For Release 2:45 P.M., May 22, 1947

"SEC AND THE STOCKHOLDER"

ADDRESS

OF

EDWARD H. CASHION

Chief Counsel, Corporation Finance Division,
Securities and Exchange Commission

before the
INVESTORS LEAGUE, INC.

Hotel New Yorker
New York City

Thursday, May 22, 1947

Thank you for this welcome opportunity to speak before you this afternoon. It is all too seldom that we at the Commission have the chance to talk with organized groups of investors about their consumer problems in the securities market. The chief reason for this is, I suppose, the fact that organizations such as yours are very few in number. This dearth of organized investor bodies is, in my opinion, much to be regretted, for I think that your type of organization can do much to educate the investor regarding his rights and his means of protecting himself in the securities market. I assume that if investors generally were not so passive about the problems directly bearing upon their interests, there would be more vocal and truly representative organizations acting on their behalf. Issuers and merchandisers of securities, being more intent and active in their own interests, do not appear to have the investors' organizational difficulties.

This afternoon I should like to discuss with you, in a very general way, the why and the wherefore of some aspects of the laws adopted by Congress for investor protection, the role the Commission plays to make these laws operative, and the role the investor must play to make them effective and protect himself.

Although I think the Federal securities laws in a very real sense protect the merchandisers of securities, they were primarily enacted for the protection of investors. The Congress saw to it that this primary purpose would not be overlooked or lost sight of in the administration of the Securities Act of 1933 and the Securities Exchange Act of 1934. In no less than sixty eight separate places the phrase "for the protection of investors" is imprinted upon these Acts. In my mind it is imperative that all investors should know, not only that these Acts exist for their protection and are enforced in their interest, but also the type of safeguards which the Acts afford them and the attendant obligations they must assume.

As we all know, the securities market has played a very vital part in the growth and development of this country. It has afforded a ready medium whereby investor capital can be placed behind production in growing industrial and utility corporations, and has also afforded an ever present mart where security holders might dispose of their securities as needs be. Investor confidence in the market is essential for the economic welfare of the country. Such confidence can exist only when the market is orderly, fair and honest. After many years of trial and error it was found that the State regulatory and enforcement bodies were not able, alone, to cope with this task of keeping securities markets orderly and clean. Only too often would a State find belatedly that securities had been sold within its borders by dishonest salesmen operating from without the State and beyond the reach of its process, or that securities were sold in violation of State laws and the seller had crossed the border before apprehension was possible. To cover this wide gap in the enforcement field was one of the reasons why the Securities Act was originally adopted. This, however, was not the only abuse aimed at by the Congress. It set its sights as well upon prevalent high-pressuring and speedy distribution of securities by inadequate, false, or misleading information, the evasion of responsibility by issuers and merchandisers of securities, and tailor-made markets.

In adopting the Securities Act, the Congress experienced no difficulty in attempting deliberately to change the then existing distribution practices. It decided that the speedy distribution technique had assumed an undue importance to those engaged in the securities business and that it should be discarded, since it operated to the serious detriment of the uninformed investing public and the nation.

It should be understood at the outset that the Securities Act is not a licensing or an approval statute. Instead of adopting that theory of securities regulation Congress adopted the disclosure theory which is predicated on the idea that the investor should decide for himself whether an investment is suitable for his particular needs and that the function of the law is to see to it that he knows the whole, material truth about the investment so that his individual decision can be reached on an informed basis.

In its essence the Securities Act prohibits the public offering of any security unless it is specifically exempted by the statute or effectively registered. The statute further provides that it shall be unlawful to sell securities through misrepresentation or fraudulent schemes. The Act contains a fairly simple mechanism for the registration of securities. A registration statement is filed on a prescribed form and must contain a minimum amount of specified information which experience has taught is essential to the exercise of an informed judgment by the investor as to whether he should or should not buy the security being offered. Provision is then made that issuers, underwriters, and certain other persons shall assume the responsibility for the information contained in the statement and if it contains material misrepresentations or omits to state material facts, these persons are subject to civil and criminal liabilities. As a part of the registration statement there is filed a prospectus or selling circular. In general, the registration statement becomes effective automatically on the twentieth day after it is filed or the twentieth day after the filing of any amendment. However, the Commission can cut down that period, having due regard among other things to the public interest and the protection of investors. This lag in time between the filing and the effectiveness of the statement is known as the "cooling period". The purpose of this "cooling period", as I see it, is threefold: to slow down the distribution process and let some steam escape from the high pressure salesmen; to give the investor a chance to digest the information expressed in the registration statement before the security is offered to him; and to give the Commission's staff some time to determine whether the demanded disclosures have been made.

If any registration statement contains a materially false or misleading statement, the Commission may prevent it from becoming effective or suspend effectiveness once attained and preclude further sales by the issuer or distributors through the issuance of a stop order. Such an order is effective not only to stop distribution but the proceedings result in a record which may be used to subject those who are responsible to severe penal and civil liabilities.

Of course, if the deficiencies in a registration statement appear to be the result of an innocent mistake and not a deliberate attempt to conceal and mislead, rather than go through the formal stop order proceeding, the Commission usually advises the registrant of the deficiencies by letter and permits the filing of appropriate amendments. Because of the sincere efforts of the great majority of registrants to cooperate and file complete and accurate information, it has been necessary for the Commission to resort to stop order proceedings in only a few cases during the past three years.

In this connection let me point out that the absence of a stop order and the effectiveness of a registration statement have no bearing on the investment merit of a security. In fact it is a crime to represent that registration with the Commission means that the statement is accurate or complete or that the Commission has approved the merits of the investment. The Commission may suspend the effectiveness of a registration statement only on the ground that the disclosure requirements of the Act have not been met. You will appreciate, I am sure, that a registration statement may be complete and accurate, contain disclosure of all material information and yet cover a security that is practically worthless. The Commission has no power to prohibit or prevent the sale of purely speculative securities. Under the Act, speculative and apparently unsound issues may be registered and sold provided that the issuer discloses the whole truth concerning them; and their unsound or hazardous nature is fully revealed. So long as the offering is accompanied by full publicity and information, it may be registered and sold to the buying public.

As the Commission stated in an opinion last fall, "[we are] without authority to pass upon the merits of a security, but [we do] have the duty to require those who propose to offer securities to the public to disclose plainly the facts an investor needs to know to make an informed judgment concerning the nature and quality of securities to be offered. The Commission, therefore, subjects all registration statements to careful and critical analysis as a result of which many clarifying revisions are made and additional facts disclosed. The Act leaves it to the investor, on the basis of the facts disclosed in the registration statement and prospectus, to judge for himself whether he wishes to invest his money in the company whose securities are being offered."

This is but a paraphrase of the principles announced as far back as 1914 by Justice Brandeis when he said "The law should not seek to prevent investors from making bad bargains. But it is now recognized in the simplest merchandising that there should be full disclosure."

The sanctions exercisable by the Commission are, of course, not limited to stop order proceedings. It may invoke civil and criminal sanctions under the Acts against any person who violates their anti-fraud provisions or registration requirements. It may revoke the registration of any broker or dealer who wilfully violates the provisions of either Act or, when the circumstances warrant such action, expel certain brokers

and dealers from membership on any national securities exchange or a registered national securities association. Of course, these sanctions, effective as they may be, as a prophylaxis or penalty for unlawful conduct, do not operate to put money back in the pockets of defrauded stockholders.

As you probably know, the Securities Exchange Act of 1934 complements the disclosure requirements of the Securities Act by providing for the filing of registration statements and annual and other periodic reports with the Commission by companies whose securities are listed and registered upon securities exchanges. It also provides for the filing of annual reports by certain unlisted companies who have registered securities under the Securities Act. These requirements, plus the pressure brought to bear by the New York Stock Exchange requiring adequate annual reports to stockholders, was a long step forward in investor protection.

Declining to accept the hypothesis that it was impossible to make corporate democracy work, the Congress gave the Commission supervisory powers under this Act over the election machinery of an important group of corporations for the declared purpose of ensuring "fair corporate suffrage". In the exercise of this responsibility the Commission has promulgated and administers proxy rules which are designed to enforce minimum standards of fair disclosure in the solicitation of proxies and to afford persons other than the management a chance to get their views before the electorate. If you own voting stock of a listed company you must be furnished a full proxy statement in the event your proxy, consent or authorization is solicited. In this statement you will find a full description of the matters upon which your vote will be cast and much other information necessary to enable you to make up your mind intelligently as to how to vote. The purpose of the proxy provisions is to facilitate an intelligent participation by stockholders, the proprietors of the business, in the affairs of their companies. It is up to you to use this information afforded to you.

In addition, the proxy rules provide for the democratic interchange of ideas among stockholders in connection with such solicitations. Under our rules a qualified security holder has the right to have the management tell him how many security holders there are of any class which the management is soliciting and have the management estimate the cost of mailing proxies to such holders. Further, management must on request mail out proxies or other communications provided by any security holder who provides the material, envelopes, postage and costs. On reasonable notice, the management must send out on behalf of a stockholder any proposal which is a proper subject for action at the stockholders' meeting. And if the management opposes the proposal it must, on request, incorporate in its soliciting material a statement of 100 words or less by the stockholder in support of his proposal and state his name and address.

While the proxy rules are far from perfect, they provide the basic machinery for putting corporate democracy into action. If the machinery of the corporate franchise is not used, it is due largely to the lethargy of stockholders.

This Act contains additional provisions designed to prevent unfair, manipulative and fraudulent practices in connection with trading in outstanding securities, and to prevent the excessive use of credit in security trading. In general, it fills many of the loopholes left by the Securities Act and makes it possible for the Commission to control practices which, if left unchecked, could make the securities market a mere toy for the play of certain powerful, unprincipled economic groups. Here again, the purpose and power of the Commission is to require disclosure, to prevent and punish unfair practices and not to approve or bless any type of security or transaction.

One further feature of the Exchange Act might be noted at this point. While the general impact of the two Acts is upon the person who is guilty of unfair practices and fraud in the sale of securities to investors, the Commission realized that the investor is in need of just as much protection in cases where highly skilled promoters and security sharks, who are neither brokers nor dealers, buy securities from him. With this end in mind the Commission, in May 1942, adopted Rule X-10B-5 which specifically prohibits fraud by any person in connection with the <u>purchase</u> or sale of securities. Under its terms no person may purchase securities from a security holder without first disclosing to the holder all material facts which may have a bearing on the investment value of the security.

A great deal of securities buying is done over the counter. That phrase designates the securities trading which is not done through the medium of national securities exchanges. Many securities are listed and traded on such exchanges as the New York Stock Exchange, the Philadelphia Stock Exchange, and so on. Many are not traded on these exchanges but are traded among dealers and investors in the over-the-counter market. There is a surprising amount of ignorance about over-the-counter methods and practices and one of the excellent things which an investors' organization can do is to familiarize investors with those practices.

Over-the-counter securities professionals act either as brokers or as dealers. If a firm acts as a broker it will buy securities <u>for you</u>, as your agent, and charge you a commission. Under general law a broker cannot sell you his own securities but must buy them for you from an independent third person. Furthermore, a broker must limit his compensation in his dealings with you to a commission. A broker is obligated under the S.E.C. rules to tell you how much commission or other remuneration is being received by him in connection with the transaction.

The same firm may act as a dealer. When it acts as a dealer it is selling securities to you, or buying them from you, and it does not necessarily deal with any third person. As a dealer, selling securities to you, a firm expects to make a profit and if it charges a price reasonably related to the market price it is not required to tell you how much profit it is making.

Whether a firm is at liberty to act as a broker or dealer depends on you. If you order a firm to buy securities for you, as your agent, it is not entitled to sell you its own securities. It is fundamentally necessary for you to know the difference between a broker and a dealer and to give your orders in such a way as to make it clear in what capacity you want the over-the-counter firm to act.

Brokers and dealers are required to send you confirmations of your transactions. The confirmation must state whether the firm is acting as a broker or as a dealer. If you are cautious in giving your orders and read your confirmations to see whether the firm has acted pursuant to your order you will be better able to protect yourself.

The foregoing represents a summation of some of the more important aspects of the Securities Act and the Exchange Act as they bear upon the Commission's powers and obligations toward the protection of members of the investing public.

Let us now see what role the investor must play to make these Acts effective. What are his rights and obligations?

He should first inquire whether the security offered to him is registered with the Commission or exempt from registration. In the event that a non-exempt security is sold to him before the effective date of a registration statement, while a stop order is in effect or, in general, without registration, the purchaser may sue the seller and recover the money paid for the security, or damages, if he has resold it.

If a purchaser buys a registered security and the registration statement when it became effective contained materially false or misleading information, he may sue the issuer, its officers, directors, the experts who prepared any part of the statement, and the underwriters and recover damages.

If a purchaser buys either an exempt or registered security sold to him by means of a prospectus or oral communication which contains materially false or misleading information, he may sue the seller and recover the amount he paid for the security or damages if he no longer owns it.

On the other hand, if a stockholder should be induced to sell his securities by reason of a purchaser's misrepresentation or non-disclosure of material facts, it has been held that Rule X-10B-5 provides a basis for private action by the seller against the buyer.

When we add up the disclosure requirements of the statutes, the enforcement powers and activities of the Commission, not to mention those of the various State regulatory bodies, the better business bureaus, the National Association of Securities Dealers, and particularly the recent advertising campaign of the New York Stock Exchange, together with the

stockholders' private rights of recovery, it would appear that the fraud field is very adequately covered and there should be no room in it for the crooked security salesman or promoter. Notwithstanding all this, securities frauds and uninformed investments still continue and investors constantly complain. Why? Where does the fault lie? If you should ask me, I'd say, not with the statutes, nor the enforcement agencies, nor with the various groups of businessmen who have been trying to educate investors during the past years. It is my personal opinion that the fault lies on the investor's own shoulders: those who listen to the blandishments of the swindler and turn a deaf ear to the advice and warnings of the Commission, the exchanges, the better business bureaus, and the State regulatory agencies; those who buy on the tip, the hunch, and the half page of written information and, in fact, even refuse to obtain and read the prospectus; those who for years work and sweat to save a few dollars and are too lazy to spend a few hours to read and attempt to understand twenty pages of information about the business into which their savings are to go. They want to put their money to work but will expend no reasonable effort to inquire into its source of employment.

These are the persons who negative our work and make the swindlers' task a happy one. These persons are the delight of the high-pressure salesmen. These are the victims of the fly-by-night security schemes. We cannot, no matter what our efforts, protect them from loss. The best we can do in nearly all such cases is apprehend the crook after the job has been done and the proceeds of the fraud have been dissipated.

We have all heard the old refrain that security purchasers don't and won't read a prospectus before they commit themselves to buy securities and that they will not investigate before they invest. If these purchasers are acting purely as gamblers in every case their action might be understandable. They then know they're buying a long shot on meager information and are interested chiefly in a quick run for their money, with the chance of severe loss or great gain.

On the other hand, the purchaser who buys with the intention of preserving his capital, with the idea of putting his money to work for him for a return over an extended period of time, is in an entirely separate category. He is the one who must work at and sweat out his investment program. He is the one who must sit down and read and try to understand the information carefully compiled in the prospectus for his benefit. When he fails to do so, all the labor of drafting, passing and administering a law requiring disclosure for his benefit goes to waste. If there is any one, single, important message for such investors it is this: take advantage of all possible avenues of information before you buy. That is not always easy advice to follow, as I fully realize. At times the prospectus may be difficult for the particular investor to read, and even to obtain. But to the extent that you can inform yourself from a prospectus, by all means do so before you buy. Read it with all the intelligence you can command and don't hesitate to ask the dealer who has offered you the security to explain any complex items which you cannot understand.

While the dealer or salesman is ordinarily honest enough to give you decent answers to your questions, it often may happen that you won't know what questions to ask. Your best recourse in such cases is to read the prospectus completely. It will tell you more about the history and condition of the business than the salesman can usually divulge. And it will at least serve the function of directing you toward intelligent inquiry.

Don't be deluded by anyone into believing that you don't have to read the prospectus, or that the salesman's oral or written summaries provide sufficient data for your investment purposes. The Congress after extensive study found otherwise. And the Commission after years of experience with the disclosure requirements thinks otherwise. It has streamlined these requirements down to what it believes are bare essentials and does not require the prospectus to contain any information not material to investors. And, I might add, most registrants have been making a sincere effort to present this information in a concise and readable form.

Surely, it is not too much to ask an investor that he assume the obligation of sitting down and reading some ten to twenty pages of information before he is finally committed to buy. If he wants to put his hard earned savings to work for him with the expectation of return and if he desires any sense of security about his investments at all, he must work at it. No man would buy a home without thorough consideration and examination of its qualities and cost. Why should he be less careful when buying an interest in a business?

However, as one of our courts has noted: "Many persons in this world of ours desire to make money without effort. Men and women in all professions, busy men and women with good incomes, have an innate desire to increase their income or their principal. They do this by so-called investments. They venture into realms of which they know nothing." So long as such venturing continues, so long as men and women will invest in wilful ignorance, just so long will there be shrewd promoters, dealers and salesmen who will take advantage of the venturesome with ugly pipe dreams of fortune. It approached futility for the Commission to bring the falsehood and pitfalls out into the glaring light of publicity if investors are going to buy blindfold.

In my mind, if investors would in every case where a new security is offered to them insist upon a prospectus; if they would take that prospectus and sit down and read it; if they would make sure that they understand all they read before they buy; and finally, if they would work at and sweat out their investment programs, I am quite convinced that the fraudulent and unsound promotions would be reduced to practically nothing. So long as that will not be done, our job at the Commission is not only increased 100 fold, but our efforts in obtaining disclosure of information from sellers are to some extent reduced to an empty gesture.

I might add that there are many important elements in the securities industry just as interested in enforcement of the Securities Act and the Exchange Act as the Commission. And they are just as interested in seeing to it that you know what you are buying when you buy. To my knowledge, they are not interested in turning the clock back to the roaring 20's and griping 30's. They know as we do that a satisfied informed investor is a good customer.

These elements in the industry know too, as well as we, that the bad apples must be removed from their barrel. And they appreciate as much as the Commission and all other regulatory bodies that these bad apples will stay in the barrel just so long as the investing public will tolerate them. So let the investor assume his full responsibility. All we ask is that he do what he should do.

We want the stockholders' cooperation not only for his own protection but in order to make our work achieve its desired purpose--full disclosure to those who need it. We want your assistance as well in the amendment program which the Commission revived some months ago, so that we may recommend to the Congress workable and desirable revisions in the Federal security laws. In this program, as you know, we have talked to representatives in the securities market-- investors, issuers, investment bankers, dealers, State securities commissioners, and the stock exchanges. We should like, so far as possible, to get widespread distribution of prospectuses to the investing public, to encourage their use by investors, and to provide some effective period of time during which an investor will have a prospectus and the opportunity to examine it before being called upon for final purchase.

Whether we can achieve these goals, or in what form it can be done, no one can say at present. But I want to assure you that what motivates the Commission exclusively in this program is to find some practical, workable means of improving the investor's position.

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