THE SEC: RECENT DEVELOPMENTS OF INTEREST TO CORPORATE SECRETARIES

Address of

Edward N. Gadsby
Chairman
Securities and Exchange Commission
Washington, D. C.

before the
American Society of Corporate Secretaries
French Lick, Indiana
June 7, 1960

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The corporate secretary, generally speaking, is by way of being a sempiternal client of the SEC, and I suppose his interest in our work is broad enough to justify me in discussing almost any phase of our activities. From this standpoint, it might even be relevant to regale you with some of the more colorful facets of our enforcement work, such as the weird proposals of one Otis T. Carr of Baltimore who, rather ungrammatically, furnished prospective investors with plans for "a real OTC-XI electro-gravitational spacecraft like the one /he/ will pilot to the moon and return." However, I have selected some of the less romantic matters within our jurisdiction, which are perhaps more directly pertinent to your own work. I assume that flights to the moon fall outside this category.

Since the current proxy season is now drawing to its conclusion, I might begin with a short review of the problem of stockholder proposals. I do not have final figures relating to the present season, but I can say that they seem to follow the trend of the last few years. In the fiscal year ending July 1959, stockholder proposals included in management's proxy statements pursuant to our Rule 14a-8 covered a wide variety of topics. The proposal most often appearing was for cumulative voting, which was inserted by stockholders in the proxy material of 38 companies subject to the Securities Exchange Act of 1934. The next most popular shareholder request was for restrictions of one type or another on stock option plans which appeared some 24 times. Generally, these proposals requested plan amendments to provide that shares acquired pursuant to options be held for a specified period, that the purchase price be not less than the fair market value at the time the options are granted and that shares be optioned in annual installments with the right to purchase expiring as to shares not purchased during the pertinent installment period. Other popular proposals related to changing or rotating the place of the annual meeting, furnishing post-meeting reports, approval of independent accountants by stockholders, restrictions on bonus plans and reduction of management compensation.

As you know, our rules provide that management may omit any proposal which, under the laws of the issuer's domicile, is not a proper subject for action by security holders or one which relates to ordinary business operations. To take a somewhat extreme example, the Commission acquiesced during the last fiscal year to the omission from the proxy material of two automobile manufacturers a proposal that cars produced

after July 1, 1960 should be constructed so as not to operate in excess of 60 miles per hour. The same position is taken where the proposal is an attempt to promote a general social, political or racial cause, where it is motivated by personal grievance or where under certain circumstances it has met with prior stockholder rejection.

By this time, the Commission has had a good deal of experience with stockholder requests, and most of the questions which arise can be handled in a fairly routine manner. However, each season brings its surprises. For instance, I suppose that most of you have read that Mrs. Soss was successful this year in compelling U. S. Steel to insert a proposal for a secret ballot in its proxy material. This action followed after proposals had been rejected for several years which might be regarded as similar but which actually were essentially different. In this case, management's argument relied heavily on counsel's opinion that the proposal was illegal under New Jersey law. As a matter of fact, in most of these cases we are amply supplied with opinions as to the propriety or impropriety of the particular stockholder request, but, more frequently than not, counsel is unable to furnish us with a citation to controlling authority. With all due deference to the bar, the administration of this aspect of our proxy rules would quickly fall into hopeless confusion if we relied solely upon the arguments and opinions of counsel. We have found that, in most instances, it is necessary for the Commission to make an independent analysis of the proposal and of its probable legal effect under the appropriate state laws. If we are wrong in our conclusions, as we well may be, there are a number of courses which the corporation may take in order to prove it.

An interesting question arises when a stockholder proposal falls in that gray area where it is uncertain whether a court would declare that it was in conflict with or violative of some provision of the local corporate code. However, the development of corporate jurisprudence would hardly be served by the exclusion of all matters except those clearly supported by relevant statutory directive or judicial precedent. What may at the moment appear to be of doubtful legality may tomorrow be held to be clearly appropriate. Where a question of legality is raised, the Commission has adopted a policy of requiring a clear showing that the proposal will lead to illegal action before acquiescing in its omission.

Another publicized event of the proxy season was the Commission's decision with respect to the proxy material of Lionel Corporation. As you may recall, a group of investors acquired control of this company in

September 1959. The purchase of the shares was financed with funds borrowed in Hong Kong, Panama and New York, and involved a pledge of the purchased shares together with other Lionel stock loaned by members of the purchasing group.

It has been suggested that the Commission has covertly amended its proxy rules by its insistence that the intricate and somewhat exotic financial arrangements of the purchasing group should be disclosed in their solicitation for the election of directors. However, our action was based on what we conceive to be a logical interpretation of Items 5 and 6 of Schedule 14A and Rule 14a-9. The Commission concluded that the pattern of the financial arrangements which lies behind the acquisition or retention of control may be an integral part of the arrangement by which controlling parties are proposed to be elected or represented as directors, and that Rule 14a-9 requires disclosure of the full financial story in order to prevent the proxy statement from being misleading.

In discussing this matter, let me make it clear that I am speaking in general terms and without intending in any way to reflect on the purchasing group in the Lionel case or on that corporation.

In the first place, the means by which a group acquires control may cast some light on the financial standing of its members. It may indicate whether the control group possesses substantial funds which may later be available for corporate purposes, whether their resources are such that they can afford a long-range investment in the corporation apart from a rise or fall of profits in the near future or whether the purchase of control can be classified as a speculation. Secondly, such information may disclose the identity of persons who, as distinct from the control group, have an economic interest in the corporation and through that interest may possibly have some influence over its future conduct. Finally, the stockholders should be aware, where control stock is pledged, that management control is subject to all the vicissitudes of any security interest, and that the pledgees may be compelled to realize on their security in a manner which may affect the value of the corporation's stock generally and which may lead to a relatively quick change in power to control and in the nature or purposes of management.

As this information is relevant in proxy material, so also is it relevent in the Form 8-K. While, as presently drafted, the instructions to the form ought to be so interpreted, we are considering an amendment which would make specific such a requirement.

On the subject of Form 8-K, you may be curious about our proposed general revision. The Commission's delay in publishing a definitive revised form is due to the vast number of critical comments which descended on us from the bar and the industry. The chief target of criticism has been Instruction 3 to Item 2, which would require information in regard to the execution of contracts concerning mergers and acquisitions. If the letters which have been received are an accurate index, it would appear that a sizeable segment of the industry has concluded that this instruction is in some manner linked to legislation now pending in Congress under which the Department of Justice would receive prior notice of such guide-posts to corporate growth, and that the Commission is attempting to accomplish by administrative indirection what the Congress has so far declined to enact into law. I can assure you that we have not entered into some dark pact with the Justice Department to implement the antitrust laws. One reason for the proposal we have made was the fact that rumors of mergers and major acquisitions and dispositions have become a recognized vehicle by which to manipulate stock prices and, in some instances, have created a situation where insiders have been able to take advantage of the public by their securities transactions in a gossip-stimulated market. However, it was considered that whenever negotiations of this type have once taken definite form, they become a matter of general shareholder interest and their prompt disclosure is in the public interest as a matter of principle, wholly aside from any manipulative aspects of, or resultant fluctuations in the price of the company's stock.

Objections to Instruction 3 were also made on a number of other grounds. It was thus stated that most merger agreements are in the nature of "hunting licenses," that is, that they are informal agreements to explore the advisability of merger or purchase and that such premature disclosure would tend to create an environment of uncertainty in which valuable employees might leave the company, customers might seek other connections and shareholders might be prejudiced.

Item 1(c) of the proposed amendments to Form 8-K also drew considerable critical fire. This item requires detailed information as to the pledge of control stock in the registrant or any of its affiliates. Among other things, it was claimed that this new item would require a registrant to supply information concerning transactions by persons over whom it exercises no control. This purported difficulty was illustrated by the plight of a domestic

registrant having a foreign parent with subsidiaries in various parts of the world, where the registrant may not be in position to know of transactions by its foreign affiliates or to require such disclosures by them. These criticisms, along with many others, are receiving the Commission's study and respectful consideration.

The draftsmanship of our various forms and regulations is subject not only to the rigors of preliminary industry criticism but to the less overt analysis of those who seek to circumvent them. As an example, I cite Alexander Guterma as one who gave us a lesson in draftsmanship with respect to what has since received the colorful appellation of the "Guterma Gap." This hiatus was created or at least revealed when the trial court dismissed several counts against Guterma based on failure to file Form 8-K reports. As you know, the Form 8-K must be filed within 10 days after the close of each month during which certain events occur, including the disposition of a significant amount of assets otherwise than in the ordinary course of business. An acquisition or disposition is deemed to involve a significant amount of assets if the net book value thereof exceeds 15% of the registrant's total assets or if they were sold for a price in excess of such percentage. By Instruction 3 to Item 2, such information must be given "as to each transaction or series of related transactions of the size indicated."

Mr. Guterma eyed incredulously our assertion that a filing was required whenever a series of related transactions, regarded in the aggregate, reached the 15% mark. As he saw it, we may have meant that, but we failed to say it. He admitted that the instruction called for information on a "series of related transactions," but maintained that a report was required only if the entire series occurred within a single month. To our chagrin, the Court apparently accepted the argument that we had not spelled out what we intended, at least with sufficient precision for a criminal prosecution.

The Commission does not intend to revise its forms in order to eliminate every possibility of an ingenious attempt at evasion. The result would be a jungle of administrative jargon which would unreasonably complicate the work of an honest man. Our forms are drafted for the daily use of men of good will and we are anxious to avoid undue complexity. On the other hand, where it is necessary to do so, we intend to rewrite our various instructions so as to avoid such problems as the "Guterma Gap." In the interim, however, I recommend against reliance upon this particular ruling in your day-to-day work.

In connection with these various reporting requirements, I might remind you that the Commission's still pending legislative program contains a provision which would impose a per diem forfeiture for the failure to file certain reports under the Securities Exchange Act of 1934, to be collected by the Commission in a civil suit. This measure would, I think, operate as an efficient supplement to our battery of enforcement techniques. A glance at the SEC Monthly Official Summary of Securities Transactions shows that, in spite of the fact that the statute has been on the books for twenty-five years and has certainly been given adequate publicity, there is still an occasional officer, director or 10% stockholder who is inexcusably late in filing his Section 16 report. The only penalty at present for such delinquency seems to be a possible waiver of the statute of limitations, which is cold comfort to an observer who is relying on the law to compel notice of important shifts in corporate affairs.

Under the 1934 Act, as now in effect, the Commission must in most cases rely on Section 32(a) which provides general criminal sanctions for willful violations. The only specific civil provision relating to delayed filings is contained in Section 32(b), which imposes a $100 a day forfeiture, limited to the failure to file reports required pursuant to an undertaking furnished under Section 15(d) by certain non-listed companies.

As originally drafted, our proposal contemplated a penalty of $100 a day for failure to file any information or reports whatsoever required by the 1934 Act or our rules thereunder, which penalty would not have been in lieu of possible criminal sanctions. However, opposition to this proposal developed at the Congressional hearings on the grounds that the Commission should specify the particular documents to which the penalty was to apply, that a dollar limit should be placed on the total forfeiture and that the penalty should be in lieu of and not in addition to a criminal sanction. The most far-reaching suggestion was that the penalty should be restricted to cases of intentional failures to file or that the Commission should be required to notify or make a demand on the persons responsible for the delinquency prior to the imposition of penalties.

The suggestion that the penalty be restricted to intentional delinquencies may at first blush appear to be adequately reasonable. Further consideration, however, makes it clear that such a modification would place upon us an almost insuperable administrative burden. Presumably it would mean that the Commission would have to show that the delinquency was the

result of a calculated decision not to file the required reports. In practical effect, the result of such a modification would be similar to that of the proposal which would require notification of delinquency. In other words, the Commission would be compelled to rely upon delinquency after notification by registered mail in order to justify sanctions for failure to file. Such a requirement of notification would eviscerate our enforcement activities in this direction, since the penalty provision would cover filings the necessity for which in very many, if not most, cases is dependent on events wholly unknown to us. In fact, the whole point of the filing requirement is to bring such occurrences to our attention and to the attention of the public. This is true, for instance, of Section 16 reports. It is also true of Form 8-K.

Having this in mind, the Commission quite understandably failed to support these particular suggestions. On the other hand, after considerable study and thought, we decided that we should modify our proposals in a number of respects. In the first place, we felt that the forfeiture provision should be limited to a failure to file reports under Sections 13 and 16 of the Act, that is, periodic reports of issuers and ownership reports by insiders. Secondly, we decided that we should support the suggestion that recovery of the forfeiture should operate as a bar to criminal prosecution. Finally, in the case of Section 16 reports, we concluded that the penalty should be limited to such sum as might be determined by a Federal district court but not to exceed $50 per day.

This last change was designed to assuage those who were urging that the Commission be compelled to demonstrate an intentional failure to file since, as a practical matter, it exorcises the specter which apparently haunted some members of the industry of the resultant bankruptcy of a well-meaning but uninformed or forgetful corporate officer. I admit that the future prospects of a corporate officer returning from an extensive summer vacation to find that he had inadvertently left his Section 16(a) report in a desk drawer would be something less than roseate. Accordingly, the amount of any penalty for a failure to file such a report is now left to judicial discretion.

For what we consider to be good reason, this same approach was not adopted with respect to reports by issuers. In the first place, it seems desirable to preserve a consistency between the new provision and the old provision with respect to filings pursuant to Section 15(d) undertakings. Moreover, we feel that excuses which might mitigate the offense in the

case of individuals should not be given the same weight in the case of issuing corporations which presumably do not take extended vacations. Incidentally, I might note that even if there is no judicial discretion with respect to such corporate delinquencies, there is at least an administrative discretion. I suppose that the Commission might well countenance trivial or apparently accidental delays. I would hesitate to face a Federal court with a demand for assessment of penalties for a week-end delinquency. It is the prolonged, intentional or negligent delay which would cause us to take action, and for such delay there would appear to be no excuse. The best case in point is, perhaps, the East Boston case, involving Mr. Goldfine, with which you are no doubt familiar. In cases of exigency, moreover, the corporation may properly request that the Commission grant it an extension of time within which to file a report, though I would certainly not recommend application on the grounds of secretarial fatigue. However, where good cause is shown, I am sure that you will meet with a sympathetic reception.

Senator Harrison Williams, Jr., Chairman of the Subcommittee on Securities of the Senate Committee on Banking and Currency, has recently announced that he intends to press for enactment of our legislative program and has specifically indicated that the modified provision with respect to penalties appears to offer no problems. The Commission thus has reason to hope that this addition to its enforcement weapons will be available in the near future.

You have recently received the Commission's final version of Rule 16b-3. As you know, the purpose of the revision is to remove the acquisition of stock under a stock option plan from the present exemption from Section 16(b). This amendment was adopted as a matter of policy following judicial criticism of the rule in its prior form. In this connection, let me announce that we still believe that the earlier version of the rule was within our power and thus we still take issue with the dicta in the case of Greene v. Dietz and the holding in the case of Perlman v. Timberlake. On the other hand, we have always had some reservations about the desirability of exempting stock acquired upon the exercise of options. The amendment of the rule was prompted not only by these reservations but also by the doubtful propriety of leaving a provision on our books after it had been questioned by such respectable authority. Certainly, retention of the rule in the uncertain legal climate resulting from these decisions might serve seriously to mislead those who are unfamiliar with the judicial background.

As presently drafted, Rule 16b-3 affords an exemption to stock acquired pursuant to a stock bonus, profit sharing, retirement, incentive, thrift, savings or similar plans. It also extends an exemption to the acquisition of a restricted stock option but not for the acquisition of stock on its exercise. Whatever the nature of the plan, it must be approved by the stockholders and, if it provides for discretion as to the selection of the recipients of benefits, such discretion must rest in the hands of disinterested officers.

Along this same general line, I think I should mention the problem of the applicability of our Form S-8 under the 1933 Act. As you know, under certain circumstances, Form S-8 may be used for registration of equity securities offered pursuant to an unincorporated stock purchase, savings or other similar plan, but it contains no provision for use in connection with stock options. Nevertheless, as I am sure you are aware, the Commission has raised no objection where this form is so used, particularly in connection with the usual stock option plan, provided that the offering is not made to a relatively small group of officers or employees who may later be expected to make a public distribution of the stock acquired thereunder. A revision of Form S-8 is under consideration which will specifically indicate its availability to option plans of this character and which will, at the same time, reflect our experience with the form since its adoption.

There are some other problems under the 1933 Act which are of continuing interest both to you and the Commission. For instance, the definition of "underwriter" in Section 2(11) of the Act justifies the attention not only of the investment banking fraternity but also of issuers who, in the words of a recent court decision, must deal "at their peril" with persons who may fall within the ambit of the statutory language. This is true because, where it can be shown that an issuer intended a public distribution, the Commission will look through any camouflage to the substance of the transaction. Where it cannot be shown that the issuer intended a distribution of its stock, a determination of whether or not the Act has been violated may depend on a finding as to whether those who initially received the stock from the issuer received it with a view to its distribution. As evidence of the intent of these parties, the Commission turns to the facts surrounding the purchase and sales, and particularly the timing of the latter.

Each year we receive a number of requests for no-action letters in this connection. Staff personnel, other Commissioners and I have tried to place this problem before the industry from time to time. This may

not be the suitable time, place or audience for a further analysis of the intricacies of private placements, investment intent and change of circumstances. Generally speaking, the Commission has tried to temper the administration of the securities laws with understanding and to keep in mind that the vicissitudes of life are many and various. On the other hand, we have had to recognize that some arguable change of circumstances is fairly easy to adduce in almost any case. In dealing with these problems, therefore, the Commission has scrutinized the context in which the securities were issued for some objective assurance that they were not acquired simply as a "good deal" and as part of a portfolio of frankly speculative securities subject to the normal vagaries which ought to be expected when such an investment is made.

The problems of investment intent revolving around Section 2(11) are obviously not limited to placements with officers and promoters. An example is found in the private placement of equity securities with syndicates of individuals and investment bankers or their affiliates. It is usually represented that the proposed placement will be made to a limited group of wealthy and sophisticated investors, often including the banking firm or its partners, and that this group stands in no need of the protection of the registration requirements. In many cases this may be true, although the securities laws make no general exemption on the ground of the wealth of the investor. On the other hand, these cases do pose the problem of whether or not the syndicate in question should be regarded as an underwriting group and whether or not registration should be required when the group disposes of its shares to the public. It is quite possible to conclude that these syndicates perform the same underwriting function as do Small Business Investment Companies, "development banks" and "venture capital" companies. That is, they supply capital which is unavailable from conventional sources with the intention of marketing the securities when the business is seasoned, realizing their profit and releasing cash for further investment. They are very often operating in a tax bracket as the result of which they are primarily interested in capital gains and not in ordinary income. Such gains can, of course, be realized only by selling the securities. It does not seem to me that we are being too ingenuous when we suspect that they had a sale in mind from the beginning, and that they are properly classified as underwriters.

Lest I be accused of overlooking a very important and extremely sensitive question in this area, I may say that we are currently much concerned with the effect under the 1933 Act of the distribution of stock

following foreclosure of a pledge in transactions such as I have described in discussing the reporting requirements under the proposed Form 8-K and the proxy rules. In this connection, I commend for your thoughtful perusal the opinion of the Circuit Court for the Second Circuit handed down as recently as May 20, last, in the matter of SEC v. Guild Films. When read in the context of the line of cases to which it refers, this opinion carries implications to the corporate issuer of securities which, I believe, should give it very substantial pause.

One final matter which might warrant discussion with you is the Commission's situation with respect to the processing of registration statements. I doubt that it comes as news to you that the Commission is confronted with an immensely serious problem in this area. During fiscal 1958, there were filed with us 913 registration statements, which work, together with certain other matters, was handled by 117 employees of the Division of Corporation Finance. In the fiscal year ending June 30, 1959, there were 1,226 such filings, an increase of over 34%, which were handled by 122 employees, an increase of about four per cent. In the current fiscal year, which ends on June 30th, we have had an authorized strength in the Branches of Corporate Analysis and Examination of the Division of Corporation Finance of 129 employees, representing about a five per cent increase. It now appears that the volume of filings in fiscal 1960 will surpass that in fiscal 1959 and that, as of the end of this month, some 1,600 registration statements will have been filed with us, representing an increase in workload of 30.5 per cent. As of the present time, we are handling in this field an increase since 1958 of 75.2 per cent in workload with about ten per cent more employees. A further unpleasant aspect of this story is that the volume of filings shows little sign of substantial decrease and that we anticipate that at least the same number of statements will be filed with us in the forthcoming fiscal year. Since we will start the year with an out-size backlog, we expect that during such period we will have to process a total of some 1,900 statements.

The gravity of our registration problem is not completely described in terms of the number of filings. There were 809 registrations which became effective in fiscal 1958, aggregating about $16.5 billion in value or an average per issue of $20,400,000. The 1,055 issues effective in fiscal 1959 represented $15.657 billion, or an average per issue of under $15 million. In fiscal 1958, the number of issues of companies which had not previously filed registration statements was 28% of the total. In 1959, the

ratio reached 39%. By now the number of issues filed with us by new customers is in excess of 50% of the total.

These are extremely significant figures to us from the standpoint of administration. A registration statement filed by an established company with a long history of financing will ordinarily offer us little difficulty. Its officers and counsel know precisely what information our regulations and practices call for, and our staff is familiar with the company's activities and structure. Thus, such an issue having a value of $50 million may require only a comparatively brief amount of staff time. At the same time, an offering of $500,000 in stock of a small manufacturing concern may cause us real administrative agony. Broadly speaking, to clear the statement of a new issuer requires about 50% more time than one filed by an old customer.

Despite our vigorous and even desperate efforts, it is becoming progressively more difficult to determine the time within which a given statement will become effective and just when the issuer may expect to be able to reach the market. The median time within which a registration statement is processed has increased from 24 days in 1958 to 40 days at the present time. Initial letters of comment, which formerly went out in about 14 days, now take an average of about 26 days.

I can give you absolutely no assurance whether, when or to what extent the situation will be remedied. At the best, given the most sympathetic treatment by the Congress, we will be able to add 47 positions to our Division of Corporation Finance and would then hope to reduce from 40 days to 35 days the median elapsed time between filing and effectiveness. If we are unsuccessful in obtaining appropriations in the amounts which we have requested, you can expect that such median time will begin to soar. You may thus have occasion to look back on this last year as the golden period of easy registration.

One of our problems, of course, is that we simply cannot transfer personnel from our other divisions and our regional offices into the Division of Corporation Finance. Enforcement work is a vital part of our work, and the Commission is confronted with a constantly increasing number of shady transactions in the securities markets. On April 30, 1960, there were 1,033 investigations pending involving suspected violations. This backlog has reached dangerous proportions, and we are approaching the embarrassing

point where effective treatment of every serious violation may no longer be possible. We will need additional men in our enforcement program in order to alleviate this situation, and a fortiori cannot afford to weaken this branch.

I dislike to conclude this discussion on this somber note. It might, after all, have been more enjoyable for you had I gone on to discuss Otis T. Carr, his OTC-X1 electro-gravitational spacecraft, and his projected flight to the moon. Let me again assure you of my appreciation of your forebearance in this review of our mutual problems, and of my personal expectation that, with the assistance of such meetings as this, we will eventually be able to solve them to our mutual satisfaction, and that the interests of the great corporations which you represent and the interests of the investors which we are charged to protect will be made so compatible as to make it certain that our capital markets will continue to expand in a sane and wholesome manner.

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