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ADDRESS

of

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CURRENT ASPECTS OF FEDERAL REGULATION OF THE SECURITIES MARKETS

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When you were gracious enough to invite me to address your Convention, I was genuinely happy to accept. Naturally, the fact that the Convention was to be held in Los Angeles, that magic oasis of the Western World, was not exactly a deterrent. But I was particularly gratified at the opportunity to discuss with you some of the questions which are currently of concern to the securities business.

At the outset let me state my credo with respect to the legislation embodied in the Securities Act of 1933 and the Securities Exchange Act of 1934. I am among those who believe that this legislation is not an accident or a flash in the pan or the spasmodic outburst of an enraged people. I believe that it was demanded with a cold and irresistible logic by the events leading up to and following the economic convulsion of 1929; that it is as significant as any piece of social legislation thus far evolved by a capitalistic society; and that it is here to stay.

Two years have elapsed since the Securities Exchange Act became law. Those years have been packed with incident, experience and organic change. New concepts and conventions have been introduced into the securities business. The process of adjustment to those innovations has been gradual but continuous. Occasional backfires have been heard on the way but the machine which the American people created in the summer of 1934 has moved steadily along.

In what direction has it moved? What progress has it made toward the goal of protecting the investor? These questions ought to be answered frequently, honestly, without heat and without dogma. The answers are of

paramount importance - to you in the securities business, to us in the business of government and to that great, amorphous, myriad-minded entity that we designate "the public".

Thus far, we have been strong in the conviction that we are moving in the right direction. Neither have we doubted that the goal is worth achieving. But it is not sufficient that we alone should think so; it is a matter of deep concern to us that you should think so as well. For if you do not believe with us that the thing we are doing is a vital thing, then we are like men shouting at each other across a chasm between whom there is no middle ground. But if you agree that the task is worth doing, the differences which may arise between us as to the method of its accomplishment can readily be composed.

So I would like to discuss with you some of the recent steps taken by the Commission in connection with the regulation of the securities markets. An analysis of those steps and of the conditions which called them forth may serve to answer the questions I have suggested.

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One of the current aspects of federal regulation is the amendment to Section 15 of the Securities Exchange Act of 1934. In its original form, Section 15 merely empowered the Commission to prescribe rules which would insure to investors in the over-the-counter markets protection comparable to that provided by the Act in the case of organized exchanges. The Commission, by a process of testing and refinement, evolved a method of registering brokers and dealers transacting business in the over-the-counter markets and demonstrated the practicability of such a program. The amendment, which was signed by the President on May 27, 1936, translates into statutory law the salient features of that program.

As amended, the Act provides that no broker or dealer shall use the mails or the channels of interstate commerce to effect or induce any transaction over the counter unless he is registered with the Commission. Formerly, a broker or dealer was required to register if he made or used a market, otherwise than on a national securities exchange, for both the purchase and sale of any security. As the law now stands, any broker or dealer must register if he engages solely in selling or solely in buying securities or if he induces the purchase or the sale of a security, through the mails or in interstate commerce. An exemption is provided for those whose business is exclusively intrastate or who deal only in exempted securities.

The Commission is now required by the statute to deny or revoke the registration of any broker or dealer if the public interest so demands and the registrant or a key person in his organization has wilfully made a false statement in connection with his registration; or has been convicted within ten years of a crime connected with a securities transaction or the securities business; or is enjoined from any conduct connected with the purchase or sale of any security; or has wilfully violated the Securities Act of 1933 or the Securities Exchange Act of 1934 or a rule or regulation thereunder.

These, in brief, are the codified standards for identifying those who are required to register and those who are to be excluded from registration. As of May 27, 1936, when the amendatory act was approved, the Commission had permitted the registration statements of 5785 brokers and dealers to become effective and these were blanketed in under the amendment without further formality. Since then about 300 additional applications have been received and it is estimated that 2,000 new registrations will result from the change in the standard of inclusion.

How does this far-flung registration program fit into the pattern of the legislative scheme to protect the investor?

The program constitutes the first attempt on a national scale to identify the persons transacting business in the over-the-counter markets and to procure certain basic information concerning their business. But it is something more than a mere research expedition. It is the continuation of the long-range campaign begun in the Securities Act of 1933 to exterminate the swarm of racketeers who have descended upon the Securities business like locusts and are fattening upon the savings of the American people. It is a major offensive against manipulative and deceptive devices wherever they are found.

From where I sit, the people in the securities business appear to fall into three concentric circles. In the outermost circle are the outlaws--the bucket shop operators, the sell-and-switch peddlers, the boiler room technicians, the purveyors of fake securities, the swindlers, the unregenerate ex-convicts, and all the other light-fingered gentry whose aim is not profit but plunder. In the middle circle are those brokers and dealers who steer clear of outright fraud or daylight robbery but are not above attempting to circumvent a provision of the law or taking unfair advantage of customers and competitors. In the innermost circle is that body of honorable men who regard themselves as engaged in a great and progressive profession, who have a deep and abiding recognition of their grave responsibilities to their clients and the public and who will receive the protection, encouragement and support to which they are entitled.

The success of the persons who fall into what I have called the outermost circle depends upon the guilelessness of the public. A fertile field for their depredations is that group of people who have just arrived at

the point where they find themselves with funds to invest. Some of these victims are afflicted with the itch to get rich quick. But many are simply unversed in the distinction between a sound investment and a wild promotion scheme. They have still to learn that the more sensational and extravagant the promises accompanying a solicitation to invest, the less substance those promises are likely to have. Millions have been betrayed by the siren song of easy money. Funds that should flow to legitimate enterprise are thus lost to fraudulent promotions. Do you doubt that the investor needs protection? Let me open the Commission's files to you and show you a few recent schemes for which the investor, whose name is legion, has fallen. Some of these cases were within the Commission's jurisdiction and others were not; but we endeavor to keep a record of all of them on the theory that a man is known by the companies he promotes.

In Florida a corporation was formed with no assets except a lease on 500 acres of oyster bottoms in Apalachicola Bay. A generous appraisal of the value of the lease was $250. The promoters offered securities to the public first at $30 per unit, then at $80 per unit and later at $120 per unit. These securities gave investors the right to participate in the profits to be derived from the cultivation and marketing of oysters from oyster beds located in Apalachicola Bay. Five offices for the sale of securities were maintained in Miami and other important cities in Florida. Three seafood restaurants were also operated in Miami to stimulate the public's appetite for securities. Open-air, talking pictures were shown daily during the winter tourist season. Hundreds of agents were employed to sell the units. Over a period of four years ending in 1935 more than $1,300,000 worth of these securities were sold.

If you bought a unit, the company agreed to plant a specified quantity of seed oysters on your behalf on oyster bottoms which were to be cultivated

and harvested by the company. You thus became foster-father to a bed of oysters. The crops were to be pooled and a dividend of 50¢ per barrel paid to each unit holder for each barrel sold. The only dividend ever paid was one of $2000 in 1934 which was distributed among 14,000 unit holders. Even this dividend was not paid out of earnings. It was based upon the sale by the corporation of 20,000 gallons of oysters. Not an oyster among those sold was raised on the so-called cultivated oyster bottoms--they were all bought from oyster fishermen and public bars. In selling them the company took a loss of $12,000 so that the term dividend was something of a misnomer. The promoters never harvested a single cultivated oyster in four years.

The representations to the public regarding the rate of increase in the oyster population would have surprised no one more than the oysters themselves. The fact that the life cycle of the oyster from the cradle to the market occupies a period of three years was not revealed; and from the advertisements published by the company you would easily have inferred that the Apalachicola oyster is immortal or at least immune from the ravaging effects of low tides, heavy gales and high freshets and from the depredations of mussels, drum fish, leeches, algae, clams and all the other aggressive marine fauna which, like these corporate promoters, regard the world as their oyster.

As an added inducement to purchase units and more units the unit holders and the public were informed that the corporation had purchased an island in Apalachicola Bay, free and clear of all liens and encumbrances. Later it was discovered that the island was subject to an over-due mortgage large enough to extend into the surrounding waters.

Through the efforts of the Commission the operations of this outfit were enjoined for violations of the Securities Act of 1933.

In Chicago a few months ago, eight men were convicted for using the mails to defraud some 70,000 persons through a scheme that has been practiced with success for over 200 years. It is the venerable old Sir Francis Drake swindle. The legend is that the famous Elizabethan buccaneer, who died in 1596, left an estate amounting to the tidy little sum of 20 billion pounds which was plundered from Spanish treasure ships and is now lying about somewhere waiting for his rightful heirs to collect. The chief defendant in the Chicago case claimed to have dug up a direct descendant and heir of Sir Francis Drake who had assigned to him all rights to the estate. He promised a return of $5000 for every dollar invested, although occasionally, in an excess of caution, he modestly stated that the return would be "so much that you cannot believe it". He represented that the governments of Great Britain and the United States were busily engaged in arranging for the delivery of the estate to him. Again and again the existence of any such estate has been proven a preposterous fable. Yet 70,000 persons paid over $1,300,000 for share in it - not 200 or even 20 years ago but recently.

Are you curious as to what really caused the depression? Let me read an excerpt from a letter sent by one of the "heirs" of the Drake Estate to an investor on December 19, 1934, which explains the whole thing for you. "* * * this assignment was approved by the highest court in England on February 4, 1926 and since then this deal has been just as sure as the sun coming up. Since then it has been a process of collection from 60 nations of the earth which tied up 85% of the world's gold. This is what caused the depression and nothing else and said depression will not get better until this deal is finished and this gold released, no matter what they may try and what you see in the papers to the contrary."

When the trial was held in Chicago, the main defendant was already a denizen of Leavenworth Penitentiary, having been convicted for perpetrating the same swindle in Iowa. This, however, did not discourage his ingenious salesmen. Their victims were informed that the government had taken over their leader's business and was conducting it for him. In fact, it was widely advertised that "the settlement of the estate would have been made sooner if Hoover had been re-elected because new government leaders under President Roosevelt were unfamiliar with the work and had to be informed".

In Michigan less than three months ago two men were convicted of violating the blue sky laws in connection with a nation-wide estate scheme called the "Heirs to the Patentees of the Town of New Harlem, Inc." The promoters offered investors an opportunity to acquire an interest in 2,500 acres of upper Manhattan Island valued at $2,000,000,000 including such odds and ends as public parks, produce markets and suspension bridges. The title of the estate depended on the premise that the rich acreage had been granted to early settlers back in 1666 and that millions of dollars had been placed in escrow in New York banks to be paid to the settlers' blood heirs as soon as the courts authorized payment. Duped by that tale, thousands of investors built "heir" castles at a cost of $30 per share and a monthly assessment of 75¢. Over 700 persons in Detroit alone were victims of this grotesque scheme.

Only a few weeks ago, in Georgia, the Commission procured the indictment of 24 persons as members of a nation-wide stock swindle which netted profits in excess of $10,000,000 during the past three years.

No promotion is too fanciful, too vaporous, too fatuous to have its full measure of devoted followers. The Commission, is of course, without power to prohibit uninformed individuals from buying stocks. It can, however, ceaselessly pursue the perpetrators of fraud. It can also stop the

sale through the use of the mails or the instrumentalities of interstate commerce of securities in respect to which honest disclosure is not made. It may interest you to hear a description of one or two of the proposed offerings in which the public missed the opportunity to invest.

The Commission stopped the sale of securities by a corporation which proposed to sell to the public 6,500,000 additional shares of stock, 1 mill par value, at a price of 15¢ per share. The corporation was formed several years ago to develop and manufacture an aeroplane in accordance with a design and principle invented by its president and also to develop and manufacture a three-wheeled stream-lined automobile with automatic gear shift to be known as the "aeromobile". About the time the company was organized the inventor-president met a grocery-man and they joined hands in supervising the activities of about 50 stock salesmen. As funds were received by the corporation they were not deposited in a bank but were divided equally between the inventor and the grocery-man, each of whom paid one-half the expenses in cash. This convenient procedure was adopted, according to its beneficiaries, to prevent the corporation's money from becoming tied up in legal proceedings and to give them "the first shot at it, as the fellow says". When the registration statement was filed, the company after four years had completed one aeroplane and one aeromobile body and chassis without an engine. Nothing manufactured by the company had been sold except some polish and a lot of stock. Two attempts to fly its aeroplane had been made. On the first attempt the housing of one of the rotary wings broke; on the second the plane was brought safely to the ground from a stratospheric height of eight feet after a record flight of nearly fifty yards.

The Commission stopped the sale by a mining company of 100,000 shares of its preference stock at $1.50 per share. Over 225,000 shares had been previously sold in Canada at prices ranging from 10¢ to 50¢ a share. The

registration statement and the prospectus contained metallurgical reports prepared by an ex-fruit grower who had taken up the vocation of detecting gold veins. He had no training or education as a geologist or metallurgist, yet his report on the company's property was described as that of a "scientist and geologist, with a worldwide reputation as inventor of the mineral indicator". The so-called mineral indicator consisted of a leather-covered cylinder hanging at the end of a leather thong. The inventor refused to disclose the contents of the cylinder--undoubtedly an incalculable loss to metallurgical science. He claimed that if held in certain positions it would indicate the various dimensions and value of ore body by certain vibratory or oscillatory motions. The acrobatics involved in this delicate operation would take too long to describe.

The instrument falls within the class of devices known as "doodlebugs" and has been consistently repudiated by metallurgical engineers and geophysicists. Nevertheless, the inventor was permitted by the Commission to give a practical demonstration of what his instrument was capable of doing. Five cardboard boxes were placed on a table one of which, number 5, contained a piece of rich gold ore. The others contained assorted vegetables. He tested each box with his mineral indicator and finally reported that there was gold in number 3, but not in number 5. My recollection is that number 3 contained a ripe tomato.

Cases like these arise in all corners of the nation. We are exerting every effort to keep abreast of them and many of the state commissions and better business bureaus are contributing their full share of the work. But in the final analysis it is essential to cultivate in the American people a new attitude--an attitude that will manifest itself in a healthy skepticism toward promotional schemes; in a realization that a piece of paper with a corporate seal affixed is not, like Aladdin's lamp, endowed

with magic qualities; and in a universal demand for cold, hard facts, as distinguished from promises and assertions, before investments are made. An encouraging sign that such an attitude is beginning to harden is the constantly growing number of persons who are resorting to the Commission's files in Washington and in its regional offices for information. The number of visitors to our public reference rooms has increased from a mere handful in January, 1935 to thousands each month. Many are persons in the securities business who in turn transmit to countless others the facts gleaned from their examination of the files. As this spirit of skepticism and this insistence upon facts continue to develop, it will become less and less profitable for the operators in the outer circle to carry on what we euphemistically call "their business".

Let us turn now to that group of brokers and dealers who fall within the middle circle--those who will evade a provision of the law or take unfair advantage of a customer or a competitor to increase their profits. Some of these are chagrined at the passing of the gilded age of cutthroat competition; some are scornful of the principle that the public interest is paramount; some disagree with the provisions of the law and see no reason to comply with them; and some simply take a chance that the Commission is too remote or too busy to know what they are doing. The mistaken notion prevalls in some quarters that certain practices are a mystery to the Commission. This fallacious idea is held only where there is complete ignorance of the Commission's work.

One of the practices to which I refer is that of "jumping the gun". A registration statement under the Securities Act of 1933 cannot become effective until 20 days after the filing thereof. The primary purposes of this provision were to afford the Commission an opportunity to examine the statement in order to determine whether it conforms with the statutory

standard; and to guard against the feverish methods of distribution which characterized the capital markets in previous years by creating a cooling period during which the material facts concerning a security can be disseminated. The Commission has no power under the law to abbreviate this period. Before the effective date, it is illegal to sell, offer to sell, or solicit an offer to purchase the security covered by the registration statement. The penalties for a violation are found not only in the Securities Act itself but also in the amendment to Section 15 of the Exchange Act which imposes upon the Commission the duty, when the public interest so requires, to revoke the registration of any broker or dealer found guilty of violating the Securities Act.

Among the other practices which are receiving our attention are the following: The tendency on the part of some brokers and dealers to extort exorbitant profits from their customers; high-pressure merchandising methods; the publication or circulation of bid and asked prices or reports of transactions known to be fictitious; the making of offers to buy or sell at stated prices with no bona fide intent to effect transactions; the failure to make full and unequivocal disclosure to a customer as to the capacity in which a broker-dealer is acting; the subsidizing of corpetitors' employees; and the making of concealed profits by collusion with other brokers and dealers. The practice last described takes some interesting forms. For example:

> A, an employee of a brokerage firm, has an order to buy $10,000 XYZ bonds at the market. A goes to B & Co. who make a market in the bonds and with whom he has a friendly understanding. B & Co. quote the market to A as being 90 bid for ten bonds; ten offered at 91. A says "Okay. You sold me ten at 93." Later he collects $100, his share of the difference.

Or let us suppose that A has an order to buy $250,000 XYZ bonds up to 95. The market is 90 - 90 3/4 on the stock exchange. About 40 bonds trade in an ordinary day and to complete his order he realizes that he will have to pay at least 95. He tells his friends B & Co. to buy 10 of these bonds. B & Co. buy 10 at 91. A immediately stops B & Co. on the last 10 bonds of his order. In the course of a day or two B & Co. sell the bonds at a handsome profit, half of which goes to A.

Practices such as these take their toll from investors. They also take their toll from legitimate brokers who cannot and will not compete for business by resort to such tactics and who, like the reputable members of every other profession, feel themselves besmirched by the activities of its disreputable members. Sooner or later this middle circle must be evacuated.

I feel and I know you feel that there is no room in the securities business except for the people in the innermost circle. Their steadfast adherence to the principle that the interests of the investor are paramount is the foundation upon which public confidence rests. Every votary of that principle added to their ranks strengthens the foundation; every defection weakens it.

When I refer to the people in the inner circle I do not intend to imply that their numbers are relatively small. I want to say as plainly and emphatically as possible that I believe the great majority of persons in the securities business to be men of honor and integrity. If I have discoursed at some length on fraudulent and deceptive practices it was with no thought of condemning the business generally. On the contrary it is precisely because I feel that the business is so essential to our financial economy, that I dwell upon those practices which tend to diminish its value in the public mind.

A short time ago the Commission filed with the Congress its report on the feasibility and advisability of the complete segregation of the functions of dealer and broker. The limitations of time do not permit me to explain the details of the program proposed in that report. Over 10,000 copies have been distributed and persons in the securities business throughout the country will have ample opportunity to familiarize themselves with the contents. It is unfortunate that in some quarters an attempt has been made to create the impression that the report contains a general indictment of all persons in the securities business. Nothing could be further from the truth or from the intention of the authors. The potentialities of abuse inherent in the combination of the functions of broker and dealer are described in detail; the fact that abuses exist is also demonstrated; but the point is clearly made that insofar as reputable brokers and dealers are concerned these abuses are held in check by their standards of business conduct.

I would like to direct the attention of your organization to one suggestion that is made in the report. In the conclusions relating to the over-the-counter markets it is pointed out that continued exploration of the questions affecting these markets is desirable not only by the government but by persons in the securities business and others. Organizations that would consider the problems of the business from an imaginative standpoint and would think ahead as to the directions of possible and desirable development, could perform a true service. To do so they must approach the problems from the broad viewpoint of public interest, and must not, because of possible implications affecting the revenues immediately derivable from their business, resist the logic or the consequences of their own clear thinking.

Your business during the past 20 years has come to assume a truly national character. It is in a very real sense affected with a national public interest. The hope of the Commission and of every honest person in the business is that it may become a subject of national pride.

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