

FEDERAL SECURITIES REGULATION UNDER
PRESENT MARKET CONDITIONS --
THE WORK OF THE
SECURITIES AND EXCHANGE COMMISSION

Address of

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before the

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It is a great pleasure for me to be in Cincinnati to speak before the Cincinnati Club at your annual meeting. This is the first opportunity since I became a member of the Securities and Exchange Commission in 1953 to visit Ohio, although I confess that I have flown over your State and travelled through it a number of times in the past two years. In so doing I have often hoped that I would have an opportunity to visit professional and civic groups in your State.

These trips which I make to various parts of the country in connection with the work of the Securities and Exchange Commission are valuable to me because they give me a chance to describe the work, under its present administration, of our Federal agency and also to hear, in face-to-face discussions with people like yourselves, general public reaction to our work and our law enforcement program.

I may say that in the case of the State of Ohio we are particularly helped in Washington by the friendly interest of your two Senators. Your senior Senator, John W. Bricker, is a member of the Banking and Currency Committee of the Senate, which is the committee charged with watching over the work of the Securities and Exchange Commission, and your Senator, George H. Bender, has during his service in the House and in the Senate taken an active and friendly interest in the work of our Commission. Consequently, it is a particular pleasure to be here in Ohio for the first time.

The Securities and Exchange Commission is the agency in the Federal Government which was established in order to require, in interstate and foreign commerce in securities, certain standards of conduct by corporations selling their securities to the public and by brokers, dealers and others trading in securities which would, speaking broadly, protect the public against abuses and fraud. The Commission in effect is the "policeman on the beat" of the securities markets. Other agencies of the Government, such as the Treasury Department, the Federal Reserve System, and the Council of Economic Advisers, are directly concerned with the country's economics, including the securities markets. However, the Securities and Exchange Commission, in requiring adherence to certain standards and preventing and punishing abuses and fraud, is of great importance to the proper functioning of the securities markets.

The confidence which the investing public today shows in the securities markets is at least in part due to the Securities and Exchange Commission's activities. This being so, I will mention several factors at work in the markets today which cause us at the Commission concern, and which will require responsible and thoughtful action by Government, the securities industry and the public.

First, let me explain briefly what the jurisdiction of the Securities and Exchange Commission is. The Securities and Exchange

Commission was established by the Congress in 1934 for the purpose of extending Federal regulation into the field of corporate securities sold to the public and traded in interstate and foreign commerce.

The adoption of these laws, the Securities Act and the Securities Exchange Act, was not a new idea in the middle 1930's. There had been Congressional recognition of the problems of the corporate securities markets as far back as the turn of the century. During the presidency of Theodore Roosevelt, there was considered by the Congress a bill to provide for the incorporation of companies doing business in interstate commerce under Federal law rather than under the laws of the several States, as had been the traditional legal pattern over the years. Also, there had been studies in the 1920's by Congressional Committees and the Federal Trade Commission.

The stock market crash and the very drastic losses in securities which the public suffered in the late 1920's and early 1930's brought about the public demand for the creation of the Securities and Exchange Commission and the granting by the Congress to the Commission of regulatory authority in this area of interstate and foreign commerce.

The fact that there was such a long history of consideration of Federal regulation of the securities markets has been a factor in the success of the Commission in accomplishing its basic objectives in the years since it was created and the general public acceptance of the Commission's work.

What are the basic objectives of the Securities Act and the Exchange Act? Let me tell you about them briefly and, in the hope that it may be more interesting to you, I will try to relate what I say to the present economic conditions. The condition of the capital markets today is vastly different from their condition in the middle 1930's.

The Securities Act, which we administer, provides that before a corporation may issue and sell new securities in interstate commerce, or before a large holder, called technically a "controlling person," may sell the securities of a corporation in interstate commerce, the corporation must file with the Securities and Exchange Commission a document called a registration statement. The offering prospectus, which is a part of the registration statement, is required to set forth the basic business and financial information which a person to whom the stock, bonds or other securities are being offered should know in order to form an intelligent investment judgment as to whether or not to purchase the securities offered.

The type of information required to be given in the prospectus includes such things as a description of the business of the company, a description of its principal plants and properties, a description of the business experience of its officers and directors, a description of the contractual relations between the company and its officers and directors, particularly such things as stock options, pension plans, bonuses and

other emoluments of office, a description of any outstanding options and warrants, a description of the relative rights and preferences in the corporate structure of the security being offered, and a statement of the terms of offering, that is the prices at which the securities are being sold by the company to the underwriters, and in turn by the underwriters to the public, or, if there is no underwriting by dealers, then a description of whatever arrangements have been made to assure the sale of the issue. Also, and most important, there is required a summary of earnings of the company and profit and loss statements for the past three years and a recent balance sheet certified by independent public accountants as having been prepared in accordance with the accounting rules of the Commission and with generally accepted accounting principles. I cannot emphasize too strongly the importance of the accounting requirements of the Commission because the accounts, more than any other type of information, when properly prepared and presented give the prospective investor reliable data on which investment judgment can be based.

In processing the registration statement the Commission normally takes twenty days' time. This results from the provision of the Act that the registration statement shall become effective at the end of a twenty day period after filing with the Commission. The purpose of this is to assure that the business and financial information pertaining to a company issuing a new security or a controlling person selling securities of a company to the public shall be publicly

disseminated and become generally known before the securities are actually sold. While the Commission has power to shorten the 20-day waiting period, this may be done only when we determine that to do so is consistent with the public interest and the protection of investors, having due regard to the adequacy of the information about the issuing company available to the public prior to the proposed distribution and also to certain other factors specified in the statute.

Also, one of the requirements under the Securities Act is that most companies which have registered securities under the procedures I have just described must continue to file annual and other interim financial reports in the form required by the Commission's rules. Thus, with minor exceptions, with regard to all of the companies which have sold registered securities to the public under the Securities Act, there has been built up over the years an enormous body of financial information which is available generally at the Commission's offices in various principal cities, through private statistical services and other means. This has given the investing public a basis upon which to have confidence that the securities being offered to him will be bought, if he decides to buy, on reliable information about the company in which he is investing his savings.

Now, how does the Commission administer the Securities Act? Very briefly, we have a staff in Washington which examines the registration statements and financial reports that are filed and attempts to secure compliance with the disclosure and accounting standards of the

Securities Act. Also, the Act provides administrative and judicial relief against misstatements and fraud. The administrative relief against misstatements in the registration statements is provided by a section of the Act which permits the Commission, after a full evidentiary hearing, to suspend the effectiveness of a registration statement, and the legal effect of this is that any public offering and sale of the securities would be unlawful. There are civil and criminal penalties attached to violations of the Act and the rules.

There have been filed with the Commission in recent months a number of registration statements which cannot meet the disclosure and anti-fraud provisions of the Securities Act. The companies proposing to issue these securities appear to have forgotten or overlooked the basic fact that the responsibility for preparing and filing a registration statement rests upon the issuing company and the underwriters who propose to sell the securities to the public. Oftentimes, such companies appear to consider it to be the function of the staff of the Commission to rewrite their registration statement for them. The Commission's staff is ready to assist those who in good faith assume the burden of preparing a registration statement and to be as helpful as possible in suggesting whatever may be needed in the way of additional information if the registration statement as filed is not entirely complete. But in those cases in which the issuer and underwriters refuse or neglect to comply

with the disclosure standards of the law, or where the registration statement appears on its face to be false and misleading, the Commission's policy in the public interest and for the protection of investors is immediately to order stop order proceedings. Since the beginning of the present calendar year, the Commission has instituted eight such stop order proceedings and has instituted several investigations under its statutory investigative power with respect to a number of others. The Commission is determined to do all that it can under the law to assure compliance with the standards which the Congress specified in the Securities Act.

Now, that is a very brief description of a large and technical subject, but let me relate to it what it means in terms of the capital markets. The capital formation process in the middle 1930's was almost dormant. For example, in 1935 the amount of corporate securities registered with the Commission for sale to the public was only \$2.8 billion. Just to pick several other years at random, five years later in 1939 the amount was \$1.8 billion, in 1942 \$800 million. Contrast this with the enormous capital formation process which is going on today. In 1953 the amount of corporate securities registered with the Commission for sale to the public was \$9.2 billion, in 1954 \$9.6 billion, and, in the first nine months ending September 30 of this year, \$10.1 billion.

This very large volume of new issues of corporate securities being sold to the public in interstate commerce at the present time is

one of the characteristics of the present tremendous economic activity generally. The September figures of the Department of Commerce on the so-called "gross national product" indicate an annual rate of \$391.5 billion based on statistics for the third quarter of this calendar year. In this figure is included a total of \$60.5 billion of private investment, of which \$32.8 billion is allocated for building, \$25.1 billion for tools, and \$2.6 billion for inventories. Funds for this enormous investment by private business are provided from "internal sources," such as retained earnings not paid out to shareholders in dividends, depreciation accruals, amortization provisions and the like, from securities sold privately, and from the securities sold to the public under registrations with our Commission.

I am sure you can realize from the figures I have just cited the enormous importance to the economic activity of the country as a whole of the proper functioning of the capital formation process under the provisions of the Securities Act.

Now, let me turn to the Exchange Act. The Exchange Act provides for the registration and regulation by the Commission of national securities exchanges, that is stock exchanges. This law also provides for the filing by companies whose securities are listed on the exchanges of annual and other financial reports similar to those I mentioned a moment ago as being required of companies which have offered new issues of

securities for sale. The Exchange Act provides for regulation by the Commission of the solicitation by listed companies of proxies from their stockholders. This means that a company soliciting proxies of its stockholders, for the election of boards of directors and for other corporate action which the law requires must be voted on by security holders, are required to conform to certain standards of fair disclosure about the directors seeking election or the transaction proposed to be entered into by the company. The Act requires brokers and dealers to register with the Commission and comply with statutory standards and Commission rules. The Act requires officers, directors and large stockholders, that is holders of 10% or more of the equity securities of companies whose securities are listed on exchanges, to report their transactions in said equity securities and provides for recovery by the corporation of any short swing profits made by them. This deters "profiteering" by the use of "inside information." The Act gives the Commission power to review the rules and regulations of the stock exchanges or to impose rules upon them. Manipulation of the securities markets is prohibited. Securities dealers' associations are under the Commission's jurisdiction, and the Commission has a limited supervisory authority over the unlisted securities markets.

The Exchange Act and the procedures which the Commission has established under it have required stock exchanges, securities dealers and brokers and certain other persons to conform to legal standards of good conduct protective of the public interest and the public investor and have contributed toward the confidence which the public has shown in the past few years in the capital markets.

Again, let me give you a few comparative figures to show the difference between the capital markets in the 1930's and now. For example, in 1935 the market value and volume of all shares traded on registered stock exchanges was \$15.3 billion and 660 million shares. In 1939 these figures were down to \$11.4 billion and 460 million shares, in 1942 \$4.3 billion and 220 million shares. Contrast the figures in the past several years. In 1953 the market value and volume of stocks traded on the exchanges was \$16.6 billion and 630 million shares, in 1954 \$28.1 billion and 990 million shares, and in the first nine months of 1955, \$29.3 billion and 940 million shares.

A phase of the capital formation process which has been giving the Commission a great deal of concern in the past year pertains to the sale of many issues of securities under the exemption provision of the Securities Act which Congress specified for issues of small or moderate size.

The Securities Act, when it was passed in 1933, gave the Commission power to exempt, subject to terms and conditions and rules and regulations which the Commission might prescribe, issues not in excess of \$100,000 in aggregate offering price where the Commission should find that the enforcement of the Act with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering. In 1945, by an amendment of the Act, Congress raised the exemptive amount to \$300,000.

Nothing which our Commission does by way of conditioning this exemption on strict rules and regulations should be designed to interfere with the legitimate raising of capital by small businesses. Rather, we have been cooperating with the Small Business Administration in gearing our requirements and rules to the needs of small business seeking amounts of capital of the size I've just mentioned. Nevertheless, there have developed conditions that disturb us and on which we are contemplating action the better to protect the investing public. There has developed a boom in "penny stocks," principally uranium mining issues.

A Subcommittee of the Interstate and Foreign Commerce Committee of the House of Representatives has been so concerned about this problem that it has held hearings in the past few months in Washington, Denver, Salt Lake City and New York and is considering a bill which

was introduced by Representative John B. Bennett of Michigan which would repeal the exemptive provision of the Act, thus requiring all small issues to comply with the full registration requirements. There is considerable to be said in favor of requiring issuers and underwriters of speculative, promotional issues to comply with the registration provision of the Act. One particular advantage of requiring registration is that the issuer and underwriter would be subject to more drastic civil liability for misstatements and omissions of material facts and this would have the effect of placing the responsibility where it belongs -- on the issuers and promoters and underwriters. Just to illustrate the importance of the problem, the amount of new issues of uranium company securities that filed under the Commission's \$300,000 exemptive regulations in 1954 aggregated about \$40 million, and in the first nine months of 1955 about \$105 million, but in the current year because of substantial failure to comply with the full disclosure and anti-fraud provisions of the Act, the Commission has commenced 35 denial or suspension proceedings against these small issue filings.

The Commission, however, is considering a less drastic approach than withdrawal of the exemption completely. We believe that most of the regulations with respect to the promotional issues should be tightened in order to give the investing public a better break. Nevertheless, the Act should not be applied in such a way as to strangle or hamper legitimate small business in raising needed capital.

Finally, I think you will be interested in view of the very active trading markets in recent months of something of the Commission's regular market surveillance work. This became particularly important in view of the drastic market action in the weeks following the announcement of the President's illness when there was a considerable decline in price levels followed by an almost complete recovery of those prices to their levels before September 26.

The Commission is actively engaged in observing market conditions so as to carry out the Congressional mandate against the types of abuses, manipulation, rigging, pools and the like, that were typical in the stock market before the Commission was created. We have various rules in effect directly regulating trading on exchanges and the exchanges themselves have many more self-policing rules and procedures. For example, the Commission has in effect a rule covering prices at which short sales may be effected on an exchange which generally prevents short sales on a declining market. This serves to discourage "bear raiding." Our rules also prevent persons engaged in the distribution of the security from paying others to solicit purchases of securities of the same issuer on an exchange except under specified conditions. The Commission recently adopted, after two years of careful study, rules dealing with the stabilization of securities prices to facilitate a distribution which operate to prevent persons engaged in distributing a security from creating active trading or raising the price in connection

with a distribution, and limit the stabilization of prices by requirements of disclosure and other controls which operate to prevent deception or unfair advantage being taken of the buying public. Also, the statute and our rules prohibit the use of manipulative or deceptive devices in connection with purchase or sale of securities.

The Commission enforces this prohibition of manipulative and deceptive practices in a variety of ways. We inspect the books and records of brokers and dealers and our inspectors, among other things, review transactions recorded in such books in the light of anti-manipulative standards. We investigate complaints coming to us from the public, from customers and from brokers and dealers.

In addition to this, we carefully watch activities on the exchanges themselves. A considerable volume of reports and statistical material comes to us regularly from the exchanges, covering short selling, the activities of floor traders, and similar matters. These are published in the Commission's Monthly Statistical Bulletin. Beyond this we maintain a "market surveillance unit" in our New York Regional Office which watches the recorded transactions on the New York exchanges as they come over the ticker, and the quotations in the over-the-counter market as they are published on the National Quotation Sheets, for the purpose of detecting activity in any security which does not appear to be based on economic factors and may indicate the presence of manipulation. When such a question arises, this "market surveillance unit" conducts a

"flying quiz" with respect to the transactions in the particular security. In the "flying quiz" the identities and activities of purchasers and sellers are ascertained and reviewed. The market surveillance unit also investigates complaints coming to us from all sources concerning possible manipulative activity. Ordinarily none is found. But we feel that the very existence and activity of this surveillance group has a powerful deterrent effect on possible market manipulation. And on those rare occasions when a manipulation can be proved, the civil and criminal sanctions of the Exchange Act can be brought to bear. The statute provides a maximum penalty of \$10,000 fine and imprisonment for two years in a Federal penitentiary on conviction of manipulating the market, which is perhaps one reason why there are so few manipulation cases nowadays.

In addition to these direct controls, the light of full disclosure is brought to bear on many market activities where formerly inequitable practices flourished under the cover of darkness. As I mentioned earlier, issuers of securities listed on national securities exchanges file with us and make available to the exchanges and thus to the investing public comprehensive reports of their financial condition as well as of events of major significance to investors. "Insiders" -- that is officers, directors and 10% stockholders -- report currently to the Commission and the exchanges changes in their ownership of their company's securities, which are published in the Commission's monthly bulletin on Ownership Reports,

and "insiders" are required by Section 16(b) of the Exchange Act to pay over to the company profits realized by them on short-swing trading.

We feel that by all these methods the Commission, working in collaboration with the securities exchanges and the securities industry, has come a long way toward providing for investors an orderly market, generally free of manipulation, deception and other unfair practices. Public confidence in the integrity of the securities markets is high and sustained and these markets are in a better position than ever before to perform their important function of channeling the savings of the public into productive corporate enterprises.

I do not mean to suggest that there are no violations of law going on, or that those that do occur are all detected by the Commission. That would be too much to expect of any law enforcement agency. But I do mean to say that with the limited funds and personnel available to the Commission much has been accomplished.

Let me describe just briefly recent conditions in the stock market. Stock prices fell precipitously on the New York Stock Exchange on Monday, September 26, the break of 31.89 points or 6-1/2% in the Dow-Jones industrial average being one of the sharpest in the history of the Exchange. For perspective it should be noted that the Dow-Jones industrial average was at an all-time peak of 487.45 at the closing on Friday, September 23. It had advanced from an historic low of 41.22

in 1932, from 92.92 in 1942, from 161.60 in 1949, and from 255.49 in September 1953 when the present long and rapid advance began. Beginning September 26, the average declined 48.86 points in eleven trading sessions or slightly over 10%. The aggregate market value of all stocks listed on the New York Stock Exchange was about \$205 billion on September 23 and during the next eleven trading sessions lost an estimated \$18 to \$20 billion.

Most of this has since been regained and the present estimated value is about \$200 billion. The differences in the market today from the day in the late twenties are extremely important. As you no doubt know, the margin requirements of the Federal Reserve System have been increased from 50 to 60% and then to 70% during the present year. Thus, data available to us indicates that on the days of rapid market decline there was little or no problem of margin calls. Forced margin accounts selling and stop loss orders were not an important factor. There was only a moderate amount of short selling and also there was much more covering of short sales than short selling between the 15th of September and the 15th of October. In the days of active trading, a great responsibility was thrown on the specialists on the floor of the exchange. The specialists are members who are required by the exchange to maintain a liquid market in particular stocks and they assumed very large commitments on September 26 in order to keep the market

orderly. For example, the specialists purchased on that day a total of over 1,700,000 shares in order to cushion the avalanche of selling orders from the public and their total purchases were approximately \$80 million. It also may be noted that, although the amount of credit presently being used to carry securities has increased over the past several years to a top of nearly \$4 billion, both in dollar amount and in percentage of aggregate market value this is drastically less than the amount of credit in the market in the twenties. Needless to say, our Commission is very actively observing market conditions.

In conclusion, let me stress the importance of the maintenance of the confidence of the American people in the securities markets. In our economy today, few citizens are unaffected by these markets. The 90 million Americans holding life insurance policies have an indirect interest in these markets through the great investment in stocks and bonds of corporations held by insurance companies. Beneficiaries under pension funds and holders of investment company shares have an indirect interest. And the 8.5 million citizens who directly own shares of corporations are vitally concerned. Our corporate wealth is very broadly held. The securities markets provide the mechanism by which business raises the capital required to serve the economic needs of the people. They provide a mechanism by which industry may be broadly shared by the people. Ownership of American industry has become, through the operation of the capital markets, freely transferable. Thus, investors

are willing to place their savings at the disposal of industry and the capital so essential to the nation's economic progress is provided.

The Securities and Exchange Commission is not directly concerned with the economics of this process. It is not the Commission's business whether prices of securities on the markets go up or down. But we are vitally concerned that price movements result from the free judgment of buyers and sellers trading in fair, honest and orderly markets. The Commission does not, and under the statutes is nor permitted to, pass on the quality or investment merits of securities registered with it for initial sale or listing on exchanges. That is not our province. But it is our business to require, under the Securities Act and the Exchange Act, adherence to the "fair disclosure" standards of the law, the maintenance of free, fair and orderly securities markets, and the detection, prevention and punishment of fraud in the sale of securities. This is a great responsibility and requires the cooperation of securities dealers, brokers, investment bankers, the exchanges, dealers' associations, and all those who have to do with the securities markets, working together for the best interests of the investors of America and the American people.