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CERTAIN ASSUMPTIONS AND INTERPRETATIONS OF THE SECURITIES AND EXCHANGE COMMISSION

Address

by

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I should like to discuss today first, certain assumptions underlying the philosophy of the Securities and Exchange Commission in its administration of the securities laws, and second, some of the more difficult problems of interpretation that continue to arise. The assumptions are self-evident. The interpretations, I sumbit, are consistent with the intendment of the Congress in enacting these statutes.

The first assumption is that the channeling of capital to industry through the process of distributing corporate securities to the public is an indispensable function in sustaining the expansive growth of our economy. The expenditures of American business for plant and equipment outlays are currently running at an annual rate in excess of 37 billion dollars, of which approximately 10-1/2 billion must be raised by corporations in the capital markets from individual savings. The authority entrusted to the Securities and Exchange Commission to regulate the methods and procedures employed in the sale and trading of securities in the public markets must, therefore, be exercised wisely and fairly to preserve a healthy climate for the raising of capital.

The second assumption is that the laws regulating the sale and trading of corporate securities in interstate commerce are salutary and are necessary to protect the paramount interest of the investing public. No one can reasonably object to the principle that public investors are entitled to receive adequate and accurate financial and business facts about securities offered for sale or traded in the public markets. Reliable corporate information must be made available directly to public investors and to security analysts, investment advisers and counsellors, underwriters and brokers and dealers in order to attract individual savings to corporate investments.

The third assumption is that the vast majority of the business and financial community are honest. Most persons who are subject to the disclosure provisions of the securities laws conscientiously try to adhere to the prescribed standards.

The fourth assumption, as a corollary to the preceding one, is that illegal practices that seriously undermine certain investor safeguards develop because the statutory requirements and interpretations of the Commission are not correctly or clearly understood or because of deliberate or careless evasion of the law by a small minority of the securities industry and the financial bar. Included in this category are such activities as the misuse of so-called "investment letters," the abuse of the exemptions from registration provided for

private offerings and for certain exchanges of securities, the misapplication of the "no sale" theory in connection with statutory mergers and consolidations, and gun-jumping.

The fifth assumption is that, absent statutory compulsion, many corporations will not voluntarily conform to the high standards sought to be maintained by the Commission in disclosing to the public financial and business data necessary for making informed investment judgments. The objective, factual study conducted by the Commission concerning the practices of unlisted companies that would be subject to the reporting, proxy and insider trading provisions of the Fulbright bill establishes the validity of this conclusion. For example, the findings in that study showed that material items of information required by the Commission's proxy rules were omitted in over 50% of the proxy material reviewed. The financial data of over 20% of the companies studied (which are not required to file reports with the Commission) was found to be materially deficient under the standards of the Commission's accounting regulations.

The sixth assumption is that the risk of potential abuses to the investing public is innate to the business of distributing, trading, selling and purchasing such a complex commodity as corporate securities.

Two general conclusions may be derived from these six assumptions. In exercising its mandate to protect the investing public the Commission must, first, proceed vigorously in enforcing the prospectus, reporting and anti-fraud provisions of the securities laws, and second, give frequent and clear public expression of its views as to the meaning of various statutory provisions and of its rules.

Our program to enforce the disclosure and anti-fraud provisions of the securities laws has included the following techniques.

First, the Commission institutes stop-order proceedings to prevent offerings from becoming effective where issuers file registration statements under the Securities Act in grossly inadequate form or where filings appear to be instinct with fraud. During the last fiscal year the Commission commenced 10 stop-order proceedings as compared with 8 during the preceding fiscal year.

Second, the Commission initiates disciplinary actions against brokers and dealers who distribute securities in violation of the registration provisions or who do not comply with its various rules prescribing capital, bookkeeping and margin requirements. To stop these types of violations the Commission instituted 48 injunctive actions and commenced 74 administrative proceedings to deny or revoke broker-dealer registrations during the past fiscal year as compared with 13 injunctive actions and 44 administrative proceedings during the preceding fiscal year.

Third, the Commission orders administrative proceedings to withdraw or suspend the listing of securities on national securities exchanges where the issuer has filed incomplete or misleading annual or periodic reports with the exchanges and the Commission. During the past year a total of 7 such proceedings have been ordered.

The impact of several statutory provisions and rules on certain common types of transactions and practices requires repeated exposition.

First, consider the misuse of the private offering exemption and so-called investment letters. The question of when transactions in securities do not involve any public offering, which, therefore, may be made without compliance with the registration provisions, is both persistent and perplexing. In the Ralston Purina case the United States Supreme Court established that the principal test in determining whether an offering is public or private is the need of the particular class of offerees for the protection afforded by registration. This determination turns on the knowledge of the offerees about the affairs of the issuer or their access to the same kind of information about the issuer that would be contained in a registration statement. The Court rejected a numerical test of offerees as the criterion. However, as a matter of administrative convenience, it did approve the adoption by the Commission of some minimum figure in determing whether to investigate a transaction in which a private offering exemption is claimed to be available. As a rule of thumb, the Commission has considered that an offering made to not more than 25 or 30 persons who take the securities for investment and not for distribution, is probably a private transaction not requiring registration.

In attempting to justify reliance upon the private offering exemption, issuers have followed the practice of collecting letters of alleged "investment representations" from a limited group of purchasers - usually 25 or 30 in number. In many instances, issuers have relied on the formality of securing investment representations, and accepted them at face value, without making any investigation of the actual scope of the offering and of the financial and business facts which should have indicated that the availability of the exemption might be in jeopardy or non-existent. Neither the issuer receiving,nor the purchaser making, the representation has apparently understood the significance of these statements. Securities have been sold in transactions purporting to be private and for the purpose of investment when, in fact, they were immediately resold to many other persons in an illegal distribution. In some cases, these resales involved not only an illegal public distribution but also involved violations of the anti-fraud provisions.

Issuers and underwriters must assume the responsibility, and act at their own risk, in determining whether investment representations reliably reflect the authentic intention of purchasers and, in fact, protect the claimed exemption. If a purchaser means by "taking for

investment," for purposes of providing an issuer with a claimed private offering exemption, to hold the securities simply for the six months capital gains period, or for a year, or to hold the securities in an "investment account" rather than a "trading account," or for deferred sale, he is operating under an erroneous concept.

The Commission considers that purchasing for deferred sale is purchasing for sale. If the subsequent sales at some future date involves a distribution to more than 25 or 30 persons, the burden is on the issuer or controlling persons to register or find some exemption.

Issuers and underwriters cannot justifiably rely on the private offering exemption unless they ascertain with preciseness the identities of all the offerees and purchasers and all the circumstances relevant to a clear determination that a public offering will not be involved.

A second recurring problem involves the exemption from the registration provisions of the Securities Act provided for exchanges of securities. This exemption is available where an issuer exchanges one of its securities for another of its securities with its existing security holders exclusively and no commission or other remuneration is paid or given directly or indirectly for soliciting the exchange. It is perfectly clear that this exemption was never intended to be available in transactions where the holders of the convertible securities distribute the securities received on conversion under circumstances which would cause them to be underwriters within the meaning of the Securities Act. If the exchange exemption were construed to afford an exemption for effecting a distribution of the underlying security, evasion of the registration provisions would be invited on a widespread scale.

A third type of transaction that requires clarification involves the illegal use of the Commission's rule interpreting the statutory definition of "sale." Rule 133 excludes from the definition, and makes the registration provisions inapplicable to, certain mergers and consolidations effected under state laws. This rule has been misused by some persons to effect a public distribution of the securities of the surviving company without disclosure of the essential business and financial facts concerning the issuer and the transaction.

Another persistent problem involves gun-jumping. This is the practice of offering securities for sale before filing a registration statement or selling securities prior to the effective date of the registration statement. The restrictions on the activities of prospective issuers and underwriters during the pre-filing period apparently require constant reiteration and exposition.

The dissemination of information about the issuer in the form of brochures or letters, prior to the contemplated filing of a registration statement may violate the registration provisions, if the publication is designed to "condition the market" or to facilitate the sale of a securities issue to be registered in the near future, or may have that effect. In determining the appropriateness of these activities, the Commission considers such factors as the nature and content of the publication, the scope of the distribution of the publication, the length of time between the dates of publication and the subsequent filing of the registration statement, and the relationship of the issuer to the person responsible for such publication.

An issuer may send its customary periodic reports to stockholders without violating the law provided the reports do not contain an express offering of securities or refer to an impending securities offering in a manner designed to solicit from stockholders and others pre-filing offers to buy. However, the publication, at or about the time a registration statement is to be filed, of special brochures dealing with the prospects of the issuer should be avoided. These documents often contain the kind of puffing statements that are not permitted in statutory prospectuses. Similarly, advertisements that are published by an issuer which are other than routine statements of its financial condition or operations, just prior to the filing of a registration statement or during a distribution, are often a thinly veiled attempt to arouse interest in the issuer's securities rather than in its products or services and might be deemed the first step in a securities offering.

Where an officer of a prospective issuer makes a speech about the operations of the company in a public forum - such as a security analyst group - shortly before a registration statement is to be filed, the speaker should take appropriate precautions to avoid any possible inference that his remarks were designed to condition the market for the imminent financing of the issuer. In a number of recent cases the Commission has advised the issuer that widespread distribution of reproductions of such speeches would raise questions as to possible violation of the registration provisions. Prediction of dollar amounts of profits or projections of earnings are particularly objectionable since these types of estimates usually are of a character which could not be made under the disclosure standards of the Act. These types of statements are objected to when included in prospectuses on the ground that they involve too many unknowns to be factual in nature.

Apart from publications by the issuer itself or its officers and directors, publications by underwriters in regard to the financial condition and future prospects of an issuer may, likewise, raise serious questions regarding violations of the registration provisions. The timing, contents and distribution of such publications are among the factors that are considered. Even though an underwriting group may not have been formed, a broker-dealer who has participated in

previous underwritings for an issuer may reasonably anticipate that his firm may be invited to participate in an impending offering. In these circumstances, he must be careful that any market letters distributed by his firm shortly before the filing do not include information which might constitute improper sales activity. Furthermore, the broker-dealer should not distribute special reports on the issuer after he has learned about his probable participation in a contemplated financing. The consequence of the publication of such material prior to the filing of a registration statement or during the period between the filing date and effective date may be the denial by the Commission of acceleration of the effective date of the registration statement.

In enforcing and interpreting the securities laws, the Securities and Exchange Commission should be guided by certain fundamental principles.

First, it must be vigilant in protecting investors from fraud and unfair dealing in order that public faith in corporate securities as a medium for investing savings may continue to flourish.

Second, it must respect the important role played by the securities industry in developing the capital needed for the plant and equipment of our industrial system. Our administration of the securities laws must, therefore, be designed to encourage and assist, and not hinder, the distribution of corporate securities to the investing public.

Third, it must use its prosecutory and adjudicatory powers fairly so as not to impair any constitutional rights or privileges of any person subject to its jurisdiction.

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