STATEMENT OF RICHARD B. SMITH, MEMBER OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE ATTORNEY GENERAL OF THE STATE OF NEW YORK OCTOBER 30, 1967 "New York Legislation on Intra-State Offerings"

My name is Richard B. Smith and I am a member of the United States Securities and Exchange Commission. With me is Mahlon M. Frankhauser, the Administrator of the Commission's New York Regional Office.

I might point out, Mr. Attorney General, that while, by coincidence, both Mr. Frankhauser and I are Pennsylvania Dutchmen by birth, we both have become New Yorkers by adoption. Prior to my appointment to the SEC by the President on May 1st of this year, I practiced law for some 14 years here in New York City, all four of my children were born here, and I remain a member of the New York bar and a voting citizen of this State. A little before the time I went to Washington, Mr. Frankhauser came to New York as the Regional Administrator of this, by far the largest of the Commission's Regional Offices, and I know he is fast becoming a son of this wonderful City.

I am happy to honor your request to appear here today to present my views concerning regulation by the State of New York of intrastate securities offerings.

The Securities and Exchange Commission, of course, does not take any position with respect to the need for, or the form of, such regulation in any particular state. It would not be appropriate for a federal agency to express a substantive viewpoint on a matter that is essentially a state concern.

Nevertheless, I do not think I do violence to that inhibition on advocacy for particular state legislation, to say that the Commission does in general encourage improved state securities regulation. There are many areas where the state and the SEC have concurrent jurisdiction -- for example, the antifraud provisions of the federal laws overlap with similar provisions in many state statutes such as the Martin Act -- and to the extent that a state vigorously asserts its jurisdiction, the Commission's limited manpower and funds can be applied to the growing volume of primarily national concerns to which it

must attend. To require registration of intrastate public securities offerings, and to impose prospectus delivery requirements, would hopefully further forestall any need to resort to federal antifraud enforcement, which after all is too often like locking the barn door after the horse has been stolen.

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The statutes which the Securities and Exchange Commission administers dealing with the issuance and trading of securities contain express preservations of state jurisdiction. The Securities Act of 1933, which deals with public offerings, approaches this result in two ways that are pertinent here. First, it exempts from the registration and prospectus disclosure requirements of that Act any security which is a part of an issue offered and sold only to residents of a single state where the issuer of such security itself is a resident of or incorporated in that state and does business there. Secondly, the Act provides that none of its requirements shall affect the jurisdiction, over any security or any person, of any state agency or office performing the functions of a securities commission.

Thus, the full regulatory powers of a state over intrastate securities issues are contemplated within the federal regulatory scheme. The Congress went even further and gave the states concurrent jurisdiction, to the extent they chose to exercise it, over the portions of interstate issues offered or sold within their respective boundaries.

After an intrastate offering is completed, there is again in most cases an absence of federal regulation and concern. The federal statute that most affects outstanding securities, the Securities Exchange Act of 1934, relates only to companies with more than one million dollars of assets and at least 500 shareholders, or companies whose securities are listed on a national securities exchange, which usually are even of a larger size. The 1934 Act contains a provision that reserves jurisdiction to the states over any security or any person insofar as it does not conflict with the federal statute.

I point to these provisions of the 1933 Act and 1934 Act reserving jurisdiction to the states and exempting intrastate offerings only to emphasize that any decision made by the State of New York to impose requirements upon the intrastate offering of securities, or to require post-offering accounting to investors

by intrastate issuers, would in no way conflict with the federal regulatory scheme. Indeed, Congress contemplated that states, to the extent they chose to do so, would fill this role.

I can promise that if a decision is made to enact such laws, you will receive, as you have in the past, the full cooperation of the Securities and Exchange Commission and its New York Regional Office in your administration and enforcement of its provisions. Your distinguished Assistant Attorney General in charge of the Securities Bureau, Meyer Mencher, who is this year the President of the North American Securities Administrators, has first-hand knowledge of the extent to which the SEC coordinates its enforcement work with state administrators throughout the nation.

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Recent years have brought a tremendous increase in the interest and participation of the American public in securities investment. The preliminary results of the New York Attorney General's survey as announced in August would indicate that this tremendous increase has not been limited to interstate issues. Mr. Frankhauser tells me that the New York Regional Office receives twelve to fifteen inquiries a week concerning the intrastate exemption. That tends to reinforce the results of your survey showing a substantial amount of intrastate financing activity.

With increased public involvement has come an increased responsibility on the part of government to protect the public against those who would obtain their money under false pretenses or who merely refuse to recognize the public stewardship they undertake when they seek public investment in their enterprises.

We at the SEC are keenly aware of our responsibilities with respect to interstate issues and are attempting to discharge that responsibility as effectively as we can. In part in response to the intensive increase in public investment, the Commission is currently giving consideration to revision of procedures and requirements for registration of issues and the expanded application of certain of the 1934 Act requirements.

While we are so engaged in consideration of revision, I think it highly significant that the three largest industrial states -- New York, Pennsylvania and California -- are also currently considering revisions of their securities laws. As you know, there has been a very wide range in the form of

securities regulation by the various states, extending from the highly regulatory approach of California, where the Commissioner of Corporations may permit the issuance of securities only if he determines that the proposal is "fair, just and equitable," to the absence of any regulation other than general antifraud provisions, as in New York.

A committee organized by the California Corporations Commissioner prepared last month a draft of a new Corporate Securities Law that would at least to some extent soften the highly regulatory approach traditionally taken by that state. For instance, securities registered under the federal act would be registered by coordination and would automatically become qualified for sale unless the Corporations Commissioner affirmatively found that the offering was not "fair, just or equitable." While this may seem a small step, it is a significant proposal, I believe, in a state which otherwise has been quite rigid in its approach.

The Pennsylvania legislature held hearings within the past two weeks on a new Securities Act which would introduce revised registration requirements into that state. Pennsylvania, however, is contemplating following, with some variations, the federal system of disclosure rather than the regulatory approach of California. The bill would exempt from registration in Pennsylvania any security registered under the Securities Act of 1933.

I might point out that the Pennsylvania bill does not contain any provision for the post-offering filing of financial statements or any requirement that shareholders be provided with annual reports following the offering. The draft California securities law contains only a provision empowering the Commissioner to require the filing of semi-annual reports for a period of 18 months after the registration is effective.

While it is interesting to note the varying approaches of these other major states, it does not seem appropriate at this stage to give further analysis to them. The significant fact to note here is that they, like New York, have been motivated by the increased investor interest in new securities to consider new legislation. New York, as the financial capital of the country, and indeed the world, has its own traditions of an open market, and a matched concern for the protection of investors that is demonstrated anew by this hearing.

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In his statement of August 7th, Attorney General Lefkowitz indicated that he was primarily interested in prospectus disclosure and financial reporting. It might be helpful, therefore, to discuss briefly the federal requirements in those areas and the manner in which they operate.

Registration with the Commission is required for any interstate public distribution of securities by or on behalf of the issuer or persons in control of the issuer. Registration is effected by means of a document designed to provide full and accurate disclosure of the facts material to an investor's evaluation of the offering. These disclosures include the terms of the offering, the nature of the securities being offered, the issuer's business or proposed business, its management, and its financial condition and previous operating results. Where the issuer has a prior history of operations, there must be included a recent certified balance sheet and earnings statement for five years, of which at least the last three are certified.

The principal part of the registration statement filed with the Commission is a prospectus required to be delivered to offerees and purchasers. The registration statement becomes effective unless the Commission finds that it contains material misstatements or is rendered misleading through failure to state a material fact. There are no other grounds for the refusal or suspension of registration, and any securities of any issuer may be offered on any terms not fraudulent so long as full and fair disclosure is made in the prospectus.

After the offering is completed, the issuer must file periodic reports for its first fiscal year and for as long as the securities are held by 300 or more investors. These reports must be filed as frequently as monthly if material corporate events have occurred, and at least include an unaudited mid-year summary of earnings and a year-end report containing full financial statements audited by an independent public accountant.

If the securities are listed on a securities exchange, or if the issuer is of a certain size and has 500 or more stockholders, an annual report must be sent to shareholders containing two years certified financial statements in comparative form. This continuing reporting to shareholders <u>after</u> the public offering is extremely important.

The requirement that the financial information provided investors be audited by independent public accountants is indispensable to the success of the disclosure philosophy. This includes the requirement that the independent accountant's opinion be unqualified except in particular justifiable circumstances. The contribution of the accounting profession to investor protection cannot be overestimated. Interested management is not in a position to independently certify the results of its own endeavors. Moreover, no public authority could possibly expend the money and manpower necessary to reasonably assure that financial disclosures were complete and fairly presented. The public accounting profession, and especially the membership of the American Institute of Certified Public Accountants, with its standards of independence, has filled this gap commendably with a minimum of involvement of the regulatory agencies.

The disclosure requirements of the federal acts have proven to be extremely effective in providing interstate investors with the information necessary to an evaluation of securities, and in requiring a continuing accounting by management for their responsibilities to their shareholders. It is impossible to estimate the abuses of public trust and investment that have been prevented or discovered because of these requirements that corporate affairs be exposed in a very visible fish bowl. At the same time, the requirement of full disclosure has not impeded the access of honest marginal or speculative enterprises to public capital.

No company which is unafraid to air its affairs in public is denied the right to seek public investment. No dealer is denied the right to sell securities he has underwritten if he fully discloses the facts bearing upon their worth and the conscionable terms upon which he offers them. Moreover, the terms of the offering, once negotiated with a responsible underwriter or determined by the issuer, need not be renegotiated with a public agency. Because of this, registrations are processed relatively expeditiously and the close and fragile timing of many public offerings is not unduly upset.

The experience of some 35 years with the federal disclosure requirements has established, I believe, the efficacy of this system. This is not to imply that we at the federal level have solved all our regulatory problems. For one thing, neither disclosures nor government enforcement can supplant the need for maintenance of ethical standards by the financial community itself through its self-regulatory organizations. For another, more can be done to furnish investors more useful information, and more can be done to reduce the burden on the business

community of providing this information. Nevertheless, the system works and in my opinion represents an effective balancing of the value of an individual making his own decisions with the value of protecting him where he is unable to get the facts for himself.

I indicated earlier that the disclosure philosophy of the federal acts places manageable requirements on almost any issuer seeking public financing. Offerings of every type of security -- ranging from the highest grade corporate bond to, most recently, a contract for the lease of a cow -- have been registered with the Commission by every size and form of issuer. New York has had, I believe, successful experience in registration on a disclosure basis of theatrical and real estate offerings, under the able supervision of Assistant Attorney General David Clurman. The adaptability of a registration process based on disclosure has not prevented adequate financing of our expanding and wonderfully varied economy. Thus, both our experiences tend to show that without impeding the open flow of capital from private savings to our business enterprises, the channels of private investment can be kept honest and fair.

I know that is New York's objective here. The genuine concern for investors, as for consumers, is a credit to its Attorney General.

Thank you.