THE SECURITIES MARKET

AND THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION

Address of

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before the

HOUSTON CHAPTER

of the

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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It is a great pleasure for me to appear before the Houston Chapter of the Texas Society of Certified Public Accountants. This is my second visit to Texas in a little over a month's time and I can assure you that I appreciate the opportunity to return. I am also pleased to have the chance of addressing a group of professional accountants. Accounting is the backbone of all financial reporting. The Commission's relationships over the years with the American Institute of Accountants and other professional accounting societies has been of immeasurable benefit to the Commission as a regulatory agency and to American business.

You will be interested, I am sure, in a brief survey of recent activity at the Commission, as well as in some observations on matters directly in the accounting field.

The past year has been one of strenuous activity for the Commission and our staff in handling the heavy volume of public business, in reviewing and revising our rules and forms, and in responding to requests by Congressional Committees for information in connection with various proposals and bills to revise the laws administered by the Commission, in connection with our rule making functions under these laws, and in connection with studies of stock market activity and behavior. An indication of the large volume of business handled by the Commission is given by the fact that in fiscal 1946 (until last year our busiest post-war year) there were 752 registration statements filed, covering $7.4 billion of new issues of corporate securities offered to the public in interstate commerce, but in fiscal 1955 there were 849 registration statements for a total of $11 billion of such securities.

Offerings of small size, that is not in excess of $300,000, under our exemptive regulations have placed a heavy burden on the staff, particularly in our regional offices. There were 1348 of these offerings under Regulation A in 1946 for an aggregate offering price of $182 million, but in 1955 there were 1628 for a total of $294 million. Troublesome accounting problems turn up in the financial statements submitted for use in these offering circulars, some of which are due to inexperience but many of which are due to attempts to put a "best foot forward" through old fashioned "window dressing" techniques.

Now let me tell you a little about some of our work which results from the stock market investigation conducted by the Senate Banking and Currency Committee last winter. In a report issued by the Committee in May, several areas for further examination by the Committee and by the Commission were suggested. Among these were the regulation of proxy soliciting activities of companies whose

securities are listed on the exchanges. Problems arising out of the contests for control of some of the nation's large corporations which have been waged in recent years are very much in the spotlight.

Generally speaking, the Commission's proxy rules have worked well in relation to the solicitation of proxies where there has been no contest. But criticism has been leveled at our rules as they have been applied in proxy contests. One of these, which the Commission has felt for some time should be remedied, is that the rules have not spelled out precisely who and what they covered when contests are involved.

It is said that the Commission's proxy rules do not elicit sufficient information concerning the background and motivation of persons who seek to wrest control of a corporation from its management. It has also been suggested that the Commission is not able to deal promptly with the many situations which arise in complicated and hard fought proxy contests.

To meet these problems, it has been suggested that the Commission should be given by the Congress more specific power than it now has to stop, by administrative order, violations of its rules and to compel such remedial action as may be appropriate in the circumstances. At present the Commission cannot by its own administrative authority prevent the use of misleading soliciting material or compel the correction of such material. The Commission's only remedy now is to go into the Federal courts and ask for an injunction against the use of misleading proxy material or the voting of proxies obtained from stockholders by the use of misleading material.

In August 1955, the Commission announced a proposed revision of its proxy rules, designed to spell out precisely the persons, activities and the soliciting literature which the Commission deems to be subject to the proxy rules. The proposals are intended to state more specifically the administrative policies of the Commission in regard to proxy contests. They specify the persons who would be deemed to be participants in the solicitation and would require the filing with the Commission of comprehensive information regarding their interest in and connection with the issuer, and as to their background. The proposed rules would also spell out in some detail the types of representation which in the past have created difficult problems of administration.

The proposed revisions have been the subject of intense public comment, both in writing and orally at a hearing held in Washington on November 17. The revisions have attracted much comment in the press, and the proxy rules generally were the subject of hearings by the Senate Committee on Banking and Currency in June. We are now digesting all of the comments, considering the proposed draft revision, and preparing it for final adoption.

The Commission, as a governmental body charged with the responsibility of preventing misleading statements, is obligated to object to misrepresentations in the solicitation of proxies of companies under its jurisdiction. Some of these misleading statements are the manner in which financial data are presented and calculations and interpretations are made based on financial statements which are themselves not subject to criticism. Material of this kind can become highly controversial. Such material is often found in proxy material intended for use in contests for control of the company. In the calendar year 1954 there were 13 non-management solicitations for control, of which 8 won. In 11 such cases, up to November 15 of this year, 4 were successful, 5 lost, and 3 were pending.

Another concern of the Senate Committee and the Commission is the growth of speculative enthusiasm for penny stocks. We are, therefore, in the process of revising our rules pertaining to securities which, because the amount offered in any one year does not exceed $300,000, fall under the conditional exemption provided by the Securities Act. 1/ The proposed revision pertains primarily to "promotional" companies.

We are aware that our regulation of the offering of these promotional issues should take into consideration the exemption which the Congress specified should be available. We recognize the necessity and desirability of not interfering with the raising of capital for speculative exploratory purposes in the extractive industries, such as oil and mining. But we also recognize that the exemption provided by the Congress was conditioned and was not intended to free issuers and underwriters of such securities of all regulation whatsoever.

There are difficult questions of judgment to be decided in acting upon our pending revisions of Regulations A and D. The Commission has been greatly aided in its consideration over the past few months

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1/ Securities Act Release No. 3555.

of this difficult problem by the work of the Subcommittee on Commerce and Finance of the Interstate and Foreign Commerce Committee of the House of Representatives. The Subcommittee has been considering a bill introduced by Representative John Bennett of Michigan to repeal Section 3(b). 1/ The Subcommittee has held hearings on the problem in Washington, Denver, Salt Lake City and New York. There is certainly a great deal to be said in favor of requiring issuers and underwriters of speculative promotional issues to comply with the registration provisions of the Securities Act. One particular advantage of requiring registration, rather than continuing the conditional exemption techniques which the Commission has permitted under present regulations, is that the issuer and underwriter would be subject to the civil liability provisions of Section 11 of the Act for misstatements and omissions of material facts required to be set forth in the registration statement.

We are determined that our revision of these regulations shall reflect the Commission's best judgment as to how investors in new issues of securities of the speculative promotional type can be given a fair disclosure of the pertinent business and financial information in accordance with statutory standards without strangling the capital market for such issues. But I, for one, have never been aware that the registration requirements of the Act strangled legitimate capital formation, even for speculative purposes.

The Commission is engaged in an objective factual study of the provisions and possible effects of the so-called Fulbright Bill. 2/ This bill, which was introduced in the Senate by Senator J. William Fulbright of Arkansas, Chairman of the Committee on Banking and Currency, and its counterpart 3/ introduced in the House by Representative Arthur G. Klein of New York, would subject companies whose securities are not traded on the stock exchanges to the financial reporting, proxy and insider trading requirements of the Exchange Act.

Shortly after the bill was introduced in the Senate, the Commission was asked to report on it to the Senate Committee. The Commission stated that it agreed with the broad principle of the bill, but could not take a definitive position on such short notice and without careful study of the possible effect of the bill.

1/ H.R. 5701, 84th Congress, 1st Session (April 20, 1955).
2/ S. 2054.
3/ H.R. 7845.

One problem raised by the bill which is of particular concern to the Commission is the question whether the application of the insider short term trading provisions of the Exchange Act to the securities of many of the smaller companies which would be brought within the Commission's jurisdiction would be detrimental to the maintenance of orderly and adequate markets for these securities. The Commission feels that an answer to this question is important to any conclusion as to the public interest and investor protection which would be served by enactment of the bill.

The Commission has mailed to about 1600 corporations which it believes would be subject to the bill, if enacted, a letter asking two questions: (1) whether the company has within the past three years sent an annual report to its stockholders and requesting a copy; and (2) whether management has sent proxy soliciting material to stockholders and requesting a copy. The Commission expects that on the basis of the information thus obtained and other information available it will be in a position to report to the Congress early in the next session. We are heartened by the cooperation of the companies to which we have sent the questionnaire. To date approximately 95% have responded to our questionnaire and information from those from whom replies have not been received (approximately 80) has been obtained elsewhere. This industry response will help the Commission to the end of permitting in developing a comprehensive, factual and objective study.

These bills have generated considerable adverse criticism in financial circles as an unneeded extension of the reporting requirements of the Commission. A meeting of accountants seems an appropriate place for comment on one of the objections raised by a number of critics. This is that publication of sales and cost of sales will place single product companies at the mercy of their customers and their competitors, and therefore such publication will harm the investor rather than protect him.

This argument has a familiar ring. It was used against the reporting requirements of the Securities Exchange Act when it was pending in the Congress in 1934. It has been used in support of applications for confidential treatment by the Commission of sales and cost of sales after the furnishing of this information was made part of the financial statements required to be filed on Form 10 for the registering of securities under the Exchange Act and on Form 10-K for annual reports to be filed thereafter.

The importance of sales and cost of sales in the analysis of financial statements was explored at length in hearings in 1938 In the Matter of American Sumatra Tobacco Corporation after the United States Court of Appeals for the District of Columbia had ruled the Commission's denial of confidential treatment of sales and cost of sales was subject to review by the Court. Upon completion of the record in the hearings the Commission again denied confidential treatment and was upheld when the Company again appealed to the Court. 1/

In this case the tobacco company made two principal arguments. First, it said that since its customers, the cigar manufacturers, are in a position to stay out of the market for one or two years, they would, if they knew the registrant's profit margin, refuse to purchase its tobacco unless it reduced its profits by lowering its prices. Second, it said that since the registrant is the only company engaged exclusively in the business of growing, processing and selling wrapper tobacco which has securities listed on a national securities exchange, disclosure of its sales and cost of sales would be disadvantageous to it from a competitive standpoint.

The Commission disposed of these arguments in its decision in the following language:

> "The evidence presented in this case shows that the registrant's assertions of the harmful effects which would follow the disclosure of its sales and cost of sales figures are no more than the stock arguments often advanced in opposition to proposals for the disclosure of such information. Essentially the same claims could be made by every corporate management which in the past has not disclosed these figures. Every company which has competitors that have no securities listed on a national securities exchange, or which produces one general product, in however many grades and qualities, and sells its product to a relatively small number of customers, could express similar fears of injurious competitive and customer reaction. Every such company which is required to register under the Act -- and there are many which have registered and disclosed their sales and cost of sales figures -- could (and most likely would) make the same arguments as the registrant. Despite the registrant's attempt to color these arguments as applying with unique force to its

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1/ 7 S.E.C., 1033; 110 F. (2d) 117.

own particular case, they are no more than general arguments against the policy of disclosure of the figures whose confidential treatment is here requested."

After appeal this opinion of the Commission was made public in 1940 when permitted by an order of the Court without objection by the tobacco company.

A treatise on Investments published in 1941 in a chapter entitled "Accounting and Statistical Tools in Analysis: The Income Account" contains a paragraph pertinent here:

"With many enterprises, unfortunately, the published income account is a great deal less illuminating than it should be. Much too often, it is lacking in adequate detail, sometimes with the unconvincing explanation that it is necessary to screen essential operating information from competitors. Steady progress is being made, however, in improving the general standard of such reporting, in part through the activities of the Securities and Exchange Commission in obtaining and publishing essential data upon the volume of sales, cost of sales, non-operating income, and similar items formerly held secret. It is increasingly being recognized that competitors are able to discover such data for themselves and that the screening is effective principally against stockholders." 1/

Another subject with which the Commission is presently dealing is the implementation by new rules and forms of the 1954 amendments of the securities acts. These amendments of the law had as a main purpose broader freedom in disseminating to the investing public pertinent information about new issues of securities prior to their actual sale.

The Commission has already adopted several new rules for this purpose. One of these permits communication by issuers to their security holders of information regarding forthcoming rights offerings. 2/ Another enlarges the types of information which may be included in the so-called "tombstone" ad. 3/ Another gives express sanction for the use by underwriters and dealers of the so-called "new issue" cards, which are prepared by statistical service organizations. 4/ We are also working on

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1/ Dowrie and Fuller, p. 355, John Wiley & Sons, Inc.
2/ Rule 135, Securities Act Release No. 3568.
3/ Rule 134, Securities Act Release No. 3568.
4/ Rule 434, Securities Act Release No. 3592.

a draft of a proposed summary prospectus rule for use by underwriters and dealers to advise prospective investors more fully regarding proposed offerings. It is hoped that such a summary prospectus may be relatively short in size which may be conveniently and inexpensively sent through the mails. The Commission feels that the adoption of these rules, and the development of appropriate practices by underwriters and dealers under these rules, will give greater freedom to issuers, underwriters and dealers in approaching members of the public with new issues.

The last two years have seen a program of revision and simplification of forms and requirements to ease the burden on reporting companies, to make the Commission's operations more effective and efficient, but not to diminish the investor protections provided by our rules and regulations under the Acts.

Just to give you an example, let me mention the completion in the past few weeks of the revision of the basic form for registration of new issues under the Securities Act. 1/ This has brought into conformity for the first time in the history of the Commission important disclosure requirements which are common to the basic reporting form for new issues, the basic reporting forms for companies soliciting proxies 2/, the basic form for listing new issues on the stock exchanges 3/, and the annual financial reporting requirements of listed companies 4/ -- all of which revisions have been accomplished in the last two years. This is but a typical example of the recent efforts of the Commission toward efficiency, both for our agency and for the companies we regulate.

In the revision of our forms and regulations proposals are placed before the public for comment and the responses are carefully considered by the staff and the Commission and suggestions deemed to have merit are adopted. For example, in the revision of Form S-1, adopted in October, comments were received from registrants, professional organizations, investment banking firms, law firms and public accounting firms. The experience of most of these is with large corporations and hence some of the comments indicated an unawareness of some of the problems encountered by the Commission in handling registration statements of small companies served by accountants and lawyers with less experience in the registration process.

1/ Securities Act Release No. 3584.
2/ Securities Exchange Act Release No. 4979.
3/ Securities Exchange Act Release No. 5243.
4/ Securities Exchange Act Release No. 4991.

I do not intend to discuss our approach to the revision of Form S-1 in detail but I think you might be interested in our disposition of some of the comments received with respect to Item 6, which prescribes the Summary of Earnings. As we expected, many comments were directed to this item as it is considered by many to be the most important single item in the Form. The item and the instructions now call for all of the disclosures which have been developed in the administrative process. These include disclosure of interest and dividend requirements on new bonds and preferred stock, permission to include interest coverage on bond issues as in Form S-9, interim period data for a corresponding period of the preceding year and the statement with respect to any unaudited interim periods that all adjustments necessary to a fair statement of the results for such periods have been made. The requirement that a letter be furnished to the Commission detailing any adjustments other than normal recurring accruals is included.

A number of comments received objected to the requirement for comparable interim period results. This requirement was retained for experience has shown that the summary of earnings may be misleading without such information. The staff has had to request it in so many cases that it was considered desirable to include it in the instructions.

One person suggested that the required statement as to adjustments be deleted and others that it be qualified in various ways. Experience has shown that the requirement has caused many registrants to take a good hard second look at unaudited interim periods. It is common practice for the certifying accountants to assist the registrant in preparing the required letter to the Commission. And of course we assume that the accountants wish to know that the interim periods are prepared on a basis comparable to the certified statements, and, if not, that changes in the application of accounting principles are appropriate. He also wants to be sure that no event has occurred between the date of the certified statements and the effective date of the registration statement that should be disclosed or that should be reflected in the statements he has certified. This Commission places great reliance upon the independent public accountant. This applies to the principles reflected in the uncertified financial statements as well as to the audited statements required to be certified. In a recent case, for example, the accountants' certificate called attention to the fact that the unaudited interim period reflected an important change in accounting. Conferences resulted in a significant change in presentation. "Window dressing" of the type I mentioned a few minutes ago is not confined to offering circulars for small issues. A part of your "reasonable

investigation" as certifying accountants prior to the effective date should be directed to uncovering such efforts. The management's statement on adjustments in the prospectus and its letter on this subject to the Commission are required by the Commission for the purpose of assuring that the interim unaudited statements do not suffer from errors of omission or commission.

Another accounting activity of the Commission should be mentioned. Experience over the years has shown the need for an adequate guide for the auditing of broker-dealers who are required to file reports on Form X-17A-5 with the Commission, under Rule X-17A-5. These reports include responses to a financial questionnaire and supplementary questions. Our rules now prescribe what are referred to as "Minimum Audit Requirements." Examination of the reports seems to indicate that many accountants consider these to be all of the requirements and fail to vary their procedures to fit changing conditions. Our Chief Accountant has been cooperating for some time with committees of the American Institute of Accountants in an effort to produce a comprehensive guide in this specialized field of auditing. This work is nearing completion. When this is available it is expected that Form X-17A-5 will be amended to delete the minimum audit instruction and to make the Form subject to the general instructions in Regulation S-X. At the same time the Form will be clarified where necessary.

In the meantime, we have under consideration an amendment to eliminate the certification exemption. We have felt for some time that we should have the protection afforded by an independent audit of all brokers and dealers, as our small field staffs have not been able to make the examinations that should be made. It has been suggested that such a requirement would involve an unwarranted expense partly on the assumption that qualified public accountants are not available in or near all cities where their services would be needed. This I doubt. As of September 30, 1955, there were 236 broker-dealers in the State of Texas registered with the Commission. The 1955 roster of accounting firms and individual practitioners of the American Institute of Accountants shows members of the Institute in 94 cities and towns in Texas. I have no doubt there are other accountants who are members of your Society who would be competent to undertake audits of broker-dealers.

Apart from its consideration of elimination of the certification exemption applicable to the annual reports of broker-dealers, the Commission is about to begin a special inspection program for broker-dealers in the jurisdiction of the Fort Worth Regional Office. We are sending a team of additional broker-dealer inspectors, taken from some

of our other offices to Fort Worth to assist Mr. O. H. Allred, the Administrator of that office, and the staff there in carrying out the Commission's inspection program. Regular inspection of brokers and dealers is a vital part of the Commission's enforcement program for the protection of the public and public investors. The number of registered brokers and dealers in the five state region, which comprises the states of Kansas, Oklahoma, Texas, Louisiana and Arkansas, served by our Fort Worth office was 356 at September 30, 1955, and has increased by 55 in the past eighteen months.

Broker-dealer inspections are conducted to assure compliance by registered brokers and dealers with the requirements of the Securities Exchange Act and to discover and prevent violations of the Federal securities laws. The inspectors review compliance with Commission regulations relating to dealings with customers such a hypothecation of customers' securities, extension of credit on securities, churning, switching and other improper or fraudulent practices, and the giving of proper confirmations, together with regulations relating to the conduct of the business including maintenance of books and records, filing of financial reports, and compliance with the Commission's net capital rule. These inspections frequently discover situations which, if not corrected, might result in substantial losses to customers.

This, together with a special broker-dealer inspection program in the Denver area, which is now approaching completion, represents another step in the Commission's efforts to make our broker-dealer inspection program as effective as possible with the personnel presently available.

However, the work of our broker-dealer inspection program must be implemented by the regular continuing year to year review of broker-dealer financial statements by the public accounting profession. We feel that the public accounting profession can make a great contribution to that protection of the public and the protection of public investors envisaged by the Exchange Act by assuming increased responsibilities with respect to the financial reports of brokers and dealers.