# FEDERAL REGULATION OF SECURITIES MARKETS --
# RESPONSIBILITY OF THE SECURITIES AND EXCHANGE COMMISSION

Address of

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before the

NEW ENGLAND GROUP

of the

INVESTMENT BANKERS ASSOCIATION OF AMERICA

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I appreciate very much this opportunity to address the New England Group of the Investment Bankers Association of America. I particularly like being in Boston. This great Commonwealth of Massachusetts has sent a number of her sons to serve in very high places in the present national Administration. The nation sees you represented in the Senate by the distinguished lawyer, scholar and gentleman, and staunch supporter of The President -- Leverett Saltonstall. In the President's own Cabinet, head of a great government department, Commerce, is Sinclair Weeks. At the United Nations, translating America's peaceful hopes and policies into action, is Ambassador Henry Cabot Lodge. The country owes you a debt for sending these men to their posts in Washington. If you'll forgive a personal reference, I would like to think that a little bit of the spirit and culture of Massachusetts has rubbed off on me too. I spent my high school, college and graduate school years here. So Boston has many memories for me. The word "Veritas" -- "Truth" -- on the Harvard shield in a way epitomizes the basic purpose of the Federal securities legislation which I am called on to administer as a member of the Securities and Exchange Commission. It is therefore appropriate that I discuss, in its relation to securities, knowledge and the dissemination of knowledge. More particularly, I want to talk with you about the permissible scope and range of information which may be disseminated in connection with the sale of securities registered under the Securities Act, both before and after its 1954 amendment. I would like also to put before you some of the current thoughts of the Commission and the staff on the subject.

The securities industry is peculiarly dependent for its continued vitality upon ready access to and wide dissemination of reliable information. The dynamics of our economic society depend on accurate knowledge about securities and their values. In our society the process of capital formation is entrusted to private enterprise. Our expanding economic and social well being is hinged to a continuous process of channelization of the savings of the public into investment in the brick and mortar and the plant and equipment and skills of industry. Investor confidence in the integrity, dependability and honesty of this system of capital formation must be maintained. This confidence will thrive when investment information is honest, is accurate, and complete.

The securities industry, therefore, bears a high responsibility for the character and type of information which the investing public needs to make the judgments so essential to the strengthening of our economic system. It is primarily your function as investment bankers to cooperate with issuers to obtain the information required by the Securities Act and the Commission's rules and to make the judgments as to the materiality of information for the purpose of investment analysis. It is to our mutual problems -- the industry's and the Commission's -- involved in the dissemination of this information to the public which I wish primarily to bring to your attention tonight.

As you know, the Securities Act basically provides a system for obtaining essential investment information and for the dissemination of such information among the public to provide a basis for judgment as to the merits and value of the securities being offered. The Act appropriately has for its chain of communication, the existing investment banking processes for the public offering of securities, -- that is, the chain of issuer to underwriter, to securities dealer and ultimately to the investing public. To accomplish its purpose, the Act requires the issuer of the security to file a registration statement with the Commission which includes a prospectus containing the material information prescribed by the statute. Responsibility for the accuracy and adequacy of the information is placed in varying degrees of severity upon the participants in the chain of communication from issuer to investor by the imposition of civil and criminal liabilities for misstatements or omissions of material facts necessary to make facts stated not misleading in the circumstances.

The Act also imposes a waiting period after the date of filing before the securities may be sold. Normally this is twenty days. During this period, it is unlawful to make binding commitments to sell or to contract to sell the security being offered. The purpose of this waiting period is to enable public opinion to crystalize in respect of the security and its merits in an atmosphere relatively free of sales pressure.

The twenty-day waiting period also is utilized by underwriters and issuers to gauge the degree of acceptability of the security being offered, to obtain the benefit of judgments as to price and other terms and generally to enable the issuer and underwriter to determine whether the offering will be feasible.

All of these functions of the waiting period have proved of assistance to sound capital formation, both from the viewpoint of investors and from the viewpoint of underwriters and issuers. Investors, underwriters, dealers and investment advisers have become accustomed to a period of analysis comparatively free of sales pressures and underwriters and issuers now used to utilizing the period to gauge the feasibility of the issue prior to the making of binding commitments. It is not desirable -- not only for either issuer or underwriter but for the economy in general -- to have an offering fail when, without material adverse effect to investors, the unhurried judgments of issuers and underwriters, based on adequate information about the security to be offered and the market conditions likely to attend the offering, could have formed a basis for a decision which would have produced a successful deal. Thus issuers and underwriters and the economy in general have benefited from the waiting period.

Although it is clear that the waiting period was intended to accomplish these purposes, the Act as it existed until the amendments of 1954 placed obstacles in the way of freely and openly accomplishing these objectives. The Act, before amendment, forbade offers to sell the securities by the use of the mails or facilities of interstate commerce during the waiting period. On the other hand, the Act permitted discussion during the waiting period between the underwriter and the issuer and between dealer

and his clientele providing the dealer did not use the mails or the interstate telephone or telegraph. This was an obstacle of no great burden to dealers whose clientele normally is local and whose salesmen can call upon them in person or by telephone. However, under the Act as originally enacted, the chain of interstate communication between dealer and underwriter legally was considered by many to be an extremely hazardous one. Dissemination of information by underwriter to dealer normally requires the use of mails and facilities of interstate commerce such as the telephone. The relative dollar amount of most issues and the necessity of nation-wide distribution to insure the success of the offering makes interstate communication between underwriters and dealers a business necessity. However, here the original Act forbade any communication which could be legally deemed an offering to sell the security. The line of demarcation between the "dissemination" of information such as copies of the prospectus filed with the registration statement or fair summaries of its information and "offer to sell" was not an easy one even for lawyers to draw.

For two decades both the industry and the Commission evolved administrative techniques to prevent the waiting period from becoming a meaningless vacuum. After 1940 when the statute was amended to permit the Commission to reduce the waiting period if it was satisfied that prescribed standards had been met, the Commission utilized its power to shorten the waiting period so as in effect to require a distribution of the prospectus as filed with the registration statement during the waiting period at least among dealers. The investment banking industry obtained a consensus as to the merits and marketability of the issue by the device of accepting "indications of interest" from dealers and investors which only by hairline rationlization could be distinguished from "offers to buy" condemned by the statute.

While these techniques succeeded to a degree in achieving the basic purposes of the waiting period, they were nevertheless under a continuous cloud of doubtful legality. Moreover, it was general practice that copies of the pre-effective prospectus as filed did not move beyond dealers to the ordinary investor. The industry asserted that the situation existed largely because the prospectuses were too costly to mail in the absence of some means whereby those investors entirely uninterested in the security could be weeded out and the prospectus distributed solely to those evincing an interest in the security.

In 1954 the statute was amended to remove any aspect of illegality which might attach to the practices which were in fact occurring during the waiting period. Written as well as oral offers to sell or to buy by interstate means are now permitted during the waiting period. However, it is still forbidden to make any contract to sell or any sale during such period. The basic objective is to promote discussion of the merits of the security but to prevent undue sales pressure upon investors by forbidding any binding commitments until the informational requirements have been met and final prospectuses are available.

In summary, then, the statutory disciplines affect pre-effective activities in the following ways:

1. The Act imposes severe civil and criminal penalties for misstatements or material omissions whether oral or in writing, made either during or after the waiting period;

2. The Act severely restricts the types of written communication which may be utilized during the waiting period. The use during the waiting period of written literature which is not filed with the Commission is forbidden. Under the amended law the only writings which can be distributed during the waiting period are:

   (a) the preliminary prospectus, as filed with the registration statement, complete except as to such information as price, underwriting spread, convertibility features and other factors which are basically related to price and which can be determined only after analysis of judgments crystalized during the waiting period.

   (b) a summary of the preliminary prospectus, that is one which omits in part and summarizes information in the preliminary prospectus. It is contemplated that this type of summary prospectus will be filed as part of the registration statement and processed by the Commission's staff but will not be subject to the liabilities of Section 11 of the Act. It will, however, be subject to civil and criminal penalties for misrepresentations. The Commission is given the power to suspend the use of a summary prospectus at any time if it determines that it contains misstatements of the facts or omits to state any material facts necessary to make the statements therein, in the light of the circumstances under which such prospectus is, or is to be used, not misleading. The contents of this summary prospectus are left to rules and regulations of the Commission. More about these in a few minutes.

   (c) the statute authorizes a writing which states from whom a complete or summary prospectus may be obtained and in addition does no more than identify the security, states the price thereof, states by whom orders will be executed and contains such other information as the Commission by rules or regulations deems necessary or appropriate in the public interest. The statute as amended thus provides an expanded type of the well known "tombstone ad." The purpose of this expanded "tombstone ad" is solely to permit underwriters and dealers to publish or mail a simple notice containing just enough information to enable a determination by the investor as to whether or not he is interested in receiving further information. It is not intended to be a document for decision by the investor. It would not be filed or processed by the Commission's staff in advance of use. A proposed rule implementing this amendment has been circulated for comment, but not yet adopted by the Commission.

This then is the entire arsenal of writings available under the revised statute for dissemination during the waiting period. Taken together they furnish an effective means of enabling investors to appraise oral representations made to them by sellers before the investor can be legally obligated to buy the security.

The Commission, as I have indicated, is presently devoting its attention to the preparation of rules in respect to the permissible content of the "expanded tombstone advertisement" and of the summary prospectuses. The Commission has recently distributed for comment a proposed rule which would permit underwriters and dealers to circularize potential investors with an expanded tombstone advertisement which would include no more than the following: The name of the issuer; the title of the security and the amount being offered, the identity of the general type of business of the company; the price of the security or the method by which the price will be determined; the yield of a debt security with fixed interest provisions; the name of the dealer circularizing the advertisement; the name of the managing underwriter; the approximate date in which it is anticipated the security can be sold; whether or not the security is a legal investment or is exempt from specified taxes; or the extent to which the issuer has agreed to pay certain taxes and whether the securities are being offered pursuant to rights issued to security holders. The rule also provides that the investor be afforded an opportunity to indicate by coupon, card, or otherwise, whether he would be interested in receiving a copy of the latest prospectus in respect of the security. This type of rule should fulfill the statutory objective of enabling underwriters and dealers to communicate by the press and the mail with prospective investors to determine those who are interested in the security, thus reducing the cost of distributing prospectuses which but for this type of advertisement might require the use of a prospectus as an initial approach to the investor. At the same time it facilitates a broadening of the base of potential investor interest available to the underwriter and dealer without loss of necessary protection to the investor. From the standpoint of the investor, he is enabled to obtain a copy of the prospectus during the waiting period.

With respect to contracts effected by acceptance of pre-effective offers to buy, the final prospectus in practice under the law must be delivered to the investor before he parts with his money. This follows partly from the requirement of the statute that written confirmation of a sale of a security must be accompanied or preceded by the full statutory prospectus. Also it is believed that the courts will regard the acceptance or segregation of funds pre-effectively as evidence of an illegal contract. As a result, between the date of the written confirmation and the settlement date, the investor has the opportunity to read the full prospectus and form a judgment as to the verity of oral statements which may have been made to him.

It is hoped that the expanded "tombstone" advertisement and reliable summary prospectuses, as now permitted by the statute, will be widely distributed to investors by underwriters and dealers during the waiting period prior to the dissemination of the full prospectus which must be given to every investor who purchases the security.

Serious problems to you as well as to the Commission are, however, presented by the concept of a summary prospectus. Indeed, the statute itself recognizes that such a prospectus necessarily must omit material facts. I need not labor the proposition that investment analysis is a complex matter necessarily involving an evaluation of many factors. The Act itself, in Schedule A, specifies 32 items of information which registering companies are required to set forth in the registration statement. The Commission is empowered to add to or to subtract from such requirements to the extent that it believes the residual disclosure is fully adequate for the protection of investors. The contents of the prospectus which must be given to each investor are also prescribed by the statute but the required content may be varied by the Commission in the public interest and for the protection of investors.

Economics teaches us that fundamentally the purchase of a bond, a preferred stock or a common stock is basically a participation in the assets and earnings of a business aggregate which is expected to continue in existence for profit-making purposes. The intrinsic value of the investment will depend on many things, some of which of course will occur in the future.

For both those who administer the Securities Act and those who must comply with it, the range of information which is in fact of paramount importance must be judged in terms of the basic statutory standards. Predominantly, the material disclosures necessary to appraise value as against offering prices will be disclosures in respect of the past earnings of the company, its financial position as revealed by a balance sheet and other statistical data, the intended use of the proceeds of the financing, the nature of the business in which it is engaged and a description of the contractual rights and the relative participations in the assets and earnings of the company of the securities being offered. In its newest form for registration under the Securities Act (Form S-9), a form of registration for high-grade, institutional type, non-convertible debt securities, possessing on the basis of past earnings a very substantial degree of interest coverage, these areas of information are all that are required to be included in the registration statement. I think it is a fair statement that over the years the Commission in its form making has attempted to emphasize these aspects in its prospectus requirements and has reduced materially information formerly contained in and not primarily necessary to the prospectus investment analysis, such as the proposed terms of underwriting and the mechanics of the proposed distribution of securities. We are firmly convinced that these areas of information are the basic minimum of information necessary to an informed analysis. We are now faced with the real and immediate problem of translating a statutory theory into a practical finished tool.

To condense into a two or three page document, selected material information in respect of a modern business enterprise engaged in many and diverse business activities will require nice judgments of you and of us. The modern debt security or preferred stock usually constitutes an aggregate of exceedingly complex rights and privileges. Variations in asset coverage requirements and dividend restrictions, sinking fund provisions and other characteristics of the instrument may have a sharp incidence upon value judgments. So also the description of the business of the enterprise necessary to an understanding of earning power and an appropriate rate of capitalization of such earning power must in most cases be something more than a simple statement of what is manufactured or what services are performed. The description to be informative must involve a discussion among other things of the product manufactured or the service rendered, its utility and the relative sensitivity of production and sales to cyclical change, the range of demand for the product among other manufacturers and ultimate consumers, the existence of competing products or services and the relative acceptance of such products or services as against those manufactured or furnished by the company, the existence of new technologies or of new products and services which may make the company's products or services obsolete, the dependence of the company upon one or a relatively few customers such as the government, if the company's business is primarily defense-connected, the patent or other protection which the company has for its products and the possibility of more intense competition if and when such patent protection expires, and the growth or decline of the competitive position of the company in the industry over the period of its summary of earnings included in the prospectus.

I cite these illustrations to depict the extent of material information which may be lost by omission and summarization. The problem becomes of greater concern because as a practical matter the summary prospectus may be the actual document of decision by the investor. To be sure the investor must receive the final prospectus in connection with the consummation of the sale. Nevertheless the temptation will be strong to ignore the full statutory prospectus and to rely upon the so-called summary prospectus.

To be useful a summary must attract interest without distorting - arouse curiosity without suggesting exaggerated or misleading inferences to be dispelled by later communications of the full facts - stimulate inquiry without in fact selling or discouraging further analysis of the merchandise.

Against this background, it is the Commission's staff present thinking that a summary prospectus rule should be made available at least initially only to those companies which already have securities owned by the public and which have had an operating record of earnings for at least five fiscal years, three of which must have been profitable years. It is suggested that such a rule apply at least initially only to companies which are presently required to file annual and interim financial and other reports with this Commission because of either

previous registration under the Securities Act or registration under the Exchange Act for listing on a national securities exchange. Presumably, the summary prospectus would not be available when there are outstanding problems of disclosure between the company and this Commission. In the case of such companies of the kind just mentioned, their business and earnings prospects presumably have already been subject to some degree to the scrutiny of the market place. The danger of a condensation which may omit material facts may perhaps be less than in the case of the unknown or the new company. In line with our concept as to the predominantly important areas of information necessary to the formation of an informed judgment as to the merit of a security, the staff is considering recommending to the Commission a rule which would permit a short-form prospectus which need summarize the contents of the full statutory prospectus only in respect of the summary of earnings for the five full fiscal years; the company's capital structure before and after giving effect to the financing, a brief description of its business; a brief description of the rights and incidents of the security being offered; the purpose of the use of the proceeds of the company and the name of the principal underwriter. Finally, a legend would be required pointing out to the investor the existence of, and his right to obtain a full statutory prospectus before he can become obligated to purchase the security. Let me emphasize that this is only tentative thinking as to the possible scope of the use and content of a summary prospectus.

We also have before us the problem as to whether if such a summary prospectus is adopted, our power to shorten the waiting period should take into account the degree to which the summary as well as the full statutory prospectus has been distributed to investors. After all the justification for a summary prospectus, in theory, is that it will be in fact disseminated widely among investors during the waiting period to supply them with at least minimum information in respect of the security and that inquiries will be responded to with the full prospectus or a seller's judgment based on the full prospectus.

It must be clear that, while the Commission with the advice and assistance of issuers, underwriters, dealers and investors or their representatives, can chart the general areas of information necessary or appropriate for inclusion in a summary prospectus, the ultimate responsibility rests with the underwriters - that is you, the investment bankers - for the success of the summary prospectus, not only as an effective tool in the public offering of securities but also as an appropriate instrument for fairly eliciting intelligent inquiries from dealers, investors and their advisers.

I hope this brief discussion has given you some idea of the current problems with which the Commission is presently concerning itself with respect to the dissemination of information during the waiting period under the Securities Act as amended in 1954. In the past we have had the earnest cooperation of your association as an aid in the evolution of Commission policies. We earnestly solicit your comments.

Let me thank you again for the real privilege of addressing you here in Boston.