NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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THE SECURITIES BAR AND THE SECURITIES LAWS

An Address by

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Securities and Exchange Commission

January 27, 1972

New York State Bar Association
Banking, Corporation and
Business Law Section

New York, New York

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I think it quite fitting that this group of lawyers should have the Chairman of the SEC here this afternoon as its guest. After all, the SEC has done much for the practicing bar. Think of the torrent of legal work engendered by this small government agency employing a mere fourteen hundred people. Whatever else it may or may not have accomplished over the years, no one can question the Commission's outstanding record as progenitor of interesting and remunerative legal work. We have also done a good deal for the profession's academic branch. The mysteries of "investment intent" and of the precise scope of Rule 10b-5, the interaction of the Securities Exchange Act with the anti-trust laws, the circumstances under which private rights of action should or should not be implied, the true inner meaning of the <u>Texas Gulf</u> case and kindred topics have proven a godsend to law reviews in search of material.

Indeed, a young economist equipped with his profession's latest mathematical techniques might well employ them in investigating the question of whether the primary beneficiaries of the securities statutes have been lawyers, accountants, financial printers -- or Professor Louis Loss and his publishers.

I begin in this half-facetious vein because I think it a good way to make a serious point. The whole system of securities regulation is a system of legal control. As such, it depends on the lawyers. Without them, without their allegiance to the goals embodied in the statutes and in the rules that the Commission administers, the whole thing can't possibly begin to work. What is done at 500 North Capitol Street in Washington, and in the Commission's regional offices around the country, to implement the securities laws depends in very great measure for its effectiveness on what you, as lawyers, do in your offices.

The whole disclosure system turns on the accuracy and on the utility of the registration and the proxy statements that you write. We have to count on you to interpret and to enforce the rules that we develop on fair dealing. When we adopt new rules or broaden our disclosure requirements to remedy past deficiences and to keep pace with social and economic change, we need your help for two purposes. First, we need it so as to be reasonably certain that what we're doing -- or trying to do -- is practical and realistic. In securities

regulation as in other types of social control, regulators can attempt to do too much. When that happens, the social costs of regulation become disproportionate to the benefits it produces. Candid comment and frank criticism from a knowledgeable and a vigilant bar can help us to avoid that. At times we'll disagree with you, but neither we nor our staff can do our jobs intelligently unless we know what you think. Secondly, we need your help to educate the business community in what the securities statutes require of its members.

So the Commission listens to the bar and heeds what it says. To illustrate that I need only refer to the arcane body of law and lore that grew like topsy over the years around the so-called private offering exemption from the Securities Act's registration and prospectus delivery requirements. That corpus of doctrine turned on the purchaser's state of mind. It made for heavy emphasis on subjective factors, an emphasis that threatened at times to convert significant areas of securities law into a branch of

psychoanalysis. It led to the development of such cloudy concepts as "change of circumstances" and "fungibility" -- neither of which had any clearly discernible relationship to the investor's need for information. After a prolonged -- perhaps a much too prolonged -- process of gestation the Commission has brought forth what I believe to be a body of clear and rational rules to replace the uncertain subtleties of old. Just as important, this rule is designed to make additional information available to the public in the course of eliminating psychology and bringing greater clarity and certainty to the rules governing securities transactions. Now I was not a member of the Commission -- I was one of you in private practice here in New York -- when the Wheat Report, which led in due time to Rule 144, was launched. But it is no state secret that critical, acute, analytical comments from the bar did much to cause the Commission to take a fresh look at the validity of its traditional approach to secondary offerings. Critical comment from the bar on the 144 rules resulted in the demise of the fungibility concept and other significant simplifications in the final proposals.

This fruitful experience leads me to consider it essential for the Commission to redouble its efforts to keep in touch with the best thinking on investor protection at the private bar, in the accounting profession, and in the

financial community generally. As one step -- and I hope that it will prove a significant step -- toward that end, I have created a special committee of three highly experienced practicing lawyers who will at my request examine the SEC's enforcement policy and practices, engage in frequent dialogue with the members of the Commission and with our staff, seek and sift the suggestions of the bar and make recommendations to the Commission for worthwhile improvements to our time-honored ways. To that task these three men will bring a wealth of experience. The lawyers who will be rendering this valuable public service are Ralph H. Demmler of Pittsburgh, who was Chairman of the Commission from 1953 to 1955 and who has been in private practice at the securities bar for many years; Manuel F. Cohen, who after spending most of his professional life in highly responsible positions on the Commission's staff and contributing significantly to its work became a member of the Commission itself in 1961, served as its Chairman from 1964 to 1969, and has since been in private practice in Washington; and John A. Wells of the New York law firm of Royall, Koegel & Wells. Mr. Wells

is not a securities lawyer; that's why he is the Chairman. He will bring the benefit of an unusually broad experience at the bar and in public life to the group. Those of you who know Messrs. Demmler, Cohen and Wells will know what I mean when I say that I expect them to be critical and searching.

This is not a Practicing Law Institute forum, and I have no intention of boring you with detailed commentary on the Commission's new Rule 144. But I do want to say that I hope that this rule will free you from the endless variations that you have been playing for so many years on the sterile themes of investment intent and change of circumstances and that the time and talent thus liberated will be devoted to more productive ends.

Chief among those ends in my view is the need for a great improvement in the quality of the disclosure literature elicited by the 1933, 1934 and 1940 Acts. Since it is the lawyers who produce this literature, the task of improving it is one for our profession.

With some exceptions lawyers have been and are careful and meticulous in preparing disclosure material for filing with the Commission.

But have we done well enough? How can we do better? Most of us have been careful. Most of us have been diligent, and some of us have even been intelligent, which is harder. But carefulness, diligence -- even intelligence -- are not enough in themselves. It is also well to be as useful as one possibly can, and I submit that we lawyers ought to be and can be a good deal more useful than we now are.

When a lawyer writes a prospectus, a proxy statement, or a 10-K report, he is or should be communicating information. To whom? Not just to the staff of the Commission's Division of Corporation Finance. If he views that as his sole or even as his primary audience, he is engaging in a ritual whose only point is to keep his client out of trouble with the law.

Cynics say that this is exactly what SEC disclosure is -- ritual, mumbo-jumbo, a medium-sized unemployment relief project for lawyers, accountants and printers. I disagree. But when we follow Dr. Johnson's admonition to clear our minds of cant, we see, I think, that there is

an uncomfortably large element of truth in what these debunkers have to say.

Lawyers in this city and all around the country file reams of stuff with the SEC. On the whole, they do it carefully -- as good lawyers should. This paper is antiseptically factual. Most of it is terribly dull. And though the whole business supposedly exists for the purpose of informing investors, it seems to be generally assumed that few investors in their right minds ever bother to read it. Actual investment decisions are said to be based on word of mouth presentations and on written material of a sort quite different from the sedately written brochures replete with lugubrious caveats that you gentlemen deposit with us. You know what I mean. Would an investment adviser who wrote in the style favored by the typical prospectus writer, who religiously eschewed forecasts and projections, and whose "analysis" consisted in toto of rehashes of the historical financial material, have many clients?

A Martian would find this a rather strange system. But able men at the Commission and at the bar have rationalized

it over the years by explaining that prospectuses and complex proxy statements are studied by an initiated few, that these sophisticates translate this material into ordinary English for the common man and the common woman and that everything works out very well in the end in this best of all possible worlds. I do not mean to suggest that this view is altogether fallacious. On the contrary. I think that there is a good deal to this conventional wisdom.

But I have two very serious reservations about this system in which little books (sometimes they're not so little after all) called prospectuses and proxy statements are passed around as ceremonial accompaniment to a distribution process that turns on other factors and that differs little in essence from what it was before 1933.

First, I cannot believe that the Congress that passed the Securities Act intended the prospectus to be either a mere memento of the transaction or a document designed for a professional elite of analysts, accountants, and lawyers looking for verbal formulae usable in future prospectuses. If that is what the draftsmen of the Act intended, why were they so careful to insist on the physical delivery of a copy of the prospectus to the purchaser? Secondly, the hot issue crazes of 1959, 1962, 1967 and 1969 show that the status quo leaves much to be desired.

Of course, disclosure is no cure-all. It is also axiomatic that investment involves the assumption of risk and that losses are inevitable in a private enterprise

economy. But we -- and when I say "we", I mean the Commission as well as the bar -- must do a better job on disclosure than we have been doing. That is our responsibility in and to a free economy. And we cannot escape from that responsibility by repeating adages about horses and water and the ease with which fools are parted from their money. This is serious business, much too serious to be disposed of by off-hand references to tired aphorisms. It is not just the welfare of the relatively limited number of people who put money into new equity securities that we're talking about. It is the welfare of the whole society. If the mechanism by which risk funds flow into fixed capital works irrationally so as to divert that scarce resource into unproductive channels, all Americans (including those who have never bought a share of stock in their lives) are worse off than they would be if the risk capital market were working more efficiently.

Hence, I think it imperative for all involved with securities regulation to address themselves to the task of improving the disclosure system.

The style as well as the content of SEC disclosure documents was shaped in the 1930's by the stop order opinions that fill the early volumes of the Commission's reports, by the letters of comment that were written by a staff that may have been overreacting to the experience of the 1920's, and by lawyers in private practice who were understandably fearful of the novel liabilities to which their clients might be subjected and who were also ingenious enough to convert the prospectus, which had theretofore been a selling document, into an insurance policy for the issuer and for its underwriters. It is high time for all of us to take another look. We might begin by trying to write prospectuses in good, clear English. Accuracy can be combined with readability. And nothing in Form S-1 requires that registration statements be soporific. The problem of the unreadable prospectus has been with us ever since 1933. But I am not ready -- not yet -- to declare it insoluble. I think that we can do something about it -- if we really try.

I am even more unhappy with the content of the contemporary prospectus than I am with its style. We all know that the securities markets are essentially markets for

discounted future incomes and that investors are future oriented. The disclosure system exists to help investors. Yet as now administered, it does so in a strange way by blocking out as obscene -- utterly devoid of any redeeming social value -- any reference to the matters in which investors are most keenly interested. Projections of future earnings are one example. Actual market values of assets carried at depreciated historical cost are another.

The traditional view does not even permit -- let alone require -- that we sully the purity of a prospectus by references to these earthy subjects. Of course, these forbidden topics always come up in the actual sale of securities. Everybody talks about them. But you can seldom print anything about them in a prospectus or a proxy statement. Why? Some say that the investor must make up his own mind about these vital topics, that the prospectus can only supply him with raw and rather unpalatable factual material that he must sift for himself. Others say that investors are so stupid that they would attach undue weight to forecasts and appraisals.

Somehow this applies only to forecasts and appraisals found in documents filed under the securities laws. Forecasts and appraisals appearing in the New York Times or in the Wall Street Journal are okay. This investors-are-stupid theory seems hard to square with the every-man-his-own-analyst rationale. Yet there are intelligent men who subscribe to both theories simulaneously.

We are embarked on a major effort to make disclosure more useful. To start off, we are not going to play God and say disclosure is for the analyst and not his Aunt Nellie. Nor are we going to say the reverse. We are going to straddle that issue and ask for both the detail the analyst wants -- and the highlights designed to help Aunt Nellie. We have a hot issue inquiry going which, among other things, is designed to help us substitute significant disclosure for boilerplate, particularly for new and young companies, on competition, markets, technology, budgeting practices and the track record of principals. We are reviewing our position on the use of appraisals and other indicia of market values, and on the

use of forecasts. We know forecasts are pivotal to values in today's trading market. We are pushing as hard as we know how the principle that if forecasts are put out at all, they should be made available to everyone. Perhaps, because forecasts are in fact being used so widely they should be permitted in disclosure documents where methods, assumptions, deviations between forecasts and performance and such factors can also be brought out. We are studying that. Just this week we met with committees of the American Bar Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, and the Financial Analysts Federation, to get their views on the problems, risks and benefits in disclosing budgeting and forecasting data.

We are charged by Congress with recommending by the middle of this year our views on the need for legislation of oil and gas offerings and we have established a special branch to handle tax shelter issues. On handling the special conflicts involved and the sorting out of tax and economic factors, we will be looking for practical advice and guidance from those of you who design and put together these packages.

Accounting has been called the heart of disclosure. A better metaphor might be the eye or lens because different perspectives can produce such sharply different images. Changes in methods or in assumptions have doubled and quadrupled earnings, and the reverse. The accounting profession has, and continues to put enormous amounts of professional time and intellectual energy into standardizing accounting principles and their application. This is a truly valiant effort. Progress has been made. But it is a long and difficult journey. I sometimes think we expect too much of the financial statement when we look to it to reflect adequately and uniformly the complexities, the business strategies, and the management approaches which prevail in this intricate economic system of ours. It may be that we should recognize the limitations of the financial statement -- even the heavily footnoted one or perhaps, especially, the heavily footnoted one -- and rely to a greater extent on supplementary disclosure to create a fair picture of basic economic reality. At the Commission, under the leadership of Commissioner Needham and Alan Levenson, we are giving serious consideration to requiring that all

prospectuses carry a textual exposition under the title -- Accounting Policies, or something of the sort. This would be designed to elucidate on the financial statements, make them more meaningful, indicate underlying assumptions and changes in method and their significance and generally aid in the interpretation of financial data. We are interested in getting advice and suggestions on the values and the pitfalls in this step.

Finally, disclosure is only as good as the dissemination it gets. We have made a lot of progress in blending the 1933 Act disclosures and the 1934 Act disclosures into a comprehensive, continuous disclosure system. Some one hundred million pages of this disclosure data are disseminated each year around this great country -- most of them on microfilm. But by far the most effective disseminator of investment information in this country remains the corporate report to stockholders. I want to submit to you that our corporations and the bar, as well as the SEC, should work intensively to make these reports more valuable to investors. Corporate directors and officers, and their lawyers, are gravely concerned today about

increasing exposure to greater liabilities. As analysts dig up information about a company and investment houses spread it around, we get sometimes capricious, sometimes precipitous reactions in market values and we get perplexing problems on the need or obligation to put out public statements and possible claims are generated. It seems to me that to the degree the corporate report to stockholders seizes the bull by the horns and spells out hard facts about corporate progress and problems, and competition, and technology, these latent problems tend to be brought under better control. I suppose that this can be argued but that is the way I tend to look at it. Also, surveys show that existing stockholders are the best source of new capital and a policy of continually taking them into the full confidence of the corporation and giving them the kind of information that securities analysts provide about the company would seem to be in the best long-term interest of the corporation. At the SEC, we would like to see reports sent out to stockholders carry as much as possible of the information which is filed with us. That's, of course, in the discretion of management but we have

specified the information to be filed; we have done this in the discharge of our obligation to make necessary information available to the investing public and we have a resulting obligation to make it as widely available as possible. We are now considering a requirement that the annual 10-K, and possibly the quarterly filings, indicate the items of information filed with the SEC which were not included in reports sent to stockholders. This will, hopefully, indicate to researchers and financial publishers and ultimately filter to the investing public the additional data which has not yet received general public dissemination. This, again, is something on which we would like your views.

It is said that any departure from the puritanical austerity of today would lead to a plethora of abuses, which the Commission would find it administratively impossible to police. Finally, lawyers are frightened by the spectre of liability for good-faith forecasts and bona fide appraisals that hindsight proves erroneous. I don't dismiss these last two reasons out of hand. As the Commission's Chairman, I am painfully aware of the enormity of its tasks and of its severely limited resources. And as one who was a lawyer for

many years, I know something about liability and about the fear of liability. It is very tempting to say nothing when you're afraid that saying something may get you or your client into serious trouble a long time from now.

But the Commission's administrative difficulties and the bar's understandable fear of new liabilities do not in my judgment warrant a decision to cling to the old ways in spite of their demonstrated inadequacy and their patent lack of realism. A searching inquiry is needed. And that inquiry cannot be made by the Commission alone. Cooperative effort by all concerned is called for. I trust that this effort will soon be under way and that the organized bar will play a big part in it.