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"AMENDING THE SECURITIES LAWS"

Address by

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I was glad to accept the kind invitation to speak at your interim meeting. I've regretted not knowing all of you, and I welcome this change to get to meet you.

The financial writer, to our way of thinking at the Commission, is a pretty important fellow. His news has a lot to do with the market behavior. His news stimulates investors. Assuming the news is good, that in turn has a lot to do with what happens to stock prices. And you know stock prices are one of our cardinal instruments for measuring economic change. You are in a field that calls for accuracy. You are in a field that calls for swiftness and a tremendous amount of specialized know-how.

You are important to us at the S.E.C. What we do affects the public and investors. Our effectiveness depends, to a great extent, on the fullness and fairness of our news coverage. Let me make it clear -- We have no complaints about our press. - We work to get a job done and not to make headlines. The press has been fair in covering us, and it has brought to the people who need and can use it, necessary information about our work.

We have been criticized, but that is all right. Every honest administrator should welcome fair criticism. Because of you we live in a gold fish bowl. That is also as it should be. All we ask is that the glass of the bowl be clear and that it should not distort what goes on inside.

While we are on the subject of news, let's talk about some news of the week. The Frear Bill is news, and I'd like to discuss it with you tonight. A subcommittee of the Senate Committee on Banking and Currency has been holding hearings on the bill. President Truman has endorsed the bill in letters to both houses of Congress. I had the honor of making the opening statement in support of the bill. I believe definitely in the basic merits of the bill.

What is the bill, and why do we need it?

In short, the bill would extend to all investors in large companies with substantial investor interest certain protections which the law gives today only to investors in listed securities or in certain specially regulated companies.

Under the law today a company that seeks to give its security holders a listed auction market on an exchange undertakes the following obligations for the protection of its investors:

1. It files initial, periodic and current information about its financial affairs so that trading can be on an informed basis.

2. It gives the voting stockholder a statement that tells him what his proxy is being solicited for, and the proxy gives the stockholder a chance to vote for or against proposals submitted.

3. It gives the stockholder a chance to get his own reasonable proposals before fellow holders and to support his proposals through the proxy machinery.

4. Officers, directors and controlling stockholders have to disclose their trading in the company's stock - so that the investor has some idea of what the insiders are doing.

5. In order to prevent abuse of inside information the law gives the company the right to recover profits made by insiders in short-term trading in the company's stock, and insiders cannot sell their company's stock short.

In my testimony before the Senate I called these protections the Magna Charta of stockholders' rights. But this Magna Charta today protects only those investors who hold listed securities or securities of public utility and investment companies specially designated by statute. This seemingly double standard just doesn't make sense. No matter how big a company may be or how extensive may be the public investment in it, the public is deprived of these protections, and the company need not make these disclosures unless the security is listed or is specially regulated.

The Frear Bill would do away with this difference in treatment. It would apply these protections to all investors in companies having $3,000,000 or more in assets and 300 or more security holders.

Why do we need this legislation? If all that could be said for it is that it equalizes the application of regulation that would not be enough. The crucial fact is that this regulation is based on real need and affords real protections. Most of the fraud cases we pick up are in unregistered securities, and many of them would have been avoided if the requirements of the Frear Bill had applied.

Periods of rapid economic change like those which have marked the war and post-war periods are fertile grounds for over-reaching. The cases I am going to cite are not typical. On the contrary, they are rare. But they illustrate what can be done under the veil of secrecy. In one case, on the eve of a merger, members of management were buying in shares of their company at prices ranging from $3 to $6 a share while they were negotiating to transfer their own shares at $45 per share. While they were paying from $3 to $6 a share, the stock was earning over $15 a share.

In another case the president of the company was offering to pay his own stockholders $2 a share for their stock when the net current worth alone, disregarding all fixed assets, was $16 a share and the book value was $40 a share. True, the company published a balance sheet. But it did not disclose the number of shares outstanding and, therefore, no investor could figure out his per-share position.

There are cases of systematic bleeding of companies by insiders that are nothing short of shocking. Several promoters instituted a small loan company financed almost completely by public investors. Before long the company went into bankruptcy and the reason was simple. Within a short time the promoters had borrowed about $750,000 from their own company. These same promoters later formed a collection agency and charged their own company 33-1/3% to collect payments on its loans. They caused the loan companies to loan to bad credit risks so that - in turn - this agency might collect and receive a commission.

As I said, these cases are not typical. But they are real; they are actual - and their facts are such that they would not have happened if the Frear Bill had applied. Current reliable information, decent proxy disclosure, disclosure of insiders transactions would have flagged these frauds at the outset - and the need to disclose, itself, would nip in the bud many schemes such as these.

The outright fraud is not, by far, the most important area in which we hope that the bill will do its clean-up job. Many accounting, reporting and trading practices stop short of fraud but have the same effects. In the hands of an expert, a balance sheet or income statement is like a musical instrument. He can make it play any tune he wants. If his operations show losses, he can show a profit by running his losses through the surplus account rather than the income statement. If his profits are embarrassingly high and he wants to conceal them, he can create miscellaneous reserves and treat his reserve allocations as expenses.

The financial statement on which plastic surgery has been performed may look good to the uninitiated, but if we want the financial statement to be a reflection of reality rather than of someone's idea of what looks good, we must have sound accounting principles uniformly applied and enforced.

And that is what the S. E. C. would do under the Frear Bill. We estimate that about 1800 companies would be fully covered by all the provisions of the bill. We estimate further that investors in about $19 billions of their securities would become covered by its protections. I can think of nothing more important than that investment in securities be based upon reliable and current information.

To the experienced corporate politician a free hand at the controls of an unregulated proxy machinery is the guarantee of a life-time job. With investments in our large enterprises scattered among many holders, geographically remote from the central offices and places of business of their companies, the proxy machinery is either an instrument of corporate democracy or autocratic control - depending on its use.

Even today, many proxies are solicited without affording even meagre information to security holders about what issues are to be voted on, and without an opportunity to vote for or against. Meetings are often held at remote places and at inconvenient times. Proxies are often not proxies at all, but powers of attorney giving full discretion to the insiders. A management living behind a veil of secrecy can perpetuate itself and ratify its own acts with such proxies in its hands. We have a record of one case where the proxy was printed on the back of the dividend check so that every endorsed check became a free-wheeling proxy with which the management could perpetuate and ratify itself.

The security holder who has financed the enterprise by turning his money over to the stewardship of others deserves better treatment than this. If the Frear Bill is enacted, substantial companies will have to obey minimum standards in permitting a fair exercise of the stockholders' franchise. It will eliminate the effect of the present situation where certain managements' unchecked control of the proxy machinery enables them at will to disenfranchise their public security holders while other managements obey the rules laid down in the law.

The Frear Bill would not prevent the buying and selling of their companies' stock by officers, directors and large stockholders. It would require the filing of information about such buying and selling. To anyone who knows the facts of corporate life the merits of this requirement are obvious. With its access to inside information, management is in a key position to foresee market movements in the company's stocks. They are in a position to anticipate these movements and to trade against them. Every purchase by a director is from one of his company's investors. Every sale makes the buyer one of his company's

investors. These investors have the right to know what the insiders are doing and to appraise for themselves the significance of insider trading.

Without that information investors are vulnerable to having insiders bail out wholesale while the small holder is left holding the big bag; they are vulnerable to having insiders buy in when good news in the offing still has not broken. The least the investor is entitled to know is what the insiders are doing.

One of the most controversial aspects of the Frear Bill is that it extends generally the provision of the Securities Exchange Act which permits the corporation to recover profits made by insiders in short-term trading. The stated purpose of the law is to prevent abuse of inside information. But the law doesn't require any proof that inside information was used to get a profit out of purchase and sale or sale and purchase within six months. The profit is automatically recoverable unless the S. E. C. has by rule exempted the particular type of transaction.

The Commission has exempted certain classes of insider trading as not contemplated by this provision. We have drafted these rules to cover difficult cases as we have met them. Let me give you an example. A very large company has a bonus plan according to which an independent committee of the board of directors (none of whose members participate in the plan) decides each year what amount of the company's stock will be given to deserving members of management. The history of the plan shows that it has been approved by stockholders, is a moderate one, and has been reasonably applied. Since the acquisition of securities under the plan is in consideration of services rendered, the securities have - legally, been "bought". Now under the plan these securities are "bought" by the participants once each year. Thus any sale by a member of management must take place within six months of a purchase (either the last bonus or the one to come) and therefore the participant would be locked in and couldn't sell at a profit without having to return that profit to the corporation.

It seemed clear to us that the law wasn't intended to apply to that situation, and we adopted a rule to exempt it. However, new cases arise all the time and present new problems. We hope to be able to keep up with them and to keep the law from working undue and unnecessary hardship.

That is a promise I can make without reservation. We don't know all the answers and we haven't seen all the problems that will arise under the Frear Bill. Even when passed, the Bill would not come into operation for six months. We hope to have much of the field cleared in that period. Thereafter, the problems can be dealt with as they arise.

The Bill gives the Commission ample power to exempt companies and persons from its provisions whenever we think it consistent with the public interest.

This has been an unusual experience. Every morning I get thrown at me a batch of clippings containing your thoughts. Tonight I have thrown mine at you.

I hope the exchange was fair.

Thank you.