

TWENTY-FIVE YEARS OF SEC REGULATION

Address by

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It is a great pleasure for me, a graduate of the University of Virginia College and Law School, to address the Virginia State Bar Association today. I have been asked to talk to you about the 25 years of SEC regulation. On July 2, 1934, the five first members of the Securities and Exchange Commission were sworn into office on interim appointments. They were all confirmed by the United States Senate early in January of 1935.

I am particularly pleased to be here today because of my firm belief that from the standpoint of lawyers it is tremendously important for each of you to know something about the functions of the capital market and the part which the Securities and Exchange Commission plays in those markets. I say this because if you represent corporate clients, sooner or later they will probably have to consider going to the capital markets to obtain essential external financing in order to produce the capital goods and thus to participate in the giving to our country the highest standard of living in the world today. On the other hand, you may well find that your individual clients may come to you for advice on whether a particular company is one in which an investment should be made. An ability to impart a little common sense to such query may go a long way towards cementing your relationship with such client. To represent either of these two types of clients will require a certain familiarity with the functions of the SEC.

Perhaps more important to you as lawyers, you must always bear in mind the importance to yourselves personally of being able to create capital funds of your own in order to insure economic security for yourselves upon your eventual retirement from the active practice of the law. In order to be able to produce these funds, it is essential that you understand the functions of the capital markets and the position which the Commission, of which I am a member, occupies in the market place.

It is my belief that to have an understanding of the functions of the capital markets and the agency's participation therein, one must understand the historical development which has taken place during our 25-year existence. For the few minutes allotted to me, I would like to take you back to the period just prior to the 1929 crash. During those days the securities markets were operated without any real sense of morality, without any concept of fairness, and without any attempt to give to public purchasers a fair shake for their money. Almost the entire investment banking industry was replete with inflationary market write-ups of assets, acquisition of properties at grossly inflated prices, and the issuance of excessive amounts of debt securities secured by overvalued properties and assets. Management was generally completely preoccupied in financial maneuvering predicated essentially upon "upstreaming" subsidiary earnings to the top-heavy parent holding company in order to support excessive dividends necessary to maintain market accessibility of the holding company securities rather than upon creating sound operating companies.

The total value of all stocks on the New York Stock Exchange as of September 1, 1929, aggregated \$89 billion. By the middle of 1932, a total aggregate value of these stocks on that exchange was \$15 billion, or a loss of \$74 billion in that short two and a half year period. During the decade from 1919 to 1929, \$50 billion worth of securities was sold, and 50%, or

\$25 billion, proved to be worthless. During the 30's, as many of you will recall, there was complete financial collapse. Public investors simply withdrew what money they had from the capital markets, putting it in savings banks or into the proverbial mattress. There were few people in those days who would consider that a corporate security, be it of the debt or equity type, i.e. debenture or common stock, was a proper medium of investment.

Into this completely demoralized capital picture came the SEC. The first attempt by the Federal Government to regulate the securities markets was the Securities Act of 1933. This has often been referred to as the "truth-in-securities" law. It had as its basic design the requirement that corporations seeking to sell their securities to public investors disclose the basic facts, financial and otherwise, so that public investors could become informed persons in a position to be able to determine for themselves whether the particular securities offered met their own investment needs. You will note that the Securities Act did not give to the regulatory body, the SEC, the opportunity to pass upon the merits or to make value determinations of the security. Personally, I believe the Congress made a very wise decision in denying to the regulator the obligation or ability to determine whether a particular capital venture was a sound one or not. The decisions as to the merits of securities was left where it rightfully belonged, with the investor who would by the protective provisions of the Securities Act be placed in a position of knowing the facts and making his own determinations as to value. There are, of course, heavy civil and criminal liabilities which attach under the securities acts to misrepresentation or false statements made by a corporation, its officers or agents in describing its securities.

The second attempt by the Federal Government to get into the regulation of the securities markets was the Securities Exchange Act of 1934. This is the Act which created the Securities and Exchange Commission, the Securities Act having been administered by the Federal Trade Commission for its first year. In contradistinction to the Securities Act of 1933, which attempted to regulate the initial distribution of securities, the 1934 Act aimed at regulating the trading in securities after such initial distribution. Thus, the 1934 Act regulates, as the name implies, the 14 national securities exchanges throughout the country, such as the New York Stock Exchange, the American Stock Exchange, the Midwest Stock Exchange, the Pacific Coast Stock Exchange, and the others located throughout the country.

The 1934 Act also requires that all brokers and dealers who sell securities in interstate commerce must register with the agency. It also requires further that corporations listed on the 14 national securities exchanges must file annual, semi-annual and periodic reports with the agency. Officers, directors and 10% stockholders of such listed companies must file reports as to their stock ownership in their particular companies and any changes in such ownership. In addition, that Act provides that proxy solicitation material to be used by listed companies must be filed with our agency at least ten days before it is used.

In addition to these two acts, we are charged with the responsibility of administering four other statutes:

The Public Utility Holding Company Act of 1935, which has to do with the regulation of the public utility holding company systems and their operating companies. There are today some 22 such systems which are required to comply with regulatory provisions of that Act in terms of their financial plans. These systems contain some 176 operating companies with assets in excess of \$10 billion;

The Trust Indenture Act of 1939, which requires that corporate indentures contain certain protective provisions for the benefit of bondholders, including a requirement that the trustee in the indenture be completely independent from management. This latter Act operates comparably to the 1933 Act in that it is basically a disclosure act complementing the 1933 Act;

The last two acts, both of which became law in 1940, are the Investment Company Act and the Investment Advisers Act. The former gives the Commission regulatory power over investment companies or mutual funds. Those publicly held funds must, of course, register with our Commission and must comply with many provisions protective of the interest of the security holders. The Investment Advisers Act merely tries to regulate persons who are selling investment advice for compensation.

In addition to these statutes, we act as advisers to the Federal District Court in corporate reorganizations under Chapter X of the Bankruptcy Act.

The important thing that I would like to talk to you about today is the sizable build-up in the capital markets which has occurred since 1950. Up until 1950, the market seemed to have rocked along somewhat listlessly without appearing to go anywhere in particular. In 1950, the total number of shares sold on all United States securities exchanges was 893 million shares. By 1958, the total number sold had risen to an annual rate of 1,400 million shares. For the first half of 1959, the shares sold on an annual rate was in excess of two billion shares. In terms of the dollar value of these sales, they rose from \$21.8 billion in 1950 to \$38.4 billion in 1958. For the first half of this year, the sales were at an annual rate in excess of \$50 billion. From 1950 to 1959, the investment banking business employees rose, in accordance with the Department of Labor's Bureau of Labor Statistics, from 60,000 in 1950 to 84,600 in 1958, or an increase of 24,600 people. It appears that this increase only includes employees who have some connection or relationship with customers. It does not include the many thousands of employees who are engaged in relatively minor positions within the investment banking business. Merrill Lynch, Pierce, Fenner & Smith has some 6,000 employees, Blyth & Co. has around 740 employees, and Reynolds & Co. has around 1,000 employees. Brokers and dealers selling securities in interstate commerce registered with our commission rose from 3,930 in 1950 to 4,906 in 1959.

In the 25-year history of the Commission, there have been more than 15,000 registration statements filed for a total dollar value of \$161 billion, yet one-third of these filings in number and one-half of the dollar amount sought occurred in the last six years.

It is both logical and natural that accompanying this really fantastic build-up in the capital markets will be great stimulation and interest in areas other than the so-called financial centers of our country, i.e. Wall Street in New York City and LaSalle Street in Chicago, Illinois. It seems to me that more and more corporate issuers will tend to raise needed capital for expansion and development from local sources. Throughout the Commonwealth of Virginia, attorneys, who by reason of study and understanding become conversant with the acts which the SEC administers, are inevitably going to be in a position to reap the benefits of this expanding capitalistic system. We, as an agency, have always maintained a desire to be helpful in guiding attorneys who are unfamiliar with the intricacies of our statutes. We have spent over the years a tremendous amount of time in trying to assist members of our profession to educate themselves in the basic functions of the SEC, and we always hope that attorneys who desire to obtain information with respect to a client's problem will seek us out for guidance so that as attorneys they can be in a better position to furnish to their clients sound legal advice.

One of the really bothersome features of the surge in capital market price conditions is the tendency for such activity to attract into the market place persons who are seeking by schemes and artifices to defraud public investors. We have seen fraud artists, "con-men", shysters and fast-talking swindlers practice the most diabolical schemes in order to separate innocent public investors from their life savings. You probably would not believe that in New York City two years ago I picked up a classified telephone directory and, under the listing of "Mails", I found four pages of companies which would furnish me a list of any conceivable category. I suppose I could have obtained a list of 50,000 red-headed Baptists. In the small type advertisements in this directory, there was one in which a list of 50,000 widows with assets of \$50,000 or more was mentioned. I telephoned this company and spoke to one of its employees. I was told that this particular list would cost me \$2,500. I was also informed that it was an efficacious list, that the company had had good results with it! I asked whether it was the company's best list. "No" was the reply, "the best list would cost \$5,000." "What was that list?" I asked. That was a list which contained - and here I quote him - "50,000 names of current widows with net assets in excess of \$50,000." I asked him what "a current widow" was and he said - again I quote - "A current widow is a widow who has enjoyed that status for less than six months!" The mere telling of this incident, I believe, emphasizes the diabolical nature of the scheme which can be and is employed by certain unscrupulous persons to sell securities which, in almost any sense, have little or no value. Throughout our vast and great country, persons are being called by long distance telephone, only because their names are to be found on a similar list, by salesmen whose only interest is to make a sale, whose only purpose is to find another sucker.

The real reason I tell you this story is to alert you to a problem which is widespread but which can only be stopped if the SEC policeman can get the word. You can do a world of good for your client if you can apprise him of the dangers of dealing with persons he does not know, or if you can convince him to use a comparable amount of common sense as he would use in buying a new car or a new house. He ought to at least perform checks similar to picking up the hood of the car to see if there is an engine. Certainly in buying a house you would want to see the abstract of title. Get your client to ask the stranger for a prospectus and thus get something in writing. Then, I implore and beseech you to get in touch with us. We, of course, cannot tell you anything about the merits of a security or whether you or your client should purchase or not, but we certainly want to know what course of conduct is being employed by unscrupulous persons in selling securities. Believe me, we have methods to deal with such persons effectively and expeditiously.

Let me, at this point, say something about the investment banking profession. It is possessed of a great many men of the highest moral integrity and honor. Few people, lawyers especially, realize that transactions in amounts of many billions of dollars are consummated in any year, either on national securities exchanges or in the over-the-counter market, predicated upon oral representations that "I will buy" or "I will sell," yet there is practically never any welching. Persons continuously engaged in this business have to live by a premise that their "word is their bond." I want to make it abundantly clear that it is not these persons about whom I am talking. Personally, I have a tremendous respect for members of the honorable securities business. But, as in almost every endeavor in life, there is a segment which because of shortsightedness, avarice or greed will act solely for its own personal interests without any consideration for the proverbial black eye such conduct may give the industry as a whole. It is against persons of this ilk whom you and your clients must always be on guard.

I might also say that these fraudulent manipulators usually don't get anywhere with the highly sophisticated investor located in the center of a financial community; they often seek out small towns to talk to uninformed, uninitiated local businessmen or doctors. In fact, they seem to love doctors! But these are the types of persons found in any locality and they are your prospective clients who are in real need of your services. If they come to you as a result of some telephone call they have had from some complete stranger, I hope you can assist them to guard against their own folly by telling them not to invest until they can get the facts. These are available largely because the SEC insists that, before public sales of securities are made, a registration statement which sets forth all the facts be filed and distributed to public investors.

Let me tell you of a few other types of cases with which we have recently been involved. You may recall that last June we went to court in Texas seeking an injunction to prevent the sale of securities by a prospectus used in an intrastate offering, which sought to comply with an

exemption from the registration requirements of the 1933 Act. The prospectus stated that the company was seeking to raise capital to produce a space ship which was to take off from Space, Maryland on a 14-day trip to the moon in December of this year. In the prospectus there was an assertion that a do-it-yourself flying saucer kit could be purchased for \$5.00. You'd scarcely believe it, but public investors in Texas were purchasing this security.

In another case, we recently went to court to prevent a person from selling securities in a non-existent corporation on whose purported board of directors was claimed to be a Member of Congress, a high-ranking General who had been dead for six months, and the president of the Gettsburg College.

These are only two simple examples of the types of proceedings which we have been compelled to institute in order to protect the securities markets from fraud and misrepresentation.

In fiscal 1959, we commenced numerous proceedings against interstate brokers and dealers who were in violation of the protective provisions of the 1934 Act, such as finding themselves completely and entirely insolvent, selling securities where no registration statement had been filed under the 1933 Act, and for many other sundry types of misconduct, including the grossest type of fraud and misrepresentation.

There is another important matter I would like to discuss with you today. We have been, as I have already told you, very busy during the last year; so have the market places. The value of all stocks listed on the New York Stock Exchange as of June 30, 1959 was \$298.8 billion, as contrasted to the \$89 billion figure I mentioned as of September 1, 1929. Incidentally, the value of all stocks on all exchanges was around \$337.6 billion. In registration statements filed with our agency under the 1933 Act for fiscal 1959, ending June 30, there were 1,226 for a total dollar value of over \$16.6 billion, as against 913 for \$16.9 billion in fiscal 1958. Thus, there were 313, or some 34%, more registration statements filed this year over last. This increased number has literally swamped the SEC's Division of Corporation Finance which processes these statements.

In addition, we opened more investigations and we referred more criminal cases to the Department of Justice than in any previous year in our history. Yet the number of employees in our agency has fallen from 998 in 1950 to 937 at the end of June, 1959.

In January, we went before the Subcommittee on Independent Offices of the House Committee on Appropriations, chaired by the Honorable Albert Thomas of Houston, Texas. That Committee heard our presentation, listened to our estimate of needs for the agency, and proceeded drastically to cut our appropriation by \$475,000, allowing us an increase of only 10 persons and stating specifically that the 10 persons must be used in our regional offices.

Subsequently, we appeared before the Subcommittee on Independent Offices and General Government Matters of the Senate Committee on Appropriations. That Committee heard our presentation and came to the conclusion that it was essential that this agency be properly staffed and that it be given a proper appropriation. It restored our appropriation in toto, i.e. put back the \$475,000. Thank God for the United States Senate!

A conference between the House and the Senate occurred in which the differences of the two bodies were resolved, partially in our favor and partially against us. We were given back \$300,000, which allows us to take on an additional 45 persons. We lost \$175,000, which would provide for 20 persons.

I might say at this point that last year of our total appropriation of \$7,705,000 we recovered for the benefit of the United States Treasury 34.6% in terms of the fees which we charge for registration statements and in terms of the 1/500ths of 1% charge imposed upon all sales on national securities exchanges.

In our investigative work, we are opening more cases than we are closing and, in fact, we simply cannot with our limited personnel do much more than what at times seems to be little more than a holding operation. Yet the appropriations committees of Congress failed to give to this agency all the funds which we felt were essential to the proper functioning of our agency. What strikes me as being completely anomalous is that these same appropriations committees of Congress provided a budget for the General Services Administration which includes the expenditure of around \$500,000 for the renovation of the building in which we are housed, which has often been termed "the broken down, dilapidated, World War II temporary tarpaper shack" on Second Street. That temporary building, built in 1942, was designed to accommodate the Federal Government's expanded activities during the Second World War. One of the men on the job, in humor, said to me the other day that it had been purposely constructed of non-permanent, secondary quality materials because it was hoped that the building would not become comparably permanent to the Navy Department temporary buildings constructed on Constitution Avenue during the First World War. They are still there.

It is my humble belief that the budget limitations which Congress has imposed upon us are going to cause serious restrictions upon our activities in the capital markets. A columnist recently said:

"Several years ago, Russia actually expected the U.S. to be destroyed as a result of the collapse of its economy, being followed by the Communists and their fellow-travelers taking over the Government. Russia's prediction of a financial catastrophe failed, but they were right in one thing -- America can be destroyed by financial failure just as completely as by bombs, planes, submarines and missiles. In

other words, the maintenance of a sound and adequate financial system is just as important to us today as the Army, Navy and Air Defense facilities are."

It is the SEC, which is one of the agencies of your Government, which attempts to protect the soundness of the expanding financial system. Unless the integrity and the honesty of the capital markets can be preserved so that public investors will continue to have faith and confidence in the functions of those markets, our whole capitalistic economy cannot succeed in the cold war which we are still facing today. It is the SEC, as the "Investor's Watchdog" and as "Uncle Sam's financial police force," which is charged with the duty of protecting the financial markets.

In my judgment, the Appropriations Committee of the House has failed to recognize the tremendous importance of staffing this agency properly at a time of unprecedented growth in financial activities. I believe that the Committee members have indulged in a penny-wise pound-foolish philosophy and have placed this agency in a political arena in order to accomplish personal aims or objectives. This is a situation which I deplore and about which I wanted to say something to you today.

Thank you very much for giving me the opportunity of being here with you on the occasion of your 69th Annual Meeting.