THE CORPORATE SECURITIES MARKETS

Address of

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It is a great pleasure for me as Chairman of the United States Securities and Exchange Commission to address this banquet of the 42nd Annual Convention of the Association of School Business Officials of the United States and Canada. Your invitation to speak to your Association of School Business Officials carries with it a recognition of the importance of the securities markets of the country to our public school system. The financing of our public schools by the sale of bonds in the country's capital markets has made it possible for a very large portion of all of our public schools to be built. The ability of the public schools to raise funds for construction of the very large number of new school buildings and facilities, which will be needed in the years immediately ahead to provide for our greatly increased school population, to a great extent will depend upon the willingness of American investors through the medium of our capital markets to purchase and hold school obligations. Therefore, the successful operation of the capital markets is of vital importance to you as school business officials.

I have taken as a title for what I am going to say to you "The Corporate Securities Markets." I have done this because the jurisdiction of the Securities and Exchange Commission is principally in the field of corporate securities. As you all know, Federal, state and municipal obligations are exempt from the Federal securities laws, except in those rare cases where there appears some fraudulent transaction in such securities, and thus our Commission has no jurisdiction over them. However, the capital markets in the broad sense involve the primary issuance and sale of Government, state and municipal obligations, including those of the school systems, corporate securities of all kinds, that is, stocks, debentures and bonds, as well as the secondary trading markets for outstanding securities, and it is to a considerable extent because of the work of the Securities and Exchange Commission in administering the Federal securities laws with respect to corporate securities that our capital markets today are in their present healthy condition.

I will, therefore, describe to you some of the principal activities of the Securities and Exchange Commission and their impact on the capital markets for corporate securities, and after that I will make some observations about the financing of schools and the competition that schools will be in to attract to their bonds and other obligations the savings of the American people.

Let me commence with the discussion of the work of the Commission and its impact on the corporate capital markets.

The Securities and Exchange Commission, commonly known as the SEC, is sometimes thought of as a Federal agency with an alphabetical name, hidden away somewhere in one of the government buildings in Washington, which has something to do with high finance but has little or no impact upon our daily personal business affairs, and least of all on the operation of our public schools. Actually, the work of the SEC reaches you very directly.

In the United States, unlike most other nations, corporate wealth is very broadly held. Our great industrial production and distribution facilities are actually owned by the masses of our people through their direct or indirect ownership of securities of many business corporations, ranging in size from the few industrial giants to the hundreds of thousands of small enterprises. It is estimated that there are 8-1/2 million individual citizens who directly own corporate stocks, an increase of several million in recent years. Many more millions of people indirectly through savings bank accounts, life insurance policies, household and car insurance, pension and welfare funds and through the ownership of mutual fund shares have participated to a very important degree in making our country the greatest nation of small security holders in the world. Through the operation of our capital markets, which are the largest in the world, this broad ownership of American industry by our people has become freely transferable. Investors are willing to place their savings at the disposal of industry, and thus the capital so essential to our country's economic progress is provided.

In planning for the financing of new plants and facilities required by the expanding demands of their customers, business establishments have an important advantage which schools do not have. Business corporations have funds available over and above what is required to pay operating expenses and taxes and meet the interest, dividend and principal payments on their securities. These funds come from the cash accruing from depreciation, depletion and other non-cash charges, and earnings retained in the business and not paid out to stockholders. They constitute "internal funds", and are sufficient to cover a substantial part of the cost of plant expansion. Many of our large industrial companies have been able to finance almost all of their plant additions and improvements with funds generated internally.

But our school districts, the public schools located within their borders and the Boards of Education which operate the schools have no undistributed earnings and no other internal sources of cash with which to pay for capital additions. Their construction expenditures must be paid for directly out of current tax revenues and with the proceeds from the sale of school district or other state or municipal bonds.

During the decade following World War I, $50 billion of new corporate securities were sold to investors in the United States. By the middle nineteen thirties half of these securities had proved worthless. The investing public were the victims of many abuses. Misrepresentation and fraud in the sale of securities to the public were widespread and our securities markets were often rigged and manipulated by "pools" and other unscrupulous insiders who freely took advantage of the unsuspecting public investor.

As a result of these tragic losses in the values of their security holdings, people lost confidence in the capital markets as a place to invest their savings. Not only did the issuance of new corporate securities and trading in outstanding securities come to almost a complete halt, but this loss of confidence was also felt in the markets for municipal securities. In fact, some of our municipalities found it necessary to seek relief from their debt burdens because of severe losses of tax revenues.

Into this capital market virtually struggling for survival came the Securities and Exchange Commission in 1934. The Commission was created by the Congress to provide against abuses of the public investor by requiring that there be given to the public full business and financial information about corporations which were selling new issues of their securities in interstate commerce and other securities which were traded on our stock exchanges. The Commission was also empowered to prohibit and punish artificial manipulation of security prices and fraud with respect to all securities sold in interstate commerce, whether traded on stock exchanges or in the so-called "over-the-counter" market. The anti-fraud provisions of the Federal securities laws also extend to securities sold by fraudulent means within a single state.

Additional legislation later enacted provided for the complete reorganization and overhauling of the complex holding company systems controlling our electric and gas utilities, for the registration of investment advisers, and for the regulation of the activities of investment companies, the "open-end" type of which has grown tremendously since that time and is commonly known today as the "mutual fund", to prevent overreaching by persons affiliated with investment companies, and assure that these companies will follow the investment policies set out in their sales literature and that they will not employ corporate names having plenty of sales appeal but which deceive investors as to the real character of the company's investments.

The Commission is a bipartisan agency, with five commissioners, no more than three of whom may belong to the same political party, each having a five-year legal term of office. With its headquarters office in Washington and field offices in fourteen cities having important capital markets, and with a staff of 800 highly skilled personnel, the Commission is in fact an influence all over the country where securities are sold and traded.

The first, and certainly one of the best known of Federal securities laws, is the Securities Act of 1933, often called the "Truth in Securities" Act. This law requires that corporations desiring to sell their securities to the public disclose the essential business and financial facts which investors should have to make an informed decision whether to buy the security. Civil penalties are imposed for misrepresentation and there are criminal penalties for sale of securities by fraud or otherwise in violation of the law.

For the purpose of complying with this law, corporations proposing to sell securities to the public are required to file a registration statement with the Commission. This contains a copy of the offering prospectus, which is intended to be given to investors to provide them with the necessary information concerning the securities, and considerable additional information which is also available to the public. The statement is examined by the staff of the Commission to determine as nearly as can be ascertained from the face of the document if adequate information describing the securities is being furnished. In addition to the power of the Commission to issue a stop order to prevent the sale of securities the disclosures about which are inadequate, and in addition to the criminal penalties for fraud, the law imposes drastic civil liabilities, not only on the corporation itself, but on its officers, directors, controlling stockholders, certifying accountants and others giving expert opinions, such as engineers and geologists, for material misstatements and omissions in the registration papers filed with the Commission. While it is manifestly impossible for our expert analysts to turn up all deficiencies of essential information as they examine these statements, the process has a wholesome effect in forcing the corporation to face up to the responsibility which the law places on it to state all material required facts, not leaving out material facts and avoiding misrepresentation and fraud.

The public could take considerably greater advantage of the information required to be stated in the offering prospectus than it does. This is so because the law requires that the offering prospectus describing the new issues of securities contain a good deal of technical information the careful reading of which has been pretty much limited to the financial community. This does not mean, of course, that the prospectus is not an effective means of getting the information to the public. Actually, it is an extremely useful document because dealers, brokers, banks and investment advisers and the various statistical publications study this information carefully as a basis for the advice they give their clients and customers.

This law does not provide that the Commission shall guarantee the accuracy of the information made public by a corporation registering a new issue of securities. Just the opposite is true and as a matter of fact, the law provides that the Commission has no power to pass upon the merits of a security. It is a criminal offense for a person offering securities to represent that the Commission has approved them. It is up to the investor to make his decision whether to buy the securities on the basis of the information which the statute requires that he receive. In my opinion it would be foreign to our Federal system for a federal agency to have the power to pass upon the investment quality of any security. If an investor will but study the information which becomes available to him. through the operation of the Federal securities laws, he will be in a position to exercise prudent investment judgment.

The next of our statutes that I will tell you about is the Securities Exchange Act of 1934. This law regulates trading and other activities in the securities markets. It provides for certain regulation of brokers, dealers and stock exchanges trading in securities and for the periodic reporting of information concerning securities which are listed and traded on the stock exchanges. It also requires corporations to make proper disclosures to their stockholders when soliciting their proxies, and regulates abuses of "inside information" by officers and directors and 10% stockholders. The Exchange Act also provides for limited surveillance of the "over-the-counter" markets and prohibits manipulative activity and fraud. All brokers and dealers are required to register with the Commission, to file periodic reports of their financial condition, to maintain certain capital in relation to their indebtedness and obligations so as to assure their solvency, and to comply with the rules of the Commission designed to protect their customers against improper practices that might endanger customer's funds and securities.

The Commission has a continuous program for the enforcement of the Federal securities laws, carried on in its 14 field offices in the principal cities where securities markets are active, and in the past several years, in the light of a very greatly increased market activity, this program has been increased in tempo. The enforcement program takes on three general aspects.

First, we maintain a broker-dealer inspection program under which our inspectors go into about 900 broker-dealer firms a year, on surprise visits, to check upon violations. Many are uncovered and corrected without disciplinary action, but serious violations result in revocation, injunction or criminal proceedings. Naturally we try to concentrate on firms with which our experience leads us to expect that the public protection afforded by our inspections is most needed. As provided in the President's budget, this year we have obtained from the Congress funds for a larger inspection staff to complete 1,400 inspections a year.

The second phase of our enforcement program is the investigation of securities frauds. These are based on complaints we receive from the public and on information we pick up from the stock exchanges, dealers associations and individual brokers and dealers in the course of our inspections and on our general familiarity with the markets.

Third, we maintain a very close watch over securities prices so as to detect market manipulations. Skilled personnel watch the prices of the 3,000 stocks traded on stock exchanges which come out over the ticker tapes. The quotation records of some 6,000 securities which are traded in the "over-the-counter" markets are also studied each day. Any unusual movement which suggests that factors are at work not based on the free flow of supply and demand prompt an immediate investigation of the trading in that particular stock. These are called "flying quizzes", and while most price movements which initially appear unusual are found to be legitimate, a serious manipulation occasionally is discovered. The criminal penalties for a person convicted of unlawful manipulation are severe. This phase of our enforcement has a healthy deterrent effect and manipulation cases occur only infrequently today.

The Federal securities laws make it clear that neither the legislation nor the Commission is intended to make it difficult for legitimate business to raise capital. We are striving to the utmost to keep the securities markets fair and honest so that public confidence will continue. It is in no small part through the provisions of these laws for disclosure of pertinent business, financial and managerial facts that an enormous body of reasonably accurate information about corporations, which have done public financing or the securities of which are listed and traded on stock exchanges, has become available to the investing public. It is no longer necessary for a person to buy securities in the dark or on the basis of tips and rumors. Savings can be invested in securities registered with the Commission or listed and traded on exchanges with considerable confidence that the investor is getting the security which he believes he is getting.

I wish to emphasize again, however, that the Commission does not have the power - and should not have the power - to pass on the quality or investment merits of a security. The investor must make his own decision on the basis of the information which the Federal securities laws make available for him. No law can protect a man against his own folly. Our concern is not directly with whether prices of securities go up or down. Our real concern is whether price movements, up or down, result from the judgment of buyers and sellers trading in fair, honest and orderly markets free from manipulation and fraud.

By what I have said I do not want to mislead you into thinking that, because of our vigorous enforcement of the Federal securities laws, unscrupulous persons attempting to sell securities never make misrepresentations to the investing public. The Commission is deeply concerned about stopping losses to the investing public caused by fraud and misrepresentation in securities sales. At a time of record prosperity in this country such as we have witnessed in recent years, people seem to be more free with their money than in the past and to be more willing to take a flyer or a chance. A strong stock market appears to tempt the unscrupulous promotors and dealers in securities to take advantage of the "get rich quick" appetite of some investors for securities of dubious merit. No law can stop these people from parting with their money if they want to believe in glib and often fantastic promises of the small group of "stockateers" now operating in the securities markets. Besides, by the time that the law can catch up with the swindle, the investors' money may be gone forever.

Our enforcement agents working in the field have turned up some extraordinary cases. These schemes defraud a lot of unsuspecting investors of their hard-earned money.

The unprincipled securities salesmen concentrate on the uninformed individual investor who still clings to the notion that he can make a fortune overnight simply by picking the right stock. The victim seldom asks: "How much income will I receive from this investment?", but rather "Are you sure it will go up?" The initial contact the salesman makes with his intended victim is frequently by mail. The touting literature extravagantly describes the extraordinary hidden wealth in the assets of the company and the unusual investment opportunity which the particular security affords. The victim is assured that by investing promptly he can double or treble his investment within a few weeks or months. The victim then receives a series of telephone calls in which a "stockateer" heaps more frosting on his deceitful stories.

Many of these telephone campaigns are conducted by salesmen located in Canada where they operate safely behind a wall of legal immunity. The securities of dubious merit are brought physically into the United States by persons who are called "bagmen", because they use little black bags to bring in the securities and carry out their victims' money. But the telephone campaigns are not limited to international operations. Many of them are directed by what we call "hoods" who run "boiler shops" right here in the United States. The salesmen who push the sale of questionable securities by means of telephones from these boiler shops are called "hoods" because the cubicles from which they usually make their calls are protected by a hood or cover to insure them some privacy.

In recent years the Commission has successfully prosecuted many dishonest securities salesmen who have cheated the public out of large sums of money through the use of fantastically fraudulent misrepresentations concerning the assets of the companies whose securities are being hawked.

These frauds present difficult enforcement problems because often on the surface there may be little or nothing to arouse the suspicion of an investor. Once the Commission has learned of the deceit, long, careful and painstaking work may be required to develop enough facts so that the case will stand up in court. Not infrequently investigation shows that a complaint or suspicion is unfounded and consequently our investigators must be very careful not to cast reflections on reputation and character.

It is of interest to compare the capital markets today after 22 years of the Commission's work with those of the early 1930's. In 1932 only $644 million of corporate securities were sold to the public, and in 1933 the amount had dropped to $382 million. Municipal financing had also come to a virtual halt. In 1932, $849 million of municipal bonds were offered to the public, and in 1933 only $520 million were sold. By the middle 1930's conditions had improved somewhat, and new issues of corporate securities registered for public sale totalled $2.5 billion a year. Only a little more than $1 billion of municipal securities were sold each year in that period. In 1934 the value of all shares listed on the New York Stock Exchange was only $34 billion. Today it is about $200 billion. In 1955 $12 billion of new corporate securities were registered with the Commission - an all-time record, and sales of municipal bonds are now running between $6 and $7 billion a year.

Mutual investment funds, technically known as open-end investment companies, have grown tremendously since the early 1930's. The year 1936 witnessed the greatest volume of mutual fund sales on record up to that time. In that year mutual funds sold $110 million of their shares to investors and redeemed $28 million, leaving net sales for that year of $82 million. In 1940 mutual funds reported 296,056 separate shareholder accounts. During the fiscal year ended June 30, 1956, 126 mutual funds, reporting to the National Association of Investment Companies, indicated gross sales of $1,275 million of their shares and redemptions of $430 million, leaving net sales of $845 million. At the end of 1954 mutual funds, which were members of the Association, reported 1,703,846 shareholder accounts. The shares of these companies are widely held by individual investors, various types of charitable funds and by other institutions.

All of these changes reflect the restored confidence of the American investing public in our capital markets, and it is due at least in part to the reliance by the public on the legal protection afforded by the federal securities laws and the other statutes enforced by the Securities and Exchange Commission. That restored investor confidence in turn has helped to make possible the raising of the enormous amounts of new capital needed to sustain and foster the present high rate of business activity.

So much for the corporate securities markets and the effect upon them of the Federal securities laws. Now let me close with a few observations about school financing.

The work of the Commission also has indirect, though very important, effect upon your pursuit of your daily business of financing the new school facilities which you will have to provide for the needs of our rapidly expanding student population.

The growing pains which our public schools have endured in the past several years, and which they must expect to face in the next several years, are presenting you with very serious financing problems - much more serious than those encountered by private business organizations. The Office of Education of the United States Department of Health, Education and Welfare forecasts a continuing upward trend in the numbers of our children to be educated over the next 10 years. They predict that student population will increase 30% between 1956 and 1965. Studies indicate that our public elementary and secondary schools were short as many as 312,000 class rooms four years ago. It would have been necessary to add 167,000 class rooms in those four years merely to keep up with the increases in enrollment. In other words, 479,000 class rooms should have been added to our public school system in the last four years to keep completely abreast of the situation. Actually, only 232,000 were constructed in that four year period, with the result that we still have a deficiency in facilities of 247,000 class rooms as of today without making any provision for future increases in enrollment.

Another survey made a few years ago by the Office of Education of the school building plans of the various states indicates that all of the states of the United States planned to build during the four year period from September 1954 to September 1959 a total of 476,000 new class rooms and related facilities, without providing for replacement of obsolete or worn out facilities.

Two years have elapsed since the beginning of the period covered by that study and in that two years only 127,000 class rooms, or much less than one half the number of rooms planned, were actually constructed. Assuming no changes in the states' plans of September 1954, 349,000 new class rooms must be built in the next three years in order to meet the original target. But 247,000 of this 349,000 new class rooms would go to meet today's deficiency, leaving planned additions of only 102,000 to take care of increased enrollment in the next three years - or 34,000 rooms a year. The five year building plans of the states, to which I have just referred, called for annual additions of 95,200 class rooms. While it is probable that the states have raised their sights on construction plans somewhat since the last survey was completed, it is quite clear that the problem of providing future public school facilities remains a most serious one.

The cost of the 476,000 class room additions projected for the 1954-1959 period was estimated to be $4 billion a year, or a total of $16 billion for the four year period.

In view of the continuing rise in student population expected for the next several years, it appears safe to assume that the amounts expended in future years for class room additions will increase considerably above the $2.5 billion expended in the 1955-1956 school year. Total expenditures for this purpose in the 1954-1955 school year totalled $2.2 billion and in the 1953-1954 fiscal year expenditures amounted to $1.5 billion. This means that the business managers of our public school system will have a very tough financing job on their hands for a number of years to come.

Approximately $1.5 billion of school purpose state and municipal bonds were sold in the 1955-1956 school year, thereby providing about 60 percent of the total cost of $2.5 billion of the 67,000 new class rooms built in that year. In the 1954-1955 school year $1.4 billion of school purpose bonds provided 63.5 percent of the $2.2 billion expended on the public school additions completed in that year. In the 1953-1954 fiscal year sales of $1.3 billion of bonds contributed 87 percent of public school capital expenditures.

Since we know that certain amounts of previously issued school bonds were retired in those three years, it follows that the net amounts of construction funds derived from bond issues in the period were considerably less than the percentages I have indicated. At first glance, these figures might suggest a trend in the direction of less reliance by our public officials on school purpose bonds as a source of funds to finance the expansion of school facilities. However, I am told that proportionately greater amounts of college dormitory revenue bonds were included in the figures for earlier years.

In any event it is clear that, as the business managers of our public school systems, you have two very difficult tasks ahead of you in the next several years. You are going to have to convince the voters in your communities of the great seriousness of the expansion needs of your schools so that they will authorize the necessary school board issues and additional taxes or new sources of tax revenues to meet the cost. Secondly, you face a very difficult financial planning job.

Judging from the trend of bond sales and construction expenditures of recent years and the estimates of class room needs of the next three years, it is a fair estimate that you may have to go to our capital markets for between $1.5 billion and $2 billion of funds in each of the next few years. There will be many competitors for the funds you seek. Public highway, bridge and tunnel projects in your own states will be seeking as much funds from the same bond buyers you approach. In addition to the $1.5 billion of school purpose bonds sold in 1955, states, municipalities and revenue authorities sold another $4.5 billion of bonds. States and municipalities sold $1.4 billion school bonds and $5.6 billion for other purposes in 1954. School bonds totalled $1.3 billion in 1953 and bonds for all other purposes totalled $4.3 billion in that year.

Business corporations sold $10.4 billion of new securities for cash in 1955, $9.5 billion in 1954 and $8.9 billion in 1953. These figures exclude retirements of corporate and municipal securities in those years which had the effect of reducing the total supply of such securities available in the capital markets.

How are the large amounts of funds needed to be supplied? The only source is from the savings of the American people. Our savings studies show that individuals added $14.9 billion to their liquid savings in 1955, as compared to additions of $10.9 billion in 1954, $12.2 billion in 1953, and $13.0 billion in 1952. In the first six months of 1956 individual's liquid savings increased $7.2 billion in contrast with the gain in such savings of $4.4 billion in the comparable period of 1955. In other words, the individual citizens of our country have substantially increased their rate of liquid savings in the past year and a half. This increase is an important development as these savings are a rough measure of the funds available for investment in corporate, municipal and Federal government securities and in real estate mortgages.

However, in tune with the continued healthy expansion of our economy, the demands for funds by business corporations and states and municipalities to finance their capital expenditures have also increased rapidly in the last three years. It is estimated that total plant and equipment expenditures by business corporations in 1956 will reach $35.3 billion, as compared with actual expenditures of $28.7 billion in 1955, $26.8 billion in 1954, and $28.3 billion in 1953. States, municipalities and revenue authorities reported capital additions of $9.6 billion in 1955, $8.5 billion in 1954, and $7.2 billion in 1953.

The conclusion I wish to draw from this discussion of public school requirements and financing problems is that it is absolutely essential that capital markets be available to provide the large amount of funds required to finance the tremendous increases in class room capacity which will be needed to take care of the needs of our youngsters for years to come. You as individual investors in American enterprise and you as the business managers of our public school system have a vital stake in the soundness of our capital markets.

If, after what I have said, you still ask why the work of the Securities and Exchange Commission is of interest to you, the answer lies in a single word - "confidence." By that I mean the all-important element of the confidence of the American investor, both big and little, in our securities markets and in the information concerning the new securities being offered for his investment. This is where the Commission comes into the picture. The regulation of our securities markets by the Securities and Exchange Commission according to the legal standards established by the Congress in the Federal securities laws is vital to the proper functioning of the capital markets.