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Speeches SEC Staff

SECURITY UNDER THE SECURITIES LAWS

ADDRESS

of

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Before the

NATIONAL CONVENTION

of the

JUNIOR CHAMBER OF COMMERCE

Tulsa, Oklahoma

June 23, 1939

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It is indeed a pleasure to appear before you, the Junior Chamber of Commerce, who represent a group of outstanding young American business men. It is a privilege to address you and discuss some of the work which the Securities and Exchange Commission is doing in administering the laws placed under our jurisdiction by Congress.

As I was coming to Tulsa, three things very similar in their youthfulness were called to my mind. The dash of youth always catches the fancy and feeds the imagination.

The City here where your National Convention is in session is a new city in a young State. From the Osage Hills, where the natives of the Osage tribe lived, has arisen this City in a few decades. In this new country, whose development and progress have been so phenomenal and rapid, no doubt some errors of judgment and policy have been made, but these have been corrected by the experience of the years which followed. The present beautiful city speaks for itself.

In the second place, the membership of this organization is youthful. You are a group of young men who are frequently compelled to make decisions, but find in your past experience no guidance; yet I have sufficient confidence in you to feel that you will come out on top. Youth learns by trial and error -- reducing errors to a minimum. Your very enthusiasm will carry you through. What you lack in experience you will make up in determination and effort.

And last I come here as a representative of the Securities and Exchange Commission, a new organization about four and a half years of age. Our expansion and development has been rapid. Just as you have found it necessary to make decisions upon matters which at the moment seemed to confront you prematurely, so also has this Commission been faced with the necessity of expeditiously determining policies and procedures for the effective enforcement of new laws. Within this short period we have met the challenge, and have put into effect a program which meets the requirements of an efficient administration of the Securities Laws.

We of the SEC, in administering the three principal laws which fall within our jurisdiction, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935, have been assisted by various organizations, both private and governmental, whose aid has been of material help in equitably and efficiently performing our duties. In cooperating with the President's Temporary National Economic Committee, the Commission has recently undertaken a study to obtain a factual picture of the problems faced by small business in the United States. Detailed estimates of the financing needs of local industries are being sought. The sources of capital and the channels through which small enterprises should be able to obtain financial assistance are being looked into. Suggestions will be made looking toward the elimination of the factors which are deterring small businesses from securing necessary operating capital.

While this inquiry has been progressing, on-the-ground surveys have likewise been in progress. Representatives of the SEC are making studies in Omaha, Nebraska, Birmingham, Alabama, and Fall River, Massachusetts, calling upon bankers, manufacturers and merchants to discuss the financing problems faced

by small businesses in these areas. Omaha was selected for study as an example of a city where local industries have been seriously affected by the agricultural problems of the prairie states. In the South, Birmingham was chosen because it is representative of the new industrial development in that area. The problem in this area is one of obtaining local capital for local expansion. In New England, Fall River was selected as it represents a community which has suffered heavily because of the loss of a considerable part of its major industry--cotton milling--to other sections of the country. Additional studies are contemplated in other areas where there are relatively high degrees of business activity, such as the Detroit-Toledo area, the Dallas-Houston area and the Seattle-Portland area.

The participation of the SEC in this study evidences our vital interest in solving the problems of the miller, the merchant and the local manufacturer. To assist in this work, the Junior Chamber of Commerce has undertaken a study of its own, which is being made concurrently with the TNEC study, and which will be reported to the Committee upon its completion. This particular fact is a signal of what I believe will be an outstanding step in the cooperation of business and government in helping the National Economy, and I dare to venture that in the future you will see more efforts made by similar private organizations to cooperate with the Federal Government.

I cannot exaggerate the value of the contribution which the Junior Chamber of Commerce can make to this study. Located as you are in representative communities throughout the United States, you are cognizant of local problems and conditions, and are in a unique position to make pertinent suggestions.

The relative importance of small business to the national picture is realized when one considers the statistics of income most recently available. We find that 25% of the total assets of all corporations is held by 409,000 concerns with capital assets of less than \$5,000,000. This represents an investment of 78 billion dollars in small businesses--a stupendous sum.

Figures compiled by the Social Security Board show that approximately 14,000,000 wage earners, or 38% of the total, are employed in relatively small businesses with less than 100 workers each--another striking figure.

These statistics graphically reveal the vast number of small businesses in the United States, the large aggregate amount of capital invested in them, and the tremendous army of wage-earners dependent upon them for their livelihood. It is obvious that the prosperity of small business will affect the national economy.

One way to encourage and stimulate small business is to induce those whose capital now lies idle to invest it in the development and expansion of such enterprises. From that would flow more employment, a greater utilization of raw and manufactured products, and ultimately the economic adjustment we are seeking.

It is important that Government and business get together. The Government is not only dependent upon business for its revenue, but it would not long exist if it did not have the welfare of business at heart. The TNEC study is an attempt on the part of the Government to understand and appreciate

the problems of business. The desire on the part of business to meet us half-way--especially evident in this group--is encouraging. As one witness before the TNEC stated:

"After all, this being a democratic form of government, why not work in closer harmony for the mutual good of all concerned? If a Governmental representative walked into our office three or four times a year and said 'How is business?' or 'Do you have any suggestions I could carry back to our committee in Washington?' I'd feel not only flattered but also feel that I was more a vital part of this Government than under the present conditions.

"Such a representative would bring back many valuable and worthwhile and helpful ideas. After all, business still operates through barter and exchange. If the Government goes out of its way to help business, let business be appreciative and work hand-in-hand with the Government, and vice versa."

In Washington, we frequently hear such remarks as, "There is too much Government in business"; "Leave the storekeeper and the mill operator alone and they will take care of themselves"; "Withdraw Government from business". We believe this study will remove the fears that prompted these statements and that the Government ultimately will be considered the friend, not the foe, of business. So also we hope the Securities Laws will be regarded as fostering, not depressing, legitimate business enterprise.

A mass of necessary laws, regulations and forms has grown up in connection with the Government's attempt to stimulate business and industry. I sympathize with the business man's dilemma, confronted as he is with the necessity of complying with all this new legislation, and his very natural desire to run his own business in his own way.

The laws, however, have been enacted because of necessity. History is replete with incidents where a small group of individuals in furthering their own selfish interests have acted in utter disregard of the good of others, and have brought poverty, destitution and ruin to their fellow-men.

In our own field of securities, all of us present can recall the days of active stock promotion in the middle twenties with everyone, from elevator boy to president, wildly speculating in a rising market. Stocks rose to nebulous heights, entirely out of proportion to any proper basis for their valuation. Huge paper profits were made. Anything was possible. The public was so credulous it was easy for a ruthless promoter to flood the market with worthless stock, beautifully embossed with a golden seal, with promises of fabulous returns far exceeding the rosiest dreams for the gullible investor. Get-rich schemes were commonplace. No investor was too small for him to contact; he exercised no conscientious or moral restraint in his activities. State laws could not hold him, state boundaries offered no resistance. He operated throughout the length and breadth of the land, relying on distance for his protection, using the mails, the telephone and telegraph to perpetrate his fraud across state lines, with no effective federal control to block his efforts. The investing public was swindled out of millions of dollars by these methods. Those who could ill afford it were induced to part with their life's savings.

With the market crash of 1929 and the financial crisis which ensued, many investors, even those comparatively well off, found themselves in greatly reduced circumstances, with the accumulation of years wiped away. Some lost everything. In desperation many made an effort to recoup their resources by investing their few remaining dollars in wildcat promotions, becoming the unwitting prey of these same unscrupulous promoters, who fleeced them again with promises of quick recovery.

These experiences could not be repeated. There came a public demand for effective federal regulation of these evils. Then followed the enactment of the Federal Securities Laws, and the creation of a special agency devoted to their enforcement.

The first of these acts, known as the "truth in securities" act, was designed to provide a true and complete picture of new securities to be offered to the public by means of the registration process. The prospectus required to be furnished to each investor is designed to provide sufficient facts to enable him to determine for himself the advisability of the investment.

In addition, this act has a sweeping fraud provision, prohibiting in the sale of securities the use of the mails or the facilities of interstate commerce to devise fraudulent schemes, the obtaining of money by false or misleading representations, or the engaging in a course of business which would operate as a fraud or deceit upon the purchaser.

The 1934 Act effected similar provisions for securities registered on national securities exchanges. Requirements as to registration and reporting were adopted. Provisions were made against the artificial manipulation of securities prices; a fair and open market was sought to be maintained. In addition, over-the-counter brokers and dealers were required to be registered, if they used the mails or the facilities of interstate commerce to conduct their business.

The 1935 Act provides for the control and regulation of the vast public utility holding company systems, suggests reforms relative thereto, and places upon the Commission certain responsibilities regarding their operation, coordination and ultimate simplification.

The fraud section of the Securities Act is a sweeping and inclusive provision and is the principal weapon of the Commission in its campaign to eliminate the securities racketeers. The type of frauds are as numerous and as different as the human imagination can make them and they have even changed in character and emphasis as the enforcement work of the Commission has progressed.

At first the most flagrant kind of fraud was the sell-and-switch, boiler-room operation, where a battery of salesmen would be employed to make thousands of telephone calls to unsuspecting victims whose names were obtained from a purchased "sucker list", or even at times from pages of a telephone directory--starting on the Atlantic seaboard in the morning and following the sun to the west coast late at night--gaining the confidence of the victims, making a little money for them at first on some reputable stock, and persuading them each time to re-invest their profit, and finally ending up by switching the purchasers into a cat or dog which the promoters were trying

to unload—without a chance of making a dime and every likelihood of losing every cent invested.) At times the promoters would actually pay "dividends" out of their own pockets in an effort to lull their victims into a sense of security, and entice them to pay in additional capital. Money received from new customers for investment was used to pay false profits to the old—the old Ponzi racket. Installment selling was resorted to—something even the small investor could afford. Everyone was happy—until the bubble burst.

In one case, the Kopald-Quinn case, which is characteristic, the investors were induced to buy securities on an installment basis, delivery not to be made until fully paid for, at outrageously advanced prices which had been achieved by clever manipulation of the market. When everyone had signed up, the plug was pulled; support was withdrawn from the market, which caused it to drop to practically nothing. Everyone's account was closed out, leaving all that had been paid in to be enjoyed by the perpetrators of the scheme. Ample jail sentences have taken care of the principal actors in this particular case, and their prosecution has had the desired result of frightening others from similar enterprises.

Lurid promotional oil and mining literature was once the vogue. Impossible promises and predictions were made in these sheets—all to allure the credulous investor who dreamed of making his small, hard-earned savings grow into fabulous sums overnight. He put up his money, but as time went on and these glowing promises failed to be realized, he eventually came to know that he had bought a hole which had long been dry, or a shaft barren of gold—if indeed his money had been invested at all by these unscrupulous promoters.

These schemes were vast promotions. Many of their promoters are now serving long terms in federal prisons. Others have scattered to the wind. While these practices are not altogether stamped out, I think there is no question but that our agency has done much to lessen their menace.

However, other schemes, not so widespread and perhaps not so vicious, have grown up which still give us much concern, and keep our investigators ever busy. We have recently had a number of insolvency cases—cases in which a broker has accepted money and securities from a customer for the purpose of investing the proceeds in other securities for him, but where he has in fact "bucketed" the orders—not effected the transactions at all, but kept and dissipated the money himself. Because of his insolvency he cannot possibly make good. The recent Lawson case involving the former Police Commissioner of the City of Baltimore was a case like this.

So also we have a series of what we call "thrift plans," or "top trust" cases. In these cases the investor is persuaded to put his money into buying a certificate of participation in an investment trust, usually in small monthly payments, about ten dollars each, over a ten-year period. Various oral misrepresentations are made by the salesmen—that it is as safe as a savings bank; that the contract will pay \$2,000 on the \$1,200 invested; that the money can be taken out at any time—all false. But the most serious violation is failing to reveal the load or charge for the service—sometimes as much as 20 or 25 percent of the investment, and mostly taken out early in the game, so that the investor has practically no equity in his investment during the first years of the contract, and his only hope of getting any

return at all upon his money (and that not a certainty) is to continue his monthly payments over the entire period. Quite often he has lost his job, and counted on drawing out the money already invested. He finds he can get back only a small fraction of what he has put in. This is not what he thought he was buying, as many an investor has told us in no uncertain terms. We are doing our best to correct this abuse. Several injunctions have been obtained and one case has proceeded to criminal indictment.

A case of wide public interest was the recent Whitney case in New York. Richard Whitney, former president of the New York Stock Exchange, and one of the leading financial figures in the country, was discovered to have hypothecated to his own account customers' securities going into the millions. An immediate and thorough investigation by the Commission and the New York State authorities resulted in his conviction for grand larceny, and the Commission, in a detailed report following a public hearing, proposed certain additional rules to the stock exchanges, looking toward the more immediate detection of such malefactions.

More recently, the McKesson & Robbins case excited nation-wide interest. Donald Coster, or Musica, a former convict who had completely concealed his identity and had built up an enviable reputation as a leader in business and finance, was discovered to have falsified the assets of a whole department in his business. With the assistance of his brothers and others, he set up on the books of McKesson & Robbins false assets in the Crude Drug department running into many millions when no such assets were in existence. The necessity of filing a registration with the New York Stock Exchange and this Commission under the 1934 Act enmeshed him in a violation of federal statute and resulted in a prompt indictment of the principals and Coster's suicide.

There is another group of cases, which we call trading cases, which fall within our jurisdiction. In such instances an artificial market is created and maintained in violation of Section 9 of the Securities Exchange Act of 1934. Wash sales, matched orders, or a series of transactions on the exchange are made to give the appearance of active trading, thus raising the price artificially for the purpose of inducing others to buy. To detect such activity involves a long and arduous trading investigation. Frequently, it is necessary that a detailed study and analysis of numerous brokerage and exchange records be made to determine a possible violation. Several injunctive and criminal cases have resulted, and the Commission has also resorted in a few instances to a proceeding looking toward the expulsion of a person guilty of such practices from membership on national security exchanges.

So also the Commission has proceeded against the registrations of over-the-counter brokers and dealers. The statute provides that such proceedings may be instituted when it is in the public interest and when a broker or dealer has been convicted of a crime involving securities within ten years, when he has been enjoined, or when he has committed a wilful violation of the provisions of either the Securities Act or the Securities Exchange Act.

The Commission also has an entire division devoted to the careful scrutiny of all registrations of new issues under the Securities Act, and of all securities registered on the exchanges under the 1934 Act. When it appears to the Commission that such registrations contain false, misleading, or incomplete information, the Commission has seen fit to proceed in numerous instances, by way of stop order against the effectiveness of the registration of new issues or by way of delisting of securities registered on the exchange.

The exercise of these functions has proven a powerful weapon in the hands of the Commission in eliminating undesirable persons from membership on the exchanges, or from acting as brokers or dealers off the exchange, and has prevented the sale of many questionable issues.

This will give you some idea of the enforcement program which the Commission has conducted during the four and a half years of its existence. It by no means exhausts the field. I could go on, giving case after case, each with facts peculiarly its own.

As a result of the efforts of the SEC in obliterating the securities racketeers, at the end of the fiscal year 1938 there were pending 64 cases in which indictments had been returned against 707 defendants. The value of this to the citizens of this country can be realized when it is considered that each one of these defendants contacted numerous victims in order to effect his nefarious schemes of finance. But this is only a part of the story. At the end of the same period, injunctive proceedings were brought by the Commission in 108 cases involving 345 defendants.

It can readily be seen that the securities crook has found his field of activity greatly restrained and curtailed through our activities in enforcing the Securities Laws. Many have abandoned the securities business altogether. Some have sought new schemes to fleece the public, engaging in questionable activities just beyond the pale of the Securities Laws.

One such field of activity, on which the Commission in conjunction with the postal authorities has recently been concentrating its attention, is what is commonly called the "advance fee" or "front money" racket. The operator or confidence man approaches a small business firm which is in need of financing, and represents to the officers that he has excellent brokerage connections and through them he will be able to float a stock issue for the firm. However, it is first necessary, before the broker can be approached, for the issue to be registered with the SEC. To do this a prospectus must be prepared and filed. It is represented that this requires an initial outlay of from \$500 to \$3500, which is demanded at once, purportedly to cover the cost of preparing these papers. Usually the advance fee is paid, but the services of the operator gradually taper off, needless to say without any tangible results being produced. He may go so far in his scheme as to file an inadequate prospectus, but no financing is obtained.

The front money operator has been known to put an advertisement in the daily newspaper, offering his services either to raise or furnish capital, indicating that no fee will be charged. He does everything he can to ingratiate himself with his victim. To prove his interest, he even takes an option on a large block of stock which is to be issued. Of course, the option is carefully worded and the final result reveals there is no firm commitment to purchase or dispose of the stock. If an incorporation is needed, the front money man refers his client to a company which will draw up a charter for a fee. The fee is split with the front money operator. With its incorporation complete, the company needs a registrar and transfer agent; another "kick-back" for the front money man. Then the corporation has to file a prospectus with the SEC and a lawyer is needed--another split of the fee. When all of this is complete, the operator has some dealers to whom he may send the prospectus, who are of course never interested in the proposition. This is the

extent of his efforts to distribute the securities. If the client should complain of the racketeer's failure to distribute the stock, a ready answer is available--the dealers did not look favorably upon the issue. The disillusioned victim has lost several hundreds of dollars which he can mark off to experience.

We of the SEC are vitally interested in this front money racket because its operation casts some reflection in the public mind upon all law enforcement agencies and particularly upon our Commission. The SEC gets it coming and going. The racket's very existence depends on an artificially stimulated impression of the complexity and difficulties of our registration requirements and regulations, and its unchecked progress leads the layman to an unwarranted criticism of our efficiency as a law enforcement body. This front money racket is a significant example of a situation where we need cooperation from organizations such as yours. These promoters make their representations to you. It is through your help that they may be apprehended and brought to justice. We are making a vigorous effort to eradicate this evil. A notorious operator, Wm. P. Gage, in Florida, has already been tried and convicted. Other indictments will follow. But it is important to be on your guard. There is danger until the last operator has been apprehended or driven from this field.

And so, through the assistance of other investigating and prosecuting agencies, including the postal authorities, the SEC has been able to protect the public from the unscrupulous, even though no violations of our own statutes were actually involved.

State prosecutors, at first a little wary and reluctant, have more recently become intensely interested in cleaning up their own backyards, particularly when the SEC has been able to demonstrate to them that larceny and embezzlement have taken place within their own bailiwick, and where the crimes perpetuated were essentially state and not federal matters.

As a result of the rampant fraud perpetrated upon the investing public prior to the enactment of the federal securities legislation, and the consequent loss and disillusionment suffered by those who had put their money into these disastrous ventures, many of whom could ill afford it, the average person grew afraid to risk his savings in any sort of investment, and put his money either in the bank or hid it away entirely. Millions of dollars which could have been used for legitimate business enterprise were in this way frozen and diverted from the normal channels of industrial development. The public was unable to distinguish between the good and the bad. Confidence in securities investments reached a new low.

It has taken several years to convince the person on the street that with the advent of the new securities laws, and a vigorous enforcement program on the part of the Commission, many of the dangers which formerly beset him have now disappeared. After four and a half years of operation, however, public confidence is gradually being restored. The investor is beginning to feel, as a result of the vigorous attack the Commission has made on the securities underworld, that it is safe to bring his money out of hiding, and invest it in new enterprises, as well as the expansion of established business. He cannot and does not expect the phenomenal returns of the old-day promises. He must be content with a reasonable return on his money. But at least he can feel more secure and certain that his investment will be utilized

in the manner intended. Money will begin to flow freely in the field of industry in direct proportion to this restoration of public confidence. The SEC has done and is doing much to restore this confidence.

The Commission is interested in doing everything possible for small business. It has simplified and modified the registration requirements wherever possible. Instead of requiring a long and involved registration for issues of under \$100,000, by rule it has permitted the filing of a simplified prospectus. In issues of less than \$30,000 it has eliminated the necessity of registration altogether. Under limited conditions it has permitted the filing of offering sheets in oil and gas issues.

One of the most important things which now confronts us of the SEC, charged with the administration of the securities laws, and you of the Junior Chamber of Commerce, representative of local business interests throughout the country, is to find some method of interesting the local investor in local industry. With his confidence gradually restored, if he can be induced to put his money into industrial development and expansion in his own community, more persons will be employed in that locality, business will be stimulated, factories will be at work, and generally, a large measure of our economic problems will be solved.

The study which the Commission is making in connection with the TNEC, and the independent study which the Junior Chamber of Commerce is pursuing, will be of material assistance in solving this problem. I can promise you that the Commission will continue its vigilance against the securities racketeers. Public confidence in investments generally is bound to increase. You in your respective communities can do much to eliminate the bugaboo which has haunted investors for years. Induce your friends to put their money in local enterprise. With securities fraud on its way out, there is room for legitimate business. If you have problems in regard to securities, come to us with them. While the help we can render is described by the laws under which we operate, you may be sure the Commission will do everything within its power to help you. We should like to be regarded as the friend of small business. You can do much to strengthen that impression.