CURRENT SEC PROGRAM TO PROTECT PUBLIC INVESTORS

Address by

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I am deeply gratified at the honor that the Bond Club of San Francisco has tendered me by its invitation to address your organization. As a native of San Francisco, I welcome the chance to be with you again. As a member of the Securities and Exchange Commission, I willingly accept this opportunity to report on our stewardship in administering the various Securities Acts.

This Commission is not vested with responsibilities for determining economic policies. The general level of security prices - whether the stock market averages are high, or low, or somewhere in between - is not, of course, subject to our regulatory control. The prices paid for corporate stocks and bonds are determined by the economic decision-making of individuals.

The exercise of our functions under the Securities Acts in regulating the processes of capital formation and securities trading must, however, be considered in the context of the unprecedented economic activity in this country during the past few years - which is reflected in the growth of the annual gross national product this year to nearly 400 billion dollars. During the past three years the aggregate value of new corporate issues sold to the public averaged nearly 9½ billion dollars each year, as compared with less than 7 billion dollars a year in the immediately preceding post-war period. New corporate financings during the calendar year 1955 will probably exceed 12 billion dollars. The significance of this intense public interest in corporate investment focuses more sharply when compared with an annual volume of about 2 billion dollars during the depressed period of the 1930's. The volume of trading on national securities exchanges during the past single year has almost equalled the aggregate volume of trading during the preceding two years.

The current strength of our economy has, of course, been created by the initiative and ingenuity of American industry - by our scientists, farmers, labor and management. However, the favorable climate for economic progress and industrial expansion is grounded, in large measure, on confidence in the regulatory policies followed by the Securities and Exchange Commission by both public investors and industry. So long as the public and the financial community have valid reasons for believing that the securities markets are functioning as free, open and honest markets, confidence in the free enterprise system will prevail.

The vigorous economic activity during the past few years has generated many complex and novel problems for the Commission in carrying out its statutory responsibilities to protect the interests of the

public investor. The avalanche of speculative mining promotions, the highly-publicized proxy contests, the vast increase in the volume of trading on the national securities exchanges and over-the-counter markets, and the registration of many new broker-dealers has compelled the Commission to adopt some new administrative techniques. An appraisal of the manner in which the Commission has fulfilled its duties must, of course, be based upon the record.

First, a brief statement regarding the philosophical approach of the present Commission to its responsibilities in administering the Securities Acts: This Commission is determined to use its vast regulatory powers to protect the public investors through aggressive and strict enforcement of the disclosure and anti-fraud provisions of the statutes without stifling or strangling the economic development of legitimate enterprises by unnecessary or burdensome regulations. We intend to conserve vigorously the tested virtues of the full disclosure theory. We intend to strengthen energetically our enforcement activities against unlawful practices in the purchase and sale of securities, and by regulating wisely, to continue to maintain favorable conditions for economic growth.

The sharp market breaks this fall and the pronounced fluctuations in both trading volume and prices, following the unfortunate illness of President Eisenhower, made it advisable for the Commission to intensify its market surveillance work. Activities on the national securities exchanges are carefully scrutinized with the view to detecting and preventing any manipulative and deceptive practices. In our New York Regional Office a market surveillance unit studies 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 in the National Quotation Sheets. The Commission promptly receives reports of any unusual market movements, including such information as the size of transactions, whether large buy or sell orders dominate, the extent of foreign investor participation, and the market activities of institutions and pension funds. These studies are made for the purpose of detecting trading activities which do not appear to be based on economic factors and which may indicate the presence of manipulation. When market rigging or the use of manipulative devices is suspected, flying quiz investigations are immediately instituted to ascertain the identities and the nature of the activities of the purchasers and sellers in the suspected transactions.

Our analysis of the stock market decline on September 26, indicated that there was widespread public selling not in large blocks. There was, however, only a limited amount of forced margin account selling and stop-loss orders were not an important factor in the market break. It is also significant that on September 26 there was no substantial trading, either on the buy or sell side, by pension funds, investment trusts or other institutional investors, and that on the

subsequent Mondays when further declines were registered, institutions were buying on balance. On September 26, foreigners appear to have been buyers, but a week later, sentiment had changed and they became heavy sellers of American securities.

The statutes make it unlawful to create a false or misleading appearance of active trading 1/ or to use manipulative, deceptive or other fraudulent devices. 2/ Severe statutory sanctions - a maximum $10,000 fine and imprisonment for two years in a federal penitentiary - are imposed on conviction of manipulating the market. Various Commission rules implement these statutory proscriptions. One rule, which prevents short sales on a declining market, effectively discourages "bear raiding." Our stabilization rules prevent deception of the public investor by prohibiting persons engaged in distributing a security from creating active trading or raising the price in order to facilitate a distribution. These statutory and regulatory safeguards are enforced by our regional offices through inspection of the books and records of brokers and dealers and by means of flying quiz investigations. In our opinion, they have worked well in protecting the public from market rigging, pools, and other manipulative practices, even during the active market of this fall.

The high volume of corporate financing and increased activity in securities trading has attracted into the broker-dealer ranks many persons who are untrained in financial affairs and who have had limited, if any, experience in handling securities or funds of other persons. Many of the new registrants contribute insufficient capital to their businesses, and some are not imbued with the sense of professional calling that is generally characteristic of the investment banking and securities industry today. The number of broker-dealers registered with the Commission during the past fiscal year amounted to 4,334, which is a net increase of 202 over the number registered during the previous fiscal year.

In order to provide additional protection to the public against the danger of broker-dealer insolvencies, the Commission recently tightened its net capital rules applicable to brokers and dealers. This rule now provides that in computing net capital, a 30% deduction from the market value of common stock commitments or inventory must be made. 3/ This so-called "haircut" of 30%, as compared with the former 10% deduction, establishes a more stringent standard for broker-dealer financial responsibility. The coverage of the net capital rule has, by a further rule amendment, effective December 1, 1955, been

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1/ Securities Exchange Act, Section 9.
2/ Securities Exchange Act, Section 10.
3/ Securities Exchange Act Release No. 5156, April 11, 1955.

extended to substantially all broker-dealers registered with the Commission, regardless of whether they engage in the practice of extending credit to, or carrying money or securities for, the account of customers.[4/] Approximately 40% of the registered broker-dealers have claimed that they do not carry customers' credit balances or securities. However, since they frequently owe money or securities to customers in substantial amounts, the Commission believes that their customers are entitled to the safeguards provided by the net capital rule.

The Commission is also considering the adoption of a new rule to require all registered brokers and dealers to file annually with the Commission financial reports which have been certified by independent public accountants. At the present time, only broker-dealers who make a practice of extending credit to, or holding securities for, customers have been required to file certified financials with the Commission. The adoption of such a rule would place additional responsibilities on the securities industry for policing itself and afford increased protection to public investors.

The key to our enforcement work are the broker-dealer inspections conducted in the regional offices of the Commission. Our inspectors review the books and records of registrants, analyze their capital condition, and look for possible unlawful practices, such as transactions in unregistered securities, gun-jumping, churning accounts, and margin violations. Recently, the Commission instituted revocation proceedings against several broker-dealers for Section 5 violations - that is, selling unregistered securities or selling registered securities during the pre-effective period. Inspections are, of course, also instituted upon public complaints of mistreatment by broker-dealers.

Due to lack of money and manpower, the Commission has never been able to make sufficiently frequent broker-dealer inspections to afford full protection to the public against all possible abuses. Over the past few years inspections of firms have been made on the average of once every four years, but our immediate objective is to increase the tempo of inspections to an average of once in every two and a half years.

Additional protection to public investors against wrong-doing by broker-dealers is afforded by the self-policing of member firms by several of the registered national securities exchanges and by the NASD. Last year the Commission adopted a program, in conjunction with the NASD, a few of the exchanges and some state securities administrators, which was designed to eliminate the inconvenience caused by duplication of inspections. The various participants in the program try to avoid inspecting a firm that has recently been checked by one of the other

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4/ Securities Exchange Act Release No. 5244, October 25, 1955.

agencies. In some instances, the Commission has been compelled to reinspect various firms that had recently been visited by another inspecting agency, because we cannot rely on industry groups to enforce the federal securities laws. The ultimate responsibility for maintaining free and honest markets rests with the Commission.

Our enforcement work is never completed. There will always be violations, especially of a minor and technical nature, that the Commission will never be able to discover or prosecute. However, public investors have shown their confidence in America's expanding economy and in the existence of fair securities markets. This confidence is exemplified by the increasing number of owners of corporate securities. It is estimated that $8\frac{1}{2}$ million persons directly own shares in corporations and over 90 million Americans holding life insurance policies have an indirect interest in the securities markets through the great investment in corporate stocks and bonds by insurance companies.

Favorable market conditions have encouraged the floatation of many unseasoned, speculative issues by inexperienced promoters and underwriters. Due to the intensity of the public speculative interest in uranium, the evils of high-pressure salesmanship have sometimes occurred in the distribution of the stock of small mining companies. One of the most serious abuses that has arisen is the use of Regulation A for purely stock-jobbing purposes. In some instances, offerings have been discontinued as soon as sufficient securities have been sold to pay the claims of promoters and the commissions and expenses of underwriters. The insiders walk away from the deal and the public investor is left with a worthless equity in a company without operating funds. Other promotional issues have been heavily weighted against the public investor, who has furnished all the cash capital, through the issuance of warrants and options to promoters and underwriters. Sometimes, the underwriters have received more than one-third of the total gross proceeds from the public distribution in payment of commissions and expenses.

The Commission has attempted to protect the public from front-money rackets and stock-jobbing activities in various ways, such as requiring adequate disclosure by the issuers of securities, denying or suspending offerings, investigating and prosecuting fraud, and regulating the practices of broker-dealers. Since June 1955, the Commission has ordered the denial or suspension of the effectiveness of 33 filings made under Regulation A. In addition, the Commission has proposed certain stiffer requirements for the use of Regulation A by promotional companies. The proposed revisions to Regulation A - the rules which regulate offerings of securities under $300,000 - have elicited considerable public comment to the effect that the proposals would be unduly burdensome to small companies. The Commission is presently facing the decision of whether to adopt

the revisions, in whole or in part, or whether the public interest would be best served by requiring promotional companies to submit to full registration.

The authority of the Commission to regulate the solicitation of proxies has become increasingly important in recent years due to several bitter and highly-publicized contests for control of large corporations. Where opposing factions hurl charges and counter-charges in an effort to obtain stockholder support, spcial need arises for protecting the property interests of individual stockholders by requiring the dissemination of fair and accurate information by both management and opposing groups. Last August the Commission circularized for comment its proposed amendments to the proxy rules. The principal purposes of these proposals are to codify many long-standing administrative practices and to clarify the applicability of the rules to proxy contests. In addition to numerous constructive comments received from the public, considerable interest in the subject of proxies has also been shown by the Congress. One of the principal provisions of the Fulbright bill would extend the coverage of the Commission's proxy rules to certain companies whose securities are not listed on a national securities exchange.

The most vocal comments on the proposed new proxy rules raised the issue of the freedom of the press. However, neither the Securities Exchange Act of 1934 nor the present nor the proposed proxy rules gives the Commission the power to restrict the freedom of newspaper reporters at press conferences or in private interviews or to control editorial comment with respect to proxy contests. The newspaper which publishes a story or editorial or advertisement on a proxy contest is not, by definition, a participant subject to the proxy rules. The impact of the rules is only on persons who are participants in a solicitation for proxies. Another problem of proxy regulation involves the giving of proxies by brokers and dealers for listed securities registered in their names but owned by customers. The Commission is seeking to develop a workable rule which will prevent brokers from assuming their customer's voting rights while at the same time not interfering with the orderly solicitation of proxies and voting of shares.

During the last session of the Congress, Senator J. William Fulbright introduced a bill designed to extend the reporting, proxy and insider trading provisions of the Securities Exchange Act applicable only to companies listed on national securities exchanges to certain unlisted companies. A similar bill was also introduced in the House of Representatives by Congressman Arthur G. Klein. The Fulbright-Klein proposals apply to unlisted companies having total assets of more than two million dollars if the number of holders of equity securities exceeds 750 or the total amount of debt securities exceeds one million dollars.

While recognizing the soundness of its broad principles and objectives, the Commission has not endorsed the Fulbright-Klein bill. The Commission believes that a thorough, objective study of the reporting and proxy practices of the companies affected by the legislation should first be made in order to determine the factual need for such a vast extension of its regulatory jurisdiction. The Commission is presently conducting a survey to ascertain the identities of these companies, the nature of their financial reports to shareholders and their practices in soliciting proxies. The impact of the insider trading restrictions on the sponsorship of their securities by brokers and dealers who are also directors of the companies, is also being studied. This analysis, which should be completed by the end of this year, should disclose whether, in fact, serious abuses exist that should be rectified by the proposed legislation.

The Commission is continuing its program to simplify and clarify its forms and rules. With the recent adoption of major revisions to Form S-1, the principal registration form under the Securities Act of 1933, and to Form 10, the principal registration form under the Securities Exchange Act of 1934, the corresponding items have, for the first time in the history of the Commission, been conformed with each other and with the requirements of the proxy rules. The preparation of new rules to prescribe the contents of summary prospectuses, which may be used in offering securities for sale, is being vigorously pressed.

In conclusion, the Commission fully recognizes that firm and enlightened exercise of its vast statutory powers is essential in maintaining the proper conditions for an expanding, dynamic economy. By regulating the distribution processes and trading markets of securities with fairness and diligence, the Commission assists in maintaining an honest and healthy securities industry and a prosperous America.

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