ADDRESS

of

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before

THE BUFFALO CHAPTER OF THE
NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS
AND MEMBERS OF THE
INVESTMENT BANKING ASSOCIATION AND
BUFFALO BAR ASSOCIATION

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Much has been said of late, and in many quarters, of the need for cooperation between business and government. I too want to talk with you this evening about cooperation, not as a dogmatist lecturing business on its wicked ways, but from the point of view of one on the firing line in Washington, engaged from day to day in talking and working with lawyers, accountants, investment bankers and business men in an effort to solve some of our common problems. I am not going to talk about broad social objectives, about the New Deal, or the Old Deal. I want to talk, naturally, about the work of the Securities and Exchange Commission, as it affects those in this room; but I want to assume, at least for purposes of discussion, that the main objectives of that corner of the New Deal are not in dispute, and that the question before us is not whether we in Washington should be sent back where we came from, but how you and we can best cooperate to reach some of those objectives with a minimum degree of friction and inconvenience.

In an address last Friday evening before the Bond Club of Hartford, Connecticut, Chairman Douglas of the Securities and Exchange Commission closed with the following statement:

> "I am impressed by the earnestness with which the Investment Bankers Conference and various local organizations of brokers and dealers have on their own initiative attacked the perplexing problems which beset their widely scattered and heterogeneous industry. And I am genuinely convinced that the objectives of the Commission and of the rank and file of the over-the-counter securities business are fundamentally identical. If my analysis is correct, our hope should be justified that we can achieve in the shortest possible space of time and with a minimum of public and private expense the objectives we all desire."

While Mr. Douglas dealt largely in his address with the aims and efforts in which both the Commission and the Investment Bankers Conference and other organizations of brokers and dealers are striving, the principles and hopes which he expressed before the Bond Club implied a philosophy of cooperation between government and industry which is manifestly applicable to the entire field of business in which all of you gentlemen are so directly interested. I feel sure that there is no need for me here to attempt to impress upon you what Chairman Douglas and other members of the Commission and its staff have recently so often expressed - the desirability of a program of aggressive self-regulation by the securities business itself as an alternative to increased governmental supervision over the conduct of that business in all of its ramifications.

And so tonight I welcome this opportunity to discuss the form which this cooperation might take, and to outline certain specific illustrative problems to which immediate joint attention should be given by government and by you and your representative associations. In considering these illustrations, I am sure you will understand that we in Washington recognize not only your duty to cooperate with government to seek necessary reforms in business and accounting practices, but also our own responsibility to cooperate with you to reduce to a minimum the expense and practical difficulties imposed by law and regulation on the conduct of the securities business.

In drawing upon the Commission's work for specific illustrations of the type of problem which needs your cooperation for its happiest solution - if we are to avoid the imposition of further strict governmental regulation - I can think of no field more fertile, nor more appropriate to this gathering, than the field of accounting practices. As you all know, the heart of the Commission's work under the Securities Act lies in securing full and honest disclosure of the basic information without which no purchaser of securities can be expected to decide intelligently whether a security is worth investing in; and accounting, being the science of organizing and presenting financial information in complete and accurate form, is the handmaiden of the principle of disclosure. The aims of the accountant and of the Commission lie very close together.

And yet we find that the vast majority of stop order proceedings instituted by the Commission to prevent further sale of securities on the ground that the basic data have been falsely or fraudulently represented, arise out of the failure of accountants accurately to disclose the history and present state of their clients' affairs. Many of such cases, it is true, may involve plain and wilful fraud, and such cases need not concern us here, for we are not engaged in discussion of what to do about the crook. Many another case, however, as well as many a case evoking merely criticism and condemnation from the Commission without the institution of stop order proceedings, arises out of the adoption of accounting practices which, though inherently deceptive, are nevertheless recognized by state corporation laws and therefore accepted and followed by accountants without incurring censure from their organized professional associations.

In order that I may not be accused of mere generalized criticism, let me take a few examples of accounting practices which are deceptive in their nature, and which nevertheless recur continually in registration statements filed with our Commission.

One outstanding example of the type of practice frequently condemned by the Commission is the practice of concealing promoters' profits in overvalued property accounts. You are all familiar with the problem: promoters, having acquired property of dubious or merely prospective value, transfer the same to a corporation which they have organized, in return for all or a portion of the corporation's stock. The property is then set up on the corporation's books either at the par value of the stock issued to the promoters, or at some arbitrarily selected stated value. In either event the figure at which the asset is set up on the balance sheet is frequently grossly excessive.

It would be difficult to conceive a practice more readily lending itself to deception. Yet accountants have by no means set a uniform face against the practice; nor is any effective deterrent afforded by the common law or by state statutes. The frequent lack of a realistic approach by the courts to the problem of promoters' responsibility to the corporation and its other stockholders; the many technical pitfalls besetting actions even by creditors; the further encouragement to dishonest promoters that was offered by the introduction of the device of no-par stock; the difficulty of proving the necessary elements in an action of fraud and deceit - all these have many times been observed. The decisions of federal courts in particular

have not been such as to discourage this type of over-valuation. In *Old Dominion Copper Co.* v. *Lewisohn* the Supreme Court held thirty years ago that, so long as all the stockholders at the time of the sale of the property to the corporation were aware of the facts and had ratified the transaction, the corporation was bound by its consent thus given, and no action might thereafter be maintained by it against the promoters, even though other investors subsequently purchased authorized but unissued stock from the corporation without knowledge of those facts. Since the promoters usually comprised all the stockholders at the time of the sale to the corporation, this rule, of course, effectively immunized them from any liability. *McCandless* v. *Furlaud*, decided two years ago by the Supreme Court, may have made some inroad into this doctrine, but it is questionable whether it overthrew it. A bare majority of the state courts, it is true - New York does not seem to be among them - follow what has come to be known as the Massachusetts rule, enunciated in *Old Dominion Copper Company* v. *Bigelow*. Under this rule the promoters' fiduciary duty is considered to extend to incoming subscribers in cases where the promoters held all of the issued but not all of the authorized stock at the time of the corporation's consent and where as part of the original plan of promotion the corporation later issued additional stock to persons unaware of the promoters' profit. Even these courts, however, concur in the federal rule to the extent of holding that the corporation may not recover when, at the time of the corporation's consent, all of its authorized stock was outstanding and held by the promoters, even though the promoters themselves immediately resold the stock to the public as part of the promotion scheme. Even under this relatively enlightened doctrine, then, the promoters need be careful only to take all the authorized stock, and so far as the laws of liability are concerned, they will have virtual *carte blanche* to set up the properties at grossly excessive valuations, and by means of this misrepresentation of asset value induce into their enterprise a credulous public. And where the laws of liability do not prohibit or deter, too many an accountant has been willing to accede to the demands of an unscrupulous and self-seeking client.

The example I have given is obvious to all. Less crude, though perhaps no less obviously filled with the seeds of deception, is the scheme whereby preferred stock is sold to the public under such circumstances that a large part of the proceeds is made legally available to common stockholders by way of dividends. The operation is simple: preferred stock is issued with a par or stated value of $5 per share, a liquidation value of $25 per share and a redemption price of the same. Relying upon the liquidation and redemption values, the public is induced to purchase at an offering price of $25 per share. The corporation, however, sets the stock up in its capital account at $5, the par or stated value, the $20 balance being credited to a surplus account available for common stock dividends. At the best the preferred stockholder is misled as to the true degree of protection to which his investment is legally entitled; at the worst, he may wake up one day and find that four-fifths of his investment has been expropriated and that he is without remedy.

I doubt if any of you would argue in support of deception of this character. Preferred stock sold as I have suggested is in every real sense offered as a twenty-five rather than a five dollar investment, and it is nothing more nor less than fraud to take advantage of a nominal "par" or

"stated" value to permit diversion of the proceeds of sale into the pockets of junior security holders. Yet the Delaware corporation laws seem rather clearly to sanction such a practice, and the New York corporation laws at least do not clearly prohibit it. It may well be that, notwithstanding statutory permission, a court of equity would be persuaded, at the suit of a preferred stockholder, to enjoin such a patent misappropriation of his investment; but this question is still unsettled, and again, where the law does not prohibit, the accountant has been willing to go.

I will not weary you with a further detailed statement of examples. Suffice it to refer briefly to the recent widespread practice of reducing depreciation charges by means of arbitrarily writing down fixed assets, for the purpose of freeing current income for the payment of dividends; the failure of many companies to restrict their earned surplus accounts for the cost of their own stock reacquired and held in the treasury; the failure of many companies to employ any scientific method of determining depreciation for the purpose of the accounts which they present to the potential investor, even though the same companies may be very careful to work out an orthodox straight-line depreciation scheme for tax purposes. Those of you who are acute to the professional responsibilities of the accountant can fill in the outlines and could yourselves produce many more examples of equally questionable character.

We in the Securities and Exchange Commission are not entirely remediless in coping with these abuses. From the Unity Gold Corporation case, decided by the Federal Trade Commission at the outset of its administration of the Securities Act, through the Queensboro Gold Mines case, decided only a few weeks ago, the Commission has not hesitated to attack with its heaviest artillery - the stop-order proceeding - registration statements containing misrepresentations of the value of assets acquired from promoters. In cases not meriting this severe penalty, we have at least secured a modicum of disclosure by requiring that any purported independent valuation or appraisal be supported by a statement of its basis, and that valuations not purporting to be thus based be footnoted to indicate not only the relationship of the vendor to the corporation, but also the purely arbitrary character of the valuation. Where the valuation is at par and contemporaneously stock has been sold to the public below par, even this explanation has not been permitted to suffice, for misrepresentation cannot be cured merely by apology. Similarly, where preferred stock has been capitalized at below its liquidating and redemption values we have done our best to minimize the deceptive character of the operation by requiring a footnote to the balance sheet indicating the aggregate liquidating value and also stating the opinion of registrant's counsel as to the legality, from the point of view both of statute and of possible equitable remedies, of any use of the so-called surplus for common stock dividends. Lawyers dislike giving such opinions, but the need is one of their own, or their clients', making.

Yet these sanctions, though they may serve as piece-meal protection to the public in the individual instances which come before our Commission, are not sufficient from the point of view of any long-range program. True, we may demand and even compel full disclosure of the inherently dishonest or deceptive character of particular devices; but misleading practices accompanied

by confession of dishonesty are but poor substitutes for straightforward and conscientious accounting principles. Elimination of unsound accounting, not merely disclosure of its unsoundness, is the goal.

Here, then, I return to my central theme, the essentially cooperative nature of the job of government and business. We may bring stop-order proceedings. We may serve notice of deficiencies and use our salutary power to delay, at least for a period, the public offering of securities until the deficiencies are corrected. We may circulate, as we have done, the opinions of our Chief Accountant, Carman G. Blough, as to the fundamental principles underlying the accountant's function as an aid to disclosure. But these are not enough, for they are either fragmentary or purely advisory. What we, or you, or both of us, must do, is to get a clear picture of the scope of the problem, and then attack it concertedly.

There are two remedies. One lies with us. We may, as we have not yet done, seek to develop our rule-making power under the Securities Act for the formulation of accounting rules designed to impose minimum standards of accounting theory and practice upon accountants whose work is to be submitted to our scrutiny. Already, as Judge Healy announced in his recent address before the annual meeting of the American Accounting Association, efforts along this line are being undertaken by the Commission's staff, with a view to codifying a few of the more elementary standards of sound accounting which are accepted by a majority of good accountants. As we now visualize it, this program is no more than a cooperative attempt on our part to aid the accounting profession in its own efforts to fix and maintain the standards to which all responsible and independent accountants already adhere. We should deplore as much as you the necessity of going further, and imposing drastic government restriction and supervision on the practices of accountants.

The alternative to a more pervasive policy of government regulation of accounting practices lies with you. By this I do not mean that you have not, both individually and through your professional associations, contributed heroically to the task of raising accounting ethics. Much has already been done. But even the best intentioned and most conscientious accountant may hesitate to refuse, merely in the interest of sound accounting theory, to comply with the wishes of his client in following practices clearly sanctioned by state laws; and much therefore remains to be done in the way of overhauling state laws which authorize or permit practices repugnant, as many of those I have described must be, to the ideals of the profession. Therefore, it is incumbent upon you, if you would do your part of the job, not only to establish your own standards of sound practice and theory, from which you will not be swayed by the importunities of your clients, but also to lend the full weight of your influence to revision of those corporation laws which serve as temptations to depart from that objectivity essential to a proper discharge of the accountant's duties. Laws themselves, you must recall, are the product of public demand for the codification of standards evolved by the public conscience; and the articulate members of interested professions are the most potent force in the crystallization and codification of those standards.

Thus far I have been talking primarily to the accountants, and although I have done my best to stress the cooperative nature of the job which faces

both us and them, I fear some of you may feel that I too have taken the position that cooperation means that the other fellow should do something about it. To protect myself against this charge, let me discuss briefly before I close an entirely different field where joint efforts by government and business are needed to bring about results desired by both - a field in which the demand for improvement has come from business rather than government, and in which government, rather than business, is on the defensive. I refer to the problems created by the overlapping of federal and state jurisdictions over the issuance and sale of securities.

Outstanding among the problems facing the investment banker, the lawyer and the accountant alike, in preparing for the distribution of a new issue of securities to the public is the problem of meeting the diverse requirements of state and federal regulating bodies. We in Washington realize no less than you - perhaps because you so frequently tell us about it - the sheer physical burden of work involved in registering or qualifying an issue of securities under the laws not only of the Federal Government but also of the several states in which the offering is to be made. What you gentlemen often fail to realize, I believe, is that by and large we in the government are no less anxious than you to achieve simplicity and uniformity, to reduce the burden of detail and red tape, and to concentrate our efforts and yours in a joint endeavor to reach the simple objectives of the Securities Act - full and honest disclosure of the basic facts which must be known before anyone can intelligently make up his mind whether or not a security is worth investing in.

If this be so, you may ask, why do not we in the government take more affirmative steps towards the simplification and integration of the processes of governmental supervision of the issuance of securities?

To answer this question let us review briefly the history of the problem. As you know, entirely apart from the Securities Act of the Federal Government, and long before any statute of so sweeping a character had been even conceived, the several states of the Union were engaged in the enacting of "blue sky" laws of one kind or another. Over a period of a generation such laws have been enacted in 47 out of the 48 states. These statutes have varied widely in character, but in general they fall into three classes: the so-called "fraud statute", of which your own Martin Act is a modified form, the "disclosure" statute upon which the Securities Act is based, and finally the type of statute which requires qualification and even approval of the merits of securities before they may be offered to the public.

While these statutes undoubtedly did much for the ten millions or more of investors in the country, their effects were, of course, necessarily limited by the constitutional restraints of our federal form of government. Full realization that the distribution of securities had become in large measure a nation-wide business with which the individual states could not successfully cope came only after the depression of 1929, and, when it came, led to the enactment of the Securities Act. This federal statute, however, sought to do no more than impose basic standards of honesty and completeness in the disclosure of the facts from which alone understanding of the merits of securities can be gained. The Securities Act could not, and did not seek to, supersede state control of the sale of securities within their own boundaries; it could, and did, implement state laws by providing basic standards of disclosure for all issues not purely local in character.

With the theory of state supervision and federal coordination few of you would disagree. Yet you and we both know that much still remains to be done to adjust this theory to the practical exigencies of modern interstate financing. Lawyers and accountants alike may be glad to lay before both the Securities and Exchange Commission and the commissions of the several states where their clients' securities are to be sold, all of the facts bearing upon the nature and merits of the securities. But they resent, with a well justified bitterness, the demand that the same information be submitted to half a dozen or more commissions in an equal number of different forms and on an equal number of different time schedules. It is not the fact that so many governmental bodies are inquisitive about us, they say, but that each one of them has its own idea of how they want us to explain our proposition.

Here, then, is the second example I would give you of the need for cooperation between government and business. Failure of state and governmental authorities adequately to integrate their regulatory processes is of concern to government and business alike; for the irritation of business in its efforts to satisfy government can only result in creating friction which decreases the efficiency of government. The job of bringing about a closer integration between these processes is a joint one for business and government.

Some recognition of the problem, and attempt at its solution, is already being manifested by government. In Massachusetts a commission was created at the last session of the general court for the purpose, among other things "of making a survey and study of the laws of the commonwealth regulating or otherwise pertaining to the promotion and sale of securities, with a view to bringing said laws into harmony with the Federal Security Act of 1933". In Pennsylvania and Michigan consideration was given at the last sessions of their respective legislatures to laws designed to effect a similar integration; and in Maryland the problem has received some consideration from State officials. The National Association of Securities Commissioners resolved at its 1936 conference that the Association "accept such forms that might be drawn and presented by the committees on uniform registration statements, as far as they are applicable to the laws of the several states". And in South Carolina a law was adopted in 1936 under which "seasoned" securities registered with the Securities and Exchange Commission on Form A-2 may be qualified in South Carolina by a simple process of "notification".

These developments in the process of integration have, I believe, had the hearty support and assistance of such organizations as the Investment Bankers Association and the Investment Bankers Conference, Inc. These and other similar organizations have recognized that the impetus must come from business as well as government - that even the best intentioned government officials may frequently be so busy in the handling of day to day details of administration that the development of long-range programs may lag sadly unless stimulated by the constructive criticism and suggestion of interested and informed professional groups. If you and your representative associations will believe, and act on the belief, that this constructive criticism and suggestion not only is welcomed by government but also helps government to do its part in the attaining of objectives desired by both, the attaining of those objectives will be vastly easier.

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