<sup>46</sup> The Commission also adopted Rule 15b8-2

under the Exchange Act to prohibit a SECO firm from engaging in securities activities if it or an associated person has been expelled or suspended from the NASD or from an exchange for conduct inconsistent with just and equitable principles of trade or barred or suspended from association with any member of the NASD or an exchange for such conduct.<sup>47</sup>

Rule 15b9-2 under the Exchange Act provides for an annual assessment to be paid by nonmember broker-dealers to defray the cost of regulation. During the fiscal year, the Commission amended the rule by deleting a provision which imposed a charge for each office of the broker-dealer.<sup>48</sup> It increased the base fee from \$100 to \$150 and the fee for each associated person from \$5 to \$7.50 and eliminated the fee ceiling which had previously been \$50,000.

### SIPC Litigation

*Lohf v. Casey.*<sup>49</sup> The trustee of Sudler, Hart & Co., a registered brokerage firm that had been adjudicated bankrupt in 1969, brought suit to compel the Commission and the Securities Investor Protection Corporation under the Securities Investor Protection Act of 1970, to bring the customers of the bankrupt firm under the protections afforded by the Act. The district court dismissed the trustee's complaint for failure to state a claim upon which relief could be granted. The Court of Appeals for the Tenth Circuit affirmed the dismissal, holding that the Act does not extend coverage to the customers of a registered brokerage firm which had been adjudicated a bankrupt prior to passage of the Act. Although the firm's registration had not been officially terminated (and thus its automatic membership in SIPC had continued in form) the court concluded that the firm did not have the status of a "broker or dealer" as

contemplated by the Act. The court reasoned that the statutory reference to "brokers or dealers" meant firms or persons that were actually in business in the usual sense at or after the date of enactment, since Congress had deliberately declined to make the legislation operate retroactively, drawing the line to exclude those which had failed. Because the firm's business was under the jurisdiction of the bankruptcy court on the effective date of the Act, the court of appeals concluded that the firm was at that time not conducting its business as a broker or dealer.

*S.E.C. v. Alan F. Hughes, Inc.*<sup>50</sup> The Court of Appeals for the Second Circuit, in a case of first impression under the Act, considered whether SIPC is required to afford a hearing when it determines that one of its members has failed or is in danger of failing to meet its obligations to its customers and that there exists one or more of the conditions to the appointment of a trustee that are specified in Section 5(b) of the Act. The court held that no hearing was required at the time of SIPC's determination because it "has no binding legal consequences and deprives no broker-dealer of property." The court noted that SIPC must make an application to a district court and that the court is required to make its own findings. The court found that an appropriate determination had been made by the district court and that it was supported by the evidence, and it affirmed the district court's order appointing a trustee. It also affirmed the appointment of a receiver in the injunctive action brought by the Commission which had given rise to the application for appointment of a trustee. The court approvingly noted that the district court's order had appointed a receiver only until SIPC made a determination whether to seek the appointment of a trustee and that the receiver had been authorized to liquidate the broker-dealer only if necessary.

## NOTES FOR PART 3

<sup>1</sup> In March 1971, the Executive Committee of the Board of Trade of the City of Chicago adopted a resolution to close the Board's securities market.

<sup>2</sup> The Philadelphia-Baltimore-Washington Stock Exchange changed its name to PBW Stock Exchange, Inc. when it incorporated.

<sup>3</sup> This exchange was known as Salt Lake Stock Exchange prior to May 19, 1972.

<sup>4</sup> The term "call option" refers to a negotiable instrument whereby the seller of the option, for a certain sum of money, grants to the buyer of the option the irrevocable right to demand, within a specified time, the delivery by the seller of a specified number of shares of a stock at a fixed price.

<sup>5</sup> 373 U.S. 341, 357 (1963).

<sup>6</sup> In addition to the cases discussed in the text, this position has been urged in *Shumate & Co., Inc. v. New York Stock Exchange*, Civ. No. CA-3-4663-D1 (N.D. Tex.); *Shumate & Co., Inc. v. National Association of Securities Dealers*, Civ. No. CA-3-4361-C (N.D. Tex.); *Shumate & Co., Inc. v. American Stock Exchange*, Civ. No. CA-3-4708-D (N.D. Tex.); *Jefferies & Co., Inc. v. New York Stock Exchange*, 71 Civ. 4542 (S.D.N.Y.).

<sup>7</sup> 72 Civ. 2528 (S.D. N.Y.).

<sup>8</sup> 346 F. Supp. 217 (S.D.N.Y. 1972).

<sup>9</sup> C.A. 2, No. 72-1810 August 29, 1972.

<sup>10</sup> E.D. Wis., No. 63C-264.

<sup>11</sup> *Thill Securities Corporation v. New York Stock Exchange*, 433 F.2d 264 (1970), *certiorari denied*, 401 U.S. 994 (1971).

<sup>12</sup> *Thill v. New York Stock Exchange* (C.A. 7, No. 72-1260).

<sup>13</sup> 66 Civ. 1265 (S.D. N. Y.).

<sup>14</sup> 452 F.2d 935 (C.A. 5, 1971), *certiorari denied*, 41 U.S.L.W. (October 10, 1972) (No. 71-1378).

<sup>15</sup> Under legislation proposed by the Commission and discussed in Part 1 of this report, the Commission would be given the power to review such action.

<sup>16</sup> See Part 1 of the report for a discussion of the NASDAQ system.

<sup>17</sup> 451 F.2d 240 (C.A. 5, 1971), *re-hearing denied*, 459 F.2d 461 (1972), *certiorari denied sub nom. National Association of Securities Dealers, Inc. v. Harwell*, 41 U.S.L.W. 3187 (October 10, 1972) (No. 72-58).

<sup>18</sup> 37th Annual Report, pp. 88-89.

<sup>19</sup> Securities Exchange Act Release No. 9632 (June 7, 1972), petition for review pending, C.A.D.C., No. 72-1975.

<sup>20</sup> Last year's corresponding figures were 291 member firm actions and 206 actions against individuals associated with member firms.

<sup>21</sup> As of July 26, 1972, the NASD had 170 of its authorized quota of 171 examiners, a 20.6 percent increase from the end of 1971.

<sup>22</sup> This number of review cases is a significant increase over the number of review applications filed in previous years and reflects the NASD's expanded disciplinary program.

<sup>23</sup> Securities Exchange Act Releases Nos. 9242 (July 9, 1971) and 9475 (February 3, 1972).

<sup>24</sup> Securities Exchange Act Releases Nos. 9325 (September 7, 1971) and 9476 (February 3, 1972).

<sup>25</sup> Securities Exchange Act Release No. 9475 (February 3, 1972).

<sup>26</sup> 460 F.2d 1034 (C.A. 10, 1972).

<sup>27</sup> C.A.D.C., No. 71-1591, January 24, 1972.

<sup>28</sup> Securities Exchange Act Release No. 8347 (June 28, 1968). See also 34th Annual Report, pp. 14-15.

<sup>29</sup> Securities Exchange Act Release No. 9654 (June 30, 1972).

<sup>30</sup> Securities Exchange Act Releases Nos. 8876 (April 30, 1970); 8896 (May 28, 1970); 8946 (July 28, 1970); 8954 (August 11, 1970); and 9495 (February 15, 1972).

<sup>31</sup> Those registered broker-dealers which are not members of the NASD are referred to as SECO broker-dealers.

<sup>32</sup> These proposals were briefly summarized at pp. 2-3 of the 37th Annual Report.

<sup>33</sup> Securities Exchange Act Release No. 9622 (May 31, 1972). Subsequent

to the close of the fiscal year, a further revised rule proposal was issued which did not however alter the framework discussed in the text. Securities Exchange Act Release No. 9775 (September 14, 1972).

<sup>34</sup> Securities Exchange Act Release No. 9376 (November 8, 1971).

<sup>35</sup> Securities Exchange Act Release No. 9268 (July 30, 1971).

<sup>36</sup> Securities Exchange Act Release No. 9594 (May 12, 1972).

<sup>37</sup> Securities Exchange Act Release No. 9633 (June 14, 1972).

<sup>38</sup> Securities Exchange Act Release No. 9587 (May 8, 1972).

<sup>39</sup> Securities Exchange Act Release No. 9460 (January 21, 1972).

<sup>40</sup> Securities Exchange Act Release No. 9658 (June 30, 1972).

<sup>41</sup> Securities Exchange Act Release No. 9634 (June 14, 1972).

<sup>42</sup> Securities Exchange Act Release No. 9717 (August 14, 1972).

<sup>43</sup> The Act does not specifically refer to the NASD, but to broker-dealers who are not members of a registered "national securities association." However, the NASD is the only such association.

<sup>44</sup> See pp. for the discussion of NASD regulation.

<sup>45</sup> Nonmember broker-dealers must file a prescribed form (Form SECO-2) with the Commission for each associated person.

<sup>46</sup> Securities Exchange Act Release No. 9420 (December 20, 1971).

<sup>47</sup> Securities Exchange Act Release No. 9504 (February 29, 1972).

<sup>48</sup> Securities Exchange Act Release No. 9588 (April 27, 1972).

<sup>49</sup> CCH Fed. Sec. L. Rep. ¶93,589 (C.A. 10, 1972).

<sup>50</sup> 461 F.2d 974 (C.A. 2, 1972).

# **PART 4**

## **ENFORCEMENT**



# PART 4

## ENFORCEMENT

The Commission's enforcement activities, designed to combat securities fraud and other misconduct, continued at a high level during the past year. These activities encompass civil and criminal court actions as well as administrative proceedings conducted internally. Where violations of the securities laws or rules are established, the sanctions which may result range from censure by the Commission to prison sentences imposed by a court. The enforcement program is designed to achieve as broad a regulatory impact as possible within the framework of resources available to the Commission. In light of the capability of self-regulatory and state and local agencies to deal

effectively with certain securities violations, the Commission seeks to promote effective coordination and cooperation between its own enforcement activities and those of the other agencies.

### DETECTION

#### Complaints

The Commission receives a large volume of communications from the public. These consist mainly of complaints against members of the securities industry and requests for information about issuers. During the past year, some 10,000 complaints and inquiries on broker-dealers were received, most involving operational problems, such as

a failure to deliver securities or funds promptly, or the alleged mishandling of accounts. While this is a large number of complaints, it represents a substantial reduction from the 17,000 complaints and inquiries about broker-dealers received the previous year.

The Commission seeks to assist persons in resolving complaints and to furnish requested information. Thousands of investor complaints are resolved through staff inquiry to firms involved. While the Commission does not have authority to arbitrate private disputes between brokerage firms and investors or to assist investors in legal assertion of personal rights, a complaint may lead to institution of an investigation or an enforcement proceeding, or it may be referred to a self-regulatory or local enforcement agency.

### Market Surveillance

To enable the Commission to carry out surveillance of the securities markets, its staff has devised procedures to identify possible manipulative activities. These include surveillance of listed securities, coordinated with the stock watching operations of the New York, American and regional stock exchanges. The Commission's market surveillance staff has supplemented its regular reviews of daily and periodic stock watch reports of exchanges with a program for review of special surveillance reports providing a more timely analysis of the information developed by the exchanges.

The market surveillance staff maintains a continuous watch of transactions on the New York and American Stock Exchanges and reviews reports of large block transactions to detect any unusual price and volume variations. The financial news tickers, financial publications and statistical services are closely followed.

The Commission has also developed an over-the-counter surveillance program for securities traded by means of

the National Association of Securities Dealers' NASDAQ system. This program is coordinated with the NASD's market surveillance staff through a review of weekly and special stock watch reports. For those over-the-counter securities not traded through NASDAQ, the Commission uses automated equipment to provide more efficient and comprehensive surveillance of stock quotations distributed by the National Quotation Bureau. This is programmed to identify, among other things, unlisted securities whose price movement or dealer interest varies beyond specified limits in a pre-established time period. When a security is so identified, the equipment prints out current and historic market information. This data, combined with other available information, is analyzed for possible further inquiry and enforcement action.

### INVESTIGATIONS

Each of the acts administered by the Commission authorizes investigations to determine if violations have occurred. Most are conducted by the Commission's regional offices. Investigations are carried out on a confidential basis, consistent with effective law enforcement and the need to protect persons against whom unfounded charges might be made. Thus, the existence or findings of a nonpublic investigation are generally not divulged unless they are made a matter of public record in proceedings brought before the Commission or in the courts. During fiscal year 1972, a total of 374 investigations were opened, as against 410 the preceding year.

### Litigation

*Project on Corporate Responsibility v. S.E.C.*<sup>1</sup> In this case, the Project and three individual shareholders of Union Carbide Corporation seek judicial review of the Commission's determination to investigate privately, rather than through a public adversary proceeding, allegations that Union Carbide had vio-

lated antifraud provisions of the securities laws in a distribution to its shareholders of a brochure on its pollution control program. The Project had requested the Commission to conduct a public investigation into the Project's allegations, by requiring Carbide to file with the Commission a public response to each of those allegations. The Commission's staff had met with Project representatives and conferred with Carbide to discuss the allegations and sent inquiries to various federal agencies.

The Commission moved to dismiss the petition for review, asserting that it had neither entered an "order" nor taken any action that was reviewable under the judicial review provisions of the Securities Exchange Act or of the Administrative Procedure Act. After the fiscal year, the court of appeals issued an order referring the motion to the panel of the court assigned to consider the merits of the petition.

*In the Matter of Four Seasons Securities Laws Litigation.*<sup>2</sup> The Commission, at the request of the district court, filed a memorandum on proposed discovery by plaintiffs from defendants in civil litigation of testimony and documents obtained by the Commission during a non-public investigation. The court also asked the Commission to state its position if it were served directly with a subpoena for the production of transcripts of such testimony. The Commission stated that, because its investigation rules permit a witness in an investigation to obtain a copy of his own testimony and a person who supplied documents to obtain copies, the Commission did not object to disclosure by a witness of a transcript of his testimony or to disclosure of documents by the person who had supplied them to the Commission. The Commission stated that it preferred that no subpoena be served on it directly for the material in an investigatory file, because this would not give a witness or person supplying documents an opportunity to

make objections to the court on disclosure of his testimony or documents. The Commission further stated that it reserved the right to keep confidential the identities of persons who had testified or supplied documents in a private investigation. The court in its opinion concluded that "the positions taken by the SEC. . . are sound."<sup>3</sup>

*S.E.C. v. First Security Bank of Utah, N.A.*<sup>4</sup> The Court of Appeals for the Tenth Circuit affirmed the decision of the district court which had ordered enforcement of investigative subpoenas served by the Commission on two banks seeking records of checking accounts of some depositors. The court of appeals rejected the argument of two of the depositors, that because they maintained the checking accounts as attorneys for their clients the records were protected by the attorney-client privilege and thus immune from production. The court stated that the records were the property of the bank, not of the depositors, and that deposits and disbursements of money in a checking account are not confidential communications covered by the privilege.

*S.E.C. v. Mark Petroleum Corporation.*<sup>5</sup> The court of appeals declined to stay an order of the district court, which directed compliance with subpoenas issued by the Commission in an investigation to determine whether Mark Petroleum Corporation had violated the federal securities laws. The defendants had refused to comply with the subpoenas, asserting that they were "illegal," overly broad and had been issued to harass them. The defendants then requested Mr. Justice Powell of the United States Supreme Court to stay the district court's order, pending their appeal. Justice Powell, however, declined to do so.

## ENFORCEMENT PROCEEDINGS

The Commission has available a wide range of possible enforcement actions. It may in appropriate cases refer its



files to the Department of Justice with a recommendation for criminal prosecution. The penalties upon conviction are specified in the various statutes and include imprisonment for substantial terms and fines.

The securities laws also authorize the Commission to file injunctive actions in the federal district courts to enjoin continued or threatened violations of those laws or applicable Commission rules. In injunctive actions the Commission has frequently sought to obtain ancillary relief under the general equity powers of the federal district courts. The power of the federal courts to grant such relief has been judicially recognized.<sup>6</sup> The Commission has often requested the court to appoint a receiver for a broker-dealer or other business where investors were likely to be harmed by continuance of the existing management. It has also requested, among other things, court orders restricting future activities of the defendants, requiring that rescission be offered to securities purchasers, or requiring disgorgement of the defendants' ill-gotten gains.

The S.E.C.'s primary function is to protect the public from fraudulent and other unlawful practices and not to obtain damages for injured individuals. Thus, a request that disgorgement be required is predicated on the need to deprive defendants of profits derived from their unlawful conduct and to protect the public by deterring such conduct by others.

If the terms of any injunctive decree are violated, the Commission may file criminal contempt proceedings, as a result of which the violator may be fined or imprisoned.

The federal securities acts also authorize the Commission to impose remedial administrative sanctions. Most commonly, administrative enforcement proceedings involve alleged violations of the securities acts or regulations by firms or persons engaged in the securities business, although the Commis-

sion's jurisdiction extends to all persons. Generally speaking, if the Commission finds that a respondent willfully violated a provision of or rule under the securities acts, failed reasonably to supervise another person who committed a violation, or has been convicted for or enjoined from certain types of misconduct, and that a sanction is in the public interest, it may revoke or suspend a broker-dealer's or investment advisers's registration, bar or suspend any person from the securities business or from association with an investment company, or censure a firm or individual. Proceedings may also cover adequacy of disclosure in a registration statement or in reports filed with the Commission. Such cases may lead to an order suspending the effectiveness of a registration statement or directing compliance with reporting requirements. The Commission also has the power summarily to suspend trading in a security when the public interest requires.

Proceedings are frequently completed without hearings where respondents waive their right to a hearing and submit settlement offers consenting to remedial action which the Commission accepts as an appropriate disposition of the proceedings. The Commission tries to gear its sanctions in both contested and settlement cases to circumstances of the case. For example, it may limit the sanction to a particular branch office of a broker-dealer rather than sanction the entire firm, prohibit only certain kinds of activity by the broker-dealer during a period of suspension or only prohibit an individual from engaging in supervisory activities.

A chart listing the various types of enforcement proceedings as well as statistics on such proceedings is in the statistical section.

## ADMINISTRATIVE PROCEEDINGS

Summarized below are some of the many administrative proceedings pending or disposed of in fiscal year 1972.

## Disciplinary Proceedings

*Exchange Bank & Trust Co. of Dallas.*<sup>7</sup> In this case, the Commission issued an order censuring the bank for its conduct while acting as escrow agent in a public offering of common stock of Transceiver Corporation of America in 1969. The Commission found that the bank violated antifraud provisions of the securities laws by releasing from escrow \$404,750 received from subscribers for Transceiver stock, although only 34,439 shares had been sold. Transceiver's registration statement represented that the underwriter was obligated to return all funds received from subscribers unless at least 130,000 shares were sold for a total of \$1,235,000. Moreover, contrary to representations in the registration statement on use of proceeds, the bank received \$100,000 plus interest out of the funds released from escrow in payment of a loan to Transceiver. The bank consented to the above findings and censure, without admitting or denying allegations in the order for proceedings.

*Executive Securities Corp.*<sup>8</sup> Various respondents submitted settlement offers consenting to certain findings without admitting staff allegations against them. The Commission found that in the sale of stock of Executive, a broker-dealer, the firm and its principals violated registration requirements and engaged in fraudulent practices. They withheld shares from public sale, placed shares with persons associated with Executive, used nominee accounts to conceal true ownership of Executive stock and evade registration requirements of certain states, and made misrepresentations to customers. In addition, these respondents and an attorney violated registration and antifraud provisions in the sale of various other securities. Under the settlement offers, the Executive stock held by the respondent officials was to be transferred to an attorney in trust for three years during which an associate of the attorney would be the firm's

executive director. As provided in those offers, the Commission suspended the firm's registration for 10 days and barred or suspended the other respondents from association with a broker-dealer or investment adviser. The attorney was also disqualified from practice before the Commission for two years with the right to apply for reinstatement after one year.

*Gregory & Sons.*<sup>9</sup> In the case of this New York Stock Exchange member firm which went into liquidation, and two of its partners, it was found that the firm's record-keeping procedures made inadequate provision for distinguishing "restricted" securities (which cannot be included in a broker-dealer's net capital) from other securities. As a result, the firm continued in business when it was not in compliance with the Exchange's net capital requirements, and it filed an inaccurate financial report with the Commission. On the basis of settlement offers, in which they consented to these findings without admitting or denying the charges against them, the firm's registration was revoked and the partners suspended from association with a broker-dealer.

*Bohn-Williams Securities Corporation.*<sup>10</sup> After hearings, the Commission revoked the broker-dealer registration of this firm, barred its two principals from association with any broker-dealer, and expelled it and one of the principals from membership in the Spokane Stock Exchange. The Commission found that the respondents willfully violated the registration and antifraud provisions of the securities acts in transactions of unregistered common stock of Champion Oil and Mining Company. Among other acts, they sold a block of shares for control persons of Champion, a shell corporation; engaged in manipulative trading activities in connection with transactions in Champion stock in order to artificially raise the price of the stock; and used fraudulent sales literature supplied by

Champion in connection with the sale of the securities.

*Winfield & Co., Inc.*<sup>11</sup> In February 1972, the Commission issued detailed Findings and Opinion. It had previously issued orders which (on the basis of consents of the respondents contained in offers of settlement) imposed sanctions on various firms and individuals for violations in connection with portfolio transactions of Winfield Growth Fund, Inc., a registered investment company.

The Commission found that under arrangements in 1966 between Winfield & Co., the Fund's investment adviser, and some of its principals, and Meyerson & Co., a New York Stock Exchange member, commissions on fund portfolio transactions were allocated to Meyerson for payments to or for the benefit of the adviser and its principals. The Commission said these arrangements breached the fiduciary obligation to the Fund and its shareholders by the adviser and its principals and violated antifraud provisions of the securities laws. It also violated a provision of the Investment Company Act on acceptance of compensation by investment company affiliates for the purchase or sale of property to or for the company. The Commission found that proper valuation procedures were not followed for "restricted" securities in the Fund's portfolio and that some respondents failed to make reasonable investigations before causing the Fund to purchase those securities.

*Edward A. Merkle.*<sup>12</sup> In a proceeding under the Investment Company Act against the chief executive officer of Madison Fund, Inc., a registered investment company, it was alleged that Merkle, in violation of the securities acts, caused Madison Fund: (1) to purchase time certificates of deposit and place non-interest bearing demand deposits in commercial banks in return for loans by those banks to several companies affiliated with Madison Fund and Merkle; (2) to enter into transactions involving port-

folio securities on a joint, or joint and several, basis with Mad International Fund, Inc., an unregistered off-shore investment company of which Madison Fund was investment adviser and Merkle, chairman of the board; and (3) to purchase securities of National Industries, Inc. without disclosing that he was a salaried employee of National. In July 1972, the Commission entered into a settlement with Merkle in which, without admitting or denying the allegations, he consented to findings that he had committed these violations and to a 60-day suspension.

Proceedings were also instituted during the fiscal year against Herbert F. Korholz, chief executive officer and a director of The Susquehanna Corporation, and a director of Pan American Sulphur Company (Pasco); Emmett H. Bradley, also an officer and director of Susquehanna and Pasco; Susquehanna, which owned a majority of Pasco's stock; and four national banks. The proceedings are based on staff allegations that, among other things, Korholz, Bradley, and Susquehanna caused Pasco, which is subject to the Investment Company Act, to purchase certificates of deposit from the banks as an inducement for the banks to extend credit to Susquehanna and a subsidiary. Thereby, it is alleged, the respondents violated or aided and abetted violations of a prohibition under the Act against joint transactions between a registered investment company and its affiliates without authorization by the Commission.

### **Disqualification of Attorneys**

*Elliot S. Blair.*<sup>13</sup> The Commission entered an order accepting the resignation of Blair, an attorney, from practice before the Commission. According to a stipulation of facts entered into solely for the purpose of the proceeding under Rule 2(e) of the Commission's Rules of Practice, Blair held a substantial amount of securities as nominee for other persons; notifications and offering

circulars filed with the Commission to obtain exemptions from registration for proposed public offerings pursuant to Regulation A under the Securities Act listed Blair as the owner of such shares but failed to disclose his interest as a nominee; and Blair falsely testified in a subsequent Commission investigation that he had not acted as nominee although he later recanted that testimony.

*Kivitz v. S.E.C.*<sup>14</sup> Murray A. Kivitz, an attorney who, as has been previously reported,<sup>15</sup> had been suspended for two years from practice before the Commission in a proceeding under Rule 2(e) of the Commission's Rules of Practice, petitioned for judicial review of the Commission's order of suspension. In its brief filed in the Court of Appeals for the District of Columbia Circuit, the Commission argued that it has jurisdiction under its general rulemaking power to promulgate a rule providing for the discipline or disbarment of attorneys practicing before it, and that this was not withdrawn by Congress when it abolished all agency-imposed admission requirements (except those imposed by the Patent Office) for members of the bar of the highest court of a state seeking to practice before federal agencies. The statute in question contains a specific provision excluding disciplinary proceedings from its scope. The Commission also argued that it had properly suspended Kivitz from practice where it found that he had allowed a non-lawyer to control and exploit Kivitz's privilege to practice before the Commission in connection with the proposed representation of a prospective corporate issuer.

### Registration Statements/Reports

*Levitz Furniture Corporation.*<sup>16</sup> The Commission, on the basis of an offer of settlement, issued a stop order suspending the effectiveness of a registration statement filed by Levitz for a proposed offering of 600,000 shares of common stock. Levitz admitted the allegations of fact filed by the Commis-

sion's staff. These were that the registration statement, in discussing Levitz's relations with its employees, failed to disclose that certain Levitz executives had been informed by the International Brotherhood of Teamsters (IBT) that a nationwide campaign to organize the company's employees would begin on or about June 1, 1972; that one of these executives had indicated to IBT that Levitz would not oppose the campaign if deferred until completion of the proposed offering; and that IBT agreed to defer such campaign to on or about July 1, 1972. The staff alleged that the registration statement was deficient in failing to disclose those facts and what effects, if any, a nationwide campaign to organize the company's employees would have on its business operations, relations with its employees, and income from operations. The Commission subsequently issued its Findings and Opinion which discussed the deficiencies in the registration statement.<sup>17</sup>

*Performance Systems, Inc.* Proceedings placed in issue the accuracy of a registration statement and a 1968 annual report filed by the company. The principal alleged inaccuracy in both documents pertained to the accounting treatment accorded to installment notes representing part payment of franchise fees. These fees resulted from transactions in which PSI sold blocks of from 20 to 100 fast food franchises to seven newly formed companies. PSI included the full face amount of the notes in 1968 revenues.

The Commission concluded that the facts surrounding the transactions indicated that there was no reasonable basis for estimating the degree of collectibility of the notes and that inclusion of the notes in revenues was therefore improper. It noted among other things that the purchasers were undercapitalized and had no significant operating history, that some were in default on their construction schedules, and that PSI had only limited experience in

franchise operations and that such experience as it had, had been unprofitable.

Pursuant to an offer of settlement made by PSI in which it consented to the above findings without admitting or denying allegations in the order for proceedings, the Commission issued a stop order, permitted withdrawal of the registration statement, and dismissed the proceeding with respect to the annual report, which PSI had corrected by amendment, on condition that PSI distribute copies of the Commission's opinion to its stockholders.<sup>18</sup>

The Commission also entered orders in two other proceedings in which its staff had challenged the accuracy of financial statements included in annual reports filed with the Commission. Both proceedings were disposed of on the basis of settlement offers providing for appropriate amendment of the reports and notification to stockholders of the corrections. In one case, *Great Southwest Corporation*,<sup>19</sup> the company treated the sale of two amusement parks and a parcel of raw land as reportable sales and accorded revenue recognition to the consideration received even though it retained control over the management of the properties and retained substantially all risk of loss and opportunity for gain. In the other case, the Commission found reports filed by *Filtrol Corporation*, misleading on the value of certain municipal bonds representing a substantial proportion of the company's assets, in that they failed to disclose that a brokerage firm, whose agreement to repurchase certain bonds at Filtrol's cost was the principal basis for their inclusion in current assets, was not financially capable of meeting its repurchase obligations.<sup>20</sup>

### Trading Suspensions

The Securities Exchange Act authorizes the Commission summarily to suspend trading in a security traded on either a national securities exchange or

in the over-the-counter market for a period of up to 10 days if, in the Commission's opinion, it is required in the public interest.

During fiscal 1972, the Commission suspended trading in the securities of 47 companies, an increase of about 83 percent over the 26 securities suspended in fiscal 1971. In most instances this action was taken because of substantial questions as to the adequacy, accuracy or availability of public information concerning the company's financial condition or business operations or transactions in its securities. Trading suspensions are frequently a prelude to other enforcement action. The following summaries illustrate the variety of circumstances which may lead to suspension.

In March, 1972, trading in the securities of First Fidelity Company was suspended at the request of the company which advised that it was engaged in negotiations of a material transaction, and that the results of the negotiations would be made public shortly. The Commission lifted its suspension after First Fidelity had issued a press release and disseminated a shareholder letter which disclosed the transfer of substantially all the assets of a subsidiary and related financial information.

In the case of Tanger Industries, trading was suspended on the American Stock Exchange and in the over-the-counter market in May, 1972 to allow time for the clarification of questions raised on the validity of and circumstances surrounding the placing of certain orders for transactions in Tanger securities. After an intensive investigation, the Commission, in July, filed a complaint seeking to enjoin Tanger, its former chairman, and ten others from violating antifraud and registration provisions of the Federal securities laws. The complaint alleged that the defendants were involved in an elaborate scheme to raise the price of Tanger stock by controlling and absorbing the

relatively small floating supply, and that the former chairman looted Tanger of valuable assets by purchasing certain of its subsidiaries through nominees at grossly inadequate and unfair consideration. Tanger consented to an injunction without admitting or denying any of the allegations.

In June, 1972, the Commission suspended trading on the New York, Pacific Coast and PBW Stock Exchanges and in the over-the-counter market in the securities of Levitz Furniture Corporation. It acted as a result of an investigation, prompted by a review of a then pending registration statement, that raised questions as to the disclosure of material facts. The Commission subsequently filed a complaint seeking an injunction against Levitz and three of its officers, charging that the registration statement was materially misleading, and it also instituted stop order proceedings (discussed previously). Thereafter it lifted the trading suspension.

In announcing the termination of trading suspensions, the Commission generally cautions investors to consider all available information in making any investment decision on the securities in question, and it reminds broker-dealers who solicit transactions in such securities of their obligation to make diligent inquiry to determine all pertinent financial and other information about the issuer and to disclose such information to prospective purchasers.

### Judicial Review

*Quinn & Co., Inc. v. S.E.C.*<sup>21</sup> The Court of Appeals for the Tenth Circuit affirmed an order of the Commission imposing sanctions upon Quinn & Co., Inc., a broker-dealer, and its vice-president, John Dornacker. The court sustained the Commission's finding that Dornacker and the partnership predecessor of Quinn & Co., had violated the Securities Act by selling unregistered securities for one of Quinn's customers who had recently acquired these securi-

ties from the issuer in exchange for property. The court agreed with the Commission that the customer had purchased the unregistered shares from the issuer with a view to "distribution" and therefore was a statutory underwriter whose resales were not exempt from registration, even though the shares represented less than 1 percent of the issuer's outstanding stock. Because the customer was an underwriter, the exemptions provided for transactions by brokers and dealers in Sections 4(3) and 4(4) of the Securities Act were held to be unavailable. The court further sustained the Commission's finding that the violations were willful, concluding that the brokerage firm and Dornacker, as professionals in the securities business, were not entitled to rely upon the absence of cautionary legends on the customer's stock certificates but were under a duty to investigate in order to assure themselves that the sales complied with the requirements of the Securities Act.

### CIVIL PROCEEDINGS

During fiscal year 1972, the Commission instituted a total of 119 injunctive actions, as well as two civil contempt actions. Some of the more noteworthy of these injunctive proceedings and significant developments in actions instituted in earlier years are described below.

The Commission played a leading role in the investigation of the so-called "Texas stock fraud scandal" involving a scheme to use the assets of banks and other financial institutions controlled by Frank W. Sharp and his co-conspirators to finance a manipulation of the over-the-counter market in several stocks, particularly the stock of National Bankers Life Insurance Company. As a result of the facts developed in its investigation, the Commission brought suit in the United States District Court for the Southern District of Texas to enjoin 28 defendants, including Sharp, Waggoner

Carr, a former Attorney General of Texas, John Osorio, a former Chairman of the Texas State Insurance Commission, National Bankers Life, and others from violating the registration and antifraud provisions of the securities laws. Several defendants consented to a permanent injunction, and the complaint was dismissed against five corporate defendants which were then involved in receivership or conservatorship proceedings or controlled by a receiver. After a trial, the district court granted an injunction against all but one of the remaining defendants.<sup>22</sup> Four of these defendants, including Carr and Osorio, appealed to the Court of Appeals for the Fifth Circuit.<sup>23</sup> In its brief in the court of appeals, the Commission argued that, as found by the lower court, the appellants had violated the registration provisions of the Securities Act by pledging unregistered shares of control stock where there was no reasonable likelihood at the time of the pledge that the loan could be repaid otherwise than through foreclosure and eventual public sale of the collateral, and that they participated in a scheme to manipulate the market price of National Bankers Life stock and two other securities by arranging for financing to buy up shares of these securities on the open market, thereby taking such shares off the market and driving up the price.

In February, 1972, the Commission instituted a civil injunctive action against 20 defendants in *S.E.C. v. National Student Marketing Corporation (NSMC)*,<sup>24</sup> alleging violations of the reporting, proxy and antifraud provisions of the Securities Exchange Act, and the antifraud provisions of the Securities Act. The defendants include, in addition to NSMC, six of its present and former officers and directors; the corporation's auditors, Peat, Marwick, Mitchell & Co. (PMM), and a partner and a former employee of that firm; NSMC's outside legal counsel, the New York law firm of White & Case, and one of its partners;

four officers and directors of Interstate National Corporation, with which NSMC merged; Interstate's outside legal counsel, the Chicago law firm of Lord, Bissell and Brook, and two of its partners, one of whom was also a director of Interstate; and a lawyer representing the purchasers of a former subsidiary of NSMC.

The complaint alleges that various financial reports of NSMC disseminated to the public and filed with the Commission, beginning with its 1968 annual report, were materially false and misleading because they included in income certain purported commitments from customers to use NSMC's services in the future. According to the complaint, these commitments were nonexistent or were entered into after the close of the fiscal period in which they were recorded as income or contained guarantees by NSMC which precluded their being recorded as income. The complaint also alleges that a large part of the commitments included as income in the 1968 annual report was written off during 1969, but that proper disclosure of the write-off was never made.

A portion of the complaint concerns NSMC's merger with Interstate, an insurance holding company, in 1969. One of the conditions to the merger was the issuance by PMM of a "comfort letter" which was to state, among other things, that PMM had no reason to believe that NSMC's unaudited financial statements for the nine-month period ended May 31, 1969, which were contained in a proxy statement that had been used to solicit shareholder approval of the merger, required any material adjustments in order that the results of operations for the period be fairly presented. Instead, according to the complaint, the letter issued by PMM stated that it believed that adjustments reducing net income from \$700,000 to a loss were required. The complaint alleges that the merger was consummated and the lawyers issued favorable

opinions on its legality notwithstanding their knowledge that shareholder approval had been obtained on the basis of materially false and misleading financial statements.

It is further alleged that certain Interstate shareholders present at the closing sold a portion of their newly acquired NSMC stock on the day of the closing notwithstanding their knowledge that the most recent financial statements of NSMC available to the public were materially false and misleading.

Further, the complaint alleges that NSMC improperly accounted for a purported gain on the sale of two subsidiaries even though these sales did not occur until after the close of the fiscal year in which it was reported, that it was not disclosed that NSMC retained a number of financial and other obligations with respect to these subsidiaries, that it was highly unlikely that the full sales price would ever be paid to NSMC, and that NSMC's president had transferred to the purchasers of the subsidiaries the NSMC stock they had pledged as collateral for their promissory notes.

On July 26, 1972, a consent judgment of permanent injunction was entered against NSMC, which neither admitted nor denied the allegations of the complaint. The judgment granted the full relief requested in the complaint, including a provision obligating the company to file corrected reports with the Commission after making an independent investigation of its affairs from 1968 through early 1970, the period covered by the complaint.

Other cases: *SEC v. United Financial Group, Inc.*<sup>25</sup> A Commission suit instituted in the United States District Court for the District of Oregon alleged that United, 17 of its subsidiaries or affiliates and six officers of various corporate defendants violated the registration and anti-fraud provisions of the securities acts. According to the complaint, United is a world-wide complex of more

than 80 companies including off-shore mutual funds, real estate and insurance companies and banks. On the Commission's motion for a preliminary injunction, the defendants did not contest the Commission's allegations but argued that United States courts lacked jurisdiction of what the defendants claimed were extraterritorial acts.

The district court found, however, that the defendants' activities were subject to the provisions of the Federal securities laws since (1) the defendants had used the facilities of interstate commerce to offer and sell securities to United States citizens and residents and to operate their corporate empire from within the United States, and (2) their activities, originating in and directed from the United States, had caused substantial and irreparable harm both to domestic and foreign investors and creditors and could adversely affect the ability of American issuers to raise capital abroad. The court entered preliminary injunctions against each of the defendants. Having found that there was a real threat of dissipation of valuable corporate assets by the individual defendants, the court also appointed a receiver for the complex. The orders of the district court have been appealed by certain of the defendants to the Court of Appeals for the Ninth Circuit.<sup>26</sup>

*S.E.C. v. Pig 'N Whistle Corporation.*<sup>27</sup> The Commission obtained consent decrees of permanent injunction against a number of defendants alleged to have participated in violations of the Federal securities laws in connection with the distribution of the stock of Pig 'N Whistle. The consenting defendants included Financial Relations Board, Inc. (FRB), a Chicago-based public relations firm which had been engaged by Pig 'N Whistle. FRB allegedly violated antifraud and antitouting provisions by distributing press releases which contained false and misleading information about the company, without making an adequate investigation, and without disclosing the



fact that it was acting on behalf of and receiving compensation from Pig 'N Whistle. Under the terms of the decree, FRB is enjoined from further violations, provided that it will not be deemed to have violated the decree in connection with any statement made or distributed by it if, after an investigation, it has reasonable cause to believe that the statement is accurate. The decree also required FRB to establish procedures for screening prospective clients and for investigating the facts contained in any release distributed on behalf of a client.

*S.E.C. v. Manor Nursing Centers, Inc.*<sup>28</sup> This action arose out of an "all-or-nothing" public offering of Manor common stock on behalf of Manor and certain of its principal stockholders. The Court of Appeals for the Second Circuit affirmed an order of the district court enjoining various defendants from violating the antifraud and prospectus-delivery provisions of the Federal securities laws. The court also upheld, with one minor modification, the district court's grant of ancillary relief, which (1) required the defendants to disgorge the proceeds received from the public offering, (2) ordered the appointment of a trustee to receive and distribute such funds to defrauded investors and (3) temporarily froze the assets of the defendants pending their transfer of the proceeds to the trustee.

The Commission had alleged that Manor and the selling-stockholder defendants had violated provisions of the securities laws by retaining the proceeds received from investors in the offering even though all the offered shares had not been sold and payment received. It charged that, after the effective date of the Manor registration statement, these defendants realized that the offering would not be successful and, aided and abetted by the underwriter and other defendants, engaged in a fraudulent scheme to make it appear that the issue was sold out. Manor received less from the offering than had

been represented, while the selling stockholders were paid in full at the closing.

In affirming the district court's finding of violations of the antifraud provisions, the court of appeals held that the failure to return to the public proceeds obtained in an "all-or-nothing" offering, where the preconditions for retention of the funds are not satisfied, is a misappropriation of the proceeds, which constitutes a fraud on investors. It further held that the antifraud provisions are violated where securities are offered on the basis of a prospectus which fails to disclose material developments occurring after the effective date of the registration statement.

After the decision, the district court, on remand, ordered two of the defendants to pay over to the trustee more than \$700,000. At fiscal year-end appeals from these orders were pending.<sup>29</sup>

*S.E.C. v. Shapiro.*<sup>30</sup> The Commission alleged violations of Rule 10b-5 under the Securities Exchange Act involving transactions in the securities of Harvey's Stores, Inc., traded on the American Stock Exchange. The Commission charged that the defendants had purchased stock without disclosing non-public material information of proposed mergers involving Harvey's, and said some of them had passed on the information to friends who then purchased shares. The defendants had obtained the information either by virtue of their positions as directors or controlling stockholders of Harvey's, or as parties privy to the merger negotiations, or through having been "tipped" by persons having direct access to the information. In addition to injunctive relief against future violations, the Commission sought an order directing the defendants to disgorge to a court-appointed trustee any profits realized or accrued from their own transactions or those of their "tippees". All of the defendants except two—against whom the case was pending at fiscal year-end—

consented to the entry of final judgments of permanent injunction and orders of disgorgement.

*S.E.C. v. International Telephone and Telegraph Corp.*<sup>31</sup> The Commission's complaint alleged, among other things, that ITT and some of its insiders had violated antifraud provisions by selling securities without disclosing significant developments in settlement negotiations in an antitrust case involving ITT. All defendants consented to injunctions as requested in the complaint.

*S.E.C. v. Advance Growth Capital Corporation.*<sup>32</sup> The Commission had filed a complaint in 1969 charging, among other things, that the chairman of the board and the president of Advance, a registered investment company, each had caused the company to enter into a series of transactions with various affiliated persons of the investment company or the board chairman without obtaining advance Commission approval as required under the Investment Company Act. In August 1971, the district court rendered its decision denying the Commission's request for injunctive relief and the appointment of a receiver. It found that, while the transactions in question had violated the Investment Company Act, the violations had not been intentional. The Commission has appealed to the Court of Appeals for the Seventh Circuit,<sup>33</sup> urging that the district court's finding of lack of intention was clearly erroneous and that, in any event, the Commission was not required to prove intent in order to obtain injunctive relief and the appointment of a receiver.

*S.E.C. v. Century Investment Transfer Corp.*<sup>34</sup> The Commission charged that some defendants participated in a scheme, aided and abetted by the other defendants, to create a public market for the distribution of unregistered shares of the common stock of four shell corporations. One of the defendants had purchased for cash controlling blocks of stock of these corporations in

proceedings under Chapter XI of the Bankruptcy Act.<sup>35</sup> Orders of the bankruptcy court stated that all shares were issued to this purchaser, which was not a creditor, under a provision of the Bankruptcy Act which exempts from the registration provisions any transaction in securities issued pursuant to a Chapter XI arrangement in exchange for claims against the debtor or partly in such exchange and partly for cash and/or property. The Commission alleged that the exemption was not available, and that an attorney for the debtors in the Chapter XI proceedings as well as the purchaser who had given opinion letters to the effect that the shares issued for cash could be traded without registration should also be enjoined. The District Court for the Southern District of New York agreed with the Commission's positions and entered an order preliminarily enjoining the defendants. The court found that the attorney's misleading opinion letters, which it said went beyond mere errors in legal judgment, were crucial to the distribution of unregistered securities and that he had aided and abetted the scheme. An appeal was taken by the attorney to the Court of Appeals for the Second Circuit.<sup>36</sup>

The decision of the district court was consistent with an earlier decision in *S.E.C. v. Budin & Co.*,<sup>37</sup> where it was held that 200,000 unregistered shares issued by one of the Chapter XI debtor companies could not be included in computing the net capital of a broker-dealer, and with the decision of the bankruptcy court in *Sveden House of Texas, Inc.*,<sup>38</sup> dismissing an attempt to enjoin the Commission from interfering with any resales without registration of the securities purchased by the non-creditor.

*S.E.C. v. Continental Tobacco Co. of South Carolina, Inc.*<sup>39</sup> The United States Court of Appeals for the Fifth Circuit held, contrary to the decision of the district court, that Continental's sale of un-

registered securities to about 40 persons, for a total of \$140,000, was not, as claimed, an exempt "private offering" under Section 4(2) of the Securities Act, and that the sale therefore violated the registration provisions of that Act. The court ruled that Continental failed to sustain its burden of proving by explicit, exact evidence that each offeree of the unregistered stock had a relationship with Continental giving him access to the kind of information that registration would have disclosed. Although Continental had distributed a brochure containing information about the company and its securities, the court stated that mere disclosure of information does not assure entitlement to the exemption for nonpublic offerings. Offerees of unregistered securities should also have the ability, by reason of their facility for acquiring information about the issuer, to verify for themselves the accuracy of the disclosure. Such ability, the court indicated, was not possessed by all of Continental's offerees since some of them lacked personal contacts with Continental's management prior to acquiring the unregistered securities.

*S.E.C. v. Computer Statistics, Inc.* The United States District Court for the District of Columbia<sup>40</sup> denied the defendant's motion to dismiss the action for improper venue, or in the alternative, for a transfer of venue and granted the Commission's cross-motion for summary judgment enjoining the defendant to file timely and proper periodic reports. On appeal,<sup>41</sup> the defendant contends that the district court should have transferred venue to the Northern District of Texas where the defendant has its principal place of business and should not have granted the Commission's motion. It argues that there was an issue of fact whether a reasonable likelihood of future violations existed in light of its assertion that it would attempt to comply with the reporting requirements in the future.

*S.E.C. v. Realty Equities Corporation of New York.*<sup>42</sup> A permanent injunction enjoining the defendant from failing to comply with reporting requirements under the Exchange Act was entered, despite its contentions that its past failure to file the required reports on a timely basis was the result of factors beyond its control. The company acknowledged that it had been delinquent in its reporting over a 5-year period. At the time the Commission's action was instituted on December 31, 1971, the company was delinquent in filing its annual report for its fiscal year ended March 31, 1971, and its quarterly reports for the first two quarters of its 1972 fiscal year. Trading in the company's securities on the American Stock Exchange had been halted in August 1970 because of its failure to file reports on time.

The district court held that bad faith and fraud need not be shown to warrant an injunction. It stated that the delinquencies were willful "in the sense they were not the result of mistake, accident or inadvertence but rather resulted from a series of factors, including financial pressures some years back, inadequate staff, lack of necessary financial records found in acquired companies, broken promises by retained accounting firms and management's failure to place timely reporting in priority status." The court noted that while assurances had been given that these matters were now under control, the delinquencies had continued after the suit was instituted, and that similar assurances had been given to the Commission in the past.

*S.E.C. v. Radio Hill Mines Co. Ltd.*<sup>43</sup> The United States District Court for the Southern District of New York entered an order which, in addition to preliminarily enjoining the defendants from further violations of registration and antifraud provisions of the federal securities laws, directed four defendants to report periodically their securities hold-

ings and transactions to the Commission. The court noted that these defendants had often engaged in securities transactions through nominees, and that a reporting requirement of this type was needed in view of the difficulty the Commission might encounter in determining whether the defendants were continuing their violative activities. An appeal was taken to the Court of Appeals for the Second Circuit.<sup>44</sup>

*Shamrock Fund.*<sup>45</sup> A temporary restraining order was entered by a district court, on the Commission's motion, enjoining this open-end investment company from failing to repurchase or redeem its shares in accordance with the terms of such securities, in violation of Section 22(e) of the Investment Company Act, and from selling its shares to the public at other than the current public offering price described in the prospectus, in violation of Section 22(d) of that Act. Subsequently, the court appointed a receiver to take charge of the assets and records of the investment company to safeguard and conserve assets. It empowered the receiver to perform the duties of a board of directors, to suspend the repurchase and redemption of the outstanding shares, and to obtain shareholder approval for a new investment adviser or to merge the Fund into another investment company or liquidate it.

*The Technical Fund, Inc.*<sup>46</sup> The Commission brought an injunctive action against this registered investment company and some of the principals of the company or its adviser, alleging that the defendants filed misleading proxy material with the Commission and violated provisions of the Investment Company Act prohibiting principal transactions between an investment company and affiliated persons and requiring a written contract between an investment company and its adviser and shareholder approval of such contract. The defendant principals were also charged with gross misconduct in engaging in prac-

tices which constituted a breach of fiduciary duty. After a hearing, the court preliminarily enjoined the defendants from further violations and appointed a receiver for the investment company.

During the fiscal year, receivers appointed by the courts in *SEC v. Fifth Avenue Coach Lines, Inc.* and *SEC v. Gray Line Corp.*<sup>47</sup> entered into a settlement agreement which eliminated cross ownership between the two companies and disposed of all claims between them. The settlement provided that Gray Line turn over all of its holdings in Fifth Avenue (approximately 25 percent of the outstanding stock) to Fifth Avenue and that Fifth Avenue turn over all of its holdings in Gray Line (approximately 37 percent of the outstanding stock) to Gray Line. In addition, Fifth Avenue was required to return \$1.85 million to Gray Line.

An order exempting the settlement agreement from applicable provisions of the Investment Company Act was obtained from the Commission and approval of the terms of the settlement was obtained from the courts. The settlement has been implemented, Fifth Avenue's receivership has been terminated, and it is presently engaged in conducting business as a registered investment company. Gray Line, under the direction of its receiver, is in the process of liquidation.

*S.E.C. v. Everest Management Corporation.*<sup>48</sup> The Commission charged 44 defendants with violations of anti-fraud provisions of the securities laws, and some of them with violation of provisions of the Investment Company Act designed to prevent self-dealing and gross abuse of trust. An investment company and its adviser which were not named as defendants moved to intervene as plaintiffs on certain counts of the Commission's complaint and against some of the defendants. The district court denied their motion after hearing the Commission's arguments that intervention would complicate the action be-

cause of the defendants' right to a jury trial, would add new issues, and would interfere with the expeditious conduct of the action and the possibility of negotiating settlements with some of the defendants. The Commission pointed out that the proposed intervenors were free to assert their claims in a separate lawsuit. An appeal from the denial of intervention has been taken to the Court of Appeals for the Second Circuit.<sup>49</sup>

### Participation as Amicus Curiae

The Commission frequently participates as *amicus curiae* in litigation between private parties under the securities law where it considers it important to present its views regarding the interpretation of the provisions involved. For the most part, such participation is in the appellate courts. During fiscal 1972, the Commission filed *amicus curiae* briefs in 20 cases and participated as intervenor in two cases.

*Superintendent of Insurance v. Bankers Life and Casualty Co.*<sup>50</sup> The Supreme Court, adopting views expressed by the Commission as *amicus curiae*, unanimously reversed the holding of the lower courts that the complaint of the Superintendent of Insurance had failed to state a claim for relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

The Superintendent had alleged that Manhattan Casualty Company, a New York insurance company, had been defrauded by its sole shareholder into selling nearly \$5 million of its portfolio securities on the assumption that the proceeds from the sale of the securities would be returned to the company. Instead, the Superintendent had alleged, the defendants misappropriated the proceeds of the sale to the detriment of the company. The defendants had argued, among other things, that the fraud, if any, was a self-inflicted wound and that, accordingly, no claim for relief had been stated.

The Supreme Court, affirmatively recognizing the existence of a private right of action under Section 10(b) for the first time, held that the Securities Exchange Act "protects corporations as well as individuals who are sellers of a security." The Court recognized the broad purpose underlying Section 10(b) and, in noting that the "crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor", stated:

"Hence we do not read Section 10(b) as narrowly as the Court of Appeals; it is not 'limited to preserving the integrity of the securities markets' . . . , though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a 'security' and since fraud was used 'in connection with' it, there is redress under Section 10(b) . . . . (T)he fact that creditors of the defrauded corporation buyer or seller of securities may be ultimate victims does not warrant disregard of the corporate entity."

*Affiliated Ute Citizens v. United States.*<sup>51</sup> The Commission urged reversal of a decision of the Court of Appeals for the Tenth Circuit concerning the application of Rule 10b-5 under the Securities Exchange Act to the sale of certain stock by mixed-blood Indians of the Ute Tribe. The Supreme Court, in accordance with the positions urged in the Commission's brief, rejected the view of the court of appeals that, under the circumstances of the case, involving primarily a failure to disclose, proof of reliance on material misrepresentations of fact was necessary to recover damages for a violation of Rule 10b-5. The Supreme Court stated that the defendants devised a plan and induced the Indians to dispose of their shares without disclosing to them material facts that

reasonably could have been expected to influence their decisions to sell.

The Supreme Court also rejected the court of appeals' view of the measure of damages. It held that the correct measure of damages was the difference between the fair value of all that the sellers received and the fair value of what they would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the seller's actual loss. In the latter case, damages are the amount of the defendant's profit.

*Cattlemen's Investment Co. v. Fears.*<sup>52</sup> The district court, as urged by the Commission, construed the term "tender offer" in Section 14(d) of the Securities Exchange Act (part of the "Williams Bill") to include acquisition by the defendant of more than 5 percent of the common stock of an issuer as a result of active and widespread solicitations of public shareholders on an individual basis, in person, over the telephone and through the mails. The Court adopted the Commission's view that, although tender offers were usually made by newspaper advertisements, the means employed by the defendant were even more designed "to force a shareholder into making a hurried investment decision without access to information, in circumvention of the statutory purpose." The court further concluded, as urged by the Commission, that the purposes of the Williams Bill would best be served by giving the plaintiff target corporation standing to sue for an injunction and by granting an injunction even though the only showing of irreparable harm was the defendant's failure to file a required report under Section 14(d).

*Naftalin & Co., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*<sup>53</sup> Six broker-dealers appealed from an order entered in a proceeding in which they petitioned to have Naftalin & Co., Inc., another broker-dealer, adjudicated an involuntary bankrupt.<sup>54</sup> The district court

disallowed the broker-dealers' claims against Naftalin to the extent it found that they arose out of extensions of credit to Naftalin in special cash accounts in violation of the credit extension provisions of the Federal Reserve Board's Regulation T. The court found that Naftalin had purported to sell securities it did not own in special cash accounts maintained with each of the six broker-dealers and that the latter had failed to liquidate those accounts until long after the dates on which Naftalin had agreed to make delivery of the securities.

The Commission, as *amicus curiae*, agreed with that part of the decision which held that the six broker-dealers violated Regulation T by extending credit to Naftalin when it failed to make prompt delivery of the securities sold in the special cash accounts. The Commission disagreed with the decision, however, to the extent it determined that delivery of the securities should have been made on or before the seventh day after their sale in order to avoid an illegal extension of credit. Instead, the Commission urged that if a special cash account customer has a credible explanation for a brief delay in delivery, a broker-dealer may in good faith rely on this explanation, but that it cannot in good faith continue a delay in delivery that extends, at most, beyond a few weeks.

*Feit v. Leasco Data Processing Equipment Corporation.*<sup>55</sup> The district court found Leasco, its chief executive officer, president, and general counsel, all also directors, jointly and severally liable in money damages to the plaintiff class, consisting of persons who had exchanged their securities of another company for securities of Leasco under a registered exchange offer by Leasco. Liability was based on the court's finding that there were material omissions in Leasco's registration statement filed with the Commission. After the court issued its findings of fact and conclusions of law but before the entry of a

final judgment, Leasco and the individual defendants moved the court for an order declaring that Leasco's intention to pay the entire judgment and not to seek contribution from the individuals would not contravene public policy as expressed in the Securities Act. This motion was made pursuant to an undertaking in Leasco's registration statement which paralleled that contained in the note to Rule 460 under the Securities Act. That note expresses the Commission's opinion that such indemnification is against public policy and thus unenforceable and generally provides for the registrant to submit the question to a court for adjudication should a claim for indemnification be asserted against it.

In a memorandum filed by the Commission, at the invitation of the court, it took the position that where inside directors of a corporation have been found to have failed to exercise the degree of care imposed upon them by Section 11 of the Securities Act, it would be contrary to public policy as expressed in the Securities Act to permit the corporation to indemnify them directly against their liability or to do so indirectly by failing to seek contribution from them.

After the Commission had filed its memorandum but before the court ruled, the defendants' motion was withdrawn. The court entered a final judgment but expressly retained jurisdiction over the issue of contribution.

In June, 1972, the individual defendants offered to contribute \$5,000 each to the total judgment of \$112,000. The Commission advised the court of its position that if under all the circumstances the court should find that the amount the individuals proposed to contribute was only a token payment, it should reject their offer. The Commission took no position as to what might be an appropriate amount. After having directed publication of a notice of the terms of the proposed settlement, and there apparently being no objection, the

court approved the settlement on August 1, 1972.

*The Birnbaum Doctrine.* As *amicus curiae*, the Commission has continued to urge rejection of the doctrine established by *Birnbaum v. Newport Steel Corp.*<sup>56</sup> that permits only a purchaser or a seller of securities to recover monetary damages in a private action under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. In *Mount Clemens Industries Inc. v. Bell*,<sup>57</sup> the plaintiffs alleged that they had been induced to refrain from bidding on and purchasing securities at a sheriff's sale because of misrepresentation by one of the defendants. The Commission expressed the view that neither the legislative history nor the language of Section 10(b), and Rule 10b-5 thereunder, restrict the ambit of those provisions to purchasers and sellers of securities. The Court of Appeals for the Ninth Circuit, however, held that the purchaser-seller limitation was a desirable method for effecting what it considered to be the congressional intent, and it suggested that this limitation might be a matter of constitutional necessity. In *Manor Drug Stores v. Blue Chip Stamps*,<sup>58</sup> an action presently pending before another panel of the Court of Appeals for the Ninth Circuit, the plaintiffs allege that as a result of the defendants' misrepresentations they were induced to refrain from purchasing securities offered in connection with the settlement of an antitrust action. The Commission urged this panel to reject the purchaser-seller limitations. In a supplemental memorandum requested by the panel, the Commission explained its disagreement with the *Mount Clemens* decision.

In *Travis v. Anthes Imperial Limited*,<sup>59</sup> the district court, on the basis of the *Birnbaum* doctrine, had dismissed a complaint which alleged that the plaintiffs in St. Louis had been fraudulently induced by Canadian defendants to refrain from selling certain

securities. On appeal to the Court of Appeals for the Eighth Circuit, the Commission took the position, as *amicus curiae*, that there should be a private right of recovery under Section 10(b) and Rule 10b-5 whenever an investor has been fraudulently induced to refrain from buying or selling securities, as well as when he has been fraudulently induced to purchase or sell. The Commission also took exception to the district court's determination that there was no jurisdiction under the Federal securities laws because there were not sufficiently substantial acts committed within the United States in connection with the alleged violation. The Commission noted that the defrauded victims were in the United States at the time deceptive statements were made to them by telephone and that the Securities Exchange Act applied to communications between any foreign country and any state.

After a *rehearing en banc*, the Court of Appeals for the Second Circuit, in *Drachman v. Harvey*,<sup>60</sup> reversed the dismissal of a share-holders' derivative suit that sought damages under Section 10(b) and Rule 10b-5 on behalf of the corporation for losses allegedly suffered when defendants caused an improvident redemption of convertible debentures to prevent dilution of voting control—which the defendants had sold at a premium. The court did not, however, find it necessary to repudiate the *Birnbaum* doctrine as urged by the Commission in its brief as *amicus curiae*.

## CRIMINAL PROCEEDINGS

During the past fiscal year the Commission referred 38 cases to the Department of Justice for prosecution, representing a sharp increase over the 22 cases referred in the prior year.<sup>61</sup> Twenty-eight indictments were returned against a total of 67 defendants, in cases that had been referred in that and prior years, and 75 defendants were convicted in 25 cases that were tried. Convictions were affirmed in 10

cases, and appeals were still pending in 9 criminal cases at the close of the period. Staff members of the Commission familiar with a case generally assist in the prosecution and in any appeal from a conviction.

The cases handled again demonstrated a variety of fraudulent and other unlawful practices to which the investing public is subjected. In *U.S. v. Colasurdo*,<sup>62</sup> the convictions of Lewis Colasurdo and other defendants for conspiracy and other crimes were upheld by the Court of Appeals for the Second Circuit. Colasurdo and his associates were able to gain control of Crescent Corporation, listed on the New York Stock Exchange, using Crescent's own money. They caused another corporation controlled by them to transfer an agricultural operation to Crescent through a series of sham transactions and used the proceeds of the sale to pay for their Crescent stock, and they subsequently concealed their activities by causing Crescent to file false statements with the Commission. Colasurdo was sentenced to a two-year prison term and a \$50,000 fine. Other defendants received various prison sentences and were fined a total of \$50,000.

The securities fraud convictions of Service Securities, Inc., a New York broker-dealer, and M. Perry Grant, its president, were upheld by the Court of Appeals for the Second Circuit.<sup>63</sup> In connection with an all-or-nothing offering of common stock of Data Industries Corporation of Texas, through Service Securities as underwriter, these and other defendants defrauded public investors by entering fictitious subscription orders to make it appear that the offering was sold out by the specified deadline. Thereafter, they generated purchase orders for the stock to offset the fictitious subscriptions. Grant received a six-month prison sentence, and Service Securities was fined.

Recently, the Court of Appeals for the Tenth Circuit upheld the convictions of



four defendants for fraudulently selling certain loan commitments letters (which the court held to be securities).<sup>64</sup> The defendants promised to provide loans for prospective borrowers and caused them to pay them an advance fee in return for a loan commitment letter. In fact, no loan was ever placed or consummated and with few exceptions the fees paid were not returned. The court characterized the defendants' acts as a "carefully designed scheme to defraud persons seeking equity capital or mortgage money."

In a case involving the first criminal prosecution for violation of Section 17(e)(1) of the Investment Company Act, the Court of Appeals for the Second Circuit upheld the conviction of Jerome Deutsch for aiding and abetting the violation of that provision by a co-defendant.<sup>65</sup> Deutsch, an officer of Realty Equities Corporation, attempted to place \$12 million of Realty's promissory notes with institutional investors. His efforts were unsuccessful until he convinced the co-defendant, Frank D. Mills, senior officer of the investment adviser for 12 mutual funds, to purchase notes for one of those funds. Thereafter, Deutsch was able to place the entire issue. After Realty had contracted to repurchase several notes, Mills, using a nominee account, purchased one of those notes through Deutsch for \$537,000. Three days later one of the funds, of which Mills was a vice-president, purchased identical notes for \$928,125 per note. Section 17(e)(1) forbids affiliated persons of an investment company from accepting, while acting as agent, any outside compensation for the purchase of any property for the investment company. The court, after ruling that the statute was not unconstitutionally vague, stated that "The objective of Section 17(e)(1) is to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest. It is clear that, as soon as Mills purchased the Realty note

at a reduced price, he was inhibited by a conflict of interest which could easily becloud his judgment to the detriment of the beneficiaries of the funds." The court held that the jury was justified in finding that Deutsch's sale to Mills of the note at a discount was "compensation in appreciation of past conduct."

In *U.S. v. Zimmerman*,<sup>66</sup> various defendants pled guilty to securities fraud charges in connection with transactions involving State Fire and Casualty Insurance Co. The defendants obtained control of the company and then exchanged its valuable marketable assets for restricted unmarketable securities of other corporations. The company failed and was forced into receivership. Defendant S. Mort Zimmerman was fined \$30,000 and placed on five years probation. Other defendants, including C. Carey Matthews, an attorney and former member of the state legislature, were also fined and placed on probation.

Another public official, former Louisiana Attorney General Jack P. F. Gremillion, was found guilty of giving false testimony before a Federal grand jury investigating possible violations of the Federal securities laws in connection with the operations of Louisiana Loan and Thrift Corporation.<sup>67</sup> Gremillion was sentenced to concurrent three-year terms on each of five counts of perjury.

### Organized Crime Program

The prosecution of securities cases is often based on circumstantial evidence requiring extensive investigation by highly trained personnel. The difficulties in such prosecutions are compounded when elements of organized crime are involved. Witnesses are usually reluctant to cooperate because of threats or fear of physical harm. Books, records, and other documentary evidence essential for successful prosecution may be destroyed or nonexistent. The organized criminal element is prone to disguise transactions by using nominees and taking advantage of foreign bank secrecy

laws. It frequently operates through "fronts" and infiltrates legitimate business concerns. Organized crime has an extensive network of affiliates throughout this country in all walks of life, and in many foreign nations.

Despite these difficulties, the Commission, working in cooperation with other enforcement agencies, has been able to make major contributions to the fight against organized crime. Members of its staff, including a special unit in the headquarters office, assist the Department of Justice and its various organized crime "strike forces" in the investigation and prosecution of securities cases involving organized crime. For example, the Commission, in cooperation with the New York Strike Force, as well as the New York Police Department and the New York County District Attorney's Office, participated in the investigation and successful prosecution of certain defendants, including Arthur Tortorello, John Dennett and Frederick Hesse, for violating the antifraud and registration provisions of the securities acts in connection with the financial affairs of Underwriter Investment Company. The defendants caused the preparation of inflated balance sheets for that company, which was in fact a corporate shell. They then engaged in a complex scheme to distribute the overvalued shares to the public. Six defendants pled guilty prior to trial. Tortorello and Dennett were found guilty after trial. They have appealed their convictions.<sup>68</sup>

In another significant case, the Commission's staff participated with the New York Strike Force in the trial resulting in the convictions of John Lombardozzi, Hilmer Sandine, Leslie Zacharias, Samuel Benton and William Hamilton of securities fraud, mail fraud, and conspiracy to defraud investors in connection with transactions in the stock of Picture Island Computer Corporation.<sup>69</sup> Two other defendants, Peter Crosby and Dinty Whiting, failed to appear for trial,

and became fugitives from justice.

Evidence produced during the six-week trial revealed that the defendants caused more than 23 million unregistered shares of Picture Island stock to be distributed throughout the United States, Europe and South America. In connection with the distribution, they disseminated financial statements and shareholder reports which falsely stated that Picture Island had assets in excess of \$50 million. In fact, the company was a nearly worthless shell. Among the assets claimed for Picture Island were 3½ million acres of government-owned off-shore oil lands in the Arctic, which were assigned a value of over \$31 million. After the trial, Lombardozzi, Sandine, and Zacharias jumped bail and became fugitives from justice. The other defendants were expected to be sentenced in the fall of 1972.

In addition to providing direct assistance to the Justice Department and its "strike forces" in the investigation and prosecution of organized crime cases, the Commission also participates in other ways, both direct and indirect, in the fight against organized crime. The Chairman of the Commission is a member of The National Council on Organized Crime. Quarterly reports concerning organized crime investigations are submitted to the Justice Department. The Commission also frequently supplies information from its extensive files on publicly-held companies and broker-dealers to the Justice Department and other agencies engaged in fighting organized crime. A potential contribution of great significance relates to the problem of securities theft. Securities worth hundreds of millions of dollars are stolen each year from brokerage firms, banks, insurance companies, and other institutions. Organized crime is responsible for much of this theft. Although the Commission has no direct responsibility in the area of stolen securities, its current efforts looking toward the immobilization of stock certificates in central

depositories will greatly reduce the opportunities for securities theft.

### **Proposed Swiss Treaty**

The Commission has continued its participation with other agencies of the Federal Government in discussions looking toward a possible Treaty of Mutual Assistance in Criminal Matters between the United States and Switzerland.<sup>70</sup> It is believed that such a treaty would be of assistance to the Commission in dealing with problems presented by the use of Swiss financial institutions in connection with securities transactions taking place in the United States.

The Commission's representative participated in two further rounds of informal discussions between Swiss and American representatives which took place in Washington in the fall of 1971. These meetings resulted in resolution of the known remaining substantive problems between the two working groups. The matter now awaits a determination by the governments concerned as to what further action they may desire to take.

### **COOPERATION WITH OTHER ENFORCEMENT AGENCIES**

In recent years the Commission has given increased emphasis to cooperation and coordination of its own activities with the various other enforcement agencies, including the self-regulatory organizations and enforcement agencies at the state and local level as well as certain foreign agencies. Its programs in this area cover a broad range. For example, the Commission believes that certain cases, where the violations, while involving the Federal securities laws, are of a local nature, are more appropriately enforced at the local rather than the Federal level. In these instances the Commission authorizes referral of the case to the appropriate state or local agency, and members of the staff familiar with it are made avail-

able for assistance to that agency in its enforcement action. One recent such case involved Dempster Investment Co. and its president who were found guilty by a Michigan state court of selling unregistered securities in violation of that state's securities law. The Commission had previously obtained a Federal court order enjoining the defendants from violating registration and antifraud provisions of the Federal securities laws. The case was initially developed through a joint investigation by the Commission's staff and the Michigan Securities Bureau.<sup>71</sup>

The Commission has also fostered programs designed to provide a comprehensive exchange of information concerning mutual enforcement problems and possible securities violations. During the fiscal year, it continued its program of regional enforcement conferences held once a year within each of the Commission's nine regions. These conferences are attended by personnel from state securities agencies, the U.S. Postal Service, Federal, state and local prosecutors' offices and local offices of self-regulatory associations such as the NASD. They provide a forum for the exchange of information on current enforcement problems and new methods of enforcement cooperation. One result of these conferences has been the establishment of programs for joint investigations. Although the conferences were initially hosted by the Commission's regional offices, many state agencies are now serving as sponsors.

The Commission is constantly seeking ways to improve these conferences. One innovation that has been tried in some regions is to open one session to the brokerage community and to private practitioners in the securities field. The resulting exchange of views has so far proven to be very beneficial to all concerned. It is planned to follow this practice in the future at other regional conferences.

During the past year the Commission

reinstated its annual enforcement training program, after a lapse of one year. The more than 150 persons in attendance included, in addition to Commission personnel, 30 persons from various state agencies, 15 from other Federal agencies and 7 representatives from Canada, 2 from Mexico and 1 from Panama. The program seeks to impart an understanding of how the securities markets operate, explain applicable rules, suggest desirable investigative procedures, indicate how available enforcement remedies can best be utilized and provide guidance in connection with the trial of securities cases.

The Commission's Section of Securities Violations provides one of the means for cooperation on a continuing basis with other agencies having enforcement responsibilities. This Section acts as a clearinghouse for information regarding securities enforcement actions taken by state and Canadian authorities, other governmental and self-regulatory agencies, and the Commission itself. It answers requests for specific information, and in addition publishes a periodic SV Bulletin which is sent to contributing agencies and to other enforcement and regulatory agencies. During fiscal year 1972, the Section received 4,212 letters either providing or requesting information, and sent out 2,457 communications to cooperating agencies. Records maintained by the Section reflect a steady increase in recent years in the number of enforcement actions taken by state and Canadian authorities.

The data in the SV files (which are computerized) is useful in screening applicants for registration as securities or commodities brokers or dealers, issuers and investment advisers, as well as applicants for loans from such agencies as the Small Business Administration and the Economic Development Administration of the Department of Commerce.

The Wanted Supplement to the SV

Bulletin is a valuable source of data on fugitives in securities-related criminal actions. As an example of results attainable through coordination and cooperation between agencies, an individual listed in the Supplement was discovered to be in Honolulu using an alias. He was seized through the joint efforts of the Commission's San Francisco Office, the Honolulu Police Department, and the State of California.

### FOREIGN RESTRICTED LIST

The Commission maintains and publishes a Foreign Restricted List designed to alert broker-dealers, financial institutions, investors and others to possible unlawful distributions of foreign securities. The list consists of names of foreign companies whose securities the Commission has reason to believe recently have been, or currently are being, offered for public sale in the United States in violation of registration requirements. Most broker-dealers refuse to effect transactions in securities issued by companies on the list. This does not necessarily prevent promoters from illegally offering such securities directly to investors in the United States. The number of companies on the list increased from 54 on June 30, 1971, to 60 at the end of the 1972 fiscal year. The following companies were added to the list during the year:

*Trans-American Investments, Limited, Land Sales Corporation, Timberland, and Vacationland.*<sup>72</sup> These are all names under which one Edward Zelsman was selling investment contracts which involved interests in Canadian land, including mineral and timber land leases and vacation land properties. The contracts were offered in the United States by mail and extensive advertising in national magazines. Representations were made that purchasers of the leases need do no work and would realize profits. Moreover, many U.S. investors complained to Canadian authorities that documents they received purporting to

convey leasehold interests were unacceptable to Canadian land record offices because descriptions were too vague and the instruments were not properly executed.

*Normandie Trust Company of Panama*.<sup>73</sup> The Commission received information that transactions were being effected in securities purporting to be "letters of credit" of Normandie Trust Company, purportedly a Panamanian corporation, and investigation disclosed several instances where such "letters of credit" were sold for cash in the United States. In connection with these sales, financial statements of highly questionable origin and content were disseminated to the public.

*Santack Mines Limited*.<sup>74</sup> The Commission received information that unregistered shares of this Canadian mining corporation had been sold to residents of the United States.

*Strathmore Distillery Company, Limited*.<sup>75</sup> This company, located in Glasgow, Scotland, was publicly advertising and mailing solicitations to investors in the United States in an attempt to induce them to buy whiskey warehouse receipts covering kegs of Scotch whiskey stored in warehouses in Scotland. The investments were solicited on the basis that profits would be realized from the sale of the whiskey after it had become more valuable through aging. It appeared that what was being offered constituted investment contracts which are securities as defined in the Securities Act.

## NOTES FOR PART 4

<sup>1</sup> C.A.D.C., No. 71-1963.

<sup>2</sup> M.D.L. Docket No. 55.

<sup>3</sup> CCH Fed. Sec. L. Rep. ¶93,400 at p. 92,003 (March 1972).

<sup>4</sup> 447 F. 2d 166 (C.A. 10, 1971), *certiorari denied*, 404 U.S. 1038 (1972).

<sup>5</sup> No. 72-2574 (C.A. 5).

<sup>6</sup> See, e.g., the court of appeals decision in *S.E.C. v. Texas Gulf Sulphur*

*Company*, 446 F. 2d 1301 (C.A. 2, 1971).

<sup>7</sup> Securities Exchange Act Release No. 9708 (August 7, 1972).

<sup>8</sup> Securities Exchange Act Release No. 9614 (May 23, 1972).

<sup>9</sup> Securities Exchange Act Release Nos. 9247 (July 15, 1971) and 9516 (March 8, 1972).

<sup>10</sup> Securities Exchange Act Release No. 9327 (September 8, 1971).

<sup>11</sup> Securities Exchange Act Release No. 9478 (February 9, 1972).

<sup>12</sup> Investment Company Act Release No. 7280 (July 19, 1972).

<sup>13</sup> Securities Exchange Act Release No. 9666 (July 10, 1972).

<sup>14</sup> C.A.D.C., No. 71-1602.

<sup>15</sup> 37th Annual Report, pp. 138-139.

<sup>16</sup> Securities Act Release No. 5266 (June 27, 1972).

<sup>17</sup> Securities Act Release No. 5295 (September 6, 1972).

<sup>18</sup> Securities Act Release No. 5218 (December 20, 1971).

<sup>19</sup> See Securities Exchange Act Release No. 9629 (June 6, 1972).

<sup>20</sup> Securities Exchange Act Release No. 9536 (March 20, 1972).

<sup>21</sup> 452 F. 2d 943 (C.A. 10, 1971), *certiorari denied*, 406 U.S. 957 (1972).

<sup>22</sup> *S.E.C. v. National Bankers Life Insurance Company, et al.*, 334 F. Supp. 444 N.D. Tex. 1971).

<sup>23</sup> C.A. 5, No. 71-3599.

<sup>24</sup> D.D.C., No. C.A. 225-72.

<sup>25</sup> CCH Fed. Sec. L. Rep. ¶ 93,383 (D. Ore. February 16, 1972), *appeal pending*, C.A. 9, No. 72-1334.

<sup>26</sup> C.A. 9, No. 72-1334.

<sup>27</sup> N.D. Ill., Civ. Action No. 71 C 545.

<sup>28</sup> 458 F.2d 1082 (C.A. 2, 1972).

<sup>29</sup> *S.E.C. v. Manor Nursing Centers, Inc.*, CCH Fed. Sec. L. Rep. ¶ 93,359 (S.D. N.Y., 1972) and ¶ 93,501 (S.D. N.Y., 1972), *appeals pending*, C.A. 2, Nos. 72-1304 and 72-1614.

<sup>30</sup> S.D. N.Y., 72 Civ. 269.

<sup>31</sup> S.D. N.Y., 72 Civ. 2561.

<sup>32</sup> N.D. Ill., No. 69-C-1266.

<sup>33</sup> C.A. 7, No. 71-1817.

<sup>34</sup> S.D. N.Y., 71 Civ. 3384.

<sup>35</sup> In the *Matter of Sveden House of Texas, Inc., et al., Debtors*, S.D. Texas, No. 69-H-135 (consolidated).

<sup>36</sup> C.A. 2, No. 71-2167.

<sup>37</sup> CCH Fed. Sec. L. Rep. ¶ 93,088 (D. N.J., 1971).

<sup>38</sup> S.D. Texas, No. 69-H-135, reported previously in 37th Annual Report, p. 202.

<sup>39</sup> 463 F.2d 137 (C.A. 5, 1972).

<sup>40</sup> No. 307-71.

- <sup>41</sup> No. 72-1230 (C.A.D.C.).  
<sup>42</sup> D.D.C., No. 2544-71.  
<sup>43</sup> S.D. N.Y., No. 70-3286 (November 5, 1970).  
<sup>44</sup> C.A. 2, No. 71-1073.  
<sup>45</sup> C.D. Cal., No. 72-569-ALS.  
<sup>46</sup> D.C. Mass., No. 72-1080-M.  
<sup>47</sup> See 37th Annual Report, pp. 163-165.  
<sup>48</sup> S.D. N.Y., No. 71 Civ. 4932.  
<sup>49</sup> C.A. 2, No. 72-1782.  
<sup>50</sup> 300 F. Supp. 1033 (S.D. N.Y., 1969), *affirmed*, 430 F.2d 355 (C.A. 2, 1970), *reversed and remanded*, 404 U.S. 6 (1971). Previously reported in 37th Annual Report, p. 124.  
<sup>51</sup> 406 U.S. 128 (1972).  
<sup>52</sup> W.D. Okla., Civ. No. 72-152 (May 3, 1972).  
<sup>53</sup> C.A. 8, Nos. 71-1634, 71-1672.  
<sup>54</sup> *In the Matter of Naftalin & Co., Inc.*, 333 F. Supp. 136 (D. Minn., 1971).  
<sup>55</sup> 332 F. Supp. 544 (E.D. N.Y., 1971).  
<sup>56</sup> 193 F.2d 461 (C.A. 2, 1952) *certiorari denied*, 343 U.S. 956 (1952).  
<sup>57</sup> (Current Binder) CCH Fed. Sec. L. Rep. ¶ 93,552 (C.A. 9, June 28, 1972).  
<sup>58</sup> No. 71-2223 (C.A. 9).  
<sup>59</sup> No. 71-1587 (C.A. 8).  
<sup>60</sup> 453 F.2d 722 (C.A. 2, 1972).  
<sup>61</sup> In addition, five criminal contempt actions were referred or instituted by the Commission.  
<sup>62</sup> 453 F.2d 585 (C.A. 2, 1971), *certiorari denied*, U.S. Sup. Ct., Docket No. 71-1267 (May 22, 1972).  
<sup>63</sup> *U.S. v. Grant*, (Current Volume) CCH Fed. Sec.L.Rep., ¶ 93,502 (C.A. 2, May 25, 1972).  
<sup>64</sup> *U.S. v. Austin*, (Current Volume) CCH Fed. Sec. L. Rep., ¶ 93,539 (C.A. 10, June 26, 1972).  
<sup>65</sup> *U.S. v. Deutsch*, 451 F. 2d 98 (C.A. 2, 1971), *certiorari denied*, 404 U.S. 1019 (1972).  
<sup>66</sup> See Litigation Release No. 5307 (January 26, 1972).  
<sup>67</sup> See Litigation Release No. 5278 (January 5, 1972).  
<sup>68</sup> See Litigation Release No. 5230 (December 29, 1971).  
<sup>69</sup> See Litigation Release No. 5434 (June 20, 1972).  
<sup>70</sup> See 37th Annual Report, pp. 128-129.  
<sup>71</sup> See Litigation Release No. 5294 (January 18, 1972).  
<sup>72</sup> Securities Act Release No. 5184 (August 31, 1971).  
<sup>73</sup> Securities Act Release No. 5194 (September 22, 1971).  
<sup>74</sup> Securities Act Release No. 5202 (October 14, 1971).  
<sup>75</sup> Securities Act Release No. 5245 (April 19, 1972).



# **PART 5**

## **INVESTMENT COMPANIES AND ADVISERS**





# PART 5

## INVESTMENT COMPANIES AND ADVISERS

Under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, the Commission is charged with extensive regulatory and supervisory responsibilities over investment companies and investment advisers. Unlike the other federal securities laws which emphasize disclosure, the Investment Company Act provides a regulatory framework within which investment companies must operate. Among other things the Act: (1) prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval; (2) protects against management self-dealing, embezzlement or abuse of trust; (3) provides specific controls to eliminate or

mitigate inequitable capital structures; (4) requires that an investment company disclose its financial condition and investment policies; (5) provides that management contracts be submitted to shareholders for approval, and that provision be made for the safekeeping of assets; (6) prohibits underwriters, investment bankers, or brokers constituting more than a minority of an investment company's board of directors; and (7) sets controls to protect against unfair transactions between an investment company and its affiliates.

Persons advising others on their security transactions for compensation must register with the Commission under the Investment Advisers Act of

1940. This requirement was extended by the Investment Company Amendments Act of 1970 to include advisers to registered investment companies. The Adviser's Act, among other things, prohibits performance fee contracts which do not meet certain requirements; fraudulent, deceptive or manipulative practices; and advertising which does not meet certain restrictions.

The August, 1972, reorganization of the Commission for the first time placed responsibility for both investment companies and investment advisers in one Division, the Division of Investment Company Regulation. This union should enhance the ability of the Commission to oversee the activities of these important elements of the investment community and enable the Commission to deal comprehensively with problems involving the economics, distribution methods and services in the growing money management field complexes.

### **ECONOMIC, REGULATORY MATTERS**

Investment companies provide an important means for the pooling of the collective resources of individuals in the nation's capital markets. Investor confidence is vital to their success in attracting the savings of individuals, and the safeguards provided by the Investment Company Act contribute to sustaining such confidence.

A dramatic example of the importance of investor confidence is found in the continued acceleration of the internationalization of the capital markets. Because of the degree of investor confidence existent in this country, our securities markets have historically served as a magnet for foreign investors.

One of the vehicles created to meet this demand from foreign investors has been the establishment of offshore funds—investment companies created to trade in the United States securities markets, but which are domiciled in for-

eign countries in order to avoid regulation by the Commission and to achieve tax advantages. Because of their foreign domicile, these funds are not registered under the Act and generally operate free of regulation. In many cases, however, their sales practices have been too aggressive, and their disclosures inadequate. Moreover, the managers of these funds are generally not subject to restrictions against overreaching, on the extent of their compensation, or on their use of fund assets.

In response to this problem, the Commission on August 11, 1971, announced the formation of an Interagency Task Force, consisting of representatives of the Commission, Department of State, Department of Treasury and the Board of Governors of the Federal Reserve System in order to consider the possible development of a regulated vehicle which would still provide appropriate tax advantages for foreign residents. The Task Force has completed substantially all of its work, and it is expected that shortly the Commission and the Department of Treasury will propose legislation to the Congress which will extend the regulatory policies of the Act to at least some offshore funds.

Another business area where the Commission deems further regulation necessary for investor protection and to stimulate investor confidence is that of oil and gas programs. As discussed in Part 1 of this report, the Commission has submitted proposed legislation to the Congress designed to provide such regulation. Both the Commission and the oil and gas drilling industry recognized that increasing national demands for energy require large amounts of capital for exploration and that such capital may be more difficult to raise if in addition to the risk of a drilling venture investors must also bear the risk of being treated unfairly. The proposed legislation took the Investment Company Act as its model.

## Mutual Fund Distribution

Since the adoption of the Investment Company Act, perhaps no facet of open-end investment company activity has received greater attention than the distribution process for the shares of such companies. The past year was no exception. The Commission's concern over the cost to investors of participating in mutual funds and over regulatory problems associated with the distribution system was manifested in a number of areas.

It has been a widespread practice to use fund brokerage commissions to reward broker-dealers for sales of fund shares. This practice, however, creates a myriad of economic and regulatory problems. Among other things, there is a danger that a retailer of fund shares will base his recommendations not on a customer's needs but rather on the relative amounts of brokerage he can expect from different funds. In addition, the need of a mutual fund to allocate brokerage as a reward for sales of its shares can create pressures for unnecessary portfolio transactions. And the practice of allocation can have serious anti-competitive effects in that larger funds have more brokerage available for compensation to fund sellers.

To correct these problems and potential for abuse, the Commission, in its Statement on the Future Structure of the Securities Markets, concluded that the practice of using brokerage from the portfolio transactions of mutual funds to reward broker-dealers for sales of fund shares must be terminated. Subsequently, the National Association of Securities Dealers proposed an amendment to its Rules of Fair Practice which would bar the reciprocal practice of giving or receiving portfolio brokerage business as an inducement to or reward for the sale of fund shares.

The elimination of the cloud caused by reciprocity will better enable the Commission to determine the conse-

quences of a repeal of the "retail price maintenance" provision of Section 22(d) of the Act.

Section 22(d) precludes the sale to public investors of redeemable investment company securities which are being currently offered to the public by or through an underwriter except at a current public offering price described in the prospectus. The Committee on Banking and Currency of the United States Senate had requested in 1969 that the Commission review the potential consequences of repeal of the section and report its findings to the Committee. The Commission's staff has been engaged in a study of the potential economic impact of the repeal of Section 22(d) on the funds themselves, principal underwriters, retail sales organizations and their salesmen, the investing public and the stock market. The staff report is expected to be submitted to Congress early in fiscal 1973.

The recent liberalization of the Commission's mutual fund advertising rules<sup>1</sup> may also have an impact on the distribution process. Rule 134 under the Securities Act was amended to permit the expansion of mutual fund "tombstone advertisements" to include a general description of an investment company, its attributes, method of operation and services. Rule 434A under the Securities Act was also amended to permit mutual funds for the first time to use an abbreviated form of prospectus containing all of the basic information contained in the full prospectus, but omitting some of the detailed information. Although this summary prospectus may not be used in lieu of the statutory prospectus with sales literature, it can be used alone as a newspaper advertisement or mailer prior to the delivery of the full prospectus. The Commission adopted a new Rule 135A under the Securities Act governing generic advertising of mutual funds. It provides that generic advertisements may contain general explanatory

information about mutual fund shares, the nature of investment companies and services offered by mutual funds. Most importantly, in contrast with past interpretations of the Securities Act which effectively limited the use of generic advertising to those securities dealers who made available a wide range of mutual funds, under the new rule such advertising may be used by any mutual fund underwriter or adviser. Thus, those members of the securities industry who have the greatest interest in communicating the mutual fund concept to the public now have the opportunity to do so.

The Commission views the changes made so far as only a modest step in liberalizing mutual fund advertising rules, and has invited interested persons to submit additional rule proposals.

The need to develop new markets for fund shares is a product of increased competition for investors' savings. One means adopted by certain funds to attract investors has been to reduce or eliminate the sales load previously imposed on sales of their shares.

Finally, it can be reasonably expected that one consequence of the Commission's opinion in *United Funds, Inc.*<sup>2</sup> will be a reduction in costs to some shareholders of investment companies. In that case, the Commission granted an exemption from Section 22(d) of the Act to permit shareholders of United Funds and certain other open-end investment companies who redeem their shares to use the redemption proceeds to repurchase shares within 15 days without the payment of an additional sales load. The companies and their underwriter requested the exemption on the basis that it had been their experience that a substantial number of shareholders redeemed their shares without being aware that they could borrow money on the security of those shares or could exchange shares of one

of the funds for those of another fund without paying a sales load.

The Commission held that it would be equitable to permit shareholders who had mistakenly redeemed shares to correct their mistakes without paying another sales load. By the end of the fiscal year a number of other investment companies had applied for a similar exemption.

## NUMBER OF REGISTRANTS

As of June 30, 1972, there were 1,334 investment companies registered under the Act, with assets having an aggregate market value of nearly \$81 billion. Compared with corresponding totals at June 30, 1971, these figures represent a decline of 17 in the number of registered companies but an increase in the market value of assets of nearly \$3 billion, for another new high since the Act was passed. At June 30, 1972, 3,811 investment advisers were registered with the Commission, representing an increase of 326 over a year before and a new record total. Further data is presented in the statistical section of the report.

During the fiscal year, the staff of the Commission conducted 106 investment company inspections and 148 investment adviser inspections, representing increases of 10 percent and 22 percent, respectively, over the prior fiscal year.

## SPECIALIZED INVESTMENT COMPANIES

A number of registration statements processed by the Division during the fiscal year indicated the continuing interest of other financial institutions in the investment company vehicle and the development of specialized objectives and investment methods as a means of competing for investors' interest.

Following the Supreme Court's decision in *Investment Company Institute v. Camp*,<sup>3</sup> which held that the operation of a mutual fund by a national bank is

prohibited by the Glass-Steagall Act, First National City Bank (Citibank) deregistered its Commingled Investment Account. However, in January 1972, the Federal Reserve Board amended its regulations to permit bank holding companies and their subsidiaries to act as investment advisers to registered investment companies, subject to certain limitations. Under this amendment, Citibank, a wholly-owned subsidiary of First National City Corporation, has become the investment adviser to Advance Investors Corporation, a closed-end investment company. Although it is a closed-end investment company (i.e., its shareholders do not have the right to have the company redeem their shares), Advance may make purchases of its shares from time to time in market transactions as it deems advisable and has the right to borrow amounts up to an aggregate of 20 percent of its net assets for this purpose.

Similarly, Independence Income Securities Company, Inc., a closed-end investment company, entered into an investment advisory arrangement whereby Providence National Bank, acting through its Trust Division, acts as investment adviser for the company and performs all administrative functions for it. The Commission's staff was advised by the Federal Reserve Board and the Comptroller of the Currency that they considered this arrangement permissible under the banking laws notwithstanding the Supreme Court decision referred to above.

The Dreyfus Third Century Fund, Inc., whose registration became effective during the fiscal year, invests in companies which, "in the opinion of the Fund's Management, not only meet traditional investment standards, but also show evidence in the conduct of their business, relative to other companies in the same industry or industries, of contributing to the enhancement of the quality of life in America as this nation approaches the Third Century of its existence." The

factors which the Fund considers in making its investment decisions include performance in the areas of environment, occupational health and safety, consumer protection and product purity, and equal employment opportunity.

Minbanc Capital Corp., a closed-end non-diversified management investment company, was created at the instance of the Urban and Community Affairs Committee of the American Bankers Association for the purpose of making capital funds available to qualifying minority-owned banks. During the fiscal year, it registered shares for an offering to banks which are members of the Association. According to Minbanc's prospectus, funds may be made available to any bank "at least 50 percent of whose voting securities are owned, or which is managed, by individuals from minority groups in the United States which are under-represented in its free enterprise system, and which has an operating history of three years or more."

The Bache-Huntoon Paige Ginny Mae Fund, Series 1, will sell units of beneficial interest in a fund composed of "mortgage-backed securities" guaranteed as to payment of principal and interest by the Government National Mortgage Association (Ginny Mae). Mortgage-backed securities are issued against a pool of VA and FHA mortgages which have been collected by mortgage bankers or other similar institutions. The pooling arrangement permits such institutions to obtain a Ginny Mae guarantee prior to the issuance of the securities. The Fund is an open-end diversified investment company designed to seek high income.

First Real Property Securities Fund, Inc. will invest primarily in securities of entities engaged in various real estate activities. The Fund expects that a substantial portion of its assets will be invested in companies in the formative stages of their development which will have no public market for their securi-

ties. These portfolio companies generally will be formed by developers who will supervise construction on and management of real estate properties. Because information about the portfolio companies will generally not be available from other sources, the Fund will supply shareholders with such information in its periodic reports.

## APPLICATIONS

One of the Commission's principal activities in its regulation of investment companies is the consideration of applications for exemptions from various provisions of the Act or for certain other relief. Applications may also seek determinations of the status of persons or companies under the Act. During the fiscal year, 326 applications were filed and final action was taken on 406 applications. As of the end of the year, 141 applications were pending.

An investor in a periodic payment plan for the gradual acquisition of the shares of a registered investment company may change his investment objectives before he has completed the plan. First Investors Corporation applied for permission to enable an investor in a Plan sponsored by it for the acquisition of the shares of Wellington Fund, to exchange his Plan for another, also sponsored by First Investors, to acquire shares of First Investors Fund for Growth without losing credit for the "front-end" load already paid. The Commission approved the proposed exchange offer and granted an exemption from the retail price maintenance provision of the Act to permit credit to be given for past payments on Wellington Fund Plans when determining the sales charge to which future payments on Fund for Growth Plans would be subject.<sup>4</sup>

Under the Act, an affiliate of a registered investment company, such as its investment adviser, cannot participate in a joint arrangement with the investment company absent Commission ap-

proval. Massachusetts Mutual Life Insurance Company, which proposed to sponsor and act as adviser of Mass-Mutual Corporate Investors, Inc. (Fund), a closed-end investment company, applied with the Fund for approval of an arrangement whereby the insurance company would invest concurrently for its general account in each issue of securities purchased by the Fund at direct placement an amount equal to that invested by the Fund, and would exercise warrants, conversion privileges and other rights at the same time and in the same amount. In support of the application, it was represented that the insurance company had a nationally recognized position as a source of capital funds and as a purchaser of investment securities to be issued at private placement and as a result attracted issuers in all parts of the country and engaged in a wide variety of Enterprises. These investment opportunities were to be made available to the Fund under the proposed arrangement. The Commission, finding that the Fund's participation in the proposed arrangement would not be less advantageous than that of the insurance company, gave its approval, subject to certain safeguards which the applicants had proposed.<sup>5</sup>

In *First Multifund of America, Inc.*,<sup>6</sup> the applicants sought a declaratory order that it would be lawful for members of the NASD who are underwriters of the shares of mutual funds to grant concessions to other members of the NASD who act as brokers for purchasers of such shares, not excluding brokers who are affiliated persons of such purchasers. The Commission determined that where an investment company's adviser, which is also a registered broker-dealer, effects purchases for the company's portfolio of shares of other investment companies on which the adviser receives concessions from the underwriters of the selling companies, the adviser acts as a "broker" for the affiliated investment company even though

the selling agreements between it and the underwriters of the selling companies characterize it as a "dealer", and as such is entitled to receive and retain concessions which do not exceed 1 per cent of the purchase price.

## RULES AND GUIDELINES

Continued implementation of the Investment Company Amendments Act of 1970 as well as the normal continuing review of rules in light of changing conditions and administrative experience resulted in the revision of various rules under the Investment Company and Investment Advisers Acts during the fiscal year.

### Performance Fees

Prior to the 1970 amendments of Section 205 of the Advisers Act, compensation arrangements between investment companies and their advisers based on portfolio performance were often unfair to the companies and their shareholders. Many such fees were not symmetrical, in that they did not decrease where performance was poor or, if they did, decreases were disproportionate to increases for good performance. The 1970 amendments to Section 205 were designed to align, as nearly as possible, the interests of the adviser and the investment company by correcting imbalances in incentive fee arrangements.

These amendments prohibit all performance fees unless compensation increases and decreases proportionately with investment performance of the company over a specified period in relation to the investment record of an appropriate index of securities prices. The point from which increases and decreases in compensation are measured must be the fee which is paid or earned when the investment performance of the company is equivalent to that of the index.

During the fiscal year, the Commission published for comment a proposed

Rule 205-1 under the Advisers Act. The rule, in modified form, was adopted in August, 1972.<sup>7</sup> The rule is designed to assure that "investment performance" of an investment company is computed on the same basis as the "investment record" of an index, so as to make the two comparable. It requires that all increments—distributions of realized capital gains and dividends paid out of investment income, the value of capital gains taxes paid or payable on undistributed realized capital gains, and all cash distributions of the companies whose stock comprises the index—be treated as reinvested when computing both "investment performance" and "investment record."

### Series Companies

Another rule published for comment in fiscal year 1972 and thereafter adopted in modified form is Rule 18f-2 under the Investment Company Act.<sup>8</sup> Implementing an amendment contained in the Investment Company Amendments Act of 1970, the rule is designed to insure fair and equitable treatment of shareholders of investment companies of the series type.<sup>9</sup> The rule requires series investment companies, as a requisite for taking action on a matter requiring shareholder authorization, to obtain the approval of each individual class or series of its stock which would be affected by such matter. Certain matters, such as those in which the interests of the series are substantially identical, are exempted from the separate voting requirements. The rule also has special provisions concerning investment advisory contracts and investment policies which give individualized treatment to separate series.

### Capital Gains Distribution

In its report to Congress proposing amendments to the Investment Company Act, the Commission proposed an amendment to limit capital gains distributions of registered investment compa-



nies to not more than once a year. It stated that such a prohibition would relieve managers from pressure to realize gains on a frequent and regular basis, mitigate improper sales practices related to such distributions and eliminate the administrative expenses attending quarterly or semiannual capital gains distributions.

As a result of the Commission's recommendation, Section 19(b) was added to the Act as part of the 1970 Amendments to give the Commission rulemaking power with respect to distributions of long-term capital gains. The Commission implemented this provision by adopting Rule 19b-1 which limits registered investment companies to a single distribution of long-term capital gains during any one taxable year, with a limited exception, based on tax considerations, for additional distributions under certain circumstances for companies qualifying as regulated investment companies under Subchapter M of the Internal Revenue Code.<sup>10</sup>

### **Combined Orders**

In view of the possibility that a registered investment company could, by combining its orders for the purchase or sale of securities with the orders of other persons, secure the benefits of volume discounts, negotiated commission rates, and advantageous block transactions, the Commission announced that it was considering an amendment to Rule 17d-1 under the Investment Company Act which now prohibits such combination without Commission authorization to the extent it involves orders of a registered investment company and those of a related person.<sup>11</sup> The amendment would permit such combined orders for the sole purpose of execution in order to achieve the best overall execution, provided the arrangement is likely to produce a benefit for the investment company. The proposed rule would require that the net unit price paid for securities pur-

chased, or received for securities sold, be the same for each person whose order is so combined, and that the securities purchased or sold be allocated among all participants in proportion to their respective orders.

### **Fidelity Bonds**

The Commission also announced a proposal to amend Rule 17g-1 under the Investment Company Act pertaining to fidelity bonds required of investment company officers and employees with access to the company's securities or funds.<sup>12</sup> The proposed rule would set forth, for the first time, minimum required amounts of coverage, based on the amount of the company's assets.

### **Adjournment of Shareholder Meetings**

The Commission also has under consideration the adoption of Rule 20a-4 under the Investment Company Act.<sup>13</sup> The proposed rule provides that no meeting of shareholders of any registered investment company relating to a proposal requiring shareholder approval shall be adjourned if a quorum is present at such meeting, in person or by proxy, under state or applicable law or corporate charter or other instrument pursuant to such law. The rule is designed to prohibit the practice of repeated adjournments of such meetings notwithstanding the presence of a quorum, in an effort to gain sufficient additional votes to carry certain proposals. However, the rule is not intended to preclude adjournment and additional solicitations in unusual situations, such as where a material factual change has rendered proxy soliciting material misleading.

### **Small Business Investment Companies**

Rules 3c-3 and 18c-2 under the Investment Company Act were adopted by

the Commission to enable small business investment companies licensed under the Small Business Investment Act of 1958 to issue debentures guaranteed by the Small Business Administration without violating certain provisions of the Act.<sup>14</sup> Rule 3c-3 provides, among other things, that the term "public offering" as used in Section 3(c)(1) is not deemed to include offers and sales of SBA-guaranteed debentures. Rule 18c-2 exempts such securities, under certain conditions, from the provisions of Section 18(c) which otherwise prohibits a closed-end investment company from issuing more than one class of senior debt security.

### Registration Guides

On June 9, 1972, the Commission published definitive staff guidelines for the preparation and filing of registration statements under the Investment Company Act by investment companies.<sup>15</sup> These guidelines set forth the policies and practices followed by the staff in its examination of those statements. They cover such areas as the issuance of senior securities, the concentration of investments in particular industries and indemnification of directors and officers.

### NOTES FOR PART 5

<sup>1</sup> Securities Act Release No. 5248 (May 9, 1972).

<sup>2</sup> Investment Company Act Release No. 7189 (May 25, 1972).

<sup>3</sup> 401 U.S. 617 (1971). See 37th Annual Report, p. 156.

<sup>4</sup> Investment Company Act Release No. 6803 (November 2, 1971).

<sup>5</sup> Investment Company Act Release No. 6690 (August 19, 1971).

<sup>6</sup> Investment Company Act Release No. 6700 (August 26, 1971).

<sup>7</sup> Investment Advisers Act Release No. 327 (August 8, 1972).

<sup>8</sup> Investment Company Act Release No. 7276 (August 8, 1972).

<sup>9</sup> Series companies are open-end investment companies which issue classes or series of preferred or special stock each of which is preferred over all other classes or series in respect of assets specifically allocated to that class or series. For all practical purposes, individual series of a series company are separate investment companies.

<sup>10</sup> Investment Company Act Release No. 6834 (November 23, 1971).

<sup>11</sup> Investment Company Act Release No. 7035 (March 9, 1972).

<sup>12</sup> Investment Company Act Release No. 7107 (April 5, 1972).

<sup>13</sup> Investment Company Act Release No. 7087 (March 31, 1972).

<sup>14</sup> Investment Company Act Release No. 7127 (April 17, 1972).

<sup>15</sup> Investment Company Act Release No. 7221.



# **PART 6**

## **PUBLIC-UTILITY HOLDING COMPANIES**



# **PART 6**

## **PUBLIC-UTILITY HOLDING COMPANIES**

Under the Public Utility Holding Company Act of 1935, the Commission regulates interstate public-utility holding-company systems engaged in the electric utility business and/or retail distribution of gas. The Commission's jurisdiction also covers natural gas pipeline companies and other non-utility companies which are subsidiary companies of registered holding companies. There are three principal areas of regulation under the Act: (1) physical integration of public-utility companies and functionally related properties of holding-company systems, and simplification of intercorporate relationships and financial structures of such systems; (2) financing operations of registered hold-

ing companies and their subsidiary companies, acquisition and disposition of securities and properties, as well as certain accounting practices, servicing arrangements, and intercompany transactions; (3) exemptive provisions, provisions relating to the status under the Act of persons and companies, and provisions regulating the right of persons affiliated with a public-utility company to become affiliated with another such company through acquisition of securities.

### **COMPOSITION**

At fiscal year-end, there were 23 holding companies registered under the Act. Twenty were included in the 17

"active" registered holding-company systems.<sup>1</sup> The remaining three registered holding companies, which are relatively small, are not considered part of "active" systems.<sup>2</sup> In the 17 active systems, there were 91 electric and/or gas utility subsidiaries, 57 nonutility subsidiaries, and 16 inactive companies, or a total, including the parent holding companies and the subholding companies, of 184 system companies. The table on page 171 lists the active systems and their aggregate assets.

### PROCEEDINGS

*Delmarva Power & Light Company.*<sup>3</sup> The Commission instituted a proceeding under Section 11(b)(1) of the Act, which requires the Commission to limit operations of each registered holding company system to a single integrated electric or gas utility system. Retention of one or more additional integrated electric or gas utility systems is permitted only upon showing compliance with standards contained in that section. Delmarva, which operates both electric and retail gas distribution systems in Delaware and has electric utility subsidiary companies operating in two other states, has asserted that its properties are retainable under the standards of the Act and that its principal integrated public-utility operation is its electric system. Hearings began in September 1972.

*New England Electric System.*<sup>4</sup> This proceeding involves the proposed creation of a new holding company system to include Boston Edison Company and two registered holding companies, New England Electric System and Eastern Utilities Associates. Briefs were filed with the hearing officer during the fiscal year. After fiscal year-end, the hearing officer filed an initial decision approving the proposal, conditioned upon the granting of access to future major generating facilities of the proposed system to all utilities, cooperatives, and municipalities in the area, together with trans-

mission arrangements. The Department of Justice, the Massachusetts Municipal Electric Association and the Division of Corporate Regulation oppose the proposed affiliation and filed petitions for review of the initial decision with the Commission. Their petitions, and a petition filed by the applicants, were granted by the Commission on September 15, 1972.

*American Electric Power Company, Inc.*<sup>5</sup> This proceeding involves the proposed acquisition by American Electric Power of the common stock of Columbus and Southern Ohio Electric Company, a nonassociate electric utility company, in exchange for AEP's stock. Hearings were concluded during the fiscal year. Shortly thereafter, AEP submitted a settlement proposal conditioned on Commission approval of the proposed acquisition. The proposal provided in part that AEP would offer to sell certain generating units to Ohio municipalities distributing power to consumers. The Commission determined to defer consideration of AEP's proposals until it could consider the evidence after the hearing officer had submitted an initial decision. The Division of Corporate Regulation and the Department of Justice filed briefs with the hearing officer opposing the proposed acquisition, urging (among other things) that it would have anti-competitive effects, contrary to the standards of the Act.

*Louisiana Power & Light Company.*<sup>6</sup> The court of appeals affirmed the Commission's decision authorizing Louisiana Power and Light, an electric utility subsidiary company of Middle South Utilities, Inc., to issue and sell certain securities in connection with the financing of its construction program.<sup>7</sup> The cities of Lafayette and Plaquemine, La., which sought intervention in the proceedings before the Commission, alleged that certain unrelated activities of the applicant were in violation of the Federal antitrust laws.

*Middle South Utilities, Inc.*<sup>8</sup> In a re-

lated proceeding, the Commission had rejected intervention and a request for reopening the hearing (filed 15 months after its close) by the same two cities. It approved the acquisition by Middle South of the common and preferred stocks of Arkansas-Missouri Power Company, an unaffiliated company. The Commission conditioned its approval upon Middle South's filing a plan under Section 11(e) of the Act to eliminate any resulting minority interest<sup>9</sup> and upon the divestment of the gas utility and ice business of Arkansas-Missouri.<sup>10</sup> The cities filed petitions for review of the Commission decision. At the end of the fiscal year the matter was under advisement by the court of appeals.<sup>11</sup>

*Union Electric Company.*<sup>12</sup> Union, an exempt holding company and an electric and gas utility company, applied to acquire (through an invitation for tenders) the outstanding shares of common stock of Missouri Utilities Company, a nonassociate electric and gas utility company. Hearings were concluded during the fiscal year and briefs were filed with the hearing officer. The Division of Corporate Regulation opposed the application. The Division urged, among other things, that the proposed exchange offer is not reasonable; that the expansion of a combined electric and gas utility system is contrary to the Act; and that Union has failed to make the requisite showing of economies and efficiencies to result from the proposed acquisition. The Division also opposed granting a requested exemption to Union under Section 3(a)(2), except upon the conditions that (1) the gas properties of Union and its subsidiary companies, and (2) the gas and water properties of Missouri Utilities be divested.

Two proceedings pending before the Commission for decision at year-end present the question of whether a holding company, whose utility operations are intrastate but which diversifies into unrelated non-utility activities, is entitled to an intrastate exemption. The Di-

vision has taken the position that such activities are detrimental to public, investor and consumer interests, and that therefore their retention precludes the grant or continuation of the exemption. In one of the cases, an application for exemption was filed by *National Utilities & Industries Corp.*, whose utility subsidiary company, Elizabethtown Gas Company, distributes natural gas at retail in New Jersey.<sup>13</sup> In *Pacific Lighting Corporation*, proceedings were instituted by the Commission to determine whether an exemption granted to Pacific in 1936 should be revoked or modified because of Pacific's diversification into non-utility ventures unrelated to the operations of its utility subsidiary company, Southern California Gas Company.<sup>14</sup>

## FINANCING

During fiscal 1972, a total of 16 active registered holding-company systems issued and sold 67 issues of long-term debt and capital stock for cash, aggregating \$2.79 billion<sup>15</sup> pursuant to authorizations granted by the Commission under Sections 6 and 7 of the Act. All of these issues were sold at competitive bidding to raise new capital. The public utility financing table in the statistical section presents the amount and types of securities issued and sold by these holding company systems.

The volume of external financing during fiscal 1972 set a new record, representing an increase of 13 percent over fiscal 1971, the previous record year. Preferred stock and common stock issued and sold increased by 101 percent and 24 percent respectively, while the amount of debentures issued and sold in fiscal 1972 decreased by 77 percent from fiscal 1971.

This unprecedented volume of financing was accompanied by further deterioration in the earnings coverages of interest and preferred dividends. For the calendar year 1971, the 17 active registered holding-company systems earned



their interest and preferred dividend requirements an average of 2.04 times (after taxes) as compared to 2.19 times in 1970 and 2.93 times in 1966.

## LEGISLATION

During the fiscal year, a bill (S. 1991, 92nd Cong.) which would amend the Act to grant authority to the Commission to permit companies subject to the Act to invest limited amounts in low and moderate cost housing projects under programs subject to certain federal housing statutes was reported favorably by the Senate Committee on Commerce. On July 21, 1972, the Senate passed an amended version of S. 1991. An identical bill was introduced in the House (H.R. 6711), but no committee report has been issued. This legislation was an outgrowth of a Commission decision<sup>16</sup> holding that such investments were not permissible under the Act in its present form.

## NOTES FOR PART 6

<sup>1</sup> Three of the 20 were subholding utility companies in these systems. They are The Potomac Edison Company and Monongahela Power Company, public-utility subsidiary companies of Allegheny Power System, Inc., and Southwestern Electric Power Company, a public-utility subsidiary company of Central and South West Corporation.

<sup>2</sup> These holding companies are British American Utilities Corporation; Kinzua Oil & Gas Corporation and its subsidiary

company, Northwestern Pennsylvania Gas Corporation; and Standard Gas & Electric Company, which has been dissolved and its assets distributed.

<sup>3</sup> Holding Company Act Release No. 17530 (April 5, 1972).

<sup>4</sup> Previously reported in 37th Annual Report, p. 170; 36th Annual Report, p. 160; 35th Annual Report, p. 149; 34th Annual Report, p. 138.

<sup>5</sup> Previously reported in 37th Annual Report, p. 168; 36th Annual Report, p. 160; 35th Annual Report, p. 148; 34th Annual Report, p. 138.

<sup>6</sup> Previously reported in 37th Annual Report, p. 170.

<sup>7</sup> *Cities of Lafayette and Plaquemine, Louisiana v. SEC*, 454, F. 2d 941 (C.A.D.C., 1971).

<sup>8</sup> Previously reported in 37th Annual Report, p. 171.

<sup>9</sup> The plan was approved by the Commission (Holding Company Act Release No. 17446, February 1, 1972) and enforced by the U.S. District Court for the District of Missouri by order dated April 28, 1972 (Civ. Action No. 72C-199(2)).

<sup>10</sup> The Commission subsequently granted an extension of time within which to complete such divestment (Holding Company Act Release No. 17631, June 27, 1972).

<sup>11</sup> *Cities of Lafayette and Plaquemine, Louisiana v. SEC*, C.A.D.C., No. 71-1337.

<sup>12</sup> Previously reported in 37th Annual Report, pp. 172-73.

<sup>13</sup> Previously reported in 37th Annual Report, p. 172.

<sup>14</sup> Holding Company Act Release No. 17217 (August 3, 1971).

<sup>15</sup> Debt securities are computed at their price to company, preferred stock at the offering price, and common stock at the offering or subscription price.

<sup>16</sup> *Michigan Consolidated Gas Company*, Holding Company Act Release No. 16763 (June 22, 1970), *aff'd* 444 F. 2d 913 (C.A.D.C., 1971).

**PART 7**  
**CORPORATE**  
**REORGANIZATIONS**



# PART 7

## CORPORATE REORGANIZATIONS

The Commission's role under Chapter X of the Bankruptcy Act, which provides a procedure for reorganizing corporations in the United States district courts, differs from that under the various other statutes which it administers. The Commission does not initiate Chapter X proceedings or hold its own hearings, and it has no authority to determine any of the issues in such proceedings. The Commission participates in proceedings under Chapter X to provide independent, expert assistance to the courts, participants, and investors in a highly complex area of corporate law and finance. It pays special attention to the interests of public

security holders who may not otherwise be represented effectively.

Where the scheduled indebtedness of a debtor corporation exceeds \$3 million, Section 172 of Chapter X requires the judge, before approving any plan of reorganization, to submit it to the Commission for its examination and report. If the indebtedness does not exceed \$3 million, the judge may, if he deems it advisable to do so, submit the plan to the Commission before deciding whether to approve it. When the Commission files a report, copies or summaries must be sent to all security holders and creditors when they are asked to vote on the plan. The Commission has

no authority to veto a plan of reorganization or to require its adoption.

The Commission has not considered it necessary or appropriate to participate in every Chapter X case. Apart from the excessive administrative burden, many of the cases involve only trade or bank creditors and few public investors. The Commission seeks to participate principally in those proceedings in which a substantial public investor interest is involved. However, the Commission may also participate because an unfair plan has been or is about to be proposed, public security holders are not represented adequately, the reorganization proceedings are being conducted in violation of important provisions of the Act, the facts indicate that the Commission can perform a useful service, or the judge requests the Commission's participation.

The Commission in its Chapter X activities has divided the country into five geographic areas. The New York, Chicago and Seattle regional offices and the San Francisco branch office of the Commission each have responsibility for one of these areas. Supervision and review of the regional and branch offices' Chapter X work is the responsibility of the Division of Corporate Regulation of the Commission, which, through its Branch of Reorganization, also serves as a field office for the southeastern United States.

## SUMMARY OF ACTIVITIES

In fiscal 1972, the Commission entered 12 new Chapter X proceedings involving companies with aggregate stated assets of approximately \$234.9 million and aggregate indebtedness of approximately \$119.4 million.

Including the new proceedings, the Commission was a party in a total of 113 reorganization proceedings during the year.<sup>1</sup> The stated assets of the companies involved in these proceedings totaled approximately \$1.5 billion and their indebtedness about \$1.2 billion.

During the year, 14 proceedings were closed, leaving 99 proceedings in which the Commission was a party at fiscal year-end.

## ADMINISTRATIVE MATTERS

In Chapter X proceedings, the Commission seeks to have the courts apply the procedural and substantive safeguards to which all parties are entitled. The Commission also attempts to secure judicial uniformity in the construction of Chapter X and the procedures thereunder.

*King Resources Company.*<sup>2</sup> An involuntary petition was filed in the district court in Dallas. The petition was approved and a trustee appointed. The Commission joined in a motion to transfer the proceedings to Denver, the location of the debtor's principal office. This motion was made by the indenture trustees for \$39.5 million of outstanding debentures, and by banks holding \$13 million of notes. The Commission pointed out that neither the debtor's office nor any significant part of the assets were located in the Northern District of Texas and that Denver was the most convenient forum.

The transfer was recommended by the special master and was ordered by the district judge. The case is now proceeding in the district court in Denver.<sup>3</sup> In a pending appeal,<sup>4</sup> petitioning creditors are urging that the judge did not afford them an opportunity to file exceptions to the special master's recommendations pursuant to Rule 53 of the Federal Rules. The Commission filed a brief supporting the transfer, urging that the order conformed to the standard practice in the Texas district court, that it did not prejudice appellants' appeal, and that the departure from Rule 53 was permitted by the General Order 37.

*Waltham Industries Corporation.*<sup>5</sup> The Debtor moved its corporate offices from New York City to Los Angeles, and filed a voluntary Chapter X proceeding in

Los Angeles about two months later. The Commission supported objections to the venue by a major shareholder and by substantial eastern creditors. The debtor had its operating division in Massachusetts; nine of its 12 subsidiaries were located in the northeastern United States; and the one California subsidiary had ceased operations. Most of the creditors were in the northeast, and only one employee had moved to California when the offices had been moved there.

The district judge overruled the objections. An appeal was taken by a creditor,<sup>6</sup> and in the meantime the administration progressed in the California court. The appeal was subsequently dismissed by stipulation.

*Dextra Corporation.*<sup>7</sup> The debtor amended its Chapter XI petition to transfer the proceedings to Chapter X when it was unable to work out by agreement its problems with secured creditors. The special master found that the debtor's petition was not filed in "good faith" within the meaning of Section 146(3) since no reorganization under Chapter X was possible. Objections to the special master's report were overruled by the district judge who dismissed the Chapter X petition.

Transfer to Chapter X pursuant to Section 328 merely decides that no adequate relief is available in Chapter XI. The amended Chapter X petition must also satisfy the "good faith" provision of Section 146(3). This determination is made when the amended Chapter X petition is presented to the district judge for approval.<sup>8</sup>

*Viatron Computer Systems Corp.*<sup>9</sup> Trade creditors opposed the trustee's petition to include trade creditors and the public holders of the debtor's debentures in the same class. They urged separate classification on the grounds that their interests were different and that classification immediately after approval of a Chapter X petition, before

any plan was contemplated, was premature.

The district court granted the trustee's petition and the trade creditors appealed. The court of appeals, as urged by the Commission, affirmed. In a *per curiam* opinion, the court, assuming that the district court's order was appealable, stated that appellants' contentions were "unimpressive."<sup>10</sup>

*Landmark Inns of Durham, Inc.*<sup>11</sup> The court of appeals affirmed the refusal of the reorganization court to permit the ground lessor to forfeit the lease and take possession of a motel constructed by the debtor, at a cost of \$1.5 million, on land leased for a 52-year term.<sup>12</sup> Although the lease expressly provided for termination on the passage of any interest to a trustee or receiver in bankruptcy, the court held that such termination would be highly unconscionable and inequitable and "a demand for blood" and that as a court of equity the bankruptcy court had the discretion to refuse enforcement of the forfeiture. A petition for certiorari was denied by the Supreme Court.

*Bubble Up Delaware, Inc., et al.*<sup>13</sup> The trustee proposed to sell outside of a plan substantially all of the debtor's properties to a third party. The trustee relied on Section 116(3) as authority for such sale.<sup>14</sup> At the hearing on the proposed sale, another potential purchaser of the assets appeared and bid against the purchaser selected by the trustee. In accordance with the Commission's recommendation, the court instructed the parties to submit proposed plans of sale to the trustee, so that the sale would be made through a plan, which requires a vote of security holders affected hereby.

A sale of substantially all of the debtor's assets pursuant to Section 116(3) must lead to the liquidation of the debtor without a vote by security holders. This, in the Commission's view, should be authorized only in exceptional

circumstances. No such circumstances existed in this proceeding.

*Beck Industries, Inc.*<sup>15</sup> The debtor was engaged in the manufacture, importation and retail sale of shoes and related products. It conducted part of its business through 82 subsidiaries. The Commission did not object to sale of some major retail outlets since it appeared that the sale would eliminate a significant part of the debtor's operating and financial difficulties. The terms were satisfactory, and the viability of the retained operations would not be impaired.

*King Resources Company.* After the case had been transferred to Denver, as discussed *supra*, the Denver trustee secured authority to borrow \$3 million on trustee's certificates. On appeal, in view of the critical necessity for the borrowings, the case was placed on the summary calendar and, after argument, the court of appeals affirmed the district court's order.<sup>16</sup>

Among the highly publicized assets of the debtor were oil and gas exploration permits covering 35 million acres of public lands in the Canadian Arctic. These permits imposed obligations to perform exploratory work involving up to \$16 million in costs. The debtor had sold fractional interests in this property, subject to the obligation to contribute to those costs, and then entered into a contract whereby a Canadian subsidiary of a domestic major oil company, which acquired a fractional interest, was to perform the exploratory work. The debtor undertook to pay 60 percent of the cost, and forfeit its interest if it failed to pay within 30 days after notice.

The debtor fell into arrears, due partly to the refusal of the co-owners to contribute, and had been served with the 30-day notice just before the petition was filed. The Texas court had enjoined enforcement of the forfeiture, and the domestic oil company moved to vacate the injunction on the grounds that (a) the properties were located in

Canada; and (b) the contract in question was with a Canadian company, which was not subject to personal jurisdiction of the Federal courts.

The Commission supported the jurisdiction of the reorganization court, pointing out that Chapter X of the Bankruptcy Act conferred exclusive jurisdiction over the debtor's property, wherever located. It also urged that, since the court had personal jurisdiction over the domestic parent company, the court, by injunction against this company, could prevent a forfeiture through a foreign subsidiary under its control.

The district court in Denver declined to vacate the injunction. It did authorize movants to reapply for relief on the merits if the trustee should be unable or unwilling to make equitable provision for performance of the debtor's contractual obligations. A notice of appeal has been filed from this ruling, but further proceedings have been deferred because of pending negotiations. The trustee has applied for appropriate relief against the co-owners who have failed to meet their obligations.

In the same case, the Commission objected to the retention of the trustee appointed by the Texas court on the grounds that the law firm of which he had been a member had represented the debtor in certain legal matters within two years prior to the proceeding and hence was not disinterested under Section 158(3) of Chapter X. It also objected to the appointment of the debtor's chairman of the board as additional trustee because of questions as to his possible liability for alleged mismanagement of the debtor. These objections were mooted by the transfer of the proceedings to Denver and the resignation of the Texas appointees.

The Commission also objected to the retention of the counsel appointed for the trustee in Denver because his law firm had also represented the debtor within the two-year period, although concededly in a very minor and routine

oil and gas matter, and because an important client of his firm was a bank which had made substantial loans to the debtor's officers and held significant amounts of stock of the debtor and of a related company as collateral for the defaulted loans. Counsel's firm had undertaken not to represent their client in this area, but continued to represent the bank in its other legal business. After a hearing, the court ruled that counsel was not disqualified.

An objection had also been filed to the retention of the trustee on the grounds that he was an investor in a small investment club that owned one of the debtor's debentures. The trustee had undertaken to withdraw from the club and to waive his distributive share in the debenture—about \$15. The Commission declined to join this objection, which was overruled. The objectors' appeal was heard simultaneously with the expedited appeal from the order authorizing certificates of indebtedness, and the order below was summarily affirmed.

*Imperial '400' National, Inc., et al.*<sup>17</sup> The district court was informed by counsel for the trustee that a client of his firm had expressed an interest in proposing a plan of reorganization for the debtor, and that the client had retained another law firm to represent it in the Chapter X proceedings should it decide to file a plan of reorganization.

The district judge notified all interested parties that in his judgment the client was not precluded from submitting a plan provided that counsel for the trustee refrained from participation in any way with respect to the plan. The district judge also indicated that the trustee, himself a lawyer, would handle this aspect of the proceedings and invited comments with respect to the proposed procedure. Counsel for the trustee would continue to represent the trustee on all other matters.

In a letter to the district judge the Commission suggested that the arrange-

ment should be clarified to state that counsel for the trustee play no part in any aspects of the proceeding that relate to plan proposals, so long as his client is involved in the proceeding. The attorney for a substantial creditor, who was also chairman of the creditors' committee, did not object to the retention of counsel for the trustee subject to these safeguards. The Commission's suggestion was accepted by the district judge.

Subsequently, the Judicial Council of the Third Circuit adopted a resolution to the effect that when a client of counsel for the trustee or of his firm submits a plan, the restrictions imposed by the district judge are not sufficient to provide immunity against "the appearance of a conflict of interest."<sup>18</sup> In view of this resolution, the district judge dismissed counsel for the trustee, who had declined to step aside voluntarily. He has appealed,<sup>19</sup> and the Commission filed a brief affirming the views it had presented in the district court.

*Virginia Island Properties, Inc.*<sup>20</sup> A shareholders' committee consisted of five members, three of whom were officers and directors. Two of them and another member were creditors. The Commission's staff advised committee counsel that the committee has a fiduciary relationship to shareholders and hence its members may not include creditors, whose interest may conflict with that of shareholders, or directors and officers, whose management of the debtor's affairs may be subject to investigation by the trustee.

In this case the same committee was soliciting contributions from shareholders to defray its expenses. The staff advised counsel that such solicitations were improper, pointing out that under Chapter X, if the committee and its counsel render meritorious service, they may be compensated and reimbursed for their expenses on application to the court at the conclusion of the proceeding. The committee thereafter offered to



return all the funds it had collected, and it disbanded.

*Farrington Manufacturing Co.*<sup>21</sup> The indenture trustee for an issue of Euro-dollar debentures proposed to resign to avoid a possible conflict of interest and sought to have the Chapter X court appoint a successor indenture trustee. The Chapter X trustee, a large bondholder, and the Commission did not oppose the resignation but objected to the appointment of a successor indenture trustee.

The Commission urged that a successor was not required when a substantial individual bondholder, who was participating actively in the proceeding, would be an adequate representative of the interests of the class. The appointment of a successor would, therefore, unnecessarily increase the costs of the proceeding. The court allowed the indenture trustee to resign but refused to appoint a successor.

*Four Seasons Nursing Centers of America, Inc.*<sup>22</sup> The court, in confirming the plan of reorganization, appointed the trustee as a director and as initial president of the reorganized company. Although such appointment was only for a four-month term, expiring at the first meeting of shareholders, the appointee will be eligible for re-election. The Commission has consistently opposed this practice. In view of the importance of the matter, and the unsettled state of the law,<sup>23</sup> it deems it appropriate to restate its position on this important question.

A good trustee, who has successfully coped with a difficult situation and revived a failing business, is a very obvious choice when the search begins for an executive for the reorganized company. He is likely to have the confidence of the creditors and the employees. All selfish considerations aside, he may well feel obligated to carry on the work he has begun.

The Commission's opposition to such an appointment is not based on a presumption of corruption or improper pa-

tronage, but on a belief that the possibility of the trustee continuing to be associated with the reorganized company subverts the disinterested role fixed for him by Chapter X. Much more than crude bargaining for salary or tenure is involved. The trustee has many critical decisions to make during the proceeding and in preparing a plan of reorganization: The retention or disposition of property, the accumulation of liquid funds as opposed to maximum distribution to creditors, the new capital structure, with particular attention to how and to whom voting power would be distributed, and the choice between internal reorganization and sale of the enterprise. If the trustee has even one eye on subsequent employment, his judgment on these matters may be affected.

All such decisions can easily be rationalized as in the best interests of the reorganization. But the court and the parties are entitled to have wholly disinterested decisions of the trustee, not decisions that may be subtly shaped by a tendency to identify himself with the debtor's future.

## TRUSTEE'S INVESTIGATION

A complete accounting for the stewardship of corporate affairs by the prior management is a requisite under Chapter X. One of the primary duties of the trustee is to make a thorough study of the debtor to assure the discovery and collection of all assets of the estate, including claims against officers, directors, or controlling persons who may have mismanaged the debtor's affairs. The staff of the Commission often aids the trustee in his investigation.

*Federal Coal Company.*<sup>24</sup> There was a substantial identity between the public holders of the debtor's debt and equity securities, since income bonds and stock had been issued in units in an equity receivership in 1919. During the proceeding, members of the family which controlled the debtor made a

tender offer to the investors for both their debt and equity securities at a price approximately twice that which the same investors had accepted under the debtor's abortive Chapter XI plan of arrangement. The tender offer was successful.

The debtor's controlling persons then moved to dismiss the Chapter X proceeding on the ground that they owned more than 88 percent in amount of the debtor's outstanding debentures, the debtor's only liabilities, and more than 96 percent of the debentures for which proofs of claim had been filed. They argued that they could reach an accord with the remaining debenture holders without court assistance, including, if necessary, payment in full.

The Commission urged the court to deny the motion to dismiss and to direct the trustee to conduct a thorough investigation under Section 167 into the debtor's affairs and to procure an independent appraisal of its property in order to determine the fairness of the price paid the investors. The court denied the motion to dismiss and authorized the investigation and the appraisal. It stated that, while the Commission could certainly make the investigation itself, the Chapter X court, once having taken jurisdiction, should continue to go forward in order to render complete justice.<sup>25</sup> Thereafter, the trustee, assisted by the staff of the Commission, began an active and thorough Section 167 examination and retained independent appraisers. At the close of the fiscal year, the investigation and appraisal were continuing.

*Webb & Knapp, Inc.*<sup>26</sup> The Supreme Court held in a 5 to 4 decision, that the Chapter X trustee did not have standing to enforce claims on behalf of holders of the debtor's debentures against the indenture trustee.<sup>27</sup> The claims involved alleged negligent or willful failure to prevent the debtor's violation of protective covenants in the indenture. The majority of the court held that the exist-

ing law did not provide for such an action, and that whether it would be wise to confer such standing on a Chapter X trustee is a policy decision which must be left to Congress.

The motion was opposed by the trustee and the Commission. The Commission urged that (1) the record left doubt as to the adequacy of the disclosures to the public investors and the fairness of the price paid; (2) purchases under the tender offer might have violated Rule 10b-5 under the Securities Exchange Act; (3) the persons making the tender offer had failed to file with the Commission the statements required by the Williams Act amendments to the Exchange Act, thus rendering the acquisitions voidable; and (4) no provision of Chapter X was available to permit such dismissal inasmuch as no plan had been confirmed, creditors had not received full payment, and no showing had been made that a plan could not be formulated.

*Westec Corporation.*<sup>28</sup> The trustee had brought an action against 92 defendants, based on alleged violations of the securities laws and other breaches of fiduciary duty in connection with alleged manipulation of the debtor's stock. This action combined claims for various injuries to the estate with claims on behalf of the class of shareholders allegedly victimized by the manipulation. Certain defendants applied to the Court of Appeals for the Fifth Circuit for a writ of mandamus, challenging the jurisdiction of the district court and the standing of the trustee to bring the action. The court of appeals held that the action might proceed on condition that a representative of the shareholder class were joined with the trustee as a co-plaintiff.<sup>29</sup>

Following this ruling, stipulations for the settlement of the action against 20 of the defendants for an aggregate of \$1,620,437 were presented to the court. The action will continue against the remaining defendants.

*American National Trust and Republic National Trust.*<sup>30</sup> The trustee has recovered approximately \$1.2 million of assets and effected claim reductions of an equal amount (excluding interest savings) by vigorous investigation and prosecution of causes of action and defenses arising out of prior mismanagement of the debtor. His plan of reorganization, discussed below,<sup>31</sup> preserved an equity for debtors' shareholders, about half of which is accounted for by these recoveries.

## REPORTS

Generally, the Commission files a formal advisory report only in a case which involves a substantial public investor interest and presents significant problems. When no such formal report is filed the Commission may state its views briefly by letter, or authorize its counsel to make an oral or written presentation.

During the fiscal year the Commission published three formal advisory reports<sup>32</sup> dealing with five plans and a supplement to one report.<sup>33</sup> Its views on five other plans were transmitted to the court either orally or by written memoranda.<sup>34</sup>

*Four Seasons Nursing Centers of America, Inc.*<sup>35</sup> This proceeding involved a debtor engaged in the construction and operation of a chain of nursing homes whose ownership was shared between two ostensibly independent public companies, with a maze of subsidiaries, partnerships and corporations. This arrangement was designed to permit reporting of large construction "profits" by intercompany sales which formed the basis for a stock promotion. At the peak, the outstanding shares were valued in the market at over \$300 million, but the operating nursing homes had been seriously neglected and were producing substantial losses.

The trustee successfully brought the nursing homes business to a profitable level of operation, settled or tried con-

troversies with creditors and co-owners, and terminated the construction program. The trustee also faced litigation against the debtors for alleged violations of the anti-fraud provisions of the Federal securities laws in the sale of common stock. There were also pending several class suits against the directors, the underwriter and accountants, in some of which suits the debtor companies were joined as defendants.

The trustee's plan of reorganization was based on consolidation of the debtors. The assets remaining in the estates were valued at about \$50 million. The plan provided for payment in cash of priority obligations and unsecured claims of under \$200, and the assumption of about \$15 million of secured debts by the reorganized company. Unsecured creditors, including \$15 million of Eurodollar debentures, were to receive two-thirds of the new shares at the rate of one share for each \$7 of claim. The remaining one-third were to be distributed to the fraud claimants, mostly former shareholders, in proportion to their losses. Losses were defined as the cost of securities purchased prior to July 22, 1970, the date of the Chapter X proceeding, less any amount realized on resale. Claims for fraud filed in the proceeding totaled over \$110 million.

In its advisory report, the Commission found the plan feasible, and concluded it was fair and equitable in most respects. After reviewing the history and interrelation among the various debtors, subsidiaries and partnerships, the Commission found that they must be treated as a single enterprise, as proposed by the plan. It also concluded that the proposed settlement of the fraud claims was reasonable.

The plan was amended, as urged by the Commission, to provide for the first election of directors in November 1972, rather than May 1974, but the court did not adopt the Commission's recommendation for a charter amendment to re-

quire cumulative voting. As amended, the plan was approved. An order of confirmation was entered July 17, 1972, about two years after the proceeding began. Three notices of appeal have been filed from the order of approval, directed primarily at the settlement of the fraud claims. Two complain that the settlement was excessive, and one that it was inadequate. As of the close of the fiscal year these appeals were pending.

*Yale Express System, Inc.*<sup>36</sup> A motor freight carrier was reorganized in this proceeding. The trustee's plan provided for satisfaction of all creditor claims, including post-bankruptcy interest, primarily in common stock of the reorganized company. Secured creditors would receive partial payment in notes, secured by a mortgage on the debtor's building in New York City, and in cash. Since the value of the assets exceeded liabilities, the debtor's common shareholders also were to receive a portion of the new stock. The Commission urged that the plan be amended to provide for pre-emptive rights to the new shareholders, to prevent future dilution of their interests, and to provide for cumulative voting in the election of directors.

The trustee amended the plan, but qualified the pre-emptive rights provision by adding, *inter alia*, a general exception for all convertible securities which might be issued in the future by the reorganized company. Without such exception, pre-emptive rights would bar the company from issuing convertible securities unless first offered to the shareholders. On the Commission's objection, the plan was further modified to eliminate this exception.<sup>37</sup>

The trustee's plan originally provided for allowance of post-bankruptcy interest at the contract rates to holders of interest-bearing obligations and at 4¼ percent to creditors whose debts did not specify an interest rate. The trustee subsequently acknowledged the inadequacy of 4¼ percent, and proposed to

apply the prime rate of interest. The Commission found neither rate appropriate, and urged that interest rates fixed by state law should be applied to debts for which no contractual rate was specified. The district court held that the post-bankruptcy interest rate is subject to judicial discretion and allowed 6½ percent.

A merchandise creditor claimed that the plan should have granted priority to vendors who supplied goods and services necessary to the operation of the debtor's business within six months prior to the commencement of the proceeding. The bulk of the trade creditors, with claims aggregating about \$3.3 million, would have fallen within this class. The Commission opposed this priority claim.

The priority was based on the "six-months rule," an equitable doctrine first developed in railroad receiverships, and designed to ensure the continued operation of public utilities. The Commission pointed out that Congress had codified the six-months rule in §77 of the Bankruptcy Act (11 U.S.C. §208), which deals with railroad reorganization, but deliberately omitted the rule from Chapter X. Although regulated in some respects, a motor carrier does not enjoy exclusive rights to serve a geographical area, so that the continuation of its operations is not a matter of public necessity. The Commission urged that application of the "six-months" rule to single out one group of general unsecured creditors for favored treatment at the expense of the other creditors with the same legal status, such as the public investors who hold the debtor's debentures, was contrary to the basic policy of equality which the Bankruptcy Act embodied. The court agreed with the views of the Commission.

Although not all of the recommendations made by the Commission were accepted by the court, it characterized the Commission's advisory reports at the last hearing on the plan as "... extremely helpful and, indeed construc-

tive. . . ." After the close of the fiscal year, the plan was approved by the district court.

*Imperial '400' National, Inc.*<sup>38</sup> The district court judge referred to the Commission three plans sponsored by outside proponents for the reorganization of the debtor, a motel chain. Shortly after the close of the fiscal year, the Commission issued an Advisory Report<sup>39</sup> in which it found the total value of Imperial to be about \$20.5 million, including \$8.2 million of unaffected debt. This value gave an equity to the debtor's former stockholders.

A group wishing to invest in the reorganized enterprise proposed two of the plans. The original plan called for the issuance of three classes of stock, two of which included complex conversion features; three series of warrants, each with varying terms; and a secured convertible loan. The alternative plan, containing several options, called for the issuance of convertible preferred stock, or cash at a heavy discount, and a small issue of warrants. Each plan would have given the proponent control for a nominal cash investment, while the debtor's creditors and stockholders would have received an inadequate allocation of the value of the reorganized company in exchange for their claims.

The commission advised the court that both plans were unfeasible and patently inequitable, and that the inordinately complex capital structures which they proposed were contrary to the intent of Chapter X.

The third plan involved the formation of a holding company which would own all of the stock of the debtor and of a construction company whose stock was owned by the proponents. The Commission advised the court that this plan was feasible but unfair with respect to the amount of holding company stock allocated for creditors and stockholders of the debtor.

Shortly after the Commission submitted its report, several new plans of reor-

ganization were filed with the court, offering substantially better terms.

*American National Trust and Republic National Trust.*<sup>39a</sup> A plan of reorganization has been approved by the district court. Under the plan, the debtors, which are real estate investment trusts, will be combined into a single company owning rental real estate valued at approximately \$15 million. The properties are encumbered by mortgage indebtedness of about \$11 million, which the reorganized company will assume. Other creditors are to be paid in full. The public investors who own the shares of the old trusts will become owners of the equity in the new company by exchanging their old shares on a share-for-share basis.

The Commission considered the plan to be feasible and to be fair and equitable in most respects. It took the position that the disputed claims of certain former shareholders must either be litigated or compromised as a class under the plan. These former shareholders had asserted that the debtors were culpable participants in a scheme whereby a trustee of the debtors, following his resignation as trustee, obtained from the public some \$600,000 of trust shares in exchange for his worthless notes. About half of the shares so acquired were returned to the debtors in connection with abortive real estate transactions. The balance were resold by him and the proceeds squandered. Although the trustee denied liability, the plan was amended to offer the class victims, as a compromise, one new share for each two shares lost by them in the transaction with this former trustee. This offer has been accepted by the necessary majority of the class.

*San Francisco & Oakland Helicopter Airlines, Inc.*<sup>40</sup> The plan proposed the continuation of the debtor's helicopter operations and the issuance of stock to its creditors.

In its memorandum the Commission recommended that consideration of a

plan should be deferred because, in view of the debtor's past and continuing losses, there was no adequate basis from which to project future earnings. Postponement of a plan would give the trustee time to gain operating experience and to judge the feasibility of a reorganization in light of operating results. The district court deferred hearings on any plan for at least six months.

*Manufacturers' Credit Corporation.*<sup>41</sup> The proceedings demonstrated that the financial condition of the parent and its 25 affiliates and subsidiaries was hopeless and that an internal reorganization was not possible. However, with financial assistance from the State of New Jersey, the trustee was able to propose a plan of liquidation calling for the sale of all the debtors' assets to another bus company that serves adjacent routes and thereby preserve bus transportation for the communities served by the debtors. But, since the sale would not yield enough to cover secured claims, public holders of unsecured notes would not share in the proceeds of sale. The plan was submitted to the Commission, which advised the court that the exclusion of the public investors was in accord with the standards of Chapter X.

*Webb & Knapp, Inc.*<sup>42</sup> The trustee's plan of reorganization, approved by the court, provides for an orderly liquidation. The most important feature was a settlement of disputed Federal tax claims of some \$36 million for \$2,750,000 in cash. The tax dispute was based on a claim that profits made in the early years were ordinary income rather than capital gains. Other priority claims and administrative expenses are also to be paid in cash and any balance remaining distributed pro rata to unsecured creditors, including the debenture holders. The debtor being insolvent, preferred and common shareholders are excluded from participation.

*Maryvale Community Hospital, Inc.*<sup>43</sup> The court of appeals affirmed the order

approving the plan of reorganization.<sup>44</sup> The plan was based on a sale of the debtor's property and distribution of the proceeds to the bondholders, the debtor's only creditors. The debtor was a nonprofit corporation and the Attorney General of Arizona had intervened to assert a right to any surplus remaining after satisfaction of the rights of the bondholders. The court of appeals agreed with the trustee and the Commission that the bondholders were entitled to post-bankruptcy interest as well as interest on interest, as specified in the indenture. The Commission and the Attorney General had objected to allowance of a call premium but the court of appeals did not decide this issue, since it found that the other items allowed would exhaust the fund.

*Phoenix Gems, Inc.*<sup>45</sup> This case involved a debtor engaged in the formulation, production, marketing and sale of various low toxic insecticides. It had outstanding about 2.3 million shares of common stock. In 1969, the company underwent a Chapter XI arrangement which was substantially consummated. However, that arrangement did not cure the debtor's financial ills which continued and led to the filing of a Chapter X petition. Since its liabilities were less than \$250,000, the debtor remained in possession.

A plan of reorganization was proposed by proponents who owned a small company in a parallel line of business. It contemplated the acquisition of that enterprise by the debtor and the issuance of more than 18 million shares of the reorganized company, 80 percent for all of the shares of the proponents' company and 20 percent for the claims and interest in the debtor.

The staff of the Commission stated that the number of shares to be issued, 20 percent of which would be publicly traded, was not justified by the modest assets of the reorganized company. The plan was amended to reduce the number of shares to about 1.8 million.

About 1.5 million of these shares would be received by the proponents and held as restricted stock.

## ALLOWANCES

Every reorganization case ultimately presents the difficult problem of determining the compensation to be paid to the various parties for services rendered and for expenses incurred in the proceeding. The Commission, which under Section 242 of the Bankruptcy Act may not receive any allowance for the services it renders, has sought to assist the courts in assuring economy of administration and in allocating compensation equitably on the basis of the claimants' contributions to the administration of estates and the formulation of plans. During the fiscal year 275 applications for compensation totaling about \$7 million were reviewed.

*TMT Trailer Ferry, Inc.*<sup>46</sup> Two appellate matters were pending at the close of the last fiscal year.

In one proceeding, the stockholders' committee, supported by the Commission, appealed from orders awarding interim compensation to trustee's counsel. The Commission urged that, because of the lack of progress in the reorganization, trustee's general counsel be allowed no interim compensation for services rendered in 1970 instead of the \$89,020 which the district court had allowed him and that in the future he be allowed a maximum of \$35,000 interim compensation for services rendered in any one year.

The other pending matter related to the district court's award to committee counsel of \$10,000 as interim compensation, and \$5,000 as reimbursement of expenses for services rendered over the first 11 years of the proceeding. The court of appeals, as recommended by the Commission, increased the award to \$60,000 interim compensation and \$10,000 reimbursement of expenses. It also granted the committee's request

for protection against harassing depositions proposed by trustee's counsel.<sup>47</sup>

Upon remand, the district court granted the sum directed by the court of appeals, but in addition prescribed how the fees were to be divided, excluding one lawyer entirely and ordered committee counsel to account for their expenses. It also permitted trustee's counsel to bring disqualification proceedings against the committee and its counsel based on essentially the same charges raised in the prior appeal and authorized discovery proceedings in connection therewith. The committee and its counsel sought a writ of mandamus, prohibition, and related relief in the court of appeals to require the district judge to abide by the appellate tribunal's mandate. The Commission supported this position.

As to the fee for trustee's counsel, the court of appeals, noting the lack of progress in the proceeding, (1) reduced the interim compensation to trustee's counsel for 1970 from \$89,020 to \$30,000, and (2) limited any future interim compensation to him to a maximum of \$30,000 in any one year.<sup>48</sup> The court granted the committee's petition for mandamus, prohibition and related relief. It removed the restriction imposed by the district court on its previous award and put an end to the disqualification and related discovery proceedings. Noting that trustee's counsel had assured the court that the reorganization proceeding would be wound up within a year, it withheld ruling on the Commission's suggestion that a special master be appointed.<sup>49</sup>

Thereafter, the district judge filed a single petition for a writ of certiorari in the Supreme Court, seeking review of the limitation on fees of trustee's counsel and the grant of the extraordinary writ.<sup>50</sup> The committee and the Commission opposed the petition on the merits. The Commission also pointed out that the district judge was not a party to the fee appeal and therefore had no stand-

ing to seek review. After the close of the fiscal year, the petition was denied.

*Cybern Education, Inc.*<sup>51</sup> Efforts to reorganize a company engaged in developing specialized educational programs failed within a few months of the commencement of the proceeding. Small sums had been accumulated from sales of miscellaneous assets. Deducting a trustee's certificate, the estate consisted of about \$46,000 in cash. The trustee and his counsel applied for interim allowance of \$45,000, which the district court granted after a hearing. No notice of hearing, pursuant to Section 247, was given to creditors and stockholders, including the Internal Revenue Service, the holder of the principal claim against the estate and most affected by the allowance.

At the hearing the Commission sought to develop a proper record with respect to the nature and value of the services rendered and on the need for interim allowances, but no testimony was offered. The Commission also objected to the lack of notice under Section 247.

The United States, as a tax claimant, petitioned for leave to appeal, which the court of appeals granted.<sup>52</sup> The Commission filed a brief in support of the United States. The appeal was pending at the close of the fiscal year.

*Parkwood, Inc.*<sup>53</sup> The order appointing trustee's accountants in accordance with General Order 45 fixed the maximum to be paid for accounting services at \$180,000. The accountant sought this amount plus an additional \$6,750 for certain special tax services performed by an attorney in the accounting firm. The Commission agreed that the accounting firm had earned the \$180,000 authorized by the order of appointment but opposed any additional allowance on the ground that the requisite authorization had not been obtained. The court denied the additional compensation on the basis of General Order 45.

The two co-chairmen of the Secured Noteholders' Committee sought compensation of \$100,000 for services rendered during the proceeding and during the prior equity receivership. One of the applicants had acquired a note of the debtor while acting for the committee in the receivership. The Commission urged, and the court agreed, that trading in the receivership was covered by the bar of Section 249.<sup>54</sup>

The other applicant had also traded, but he had done so after substantial consummation of the plan. The trustee urged that such trading nevertheless required denial of compensation. The Commission advised the court that there was no need to reach this issue since the applicant had failed to show that he had performed compensable services, and the court agreed.

*Imperial '400' National, Inc.*<sup>55</sup> The court of appeals had reversed, as excessive, the third interim allowance to the trustee and his counsel.<sup>56</sup> On remand, the district court reduced the allowance to the maximums indicated by the court of appeals and ordered refund of the excess payments. The successful appellant urged that payment of interest on the refunds should be required. The district judge ordered that one applicant, who had invested and earned interest on his allowance, pay the earnings to the estate, but did not require the payment of interest on funds not profitably invested. An appeal followed.

The Commission had suggested that decision on this relatively small matter be deferred until final allowances were granted and the equities arising from the overpayment be adjusted in that context, and it adhered to that position in the appeal. The court held, however, that the applicants should pay interest on the refund. It fixed the rate at that earned by the estate on its surplus funds during the period they held the money.<sup>57</sup>

*Bermec Corp.*<sup>58</sup> Attorneys for the trustee filed an application for an in-



terim allowance of \$65,000. The application included the time spent on estate matters by lawyers and para-professionals. The latter are not lawyers, but render routine services which junior attorneys of the firm would otherwise have to perform. The Commission urged that their services be treated as professional services, and recommended \$30,000 as adequate interim compensation, since the time spent was weighted so heavily by the work of the para-professionals.

The referee as special master recommended \$51,265 of which \$10,000 was allotted as overhead expense for the para-professionals' service. He stated in his report that he could not allow fees for these services because such "help should be included in overhead just as is secretarial assistance or summer law students." The district judge allowed the amount recommended by the special master, without discussing the status of the para-professionals. The Commission continues to adhere to its reviews on this subject.

## INTERVENTION IN CHAPTER XI

Chapter XI of the Bankruptcy Act provides a procedure by which debtors can effect arrangements with respect to their unsecured debts under court supervision. Where a proceeding is brought under that chapter but the facts indicate that it should have been brought under Chapter X, Section 328 of Chapter XI authorizes the Commission or any other party in interest to make application to the court to dismiss the Chapter XI proceeding unless the debtor's petition is amended to comply with the requirements of Chapter X, or a creditors' petition under Chapter X is filed.

Attempts are sometimes made to misuse Chapter XI so as to deprive investors of the protections which the Securities Act of 1933 and the Securities Exchange Act of 1934 are designed to provide.<sup>59</sup> In such cases the Commis-

sion's staff normally attempts to resolve the problem by informal negotiations. If this proves fruitless, the Commission intervenes in the Chapter XI proceeding to develop an adequate record and to direct the court's attention to the applicable provisions of the Federal securities laws and their bearing on the particular case.<sup>60</sup>

*Synergistics, Inc.*<sup>61</sup> The Commission intervened because of questions regarding the viability of the debtor's business. Its main concern was the proposed issuance of an additional 800,000 shares of common stock, in addition to over 1 million shares previously issued and outstanding. Very little information about the debtor was available to the investing public and there was the possibility that a speculative market in the debtor's shares would develop.

The Commission's objections to the arrangement were withdrawn when certain amendments were proposed. These included voluntary registration of the debtor's common stock under Section 12(g) of the Securities Exchange Act, and a commitment that all of the 800,000 shares to be issued to its creditors would be restricted for two years from confirmation, after which the debtor would use its best efforts to register such shares under the Securities Act. The referee confirmed the arrangement. His order of confirmation included the following statement: "The intervention of the Securities and Exchange Commission in Chapter XI proceedings . . . is at one with the duty of a Chapter XI court . . . to make sure that it does not confirm a Plan that aids creditors in foisting stock of highly doubtful value on an unsuspecting public, the members of which may believe that the order confirming the Plan gives a validity to the issued stock beyond its real worth."

*Space City, USA, Inc.*<sup>62</sup> The debtor filed a Chapter X petition and was subsequently adjudicated a bankrupt when

it proved impossible to reorganize. After three years in bankruptcy, the debtor filed a Chapter XI petition. Though a mere corporate shell, it filed a plan of arrangement providing for the issuance of about 2.5 million shares. The Commission intervened in order to prevent the issuance of a large quantity of worthless securities, pointing out that the use of Chapter XI for the purpose of reactivating trading interest in a dormant shell was improper. The district court dismissed the Chapter XI proceeding.

*A-T Industries, Inc.*<sup>63</sup> This company began as a thrift and securities institution which issued approximately \$3.2 million of debentures to the public years ago. In later years it was converted into an operating company, with several small businesses. Although it made a modest operating profit, it had lost a large part of its capital on unsound investments. On default in payment of interest, it filed a Chapter XI petition.

The proposed arrangement provided that the debenture holders would receive \$1.6 million of new 10-year debentures issued by the debtor's bowling alley subsidiary, \$1.6 million of the debtor's new preferred stock, and 50 percent of the debtor's common stock. The debtor would guarantee payment of the subsidiary debentures at maturity. Available cash would be used to pay management its back bonuses. The debtor could not hope to pay preferred dividends and coverage of the debenture interest was doubtful.

The Commission indicated that it would file a motion under Section 328 of Chapter XI to have the proceeding transferred to Chapter X. Thereafter, the staff, at the request of the Referee, conferred with other parties. As a result the proposed arrangement was amended to create approximately \$2 million of new notes, secured by a pledge of the principal assets of the debtor and subject to appropriate sinking fund require-

ments. The preferred stock was eliminated and the debenture holders received 90 percent (instead of 50 percent) of the debtor's common stock. Management received stock rather than cash for their back bonuses. In view of the amendment, the need of the debenture holders for Chapter X seemed less clear, and the Commission determined not to proceed under Section 328.

*Capital Cities Nursing Centres, Inc.*<sup>64</sup> The debtor had made an offering of securities, representing that unless all the shares were sold, any funds subscribed would be returned to investors. Although debtor raised only \$1.9 million of the \$4.5 million sought, it spent the funds received and was unable to return them. The Commission brought a civil action under the securities laws, and the Federal Court in New York appointed a trustee on the Commission's motion.<sup>65</sup> Two weeks later, the debtor filed its voluntary Chapter XI proceeding in New Jersey, and asserted that this proceeding ousted the New York trustee. The New Jersey court overruled a motion to dismiss the Chapter XI proceeding as having been filed in bad faith, but appointed its own receiver.

Subsequently, an understanding was reached. It allowed the Chapter XI receiver to utilize current cash flow from the debtor for current operations and permitted the trustee in the civil action to seek an accounting from the individual defendants for the funds they had diverted. The Chapter XI receiver or the trustee were to retain any funds each received from the defendants pending a later determination of the proper disposition.

*Posi-Seal International, Inc.*<sup>66</sup> The debtor had outstanding about 4.9 million shares held by the public. The arrangement provided, *inter alia*, that after a one-for-ten reversesplit, new shares would be distributed in specified proportions, including 25 percent to the present stockholders and a like percentage to the holders of the debtor's de-

ventures, which apparently were not publicly held. The corporate charter was also to be amended to decrease the amount of authorized shares and to eliminate the authority to issue preferred stock. All of these charter amendments required consent of stockholders under state law and the arrangement specified that such consent was a condition precedent to consummation of the plan.

The referee confirmed the plan. A stockholder filed a petition for review, in which he objected to the jurisdiction of the court to confirm the arrangement, contending that (1) Chapter XI does not permit a stock recapitalization of the debtor as provided for in the arrangement, and (2) Chapter X, not Chapter XI, is the proper avenue of relief if rights of stockholders are thus adjusted. The district judge affirmed the referee's order and the stockholder appealed.

At the request of the court of appeals, the Commission filed a brief *amicus curiae*, in support of the jurisdiction of the Chapter XI court. The Commission viewed the plan as a composition with unsecured creditors, which could properly be implemented by the recapitalization in accordance with the requirements of state law. The Commission also concluded that the circumstances in this proceeding did not indicate the need for the safeguards of Chapter X. The court of appeals agreed with the Commission and affirmed the order below.<sup>67</sup>

## NOTES FOR PART 7

<sup>1</sup> The table on page lists all reorganization proceedings in which the Commission was a party during the year.

<sup>2</sup> N.D. Texas, No. Bk-3-2302.

<sup>3</sup> D. Colo., No. 71-B-2921.

<sup>4</sup> C.A. 5, No. 72-1158.

<sup>5</sup> C.D. Calif. 94420-.

<sup>6</sup> C.A. 9, 72-1528.

<sup>7</sup> S.D. Fla., No. 72-126-Bk-CF.

<sup>8</sup> See *S.E.C. v. American Trailer*

*Rentals Co.*, 379 U.S. 594, 618 (1965). See also cases cited in 31st Annual Report, p. 104 (1965).

<sup>9</sup> D. Mass., No. 71-218.

<sup>10</sup> No. 71-1264 (C.A. 1, 1972).

<sup>11</sup> M.D. N.C., No. B-198-69. Previously reported in 36th Annual Report, p. 179; 37th Annual Report, p. 181.

<sup>12</sup> *Weaver v. Hutson*, 459 F.2d 741 (C.A. 4, 1972), cert. den. October 24, 1972.

<sup>13</sup> C.D. Cal., Nos. 78641-FW, 78950-FW, 79596-FW and 80470-FW.

<sup>14</sup> Section 116(3) provides that the court may authorize the trustee "upon cause shown, to lease or sell any property of the debtor . . . upon such terms and conditions as the judge may approve."

<sup>15</sup> S.D. N.Y., No. 71-B-523.

<sup>16</sup> No. 72-1114 (C.A. 10, 1972).

<sup>17</sup> D. N.J., No. B-656-65. Previously reported in 36th Annual Report, p. 176; 35th Annual Report, pp. 161-162; 33rd Annual Report, pp. 132, 137-138; 32nd Annual Report, pp. 94-95.

<sup>18</sup> The resolution reads:

"RESOLVED that in all bankruptcy proceedings this Council holds as incompatible the continued representation as attorney for the trustee by any lawyer or his firm who represents a third party who submits a plan for reorganization in the bankruptcy; and that the recusal by the attorney only from commenting on proposed reorganization plans is not an adequate immunization from the appearance of a conflict of interest."

<sup>19</sup> *In re Imperial '400' National, Inc.* (Joseph M. Nolan, Appellant), C.A. 3, No. 72-1399.

<sup>20</sup> D. V.I., Division of St. Croix, No. B-4-1971.

<sup>21</sup> E.D. Va., Nos. 17-71-A, 256-71-A and 257-71-A.

<sup>22</sup> W.D. Okla., Bk. 70-1008, 70-1008A-D, 1008-A-D, 1129, 1129A.

<sup>23</sup> The principal reported decision is *In re TMT Trailer Ferry, Inc.*, 334 F. 2d 118 (C.A. 5, 1964), in which it was held that there was no rule of law precluding employment of the trustee. The court noted, however, that proof that the trustee was offered "emoluments and security" rather than a mere nomination, would disqualify him. In a later phase of the TMT proceeding the Supreme Court granted certiorari on this issue among others (387 U.S. 929 (1967)) but in *Protective Committee v. Anderson*, 390 U.S. 414 (1968) it re-

versed the orders appealed from on other grounds, and stated "finally, there is no necessity to determine whether it was improper to contemplate making the trustee president of the reorganized company" (p. 453) because of mootness. Three Justices dissented, saying:

"... the only question which could be thought even remotely to justify the presence of this case in this court is whether the trustee, by virtue of his office, was as a matter of law disqualified from being elected as president of the reorganized company." (p. 454).

The dissenters felt that failure to decide that issue required dismissal of the writ as improvidently granted.

<sup>24</sup> S.D. W. Va., No. 69-270. Previously reported in 34th Annual Report, p. 196; 36th Annual Report, pp. 194-195.

<sup>25</sup> *In re Federal Coal Company*, 335 F. Supp. 1183, 1185 (S.D. W. Va., 1971).

<sup>26</sup> S.D. N.Y., No. 65-B-365.

<sup>27</sup> *Caplin v. Marine Midland Grace Trust Company of New York*, 406 U.S. 416 (1972).

<sup>28</sup> S.D. Tex., 66-H-62. Previously reported in 35th Annual Report, pp. 163-164.

<sup>29</sup> *Ernst & Ernst et al. v. U.S. Dist. Ct.*, 457 F. 2d 1399 (C.A. 5, 1972).

<sup>30</sup> S.D. Indiana, consolidated cases, Nos. IP-68-B-447 and IP-68-B-609. Previously reported in 36th Annual Report, pp. 176, 178-179; 34th Annual Report, pp. 144-145.

<sup>31</sup> *Infra*, p. —.

<sup>32</sup> *In re Yale Express System, Inc.*, S.D. N.Y., No. 65-B-404, Corporate Reorganization Release No. 309 (January 14, 1972); *In re Four Seasons Nursing Centers of America, Inc., et al.*, W.D. Okla., Bk-70-1008, 1008A-D, 1129, 1129A, Corporate Reorganization Release No. 310 (March 16, 1972); *In re Imperial '400' National, Inc.* (3 plans), D. N.J., No. B-656-65, Corporate Reorganization Release No. 312 (July 12, 1972).

<sup>33</sup> *In re Yale Express System, Inc.*, *supra*, Corporate Reorganization Release No. 311 (March 23, 1972).

<sup>34</sup> *In re American National Trust and In re Republic National Trust*, S.D. Ind., Nos. IP-68-B-447, IP-68-B-609 (cases consolidated); *In re Manufacturers' Credit Corporation*, D. N.J., No. B-1084-67; *In re Phoenix Gems, Inc.*, D. Ariz., No. B-21072-Phx.; *In re San Francisco & Oakland Helicopter Airlines, Inc.*, N.D. Calif., No. B-70-5175; *In re*

*Webb & Knapp, Inc.*, S.D. N.Y., No. 65-1B-365.

<sup>35</sup> W.D. Okla., Bk 70-1008A-D, 1129, 1129A. Previously reported in 37th Annual Report, pp. 180-181.

<sup>36</sup> S.D. N.Y., No. 65-B-404. Previously reported in 34th Annual Report, pp. 149, 153-154; 33rd Annual Report, p. 133; 32nd Annual Report, pp. 88-89.

<sup>37</sup> The Commission said in its Supplemental Report:

"We are not suggesting that the reorganized company should remain permanently under this bar. If management believes that pre-emptive rights should be modified to permit the issue of convertible securities, it can secure such modification by a vote of stockholders specifically directed to this proposal. We do not consider such modification a proper proposal for inclusion in the plan. Present security holders voting on the plan do not have the opportunity to address themselves to this specific feature of the plan. Their only alternatives are to vote for or against the plan in its entirety."

<sup>38</sup> D. N.J., No. B-656-65. Previously reported in 36th Annual Report, p. 176; 35th Annual Report, pp. 161-162; 33rd Annual Report, pp. 132, 137-138; 32nd Annual Report, pp. 94-95.

<sup>39</sup> Corporate Reorganization Release No. 312 (July 12, 1972).

<sup>39a</sup> S.D. Indiana, consolidated cases, Nos. IP-68-B-447 and IP-68-B-609. Previously reported in 36th Annual Report, pp. 176, 178-179; 34th Annual Report, pp. 144-145.

<sup>40</sup> N.D. Calif., No. B-70-5175.

<sup>41</sup> D. N.J., No. B-1084-67. Previously reported in 37th Annual Report, p. 182; 36th Annual Report, pp. 177-178; 34th Annual Report, p. 160.

<sup>42</sup> S.D. N.Y., No. 65-365. Previously reported in 37th Annual Report, pp. 183, 193-194; 36th Annual Report, pp. 193-194; 35th Annual Report, p. 170; 34th Annual Report, p. 150; 33rd Annual Report, pp. 131, 134.

<sup>43</sup> D. Ariz., No. B-9352-Phx. Previously reported in 37th Annual Report, p. 187.

<sup>44</sup> *In re Maryvale Community Hospital, Inc.* 456 F.2d 410 (C.A. 9, 1972).

<sup>45</sup> D. Ariz., No. B-21072-Phx.

<sup>46</sup> S.D. Fla., No. 3659-M-Bk-WM. Previously reported in 37th Annual Report, pp. 191-193; 36th Annual Report, pp. 179-180, 190-191; 35th Annual Report, p. 160; 34th Annual Report, p. 153; 33rd Annual Report, p. 135; 32nd

Annual Report, pp. 92-93; 31st Annual Report, p. 100; 30th Annual Report, p. 105; and 29th Annual Report, pp. 91-92.

<sup>47</sup> *Protective Committee v. Kirkland*, 434 F.2d 804 (C.A. 5, 1970), cert. den. 402 U.S. 907 (1971).

<sup>48</sup> *Protective Committee v. Wolff*, 457 F.2d 100 (C.A. 5, 1972).

<sup>49</sup> *Protective Committee v. Mehrtens*, 457 F.2d 104 (C.A. 5, 1972) cert. den. October 10, 1972.

<sup>50</sup> No. 71-1610.

<sup>51</sup> N.D. Ill., No. 70-B-5299.

<sup>52</sup> C.A. 7, No. 72-1131.

<sup>53</sup> D. D.C., No. 39-66. Previously reported in 35th Annual Report, pp. 164-165.

<sup>54</sup> *In re Cosgrove-Meehan Coal Corp.*, 136 F.2d 3 (C.A. 3), cert. den. 320 U.S. 777 (1943).

<sup>55</sup> D. N.J., No. 656-65. Previously reported in 36th Annual Report, p. 190.

<sup>56</sup> *In the Matter of Imperial '400' National, Inc.*, 432 F.2d 232 (C.A. 3, 1970).

<sup>57</sup> 456 F.2d 926 (C.A. 3, 1972).

<sup>58</sup> S.D. N.Y., No. 71-B-291. Previously reported in 37th Annual Report, p. 179.

<sup>59</sup> See 37th Annual Report, p. 198; 36th Annual Report, p. 197.

<sup>60</sup> During the past year, the staff communicated with referees around the country requesting that it be notified of Chapter XI cases in which the proposed arrangements may involve this type of issue.

<sup>61</sup> D. Mass., No. 70-1251.

<sup>62</sup> N.D. Ala., No. 8568-NE.

<sup>63</sup> D. Oregon, No. B-71-3499.

<sup>64</sup> D. N.J., No. B-1401-71.

<sup>65</sup> *S.E.C. v. Manor Nursing Centers, Inc.*, 340 F. Supp. 913 (S.D. N.Y., 1971), aff'd 458 F. 2d 1082 (C.A. 2, 1972). Debtor is the corporate successor to the original issuer.

<sup>66</sup> D. Conn., No. 9038.

<sup>67</sup> *In re Posi-Seal International, Inc.*, 457 F.2d 237 (C.A. 2, 1972). The court said it was concerned whether the proceeding was properly brought under Chapter XI and said: "The brief of the Securities and Exchange Commission, which is scholarly and most helpful to the court supports the jurisdiction of the court below and found no error in the confirmation of the plan."

# **PART 8**

## **S.E.C. MANAGEMENT OPERATIONS**



# **PART 8**

## **S. E. C. MANAGEMENT OPERATIONS**

### **REORGANIZATION**

The first major reorganization of the Commission's structure in thirty years became effective on August 7, 1972. The Commission now has five operating divisions instead of three. The Division of Trading and Markets was divided into a Division of Enforcement and a Division of Market Regulation. A new Division of Investment Company Regulation was spun off from the Division of Corporate Regulation. Investment Company disclosure activity was transferred to the Division of Corporation Finance and all enforcement activities were concentrated in the new Division of Enforcement. Thus, the major elements in the reorganization were the concentration of

all investigative and enforcement activity in a single division, the focusing of all disclosure activity in a single division, and the creation of two regulatory divisions, one for broker-dealers and markets and the other for investment companies. Public-utility holding company and bankruptcy and reorganization functions remain in the Division of Corporate Regulation.

A more detailed description of the reorganization appears in Part 1 of this report.

### **OTHER CHANGES**

#### **Executive Director**

The position of Executive Director was reestablished by the Commission in



a move which had broad impact on the day-to-day operation of the agency. Increased public financing, intensified market activity, new responsibilities imposed by Congress, and mounting problems in the securities industry required the concentration of executive and administrative functions in an executive position reporting directly to the Chairman.

As the chief operating official of the Commission, the Executive Director exercises administrative and management direction over all divisions and offices except for three units directly assisting the Commission. The reestablishment of the position of Executive Director represents the beginning of a management structure designed to provide executive direction and control, alternative program approaches to meet policy goals, and improved operating systems.

During the year, the Office of the Executive Director was strengthened to assist in improving communications and internal procedures and in the review and appraisal of internal compliance with the Commission's policies, plans and procedures.

The Executive Director's Report was instituted in February, 1972. The report is a comprehensive management tool containing data with respect to major workload and cost items, significant events, industry operations and progress on rules, regulations, and other Commission projects. The report is distributed to the Commissioners and all division and office heads and regional offices.

In addition, the Executive Director, along with the Division and Office Heads, assumed an active role in the budget process, using the budget as a key management tool in establishing priorities and allocating resources.

### **Office of Public Information**

The Office of Public Information was established with a professional information staff to fully implement the Com-

mission's role as an agency of disclosure by bringing SEC information to the investing public, the securities industry and the corporations in an active, comprehensive, clear manner.

The Office of Public Information is responsible for seeing that the purpose of corporate and regulated industry disclosure is fulfilled by devising programs that effectively bring this information to the investing public. The Office develops programs to highlight what is most significant in disclosure and works with the communications industry to achieve maximum dissemination of this information through the financial press, commercial reporting services, microfilm facilities, securities industry, corporate and investor organizations, SEC Public Reference Rooms and investor education programs.

The Office of Public Information also shares with operating divisions the responsibility for seeing that the corporations, regulated industries and professions that serve them understand the aims and requirements of SEC disclosure. As the communications arm of the Commission, the Public Information Office also provides professional writing and other vital communications support.

### **Others**

*The Office of Chief Financial Analyst* was established in the Division of Corporation Finance to provide uniformity of comment and disclosure in comparable situations, as well as to anticipate trends in the business community which may present particular disclosure problems that could require Commission action.

*The Industry Operations Technical Staff* was established in the Division of Market Regulation (formerly part of the Division of Trading and Markets) to prepare for the elimination or immobilization of the stock certificate; to assure an orderly transition from procedures that rely heavily upon stock certificates to one that will rely principally upon

computer records; to recommend new rules to be promulgated by the Commission and/or the self-regulatory bodies; and to draft proposed legislation as appropriate.

The Office of Broker-Dealer Examinations was established in the Division of Market Regulation (formerly part of the Division of Trading and Markets) to direct and coordinate an accelerated nationwide program of broker-dealer and investment adviser examinations. This intensive approach includes development of examination policies, recommendation of new rules and regulations relating to the program, training of new examination personnel and coordination of multiregional examinations involving the states and the self-regulatory organizations.

A branch of the Washington, D.C. Regional Office was established to serve the investing public in Philadelphia, the Nation's fourth largest city.

## OMB STUDY

Early in the fiscal year the Office of Management and Budget conducted a management review of the Commission's operations. The OMB report confirmed the Commission's view that the agency had run down in numbers and strength and had not kept up with the increased workload it had been called upon to handle. The report pointed out that increased securities activity had far outstripped authorized manpower and money resources. The report also recommended increased oversight of the self-regulatory agencies and pointed out that the Commission had fallen behind in inspections, investigations and enforcement responsibility, and particularly in keeping up with its obligations under the Public Utility Holding Company Act and the Bankruptcy Act. As a positive recommendation, OMB urged a greater effort to take the lead in anticipating problems and to base this endeavor on more extended economic and policy research. The report also recom-

mended additional management support and the establishment of a public information facility. Many of the detailed recommendations already have been implemented, and the Commission is giving continuing attention to staffing, operational methods and policies in its major areas of responsibility.

## FINANCIAL MANAGEMENT

In the 1972 fiscal year, the Congressional appropriation to the Commission was \$26.8 million, of which \$19.1 million was offset by fees collected by the Commission, or 71 percent of appropriation. The net cost of SEC operations was \$7.7 million.

All fees collected by the Commission are deposited into the Treasury as miscellaneous receipts. The Commission is required by law to collect fees for (1) registration of securities issued; (2) qualification of trust indentures; (3) registration of exchanges; (4) brokers and dealers who are registered with the Commission but who are not members of a registered national securities association; and (5) certification of documents filed with the Commission.

Effective March 1, 1972, the Commission adopted a fee schedule under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Fees are now charged for certain filings and services under those Acts where no charges had previously been made. Such fees are not refundable.

In fiscal 1972, these charges produced \$2.3 million in additional revenues. For fiscal 1973, an estimated \$5.3 million will be produced.

## PERSONNEL MANAGEMENT

### Recruiting

Due to severe budgetary limitations, the Commission adhered to a general hiring freeze during the first six months

of fiscal 1972. However, with the approval of a supplemental appropriation late in December, 1971, funds became available to permit the Commission to generally resume hiring and to increase its ceiling for permanent employees by 146, from 1,416 to 1,562. Since actual employment at that time was only 1,356, it was necessary to launch an intensive effort to recruit more than 300 people to fill the 60 then existing vacancies, the 146 new jobs, and the approximately 120 positions which became vacant due to turnover between December, 1971, and June, 1972.

Altogether the Commission filled 163 professional and 152 technical or clerical positions, in all grade levels from GS-1 through GS-18, and in virtually every one of its existing job categories. Appointments were made in a wide range of grades and occupations, drawing upon persons employed in the private sector as well as in Federal and State agencies. The Commission was able to attract to its staff a number of top-flight people with significant and substantial experience in the securities industry, including several from self-regulatory bodies such as the New York Stock Exchange, the National Association of Securities Dealers, and state securities commissions. Most of the experienced accountants hired were CPA's with work experience in prominent national accounting firms. The Commission also hired a significant number of recent college graduates, including some with graduate degrees, for starting level positions of Accountant, Financial Analyst and Investigator.

In summary, in substantially increasing its permanent staff in fiscal 1972, the Commission was able to attract a good mix of recent college and law school graduates with high academic achievement, and individuals with diversified and high quality experience in the field of securities and finance, including a number of minority group persons and women.

In order to accommodate the additional staff, about 23,000 square feet of office space was acquired at 1100 L Street NW. The Offices of Hearing Examiners, Opinions and Review, and Policy Research, as well as the Branches of Public Utility Regulation and Reorganization, were moved to that location.

The following table shows the permanent personnel strength of the Commission as of June 30, 1972.

	June 30, 1972
Commissioners.....	5
Staff	
Headquarters Office.....	986
Regional Offices.....	568
Total Staff.....	<u>1,554</u>
Grand Total.....	<u>1,559</u> ✓

### Reduction in Average Grade

In launching its recruitment program, the Commission had to bear in mind the Office of Management and Budget's instructions to Federal agencies to reduce their average grades. The Commission's assigned objective was a reduction of 0.15 by June 30, 1972, and 0.30 by June 30, 1973. Despite the fact that a significant number of the additions to the staff were experienced persons appointed in the mid-level (GS-9 through GS-12) and senior level (GS-13 through GS-15) grades, the total average grade reduction that was targeted to be reached at the end of fiscal year 1973 was achieved in fiscal 1972.

### Service and Merit Awards

The Commission's Seventeenth Annual Service and Merit Awards Program was held in November, 1971. Distinguished Service Medals were awarded by the Commission to Gerald E. Boltz, then Regional Administrator of the Fort Worth Regional Office (now Regional Ad-

ministrator in Los Angeles); Arthur A. Pennekamp, Regional Administrator of the San Francisco Regional Office (now retired); Sheldon Rappaport, Associate Director, Division of Market Regulation; Charles J. Sheppe, Chief of the Branch of Forms, Regulations and Legislative Matters, Division of Corporation Finance (now retired); and Stanley Sporin, Associate Director, Division of Enforcement. Eight employees were given 35-year SEC service awards; 12 employees received awards for 30 years of SEC service. Within-grade salary increases in recognition of high quality performance were granted to 19 employees; and cash awards totaling \$7,950 were presented to 39 employees for superior performance, or special service.

### **Training and Development**

The Office of Personnel, with the help of the various Divisions and Offices, designed and is about to launch a new professional employee orientation program. The program consists of presentations by each of the major operating divisions and by other key staff and service offices. It is intended to reduce the time it takes a new staff member to become familiar with the intricacies of the agency, thus making the new employee more productive at an earlier date.

A revised Executive Development Program was adopted in April, 1972, and incorporated into the Agency's Manual of Administrative Regulations. The purpose of this program is to identify and develop employees occupying positions in Grades GS-13, 14, and 15, who are regarded by their superiors as having high potential to fill executive positions in Grades GS-16, 17 and 18.

The Fifth Annual Enforcement School conducted by the Division of Trading and Markets was held in June, 1972, with over 100 participants from both inside and outside the Commission.

In January, 1972, the Division of Cor-

porate Regulation conducted a week-long training session on the Investment Company Act in Los Angeles. In attendance were staff members from Los Angeles, Fort Worth, and Seattle as well as representatives of the California Department of Corporations and the NASD. In addition, a training program covering the amendments to the Investment Company Act was held in Denver.

Development of a series of procedural manuals was begun in fiscal 1972. The Broker-Dealer Inspection Manual was completed and issued for staff use in April, 1972. The Investment Adviser Inspection Manual was completed and issued for staff use shortly after the end of the fiscal year. A final draft of the Enforcement Manual was under review at the year's end, and an outline of the Investment Company Inspection Manual was completed and work was in progress at the year's end.

### **New Classification Standard for Investigator Positions**

The Commission received Civil Service Commission approval for the establishment of a single-agency position classification standard for inspector (investigator) type positions. The government-wide standard issued recently by the Civil Service Commission was inappropriate because it placed too much emphasis on investigators involved with so-called "street" crimes as opposed to the "white-collar" violations with which the SEC must deal. The Commission's investigative and enforcement program was identified as being sufficiently unique to warrant establishment of a new standard applicable to the SEC only. With the accompanying title of Securities Compliance Examiner primarily for those engaged in broker-dealer, investment adviser, and investment company inspections, the special title and job standard should enhance the prestige and status of those staff members involved in all inspection programs.

## Position Management and Control

A formal position management system was established in November, 1971, resulting in an improved management control in creating new positions or in filling vacancies in existing jobs. Also, promotions are now funded and planned on a selective and priority basis.

## ELECTRONIC DATA PROCESSING

During the 1972 fiscal year, the Commission increased its efforts to further apply electronic data processing technology to its information systems.

A new system developed involves the creation of a data base covering information derived from holdings and transaction reports of corporate insiders. The system is designed to reduce late reporting and failure to report; utilize these reports systematically to verify share balances and detect liabilities for short-swing trading profits; assist in the enforcement of antifraud provisions; permit wider and more detailed public dissemination of insider trading information; and aid in the compilation of data for statistical and policy planning purposes.

Another project developed in fiscal year 1972 and currently being implemented in a delinquency reporting system involving Forms 10-K (Annual Report), 10-Q (Quarterly Report), and Forms N-1Q and N-1R (Investment Company reports). The purposes of the system are to assist in enforcement of timely reporting requirements; respond to inquiries from the public, staff members and other interested persons concerning specific reports and issuers; and end the lengthy manual reviews which have been necessary in the past.

The CUSIP numbering system, a method of identifying and describing securities which was developed by the Committee on Uniform Security Identification Procedures of the American Bankers Association, was instituted during the past year. In addition to the computer programs needed to cross-reference CUSIP data with Commission data files, programs and procedures were developed to provide for the manual and automated update and maintenance of the basic file.

In addition to these standing systems, the Commission also developed computer programs and produced specific outputs for several special, one-time projects. One of these involved the collection and analysis of data concerning certain oil and gas programs for use in drafting proposed legislation affecting such programs. Another project involved the creation of a computer file consisting of data collected through an Investment Company Brokerage Commission Questionnaire. Reports generated from this data file assisted the staff in assessing the effect on registered investment companies of the elimination of minimum commission rates on portions of orders in excess of \$500,000.

EDP applications currently under development include a system for processing data reported on Form 144, the form used for notice of proposed sales pursuant to the recently adopted Rule 144 under the Securities Act of 1933. Preliminary systems work was also begun late in fiscal year 1972, to determine the feasibility and probable design of an automated information and early warning system pertaining to financial and operational difficulties of broker-dealer and investment adviser firms.

**PART 9**  
**STATISTICS**



# PART 9

## STATISTICS

### THE SECURITIES INDUSTRY

#### Securities Industry Dollar

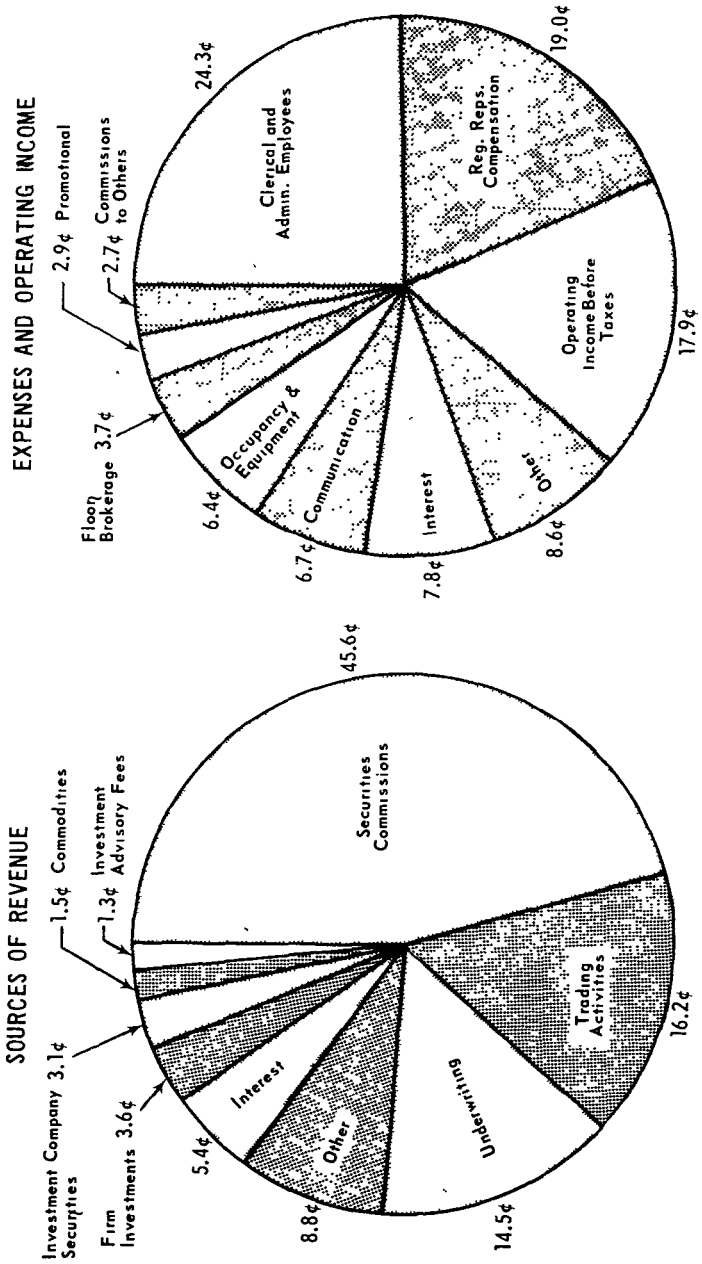
Of each dollar received by broker-dealers in calendar 1971, a total of 45.6 cents was derived from the securities commission business, 16.2 cents from trading activities, 14.5 cents from the underwriting business and the remaining 23.7 cents from secondary sources of revenue such as interest income on customers' accounts, sale of investment

company securities and gain or loss from firm investments.

Total expenses amounted to 82.1 cents. The two largest components of expenses were registered representatives' compensation, 19 cents per dollar, and clerical and administrative employee costs, 24.3 cents per dollar of revenue. Operating income before partners' compensation and taxes accounted for 17.9 cents of the average securities industry dollar.



SECURITIES INDUSTRY DOLLAR: 1971



## Income and Expenses

Gross revenue of broker-dealers from all activities rose 34 percent to \$6.8 billion in 1971 from \$5 billion in 1970. The increase was attributable primarily to a recovery in the 1971 dollar value of shares traded on exchanges and over-the-counter to nearly the 1968 peak level, and to a record volume of new issues. These factors are reflected in an increase of \$881 million in securities commission income and a \$357 million rise in underwriting income. All other sources of revenue, except interest income on customers' accounts and income from sales of investment company

securities, also recorded increases in 1971.

Total expenses increased 21 percent to \$5.5 billion in 1971, from \$4.6 billion in 1970. All expense items, except interest cost, rose in 1971, with compensation of registered representatives and clerical and administrative employees accounting for nearly two-thirds of the \$963 million increase in total expenses. Broker-dealers' operating income before partners' compensation and taxes increased by nearly 170 percent over 1970, to a \$1.2 billion level. This compares with a decline of nearly \$230 million from 1969 to 1970.

## \* BROKER-DEALER INCOME AND EXPENSES

(\$ Thousands)

Income	1969		1970		1971 <sup>p</sup>	
	Amount	Per cent	Amount	Per cent	Amount	Per cent
Securities Commission Business.....	\$2,936,795	49.0	\$2,198,259	43.7	\$3,079,118	45.6
Exchange Commission Business.....	2,268,480	37.9	1,756,273	34.9	2,429,359	36.0
Floor Activities.....	85,839	1.4	74,083	1.5	94,128	1.4
Over-the-Counter Business.....	582,476	9.7	367,903	7.3	555,631	8.2
Interest Income on Customers' Acct.....	474,057	7.9	379,568	7.6	363,949	5.4
Dealer Business and/or Trading Activities.....	706,054	11.8	846,442	16.8	1,097,387	16.2
Over-the-Counter Market Makers.....	399,928	6.7	288,719	5.8	459,369	6.8
Municipal and Government Bond Dealers.....	209,706	3.5	434,866	8.6	440,307	6.5
Traders in Non-Exempted Securities.....	96,420	1.6	122,857	2.4	197,711	2.9
Underwriting.....	645,027	10.8	625,239	12.4	981,939	14.5
Sales of Investment Company Securities.....	399,580	6.7	231,545	4.6	211,725	3.1
Investment Advisory Fees.....	79,718	1.4	67,215	1.3	84,746	1.3
Commodities.....	89,968	1.5	88,512	1.8	98,490	1.5
Gain or Loss in Firm Investment.....	133,527	2.2	65,841	1.3	241,666	3.6
Other Business.....	518,804	8.7	527,952	10.5	594,629	8.8
Gross Revenue.....	\$5,983,530	100.0	\$5,030,573	100.0	\$6,753,650	100.0
<b>Expenses</b>						
Commissions Paid to Other Brokers.....	\$181,476	3.0	\$131,679	2.6	\$182,867	2.7
Floor Brokerage Clearance, Commission Fees.....	227,768	3.8	191,382	3.8	249,860	3.7
Registered Representatives' Compensation.....	1,211,521	20.3	920,990	18.3	1,282,950	19.0
Interest.....	581,527	9.7	552,770	11.0	524,991	7.8
Clerical and Administrative Employees.....	1,582,131	26.4	1,374,192	27.3	1,643,007	24.3
Communication.....	448,405	7.5	392,940	7.8	452,696	6.7
Occupancy and Equipment.....	354,096	5.9	375,814	7.5	430,768	6.4
Promotional.....	219,192	3.7	175,956	3.5	198,578	2.9
Other.....	497,532	8.3	465,261	9.3	577,586	8.6
Total Expenses.....	5,303,648	88.6	4,580,984	91.1	5,543,303	82.1
Operating Income or Loss Before Taxes <sup>1</sup> .....	\$679,882	11.4	\$449,589	8.9	\$1,210,347	17.9
Number of Firms.....	2,631		2,346		2,517	

\* Broker-dealers with gross securities income of \$20,000 and over.

<sup>1</sup> Includes depreciation and amortization.<sup>2</sup> Before partners' compensation.<sup>p</sup> Preliminary.



Receivables from Other Broker-Dealers	244	.5	200	.4	277	.4	2,972	6.6	2,194	4.4	2,172	3.3
Securities Accounts	19	0	17	0	22	0	2,384	5.3	1,977	3.9	2,481	3.8
Commodities Accounts												
Total Net Debit Balances Carried for Customers	8,430	18.8	7,158	14.3	9,703	14.9	36	.1	30	.1	35	.1
Securities Accounts	48	.1	32	.1	6	0	154	.3	145	.3	152	.3
Commodities Accounts							109	.2	357	.7	345	.5
Net Debit Balances in General Partners' Accounts Not Covered by Equity Agreements	88	.2	96	.2	152	.2	81	.2	63	.1	73	.2
Long Positions in Securities and Commodities	7,818	17.5	10,749	21.5	11,983	18.4	865	1.9	725	1.4	916	1.4
Secured Demand Notes	151	.3	107	.2	116	.2	960	2.1	2,600	5.2	3,831	5.9
Securities Exchange Membership	346	.8	242	.5	222	.3	35	.1	5	0	6	0
Fixed Assets	235	.5	250	.5	281	.4	18,685	41.8	20,241	40.4	29,112	44.7
Other Assets							37,585	83.9	41,360	82.5	54,281	83.4
Investment in Unconsolidated Subsidiaries	44	.1	66	.1	94	.1						
Securities Business	465	1.1	2,109	4.2	2,839	4.4						
Commodities Business	14	0	11	0	7	0	670	1.5	677	1.4	765	1.2
Assets Not Related to the Securities or Commodities Business	21,042	47.0	24,422	48.8	34,648	53.3	708	1.6	543	1.1	468	.7
Total Assets	\$44,774	100.0	\$50,119	100.0	\$65,085	100.0	\$44,774	100.0	\$50,119	100.0	\$65,085	100.0
Number of Firms	2,631		2,346		2,517							

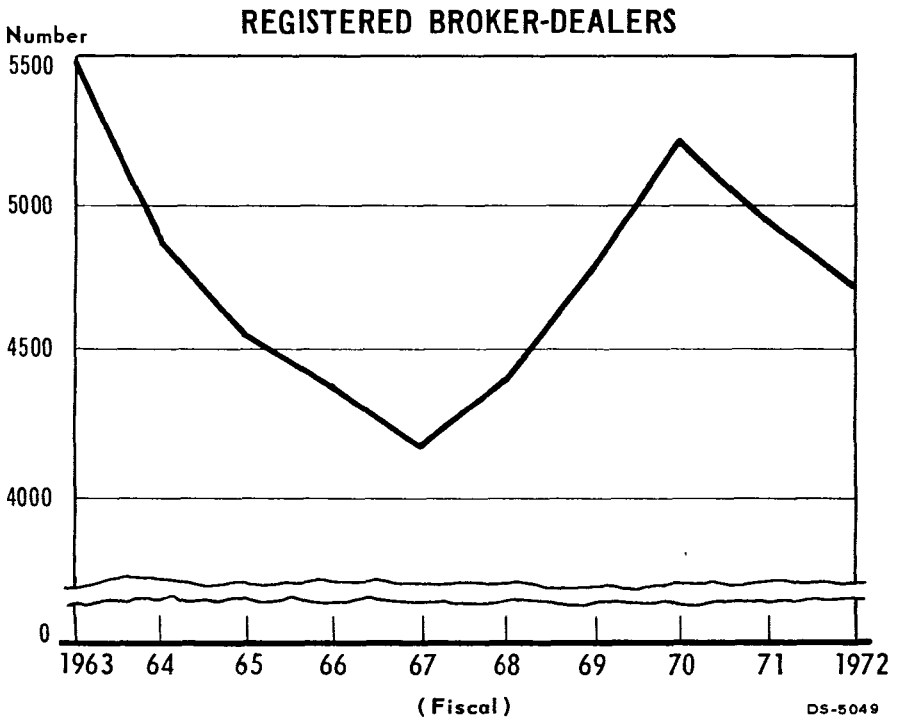
\* Broker-dealers with Gross Securities Income of \$20,000 and over.  
 † Preliminary

### Registered Broker-Dealers

During fiscal year 1972, there was a further net decline of 206 in the number of broker-dealers registered with the Commission, to 4,734. This decline resulted primarily from the withdrawal of 688 broker-dealer registrations in the course of the year. Since fiscal 1970, the net decline has totalled 490. However, the number of registered firms at the end of the past year was still substantially higher than that at the end of fiscal 1967, when the number of registered broker-dealers was only 4,175, the lowest number since 1954.

About one-fourth of all firms regis-

tered at the end of fiscal 1972 had their principal office in New York City. Another 413 firms maintained their principal office in other locations in New York State. California, with 483, accounted for the next highest numbers of firms, followed by New Jersey, with 234, and Pennsylvania, with 215. About 70 percent of the registered broker-dealers were organized as corporations. Of the remainder, the majority were sole proprietorships, with partnerships the least common form of organization. By way of comparison, at the end of fiscal 1968, only about 54 percent of the registered broker-dealers were corporations.



## LOCATION OF BROKER-DEALERS

(June 30, 1972)

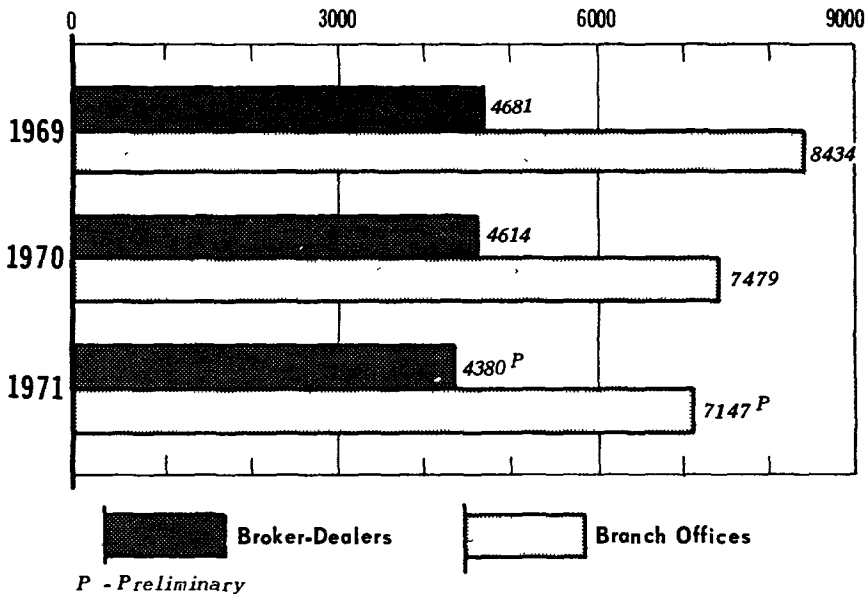
Principal Office	Number of Firms				Number of Principals <sup>1</sup>			
	Total	Sole proprietors	Partnerships	Corporations <sup>2</sup>	Total	Sole proprietors	Partnerships	Corporations <sup>3</sup>
Alabama.....	32	3	2	27	146	3	5	138
Alaska.....	2	2	0	0	2	2	0	0
Arizona.....	30	4	1	25	109	4	2	103
Arkansas.....	25	4	3	18	112	4	9	99
California.....	483	108	41	334	2,979	108	363	2,508
Colorado.....	84	14	4	66	510	14	59	437
Connecticut.....	55	7	9	39	380	7	87	286
Delaware.....	20	3	1	16	114	3	2	109
District of Columbia.....	55	8	8	39	385	8	60	317
Florida.....	133	15	8	110	495	15	24	456
Georgia.....	47	4	4	39	321	4	9	308
Hawaii.....	22	3	0	19	95	3	0	92
Idaho.....	8	0	0	8	29	0	0	29
Illinois.....	175	16	31	128	1,288	16	248	1,024
Indiana.....	55	10	1	44	298	10	2	286
Iowa.....	47	4	3	40	226	4	11	211
Kansas.....	31	3	3	25	179	3	11	165
Kentucky.....	10	2	2	6	55	2	24	29
Louisiana.....	27	11	6	10	198	11	62	125
Maine.....	14	3	2	9	44	3	9	32
Maryland.....	47	10	7	30	279	10	77	192
Massachusetts.....	199	55	19	125	1,170	55	143	972
Michigan.....	67	8	5	54	441	8	120	313
Minnesota.....	88	4	3	81	613	4	6	603
Mississippi.....	20	3	6	11	70	3	16	51
Missouri.....	85	8	7	70	714	8	74	632
Montana.....	10	4	0	6	26	4	0	22
Nebraska.....	22	1	0	21	181	1	0	180
Nevada.....	6	1	0	5	17	1	0	16
New Hampshire.....	12	3	0	9	39	3	0	36
New Jersey.....	234	58	26	150	727	58	68	601
New Mexico.....	5	1	0	4	23	1	0	22
New York (excluding New York City).....	413	146	34	233	1,008	146	114	748
North Carolina.....	31	9	3	19	170	9	17	144
North Dakota.....	8	1	0	7	30	1	0	29
Ohio.....	110	7	23	80	859	7	299	553
Oklahoma.....	27	8	1	18	90	8	2	80
Oregon.....	38	4	1	33	186	4	3	179
Pennsylvania.....	215	26	39	150	1,377	26	236	1,115
Rhode Island.....	30	7	4	19	80	7	23	50
South Carolina.....	1	1	1	14	78	1	2	75
South Dakota.....	2	1	0	1	11	1	0	10
Tennessee.....	49	4	2	43	274	4	19	251
Texas.....	174	30	6	138	1,114	30	21	1,063
Utah.....	53	5	4	44	185	5	12	168
Vermont.....	7	3	1	3	31	3	4	24
Virginia.....	55	11	9	35	340	11	54	275
Washington.....	83	12	2	69	382	12	4	366
West Virginia.....	7	2	1	4	24	2	5	17
Wisconsin.....	40	3	0	37	382	3	0	382
Wyoming.....	8	2	1	5	25	2	2	21
Total (excluding New York City).....	3,516	662	334	2,250	18,914	662	2,308	15,944
New York City.....	1,182	112	307	763	12,567	112	3,437	9,018
Total.....	4,698	774	641	3,283	31,481	774	5,745	24,962

<sup>1</sup> Does not include 36 registrants whose principal offices are located in foreign countries or other jurisdictions not listed.

<sup>2</sup> Allocations made on the basis of location of principal offices of registrants, not actual location of persons.

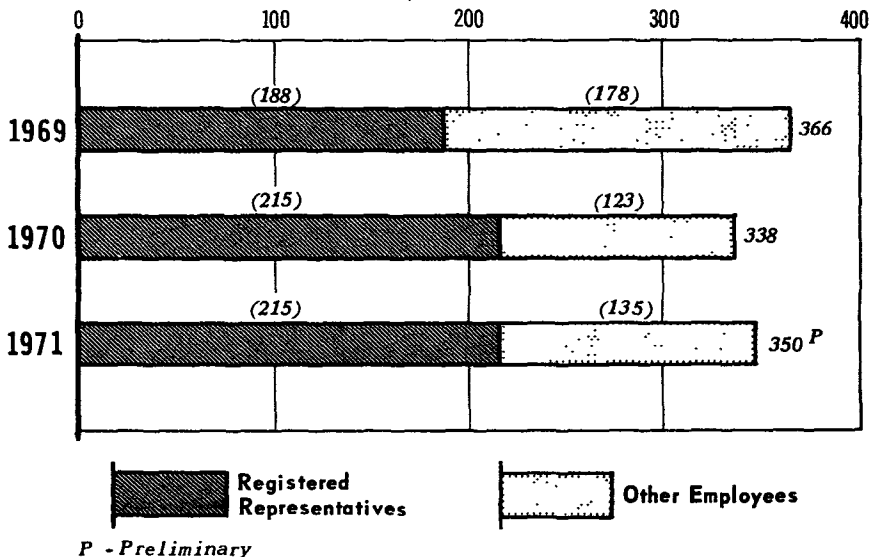
<sup>3</sup> Includes all forms of organizations other than sole proprietorships and partnerships.

**BROKER-DEALERS AND BRANCH OFFICES**



**EMPLOYEES**

(Thousands)



the same proportion as in 1970. In 1969, registered representatives accounted for 50 percent of total employment.

with 495 at the end of fiscal year 1968.

The largest decrease in this category was in the ranks of broker-dealers whose principal business is the selling of variable annuities, which dropped from 137 in 1968 to 21 in 1972. This was due primarily to the deregistration in fiscal 1970 of 94 general agent broker-dealers who became employed by a single SECO broker-dealer. The principal type of business of SECO broker-dealers is the general securities business.

**Broker-Dealers, Branch Offices, Employees**

The number of broker-dealers and branch offices has declined in each successive year since 1969. The number of employees declined between 1969 and 1970 but then increased 12,000 to about 350,000 employees in 1971. Registered representatives employed by the securities industry totaled 215,000, slightly over 60 percent of total employment—about

**SECO Broker-Dealers**

The number of broker-dealers who are not members of a registered securities association has declined in each fiscal year since 1968. Of all broker-dealers registered at the end of fiscal 1972, there were 294 SECO broker-dealers compared

**PRINCIPAL BUSINESS OF SECO BROKER-DEALERS**

	Fiscal Year-End				
	1968	1969	1970	1971	1972
Exchange member primarily engaged in floor activities.....	26	19	18	16	15
Exchange member primarily engaged in exchange commission business.....	42	37	32	37	33
Broker or dealer in general securities business.....	91	83	82	79	69
Mutual fund underwriter and distributor.....	42	35	35	27	27
Broker or dealer selling variable annuities.....	137	134	15	22	21
Solicitor of savings and loan accounts.....	22	19	19	15	10
Real estate syndicator and mortgage broker and banker.....	13	13	20	16	18
Broker or dealer selling oil and gas interests.....	9	6	4	4	3
Put and Call broker or dealer or option writer.....	27	29	27	23	22
Broker or dealer selling securities of only one issuer or associated issuers (other than mutual funds).....	21	18	16	15	17
Broker or dealer selling church securities.....	16	14	20	21	15
Government bond dealer.....	5	5	24	4	3
Broker or dealer in other securities business.....	28	33	21	19	30
Inactive.....	16	10	4	3	11
<b>Total.....</b>	<b>495</b>	<b>455</b>	<b>336</b>	<b>301</b>	<b>294</b>



**FINANCIAL INSTITUTIONS**

**Stock Transactions**

During 1971, four of the leading institutional investor groups—private non-

sured pension funds, open-end investment companies, life insurance companies, and property and liability insurance companies—bought almost \$15 billion (net) of common stock. This amount was 75 percent higher than net purchases in the previous

year. Since 1960, net acquisitions of these institutions have increased almost five times. However, as the table shows, gross purchases and gross sales, reflecting over all activity, have increased even more substantially.

**INSTITUTIONAL STOCK TRANSACTIONS**

(\$ millions)

	1960	1965	1966	1967	1968	1969	1970	1971
<b>Private noninsured pension funds</b>								
Purchases.....	\$2,610	\$5,585	\$6,610	\$10,035	\$12,285	\$15,230	\$13,955	\$21,685
Sales.....	1,670	2,560	3,165	5,655	7,875	10,270	9,370	16,800
Net purchases.....	1,940	3,025	3,445	4,380	4,410	4,960	4,585	8,885
<b>Open-end investment companies</b>								
Purchases.....	2,785	6,530	10,365	14,925	20,100	22,060	17,130	21,555
Sales.....	2,000	9,370	9,370	13,325	18,405	19,950	15,900	21,175
Net purchases.....	785	1,365	1,045	1,600	1,695	2,205	1,225	380
<b>Life insurance companies</b>								
Purchases.....	405	985	1,110	1,685	2,930	3,705	3,770	6,230
Sales.....	220	600	825	1,875	1,725	2,185	1,975	2,775
Net purchases.....	185	390	285	805	1,205	1,520	1,795	3,455
<b>Property and liability insurance companies</b>								
Purchases.....	640	770	900	1,165	2,245	3,780	3,615	4,170
Sales.....	400	945	825	980	1,645	2,680	2,720	1,945
Net purchases.....	240	-190	80	185	600	900	890	2,225
<b>TOTAL</b>								
Purchases.....	6,440	13,875	18,985	27,810	37,565	44,775	38,465	53,645
Sales.....	3,290	9,260	14,135	20,835	29,680	35,185	29,870	38,695
Net purchases.....	3,150	4,585	4,850	6,975	7,885	9,590	8,500	14,950
<b>Foreign Investors<sup>1</sup></b>								
Purchases.....	1,975	3,720	4,740	8,035	13,120	12,430	8,925	11,625
Sales.....	1,775	4,120	5,075	7,275	10,860	10,940	8,300	10,895
Net purchases.....	200	-415	-335	755	2,270	1,485	625	730

<sup>1</sup> Reflects trading in domestic issues including preferred stock.

SOURCES: Pension funds and property and liability insurance companies, SEC; investment companies, Investment Company Institute; life insurance companies, Institute of Life Insurance; foreign investors, Treasury Dept.

**Stock Holdings**

The market value of total stock outstanding in the United States, both common and preferred, passed the trillion dollar mark during 1971; at year-end it was estimated to be \$1,002 billion. Of

this total, \$304 billion was held by the institutional investors listed in the table, and \$29 billion was held by foreign investors. Individuals in the U.S. (and institutional investors not listed) held \$669 billion or 66.7 percent of the total. This

represents a slight reduction from the 67.1 percent at year-end 1970 and continues the trend evident throughout the 1960-1970 decade of a gradual decrease in the portion of total stock held by U.S. individuals.

**INSTITUTIONAL STOCK HOLDINGS**

(\$ billions)

	1960	1965	1966	1967	1968	1969	1970	1971
1. Private noninsured pension funds.....	\$16.5	\$40.8	\$39.5	\$51.1	\$61.5	\$61.4	\$67.1	\$86.8
2. Open-end investment companies.....	15.4	33.5	31.2	42.8	50.9	45.1	43.9	52.5
3. Other investment companies.....	5.2	7.6	6.2	8.2	8.2	6.6	6.2	7.1
4. Life insurance companies.....	5.0	9.1	8.8	10.9	13.2	13.7	15.4	20.5
5. Property and liability insurance companies <sup>1</sup> .....	7.5	12.0	11.0	13.0	14.6	13.3	13.2	15.5
6. Common trust funds.....	1.7	3.5	3.3	3.9	4.8	4.6	4.6	5.0
7. Personal trust funds.....	42.9	69.7	66.7	75.9	83.6	79.6	78.6	86.5
8. Mutual savings banks.....	0.8	1.4	1.5	1.7	1.9	2.2	2.5	3.0
9. State and local retirement funds.....	0.4	1.6	2.1	2.8	4.1	5.8	8.0	11.3
10. Foundations.....	9.0	14.9	14.1	15.6	17.5	15.7	15.9	18.6
11. Educational Endowments.....	4.2	7.0	6.3	7.8	8.1	7.9	8.0	8.9
12. Subtotal.....	108.6	201.2	190.6	233.5	268.4	255.9	263.4	315.8
13. Less: Institutional holdings of investment company shares.....	2.2	4.9	5.3	7.0	8.3	8.8	9.8	11.3
14. Total Institutional Investors.....	106.4	196.4	185.3	226.5	260.1	247.1	253.6	304.4
15. Foreign investors <sup>2</sup> .....	13.4	19.9	18.1	21.5	26.0	25.2	26.6	29.0
16. Domestic individuals (line 17-14-15) <sup>3</sup> .....	301.4	497.6	444.4	576.8	688.8	589.1	571.9	668.6
17. Total Stock Outstanding <sup>4</sup> .....	421.2	783.9	647.8	824.8	974.9	861.4	852.1	1,002.0

<sup>1</sup> Excludes holdings of insurance company stock.

<sup>2</sup> Includes estimate of stock held as direct investment.

<sup>3</sup> Computed as residual. Includes individuals as well as institutional groups not listed above.

<sup>4</sup> Revised estimates of market value, both common and preferred stock. Excludes investment company shares, but includes foreign issues outstanding in the U.S.

### Investment Companies

As of the end of the 1972 fiscal year, 1,334 investment companies were registered with the Commission, a decline of 17 from the number one year earlier. Of the registered companies, 90 were classified as "inactive." Approximately 65 percent of the active companies were management open-end companies ("mutual funds").

The 1,244 active companies had total assets having an approximate market

value of \$80.8 billion, with mutual funds accounting for about 80 percent of that value. The \$80.8 billion figure represents the highest fiscal year-end figure since the Investment Company Act was passed in 1940. An appreciation of the tremendous growth of the investment company industry in the intervening period may be gained by noting that in 1950 there were 366 investment companies with total assets of about \$4.7 billion, and that as recently as 1960, there were only 570 companies with assets of \$23.5 billion.

### REGISTERED INVESTMENT COMPANIES

(June 30, 1972)

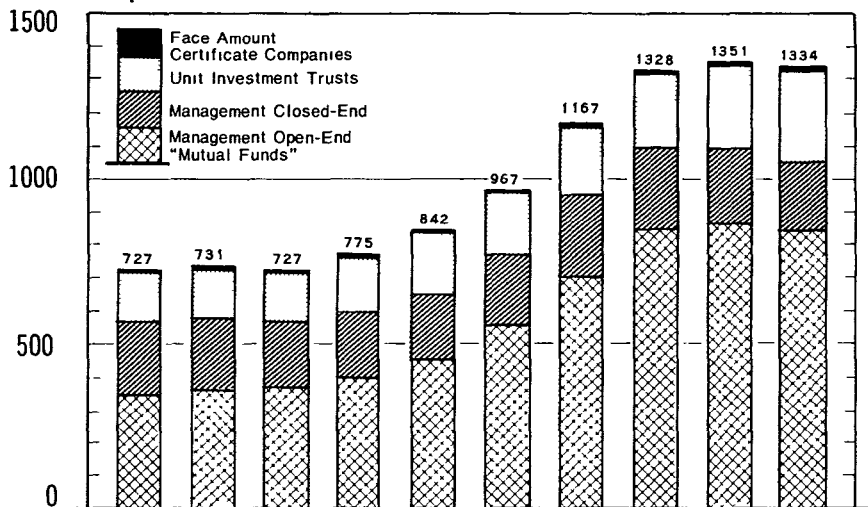
	Number of registered companies			Approximate market value of assets of active companies (millions)
	Active	Inactive <sup>a</sup>	Total	
Management open-end ("Mutual Funds").....	812	29	841	\$64,738
Funds having no load or load not exceeding 3 per cent of net asset value.....	252			8,483
Variable annuity-separate accounts.....	47			848
Capital leverage companies.....	2			67
All other load funds.....	511			55,340
Management closed-end.....	177	37	214	8,450
Small business investment companies.....	42			217
Capital leverage companies.....	7			347
All other closed-end companies.....	128			7,886
Unit investment trusts.....	250	21	271	6,515 <sup>b</sup>
Variable annuity-separate accounts.....	37			72
All other unit investment trusts.....	213			6,443
Face-amount certificate companies.....	5	3	8	1,113
Total.....	1,244	90	1,334	80,816

<sup>a</sup> "Inactive" refers to registered companies which were in the process of being liquidated or merged, or have filed an application under Section 8(f) of the Act for deregistration, or which have otherwise gone out of existence and remain registered only until such time as the Commission issues orders under Section 8(f) terminating their registration.

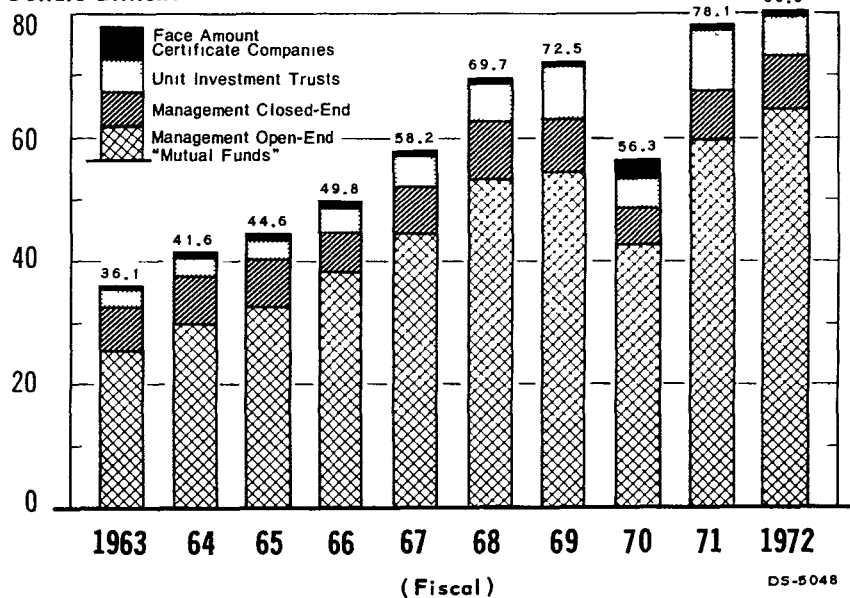
<sup>b</sup> Includes about \$4.8 billion of assets of trusts which invest in securities of other investment companies, substantially all of them mutual funds.

## NUMBER AND ASSETS OF REGISTERED INVESTMENT COMPANIES

**No. of Companies**



**Dollars Billions**



**Investment Company Registrations**

Since 1969 there has been a steady decline in registrations of new investment companies, most of it attributable

to a decline in new mutual fund registrations. At the same time more existing investment companies have terminated registrations.

**NEW INVESTMENT COMPANY REGISTRATIONS**

	(Fiscal)				
	1968	1969	1970	1971	1972
<b>Management open-end ("mutual funds")</b>					
Funds having no load or load not exceeding 3 percent of net asset value	21	33	42	18	10
Variable annuity-separate accounts	14	14	9	4	0
All other load funds	82	109	82	41	28
Sub-total	117	156	133	63	38
<b>Management closed-end</b>					
Small business investment companies	3	2	1	5	1
All other closed-end funds	32	42	26	18	23
Sub-total	35	44	27	23	24
<b>Unit investment trusts</b>					
Variable annuity-separate accounts	3	6	11	8	7
All other unit investment trusts	11	16	14	27	22
Sub-total	14	22	25	35	29
<b>Face-amount certificate companies</b>	1	0	2	0	0
<b>Total</b>	167	222	187	121	91

**INVESTMENT COMPANY REGISTRATIONS TERMINATED**

	(Fiscal)				
	1968	1969	1970	1971	1972
<b>Management Open-end ("mutual funds")</b>					
Funds having no load or load not exceeding 3 percent of net asset value	1	0	2	3	14
Variable annuity-separate accounts	0	0	1	2	0
All other load funds	20	3	9	41	50
Sub-total	21	3	12	46	64
<b>Management closed-end</b>					
Small business investment companies	6	0	2	3	7
All other closed-end funds	9	16	9	38	27
Sub-total	15	16	11	41	34
<b>Unit investment trusts</b>					
Variable annuity-separate accounts	0	0	0	0	1
All other unit investment trusts	6	2	3	10	8
Sub-total	6	2	3	10	9
<b>Face-amount certificate companies</b>	0	1	0	1	1
<b>Total</b>	42	22	26	98	108

### Private Noninsured Pension Funds: Market Value

The market value of all private non-insured pension fund assets was \$125 billion at the end of 1971. This figure was 17 percent higher than book value.

At year-end 1970, market value exceeded book value by 8 percent. These estimates include pension funds of corporations, non-profit institutions, and multi-employer and union groups; excluded are health, welfare and other employee benefit plans.

### MARKET VALUE OF PRIVATE NONINSURED PENSION FUNDS

(\$ millions)

	1960	1965	1966	1967	1968	1969	1970	1971
Cash and deposits...	500	900	900	1,300	1,600	1,600	1,800	1,600
U.S. Government securities.....	2,700	2,900	2,700	2,200	2,600	2,600	3,000	2,800
Corporate and other bonds.....	14,600	21,900	22,500	22,600	22,400	21,300	24,900	26,100
Preferred stock.....	700	800	800	1,000	1,400	1,600	1,600	2,000
Common stock.....	15,800	40,000	38,700	50,100	60,100	59,800	65,500	84,800
Own company.....	2,000	4,400	3,500	5,000	5,700	5,700	5,900	7,600
Other companies.....	13,800	35,600	35,200	45,100	54,400	54,200	59,500	77,200
Mortgages**.....	1,300	3,400	3,800	4,000	3,600	3,500	3,600	3,200
Other assets.....	1,400	3,000	3,500	4,200	4,300	4,300	4,300	4,500
Total assets**.....	37,100	72,900	72,800	85,500	96,000	94,600	104,700	125,000

### Private Noninsured Pension Funds: Book Value

Total assets of private noninsured pension funds were \$106.4 billion (book value) at the end of 1971, almost 10 percent higher than 1970. While this rate of growth exceeds the 7 percent

rise in 1970, it is less than the average annual growth rate from 1960 to 1968 (12 percent). A total of \$62.8 billion of pension fund assets were invested in common stock in 1971. This represents about three-fifths of all assets versus only about one-third held in common stock in 1960.

### BOOK VALUE OF PRIVATE NONINSURED PENSION FUNDS

(\$ millions)

	1960	1965	1966	1967	1968	1969	1970	1971
Cash and deposits...	550	940	900	1,320	1,590	1,620	1,800	1,640
U.S. Government securities.....	2,680	2,990	2,750	2,320	2,760	2,790	3,030	2,730
Corporate and other bonds.....	15,700	23,130	25,230	26,360	27,000	27,610	29,670	29,010
Preferred stock.....	780	750	790	980	1,330	1,760	1,740	1,770
Common stock.....	10,730	25,120	29,070	34,950	41,740	47,860	51,740	62,780
Own company.....	890	1,830	2,090	2,560	2,800	3,020	3,270	3,500
Other companies.....	9,850	23,290	26,980	32,380	38,940	44,840	48,480	59,280
Mortgages.....	1,300	3,380	3,910	4,080	4,070	4,220	4,300	3,680
Other assets.....	1,400	2,870	3,520	4,230	4,580	4,720	4,730	4,800
Total assets.....	33,140	59,180	66,170	74,240	83,070	90,580	97,010	106,420

**SECURITIES ON EXCHANGES**  
**Exchange Volume**

Dollar volume of all securities transactions on exchanges rose to \$195.2 billion during 1971 from \$136.5 billion in 1970. Of this total, \$185 billion represented

stock trading, \$8.8 billion bond trading, and the balance trading in rights and warrants. New York Stock Exchange transactions accounted for \$147.1 billion of dollar volume in stocks, which represented a gain of 42 percent over 1970 volume. NYSE share volume amounted to 4.2 billion

shares, up 24 percent from the 3.4 billion of the previous year. On the American Stock Exchange, 1971 share volume exceeded one billion shares, or 14 percent above the previous year. AMEX dollar volume in stocks was \$17.7 billion, 20 percent more than the previous year.

**EXCHANGE VOLUME: 1971**

	Total dollar volume (thousands)	Bonds		Stocks		Rights and warrants	
		Dollar volume (thousands)	Principal amount (thousands)	Dollar volume (thousands)	Share volume (thousands)	Dollar volume (thousands)	Number of units (thousands)
All Registered Exchanges.....	\$195,173,034	\$8,803,908	10,157,902	\$185,027,082	5,915,618	\$1,342,044	256,486
American.....	19,316,088	710,046	931,763	17,663,736	1,049,317	942,306	88,189
Boston.....	1,091,817	0	0	1,090,361	26,493	1,457	88
Chicago Board of Trade.....	93,827	26	45	93,399	1,990	0	0
Cincinnati.....	390,760	0	0	350,727	9,571	2	56
Detroit.....	7,465,874	1,136	1,201	7,443,311	215,650	11,427	2,128
Midwest.....	57,127	608	666	56,519	13,983	0	0
National.....	195,381,997	8,009,570	9,880,684	147,098,396	4,265,279	274,031	138,540
New York.....	7,143,966	79,965	138,367	6,962,108	206,327	103,893	23,355
Pacific Coast.....	4,272,614	2,556	5,176	4,260,762	114,405	8,895	4,053
Philadelphia-Baltimore-Washington.....	2,902	0	0	4,862	5,860	0	0
Salt Lake.....	0	0	0	2,902	6,752	0	0
Spokane.....	5,638	13	12	5,521	531	5	33
Exempted exchanges.....	5,538	13	12	5,521	531	5	33
Honolulu.....	0	0	0	0	0	0	0
Richmond.....	0	0	0	0	0	0	0

### Stock Volume by Exchanges; NASDAQ Volume

The NYSE share of all exchange volume rose slightly in 1971 to nearly 80 percent of share volume. AMEX share volume was 18 percent of the total, while AMEX dollar volume accounted for 10 percent of all exchange volume. For both measures, this represented a slight decline from the previous year. Of the regional exchanges, the Midwest and Pacific Coast Stock Exchanges had the biggest volume, each exceeding 3 per-

cent of total share and dollar volume.

Since November 1, 1971, trading volume for a significant portion of the active over-the-counter market has been compiled by the NASD's automated quotations system (NASDAQ). For the first six months of 1972, NASDAQ volume was 1.2 billion shares, equivalent to 56 percent of NYSE volume and 183 percent of AMEX volume. This trading volume reflects the number of shares bought and sold by market makers plus the net inventory changes for market makers.

### SHARE VOLUME BY EXCHANGES

Year	Share sales	NYSE %	ASE %	MSE %	PCS %	PBS %	BSE %	DSE %	CIN %	Other %
1935	681,970,500	73.13	12.42	1.91	2.69	1.10	0.96	0.85	0.03	6.91
1940	377,896,572	75.44	13.20	2.11	2.78	1.33	1.19	.82	.08	2.05
1945	769,018,138	65.87	21.31	1.77	2.98	1.06	.66	.79	.05	5.51
1950	893,320,458	76.32	13.84	2.16	3.11	.97	.65	.55	.09	2.61
1955	1,321,400,711	68.85	19.19	2.09	3.08	.85	.48	.39	.05	5.02
1956	1,182,467,085	66.31	21.01	2.32	3.25	.83	.47	.49	.05	5.27
1957	1,293,021,856	70.70	18.14	2.33	2.73	1.11	.40	.39	.06	4.14
1958	1,400,578,512	71.31	19.14	2.13	2.99	.84	.45	.35	.05	2.74
1959	1,699,696,619	65.59	24.50	2.00	2.81	.97	.37	.31	.04	3.41
1960	1,441,047,564	68.48	22.27	2.20	3.11	.95	.39	.34	.05	2.21
1961	2,142,523,490	64.99	25.58	2.22	3.42	.84	.31	.31	.04	2.29
1962	1,711,945,297	71.32	20.12	2.34	2.95	.92	.31	.36	.05	1.63
1963	1,880,798,423	72.94	18.84	2.43	2.83	.88	.29	.47	.04	1.38
1964	2,126,373,821	72.54	19.35	2.43	2.64	.98	.29	.54	.04	1.19
1965	2,671,011,839	69.91	22.53	2.63	2.34	.86	.27	.53	.05	.88
1966	3,312,383,465	69.37	22.85	2.57	2.68	.90	.40	.43	.06	.72
1967	4,646,524,907	64.41	28.42	2.36	2.46	.90	.43	.33	.03	.66
1968	5,408,737,347	61.98	29.74	2.63	2.65	.92	.78	.32	.01	.99
1969	5,134,994,769	63.16	27.61	2.86	3.48	1.26	.51	.12	.01	.97
1970	4,834,427,929	71.29	19.03	3.16	3.68	1.63	.52	.11	.02	.56
1971	6,172,667,835	71.34	18.43	3.53	3.72	1.92	.43	.16	.03	.44

### DOLLAR VOLUME BY EXCHANGES

Year	Dollar volume (\$ thousands)	NYSE %	ASE %	MSE %	PCS %	PBS %	BSE %	DSE %	CIN %	Other %
1935	\$15,396,139	86.64	7.83	1.32	1.39	.88	1.34	.40	.04	.16
1940	8,419,772	85.17	7.68	2.07	1.52	1.11	1.91	.36	.09	.09
1945	16,284,552	82.75	10.81	2.00	1.78	.96	1.16	.35	.06	.13
1950	21,808,284	85.91	6.85	2.35	2.19	1.03	1.12	.39	.11	.05
1955	38,039,107	86.31	6.98	2.44	1.90	1.03	.78	.39	.09	.08
1956	35,143,115	84.95	7.77	2.75	2.08	1.08	.80	.42	.08	.07
1957	32,214,846	85.51	7.33	2.69	2.02	1.12	.76	.42	.07	.05
1958	38,419,560	85.42	7.45	2.71	2.11	1.10	.71	.37	.07	.05
1959	52,001,255	83.66	9.53	2.67	1.94	1.09	.66	.33	.07	.04
1960	45,306,503	83.81	9.35	2.73	1.95	1.10	.60	.34	.07	.06
1961	64,071,523	82.44	10.71	2.75	2.00	1.10	.50	.37	.07	.06
1962	54,855,894	86.32	6.81	2.76	2.00	1.11	.46	.42	.07	.05
1963	64,438,073	85.19	7.52	2.73	2.39	1.12	.42	.52	.06	.05
1964	72,461,750	83.49	8.46	3.16	2.48	1.21	.43	.66	.06	.05
1965	89,549,093	81.78	9.91	3.45	2.43	1.18	.43	.70	.08	.04
1966	123,666,443	79.78	11.84	3.14	2.85	1.14	.57	.57	.08	.03
1967	162,189,211	77.29	14.48	3.08	2.80	1.16	.67	.44	.04	.08
1968	197,117,957	73.56	18.00	3.12	2.66	1.17	1.04	.35	.02	.08
1969	176,389,759	73.49	17.60	3.39	3.13	1.46	.67	.12	.01	.13
1970	131,710,176	78.45	11.11	3.76	3.81	2.00	.68	.11	.03	.05
1971	186,374,651	79.07	9.98	3.99	3.79	2.29	.59	.19	.03	.04



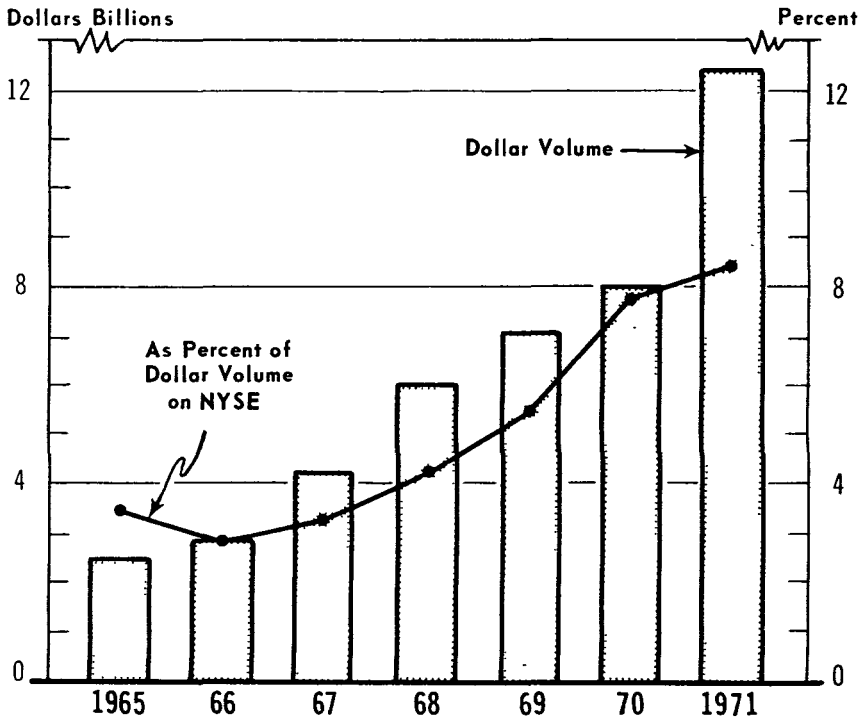
**Third Market Volume**

During 1971, over-the-counter sales of common stocks listed on the New York Stock Exchange (the so-called "third market") reached record levels in terms of both share and dollar volume. Over-the-counter volume amounted to almost 298 million shares, valued at \$12.4 billion, compared with 210 million

shares and \$8 billion the previous year.

The increase in dollar volume represented the largest annual increase since 1965, when reports to the Commission regarding third market transactions were first required. Trading over-the-counter in NYSE common stocks as a ratio to all stock trading on the NYSE reached a new high of 7.0 percent on a share basis and 8.4 percent on a dollar basis.

**'THIRD MARKET' VOLUME IN NYSE STOCKS**



**Block Distributions**

Special distribution methods are utilized when blocks are considered too large for the regular auction market on the floor of the exchanges. Most important is the secondary distribution which takes place off the floor of the exchange, usually after trading hours. The block is offered by firms at a price usually below the last transaction. In 1971, there were 204 secondary distributions involving stocks valued at \$2 billion, a four-fold increase from the 1970 level.

Special offerings, a third method, have not been used since 1968.

In another method, the exchange dis-

tributed, a group of member firms solicits buy orders sufficient to cross with the block sell order. The number of exchange distributions decreased in 1971, but value of shares sold increased.

**BLOCK DISTRIBUTIONS REPORTED BY EXCHANGES**  
(\$ thousands)

Year	Secondary distributions			Exchange distributions			Special offerings		
	Number	Shares sold	Value	Number	Shares sold	Value	Number	Shares sold	Value
1942	116	2,397,454	\$82,840	-	-	-	79	812,390	\$22,694
1943	81	4,270,580	127,462	-	-	-	80	1,097,338	31,054
1944	94	4,097,298	135,760	-	-	-	87	1,053,667	32,454
1945	115	9,457,358	191,961	-	-	-	79	947,231	29,878
1946	100	6,481,291	232,398	-	-	-	79	308,134	11,002
1947	73	3,961,572	124,671	-	-	-	23	124,270	9,133
1948	95	7,302,420	175,991	-	-	-	21	238,879	5,466
1949	86	3,737,249	104,062	-	-	-	30	500,211	10,956
1950	77	4,280,681	88,743	-	-	-	26	150,308	4,940
1951	88	5,193,756	146,459	-	-	-	32	323,013	10,751
1952	76	4,223,258	149,117	-	-	-	22	357,897	9,931
1953	68	6,906,017	108,229	-	-	-	17	380,680	10,486
1954	84	5,738,359	218,490	57	705,781	\$24,664	14	189,972	6,670
1955	84	5,738,359	344,871	19	258,348	10,211	9	161,856	7,223
1956	116	6,756,767	520,966	17	156,481	4,645	8	131,955	4,567
1957	99	9,324,599	339,062	33	390,832	15,895	5	163,408	1,805
1958	122	9,508,505	361,886	38	619,876	23,954	5	98,452	1,296
1959	148	17,330,941	822,336	28	545,038	26,491	3	23,809	3,730
1960	92	11,439,055	424,688	20	441,664	11,708	2	35,000	1,483
1961	130	19,910,013	976,514	33	1,177,266	58,072	3	35,000	1,568
1962	59	12,143,656	658,780	41	2,345,076	65,656	2	48,200	0
1963	100	18,937,935	814,984	72	2,892,233	107,488	0	0	0
1964	110	19,462,343	909,821	68	2,551,237	97,711	0	0	0
1965	142	31,153,319	1,603,107	57	2,324,277	86,749	0	0	0
1966	126	29,045,038	1,523,373	52	3,042,690	138,349	0	0	0
1967	130	30,783,604	1,154,479	31	3,482,856	123,404	0	0	0
1968	174	36,110,489	1,571,600	35	2,626,938	93,528	1	3,352	63
1969	142	38,224,799	1,571,600	32	2,969,572	52,198	0	0	0
1970	72	17,830,008	1,504,562	35	1,706,572	52,198	0	0	0
1971	204	72,801,243	2,007,517	30	2,595,104	65,765	0	0	0

### Value and Number of Exchange Securities

The market value of all securities, including bonds, on United States stock exchanges was \$928 billion at year-end 1971. This represents a gain of \$131 billion, or 16 percent, over the value reported a year earlier.

The value of common and preferred stock traded on all exchanges was a record \$795.6 billion at the end of 1971. This reflected a 17 percent increase in value during the year and compares to the previous high of \$759.5 billion at the end of 1968.

The value of stocks on exchanges has had an upward trend for the past two decades, and is now more than double the 1960 value of \$335.3 billion.

The value of stocks listed on exchanges is dominated by NYSE-listed stocks. The NYSE stocks totaled \$741.8 billion at the end of 1971, 93 percent

of the value of all listed stocks. The proportion ten years earlier was 91 percent for NYSE stocks. The value of stocks listed on the American Stock Exchange totaled \$49.1 billion at year-end 1971, sharply higher than the preceding year, but lower than the record total of \$61.2 billion at the end of 1968. Stocks totaled \$4.7 billion on December 31, listed exclusively on other exchanges 1971, \$100 million less than the preceding year total.

The number of stock and bond issues on U.S. exchanges at the end of 1971 was 5,902. This represents an increase of 447, or 8 percent, from the number of issues at the end of 1970. The majority of securities on U.S. exchanges are listed on the New York Stock Exchange which accounts for 3,915 listed securities, or 66 percent of the total. Data on the number and value of foreign securities are in a footnote to the first of the following tables.

### VALUE OF SECURITIES ON EXCHANGES

December 31, 1971

Type of Issue	American Stock Exchange		New York Stock Exchange		Exclusively on other Exchanges		All U.S. Exchanges <sup>1</sup>	
	Number	Value (\$ millions)	Number	Value (\$ millions)	Number	Value (\$ millions)	Number	Value (\$ millions)
Stocks <sup>2</sup>								
Common.....	1,234	\$47,751	1,399	\$714,358	348	\$4,410	2,981	\$766,519
Preferred.....	74	1,298	528	27,469	125	336	727	29,103
Bonds.....	182	2,761	1,988	129,445	24	302	2,194	132,508
<b>Total.....</b>	<b>1,490</b>	<b>\$51,810</b>	<b>3,915</b>	<b>\$871,272</b>	<b>497</b>	<b>\$5,048</b>	<b>5,902</b>	<b>\$928,130</b>

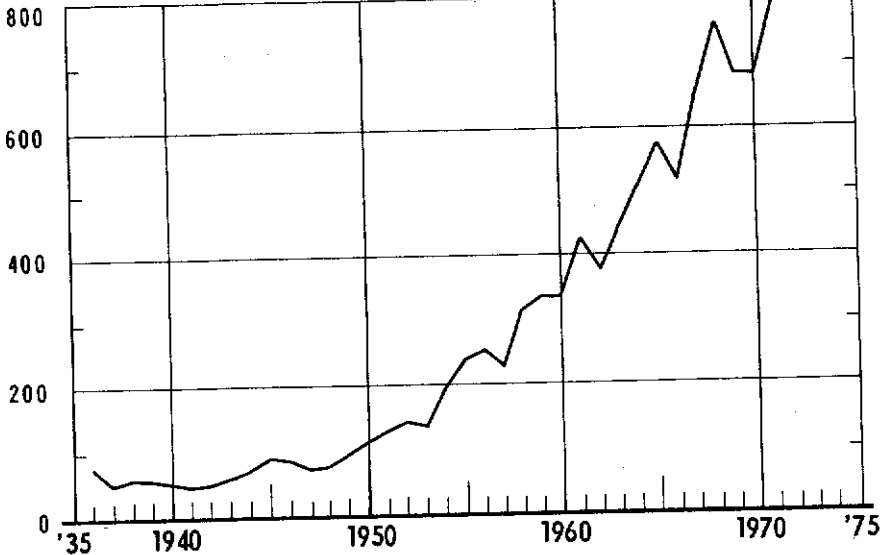
<sup>1</sup> Excludes securities which were suspended from trading at the end of the year and securities which because of inactivity had no available quotes.

<sup>2</sup> Includes the following foreign stocks:

Exchange:	Number	Value (\$ millions)
New York.....	34	\$12,414
American.....	67	9,534
All Others.....	6	165
<b>Total.....</b>	<b>107</b>	<b>\$22,113</b>

MARKET VALUE OF STOCKS ON EXCHANGES

Dollars Billions



DS-5059

VALUE OF STOCKS ON EXCHANGES

(\$ billions)

December 31	New York Stock Exchange	American Stock Exchange	Exclusively on other Exchanges	Totals
1936	\$59.9	\$14.8	---	\$74.7
1937	38.9	10.2	---	49.1
1938	47.5	10.8	---	58.3
1939	46.5	10.1	---	56.6
1940	41.9	8.6	---	50.5
1941	35.8	7.4	---	43.2
1942	38.8	7.8	---	46.6
1943	47.6	9.9	---	57.5
1944	55.5	11.2	---	66.7
1945	73.8	14.4	---	88.2
1946	68.6	13.2	---	81.8
1947	68.3	12.1	---	80.4
1948	67.0	11.9	\$3.0	81.9
1949	76.3	12.2	3.1	91.6
1950	93.8	13.9	3.3	111.0
1951	109.5	16.5	3.2	129.2
1952	120.5	16.9	3.1	140.5
1953	117.3	15.3	2.8	135.4
1954	169.1	22.1	3.6	194.8
1955	207.7	27.1	4.0	238.8
1956	219.2	31.0	3.8	254.0
1957	195.6	25.5	3.1	224.2
1958	276.7	31.7	4.3	312.7
1959	307.7	26.4	4.2	338.4
1960	307.0	24.2	4.1	335.3
1961	387.8	33.0	4.2	426.2
1962	345.8	24.4	5.3	374.2
1963	411.3	26.1	4.0	441.7
1964	474.3	28.2	4.3	506.8
1965	537.5	30.9	4.7	573.1
1966	482.5	27.9	4.0	514.4
1967	605.8	43.0	3.9	652.7
1968	692.3	61.2	6.0	759.5
1969	629.5	47.7	5.4	682.6
1970	636.4	39.5	4.8	680.7
1971	741.8	49.1	4.7	795.6

## Securities on Exchanges

As of June 30, 1972, a total of 6,160 securities, representing 3,377 issuers, were admitted to trading on securities exchanges in the United States. This compares with 5,781 issues, involving 3,220 issuers, a year earlier. Over 4,000

issues were listed and registered on the New York Stock Exchange, accounting for 52.4 percent of the stock issues and 90 percent of the bond issues. Data below on "Securities Traded on Exchanges" involves some duplication since it includes both solely and dually listed securities.

## UNDUPLICATED COUNT OF SECURITIES ON EXCHANGES

(June 30, 1972)

Registered Exchanges	Stocks	Bonds	Total	Issuers involved
Registered and listed.....	3,818	2,226	6,044	3,298
Temporarily exempted from registration.....	10	2	12	2
Admitted to unlisted trading privileges.....	53	4	57	43
<b>Exempted Exchanges</b>				
Listed.....	34	5	39	26
Admitted to unlisted trading privileges.....	8	0	8	8
<b>Total.....</b>	<b>3,923</b>	<b>2,237</b>	<b>6,160</b>	<b>3,377</b>

## SECURITIES TRADED ON EXCHANGES

	Issuers	Stocks				Bonds <sup>1</sup>
		Registered	Temporarily Exempted	Unlisted	Total	
American.....	1,306	1,333	2	59	1,394	193
Boston.....	728	69	--	692	761	15
Chicago Board of Trade.....	4	2	--	2	4	--
Cincinnati.....	244	28	--	224	252	9
Detroit.....	392	66	--	340	406	--
Honolulu <sup>2</sup> .....	41	--	--	--	50	5
Intermountain <sup>3</sup> .....	54	51	--	3	54	--
Midwest.....	632	388	2	329	719	15
National.....	131	137	--	--	137	7
New York.....	1,747	1,999	4	--	2,003	2,004
Pacific Coast.....	822	793	2	198	993	60
Phila.-Balt.-Wash.....	926	254	--	828	1,082	58
Spokane.....	34	31	--	6	37	--

<sup>1</sup> Issues exempted under Section 3(a) (12) of the Act, such as obligations of U.S. Government, the states, and cities, are not included in this table.

<sup>2</sup> Exempted exchange had 42 listed stocks and 8 admitted to unlisted trading.

<sup>3</sup> Intermountain Stock Exchange changed its name from Salt Lake Exchange in May 1972.

## 1933 ACT REGISTRATIONS

Effective Registrations;  
Statements Filed

The Commission declared effective a record number of 3,712 registration statements in fiscal 1972. Commission action cleared the way for the offering of approximately \$62.5 billion of securities. The previous record number of effective registrations was 3,645, in fis-

cal 1969. However, the total dollar amount in 1972 fell far short of the record \$82.5 billion set in 1969.

There were 4,112 registration statements filed during fiscal 1972. This volume of filings nearly equaled the record of 4,314 established in 1970. Included in this total were 1,371 statements by companies filing with the Commission for the first time, 374 more than in the previous year.

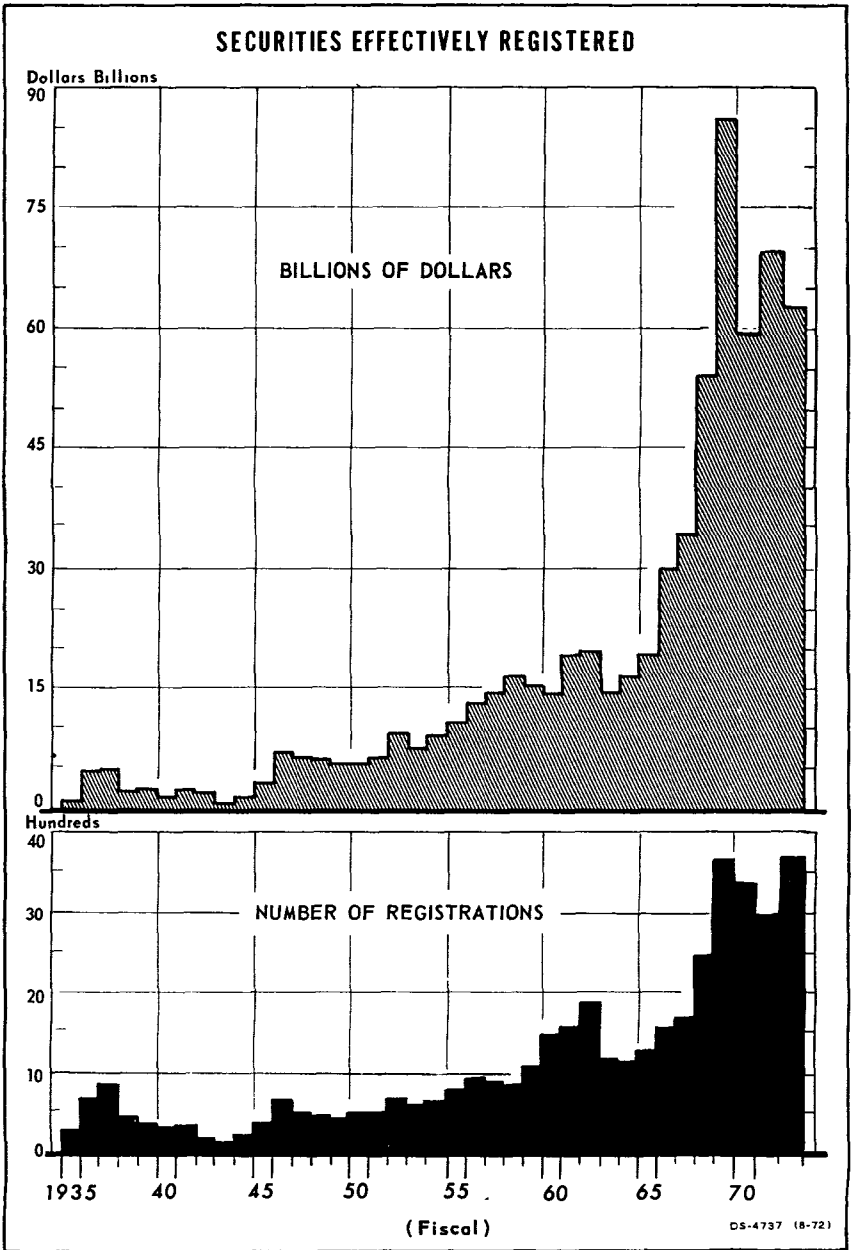
## EFFECTIVE REGISTRATIONS

(\$ millions)

Fiscal year ended June 30	Total		Cash sale for account of issuers			
	Number	Value	Common stock	Bonds, debentures, and notes	Preferred stock	Total
1935 <sup>1</sup>	284	\$913	\$168	\$490	\$28	\$686
1936	689	4,835	531	3,153	252	3,936
1937	840	4,851	802	2,426	406	3,635
1938	412	2,101	474	666	209	1,349
1939	344	2,579	318	1,593	109	2,020
1940	306	1,787	210	1,112	110	1,433
1941	313	2,611	196	1,721	162	2,081
1942	193	2,003	263	1,041	162	1,465
1943	123	659	137	316	32	486
1944	221	1,760	272	732	343	1,347
1945	340	3,225	456	1,851	407	2,715
1946	661	7,073	1,331	3,102	991	5,424
1947	493	6,732	1,150	2,937	787	4,874
1948	435	6,405	1,678	2,817	537	5,032
1949	429	5,333	1,083	2,795	326	4,204
1950	487	5,307	1,786	2,127	468	4,381
1951	635	6,459	1,904	2,838	427	5,169
1952	635	9,500	3,332	3,346	851	7,529
1953	593	7,507	2,808	3,093	424	6,326
1954	631	9,174	2,610	4,240	531	7,381
1955	779	10,960	3,864	3,951	462	8,277
1956	906	13,096	4,544	4,123	539	9,206
1957	876	14,624	5,858	5,689	472	12,019
1958	813	16,490	5,998	6,857	427	13,281
1959	1,070	15,657	6,387	5,265	443	12,095
1960	1,426	14,367	7,260	4,224	253	11,738
1961	1,550	19,070	9,850	6,162	248	16,260
1962	1,844	19,547	11,521	4,512	253	11,286
1963	1,157	14,790	7,227	4,372	270	11,869
1964	1,321	16,860	10,006	4,554	224	14,784
1965	1,265	19,437	10,638	3,710	307	14,656
1966	1,523	30,109	18,218	7,061	444	25,723
1967	1,649	34,218	15,083	12,309	558	27,950
1968	*2,417	*54,076	22,092	14,036	1,140	37,269
1969	*3,645	*86,810	39,614	11,674	751	52,039
1970	*3,389	*59,137	28,939	18,436	823	48,198
1971	*2,989	*69,562	27,455	20,637	3,360	58,452
1972	*3,712	*62,487	26,518	27,127	3,237	49,882
Cumulative Total	41,048	662,111	282,581	207,095	21,775	511,457

<sup>1</sup> For 10 months ended June 30, 1935.

\* Includes registered lease obligations related to industrial revenue bonds.



### Purpose of Registration

Securities registered for cash sale for the account of the issuers aggregated \$49.9 billion in fiscal 1972. This was \$8.6 billion less than the record 1971 amount but \$1.7 billion above the 1970 level. The decrease was primarily due to a reduced volume of debt issues; only \$20.1 billion of bonds, debentures and notes were registered for the account of the issuer during the year compared with the \$27.6 billion in fiscal 1971. Securities registered for the account of the issuer for other than cash sale, such as stock underlying a convertible issue, also declined in 1972. However, the registrations of secondary offerings (for the account of other than the issuer) jumped 68 percent and totaled \$6.8 billion in 1972.

Registrations of immediate cash offerings amounted to \$31.0 billion, down sharply from the record \$38.2 billion in 1971. All of this decline was attributable to new debt offerings which fell nearly \$9 billion to \$18.8 billion in 1972. New flotations of common stock, however, rose to a record \$10.0 billion for the year. Preferred stock registrations declined sharply from the record level of 1971, although these issues continue to attract increasing attention as a means of raising capital.

Registrations of extended offerings amounted to \$18.8 billion in fiscal 1972, unchanged from a year earlier. The larger part of this total consisted of investment company shares, registrations of which rose slightly to \$11.4 billion during the year.

### EFFECTIVE REGISTRATIONS BY PURPOSE AND TYPE OF SECURITY: FISCAL 1972

( $\pm$  thousands)

Purpose of registration	Total	Type of security		
		Bonds, debentures, and notes	Preferred Stock	Common Stock
All registrations (estimated value).....	\$62,486,640	\$20,629,059	\$3,444,507	\$38,413,074
For account of issuer for cash sale.....	49,882,065	20,126,610	3,237,308	26,518,147
Immediate offering.....	31,045,977	18,844,874	2,172,952	10,028,151
Corporate.....	30,571,865	18,385,762	2,157,952	10,028,151
Offered to:				
General public.....	28,599,381	18,341,655	2,121,695	8,136,031
Security holders.....	1,972,484	44,107	36,257	1,892,120
Foreign governments.....	474,112	459,112	15,000	0
Extended cash sale and other issues.....	18,836,088	1,281,736	1,064,356	16,489,996
For account of issuer for other than cash sale.....	5,758,758	269,105	81,444	5,408,209
Secondary offerings.....	6,845,817	233,344	125,755	6,486,718
Cash sale.....	4,518,232	116,800	25,973	4,375,459
Other.....	2,327,585	116,544	99,782	2,111,259



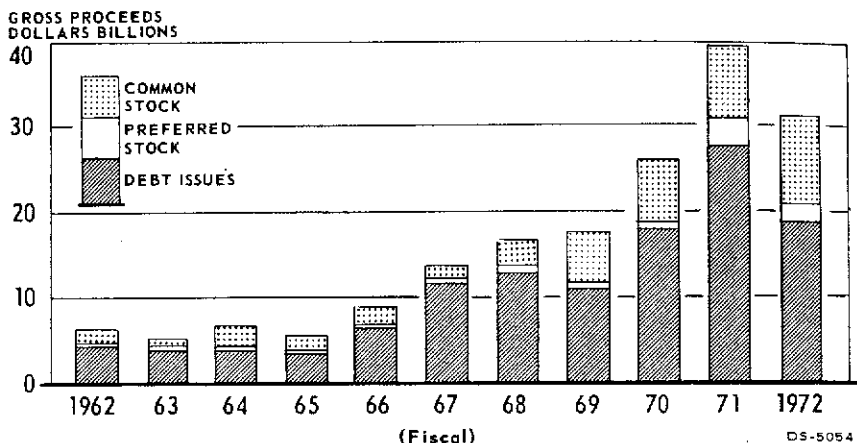
## New Corporate Securities for Immediate Cash Sale

Securities cleared for cash sale exceeded \$30 billion during fiscal 1972, considerably below the record of nearly \$40 billion during the previous fiscal

year.

Equity issues accounted for 40 percent of the total. In recent years this proportion has been significantly higher than in preceding years, as corporations have sought to improve their debt-equity ratios.

### NEW CORPORATE SECURITIES EFFECTIVELY REGISTERED



### Regulation A Offerings

During fiscal year 1972, 1,087 notifications were filed for proposed offerings

under Regulation A. Issues between \$400,00 and \$500,000 in size predominated.

	Fiscal Year			
	1960-1969 (Annual Average)	1970	1971	1972
<b>SIZE:</b>				
\$100,000 or less.....	133	90	54	52
\$100,000-\$200,000.....	132	92	116	46
\$200,000-\$300,000.....	424	922	429	118
\$300,000-\$400,000.....	0	0	114 <sup>1</sup>	182
\$400,000-\$500,000.....	0	0	123 <sup>1</sup>	689
<b>TOTAL.....</b>	<b>690</b>	<b>1,104</b>	<b>836</b>	<b>1,087</b>
<b>UNDERWRITERS:</b>				
Used.....	245	510	370	590
Not Used.....	444	594	466	497
<b>TOTAL.....</b>	<b>689</b>	<b>1,104</b>	<b>836</b>	<b>1,087</b>
<b>OFFERORS:</b>				
Issuing Companies.....	655	1,101	822	1,052
Stockholders.....	24	2	11	28
Issuers and Stockholders Jointly.....	11	1	3	7
<b>TOTAL.....</b>	<b>690</b>	<b>1,104</b>	<b>836</b>	<b>1,087</b>

<sup>1</sup> Regulation A ceiling rose from \$300,000 to \$500,000 on March 26, 1971.

**ENFORCEMENT**

**Types of Proceedings**

As the table below reflects, the securities laws provide for a wide range of enforcement actions by the Commission. The most common types of actions are injunctive proceedings instituted in the Federal district courts to enjoin con-

tinued or threatened securities law violators, and administrative proceedings pertaining to broker-dealer firms and/or individuals associated with such firms which may lead to various remedial sanctions as required in the public interest. When an injunction is entered by a court, violation of the court's decree is a basis for criminal contempt action against the violator.

**TYPES OF PROCEEDINGS**

**I. Administrative Proceedings**

Basis for Enforcement Action	Sanction or Relief
<p><b>Broker-dealer, investment adviser or associated person</b></p> <p>Willful violation of securities acts provision or rule; aiding or abetting of such violation; failure reasonably to supervise others; willful misstatement in filing with Commission; conviction or injunction against certain securities, or securities-related, violations.</p>	<p>Revocation, suspension or denial of broker-dealer or investment adviser registration, or censure of broker-dealer or investment adviser. (1934 Act, Section 15(b)(5); Advisers Act, Section 203(e)).</p>
<p><b>Member of registered securities association</b></p> <p>Violation of 1934 Act or rule thereunder; willful violation of 1933 Act or rule thereunder.</p>	<p>Expulsion or suspension from association (1934 Act, Section 15A(1)(2)).</p>
<p><b>Member of national securities exchange</b></p> <p>Violation of 1934 Act or rule thereunder.</p>	<p>Expulsion or suspension from exchange. (1934 Act, Section 19(a)(3)).</p>
<p><b>Any person</b></p> <p>Same as first item.</p> <p>Violation of 1934 Act or rule thereunder; willful violation of 1933 Act or rule thereunder.</p> <p>Willful violation of securities acts provision or rule; aiding or abetting of such violation; willful misstatement in filing with Commission.</p>	<p>Bar or suspension from association with a broker-dealer or investment adviser, or censure. (1934 Act, Section 15(b)(7); Adviser Act, Section 203(f)).</p> <p>Bar or suspension from association with member of registered securities association. (1934 Act, Section 15A(1) (2)).</p> <p>Prohibition, permanently or temporarily, from serving in certain capacities for a registered investment company. (Investment Co. Act, Section 9(b)).</p>
<p><b>Principal of broker-dealer</b></p> <p>Appointment of SIPC trustee for broker-dealer.</p>	<p>Bar or suspension from association with a broker-dealer. (Securities Investor Protection Act, Section 10(b)).</p>
<p><b>Registered securities association</b></p> <p>Rules do not conform to statutory requirements.</p> <p>Violation of 1934 Act or rule thereunder; failure to enforce compliance with own rules; engaging in activity tending to defeat purposes of provision of 1934 Act authorizing national securities associations.</p>	<p>Suspension of registration (1934 Act, Section 15A(b)).</p> <p>Revocation or suspension of registration (1934 Act, Section 15A(1)(1)).</p>

Basis for Enforcement Action	Sanction or Relief
<p><b>National securities exchange</b></p> <p>Violation of 1934 Act or rule thereunder; failure to enforce compliance therewith by member or issuer of registered securities.</p>	<p>Withdrawal or suspension of registration (1934 Act, Section 19 (a)(1)).</p>
<p><b>Officer or director of registered securities association</b></p> <p>Willful failure to enforce association rules or willful abuse of authority.</p>	<p>Removal from office (1934 Act, Section 15A(1)(3)).</p>
<p><b>Officer of national securities exchange</b></p> <p>Violation of 1934 Act or rule thereunder.</p>	<p>Expulsion or suspension from exchange (1934 Act, Section 19(a)(3)).</p>
<p><b>1933 Act registration statement</b></p> <p>Statement materially inaccurate or incomplete.</p> <p>Investment company has not attained \$100,000 net worth 90 days after statement became effective.</p>	<p>Stop order suspending effectiveness (1933 Act, Section 8(d)).</p> <p>Stop order (Investment Co. Act, Section 14(a)).</p>
<p><b>1934 Act reporting requirements</b></p> <p>Material noncompliance</p>	<p>Order directing compliance (1934 Act, Section 15(c)(4)).</p>
<p><b>Securities issue</b></p> <p>Noncompliance by issuer with 1934 Act or rules thereunder.</p> <p>Public interest requires trading suspension.</p>	<p>Denial, suspension of effective date, suspension or withdrawal of registration on national securities exchange (1934 Act, Section 19(a)(2)).</p> <p>Summary suspension of over-the-counter or exchange trading (1934 Act, Section 15(c)(5) and 19(a)(4)).</p>
<p><b>Registered investment company</b></p> <p>Failure to file 1940 Act registration statement or required report; filing materially incomplete or misleading statement or report.</p> <p>Company has not attained \$100,000 net worth 90 days after 1933 Act registration statement became effective.</p> <p>Name of company, or of security issued by it, deceptive or misleading.</p>	<p>Revocation or suspension of registration (Investment Co. Act, Section 8(e)).</p> <p>Revocation or suspension of registration (Investment Co. Act, Section 14(a)).</p> <p>Prohibition of adoption of such name (Investment Co. Act, Section 35(d)).</p>
<p><b>Attorney, accountant or other professional or expert</b></p> <p>Lack of requisite qualifications to represent others; lacking in character or integrity; unethical or improper professional conduct; willful violation of securities laws or rules, or aiding and abetting of such violation.</p> <p>Attorney suspended or disbarred by Court; expert's license revoked or suspended; conviction of felony or misdemeanor involving moral turpitude.</p> <p>Permanent injunction or finding of violation in Commission—instituted action; finding of violation by Commission in administrative proceeding.</p>	<p>Permanent or temporary denial of privilege to appear or practice before Commission (Rules of Practice, Rule 2(e)(1)).</p> <p>Automatic suspension from appearance or practice before Commission (Rules of Practice, Rule 2(e)(2)).</p> <p>Temporary suspension from appearance or practice before Commission (Rules of Practice, Rule 2(e)(3)).</p>

## II. Civil Proceedings in Federal District Courts

Basis for Enforcement Action	Sanction or Relief
<p><b>Any Person</b></p> <p>Person engaging or about to engage in acts or practices violating securities acts or rules thereunder.</p> <p>Noncompliance with provision of law, rule or regulation under 1935 Act, order issued by Commission, or undertaking in a registration statement.</p>	<p>Injunction against acts or practices which constitute or would constitute violations (plus ancillary relief under court's general equity powers). (1933 Act, Section 20(b); 1934 Act, Section 21(e); 1935 Act, Section 18(f); Investment Co. Act, Section 42(e); Advisers Act, Section 209(e)).</p> <p>Writ of mandamus directing compliance (1933 Act, Section 20(c); 1934 Act, Section 21(f); 1935 Act, Section 18(g)).</p>
<p><b>Issuer subject to reporting requirements</b></p> <p>Failure to file reports required under Section 15(d) of 1934 Act.</p>	<p>Forfeiture of \$100 per day (1934 Act, Section 32(b)).</p>
<p><b>Registered investment company or affiliate</b></p> <p>Name of company or of security issued by it deceptive or misleading.</p> <p>Officer, director, adviser or underwriter engaging or about to engage in act or practice constituting breach of fiduciary duty involving personal misconduct.</p> <p>Breach of fiduciary duty respecting receipt of compensation from investment company, by any person having such duty.</p>	<p>Injunction against use of name (Investment Co. Act, Section 35(d)).</p> <p>Injunction against acting in certain capacities for investment company (Investment Co. Act, Section 36(a)).</p> <p>Award of damages. (Investment Co. Act, Section 36(b)).</p>

## III. Referral to Attorney General for Criminal Prosecution

<p><b>Any Person</b></p> <p>Willful violation of securities acts or rules thereunder.</p>	<p>Maximum penalties: \$5,000 fine and 5 years' imprisonment under 1933 and 1939 Acts, \$10,000 fine and 2 years' imprisonment under other Acts. An exchange may be fined up to \$500,000, a public-utility holding company up to \$200,000. (1933 Act, Sections 20(b), 24; 1934 Act, Sections 21(e), 32(a); 1935 Act, Sections 18(f), 29; 1939 Act, Section 325; Investment Co. Act, Sections 42(e), 49; Advisers Act, Sections 209(e), 217).</p>
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### Enforcement Proceedings

The tables below show enforcement proceedings instituted, and, for injunctive and criminal matters, developments in pending cases.

In administrative enforcement proceedings, the Commission during the fiscal year revoked the registrations of 51 broker-dealers and four investment advisers, barred 93 persons from association with a broker or dealer, and imposed various suspensions on many other firms and individuals. The Commission also issued five stop orders on

registration statements, directed compliance with reporting requirements in three cases, and permanently suspended 20 Regulation A exemptions.

Major categories of civil litigation, other than injunctive actions in Federal district courts, in which the Commission was involved during the year included 27 proceedings in the courts of appeals upon review of Commission decisions, 51 appeals from district court decisions in injunction and miscellaneous cases and 22 actions between private litigants in which the Commission participated as *amicus curiae* or intervenor.

#### ADMINISTRATIVE PROCEEDINGS

Fiscal Year	Broker-Dealer Cases	Investment Adviser Cases	Stop Order, Reg. A Suspension and Other Disclosure Cases
1963.....	97	7	61
1964.....	119	9	35
1965.....	103	2	26
1966.....	49	8	13
1967.....	33	3	16
1968.....	32	4	6
1969.....	103	10	20
1970.....	90	12	36
1971.....	167	22	28
1972.....	122	11	32

#### INJUNCTIVE ACTIONS

Fiscal Year	Cases Instituted	Injunctions Ordered	Defendants Enjoined
1963.....	109	108	349
1964.....	76	80	347
1965.....	71	71	265
1966.....	67	63	258
1967.....	68	56	189
1968.....	93	98	384
1969.....	94	102	509
1970.....	111	97	448
1971.....	140	114	495
1972.....	119	113	511

#### CRIMINAL CASES

Fiscal Year	Number of Cases Referred to Justice Dept.	Number of Indictments	Defendants Indicted	Convictions
1963.....	49	40	117	115
1964.....	50	39	95	93
1965.....	52	34	208	106
1966.....	44	50	193	76
1967.....	44	53	213	127
1968.....	40	42	123	84
1969.....	37	64	213	83
1970.....	35	36	102	55
1971.....	22	16	83	89
1972.....	38	28	67	75

**PUBLIC UTILITY HOLDING COMPANIES**

**Assets**

holding companies registered under the 1935 Public Utility Holding Company Act. The 17 active holding-company systems in which those companies were included

represented a total of 184 system companies. Aggregate assets of these systems, less valuation reserves, were \$26.5 billion at December 31, 1971.

At fiscal year-end there were 20 active

**PUBLIC-UTILITY HOLDING COMPANY SYSTEMS**

	Solely registered holding companies	Registered holding operating companies	Electric and/or gas utility subsidiaries	Non-utility subsidiaries	Inactive companies	Total companies	Aggregate System Assets, Less Valuation Reserves, at Dec. 31, 1971*
Allegheny Power System, Inc. ....	1	2	6	4	1	14	\$1,366,074,000
American Electric Power Company, Inc. ....	1	0	14	13	1	29	3,808,969,000
American Natural Gas Company. ....	1	0	3	5	0	9	1,785,400,000
Central and South West Corporation. ....	1	1	4	8	1	15	1,291,529,000
Columbia Gas System, Inc., The. ....	1	0	10	8	0	19	2,313,827,000
Consolidated Natural Gas Company. ....	1	0	2	3	0	5	1,337,333,000
Delmarva Power & Light Company. ....	0	1	5	0	0	6	1,538,744,000
Eastern Utilities Associates. ....	1	0	4	1	2	8	376,569,000
General Public Utilities Corporation. ....	1	0	7	4	1	12	2,395,839,000
Middle South Utilities, Inc. ....	1	0	5	3	3	14	2,006,532,000
National Fuel Gas Company. ....	1	0	3	3	0	6	370,932,000
New England Electric System. ....	1	0	13	2	0	16	1,210,456,000
Northeast Utilities. ....	1	0	1	6	0	7	1,718,670,000
Ohio Edison Company. ....	0	1	1	0	0	1	1,146,658,000
Philadelphia Electric Power Company. ....	1	1	5	0	0	7	1,455,080,000
Southern Company, The. ....	1	0	1	2	0	4	3,709,121,000
Utah Power & Light Company. ....	0	1	1	0	0	2	520,367,000
<b>Subtotals. ....</b>	<b>13</b>	<b>7</b>	<b>89</b>	<b>57</b>	<b>16</b>	<b>182</b>	<b>\$25,752,518,000</b>
Adjustments (a) to take account of jointly owned companies (b) to add net assets of eight jointly owned companies not included above,**. ....	0	0	(a)+2	0	0	+2	(b)709,465,000
<b>Total companies and assets in active systems. ....</b>	<b>13</b>	<b>7</b>	<b>91</b>	<b>57</b>	<b>16</b>	<b>184</b>	<b>\$26,461,983,000</b>

\* Represents the consolidated assets, less valuation reserves, of each system as reported to the Commission on Form US5 for the year 1971.

\*\* These eight companies are Beechbottom Power Corporation, Inc., which is an indirect subsidiary of American Electric Power Company, Inc. and Allegheny Power System, Inc.; Ohio Valley Electric Corporation and its subsidiary, Indiana-Kentucky Electric Corporation, which are owned 37.8 percent by American Electric Power Company, Inc., 16.5 percent by Ohio Edison Company, 12.5 percent by Allegheny Power System, Inc., and 33.2 percent by other companies; The Arklaoma Corporation, which is owned 32 percent by the Central and South West Corporation system, 34 percent by the Middle South Utilities, Inc. system, and 34 percent by an electric utility company not associated with a registered system; Yankee Atomic Electric Company, Connecticut Yankee Atomic Power Company, Vermont Yankee Nuclear Power Corporation, and Maine Yankee Atomic Power Company, which are stationary utility subsidiaries of Northeast Utilities and New England Electric System.

## Financing

The volume of external financing by these companies set a new record in fiscal 1972 of \$2.79 billion which represents a 13 percent increase over fiscal

1971, the previous record year. Preferred stock issued and sold increased 101 percent, common stock 24 percent. The amount of debentures issued and sold decreased 77 percent from fiscal 1971.

## FINANCING OF HOLDING-COMPANY SYSTEMS

(Fiscal 1972)

Holding-company systems	(In Millions of Dollars)			
	Bonds	Debentures	Preferred stock	Common stock
Allegheny Power System, Inc.				45.4
Monongahela Power Company	30.1		5.0	
Potomac Edison Company, The			10.0	
West Penn Power Company	75.5 <sup>a</sup>		10.3	
American Electric Power Company, Inc.				139.2
Appalachian Power Company	85.3 <sup>a</sup>		55.2 <sup>a</sup>	
Indiana & Michigan Power Company			35.1	
Kentucky Power Company	50.3			
Ohio Power Company	65.0 <sup>a</sup>		70.2 <sup>a</sup>	
American Natural Gas Company				
Central Indiana Gas Company Inc.	8.0			
Michigan Consolidated Gas Company	34.7			
Michigan Wisconsin Pipe Line Company	39.6			
Central and South West Corporation				
Public Service Company of Oklahoma	29.7			
Southwestern Electric Power Company	29.7			
Transok Pipe Line Company	14.9			
Colombia Gas System, Inc., The		168.8 <sup>b</sup>		41.0
Consolidated Natural Gas Company		74.8 <sup>a</sup>		
Delmarva Power & Light Company	35.0		20.1	16.2
Eastern Utilities Associates				41.0
Brockton Edison Company	8.1			
General Public Utilities Corporation				30.1
Jersey Central Power & Light Company	25.0	25.1	50.2 <sup>a</sup>	
Metropolitan Edison Company	15.0		51.0 <sup>a</sup>	
Pennsylvania Electric Company	40.2 <sup>a</sup>	20.0	50.1 <sup>a</sup>	
Middle South Utilities, Inc.				
Arkansas Power & Light Company	65.5 <sup>a</sup>		10.0	
Louisiana Power & Light Company	25.2			
National Fuel Gas Company		23.3		
New England Electric System				
Massachusetts Electric Company			15.0	
Narragansett Electric Company, The	7.6			
New England Power Company	25.0			
Northeast Utilities				48.6
Connecticut Light and Power Company, The	30.0		20.1	
Hartford Electric Light Company, The	65.0 <sup>a</sup>		10.0	
Western Massachusetts Electric Company	30.3		20.1	
Ohio Edison Company	60.2		36.4	
Pennsylvania Power Company	22.1 <sup>a</sup>		5.8	
Southern Company, The				134.8
Alabama Power Company	209.9 <sup>b</sup>		58.2 <sup>a</sup>	
Georgia Power Company	169.5 <sup>a</sup>			
Gulf Power Company	42.6 <sup>a</sup>		10.1	
Mississippi Power Company	24.8 <sup>a</sup>		8.4	
Utah Power and Light Company	24.8			23.9
Vermont Yankee Nuclear Power Corporation <sup>c</sup>	15.0			
Total	1,403.6	312.0	551.3	520.2

<sup>a</sup> Two issues.<sup>b</sup> Three issues.<sup>c</sup> Statutory utility subsidiary of Northeast Utilities and New England Electric System.

\* Debt securities are computed at price to company, preferred stock at offering price, common stock at offering or subscription price.

\*\* The Table does not include securities issued and sold by subsidiaries to their parent holding companies, short-term notes sold to banks, portfolio sales by any of the system companies or securities issued for stock or assets of nonaffiliated companies. Transactions of this nature also require authorization by the Commission except, as provided by Section 6(b) of the Act, the issuance of notes having a maturity of 9 months or less where the aggregate amount does not exceed 5 percent of the principal amount and par value of the other securities of the issuer then outstanding.

## CORPORATE REORGANIZATIONS

## Commission Participation

During fiscal year 1972, the Commission was a party in a total of 113 reorganization proceedings under Chap-

ter X of the Bankruptcy Act. These were scattered among district courts in 35 states, the District of Columbia, and one territory. In 12 proceedings, the Commission first entered its appearance during the year; 14 proceedings were closed.

**PROCEEDINGS UNDER CHAPTER X OF BANKRUPTCY ACT IN WHICH THE  
COMMISSION PARTICIPATED: FISCAL YEAR 1972**

Debtor	District Court	Petition filed	S.E.C. notice of appearance filed
Alco Industries, Inc.	D. Ariz.	Sept. 17, 1969	Jan. 22, 1970
American Associated Systems, Inc.	E.D. Ky.	Dec. 24, 1970	Feb. 26, 1971
American National Trust	S.D. Ind.	Feb. 13, 1968	Mar. 27, 1968
Arizona Lutheran Hospital <sup>1</sup>	D. Ariz.	May 11, 1964	May 25, 1964
Arlington Discount Co. <sup>2</sup>	S.D. Ohio.	July 3, 1967	July 10, 1967
Atlanta International Raceway, Inc.	N.D. Ga.	Jan. 18, 1971	Feb. 3, 1971
Bankers Trust	S.D. Ind.	Oct. 7, 1966	Nov. 1, 1966
Beck Industries, Inc. <sup>1</sup>	S.D.N.Y.	May 27, 1971	July 30, 1971
Bermec Corp.	S.D.N.Y.	Apr. 16, 1971	Apr. 19, 1971
Bubble Up Delaware, Inc.	C.D. Calif.	Aug. 31, 1970	Oct. 19, 1970
Burton's In The Round, Inc.	N.D. Ill.	Mar. 23, 1970	Apr. 1, 1970
Business Finance Corp. <sup>2</sup>	E.D. Pa.	June 1, 1970	Feb. 3, 1971
Canandaigua Enterprises Corp. <sup>2</sup>	W.D.N.Y.	Dec. 15, 1964	Dec. 15, 1964
Central States Electric Corp. <sup>2</sup>	S.D.N.Y.	Feb. 26, 1942	Mar. 11, 1942
Clute Corp. <sup>2</sup>	D. Colo.	Nov. 5, 1962	Jan. 29, 1963
Coast Investors, Inc. <sup>2</sup>	W.D. Wash.	Apr. 1, 1964	June 10, 1964
Coffeyville Loan & Investment <sup>2</sup>	D. Kans.	July 17, 1959	Aug. 10, 1959
Commonwealth Financial Corp.	E.D. Pa.	Dec. 4, 1967	Dec. 13, 1967
Computer Services Corp. <sup>2</sup>	S.D. Iowa.	Feb. 24, 1970	Mar. 11, 1970
Continental Vending Machine Corp.	E.D.N.Y.	July 10, 1963	Aug. 7, 1963
Cosmo Capital Inc. <sup>2</sup>	N.D. Ill.	Apr. 22, 1963	Apr. 26, 1963
Creative Merchandising, Inc. <sup>1, 2</sup>	D. Colo.	Jan. 18, 1972	Feb. 11, 1972
Cybernet Education, Inc.	N.D. Ill.	Sept. 11, 1970	Sept. 25, 1970
Dextra Corp. <sup>1, 2</sup>	S.D. Fla.	Feb. 28, 1972	Apr. 10, 1972
Dumont-Airplane & Marine <sup>2</sup>	S.D.N.Y.	Oct. 22, 1958	Nov. 10, 1958
Eichler Corp. <sup>2</sup>	N.D. Calif.	Oct. 11, 1967	Oct. 11, 1967
El-Tronics, Inc. <sup>2</sup>	E.D. Pa.	Nov. 25, 1958	Jan. 16, 1959
Equitable Plan Co. <sup>2</sup>	S.D. Calif.	Mar. 17, 1958	Mar. 24, 1958
Farrington Manufacturing Co.	E.D. Va.	Dec. 22, 1970	Jan. 14, 1971
Federal Coal Co.	S.D. W. Va.	Jan. 29, 1971	Jan. 29, 1971
Federal Shopping Way, Inc. <sup>2</sup>	W.D. Wash.	Nov. 13, 1967	Nov. 29, 1967
First Holding Corp. <sup>2</sup>	S.D. Ind.	Oct. 7, 1969	Dec. 10, 1969
First Research Corp.	S.D. Fla.	Mar. 2, 1970	Apr. 14, 1970
Flying W. Airways, Inc.	E.D. Pa.	Sept. 23, 1970	Dec. 15, 1970
Food Town, Inc. <sup>2</sup>	D. Md.	July 28, 1959	Aug. 10, 1959
Four Seasons Nursing Centers of America, Inc.	W.D. Okla.	June 26, 1970	July 13, 1970
General United Corp. <sup>2</sup>	D. Kans.	May 22, 1964	July 16, 1964
Gulf Aerospace Corp. <sup>1</sup>	S.D. Tex.	Apr. 23, 1969	June 20, 1969
Heidler Corp. <sup>1</sup>	N.D. Okla.	Apr. 27, 1972	June 6, 1972
R. Hoe & Co., Inc.	S.D.N.Y.	July 7, 1969	July 14, 1969
Houston Educational Foundation, Inc.	S.D. Tex.	Feb. 16, 1971	Mar. 2, 1971
Hughes Homes, Inc. <sup>2</sup>	D. Mont.	Sept. 8, 1961	Oct. 5, 1961
Human Relations Res. Foundation <sup>1</sup>	S.D. Calif.	Jan. 31, 1964	Feb. 14, 1964
Imperial-American Resources Fund, Inc. <sup>1</sup>	D. Colo.	Feb. 25, 1972	Mar. 6, 1972
Imperial '400' National	D. N.J.	Feb. 18, 1966	Feb. 23, 1966
Indiana Bus. & Investment Trust	S.D. Ind.	Oct. 10, 1966	Nov. 4, 1966
Investors Associated, Inc. <sup>2</sup>	W.D. Wash.	Mar. 3, 1965	Mar. 17, 1965
Jade Oil & Gas Co. <sup>2</sup>	C.D. Calif.	June 28, 1967	Aug. 16, 1967
King Resources Co. <sup>1</sup>	D. Colo.	Aug. 16, 1971	Oct. 19, 1971
Kirchofer & Arnold <sup>1</sup>	E.D.N.C.	Nov. 9, 1959	Nov. 12, 1959



PROCEEDINGS UNDER CHAPTER X OF BANKRUPTCY ACT IN WHICH THE  
COMMISSION PARTICIPATED: FISCAL YEAR 1972—Continued

Debtor	District Court	Petition filed	S.E.C. notice of appearance filed
Ladco Corp. <sup>2</sup>	N.D. Calif.	Nov. 3, 1967	Feb. 7, 1968
Lake Winnebago Development Co., Inc.	W.D. Mo.	Oct. 14, 1970	Oct. 26, 1970
Landmark Inns of Durham, Inc.	M.D. N.C.	Sept. 3, 1969	Dec. 10, 1969
Little Missouri Minerals Association, Inc.	D. N.D.	July 18, 1966	Jan. 29, 1968
Los Angeles Land & Investments, Ltd.	D. Hawaii	Oct. 24, 1967	Nov. 28, 1967
Louisiana Loan & Thrift Inc.	E.D. La.	Oct. 8, 1968	Oct. 8, 1968
Lusk Corp.	D. Ariz.	Oct. 28, 1965	Nov. 15, 1965
Dolly Madison Industries, Inc.	E.D. Pa.	June 23, 1970	July 6, 1970
Magnolia Funds, Inc.	E.D. La.	Nov. 18, 1968	May 26, 1969
Mammoth Mountain Inn Corp.	C.D. Calif.	Sept. 16, 1969	Feb. 6, 1970
Manufacturers Credit Corp.	D. N.J.	Aug. 1, 1967	July 30, 1968
Maryvale Community Hospital <sup>3</sup>	D. Ariz.	Aug. 1, 1963	Sept. 11, 1963
Mayer Central Building <sup>1</sup>	D. Ariz.	July 15, 1965	Jan. 19, 1966
Mid-City Baptist Church	E.D. La.	July 30, 1968	Oct. 23, 1968
Morehead City Shipbuilding <sup>2</sup>	E.D. N.C.	Nov. 9, 1959	Nov. 12, 1959
Moulded Products, Inc. <sup>1</sup>	D. Minn.	July 6, 1971	Aug. 6, 1971
National Video Corp. <sup>3</sup>	N.D. Ill.	Feb. 26, 1969	Mar. 26, 1969
Nevada Industrial Guaranty <sup>3</sup>	D. Nev.	May 7, 1963	July 2, 1963
Norman Finance & Thrift Corp. <sup>2</sup>	W.D. Okla.	Oct. 10, 1969	Oct. 17, 1969
Paramount General Corp. <sup>2</sup>	C.D. Calif.	Feb. 18, 1969	Apr. 10, 1969
Parkwood, Inc. <sup>3</sup>	D. D.C.	June 13, 1966	June 17, 1966
Peoples Loan & Investment Co. <sup>2</sup>	W.D. Ark.	May 13, 1969	May 21, 1969
Phoenix Gems, Inc. <sup>1</sup>	D. Ariz.	Dec. 23, 1971	Jan. 31, 1972
Phoenix Mortgage Co.	D. Ariz.	Aug. 14, 1967	Apr. 17, 1968
Polycast Corp. <sup>3</sup>	D. Conn.	Sept. 6, 1966	Sept. 23, 1966
RIC International Industries, Inc.	N.D. Tex.	Sept. 16, 1970	Sept. 23, 1970
John Rich Enterprises, Inc.	D. Utah	Jan. 16, 1970	Feb. 6, 1970
Riker Delaware Corp.	D. N.J.	Apr. 21, 1967	May 23, 1967
Roberts Company	M.D. N.C.	Feb. 12, 1970	Mar. 23, 1970
San Francisco & Oakland Helicopter Airlines, Inc.	N.D. Calif.	July 31, 1970	Aug. 11, 1970
Santa's Forest Corp.	E.D. Wisc.	May 18, 1970	June 15, 1970
Scranton Corp. <sup>3</sup>	M.D. Pa.	Apr. 3, 1969	Apr. 15, 1969
Edw. N. Siegler & Co. <sup>3</sup>	N.D. Ohio	May 23, 1966	June 7, 1966
Sierra Trading Corp.	D. Colo.	July 7, 1970	July 22, 1970
Sire Plan, Inc.	S.D. N.Y.	Feb. 16, 1963	Feb. 18, 1963
Sire Plan Management Corp.	S.D. N.Y.	Mar. 4, 1963	Apr. 5, 1963
60 Minute Systems, Inc.	M.D. Fla.	July 17, 1970	July 29, 1970
Sound Mortgage Co., Inc. <sup>3</sup>	W.D. Wash.	July 27, 1965	Aug. 31, 1965
Southern Land Title Corp.	E.D. La.	Dec. 7, 1966	Dec. 31, 1966
Sunset International Petroleum Corp. <sup>3</sup>	N.D. Tex.	May 27, 1970	June 10, 1970
Swan-Finch Oil Corp.	S.D. N.Y.	Jan. 2, 1958	Jan. 23, 1958
Tele-Tronics Co. <sup>3</sup>	E.D. Pa.	July 26, 1962	Sept. 12, 1962
Texas Independent Coffee Organization, Inc. <sup>3</sup>	S.D. Tex.	Jan. 5, 1965	Jan. 13, 1965
TMT Trailer Ferry, Inc.	S.D. Fla.	June 27, 1957	Nov. 22, 1957
Tower Credit Corp. <sup>3</sup>	M.D. Fla.	Apr. 13, 1966	Sept. 6, 1966
Traders Compress Co. <sup>1</sup>	W.D. Okla.	May 12, 1972	June 6, 1972
Trans-International Computer Investment Corp. <sup>1</sup>	N.D. Calif.	Mar. 22, 1971	July 26, 1971
Trustors' Corp. <sup>3</sup>	C.D. Calif.	Sept. 13, 1961	Oct. 9, 1961
Twentieth Century Foods Corp. <sup>3</sup>	E.D. Ark.	Oct. 30, 1961	Feb. 5, 1962
Union Investments, Inc.	D. Hawaii	Feb. 2, 1970	Mar. 12, 1970
Uniservices, Inc.	S.D. Ind.	Dec. 4, 1970	Jan. 28, 1971
Viatron Computer Systems Corp.	D. Mass.	Apr. 29, 1971	Apr. 29, 1971
Vinco Corp. <sup>3</sup>	E.D. Mich.	Mar. 29, 1963	Apr. 9, 1963
Virgin Island Properties, Inc. <sup>1</sup>	D. V.I.	Oct. 22, 1971	Apr. 11, 1972
Waltham Industries Corp. <sup>1</sup>	C.D. Calif.	July 14, 1971	Aug. 19, 1971
Webb & Knapp, Inc.	S.D. N.Y.	May 7, 1965	May 11, 1965
H. R. Weissberg Corp.	N.D. Ill.	Mar. 5, 1968	Apr. 3, 1968
Westec Corp. <sup>3</sup>	S.D. Tex.	Sept. 26, 1966	Oct. 4, 1966
Western Growth Capital Corp.	D. Ariz.	Feb. 10, 1967	May 16, 1968
Western National Investment Corp. <sup>3</sup>	D. Utah	Jan. 4, 1968	Mar. 11, 1968
Whale, Inc. <sup>2</sup>	M.D. Tenn.	May 20, 1970	June 5, 1970
Wonderbowl, Inc.	C.D. Calif.	Mar. 10, 1967	June 7, 1967
Yale Express System, Inc.	S.D. N.Y.	May 24, 1965	May 28, 1965

<sup>1</sup> Commission filed notice of appearance in fiscal year 1972.<sup>2</sup> Reorganization proceedings closed during fiscal year 1972.<sup>3</sup> Plan has been substantially consummated but no final decree has been entered because of pending matters.

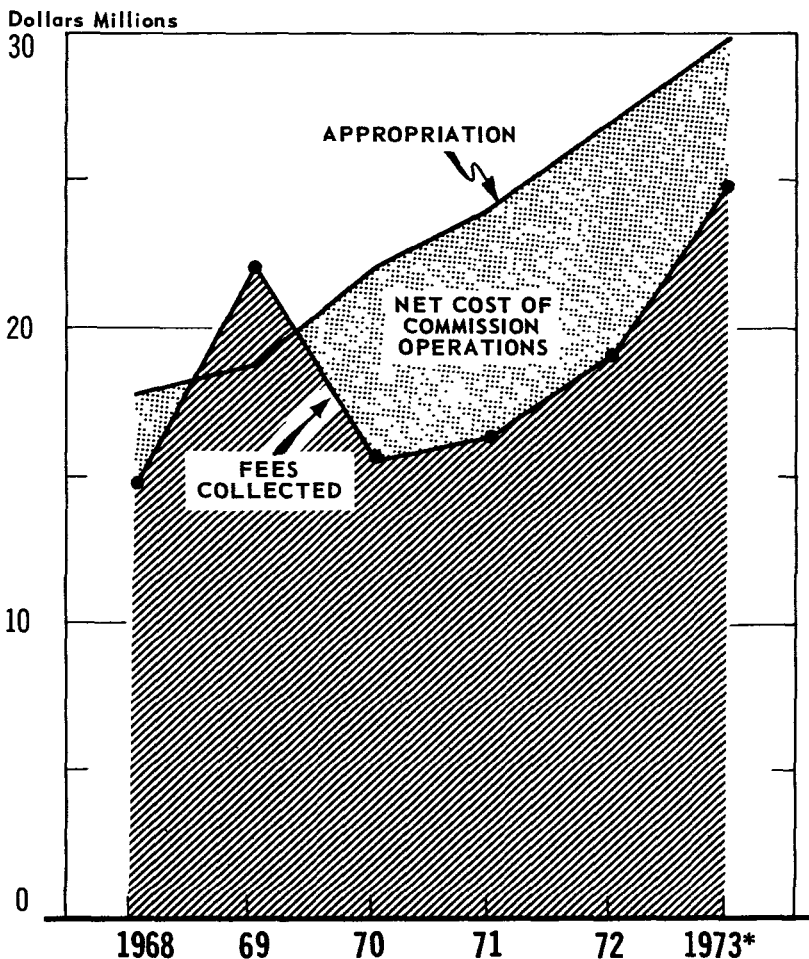
**SEC OPERATIONS**

**Net Cost**

Over the past five years, fees collected by the Commission have in no year accounted for less than 69% of funds appropriated by Congress for Commission operations. The Commission is required by law to collect fees for (1) registration of securities issued; (2)

qualification of trust indentures; (3) registration of exchanges; (4) brokers and dealers who are registered with the Commission but are not members of the NASD; and (5) certification of documents filed with the Commission. In fiscal year 1972, the Commission adopted a fee schedule, effective March 1, 1972, imposing fees for certain filings and services such as the filing of annual reports and proxy material.

**APPROPRIATED FUNDS VS FEES COLLECTED**



\*Estimated

BUDGET ESTIMATES AND APPROPRIATION

ACTION	Fiscal 1968		Fiscal 1969		Fiscal 1970		Fiscal 1971		Fiscal 1972		Fiscal 1973	
	Posi- tions	Money	Posi- tions	Money	Posi- tions	Money	Posi- tions	Money	Posi- tions	Money	Posi- tions	Money
Estimate submitted to the Office of Management and Budget.....	1,437	\$17,625,000	1,444	\$18,177,800	1,467	\$20,788,000	1,532	\$22,463,000	1,875	\$28,728,000*	1,939	\$33,691,000*
Action by the Office of Management and Budget.....	-21	-180,000	-16	-74,800	-35	-372,000	-65	-463,000	-313	-2,411,000	-283	-3,930,000
Amount allowed by the Office of Management and Budget.....	1,416	\$17,445,000	1,428	\$18,103,000	1,432	\$20,416,000	1,467	\$22,000,000	1,562	\$26,317,000	1,656	\$29,761,000
Action by the House of Representatives.....	-11	-95,000	-25	-173,000	-42	-666,000	-57 <sup>1</sup>	-200,000	—	—	—	—
Sub-Total.....	1,405	\$17,350,000	1,403	\$17,930,000	1,390	\$19,750,000	1,410	\$21,800,000	1,562	\$26,317,000	1,656	\$29,761,000
Action by the Senate.....	+11	+95,000	—	+100,000	+42	+666,000	—	—	—	—	—	—
Sub-Total.....	1,416	\$17,445,000	1,403	\$18,030,000	1,432	\$20,416,000	1,410	\$21,800,000	1,562	\$26,317,000	1,656	\$29,761,000
Action by Conferees.....	-11	-95,000	—	—	—	—	—	—	—	—	—	—
Annual Appropriation.....	1,405	\$17,350,000	1,403	\$18,030,000	1,432	\$20,416,000	1,410	\$21,800,000	1,562	\$26,317,000	1,656	\$29,761,000
Supplemental appropriation for statutory pay increase.....	—	380,000	—	594,000	—	1,488,977	—	1,815,000	—	500,000	—	—
Total Appropriation.....	1,405	\$17,730,000	1,338 <sup>1</sup>	\$18,624,000 <sup>2</sup>	1,432	\$21,904,977	1,410	\$23,615,000	1,562	\$26,817,000	1,656	\$29,761,000

<sup>1</sup> Progressive reduction of 100 positions (employment level on June 30, 1966) and subsequent reinstatement of 35 positions by the Office of Management and Budget representing a net savings of \$299,000 required under the Revenue and Expenditure Control Act of 1968. Savings to be applied to estimated pay increase cost of \$493,000 effective July 14, 1968.  
<sup>2</sup> Includes \$300,000 for the Study of Institutional Investors.  
<sup>3</sup> The reduction of 57 positions represents the Congressional reduction of \$200,000 and the absorption of the additional cost to continue the Institutional Investors Study to December 31, 1970.  
<sup>4</sup> Includes \$1,234,000 for statutory pay increases, and \$1,587,000 supplemental for programs.  
<sup>5</sup> Includes \$1,361,000 for statutory pay increases.