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"ADMINISTRATIVE PROCESSES AND PROCEDURE"

ADDRESS

of

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Commissioner, Securities and Exchange Commission

Before the

ANNUAL CONVENTION

of the

NATIONAL ASSOCIATION

of

SECURITIES COMMISSIONERS

Skytop Lodge,
Skytop, Pennsylvania

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Six years have passed since the memorable meeting of your association in Milwaukee at which representatives of the Federal Trade Commission met with the State Commissioners for the first time to discuss the then new Federal Securities Act. Any presentiment of usurpation of State powers in security regulation by the Federal Government as a consequence of the passage of the Securities Act was soon dispelled. Subsequent events have emphasized the complementary nature of our activities and we have demonstrated our ability and readiness to work together to our mutual advantage.

In these six years we have watched the growth and extension of Federal securities legislation to four other fields of activity relating to corporate securities: supervision of stock exchanges and registration of listed securities 1/, registration and regulation of public utility holding companies 2/, certain phases of corporate reorganizations 3/, and supervision of over-the-counter trading 4/. In August of this year the Commission was charged with the administration of a sixth statute -- the Trust Indenture Act of 1939, commonly known as the Barkley-Cole Act.

This latest legislation is designed to remedy a situation for which the disclosure requirements of the Securities Act do not provide a wholly adequate corrective. In general 5/, it applies only to trust indentures which must now be filed with the Commission as part of a registration statement under the 1933 Act covering bonds or other evidences of indebtedness to be issued thereunder. Its primary purposes are to provide full and fair disclosure throughout the life of bonds, notes, debentures and similar securities; to provide machinery whereby such continuing disclosure may be made to securityholders and whereby they may get together for the protection of their own interests, and to assure for the securityholders the services of a disinterested indenture trustee who will conform to the high standards of conduct now observed by the more conscientious trust institutions.

We, in the Federal Government, and you, in the State Government, are engaged in the application of a comparatively new form of governmental technique. We are a part of a movement which has gathered tremendous momentum in the last fifty or sixty years in this country, a development which is still being weighed by legal theorists and still being appraised through critical eyes by the people and by the courts. We typify the administrative process. The rulings we and other administrative agencies make have been recognized by the courts and have come to be known as administrative law.

1/ Securities Exchange Act of 1934.

2/ Public Utility Holding Company Act of 1935.

3/ Chapter X of Chandler Act. (1938).

4/ Maloney Act. (1938).

5/ Report of House Committee on Interstate and Foreign Commerce. (p. 23).

Laborious and costly experiment in government has convinced federal and state legislatures that some form of administrative and enforcement authority is necessary if protective measures are to have vitality and character. In our own particular field we know from first-hand experience how utterly impracticable and ineffective would be any legislation state or federal, designed to secure some measure of protection to investors, if no provision were made for some instrumentality of enforcement. We have also learned that the wider the range of activities, the greater the area of social interests affected, the more powerful are the forces exerted to counteract the constructive efforts and narrow the sphere of influence of the law-enforcing agency. The administrative agency, both state and federal, has become a recognized instrumentality, an established method or formula for dealing with complex and technical phases of our economic life. In the words of Justice Douglas, "Administrative government is here to stay. It is democracy's way of dealing with the over-complicated social and economic problems of today." 6/

We cannot ignore the fact, however, that while the administrative agency and the administrative process seem to offer the most effective means of dealing with increasingly difficult social problems, the powers and methods of these agencies are being subjected to a searching scrutiny. The exercise by them of quasi-judicial powers apparently has irritated many members of the bar. The sting, real or fancied, of rulings termed "legislative" in nature, has caused accusations of "arbitrariness", "interference", "prying" and "fishing" by individuals and corporations chafing at constraint. Statements of this nature, even though they may spring from small groups-slow to relinquish older methods and resistant to change-must be refuted in energetic terms lest isolated voices become joined in a chorus which may tend to discredit the work of state and federal administrative agencies.

In your contacts with the Securities and Exchange Commission and at previous meetings of your association you have become familiar with the general purposes of the legislation we administer. You know the scope of our requirements and the breadth of our activities. Today let us examine the administrative powers and processes of the Commission under the Securities Act of 1933 (since our work under that statute most closely approximates your activities under the various state securities laws) and consider the means by which broad legislative objectives are attained in everyday administration. Charges of "bureaucracy" and hostility toward business seem ridiculous when examined in the light of the powers at our disposal and the circumstances of their employment.

As you well know, the Commission under the Securities Act is not primarily a regulatory authority. We have no power to pass upon the merits of a security or the proposed methods of distribution. The fundamental thesis of this statute is that securities shall be sold upon the basis of truthful representations which are required to be reflected in the registration statement and prospectus.

6/ Douglas, W. O. - "Administrative Government" - Speech Before Eighth Annual Forum on Current Problems, New York, October, 1939.

Unless a registration statement under the Act is in effect as to a security, the security may not (in the absence of an exemption) be publicly offered for sale or sold in interstate commerce or through the mails. A security may be registered by filing with the Commission on an appropriate form a registration statement meeting the standards of the Act, and this statement becomes effective on the twentieth day after its filing with the Commission unless this period is extended as a result of action by the Commission or the registrant. The draftsmen of the Act, realizing that it would not be feasible to specify accurately the information which should be included for each particular or peculiar situation, prescribed general standards to be met by the registration statement and prospectus. These standards are briefly stated and are so familiar that they have an immediate appeal to layman and lawyer alike. Stated in negative terms they are:

1. The issuer shall not omit required material facts.

2. The registration statement shall not contain an untrue statement of a material fact.

3. The issuer shall not omit a material fact necessary to make other statements not misleading.

Rule-making powers were conferred on the Commission for the purpose of providing the elasticity necessary to a workable application of the legislative standards. These rule-making powers avoid the necessity of rigid statutory prescriptions and permit the necessary variation of requirements to meet essential differences in disclosure problems faced by different issuers. For example, in Form A-1 and Form A-O-1 emphasis is placed on the promotional aspects of the enterprise, while the items in Form A-2 are directed more toward securing information concerning operating results and management policies. In one sense the rule-making power may be considered the heart of the law. Without it there could be no orderly registration of security issues. Corporate information might be submitted in the public record without regard to uniformity and with no assurance of consistency. The power to prescribe rules and regulations is the power to give consideration to the specialized requirements of different issuers, to relieve registrants of straight-jacket legal restrictions, and to work out with industry itself difficult problems of disclosure. Rule-making includes drafting and adoption of registration forms, specifications governing registration procedure and the interpretation of statutory provisions. Obviously, a form devised for investment trusts is ill-suited to the needs of an industrial company. The public utility presents disclosure problems quite different from those of the mining enterprise or the small loan company. Specialized forms make for certainty of requirements, provide comparable data from different companies, and facilitate examination.

We hear complaints that forms are complicated; that rules have multiplied; that an issuer must thread its way through a maze of technical regulations in order to meet registration requirements. In some respects this complaint may seem justified to the casual observer. A little thought, however, will give cause for wonder that the rules and forms are not more

voluminous and complicated. The subject matter of our work embraces the entire range of business enterprise, domestic as well as foreign, and includes, as well, difficult questions arising in connection with registration of issues by foreign governments.

The Commission has followed the policy of adopting new rules and new forms only when it becomes apparent that they are necessary for the benefit either of the registrant or the investing public. A large number of our forms and regulations have been adopted or amended at the request of issuers and their representatives, to relieve them of unnecessary burdens or to permit confidential treatment of certain types of contracts. Before adopting any forms or regulations under the Act, we have submitted advance drafts and redrafts to the professions and representative business concerns for their criticisms and comments, usually finding such a cooperative approach extremely helpful. The self-governing nature of our rule-making is of the utmost importance, and I think would satisfy even those opponents of administrative agencies who propose that public hearings be held before any rule is adopted.* Public hearings on rules could never take the place of the consultations and round-table conferences that we have found essential in formulating our regulations and forms dealing with highly technical subjects. Public hearings held after these consultations are finished would furnish little if any protection to the inarticulate investors. It is our job to protect them to the fullest extent under the law, and to protect their interests in such a way as not to place an undue burden on business or commerce. A delicate balance must be struck, requiring the utmost in frank and open discussion. Public hearings, with their formalities and adversary atmosphere, do not appeal to me as conducive either to frankness or openness. In my experience they tend more to furnish golden opportunities for smoke-screen oratory, speeches by advocates who want to impress their clients, and wandering dissertations by perennial crackpots. If rule making is handled properly by the consultative method, formal hearings will be a waste of time and a duplication of enormous effort; if the power is used arbitrarily, no formal hearing will protect the public against its continued exercise.

Forms and rules, however, merely establish a norm, a working outline within and around which may be fitted the fundamental information relating to the individual enterprise. Registration statements constantly present new problems of disclosure, all of which are not and can not be foreseen in the formulation of general requirements. An additional and essential element of elasticity is found in the examination procedure. This elasticity is negative as well as positive in character. We can relax formal requirements in particular cases where it appears that enforcement would serve no useful purpose. We can suggest disclosure not specifically required by the rules where in peculiar circumstances additional information is essential to compliance with the standards of the statute. The large number of cases which become effective on the twentieth day after filing, which is the earliest possible effective date under the statute for domestic issuers, convinces us that the forms and rules are workable and present no real obstacle to public financing by companies willing to make a fair disclosure.

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* See the Walter-Logan Administrative Law Bill, S. 915.

There is a group -- fortunately, small -- who find it difficult to become reconciled to any "rules". This group draws its members from no one segment of our population. We find them in all parts of our society and in all lines of activity, social as well as economic. For this group it is well nigh impossible to provide any satisfactory system of requirements which will accomplish the purposes of law. Concealment and misstatement can be artfully practised and made to appear ingenuous. Outright untruthfulness frequently passes undetected in the absence of searching study or familiarity with the subject matter. If trained analysts can be misled, as they sometimes are, consider the position of the investor who, we fear, too frequently is induced to believe that securities legislation constitutes a guarantee of straightforward dealing. Critics of our administrative processes who complain that the terms "material fact" and "misleading statement" seem to impose vague and indeterminate limits upon our powers frequently overlook the fact that they likewise permit great latitude in expression as well as freedom of action on the part of the issuer. In the hands of the adroit, the schemes and devices of the dishonest can be cloaked in words that mislead all but the most wary investigator.

The Commission has authority under the statute to institute formal proceedings prior 7/ to the effective date if the registration statement appears materially inaccurate or incomplete, as a condition precedent to the issuance of an order refusing to permit the statement to become effective. If it appears to the Commission at any time 8/ that the registration statement includes untrue statements of material facts or omits required material facts or facts necessary to make other statements not misleading, stop order proceedings may be instituted. Finally, the Commission has authority to make an examination in any case in order to determine whether a stop order should issue. 9/ In these proceedings the Commission may demand the production of records and subpoena witnesses. The quasi-judicial powers granted to administrative agencies by statutory provisions of this character have provoked long and earnest discussion by thoughtful students of government. I shall not attempt to discuss the technical legal theories which have been advanced in support or condemnation of the grant of these powers to agencies such as ours. Congress is obviously convinced that they are essential to effectuate its declared public policy. My interest in the nature and effect of these proceedings, however, has been stimulated by first-hand observation of their use.

It is recognized that these proceedings are designed solely for the protection of investors through fair and accurate disclosure, and this does not demand that every registrant shall be deemed a potential violator of the law until the contrary is proved in public hearings. As a practical matter, through long experience we have learned to recognize the indications of violations of the disclosure standards. This recognition is not intuitive. It is the direct consequence of searching study by a trained staff. For example, the report of an engineer describing in glowing terms the

7/ Section 8 (b)

8/ Section 8 (d)

9/ Section 8 (e)

deposits of rich ore awaiting extraction might give the layman no cause for suspicion when he reads the prospectus of a mining company. Another mining engineer, however, may discover within the report facts which point to a contrary conclusion, or he may possess information which leads him to doubt the accuracy of the statements or claims made. Every registration statement filed by a mining company, therefore, is studied by an expert who has at his fingertips a wealth of technical data, contacts with other experts, as well as experience in actual mining operations. Recently we have received a number of registrations from new companies formed for the purpose of exploiting patents. In several instances the prospectus claimed that the patents were "basic" and "generic". Review of Patent Office records by a patent attorney and engineer from our staff revealed that these claims were too broad and that these companies were in fact entering a field in which there presently existed, or in which they had reason to anticipate, substantial competition. Misleading structure of financial statements or falsification of financial records frequently has been discovered by our accountants who have had experience in all phases of accounting work. Valuations of property by persons represented to be expert appraisers who are not in fact qualified, or valuations by experts who fail to apply accepted methods of appraisal, lend a deceptive air of technical excellence to values which will not withstand impartial inquiry.

The attitudes of some issuers whose registration statements do not become effective on the twentieth day because of the necessity for amendments are a source of both amusement and resentment when we hear accusations that we are hostile toward business and seek to delay legitimate financing. Some issuers adopt the view that the quickest way to secure registration is to file with the Commission a registration statement which includes a complete record of everything ever undertaken by the company. The registration statement becomes encyclopedic. The prospectus is cluttered with minutiae. Essential facts become submerged in a mass of irrelevant detail which defies assortment. From a practical viewpoint the disclosure afforded by such a registration statement and prospectus is almost as ineffective and worthless as no disclosure. Other issuers follow the practice of filing statements couched entirely in legal terms. The registration statement and prospectus then become documents prepared for the courtroom rather than the public. Contracts are stated in their entirety, or if summarized, the summary is legalistic and hedged in terms that conceal or disguise the real effect and intention of the parties. Indenture and charter provisions governing the rights of bond and stock holders are reproduced verbatim with the effect that the layman, unskilled in analysis, is faced with such a psychological hazard that he either refuses to read, or accepts the word of the salesman. Frequently issuers will withhold important information at the time the registration statement is filed and will add it by amendment only if requested, or, if voluntarily, will defer amendment until immediately prior to the anticipated effective date. Finally, it should be noted there are a number of companies which follow the practice of construing literally every rule, regulation and registration statement form. These companies include in the registration statement only the information specifically called for. Data essential to an appraisal of the particular securities being offered, if not specifically required by rule, will be omitted. We see registrants deliberately take advantage of the absence of specific requirements for the purpose of avoiding clear disclosure, and yet we feel confident that any attempt to lay down specific rules would result in loud outcries of persecution from those who now complain of delay caused by their own inability or unwillingness to assume the responsibility of approaching registration with the same methods and same spirit employed in meeting their other business problem.

The purpose of the statute in prescribing a 20-day waiting period is to give all interested persons and the public an opportunity to make a preliminary review of the facts and circumstances relating to the new issue and to serve as a "brake" upon the consummation of new financing by dealers and underwriters who too frequently in the past have been forced into security distributions without any opportunity for adequate investigation. Amendments to the registration statement have the effect under the law of establishing a new filing date for the original registration unless the Commission consents to the filing of amendments as of the original filing date. In other words, the Commission may accelerate the effective date of the registration statement by consenting to the filing of amendments as of an earlier date in order to preserve the 20-day effective date.

The considerations which move the Commission to act favorably or unfavorably on registrants' requests for acceleration are easily described and I think in the main have been eminently fair and even liberal to the registering companies. The evident purpose of Congress was that material information should be available for public inspection for 20 days prior to the public offering. The wilful violator, who for some reason escapes a public hearing, and the grossly negligent, certainly are not entitled to acceleration. The careless registrant who files an incomplete or otherwise defective registration statement may receive favorable consideration depending on the facts of the case. Companies which evidence a desire to comply with the requirements need not fear that there will be delay. The examination of a registration statement and preparation of a letter containing our comments normally require from eight to ten days. It rarely occurs that any deficiencies cited in the letter can not be remedied within a week and this ordinarily gives us time enough in which to review the amendments and act on the registrant's request for early clearance.

The letter of deficiencies and the conference are the tools we use most frequently in our daily routine. We try to confine our comments and suggestions to points which seem material and which will protect investor and issuer alike from future difficulty under the law. These suggestions and comments in the vast majority of cases are received in the spirit in which they are given. Occasionally, I am sorry to say, we detect a spirit of resentment.

No discussion of our activities under the statute should ignore the fact that administrative agencies in general, and the Commission in particular, seldom are as unfettered in the evolution of policy and choice of conduct as our critics would have us believe. The truth of this statement strikes home when we read some of the letters sent to us by men and women who protest to the Commission that certain corporate action, contemplated or already effected, by the companies in which they have invested savings will have, in their opinion, a detrimental effect upon their position as security holders, and beseech our intercession. In such cases we can only explain the limitations upon our jurisdiction. If the disclosure provisions of the law have been met we have no power to intervene. Even in the exercise of the discretionary powers specifically granted by law, the Commission could not, if it wished, chart an arbitrary course. Administrative agencies and administrative law have their landmarks and guideposts just as have the courts. The statute establishes ultimate standards. Records of Congressional hearings and reports reveal to us and to the public the considerations which caused the adoption or rejection of various provisions in the Act from the time it was first proposed until the measure became law. These records are consulted constantly in connection with new problems which arise from time to time. They frequently point the way, even at this late date, in borderline questions of interpretation of the statutory provisions.

Our discretionary powers in the quasi-judicial aspects of our work are subject to restrictions which, even though intangible in nature, are compelling in their effect. Stop order opinions become public documents at the moment of release. They are studied by the financial services, attorneys, accountants, engineers and professional societies. These groups are articulate. They are quick to discover and as quick to condemn unsound conclusions. They compare one opinion with another and relate them to judicial decisions dealing with similar problems at law. It behooves the Commission, therefore, to move cautiously. Not only are published opinions carefully studied and compared. Central clearing houses established among the legal and accounting professions permit review of letters of deficiencies and comments by the Commission on 1933 Act cases. Commission action on acceleration is observed closely.

The Commission's enforcement ability depends to a large extent on the respect it commands from the public and from the registrant and its representatives. Respect springs from confidence and confidence is not inspired by injudicious action or arbitrary methods. The Commission's professional reputation and integrity is vital to the performance of its duty under the law and is to be guarded with great care. Registration statements are studied and reviewed by from six to ten trained technicians, depending upon the nature of the case. An internal system of administrative checks tends to insure continuity of policy.

Eventually, we will overcome many of the influences which operate to retard the registration process. Controversial points will be resolved after study with the professions. Methods of dealing with some of the disclosure problems which now trouble us will be provided for in new and more specialized forms. We hope also that the lawyers and accountants who handle the vast majority of cases will continue to lend their assistance and advice in improving and simplifying procedure. Perhaps the greatest factors in favor of the ultimate attainment of our fundamental objectives are the sensitivity to changing conditions and opinions possessed by the administrative agency, potentialities of continuity of development, and increasing technical excellence.

The execution of statutory requirements has had certain effects of which the public never learns. We know that many issuers have simplified their financial structure in anticipation of registration. Many have inaugurated modern accounting systems as a consequence of the independent audit required by the law. Others voluntarily have eliminated from their records write-ups of tangible and intangible assets in a desire to present "clean" financial statements. One large industrial company made a complete inventory of its assets in preparing its registration statement and surprisingly discovered that it owned certain plants and facilities not previously known to have been a part of the system. Undoubtedly, some financing plans have never been initiated because they could not hope to survive the publicity incident to registration; financial plans which at an earlier day could have been consummated with great speed and without the disclosure of defects fatal to investors. Placed as we are at a focal point in our economic structure, with our fingers on the pulse of security flotations, we know that the savings to investors as a consequence of our efforts far exceed the cost of administration or the cost to industry. The good we accomplish is little publicized; first, because it is not spectacular, and second, because it tends to be preventive rather than remedial in nature. On the other hand, I fear that much of the criticism we encounter receives far more publicity than it deserves, for the reason that complaints usually spring from some issuer who has felt

the impact of the restraining influences of the law and who usually is not at a loss for means of registering his dissatisfaction.

The growth of state and federal securities legislation in this country has attended one of the most astonishing social phenomena in our history. Our people have become securityholders to an extent not dreamed of fifty years ago. This dispersion of corporate securities is a healthy trend in our national life. It indicates the retention of a democratic participation in business, a participation which some day may embrace, in addition to economic risk, a more significant role in management. It does far more than merely familiarize the public with the financial pages of our papers. It will assist in bringing an everwidening social consciousness to play upon some of our difficult national problems. Your job and our job is to insure, as best we can, that the public distribution of securities is accomplished by means of fair selling practices, and to insist upon the disclosure of essential business facts. If we make it possible for the investor to discover the truth we will have performed a real public service.

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