

THE FREAR BILL

An Address by

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It is a welcome opportunity for a Commissioner of the SEC to talk to this Society. So many times in the past the Commission has had occasion to look to you for advice and assistance in connection with its regulations, procedures, and statutory revision programs, that it has come to regard you as the technicians of the corporate business world. Thus, I feel that I can talk fruitfully with you -- and by the same token I feel that I am put on my mettle.

I realize that among your predominant interests, so far as the SEC is concerned, are its current regulations, particularly those that bear on your day-to-day business, such as the reporting requirements, and the rules governing the solicitation of proxies. However, I decided that I would not confine myself to the somewhat narrow subject of techniques of procedure, but would range in a broader field.

I propose to discuss the Frear Bill with you. This is the bill which would extend to large and publicly owned unlisted companies certain provisions of the Securities Exchange Act of 1934, which are now applicable only to listed companies. You may have heard it referred to as General or Universal Registration, or perhaps as a proposal to safeguard investors in unregistered securities.

It may be that some of you, as individuals, are not inclined to look upon this topic as one of primary interest, because your company is already subject to the provisions of the Exchange Act. But I submit that as you are a closely knit group of technicians having a community of interest, this is just the sort of thing that should receive your composite attention.

There are various approaches to the subject. I could treat of the merits of the proposal, and press upon you the arguments for its adoption. Or I could take the informative approach -- outline how it came into being, and what is intended to be accomplished. I propose to discuss both aspects, with much less attention to the merits. My thought is that your primary interest lies in just how the bill, if passed, will have its impact upon you, and just how it will affect you in the performance of your everyday duties.

As a starting point, I'd like to sketch the development of our federal securities legislation, with particular reference to the historical meaning of this proposal. This may serve to bring the problem into sharper focus.

As you know, that legislation was not conceived and enacted as a cohesive whole. The building of the regulatory pattern began in 1933, and proceeded by stages up into 1940. The 1933 Act, the first in the series of federal securities legislation, is aimed at protecting investors in the flotation of new securities issues. In 1934 the Exchange Act was passed, to provide protection with respect to securities publicly distributed, and being traded in interstate commerce. That Act, as to listed securities, provided the investor with certain additional safeguards, namely the reporting requirements, and the provisions governing the solicitation of proxies and insider-trading, which are embodied in Sections 12, 13, 14 and 16. I'll summarize those sections briefly:

Under the first two, 12 and 13, a company having securities listed on an exchange is required to file periodic public reports of its financial condition, earnings, capital structure, and similar information essential to

a determination concerning the merits of its securities. Section 14 requires that persons soliciting proxies, consents, or authorizations from holders of registered securities must fully disclose the purpose for which the proxies are sought, and security holders not connected with the management must be given an adequate opportunity to present their views to the other security holders. Section 16 requires that publicity be given to the holdings and tradings of officers, directors and principal stockholders in the equity securities of their own company, if that company has any equity security registered on an exchange; profits obtained by such insiders in transactions in the securities of their company within any six-month period are recoverable by the company and short selling in such stocks by these corporate insiders is prohibited.

The history of the legislation clearly shows that Congress intended that the pattern of regulation, when completed, should have an application to securities traded over the counter comparable to that in regard to registered securities. However, at the time of the adoption of the '34 Act, little was known about the over-the-counter market, and so it was thought better to leave the matter for further study. Consequently, only very general provisions, set forth in Section 15 of the Act, were enacted with respect to brokers and dealers trading in the over-the-counter market.

In 1936 the Exchange Act was amended, in partial fulfillment of that original purpose, to require the filing of periodic reports by registrants under the '33 Act, provided the aggregate offering price of the securities which are registered, plus the value of all other outstanding securities of the same class computed at the offering price, amounts to \$2,000,000 or more.

The Act was again amended, in 1938, by broadening the Commission's rule-making power with respect to brokers and dealers operating in the over-the-counter markets. At the time, Congress reviewed the history of the legislation and reaffirmed its intention of working out comparable protections governing the two types of markets, as originally contemplated.

In the meantime, the Public Utility Holding Company Act of 1935 was adopted. Its purpose was to solve the problems peculiar to the utility industry, but Congress took the occasion to make applicable to the securities of holding companies and their subsidiaries, whether or not registered on exchanges, provisions similar to those contained in Sections 12, 13, 14 and 16 of the Exchange Act. In 1940 the Investment Company Act was passed, and like the Holding Company Act, extended to holders of securities of registered investment companies benefits similar to those extended by these sections of the Exchange Act, again without regard to registration on exchanges.

And so, as a result of this fragmentary development, the reporting, proxy and insider-trading provisions apply to certain companies, but not to others, notwithstanding the fact that a great many of the latter are of comparable size, are also issuers of widely distributed securities, and are engaged in similar types of business and financing. And in between these two categories is the class of companies which are subject to the reporting but not to the other requirements of that Act.

All of the regulations, reporting, proxy solicitation, and insider trading, apply only to companies which have registered their securities on an exchange under the '34 Act, or are subject to the Holding Company Act or

the Investment Company Act. Only the reporting requirements are applicable to certain companies outside of these three categories, but which have registered securities under the '33 Act since 1936.

And so we have unequal treatment under the law. Companies which should be classed together are not dealt with uniformly, nor does the coverage of the regulations in question bear any logical relation to the need of the stockholder for current financial information about his company, or adequate information as to what is going to transpire at a stockholders' meeting for which his proxy is being solicited; or for protection against insiders trading on inside information. There is no reason for the existence of this disparity of treatment. It goes without saying that most of the companies which are outside of the operation of the regulations in question are not guilty of the abuses which they were designed to prevent. It is true that a few are. But even apart from the presence or likelihood of abuses, there should be no discrimination among issuers or among investors, where no just basis exists for such discrimination.

In 1946, the Commission formally addressed itself to the problem in a report submitted to Congress, in which it proposed that the statute be amended to cure this deficiency. President Truman endorsed the proposal. The proposal was widely -- and for that matter heatedly -- discussed. The Commission, however, did not press for immediate legislative action because it was then engaged in a full scale study of various statutory revision problems and decided to hold this matter in abeyance until a comprehensive program could be drawn up. That subsequently proved impracticable, and so the Commission has asked for separate consideration of the proposal -- and it is that which the Frear Bill embodies.

To turn now to the details of the proposal. The bill would add a new subsection (g) to Section 12 of the '34 Act, requiring companies of substantial size which are engaged in interstate commerce or in businesses affecting interstate commerce, or the securities of which are regularly traded in interstate commerce, to register with the Commission such of their securities as are not registered for trading on an exchange. Such companies would file the periodic reports required by the '34 Act, and their securities would be subject to the proxy and insider-trading provisions, whether or not a registration statement has been filed.

It is only to issuers having at least \$3,000,000 in assets and at least 300 security holders that the bill would apply. Thus, it is not intended to reach small business. The Commission would be given authority to exempt companies the securities of which are held within a single state, even though such companies are engaged in interstate commerce. Other exemptions, not too pertinent here, are provided. For example, banks would be specifically exempted, and so too would government securities, including those issued or guaranteed by states and political subdivisions thereof. Other types of securities which would be exempt are those issued by charitable and other such organizations.

It may be noted that the bill will in effect extend the coverage of the proxy and insider-trading provisions. Under Section 14, as it now stands, the proxy rules are applicable only to solicitations of securities registered on the exchanges; they do not apply to unregistered securities, if any, of the same issuer. The result of the proposed amendment would be to make the

rules applicable to all the securities of companies within the coverage of the bill.

As for the insider-trading rules, 10% holders of a listed equity security are subject to these rules with respect to all the equity securities of the company; but 10% holders of unlisted equities of listed companies are generally not subject thereto. The effect of the amendment would be to bring all the equity securities of covered companies within the scope of those rules.

A further provision of the bill is that the new subsection, to be added to Section 12, shall remain applicable to the securities of an issuer which has filed a registration statement until the Commission, upon a finding that the issuer is no longer subject thereto, cancels the registration. In entering an order of cancellation the Commission may impose such terms and conditions as it may deem necessary for the protection of investors.

The proposed amendment would also effect, in Section 12 (f) of the '34 Act, certain changes which might be of interest to you. That is the section which deals with unlisted trading. As it stands now, it permits the extension of unlisted trading privileges to a security which, in general, has the same characteristics, so far as information and other protective features are concerned, as securities listed and registered on exchanges, provided that there is sufficient public distribution, and sufficient public trading in the security, to make unlisted trading on the exchange appropriate. The bill would subject all companies within its coverage to the information and other protective features, and thus would permit unlisted trading, provided, of course, that the distribution and trading requirements were satisfied. However, it is not contemplated that securities may be admitted to unlisted trading against the wishes of an issuer, unless there are compelling considerations of public interest which demand exchange trading. Thus, Section 12 (f) would be amended to provide that an issuer may be a party to any application by an exchange in the type of case just noted; and that the application may not be granted against the issuer's objections, unless the Commission finds that the granting of the application is necessary or appropriate in the public interest notwithstanding any showing of detriment to the issuer. Under another provision, detriment to the issuer would become an additional ground for the termination of unlisted trading.

This then is, in substance, the situation as it now exists, and as it will exist if this proposed amendment is enacted into law. The number of companies which will be affected in one way or the other is, I would say, somewhere in the neighborhood of 1700. Actual figures are not yet available.

Those of you whose companies have not heretofore been subject to the reporting requirements should be particularly interested in them, because they will have a greater impact upon your work than will any of the other so-called protective provisions. The reports which must be filed consist of an annual report, one showing current changes, and a quarterly sales report.

To elaborate on this for a moment. The annual report is filed on what we call Form 10-K, within 120 days of the close of the corporation's fiscal year. It calls for certain non-financial information, such as that pertaining to the securities which the company has registered on an exchange,

parents and subsidiaries of the registrant, materially important changes in the business during the fiscal year which were not previously reported, names of officers and directors, principal holders of equity securities, and so on. In addition, the annual report must include certified financials.

The report showing current changes is filed within 10 days after the close of the calendar month in which certain material events, specified in Form 8-K, take place; and the quarterly sales report, on Form 9-K -- which calls for quarterly gross sales -- is filed within 45 days of the close of the quarter. All of the information called for should be easily accessible from the type of records which companies of any size must keep today.

The requirement that the financials be certified may be an additional obligation upon some companies. But probably most of the companies to be affected already have their financial reports certified by public accountants. In the 1946 report it was estimated that about 85% of the companies to be newly affected by the reporting requirements already have their reports so certified. I don't have the up-to-date figure, but I think it is safe to say that the percentage is at least that now.

The disclosure requirements of the proxy rules can ordinarily be satisfied, without effort and expense, by a simple factual statement. Of course, as to some special items of business, such as mergers or consolidations, or action involving a modification of the status and rights of an outstanding class of securities, the information required to be furnished to security holders is such that disclosure involves some greater effort. But a great number of companies have been living with these rules for some years and have not found them unduly burdensome.

The insider-trading section of the Act is not, strictly speaking, a corporate requirement. Subsection (a) requires officers, directors and ten percent stockholders to file with the SEC statements of their holdings and current reports on changes in such holdings. Subsection (b) allows the corporation to recover any profits such persons may realize on short-swing transactions in stocks of their own company, and subsection (c) prohibits short selling of such stocks by those persons. Obviously, no administrative burdens are thereby imposed upon the company.

So far I have attempted to explore the subject generally to the end of pointing out what the effects of the bill, if enacted, will be from your point of view. Just to round out my talk a little more, there are a few thoughts I'd like to leave with you.

Disclosure is important to the investor because it enables him to buy and sell on an informed rather than a blind basis. So too, is disclosure important to business. We all concede that advertising is vital to the selling of products. It seems to me that it is important for an organization that is interested in its continuity and growth to promote and sell itself to the investing public, and it's interesting to note that over the years business has been practicing voluntary disclosure more and more. This thought impressed itself upon me just the other day when I received from a large company literature which fully reveals the state of its affairs to the world. A security analyst wouldn't ask for more comprehensive and detailed information. The material was not prepared and disseminated in connection with an offering of securities, but was offered to the public at large on a purely voluntary basis -- obviously with the intent of keeping the company in the public financial mind. All of you know of many instances of this sort of thing.

An incidental effect of the reporting requirements, but none the less one entitled to some consideration, is that they tend to provide a continuing stimulus to the maintenance of adequate methods of internal control. It has been the experience of many companies that internal control methods -- for example, supervision over the system of accounts -- tend to be relaxed in the absence of some compelling obligation to keep a careful check upon them. Certainly, the reporting requirements provide such a motive.

I suggest also that you consider company-stockholder relations in this context. To my mind, good relations can be fostered in no better way than by letting the stockholder in on what is going on, and by giving him an adequate chance to exercise the voice in management for which he bargained. I know that management sometimes feels, and with some justification, that a certain type of stockholder is too prone to be irresponsible in the exercise of that right. As to this, I suggest that the proxy rules are a boon, in that they do afford a ready and effective legal control over insurgent stockholders who might be inclined to give vent to irresponsible and false statements. Where the proxy rules are not applicable, management does not have such a ready means of protecting itself when a proxy fight develops.

There are many other aspects of this subject, particularly as to the merits of the proposal, which would lend themselves to interesting and controversial discussion. I have not attempted to cover this phase, not just because of time limitations, but chiefly because I felt that you might be more interested in an exposition of the subject, rather than a review of the arguments that can be advanced for the adoption of the proposal.

By way of conclusion, there is nothing revolutionary about the Frear Bill. It is not a new and untried experiment nor does it promulgate any new and untested principles. I like to think of the bill as the last tile in a mosaic whose pattern has been already defined by the tiles already set. The Exchange Act has been law for some 15 years now, and well over 2,000 companies are at present subject to its provisions. They live with it, and with the S.E.C., in a reasonable degree of harmony. Then too, there is considerable that the Commission, under its rule-making powers, can do to ease the burden of complying with the various requirements of the Acts it administers. I think it's fair to say that over the years great progress has been made in that direction. I know that I can speak for the Commission in saying that it realizes that there is still room for much improvement, and that it will continue to work to that end.