

**SOME CONTEMPORARY
PROBLEMS IN SECURITY REGULATION**

Address of

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before

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It is a great pleasure for me to have an opportunity to address The New York Society of Security Analysts. In the course of my work in Boston, I have met many of your colleagues in that city and acquired a very wholesome respect for your profession. Accordingly, I have been the more anxious to extend my acquaintance to your own group.

In February of this year, my predecessor, the Honorable J. Sinclair Armstrong, now Assistant Secretary of the Navy, spoke to you on "Current Developments in Federal Regulation of the Securities Markets." I should like this afternoon to discuss some of the more significant developments since that time.

I became Chairman of the Securities and Exchange Commission less than three months ago, and I might make some preliminary observations in that regard. The Securities and Exchange Commission is a continuous body charged with the duty of carrying out the Congressional mandate as expressed in the statutes entrusted to the Commission's care. The policies and decisions of the Commission are determined by the five Commissioners acting as a body. They are not to be imputed to any single individual. I most certainly assure you that I have already discovered my colleagues to be not only eminently qualified individuals, but also quite willing to voice their own opinions and to cast

their own votes. This process of group or institutional determination makes for continuity in the Commission's policies, and contrary to some conceptions, the advent of a new Chairman does not result in what might be characterized as a new Commission embarked on new activities.

We at the Commission intend to continue our efforts to maintain the integrity of the securities markets, to furnish the vigorous enforcement necessary for the protection of investors, and to re-examine our rules and policies with a view more effectively to perform our statutory duties. Where necessary, we intend to make recommendations to the Congress for amendments to the statutes, as we have done in the comprehensive legislative program submitted in July and August of this year. We shall continue our support of legislative proposals that will provide for greater investor protection such as those contained in the Fulbright Bill. That bill, to which Mr. Armstrong referred in February last, would extend the reporting, proxy and insider-trading provisions of the Securities Exchange Act of 1934 to certain corporations whose securities are traded over-the-counter. It has been reported out of committee, but with the insurance company amendment reinstated, and now awaits action on the floor of the Senate. As so reported, it applies only to corporations having 1,000 or more stockholders and \$3 million in assets, which we have estimated would cover about 650 companies.

When Mr. Armstrong addressed you, he pointed out the significant increase in the volume of security offerings that had taken place in a relatively short period prior to that time and pointed out the increase in economic activity along other lines. Since then, we have seen new highs in various fields, particularly in the volume of security issues. In the calendar year 1956, corporations offered a record \$10.9 billion in new securities, both publicly and privately. In the nine months, January through September of 1957, corporations have issued securities amounting in the aggregate to only \$1 billion less than the record amount sold in twelve months of last year. Total registrations with this Commission, which include non-cash and secondary offerings, rose from \$13.1 billion in fiscal 1956 to \$14.6 billion in the fiscal year ended June 30, 1957. This compares with an average of \$2.5 billion per year registered during the 1930's.

During the fiscal year ended June 30, 1957, there were 919 filings covering offerings of \$167 million of securities made under Regulation A of the Securities Act of 1933. That regulation, if I may remind you, provides an exemption for offerings not exceeding \$300,000, provided certain conditions are met, including the prior filing of a simple "Notification" and the use of an offering circular containing certain basic information. These conditions are imposed in order that the exemption

might not become an instrument for circumvention of the aims of the Act. While the number of Regulation A filings has dropped, the reduction is primarily due to substantially fewer filings of highly speculative mining issues, particularly in uranium. The obvious intent of Congress in enacting Section 3(b) of the Securities Act of 1933, under which Regulation A has been promulgated, was to permit the encouragement of financing of small businesses, and the Commission has always abided by that purpose to the extent that it could do so. Indeed, it has supported in the past, and will continue to support, the increase in the statutory ceiling on the amount that may be raised by the use of Regulation A from \$300,000 to \$500,000. Legislation to this effect was passed by the Senate in the last session of the Congress^{1/} and awaits action by the House of Representatives.

I am informed that the problems involved in the permanent financing of small businesses may have been studied from time to time in the past by some government agencies, but so far, I have not been able to find a definitive statement of these questions. I have been in touch with the Small Business Administration and we expect to

1/S. 2299, 85th Congress.

cooperate with that agency in recommending initiation of a review of this field to determine whether the problem actually does exist, how extensive it is, and whether anything can be done to solve it either under the existing securities statutes or under legislation which we might propose or support. I most certainly would not even guess what we might find in such a study, let alone what recommendations might seem to be indicated. It seems to me, however, that the policies of the present National Administration toward the temporary financing of such concerns as evidenced by its sponsorship of the Small Business Administration might very well warrant some action designed affirmatively to encourage the issue and sale of permanent securities.

The sharp rise, to which I previously referred, in funds obtained from the capital markets reflects the demands of business for the purpose of expanding its plant and productive facilities. Data collected by the Commission indicate that business expects to spend a record \$37 billion on new construction and equipment during 1957. This compares with around \$35 billion in 1956. In the aggregate, approximately one-third of the funds needed for expansion by corporations is obtained from the capital markets through flotation of new stocks and bonds or long term borrowing.

As another measure of the growth in the American economy, we note that the gross national product amounted to an annual rate of \$434 billion during the second quarter of this year, compared with \$415 billion for last year, and the third quarter estimate is at the rate of \$439 billion as compared with the \$416.7 billion comparable figure for 1956. Approximately \$65 billion of the second quarter product represents the annual rate of increase in private domestic investment, that is, new construction of homes and plants, investment in machinery and equipment and the expansion of inventories.

As you know, one of the main objectives of the statutes administered by the Commission is to provide investors, both present and prospective, with appropriate material disclosing all pertinent facts concerning the issuers of securities that are offered and traded in the public markets. Under the Securities Act of 1933, the principal medium for providing such information concerning such securities is the registration statement and prospectus. There has been a growing tendency, particularly since World War II, to give publicity through various media concerning corporate affairs to an extent well beyond the requirements of the Securities Act, the Securities Exchange Act and the Investment Company Act of 1940. This is a commendable practice and reflects a growing awareness on the part of industry and the investment community of the importance of informing security holders and the public with respect to such matters.

While this trend is to be encouraged, it is necessary to keep in mind that the Securities Act imposes certain limitations and responsibilities upon persons engaged in the sale of securities. One such limitation is that imposed by the registration and prospectus requirements of the Securities Act upon the publication, either prior to or after the effective date of a registration statement, of information concerning an issuer and its affairs by the issuer, its management, underwriters or dealers. The Commission last month issued a release in which this matter is rather fully discussed. ^{2/} I should like to summarize some of the observations there made.

Under the Act, it is against the law to offer a security prior to the filing of a registration statement. A security may be offered legally after filing and before the effective date of a registration statement, provided that any prospectus employed for this purpose meets the standards prescribed in the Act. Thus, in general, during this period -- after the filing and before the effective date -- no written communication offering a security may be transmitted through the mails or in interstate commerce other than a prospectus authorized or permitted by the statute or the relevant rules. After the effective date,

2/ Securities Act Release No. 3844, October 8, 1957.

sales literature in addition to the prospectus may be employed legally, provided that the statutory prospectus precedes or accompanies the supplemental literature. The statutory prospectus must be employed by an underwriter or a dealer participating in the distribution so long as he is offering any part of an unsold allotment. Furthermore, all underwriters and dealers must use the prospectus during the 40-day period following the effective date of a registration statement or the commencement of the public offering, whichever occurs later.

It is clear from the express language and the legislative history of the Securities Act that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. Although not couched in terms of an express offer, the publication of information and statements, and publicity efforts generally, made in advance of a proposed financing, may in fact contribute to conditioning the public mind or arousing public interest in an issuer or its securities in a manner which might result in a determination that such publicity is in fact a part of the selling effort. The line is often very difficult to draw between legitimate publicity and a sales campaign, and the burden is on the issuer to draw this line.

Similarly, the release of publicity and the publication of information between the filing date and the effective date of a registration statement may be enough to sustain charges that the publicity is in fact a selling effort by an illegal means, i.e., other than by means of the statutory prospectus. Similar problems arise from publicity and the release of information after the effective date, but before the completion of distribution.

Instances have come to our attention in which information of a misleading character, gross exaggeration and outright falsehood have been published by various means for the purpose of conveying to the public a message designed to stimulate an appetite for securities. This material, needless to say, could not have been included in a statutory prospectus conforming to the standards of integrity set forth in the statute. Some of these cases are the result of a deliberate disregard of the statute. Others demonstrate a lack of understanding of the problems involved or else a failure to exercise a proper control over research and public relations activities in connection with the distribution of an issue of securities.

I can give you a couple of examples which illustrate this problem and which involve speeches by officials of an issuer to a society such as your own.

In one case, the president of a company accepted, in August, an invitation to address a meeting of a security analysts' society to be held in February of the following year for the purpose of informing its members about the company, its plans, its record and its problems. By January, the speech had been prepared together with supplemental information and data, all of which were designed to give a fairly comprehensive picture of the company, the industry in which it operated and various factors affecting its future growth. Projections of demand, operations and profits for future periods were included. The speech and the other data had been printed and it was intended that several hundred copies would be available for distribution at the meeting. In addition, since stockholders, creditors, and perhaps customers might be interested in the talk, it was intended to mail to such persons and to a list of other selected firms and institutions copies of the material to be used at the analysts' meeting.

Later in January, a public financing by the company was authorized, preparation of a registration statement was begun and negotiation with underwriters was commenced. It soon appeared that the coming meeting of analysts which had been scheduled many months earlier, would actually take place at or about the time the registration statement was to be filed. The question arose whether, in the circumstances, delivery and

distribution of the speech and the supporting data to the various persons mentioned above would contravene the provisions of the Securities Act.

It was clear that the speech had not been scheduled in anticipation that there would be a public offering by the issuer at or about the time of its delivery. Under the circumstances, no objection was raised to the delivery of the speech at the analysts' meeting. However, since printed copies of the speech might be received by a wider audience, it was suggested that the printed copies of the speech and the supporting data be withheld from distribution.

In another case, two weeks prior to the filing of a registration statement, the president of the issuer delivered a prepared address before a society of security analysts which had been booked several months previously. In his speech, the president discussed the company's operations and expansion program, its sales and earnings. The speech contained forecasts of sales and referred to the issuer's proposal to file with the Commission later in the month a registration statement with respect to a proposed offering of convertible subordinated debentures. Copies of the speech were distributed to approximately 4,000 analysts throughout the country.

The Commission denied acceleration of the registration statement and required that the registrant distribute copies of its final prospectus to each person who had received a copy of the speech.

Ordinarily, we have no great difficulty in connection with registration of securities under the 1933 Act. The great bulk of the securities industry and their legal advisers are fully reconciled to the statutes and, after some twenty-four years of experience, can operate under them deftly and adequately. But in any industry of such complexity and ubiquity, and which offers such profitable opportunities for fraud in its lower reaches, there is bound to be a margin of operations which shade from gray to black. Or, in a less sinister area, there may be some reason, based on economy or simple impatience, why a corporation feels, rightly or wrongly, that it does not care to file the papers necessary for registration. When Congress drafted the Securities Act, it provided for certain exemptions, and it is in such exemptions that many such concerns take refuge. Certain of these exemptions present recurring problems of enforcement. You will remember that Mr. Armstrong discussed some phases of these questions. One of these exemptions is "for transactions by an issuer not involving a public offering", sometimes referred to as the private offering exemption.

When we speak of a public offering, it does not mean necessarily that to be public it must be an offer to the whole world. One Court has aptly pointed out that "an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation * * * is no less 'public' in every realistic sense of the

word, than an unrestricted offering to the world at large." ^{3/} The Supreme Court in the Ralston Purina case laid down even a much stricter test. It there held that whether the number of offerees is few or many, if they are persons who do not have access to the information which would be given them by filings under registration proceedings, the offering is a public one. Consequently, an offering to "key employees" of the issuer was held to be a public offering.^{4/}

There have been many attempts to evade the registration requirement of the Act by means of devices calculated to give the appearance that a public offering is not involved. The Commission, however, has insisted that if the net effect of the transactions is a public distribution, no technical devices can change its basic character. Last summer in a public release,^{5/} the Commission made it clear that one may not isolate a part of a series of related transactions and successfully contend that this portion is a private transaction so long as the whole offering obviously involves a public sale. In that case, the company issued debentures immediately convertible into stock. The debentures were sold privately, and the issuer was given so-called "investment letters" by the purchasers. However, the purchasers converted the debentures into stock very shortly thereafter and sold the stock widely to

3/ SEC v. Sunbeam Gold Mines, 95 F. 2d 699 (C.A. 9, 1938).

4/ SEC v. Ralston Purina Company, 346 U.S. 119 (1953).

5/ Crowell-Collier Publishing Co., Securities Act Release No. 3825 (August 12, 1957).

the public. This was held to be a public offering subject to the Act.

An issuer cannot establish an exemption merely by collecting so-called "investment representations" from a limited group of purchasers if in fact a distribution by these persons is intended. A representation by a purchaser that he is taking for "investment" when in fact he is concurrently dividing a participation among others or reselling a portion of the commitment to others is worthless as grounds for such a claim. Issuers and underwriters cannot claim that a transaction does not involve a public offering if they do not know the identity and number of initial offerees or purchasers or whether the purchasers offer and sell to others. The Congress and the Courts have placed the burden of proof upon the person claiming an exemption. It is his responsibility to assure the existence and continuance of the conditions on which the exemption is claimed. Holding for the six months' capital gains period, holding in an "investment account" rather than a "trading account", holding for a deferred sale, holding for a market rise, holding for sale if the market does not rise, or holding for a year - none of these things in and of itself necessarily affords an automatic basis for exemption. There must be a genuine investment intention. One cannot safely rely on formalistic devices and ignore the actual intent. And if the issue is not exempt, it is dynamite to handle. Its sale may impose substantial liabilities on the company and on the original purchasers, may result in

injunctive proceedings which could seriously affect the market in the security, and could involve criminal liability as well. As in the case of most Federal statutes, it does not pay to flout the Securities Act. The so-called "no sale" rule of the Commission^{6/} has often been used to evade or avoid the registration requirements of the statute. Under this rule no "offer" or "sale" for purposes of the registration requirements is involved, so far as stockholders of a corporation are concerned, where by statute or the articles of incorporation there is submitted for stockholder vote a plan involving a merger, consolidation, reclassification of securities or transfer of assets of a corporation in consideration of securities of the acquiring corporation.

Last year the Commission invited comment upon a proposal which in effect would have repealed the rule and made the transactions covered by it subject to registration.^{7/} A public hearing was held on the proposal in January of this year. In March the Commission announced that it was deferring action on this proposal pending further study of the problems and questions which had been raised.^{8/} The staff of the Commission is continuing

6/ Rule 133 under the Securities Act of 1933.

7/ Securities Act Release No. 3698, October 2, 1956.

8/ Securities Act Release No. 3761, March 15, 1957.

its study of the proposal and related matters.

The Commission has undertaken twice in the last seven months to explain and define what it conceives to be the limits of the "no sale" rule.

In a fairly recent published opinion ^{9/} in an administrative proceeding where this matter was at issue, the Commission pointed out that the theory of the rule is that no sale to stockholders is involved where the vote of stockholders as a group authorized a corporate act such as a transfer of assets for stock, a merger or consolidation, because there is not present the element of individual consent ordinarily required for a "sale" in the contractual sense. However, the Commission emphasized that this does not mean that the stock issued under such a plan is "free" stock which need not be registered insofar as subsequent sales are concerned. Absent an exemption for a subsequent sale of such stock, registration would be required. Of course, subsequent casual sales of the stock by non-controlling stockholders which follow the normal pattern of trading in the stock would be exempt from registration. However, if the issuer or persons acting on its behalf participate in arrangements for a distribution to the public of any of the stock issued to stockholders, or have knowledge of a plan of distribution

^{9/} Great Sweet Grass Oils Limited, Securities Exchange Act Release No. 5483, April 8, 1957.

by stockholders, no exemption is available since an underwriting would be involved.

Again, last month in a public release,^{10/} the Commission announced the position that it had authorized staff counsel to take with respect to the applicability of the rule in a reasonably common situation.

A merger of two companies had been authorized by the Boards of Directors involved, over the objections of one director of the company to be merged. This director represented the largest single stockholder, a trust holding a substantial block of stock of that company. It was understood that upon the receipt of shares in consummation of the merger, the trust might sell out the shares so received to the public.

The parties were advised that no question would be raised with respect to the applicability of the "no sale" rule concerning the issuance of the shares of the surviving company to the security holders of the company to be merged. The parties were further advised, however, that the rule would not exempt from registration any subsequent public distribution of the shares received by any security holder of the company to be merged, who might be deemed to be a statutory underwriter. It was pointed out that in the circumstances of the case it appeared that the trust would be such an underwriter if it acquired shares in the merger with a view to distribution.

^{10/} Securities Act Release No. 3846, October 10, 1957.

I might add, that following receipt of this advice, a registration statement was filed. The statement included a prospectus consisting essentially of the information contained in the surviving company's proxy statement that had been used in connection with the solicitation of stockholder approval of the merger.

Unlike the provisions of the other statutes which we administer, the Commission has definite statutory responsibilities under the Public Utility Holding Company Act of 1935 to pass, among other features, upon the premiums at which bonds, debentures and preferred stocks may be called for the purpose of refunding at lower interest or dividend rates. During the past year of rising interest and preferred dividend rates this question has become the center of considerable controversy.

Contrary to what seems to be a general impression, we are not free agents in setting the standards governing the call prices of bonds, debentures and preferred stocks. The policy laid down by the Congress, which this Commission is required to follow in interpreting all the sections of the Act, is expressed in Section 1(b) of the Act. That section states that "The national public interest, the interest of investors in the securities of holding companies and affiliates and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected . . . when in any other respect there is . . . lack of economy in the raising of capital."

In the Commission's Statement of Policy issued in February 1956, which is, in substance, a codification of principles or policies prescribed for the protective provisions of bonds and preferred stocks of companies subject to the Holding Company Act, it is stated that securities ought to be redeemable at the option of the issuer at any time upon reasonable notice upon the payment of a reasonable redemption premium, if any. While the term "reasonable" redemption premium is not defined, the Commission has generally considered that a reasonable initial redemption price would not exceed the sum of the initial public offering price plus the coupon rate on the bonds or debentures or the dividend rate on preferred stocks. The purpose of the statute is clearly to make certain that public utility and holding companies subject to the Act may be in position to reduce their costs of raising capital if interest rates decrease materially, thereby permitting advantageous refunding of their debt securities and preferred stocks. You will note, of course, that this formula contains its own automatic escalator. When interest rates are low and protection from refunding is not of great interest, the formula produces comparatively low initial call prices. As interest rates rise the coupon rates go up and so do the initial call prices under the formula.

The Commission's problem obviously is the difficult one of

adjusting conflicting interests and considerations. From the issuer's point of view, a call premium should be as low as possible so as to enable it to take advantage of favorable changes in interest and dividend rates and yet high enough to provide the purchaser with sufficient inducement for investing. The Federal Power Commission and State public utility commissions, which have regulatory powers to prescribe rates charged by public utilities, are also interested in holding call premiums for refunding purposes to as low a level as possible. The cost of raising capital is one of the most significant factors in the rate-making process. Investors, on the other hand, and particularly the larger institutional investors, understandably prefer non-callable securities.

This problem was brought forcibly to my personal attention when I was connected with the Massachusetts Department of Public Utilities. For ten years, and through four major rate cases, I fumed in vain as I saw the New England Telephone Company paying out 5-1/2 per cent on a non-callable 35-year bond issue placed in 1925. The current interest rate while these rate cases were in progress was about three per cent. Had this issue been refundable, the consumers would have had to pay literally hundreds of thousands of dollars less per year in order to permit the Company to realize a fair return on its investment.

The Commission has been urged by some of the companies under

its jurisdiction to relax its requirements in order that debt securities may be non-refundable for a period, generally five years, or so as to permit the initial redemption price to be higher than that provided by the working formula which I have described. On the other hand, neither the Commission's staff, nor the issuers of securities, nor the investment fraternity have been able unequivocally to demonstrate to us that in fact non-callable provisions or higher initial call prices for refunding purposes would produce an appreciably better price in the market place. Even if a significant increment in price could be shown, there would remain the question of the wisdom of trading future flexibility for an immediate but small saving. As a matter of fact, if a new bond issue or preferred stock issue carries a non-callable provision or an initial call price so high as to preclude any reasonable opportunity for refunding, it would be impossible for either the issuer or a regulatory commission concerned to calculate the actual cost of money to the issuer over the life of the issue. The Commission and its staff have had this problem under continuous study since it first arose, beginning about the end of 1956. If any of you have any solid factual information bearing on the matter which you can make available to us, we would most certainly welcome it.

Because of the wide importance of this question of redemption prices for refunding purposes in periods of high interest rates such as

the present, the Commission authorized a member of the staff of its Division of Corporate Regulation to serve on a committee organized by the Wharton School of Business Administration of the University of Pennsylvania, which is now making a comprehensive study of redemption provisions under the sponsorship of the Life Insurance Association of America. The results of this study should prove very helpful to the Commission and to others interested in the call price question.

Up to the present time we have observed that practically all issues of new debt securities subject to our jurisdiction under the Holding Company Act have continued to attract a healthy number of bids. Furthermore, our studies have indicated that few of the large insurance companies, particularly the Big Five in the New York area, have shown any interest in any publicly offered utility bonds in several years - not even in those issues not subject to our jurisdiction and which have carried a 5-year limitation on refunding. There are many other phenomena which equally cast doubt upon the validity of the arguments which have been advanced to us in support of a more liberal policy in this regard.

As you will recall, the first publicly offered electric utility bond to carry a non-callable provision for refunding purposes to appear on the market in several years was an issue by New York State Electric & Gas Corporation on May 14, 1957, of \$25 million of 30-year mortgage bonds. From April 24 to October 19 of this year, a total of 16 issues

of bonds and debentures in the aggregate principal amount of \$311 million have been sold by registered holding companies and their subsidiaries - all but one of which carried an initial call price for refunding purposes as fixed by our working formula, i. e., the initial public offering price plus the coupon rate. The single exception, which was the company's own choice, carried a lower redemption premium. All of these issues attracted at least two bids and a number received six or seven bids. Furthermore, the majority of these issues were well received in the market at the time of offering. During the same period, electric and gas utility companies not subject to the Holding Company Act made public offerings of 44 issues of bonds and debentures in the aggregate principal amount of \$1,064 million. Of this number, 16 issues aggregating \$263 million were redeemable immediately for refunding purposes at prices not exceeding the initial public offering price plus six per cent. Eight issues aggregating \$173 million carried provisions permitting immediate redemption for any purpose but at substantially higher initial call prices. The balance of 20 issues amounting to \$628 million were not refundable for specified periods, usually 5 years. It is interesting to note that some of the issues carrying non-callable provisions failed to sell out readily at the syndicate price, probably due to market conditions.

In the time which I have had this noon, I have been able only to touch briefly on some of the matters involving our agency in which I know you are interested. I am grateful that you have been willing to give me your attention for even this time. I assure you that I am not merely engaged in mouthing platitudes when I tell you that the Securities and Exchange Commission sincerely asks for your cooperation in its work. The preservation of the integrity of the capital market is the joint responsibility of our Commission and those who are engaged in the industry. This is a very great responsibility which requires the cooperative efforts of all of us, and which we can never successfully meet if we work at counter-purposes. In return for your cooperation, I can promise you that the SEC will, in turn, do everything in its power to expedite and facilitate the raising of capital for legitimate private enterprise.