

February 3, 1954

STATEMENT OF THE CHAIRMAN OF THE  
SECURITIES AND EXCHANGE COMMISSION  
IN SUPPORT OF S. 2846

Mr. Chairman and members of the Committee: I am Ralph H. Demmler, Chairman of the Securities and Exchange Commission and appear before you on behalf of the Commission in support of S. 2846.

The purpose of the bill as explained in my letter of January 25 to Chairman Capehart is to effect limited amendments, principally technical, to the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939 and the Investment Company Act of 1940. All members of the Commission concurred in that letter to Chairman Capehart.

The Commission has every desire to see the basic philosophy and purposes of the Acts held intact. The Commission believes that the proposed amendments will not change the existing responsibilities of the sellers of securities to the public.

The good result produced by the Securities Act has come in great measure from the fact that the issuer and the underwriter must come forward and make a public statement concerning the issuer's business, its finances, its securities and the proposed offering -- and all of this under stern statutory liabilities, both penal and civil.

This requirement of disclosure is itself a substantial deterrent to transactions which would not stand the light of day. The imposition of liability for inaccurate and incomplete information and the administrative processing by the Commission of material filed with it have improved corporate morality, accounting standards and standards relating to business information generally.

We believe that the adoption of these amendments will serve to make more effective the application of the fundamental principle that distribution of securities in interstate commerce be conditioned upon fair and adequate disclosure.

These amendments in no way curtail the duty to disclose or the liability for non-conformity to the disclosure requirements, nor is there any decrease in the administrative powers of the Commission.

### Securities Act of 1933

#### The Section 5 Problem and Related Matters

The most important change involves Section 5 of the Securities Act of 1933. Many of the other amendments are necessary to accommodate other sections of the Securities Act to the amendment of Section 5.

The change in Section 5 and the related changes mentioned above have to do principally with the mechanics of the distribution of securities. These changes must be considered against the background of the present Act and practices thereunder.

The Securities Act presently makes unlawful the offer or sale of a security to the public by mail or instrumentality of interstate commerce, such as the interstate telephone, until a registration statement with respect to the security has been filed with the Commission and becomes effective. The period between the filing date of a registration statement and the effective date averages about 20 days. The seller of a security must deliver to the purchaser a prospectus containing a summary of the information in the registration statement.

It is clear from the legislative history of the Act that the Congress intended that by dissemination of information during the waiting period the public would become informed of the essential facts relating to a proposed issue before the effective date of the registration statement.

The securities industry has contended for many years that, in practice, the free flow of information concerning a new issue during the waiting period has been restricted

because of the fear of underwriters and dealers that their communications to prospective customers might be construed to be illegal "offers" of a security before the effective date of the registration statement. This fear springs from the criminal penalties provided for violation of the statute and also from the fact that a violation of Section 5, based on a strict construction of the term "offer", might give the purchaser a right of rescission for one year under Section 12(1) of the statute.

The Commission has recognized that the distinction between "dissemination of information" and an "offer" is difficult to draw and still more difficult for a customer to appreciate. The Commission has been concerned through the years because the objective of a widespread dissemination of information during the waiting period has not been more effectively achieved.

Accordingly, the Commission has taken administrative actions designed to encourage issuers and underwriters to make it possible for dealers and prospective investors to become familiar during the waiting period with the information which the statute intended they should have.

From the earliest days of the Commission's administration of the Securities Act, preeffective summaries of information as filed have been permitted.

In 1946, the Commission adopted a rule (Rule 131) which provides that distribution of a preliminary prospectus before the effective date of a registration statement shall not in itself constitute an "offer". This preliminary prospectus is popularly called the "red herring" prospectus, because a legend is printed in red on each page stating that it is not an offer to sell or the solicitation of an offer to buy and that it is preliminary, not final. Since that time, the Commission's action in accelerating the effective date of a registration statement has been conditioned upon a showing that there had been an adequate and timely distribution of the red herring to dealers who were expected to participate in the sale of the security to the public.

This rule and administrative policy have achieved in part the original statutory objective. Since that time, as a matter of practice, underwriters and dealers who expect to participate in the distribution of a new security receive information concerning the new issue by means of a red herring prospectus, in advance of the effective date.

The red herring, however, does not lend itself to distribution to the public generally for the purpose of preliminary screening of prospective customers. It frequently cannot be secured in sufficient quantity in various parts of the country in time to permit its general

use as a means to disseminate information or as a means by which underwriters and dealers may determine public interest in a forthcoming issue.

In 1952, the Commission took another administrative step designed to assist dealers to communicate with customers for the purpose of determining who might be interested in receiving the prospectus concerning a new issue. A rule (Rule 132) was adopted which provides for a short notice of proposed public offering called an "identifying statement" containing prescribed minimal general information concerning a new issue. This rule likewise provides that the use of the identifying statement shall not constitute an "offer" of a security for purposes of Section 5. An issuer is required to file the identifying statement with its registration statement and the Commission conditions its action in making the statement effective upon a showing that copies of the identifying statement have been made available to dealers and underwriters.

Underwriters and dealers have objected that this rule does not permit the inclusion of sufficient information to stimulate inquiries by investors for copies of the prospectus. They contend that the identifying statement fails in its purpose unless it contains more of a summary of the registration statement, including a summary of certain financial information.

These rules and policies are consistent with the Act. However, in view of the precise and sweeping prohibitions of Section 5, in view of the difficulty in distinguishing between the dissemination of information and the making of an offer, and in view of the difficulty of explaining that the use of a red herring prospectus is not an offer of the securities, even though the text of the red herring contains words which offer the securities, we believe that the statute should be revised to support expressly the practices which the Commission permits and indeed requires the industry to follow.

As I mentioned before, Section 5 of the present Act prohibits the sale of securities before the effective date of a registration statement and the term "sale" is defined in Section 2(3) of the Act to include an offer. Basically, the amendment would permit written offers to sell and solicitations of offers to buy during the waiting period by means of a preliminary prospectus filed with the Commission prior to its use. The present prohibition against the making of an actual sale or contract of sale of a security prior to the effective date of a registration statement is not affected by the amendment.

The Commission believes that issuers, underwriters and dealers should find no difficulty in regulating their

conduct during the waiting period so as not to make contracts of sale before the registration statement becomes effective. This might be done by conditioning offers, limiting activity to solicitation of offers to buy or by other means which keep the transaction short of a sale or contract of sale.

I think it must be apparent from what I have just said that the amendment does not work any fundamental change; in fact, it may fairly be said to give more specific authority for the continuance of practices which have developed over the years under the present law, and to make those practices specifically subject to the sanctions provided by the Act.

In order to accomplish these objectives, it is necessary to redefine the term "sale" in Section 2(3) and to amend Sections 5 and 10 of the present statute. As I have indicated previously, the term "sale" as presently defined includes an offer as well as a sale. Section 1 of the bill defines these terms separately.

Section 5(a)(1) of the Act continues to make unlawful the "sale" of a security prior to the effective date of a registration statement. The change in the definition of "sale" in Section 2(3), however, has the effect of eliminating the present prohibition against the making of an offer to sell or the soliciting of an offer to buy prior to the effective date.



No change is made in the present provisions of Section 5(a)(2) which prohibit the transmission of a security through the mails for purposes of sale or delivery after sale unless a registration statement is in effect.

The redefinition of "sale" to exclude offers, together with the proposed revision of Section 10 of the Act (contents of prospectuses), will change the effect of Section 5(b)(1) of the Act to permit the making of offers during the waiting period by means of prospectuses containing summary information as well as by means of the red herring prospectus.

The present provisions of Section 5(b)(2) which require delivery of a complete prospectus in connection with a sale or delivery after sale are retained.

These changes make necessary a new Section 5(c) which makes it unlawful to offer a security prior to the filing of a registration statement.

A conforming change in Section 10 is made so as to authorize the Commission to permit the use of a summary prospectus in addition to the conventional prospectus. This short-form summary prospectus will be filed with the Commission, as part of the registration statement, and must conform to the Commission's rules and regulations. In order to prevent the use of a summary prospectus which fails to meet the

Commission's requirements, the Commission will be authorized to suspend the use of a defective summary prospectus. This administrative remedy, which is intended to supplement the stop-order powers of the Commission under Section 8, is considered essential because of the necessity for speedy action to prevent the use of a defective summary prospectus during the relatively short waiting period.

Since, however, the summary prospectus will involve condensation or summarization of the full prospectus and since that process necessarily involves omission, the Commission believes, and the bill provides, that preliminary and summary prospectuses authorized by this Section should not be subject to Section 11 which imposes liabilities upon the issuer, its officers, directors and underwriters for misstatements and omissions. This will not lighten the existing burden of liability because the red herring prospectuses now permitted are not subject, as such, to Section 11 liabilities. We believe that the administrative sanctions of Section 8 and the suspension power, coupled with the liabilities of Sections 12 and 17 (which provide for civil liabilities and criminal penalties against sellers), can be relied upon to guard against the use of defective summary prospectuses.

I might mention, parenthetically, at this point one further change of substance in Section 10, although it is not

directly related to the Section 5 problem. Section 10(a) provides that a prospectus shall contain the information contained in a registration statement and that when a prospectus is used more than 13 months after the effective date of the registration statement, the information in such prospectus shall be as of a date not more than one year prior to its use.

The effect of these provisions has been to require more current disclosure for prospectuses employed after the expiration of the first 13 months of an offering than is required during the first 13 months. This arises from the fact that some of the information in the registration statement at the time it becomes effective may be as of a date, in some instances, as much as 6 months prior to the filing. The requirement that the information in the later prospectus be as of a date within one year of its use has presented something of a problem in many instances because it required the preparation of interim certified financial statements -- an expensive process.

The proposed Section 9 of the bill provides that when a prospectus is used more than 9 months after the effective date, the information in the prospectus shall be as of a date not more than 16 months prior to such use. It is felt that the amendment provides less discrimination between offers of short duration and those of long duration, without diminishing the quantity or quality of information supplied investors.

Returning to the Section 5 problem, the Commission believes that the civil and penal liabilities imposed by the statute should remain unchanged. Section 12 of the present statute provides that a purchaser of a security may recover from the seller who violates Section 5 or who sells a security by means of misrepresentations or concealment in a prospectus or oral communication. Since the terms "sell" and "sale" have been redefined, the amendment to Section 12 (Section 10 of the bill) inserts the words "offers or" before the word "sells" in clauses 1 and 2 of the section so as to preserve the effect of the present law by not excluding the newly permissible preeffective offers from liabilities under Section 12. For similar reasons, and to preserve existing sanctions, corresponding changes are made in Sections 17 and 22 (Sections 11 and 12 of the bill).

Modification of the One-Year Prospectus  
Requirement in Trading Transactions

A second amendment to the Securities Act, also relating primarily to the mechanics of distribution, involves a change in Section 4(1) of the Act. Section 4(1) requires dealers to deliver a prospectus in the sale of registered securities during the entire period, regardless of how long, in which they are engaged in the distribution of such securities. The proposed bill would not affect this requirement.

The section further provides that all dealers, whether or not participating in a distribution of a registered security, must deliver a prospectus in transactions in such securities for a period of one year after the commencement of a public offering even though the distribution of the securities has been completed prior to the expiration of the one-year period. The selection of the one-year period by the framers of the statute apparently was based upon an assumption that, generally speaking, the distribution of most public offerings would have been completed within that period.

In practice, the distribution of most issues is completed within a relatively short period of time after the effective date of the registration statement. In cases in which the distribution has been completed within a relatively short time, dealers trading in a security publicly offered within one year, particularly those who have not participated in the distribution, have found it difficult, and in many instances impossible, to comply with the requirement that they deliver prospectuses during the prescribed one-year period.

The Commission believes that the one-year period is unnecessarily long and unrealistic and that it can, without prejudice to the public interest, be shortened from one year to 40 days as provided in Section 4 of the bill.

Increase of Exemption from \$300,000 to \$500,000

Section 3 of the Securities Act describes various types of securities which are exempted from the registration provisions of the Act and from liability under Section 11. Subsection (b) of this section provides that the Commission may by rule and regulation, and subject to such terms and conditions as may be prescribed, add any class of securities to those exempted by Section 3 where the aggregate amount at which an issue of such securities is offered to the public does not exceed \$300,000.

When the statute was enacted in 1933, the figure specified in this subsection was \$100,000. This amount was increased to the present figure by an amendment in 1945. In the early part of 1953 a bill was introduced in the House of Representatives to increase this amount to \$500,000. The basic purpose of the exemption is to make the capital market more readily available to small business, and at less expense.

The Commission has adopted various regulations governing the sale of securities within the prescribed limits. The most important of these is the general exemption provided by Regulation A.

In brief, Regulation A prescribes the conditions under which the exemption is available and requires the use of an offering circular containing prescribed minimum disclosures.

The regulation further provides that the Commission may suspend the exemption by order, after a hearing, upon the showing of a violation of the regulation. The requirements of the regulation can be met by filing with a Regional Office of the Commission, a simple notification and copies of the offering literature. The entire procedure provides a method, less expensive and time-consuming than registration, by which issuers seeking relatively small amounts of money may sell their securities in interstate commerce without complying with the registration requirements of the Act.

On the basis of its experience under this regulation, and of the limited but practical safeguards which it provides, and the basic purpose of the exemption, the Commission believes on balance that the increase to \$500,000 in the permissible amount of the exemption as proposed in Section 6 of the bill is reasonable.

#### Formal Amendments to Trust Indenture Act of 1939

Next, the bill provides for the amendment of the Trust Indenture Act of 1939, which is Title III of the Securities Act, to accomplish two purposes. First, some of the proposed amendments to the Securities Act would require conforming amendments in the 1939 Act. Second, the Commission is proposing an amendment to the latter Act which it believes

proposing an amendment to the latter Act which it believes will permit the Commission greater flexibility in prescribing formal requirements for prospectuses under Section 10 of the Securities Act.

The Trust Indenture Act provides that a summary of certain specified provisions of the trust indenture must be included in a registration statement and prospectus. The Commission under Section 10 of the Securities Act is authorized to prescribe the form and content of prospectuses. The provisions of the Trust Indenture Act, in requiring the inclusion of such summaries of indenture provisions, may have the effect of restricting exercise of the Commission's power to provide for shorter and more concise prospectuses.

The Commission has in mind, particularly, a simplified registration statement and prospectus for high grade debt issues. To permit accomplishment of this objective, Section 303 of the bill provides that the Commission be authorized to prescribe by rule and regulation the extent to which summaries of indenture provisions must be contained in prospectuses.

The amendment provides no change in the substantive requirements of indentures or in the necessity of qualifying indentures with the Commission.



Securities Exchange Act of 1934

Extension of Credit on New Issues by Firms that  
Act Both as Broker and as Dealer

Section 11(d)(1) of the Securities Exchange Act prohibits a person who is both a broker and a dealer from "taking into margin accounts new securities in the distribution of which he participated during the preceding six months." This provision is intended to restrain distributors from selling new issues of securities to their brokerage customers who are margin customers. It operates to prevent dealers from extending credit as an aid to selling new issues.

At present the prohibition on extension of credit continues for six months after the distribution. It is proposed in Section 201 of the bill to reduce the six-month period to thirty days. The Commission believes that terminating the prohibition on extension of credit thirty days after completion of the distribution is sufficient to insure that new issues are sold on a cash basis.

"When-Issued" Trading

The last two sentences of Section 12(d) of the Securities Exchange Act of 1934 deal with "when-issued" trading on the exchanges. The first of these two sentences provides ample authority for the regulation of such trading under the standards of public interest and protection of investors. The last sentence represents an attempt to limit the authority thereinbefore granted. It states:

"Such rules and regulations shall limit the registration of an unissued security to cases where such security is a right or the subject of a right to subscribe or otherwise acquire such security granted to holders of a previously registered security and where the primary purpose of such registration is to distribute such unissued security to such holders."

Now where a security is a right or the subject of a right granted to holders of a previously registered security, "When-issued" trading cannot in the nature of things serve "to distribute such unissued security to such holders," for holders of the previously registered security will get the new security directly from the issuer, whether there is any "when-issued" trading or not. The purpose of "when-issued" trading is necessarily to provide a market in which the holders of the previously registered security may sell the unissued security and others may acquire it. Section 202 of the proposed bill, therefore, would repeal the last sentence of Section 12(d) thereby permitting "when-issued" trading to be regulated under the more general provisions of the preceding sentence.

The Commission believes that its current regulations with respect to "when-issued" trading, plus the over-all rule-making authority, now provided by Section 12(d), afford adequate means for dealing with any problem which might arise in this area.

Investment Company Act of 1940

Definition of Prospectus

Section 401 of the bill amends Section 2(a)(30) of the Investment Company Act of 1940 so that the term "prospectus" therein will retain its present meaning in the light of changes being made in Sections 5(b) and 10 of the Securities Act of 1933.

Furnishing of a Prospectus for Certain  
Investment Company Securities

Section 402 of the bill deals with the problem of the period during which prospectuses must be furnished in connection with the offer of certain investment company securities. You will recall that we previously discussed the same problem in respect of securities generally.

Section 402 would amend Section 24(d) of the Investment Company Act of 1940 to require, in effect, that all dealers in the securities of face-amount certificate companies, unit investment trusts, and open-end management companies must use the prospectus so long as any security of the same class as the registered security is being offered, whether or not such dealer is participating in the distribution.

In view of the continuous offerings of additional shares by such types of investment companies selling group dealers must use a prospectus continuously and the one-year period or 40-day period (specified in Section 4(1) of the Securities Act, in its present form or as amended) never expires. Furthermore, under

the present 1933 Act, the one-year period for the use of a prospectus by independent dealers (not members of the selling group) is as a practical matter constantly being renewed by reason of the prevailing practice of most such companies to file new registration statements about once a year. If the one-year period were reduced, independent dealers engaged in making a market for such shares would be subject to the prospectus requirements for only 40 days of the year. At other times a public investor would thus receive the prospectus contemplated by the statute if he purchased such investment company securities from a selling group member but not if he purchased from an independent dealer.

It is recognized that this situation was apparently not contemplated by the drafters of Section 4(1) of the 1933 Act because the distribution of securities by such investment company issuers can never be regarded as completed. The use of a prospectus by dealers for one year after registration, as presently required by Section 4(1) of the Securities Act, provides an incomplete solution at best and, accordingly, the amendment provides for use of the prospectus by dealers so long as any securities of the same class are being offered.

It is argued that dealers who are not members of the selling group will be discriminated against if they are unable to obtain prospectuses from the issuer or an underwriter in time to meet such prospectus requirements.

This discrimination can doubtless be mitigated through the exercise of the rule-making powers contained in the proposed amendment. However, in view of the nature of the problem and the different views expressed, an alternative draft of this provision has been submitted to Chairman Capehart, which, in effect, preserves the one-year period of the present Act as applied to such issues, coupled with such rule-making powers.

#### Continuous Registration of Investment Company Securities

By reason of the provisions of the last sentence of Section 6(a) of the Securities Act of 1933 which restricts the securities that may be covered by a registration statement to those "proposed to be offered", the Commission has taken the view that a registration statement may cover only such shares as may be offered "in the proximate future" and that additional shares of the same issue may be registered only by the filing of a new registration statement (see Rule 413). In the case of issuers making continuous offerings, particularly the investment companies commonly referred to as "mutual funds", it has become customary for them to file new registration statements annually so as to have registered shares always available.

The necessity for estimating a sufficient number of shares to be so registered has occasionally resulted in the payment of excess filing fees because all the shares registered

were not actually sold during the annual period. Furthermore, the preparation and filing of a new registration statement involves additional work and expense as contrasted with the filing of a post-effective amendment.

Section 403 of the bill adds a new subsection (e) to Section 24 of the Investment Company Act of 1940 (which relates to registration under the Securities Act of the securities of investment companies) which will afford to investment companies making continuous offerings the right to register additional shares of the same class by filing an appropriate amendment to the latest effective registration statement under the Securities Act of 1933. This procedure is an alternative to the filing of a new registration statement, at the option of the issuer.

The amendment also specifies the payment of an additional filing fee upon such new shares as a condition to such filing, requires the filing of prospectuses at appropriate intervals by amendment to the registration statements of such issuers, preserves Section 11 liabilities with respect to such amendments, and extends the statute of limitations provided in Section 13 so as to date the commencement of the offering from the latest amendment. In effect, this provision recognizes the special registration problems presented by investment companies engaged in making continuous offerings by providing machinery for the

continuous registration of their shares without sacrifice of disclosure standards or liabilities to investors.

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As has been stated in my letter dated January 25, 1954 addressed to Chairman Capehart, a number of conferences have been held by the Commission with Senator Bush, Chairman of the Subcommittee along with Messrs. McMurray and Donaldson of the Committee staff, and with groups which had proposed various items of legislation. All of the Commissioners, as well as many members of the staff, have been active in many discussions both with respect to policy and draftsmanship. Commissioner J. Sinclair Armstrong, in the allocation of responsibilities among Commissioners, has concerned himself in more detail than the rest of us with the actual problems of draftsmanship. He is prepared at this time or later to submit a more detailed section-by-section analysis of the bill.

I will be happy to answer any further questions which any of the Committee may have, but in view of the technical nature of the subject matter I may occasionally call on one of the other Commissioners or a member of the staff.

February 3, 1954