"Further Steps In Investor Protection"

An Address by

Clarence H. Adams
Commissioner
Securities and Exchange Commission

before the

Thirty-Fifth Annual Convention

National Association of Securities Administrators

The Wentworth-By-The Sea
Portsmouth, New Hampshire

September 3, 1952

"Further Steps in Investor Protection"

Mr. Chairman, distinguished guests, ladies and gentlemen:

It is a distinct pleasure for me to have the honor of addressing you tonight. My last appearance upon this rostrum was made during the time when I was a securities regulator in my home State of Connecticut and I had the honor of speaking to you as a retiring President of this Association. I return on this occasion in a somewhat different role -- that of an SEC Commissioner who wishes to say a few brief, yet heartfelt, words dealing with a subject that I believe is vital to effective and intelligent securities regulation.

I refer to cooperation among State, Canadian and Federal authorities in this field and the necessity for intelligent coordination of their efforts. I am quick to state that there is nothing novel about this theme. It has been spoken of many times before by others who undoubtedly were far more expert at the art of the apt phrase and the forensic term than I am. Yet I would like to think that the duality of service that it has been my privilege to enjoy -- my service stripes if you will -- qualify me to add something meaningful to what has been said before on the subject.

We all operate in a complex field and we do so in a growing society which itself becomes increasingly complicated as the decades pass. We deal too with a delicate mechanism -- the nation's economy. What we do and how we do it can give rise to effects hardly within the contemplation of even the wise, far-seeing men who enacted the first securities legislation in the State of Kansas back in 1911. It is inconceivable to me that the numerous authorities charged with supervising this important field can operate effectively and to the public good unless they are aware of each others' aims, objectives and activities; unless their efforts are coordinated; and unless they engage in the freest and most liberal interchange of comments and ideas. There would be no benefit from 47 different securities laws which, though cognate, are each administered in 47 separate little vacuums. The outgrowth of such administration could be nothing but a purposeless maze hardly conducive to investor protection.

Fortunately such has not been the case. My brief service with the SEC has rounded out my thoughts on the subject; it has convinced me of these conclusions beyond any doubt.

All securities legislation is basically a form of insurance against fraud and overreaching -- a means of suppressing the evil elements' that would attach themselves to any honest business. That is the common objective of all of our laws -- and I know it is the aim of the persons who comprise the securities industry. There seems to me to be no better way of attaining that common goal than by integrated action.

I know you share these principles. Your committee for liason with the SEC, the discussion periods held at this convention -- these and other steps you have taken make that plain. Yet these thoughts bear repetition, lest the demands of our day-to-day work obscure them. I commend to all of you the suggestion that in the coming year -- a year in which many of us will be required to do our assigned tasks with reduced staffs and deeply-pared budgets -- it particularly behooves us to set a new high in cooperative endeavor and coordinated action.

It is hardly enough to give prominence to thoughts of cooperation once a year on the occasion of this gathering. Our endeavor must be a constant one and we must take pains to do everything within our power to keep one another apprised of current plans and developments.

Let me start the ball rolling in that direction by outlining for you some of the matters that will rank high in the SEC's program in the year ahead. These matters will be of interest to all of you and will affect many of the things you are doing. Consider them then, and give us freely your ideas as to what you think of them, how you feel they can be improved and how they will fit in to your own scheme of things.

We have recently been considering at the SEC some measures designed to encourage the dissemination of information with respect to securities registered, or in the process of registration, under the Securities Act of 1933. These measures are an outgrowth of discussions which have gone on for some years relating to the amendment of the Act. However, the amendment program has been complicated by the controversial nature of some of the problems involved, as well as by the preoccupation of Congress with defense and other matters. The Commission determined, therefore, to do what it could to meet some of the problems through the exercise of its rule-making power under the present statute. Its proposed new Rule 132 and the related statement of policy regarding the acceleration of registration statements are directed toward that end.

Rule 132 and the new policy on acceleration are intended primarily to get information into the hands of investors before they buy. While the various "blue sky" laws that you administer differ in one way or another from the Federal Securities Act, I believe that you will all agree about the importance of having information about new offerings of securities available to investors, and having it available <u>before they buy</u>.

The experience of the Commission and my previous experience in Connecticut have shown that this is no simple thing to accomplish. It is true that any investor can refuse to buy a security unless the prospectus is given to him and he has had a chance to study it. However, this gets him nowhere if he finds, as he generally does, that the dealer

does not have an extra copy of the prospectus to give to him, until the issue is sold.

This problem existed before the Securities Act was adopted, and Congress attempted to meet it by providing that there should be a waiting period before the sales campaign begins. Congress intended that information about the securities should be disseminated and studied during this waiting period. In the past we have attempted to encourage the dissemination of information during the waiting period by the adoption of Rule 131, which permits distribution of so-called "red herring" prospectuses, and by requiring that at least one copy of the "red herring" prospectus be given to each underwriter and dealer who is expected to participate. This policy was helpful, but it did not solve the problem of getting the "red herring" prospectus beyond the dealer and into the hands of the investor.

Rule 132 and the related policy on acceleration are intended to meet this remaining problem. The rule permits dealers and others to advertise a forthcoming offering and the availability of the "red herring" prospectus by means of a short document, which we have called the "identifying statement." This is not permitted to include any recommendation, or information on which one could judge the merits of the security. Rather, it is intended to be used as a screening device to help dealers locate people who are interested in receiving the "red herring."

The new acceleration policy is designed to insure that enough "red herrings" are made available to dealers so that they can fill the requests of customers who want information about the security -- and not just one "red herring" to each dealer.

This program is something of an experiment. I do not expect that it will solve all of our problems, but I think that it will be a significant step toward their solution. I hope that it will make "red herring" prospectuses available before the effective date of the registration statement to those investors who want to study the security before they decide whether to buy.

One problem that we face is that the "blue sky" laws of some of the states may prohibit, or be applied so as to prohibit, the publication of identifying statements and the distribution of "red herring" prospectuses until the registration statement under the Federal statute has become effective. This problem does not arise because of any basic difference between the provisions and objectives of these state laws, on the one hand, and the Federal statute on the other. On the contrary, I believe that the State problem, where there is one, is much the same as the problem that the Commission has faced ever since 1933.

The Federal Securities Act is similar to many of the state statutes in that it prohibits "offers" and "sales" until the security is effectively registered. The rules that we have proposed take the form of a definition of the terms "sale" and "offer." They provide that the distribution of identifying statements and "red herrings" under carefully prescribed conditions shall not constitute a "sale" or "offer" and shall not be subject to the statutory prohibitions. These activities are, of course, a first step toward a distribution but, as we see it, they are an educational step contemplated by Congress when it adopted the statute.

To the extent that the language and objectives of a particular "blue sky" law are similar to those of the Federal statute, it seems to me that a similar interpretation might well be called for. We at the Commission would appreciate it if each of you would give consideration to the program that we have proposed to see whether there appears to be any conflict between it and the laws you administer, and if there is, to explore the possibilities of eliminating or minimizing the conflict. I feel that I may safely make this suggestion since I am sure that we are all in agreement on the same basic objective -- the desirability of making information available to investors in time to be useful to them.

When I speak of a conflict I do not mean to suggest that we are going to require any issuer or dealer to use identifying statements or "red herrings" where their use is prohibited by State law. We have expressly stated that our program is inapplicable in such States. Nevertheless, we believe that our objective is sound and we would like to see it furthered in all of the States. It is for this reason that I ask you to review the laws you administer, if they appear to conflict with this program, to see what can be done to avoid the conflict and to make it easier for investors to get information before they buy.

I would like to reflect for a moment or two on a comparative newcomer to the society of financial institutions -- the open-end investment company or "mutual fund," as it is popularly referred to. I do not intend to discuss mutual fund problems in any detail at this time. Our Chairman, Donald Cook, who, incidentally, asked me to convey to this association his good wishes and sincere regrets at being unable to attend personally, will speak on this subject two weeks from now before The Mutual Fund Conference in New York, and I know that many of you will be present there.

The increased importance of mutual funds is indicated by their growth during the past ten years. At the beginning of 1942 there were 73 mutual funds registered with the Commission under the Investment Company Act of 1940. Their total assets at that time aggregated $412,400,000. At the end of June of this year there were 133 registered mutual funds and their total assets had increased to $3,609,000,000.

Measured in terms of total assets, individual mutual funds range in size from a few million dollars, or even smaller, to several hundred million dollars. As the small funds grow big and the big ones grow bigger, there naturally arises the question as to what problems, if any, are created from the standpoint of protecting investors or the public interest. The size of a fund may well affect its investment policy and its ability to effectuate a policy conducive to the best interests of investors. Then too, as funds grow individually and collectively, they may have a profound effect on the securities market and the concentration of control of wealth and industry. As the insurance companies are to a large extent the holders of the debt securities of American industry, mutual funds may in time come to be the principal holders of industry's equity securities. What effect this will have upon our economy cannot be foretold at this time, but it does raise questions worthy of consideration.

Personally, I believe in the soundness of the mutual fund concept. I also believe that such funds properly managed and properly presented to the public can serve a useful purpose in our economy. However, if they are to serve such a purpose they should guard against committing two fundamental errors. In the first place, they should guard against wittingly or unwittingly misrepresenting to the public their nature and purpose. It should be made entirely clear to all would-be investors that these funds are not repositories for savings as such, but are a medium through which investors can place a portion of their surplus funds in a cross-section of American industry, or some segment of it, with its attendant risks as well as its income and growth prospects.

Mutual funds are prone, I fear, to advertise their shares in the same manner as merchants advertise their wares. This, I think, is a mistake. Mutual fund shares, as indeed all securities, are unlike the familiar tangible merchandise offered in the market place. They should not be made the subject of high pressure sales campaigns.

If mutual funds will follow conservative and constructive policies in the offering and sale of their shares, and if they will educate the investor as to the risks, as well as the advantages, of investing in such shares, then the shareholders are less apt to become alarmed if the market turns downward and they find the value of their investment declining along with the general securities market. If investors are adequately forewarned as to the possible behavior of the market and if they have faith in the soundness and future growth of our economy, they will be less likely to aggravate any unsettled situation that might arise by rushing to liquidate their shares on a then declining market.

The other fundamental error that mutual funds should guard against is the failure to give adequate consideration to the individual needs and desires of investors. As you know, there are many kinds of mutual funds. There are, for example, funds that invest in a general cross-section of industry; others invest in a particular industry, such as chemicals or electronics. Then there are funds that maintain a balance between common and preferred stocks and debt securities and other that invest entirely in common stocks. Some funds stress income; others stress capital growth.

The sophisticated investor understands these different types of funds and is able to judge for himself what type of fund, if any, is suitable for his particular situation. But the average man in the street or the average business woman or house wife does not understand either the different kinds of funds or the differences in their performance. Salesmen all too frequently are apt to sell to everyone, regardless of his situation, the fund which pays the highest commission without giving thought to whether that fund or any fund is a proper investment for the particular investor.

The advertisements of mutual funds frequently state or imply that there is a suitable fund for every investor. I disagree with such advertising. There are some persons who should not be sold shares in any kind of fund: As for example, an old person in dotage, or the widow whose funds are no more than sufficient to provide against the uncertainties of life. It is the duty of mutual funds to see to it that their shares are not sold to such persons or to others whose surplus funds are too limited to warrant their assuming the risk inherent in the ownership of mutual fund shares.

The S.E.C. has sought to promote sound practices in the sale of mutual fund shares through the registration process under the Securities Act of 1933 and through the review of supplemental sales literature filed with us under the Investment Company Act of 1940. As you know, the Commission promulgated in 1950 its Statement of Policy with respect to such literature. This has had very salutary results in that supplementary sales literature used by mutual funds is now free of much of the objectionable material that recurred so frequently prior to its promulgation

A further step in promoting sound practices in the sale of mutual fund shares which the Commission now has under consideration is a proposed revision of its form for registering mutual fund shares under the 1933 Act. This form and a related registration form under the 1940 Act were circulated for public comment last spring, and we are now engaged in considering the proposed forms in the light of the comments received. We hope by these revisions to shorten and simplify prospectuses for mutual fund shares to the end that such prospectuses may be more understandable and therefore more useful to investors.

I know that you are as deeply interested in this subject as I am, and I know I speak for my fellow Commissioners as well as for myself when I say that your cooperative efforts are most welcome to the S.E.C.

Another S.E.C. development of considerable consequence is the proposed revision of Regulation A, as to which we have recently invited public comments and suggestions. As you know, this regulation provides for offerings of limited amounts an exemption from registration under the Securities Act. This Act authorizes the Commission by rules and regulations to exempt such offerings where the Commission finds that registration under the Act is not necessary in the public interest and for the protection of investors. Under the Act the maximum amount of any single issue which may be so exempted is $300,000.

The volume of securities issued under this exemption has had a striking growth since the Congress in 1945 increased the maximum amount of the exemption from $100,000 to $300,000. For the fiscal year 1945 there were 578 filings under the regulation with an aggregate offering price to the public of 38 million dollars, whereas for the fiscal year ending June 30, 1952 there were 1500 filings with a total offering price of 210 million dollars. Considered in the aggregate, this is not small or unimportant financing.

The history of Regulation A has both its bright side and its dark side. The bright side is exemplified by the many successful offerings made under it by small and medium sized businesses for sound and constructive purposes. It has enabled these companies to obtain quickly and at limited expense the necessary capital needed to launch a new undertaking or to expand their existing capacities. This is the type of financing Congress had in mind when it raised the maximum amount of the exemption from $100,000 to $300,000.

On the other hand offerings under Regulation A have not always been honestly and soundly conceived, nor have the proceeds from such offerings always been applied to useful purposes. This is the class of offerings which the Commission must keep in mind when it is considering the terms and conditions which should be imposed upon the availability of an exemption under Regulation A. This is why we have to deny the exemption to persons with a record of fraud and sharp dealing.

Regulation A as currently in effect does not require the use of selling literature but merely provides that if such literature is used, it must contain certain specified statements and must be filed with the Commission. As a result offerings are made in some instances without the use of any selling literature at all and in these instances the investor must depend upon the oral representations made to him or upon such information as he may be able to obtain from other sources.

We have found that there is a tendency not to use literature in cases where there is the most need for it. There have been cases where the issuer initially proposed to use selling literature but decided to make the offering without such literature when it was pointed out that the proposed literature contained material omissions or misstatements.

On the basis of this experience the Commission has tentatively concluded that all offerings under Regulation A should be made upon the basis of an offering circular containing certain minimum basic disclosures with respect to the issuer and its securities. This requirement will not only furnish the investor with useful information but will also be helpful to the issuer by furnishing a guide as to the kind of basic information the investor should be given.

Another feature of the proposed regulation which we believe will be useful to issuers is a provision for limited advertisements prior to sending or giving the prospective investor a copy of the offering circular. This will permit the issuer to canvass a large number of persons inexpensively for the purpose of obtaining the names of persons who are interested in receiving a copy of the offering circular.

In the past the Commission has followed the practice of commenting upon the sales literature filed with it under Regulation A. Usually the Commission's comments and suggestions are followed but there is no procedure provided by the present regulation under which the Commission's views can be enforced, short of resorting to court action. As a result, issuers and their underwriters are occasionally unreasonably obstinate and refuse to make the changes in their selling literature necessary to keep it from being misleading.

In order to correct this situation, the proposed revision of Regulation A provides for the suspension or termination of the exemption in certain instances, chiefly where the Commission finds that fraud is being perpertrated or would be perpetrated in connection with the offering. It is not contemplated that such action will need to be taken in many instances. A similar provision in the exemption relating to oil and gas interests has been in effect for a number of years. It is seldom used but serves a salutary purpose in enabling the Commission to obtain appropriate disclosure in the case of offerings under that exemption.

These disclosure and administrative procedure provisions are not intended as a substitute for registration. They are chiefly intended to be fraud prevention devices. It is not expected that the offering circular will approximate the disclosure required in a prospectus relating to a registered security. Nor is it expected that the suspension or termination precedure will be a substitution for our present procedure of commenting on the content of sales literature where it appears that

resort to the suspension procedure is not necessary. The latter is merely a power reserved in the Commission to prevent the perpetration of fraud on small investors.

I believe that the new regulation is in the public interest and that it will not impose any unreasonable burden or expense on the smaller issuer for whose benefit Congress provided the exemptive provisions of Section 3(b) of the statute. The procedure we propose in the handling of the exemption under the Act should be of material benefit in the administration of the State Acts.

The matter I come to now is one that I know will be of very great interest to our good friends from Canada who are here with us this evening, as well as to the rest of you.

What I am about to speak of has been referred to over the years by us securities regulators as the "Canadian problem." It is a familiar subject which has received much publicity and has, on occasion, given rise to high feelings. I do not intend to debate the whys and wherefores of what occurred in the past. What I would like to know is whether you State administrators have noted a gradual decline within the past year of the mail-order and telephone promotions from our great sister country to the north -- the promotions that gave rise to those high feelings I have just mentioned. How many complaints have been made to you of any Canadian mail-order promotions since the middle of July when the new extradition treaty was ratified? If your experience has been like ours at the SEC, you have concluded that they have come to a virtual halt. It is the obligation then, of all of us, in the United States and in Canada to maintain this new and very gratifying status quo.

Such fruits as I have described do not come from unseeded and untilled soil -- and I am happy to say that most of us here tonight have had a hand in achieving these results and the promises they hold out for the future. The record of the State administrators in striving for a lasting solution to the problem has been an outstanding one. The leaders of our securities industry have lent invaluable aid all along the line. Our Canadian regulators have during the year evidenced by their enforcement actions an identity of purpose toward the common goal we have striven to reach. They have dealt very real setbacks to notorious offenders as their record of cancelled and withdrawn licenses demonstrates. As you all know, the SEC too has had a major part in the campaign which culminated in the retification of what we believe to be practical and effective new treaty terms.

Because I was a member of your group long before I was called to serve with the Commission, I know it will not be considered inappropriate for me to mention briefly the role that my colleague "Dick" McEntire ably assisted by "Milt" Kroll, Ass't General Counsel, has played in this effort. I am sure all of us agree that his contribution has been a tremendous and lasting one. Dick is like the old Scotch golfer. He does what has to be done with out superfluous weapons or fancy gestures -- and pretty generally he puts the ball in the cup, as it were, by the application of the large measure of intelligence, horse-sense, and personality with which the good Lord has endowed him. That he has been instrumental in bringing about the present situation augers well for the future in this field.

That then is where the Canadian situation rests at this moment. But we will not do justice to the problem if we stop here, if we conclude that we perhaps have achieved a solution to the problem by the setbacks thus far dealt to greedy confidence men. We must, I suggest, view the problem long-range and take progressive action if lasting and truly beneficial public results are to be achieved. We must be unflagging in stamping out fraud whenever it appears and at the same time we must not overlook the other important aspects of the problem.

Canada is a relatively new country, its vast areas are largely untapped. It has in its soil many of the resources vital to our economy and to the defense effort of the free world. It is my conviction that we as securities administrators must be careful lest we erect economic blockades, however subtle, against the development of those resources. They will not be developed without capital and obviously a good part of the financing for ventures which seek to engage in such development will come from this country. Many of our investors have exhibited a desire to share in that exploration and development on an informed and fair basis. It would seem to be our obligation to achieve a balance whereby constant surveillance is maintained against the possibility of overreaching and an open door policy is maintained toward legitimate Canadian enterprise, small or large, which seeks to come to our capital markets on the basis of full disclosure and honest dealing. It is gainsaid that our past experiences make this a difficult balance to achieve. But that very difficulty makes the challenge to us all the more real and pressing.

The Commission recently has taken a step along the lines about which I am speaking. We have circulated for comment a proposal for the adoption of a conditional exemption from registration for offerings of Canadian securities not in excess of $300,000 in any one year. This is to be known as Regulation D. Until the treaty revisions were obtained, we were not in a position to consider the promulgation of any rule of this type adapted to the circumstances of small Canadian exploratory ventures. Now we feel we can do so -- that we can take a step which we feel will provide new and important advantages to our investors and will keep to a minimum the possibility of any recurrence of the excesses

and abuses that have been visited upon them in the past. Time does not permit any detailed recitation of the provisions of Regulation D. However, they merit study and, as you know, we have asked for your comments, general or specific, on the terms of this new provision.

In this regulation, we believe you will find comprehensive machinery whereby investors will, at the outset, be provided with basic information regarding these offerings and whereby the path will be cleared for the recovery by them on judgments obtained in civil suits brought as a consequence of such offerings. Of course, criminal action is effectively provided for by virtue of the new extradition provisions.

Incentive toward compliance with the terms of the regulation should be furnished by the economy with which they can be met. The shady operator no longer will be able to hide behind the cover of excuses pertaining to the cost and difficulties of compliance. And we believe that honest security dealers will be encouraged to meet those terms.

Care has been exercised to render the benefits of the regulation unavailable to persons with a history of securities law violations; and through administrative stop-order machinery we will be able, we hope, to take speedy action, where needed, to keep the offerings clean.

Fully as important as the terms of the regulation itself is the assurance given us at Toranto, Canada in November 1951 by the security administrators of each Canadian province that, were such a regulation to be adopted, they would implement our efforts in making it a measure of very real benefit to American investors and honest Canadian business alike.

Our aim at the SEC, in which we trust you join, is to make it impossible for an "under-the-counter market" in Canadian securities ever to flourish in this country again. We propose to do all that we can to maintain a free, open and honest financial border between the countries. This first experimental step, represented by Regulation D, is advanced as a realistic means of meeting the problems that have beset us in the past. I think it will take courage and a good deal of resourcefulness to meet the new problems that such a regulation may create. But the regulation provides such prospects of substantial public benefits that it should and must be attempted. We at the SEC, hold high hopes for Regulation D as a milestone in financial relations between the United States and Canada.

There, then, is a brief description of the principal projects the SEC has recently been working on in areas in which you State regulators are interested and in which we especially need your assistance. You are much closer than the SEC is to the persons we are trying to help; that is, the individual investors. They are the ones that all of our efforts are intended ultimately to benefit. You can render valuable aid in breaching the gap between Washington and Main Street. You can do this by watching the operation of these new regulations I have just described. If they are not operating properly, please let us know. If they are not being observed, please help us to apprehend those who are violating them. On the other hand, I think I can safely promise you that we will continue to cooperate as closely with you as we have in the past. We will continue to furnish you with information which will assist you in your enforcement of State law. Working together in this fashion we are bound to achieve greater protection for the investor and for the public interest through the effective control of the unruly elements in the industry.

520914