

WHAT EVERY INVESTOR SHOULD KNOW

Address by

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It is a great pleasure for me to address the Phi Beta Kappa Association of the District of Columbia tonight on the topic "What Every Investor Should Know." Certainly this is a most formidable topic, but unfortunately I must tell you at the outset that I am not in a position to give any of you hot tips, or to suggest to you securities in which you can invest which, in all events, are bound to appreciate in market values and never be subjected to decreases. Such is the nature of the function of the capital markets that normal economic concepts of supply and demand do play, and will probably always play, an important part in determining what securities are bought and sold for, whether on the listed stock exchanges or on the over-the-counter market.

What I propose to do is to tell you something of the functions of the Securities and Exchange Commission and the statutes which we administer or enforce, and by reference to both topics to give to you a few basic thoughts which should always be borne in mind when consideration is given to making investments.

In the first place, let us look at the various statutes which we enforce, and let's try to see the basic purposes which the SEC seeks to accomplish.

Going back to the period prior to the crash on Black Thursday in October 1929, let me, by way of illustration, point out that the value of all stocks listed on the New York Stock Exchange, which is far and away the largest stock exchange in the country or in the world, stood at a total value of \$89 billion. By the middle of 1932, this value had fallen to a total aggregate value of \$15 billion, or a total loss of

\$74 billion in some two and a half years following the crash. It seems to us, who sit in the regulatory area, that this loss symbolized the lack of confidence which American public investors had in the functions of the capital markets. There were few people in the period from 1932 until at least 1940 who felt that corporate securities, whether of the debt or security type, were proper mediums of investment. Generally speaking, American public investors took or kept their money out of the capital markets, investing it either in savings banks or even sewing it up in the proverbial mattress, but the supply of capital to corporate organizations just simply dried up.

Into this demoralized picture came the Securities Act of 1933, which was the first attempt by the Congress of the United States to attempt any form of regulation in the securities field. This Securities Act of 1933, which has often been termed the "truth in securities" law, has as its basic purpose the requirement that American corporations seeking to raise capital from public investors must disclose, in a registration statement or prospectus, which are filed as public documents with this administrative agency, the basic facts and figures, financial and otherwise, of the corporation seeking to raise such capital.

The Congress did not give to this Federal agency any power or right to pass upon the merits of the securities involved, but left to public investors the opportunity and duty to determine for themselves, predicated upon the disclosures made in the registration statement, whether the particular security meets the investment needs of the investor. In my view, this was a healthy result because to give to the Government

regulator the power of determining whether any particular company can seek risk capital from public investors would tend to stifle the whole function of the free enterprise system.

The Securities Act of 1933 requires a company seeking to raise capital to file with the SEC a registration statement which includes a prospectus. Immediately upon filing, this document becomes a public record available to anyone who desires to see it. In this registration statement or prospectus are included various facts concerning the corporation, its aims and purposes, and the use to which it intends to put the proceeds raised by its public offering. In addition, the registration statement includes certified financial statements showing the corporation's capital position, its earnings picture, if there is one, and its general financial story. Before any distribution of securities can be undertaken, this registration statement must be on file for twenty days, during which time investment bankers, statistical houses, such as Standard & Poor's, members of the financial press, and anyone else can make comprehensive studies with respect to the corporation or its aims and purposes. You, as an investor in either a new company or a company which is seeking to sell its securities to the public, can obtain a prospectus and can analyze and study it in the light of your own experience.

This evening, I have brought with me a company's prospectus, which was filed with our agency in 1957. I think, as much as any other registration statement, it illustrates the type of problem which our agency faces and the method we employ to resolve difficulties in protecting the public interest and public investors. This prospectus was first filed on

September 16 of that year, and the corporation's name at that time was the All-State Commercial Corporation. The staff of the Commission which first received this prospectus was troubled by the use of the name "All-State" because of the possibility that this company was a subsidiary of Sears, Roebuck and Co. Discussions with the company established that the company had employed this name only because they hoped to sell in all the States. This did not seem to be a satisfactory answer, and the company finally was persuaded to change its name to the Superior Commercial Corporation. This company proposed engaging in the business of buying and holding second mortgages. I think most, if not all of you, are familiar with the vulnerability to adverse economic conditions to which second mortgage notes are subjected. While business conditions are in an inclining stage, the chances are good that the first mortgage will either be paid off through amortization or sinking fund provisions, but where a business decline sets in, there is an equally good chance that foreclosure of the first mortgage may result, in which case the second mortgage notes are left holding the bag. The staff felt that the disclosure of this basic concept was not sufficiently clear. I would like to read to you a few of the provisions which the staff required to be disclosed in this prospectus.

Before doing so, let me point out to you the type of information which is required in a prospectus. First of all, there must be shown on the facing page the name of the company, the type and amount of security to be sold, the public offering price, the underwriting discount, and the net proceeds which are to be realized by the company from the sale of the

securities. If the offering includes a sale by insider stockholders, commonly known as a "bail-out", the amount to be realized by the selling stockholders must also be shown. Right at the outset of the prospectus there is a table of contents in which the nature of the offering is described in detail, then the corporation's organization, its stock ownership and its basic business aims. We also require that a description of the market place in which the corporation intends to engage in business be clearly outlined, as well as the competition which the company will be facing. Following these disclosures, we insist that the use of the proceeds of the offering must be clearly set forth. Then we require a description of the management, who they are, what their backgrounds are, and what compensation they have been or are to be paid. The record ownership of the principal stockholders and the percentage of the class of stock held by each is then set forth. If the corporation is transacting any business with any of its management, these transactions must be set forth. The capitalization of the company, a description of its stock, whether it is common stock, debentures, first mortgage bonds, or whether there are any purchase warrants, must also be clearly set forth. We then require a description of the terms of the offering in detail, whether the underwriters are being paid any of their commissions in stock or options, and whether there are any conflicting interests between, for instance, the corporate management and the underwriters. There must be included an opinion of counsel as to the legality of the security being offered, and a disclosure of the fact that the registration statement contains financial statements which have been certified by an independent certified public

accountant. Finally, the prospectus includes a balance sheet and a statement of receipts and disbursements.

Now, let me show you the types of disclosures which were required in this particular prospectus because I think it will help you to see the necessity for your examining a prospectus before you purchase securities. On page 3 of the prospectus, there was a statement to the effect that the control of the three principal offices could be maintained indefinitely through their right to elect a majority of the directors. Under Business the corporation stated that it intended to engage in buying and holding second mortgages, that it had not yet commenced its operations, and that it had no office but only a mailing address. I now quote, "Even after operations are commenced, they will be carried out wherever the officers find it convenient until the maintenance of an office becomes necessary." This is very much like the "office in the hat" routine, isn't it? I read on to page 4. The purchase of second mortgage notes is a speculative business. Such notes are secured only by a lien which is subordinate to a first lien on real property. The prospects of return are considerable, but the risks are commensurably great. Certainly this would minimally constitute a fairly good caveat to an investor who would think he was purchasing a "blue chip."

With regard to management, there was a disclosure that the two principal officers had had no previous experience in the second mortgage business. Looking for a moment at the balance sheet, we discover that the cash in the Irving Trust Company totals \$764.20. The organizational expenses amounted to \$4,068.80, but these included legal fees of \$2,500,

printing charges of \$750, and corporation expenses of \$702.30, none of which are assets to which you, as an investor, could look if the company runs into financial difficulties. I think that you can see from a reading of this corporation's prospectus that there are many areas in which an investment would seem to be somewhat risky.

While this particular prospectus illustrates the importance from the investment standpoint of investors seeking out and studying the prospectus of the company in which they are considering putting their own funds, nevertheless I would like to assure you that it is not untypical of many of the companies which are today seeking to raise capital through the registration process with our agency.

In these times of dynamic corporate activities, there is a tremendous demand for capital and corporations generally are coming before our agency in increasing numbers to comply with the registration requirements in order to raise fantastic amounts of money to build the plants, to produce the goods, to satisfy the demand for capital goods. In 1953, the total dollar volume of securities registered by the Commission stood at \$7.5 billion. By December 31, 1958, it stood at \$17.3 billion. Today, corporations are raising capital to the extent of about \$18 billion on an annual basis, and we expect that by the end of 1960 the rate will have risen to about \$22 billion. Perhaps the best way to illustrate how large such amounts of money are is to point out that in 1956 West Germany, which raised more money than any other European capital country, sold securities of a dollar value of approximately \$620 million. Great Britain, which was the second largest capital country, raised about \$430 million.

Parenthetically, I might say the Ford issue was about \$450 million, and the AT&T public offering, which became effective on January 17, 1958, raised about \$1.2 billion. In other words, two of our very large American corporations raised almost as much or more money in one issue than did Germany or Great Britain in an entire year.

I have just talked about one statute which we of the SEC administer. I would also like to tell you briefly about the other statutes which we administer. The Securities Exchange Act of 1934 was the second statute passed by the Congress to regulate the securities markets. In contrast to the 1933 Act, which sought to administer public sales or distributions of securities, the Securities Exchange Act of 1934 regulates trading activities of registered or some unlisted companies and activities of brokers and dealers selling securities in interstate commerce. In addition, it requires listed companies and their managements to file annual, semi-annual and periodic financial reports as to their various activities, including their stock ownership. Also, the 1934 Act regulates the solicitation of proxies by listed companies.

The third statute administered by us is the Public Utility Holding Company Act of 1935, which has as its basic purpose the breaking up of the large, completely non-integrated public utility holding companies which, because of their size and their disproportionate division of voting power, had become economic menaces. Some of these systems had as many as 2,000 companies located in various States and had become so completely disassociated from the electric and gas business as to include, in one instance, the New Orleans baseball team. I think you can visualize the great

difficulty of local public service commissions in determining proper rates when such commissions were forced to take into consideration the existence of heavy debt structures with fixed interest charges which were put into the capitalization of the local operating companies by boards of directors sitting in plush offices on Wall Street or well-appointed establishments on LaSalle Street. Rates which consumers paid had to take into consideration these debt obligations resulting in higher costs for electricity in complete derogation of the public interest. The 1935 Act had as its basic design the breaking up of these non-integrated companies and the continuing regulation of the corporate transactions in the public utility holding company field.

The fourth statute was the Trust Indenture Act of 1939 which, as the name implies, sought to regulate indentures pursuant to which debt securities were issued, and to require that the trustees were completely independent of management and were looking out for the best interests of the bond holders.

The last two statutes are the Investment Company Act of 1940, which has to do with the regulation of investment companies, commonly known as mutual funds, and the Investment Advisers Act which, as the name implies, attempts to administer the conduct of persons who sell their investment advice to the public in interstate commerce.

In addition to these statutes, Chapter X of the Bankruptcy Act has imposed upon our Commission the duty of making recommendations in the corporate reorganization field where companies, through either bad management or bad corporate performance, have gotten themselves into economic

difficulties. We are required if a company has over \$3 million of assets to assist the district court in effecting a reorganization plan which is feasible and which is fair and equitable to the security holders.

Now, may I get back to my proposal to tell you about the functions of the SEC and the statutes it administers by way of giving you a few basic thoughts which you should bear in mind if you make investments. The Commission, for some little time now, has been engaging in a broad program of trying to warn the public of the dangers of blind or unknowing investing. The Commission, in cooperation with the then New York Attorney General and now United States Senator, Jacob K. Javits of New York, adopted a 10-point guide urging the public to be cautious in purchasing securities as a result of long distance telephone solicitations by persons unknown to them, and suggesting that public investors consider these ten points as a guide before purchasing securities:

1. Think before buying.
2. Deal only with a securities firm which you know.
3. Be skeptical of securities offered on the telephone from any firm or salesman you do not know.
4. Guard against all high-pressure sales.
5. Beware of promises of quick spectacular price rises.
6. Be sure you understand the risk of loss as well as prospect of gain.
7. Get the facts -- do not buy on tips or rumors.
8. Request the person offering securities over the phone to mail you written information about the corporation, its operations, net profit, management, financial position and future prospects. Save all such information for future reference.

9. If you do not understand the written information, consult a person who does.

10. Give at least as much thought when purchasing securities as you would when acquiring any valuable property.

These, in essence, are nothing more than common sense ideas to be employed by any potential investor.

May I say to you that it is a great pleasure for me to have had this opportunity to talk to you, and if any of you have any questions, I will be most pleased to answer them.