THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Joint Meeting of

The Committee on Post-Admission Legal Education, Section on Banking, Corporation and Business Law and the Special Committee on Securities Regulation

CURRENT PROBLEMS IN THE SECURITIES FIELD

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May 20, 1963

A little over four years ago, I discussed with you the background, rationale and proposed amendments to Rule 133 under the Securities Act -- the so-called no-sale rule. The evolution of that rule, originally adopted to deal with a problem which had its roots in the financial troubles of the early thirties and later amended to cope with an abuse born of the more prosperous fifties, marks but one chapter in the continual re-evaluation and, when necessary, modification by the Securities and Exchange Commission of its rules, regulations and practices to achieve statutory objectives in the varying contexts of growing and ever-changing securities markets. Many of you here tonight will recall that the Commission made a number of proposals in an attempt to find a reasonable solution to a recognized problem. With your assistance, though not unanimous agreement, we did find a formula which, I venture to say, has been working well.

You are also familiar, I am sure, with other attempts by the Commission, generally successful, to grapple with and to overcome problems that needed solution. Rules 154, 155, 10b-6, 7 and 8 are but a few of these examples. None of them, I should hasten to add, would have been nearly as successful without your good will and constructive criticism.

In my view, rule-making, and similar efforts through the decisional process, by which standards are enunciated, general statutory directives are implemented, and guidance furnished to those affected by the Federal securities laws represent an important, if not the most important, responsibility of the Commission. Indeed they represent, apart from enforcement, the reason for the very existence of the regulatory agency. Theoretically at least, a body of experts able to devote attention exclusively to the regulated area should be able to define, in the first instance, the complex, the technical and seemingly undefinable and then constantly to refine these definitions to reflect new experience and changed conditions. No one has as yet devised a better way to provide that informed flexibility in regulation so necessary to avoid economic stagnation and delusive and oppressive proscriptions.

In the securities field this job has not been entrusted to the government alone. While there are other examples of industry-oriented and managed self-regulatory schemes, it is probably no overstatement to note that in no other industry does there exist as sophisticated and as fully developed a system of cooperative regulation as that enjoyed by those engaged in various phases of the securities business. The stock exchanges and the NASD have developed extensive regulatory requirements, proscriptions and standards. This is not to suggest that there is unnecessary duplication of effort and expense among these organizations and governmental authorities. On the contrary, accepting for the moment that there may be some overlapping jurisdiction, in the main these organizations complement each other as well as state and federal authority

and keep small what might otherwise become a much larger governmental bureaucracy. Conceding the existence of some unresolved problems, the point I wish to make is that the principle of industry participation in the regulation of the securities industry has been firmly established and that industry organizations share with the Commission the responsibility to develop standards of fair dealing and to refine them in the light of experience and changing conditions.

The explosive growth of virtually every segment of the industry in recent years, however, seriously affected our efforts in this all important field. The tremendous growth, on the one hand, has accentuated the need for the development of new rules and reappraisal of old ones, and, on the other, increased greatly the burdens of administration and enforcement for the Commission and the industry regulatory agencies. Geometric increases in the workload you and your clients produced for the Commission deflected attention from necessary policy development. More important, it became very clear that the comprehensive examination of developing practices in the industry and of the adequacy of the regulatory structure demanded by pressing problems and incompletely recognized abuses could not be achieved by a staff concerned with other exacting responsibilities.

During the late 1950s the Commission began to explore available means of keeping pace with the expansion and changes in the industry. In 1958 we commissioned the Wharton School of the University of Pennsylvania to conduct a study of the size and structure of the mutual fund industry which had by then emerged as a significant factor in the securities markets. The completed Study was published in August, 1962, and we are currently making, through a special staff in our Division of Corporate Regulation, a thorough examination of that Study, as well as additional inquiries into certain aspects of the industry not covered by the Wharton School, to determine what changes, if any, are necessary in the existing regulatory pattern under the Investment Company Act.

More perplexing within the framework of existing personnel and budgetary limitations was the larger problem of re-evaluation of the changes wrought in an industry which had enjoyed rapid growth and segments of which were showing dangerous signs of a breakdown of standards in certain practices. The persistence of boiler-room operations despite vigorous enforcement efforts, the lack of effective controls over the hot-issue phenomena, and the failure of self-regulation on the American Stock Exchange served to heighten our concern and increase our frustration. Fortunately, the answer came from the Congress which, on September 5, 1961, directed the Commission to make a comprehensive investigation into the adequacy of existing regulatory controls in the securities markets and to report its findings and recommendations to the Congress. The initiative which led to the Commission's Special Study of the Securities Markets is a high tribute to the wisdom and foresight of the Congressional Committees which have jurisdiction over the activities of the Commission.

The intensive efforts thus made possible are now reaching fruition. The first segment of the Report of the Special Study, as all of you probably know, was transmitted to the Congress on April 3, 1963. Many of you may have made futile attempts to obtain copies for your own use, and I must apologize for the unfortunate delay in the availability of printed copies for public distribution. Hopefully, the balance of the Report, some or all of which should be completed by June 1, will find its way to the printing presses with somewhat greater speed.

When you do have an opportunity to read the complete Report, you will find that it represents a responsible and painstaking effort to examine carefully changes in the industry and the need for adjustments and improvements in the mechanisms of the securities markets to ease the strain and mitigate the excesses which have developed, particularly in the past decade. More important, it reflects a recognition that the securities industry is made up of many different institutions designed to meet the varying needs of small and large issuers, and persons of great and relatively small resources; that the problems found are complex and inter-related; that solutions are not always clear and rarely subject to simple treatment. While the Report as a whole will point to many areas of abuse and other problems that require urgent attention, the portions I have seen thus far certainly do not call for any basic reconstruction of the industry or of the securities laws. The experience of over 25 years of federal securities regulation and the much longer period of industry development undoubtedly is an important reason for these conclusions. It should be emphasized, however, that the entire Report will suggest what Milton H. Cohen, the Director of the Study, has described as a major program of reform consisting of over 100 separate recommendations. Some of you may have heard him say ten days ago that "the reform is needed no less because we suggest applying a scalpel in 100 separate places rather than a meat axe in three or four."

It is probably too much to expect agreement with all the findings and conclusions of the Study. To quote Milton Cohen again, however, it undoubtedly will provide a "springboard" for action. The Report merits careful examination and should result in serious dialogue between the industry and the Commission. I think it fair to predict that most of you will agree its recommendations call for vigorous implementation by the Congress, the Commission, self-regulatory agencies and by others interested in the welfare of the industry, along the lines suggested by the Study or by effective alternative routes.

For our part, the program of implementation is already under way. While the balance of the Report is nearing completion, the Commission has determined to transmit to the Congress a number of legislative proposals based largely on the first segment of the Report. We are now considering the details of these proposals and have been able to discuss preliminary drafts with a representative securities industry advisory committee. We have also solicited and received the views

of various members of other industry groups and of the Association of the Bar of the City of New York and the American Bar Association. Despite the pressures of a very tight time schedule, industry and the Bar have been unstinting in their cooperation and effort for which we are most grateful. Areas of agreement have been reached and potential areas of disagreement eliminated. In other respects, we have benefited from helpful criticisms and comments on the proposed legislation. We have also received suggestions which can, perhaps, be considered more effectively after we have dealt with the proposals now under consideration.

Current legislative proposals reflect a reaffirmation of our conviction, shared by the Special Study, that the disclosure principle coupled with somewhat broader enforcement authority, should remain the primary tools for insuring fair and honest securities markets for the protection of investors. Our legislative aims now are limited to implementing certain of the Study's recommendations to close anomalous gaps in the present regulatory scheme or to carry out that design in a more flexible fashion.

While we have been discussing with industry a number of proposals, the Commission has not as yet reached final decisions as to the precise provisions of the program it will shortly submit to the Congress. I am, therefore, not in a position tonight to give you the details of the proposals. However, the Commission has indicated that it agrees in principle with the legislative recommendations made in the Study Report and that it intends to submit legislative proposals to implement them. I shall, therefore, discuss the recommendations as they have been advanced by the Special Study.

Only one proposal relates to the Securities Act. It would extend the requirement for delivery of prospectuses by dealers following a public offering -- reduced from one year to 40 days in 1954 -- to 90 days in the case of new issues and empower the Commission to shorten the 40-day or 90-day period for all issues. The proposals with respect to the Exchange Act include anti-fraud provisions designed to reach fraudulent dissemination of corporate publicity; a mandatory requirement of membership in a self-regulatory agency for all registered broker-dealers; authorization for national securities associations to adopt qualification and financial standards for admission to membership; authority in the Commission to deal directly, and more flexibly than the present statute permits, with individuals associated with registered broker-dealers and to impose intermediate sanctions against a broker-dealer firm in lieu of revocation. In addition, an important gap would be closed by enactment of legislation to deal more effectively with the collection and publication of securities quotations.

Implementation of these legislative recommendations of the Special Study would provide a more effective federal regulatory structure. In my view, however, the most fundamental recommendation concerns legislation which would extend to over-the-counter issuers the reporting, proxy and insider trading provisions of Sections 13, 14 and 16 of the Exchange Act, now applicable only to issuers with securities listed on a national securities exchange and to a limited number of other companies. I would like to deal more fully with this aspect of the legislative proposals now under consideration to which I shall refer as Frear-Fulbright legislation because of the early sponsorship of such legislation by Senator Fulbright and my colleague J. Allen Frear, Jr., when he was a member of that august body.

As some of you may know, the disparity between investor protections in the two markets was not intended by the Congress which enacted the Exchange Act even though volume in the over-the-counter market then was far less significant than now. Although the mysteries surrounding trading in over-the-counter securities in 1934 made the Congress hesitant to impose, by statutory fiat, the requirements applicable to listed securities, the Exchange Act originally made it unlawful for brokers or dealers to create a market in unlisted securities in contravention of such rules as the Commission might provide to insure investor protection comparable to that provided in the exchange markets. This provision was deleted at the request of the Commission in 1936, when Congress adopted Section 15(d) -- which requires an undertaking to file reports by many companies offering securities registered under the Securities Act -- because it was found impracticable to enforce obligations for issuers by curtailment of the activities of broker-dealers which would serve only to deprive shareholders of adequate markets for their securities.

Section 15(d), however, was never considered the ultimate answer to the obligations of publicly held companies whose securities are traded over-the-counter, as the Commission pointed out in a report published at that time. Many of you are familiar with, and several of you have had a hand in, the various proposals and the intensive but futile efforts since that time to extend the disclosure and other basic protections of the Exchange Act to over-the-counter securities.

The importance of this difference between the over-the-counter and the exchange markets has been greatly magnified by the dramatic growth of the over-the-counter markets. The Special Study found that the number of different stocks appearing in the "pink sheets" of the National Quotation Bureau on January 15, 1963, for example, amounted to 8,200, as compared to 3,700 stocks on the same day in 1939. Trading volume in the over-the-counter market grew from an estimated $4.9 billion

in 1949 to $38.9 billion in 1961, a gain of almost eight times. Adequate investor protections in a market which can generate such widespread trading interest is obviously a matter of great public importance. A comprehensive analysis of the mechanics and the mechanisms of the over-the-counter market will appear in Chapter VII of the Special Study Report and a detailed discussion of its findings and recommendations should await another time and forum. But concern with investor and public interest in the over-the-counter market must start with a re-evaluation of the obligations of the issuers whose securities find their sole market place there. The first segment of the Report already published contains a comprehensive discussion of this facet of the over-the-counter markets.

Since previous reports of the Commission and reports of the Senate Banking and Currency Committee demonstrated beyond reasonable question the need to extend to over-the-counter issuers the disclosure provisions and other safeguards applicable to listed securities, it was determined at the outset that the Special Study should, in the main, direct its efforts to the areas of unresolved controversies and uncertainties and to develop new data and appropriate guideposts for consideration of these problems in the context of the expanded securities markets. Before discussing the findings and conclusions of the Special Study, it is important to note that the lack of adequate information concerning securities traded in the over-the-counter markets is inextricably related to the various abuses documented in the first segment of the Report. Irresponsible selling tactics, uninformed investment advice, extravagant financial public relations and erratic after markets apparently thrive best where lack of information is most marked. In a real sense Chapters II, III and IV which deal with abuses found in these areas provide a strong argument, without more, for legislation of the Frear-Fulbright kind. But the Study was not content to rest its recommendations on these narrow grounds alone.

A survey by the Study of 771 of the over-the-counter issuers listed in the January 1962 Monthly Summary published by the National Quotation Bureau confirmed the findings of previous Commission studies that the financial reporting and proxy solicitation practices of a significant percentage of companies whose securities are traded in the over-the-counter market are seriously inadequate. The disturbing results of the latest survey are detailed in Chapter IX of the Report. I do not intend to dwell on them or to belabor further the need for Frear-Fulbright legislation. On this point most of you agree in principle. It is in the details of this legislation that we find areas of potential disagreement which require further examination and discussion. Three of these problems, the determination of appropriate coverage criteria, the exemption of banks and insurance companies, and the impact of Section 16(b) have always been the important storm centers

of controversy. At the risk of boring those of you who have been able to read Chapter IX, I would like to address myself in more detail to the Study's findings and recommendations on these questions.

It may be argued that, in principle, the reporting, proxy and insider trading provisions of the Exchange Act should extend to all over-the-counter issuers in which public investors have an interest. Such a pervasive pattern of regulation might, however, create a burden on issuers and upon the Commission unwarranted by the number of investors protected and other relevant considerations in the public interest. The question of where to draw the line has been one of considerable uncertainty in previous legislative proposals. To establish better guideposts, the Special Study conducted a survey of the characteristics of over 1600 over-the-counter issuers who furnished adequate data in response to a questionnaire sent to every fifth issuer, excluding exchange listed companies and foreign issuers appearing in the January 1962 Monthly Summary of the National Quotation Bureau. A correlation was sought between number of shareholders versus size and concentration of security ownership of these issuers and trading interest in their securities, as measured by number of transfers and broker-dealer quotations in the Monthly Summary.

Based on findings from the numerous tests and analyses made, and in the light of over-all policy considerations as well as the burden on issuers and on the Commission, the Special Study recommended that coverage should extend, in a phased program, to virtually all over-the-counter issuers having 300 or more equity security holders of record and known beneficial holders. It found that an asset test has no relevance to the number of public shareholders, the extent of trading interest, or the value of outstanding securities. Indeed, it is suggested that the need for protection may vary in inverse proportion to the amount of available assets. At any rate it is pointed out that, unless the asset test is very small, it would exclude from coverage of the statute a significant number of actively traded issues. The Study estimated that at a level of 300 or more shareholders the proposed legislation would reach 6,910 companies, 1,438 of which are now subject to reporting requirements under Section 15(d). This would include almost all the actively traded over-the-counter companies and only a small percentage of relatively inactive ones.

The Commission is currently studying a variety of possible criteria of public interest and their relevance to various types of issuers on the basis of the information developed by the Study, materials gathered from other sources, the comments of various members of the industry committee and others. It is evident, however, that whatever test or combination of tests is finally proposed by the Commission, the requirements of Sections 13, 14 and 16 should be administered discriminately and flexibly.

It would be unnecessary, for example, to require that mining corporations with no current material revenues or expenditures comply with the full panoply of accounting requirements established for large and complex business organizations. Nevertheless, the hundreds and sometimes the thousands of public shareholders of such a corporation, or those interested in purchasing its outstanding securities, would receive significant protection if they could learn of its dormant status, the factors bearing on a possible resurgence of activity and events reflecting subsequent material changes in that status. Undoubtedly there would be a wider range of companies so far as activity, financial resources and public interestare concerned among over-the-counter issuers than generally exists in respect of companies whose securities are registered for trading on stock exchanges. The Commission would necessarily undertake to develop a range of requirements to fit the special needs of such companies and to take into account any special burdens imposed by the legislation. To this end, the Commission should be provided with ample authority to classify and to exempt issuers, persons and transactions.

The Special Study recommended against providing exemptions for banks on the ground that existing state and federal bank regulation, albeit effective as a tool for safeguarding the interests of depositors, does not, as has been urged, provide equivalent protections for investors. The securities of the 13,445 banks in the United States form an important part of the over-the-counter market. Bank stocks accounted for an estimated 20% of the issues listed in the January, 1962 Monthly Summary of the National Quotation Bureau. Since bank stocks tend to be more closely held than other over-the-counter securities, a 300 shareholder standard would reach only about 1,000 of the more actively traded bank stocks.

All but approximately 500 banks are subject to the authority of one of the three Federal bank regulatory agencies. The others are regulated only by the various states. It is important to re-emphasize that the regulatory controls imposed by these agencies historically have not been designed to provide information essential to investment decision by security holders. Recently, the Comptroller of the Currency, who has jurisdiction over the 4,520 national banks, took a number of steps toward furnishing protections for shareholders. Although far short of Commission requirements, and without benefit of statutory guides, regulations of the Comptroller now require that ownership reports be filed when a change in control occurs and that banks with more than $25 million in deposits send annual financial reports, including income statements, to shareholders and provide "adequate" information if proxies are solicited. Except for these limited requirements of the Comptroller, bank regulation provides no controls over proxy solicitation or insider trading and is not concerned, to any significant degree, with

public disclosure of financial or other material information. Statements of income are generally not required, and reports of earnings and dividends are deemed to be confidential information. I should point out that although the Commission, in its letter transmitting the first segment of the Study Report, urged that the legislative proposals should apply to banks, it did suggest that administration might well be granted to an appropriate federal banking authority.

The Report also points out that existing regulation of insurance companies does not provide an adequate substitute for investor-oriented securities legislation. Securities of insurance companies comprise about 5% of the over-the-counter market. It is an industry that has grown rapidly in recent years. The Commission has previously had occasion to express its concern over the pressing enforcement problems created by the fraudulent promotions of a large number of newly organized insurance companies. Regulation of insurance companies, which rests almost exclusively in the hands of the various states, is directed towards the protection of policy holders and has been described by the Supreme Court as "less and less meaningful" to investors. Concerned mainly with such matters as solvency, adequacy of reserves and legality of investments, the reports required to be filed with state authorities, while voluminous, are extremely complicated and designed to disclose matters primarily of interest to the regulatory authority.

Finally, it should be pointed out that the Special Study's separate examination of the financial reporting and proxy solicitation practices of banks and insurance companies produced a picture of deficiencies generally similar to, and in some aspects worse than, that revealed by the survey of other over-the-counter issuers.

Perhaps the most perplexing of the problems connected with Frear-Fulbright legislation, and one that has caused much concern in the financial community, is the impact of Section 16(b) on the market-making functions and the sponsorship activities of broker-dealers. This problem arises, of course, only in the situation where the broker-dealer who is making a market in a security is an insider of the issuer, usually a member of its board of directors. Despite a wide divergence of industry views on the desirability of such affiliation, the Commission's decision in the Cady, Roberts case and the New York Stock Exchange's warnings as to the potential conflicts of interest involved, the Special Study found that in early 1961 a little less than 10% of the registered broker-dealers held directorships and made markets for the securities of approximately 13% of all over-the-counter issuers whose securities evoked some trading interest at that time.

In the opinion of the Study the application of Section 16(b) to over-the-counter securities would have little effect on the market for

such issues and that the concern of the industry as to the impact of Section 16(b) was unwarranted. The Study recommended against statutory exemption from Section 16(b) for transactions of market-makers but urged that the Commission have authority to exempt, on an ad hoc basis, the rare situation in which it is shown that a continued affiliation between the issuer and a broker-dealer and market-making by that same broker-dealer are both necessary.

These conclusions have evoked widespread disagreement among those who have been meeting with the Commission to discuss the details of the legislative proposals. The Commission is presently considering these objections to determine what, if any, exemption from 16(b) should be provided for market-makers. Whatever the recommendation of the Commission, this is a problem which will require continued study to achieve a satisfactory reconciliation of the policies of Section 16(b) and the function served by the activities of market-makers in the over-the-counter market. I should also note, parenthetically, that the proposed drafts of legislation circulated to the industry did not incorporate the Special Study recommendation that the Commission seek statutory reversal of the holding of the Supreme Court in Blau v. Lehman. In that case, recovery of the trading profits realized by a broker-dealer firm from short-swing transactions, in the security of an issuer of which a member of the firm was a director, was limited to the partner-director's share in the absence of evidence showing that he was deputized by the firm to represent its interests on the board.

The Special Study has made a number of other recommendations for legislative changes which are closely related to the extension of Sections 13, 14 and 16 to over-the-counter securities. These include retention of Section 15(d) until the phasing in process of initial registration is completed, repeal of the provisions for extension of unlisted trading privileges contained in Section 12(f)(3) and a strengthening of the proxy rules with respect to both listed and unlisted securities. We have been giving active, indeed, daily consideration to all these and a multitude of related matters at the Commission table. None of our responsibilities is more important, for the application of the reporting, proxy and insider trading provisions of the Exchange Act will provide the underpinnings for effective investor protection in the over-the-counter market. I should also mention the Commission intends to consider with the Federal Reserve Board proposals for the imposition of margin and related provisions of the Exchange Act to some categories of over-the-counter securities.

The extension of adequate disclosure obligations to issuers of securities traded in the over-the-counter market is important in light of the obligation of the financial community to observe the standards

of fair dealing imposed under the anti-fraud provisions of the securities laws. Most of you are probably aware of the Commission's view "that the making of representations to prospective purchasers without a reasonable basis, couched in terms of either opinion or fact and designed to induce purchases, is contrary to the basic obligation of fair dealing." Unfortunately, we do not have time tonight to explore the background of and rationale for this application of the "shingle theory," a concept first enunciated by the Commission in the 1930s. It has aroused great interest among the members of the securities bar and some suggestion that the Commission is seeking to impose unprecedented and perhaps unwarranted responsibilities on members of the financial community. In my view, however, this application of the "shingle theory" merely reflects the widespread recognition within the securities industry that it is good business to "know your merchandise." Put simply, the "shingle theory" serves to prevent the unscrupulous from exploiting the confidence of the investing public built upon the integrity and competence of responsible elements of the industry.

It seems clear that the vitality of the over-the-counter market and the fulfillment of the obligations of all those who deal with the public will be affected by the availability of reliable and current information concerning the securities traded. Moreover, the extension of these requirements to issuers of over-the-counter securities is in the interest not only of investors and the financial community but also of corporate management which has a legitimate concern in the maintenance of informed and orderly markets for the securities of their companies.

Finally, those of you who constitute the securities bar, share with us a responsibility in advancing these proposals. Many of you represent issuers, as well as broker-dealers, whose interest may be affected by the proposed legislation. You will be asked to advise whether it merits sympathetic consideration. The public interest demands your support for the basic legislation as well as the benefit of your counsel as to proper implementation.

Neither industry nor the Bar can afford to refuse the challenge and the opportunity to strengthen the capital markets which occupy such an important and strategic position in our economy.