

ENFORCEMENT OF THE SECURITIES ACTS

An Address

by

ANDREW DOWNEY ORRICK
Commissioner

Securities and Exchange Commission

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My remarks will be directed to a discussion of the enforcement activities of the Securities and Exchange Commission with the view to considering the effectiveness of our job in protecting the public interest.

The Commission, as an independent regulatory agency entrusted with the administration of the securities acts, performs its duties in three distinct but interrelated capacities. It has quasi-legislative and quasi-judicial powers, in addition to its executive and administrative responsibilities, in enforcing the seven statutes under its jurisdiction. The vigorous discharge of each of these functions is essential to the protection of public investors from the schemes of unscrupulous promoters and dishonest broker-dealers and salesmen.

In considering the functions of the Commission, it is well to be mindful that a federal agency, operating within the American system of free enterprise and limited by the full disclosure theory of the securities acts, cannot, and should not, protect the public from its own cupidity "to get rich quick" by gambling in untested promotional ventures. The securities acts are designed to prevent neither the popular pastime of speculation nor the exercise of poor judgment by individual investors. However, through the vigorous conduct of its law enforcement responsibilities, the Commission effectively reduces the operations of free-wheeling "pencil bandits" and the area of uninformed risk-taking.

It should not be overlooked, in assessing the work of the Commission, that the clearance of a securities offering or the listing of securities on a national securities exchange does not denote that the Commission considers such securities to be safe investments. Paternalism, in the sense of cloaking publicly distributed or publicly traded securities with a seal of governmental approval as to their quality, is as alien to the philosophy of the securities acts and to our administration of the statutes as would be a mandate by the government that an individual had to buy particular securities.

The most difficult and persistent enforcement problem with which the Commission is currently concerned involves the sales of the securities of promotional mining and oil companies, from both Canada and within the United States. The distribution of many of these issues has been, and are being, made in violation of the registration provisions of the Securities Acts of 1933 and through high pressure sales campaigns conducted by telephone, in which pertinent information about the securities being offered is fraudulently misrepresented.

By reason of the expanding American economy, high employment and record national income, the public apparently has sufficient funds to

speculate in such promotional enterprises and has been readily susceptible to the provocative inducements of "stock-pushers" promising miraculous profits. Unprincipled salesmen make their sales pitches by telephone because they can reach a greater number of victims with the least effort through this media. By avoiding the use of written material and face to face contact with the investor, they make criminal prosecution for fraud more difficult.

The initial contact of the "stockateers" with their intended victims is frequently by mail. The touting literature extravagantly describes the wealth of ore contained in the company's claims and the unusual investment opportunities afforded by purchasing its securities. Prospective investors then receive a series of telephone calls in which the salesmen embroider their deceitful stories. The prospects are assured that by investing promptly they can double or triple their investment within a few weeks or months.

Many of these telephone campaigns are conducted by salesmen located in Canada where they operate behind a wall of jurisdictional immunity. The physical distribution of unregistered Canadian issues is commonly effected by so-called "bagmen" who use little black bags to transport the securities across the border and to carry back the funds paid for the securities. Other telephone campaigns are directed by "hoods" running boiler shops in the United States. Salesmen pushing the sale of securities through the use of telephones are referred to as "hoods" because the cubicles from which they customarily make their calls are protected by a hood or cover to insure privacy.

Telephone campaigns are most difficult for the Commission to control. To a great extent, it necessarily must rely on the complaints of investors for its information about such fraudulent activities, and even with the full cooperation of defrauded investors, legal proof of dishonest practices in the sale of securities is not easy to establish. Upon learning of the existence of a telephone campaign, an investigation is immediately started with the view to enjoining further sales of the securities and to prosecuting the salesmen for criminal fraud. Where such high pressure sales campaigns are conducted by broker-dealer firms registered with the Commission, an administrative proceeding to revoke the registration would also be instituted. If the securities being sold are part of a distribution of a Canadian issue which has not been registered with the Commission, the name of the issuer would be added to the Commission's restricted list. This list, which the Commission recently reactivated, is distributed periodically to all brokers and dealers registered with the Commission and serves as a warning that trading in such securities may be illegal.

Most of the fraudulent and misleading representations that occur in the sale of securities are made orally, by personal contact or telephone, and in touting literature that has not been processed by the Commission. Since it is impossible to regulate in advance what promoters or salesmen may say orally or in written material that has not been filed with the Commission, the investor has usually parted with his money before the Commission is able to enforce the anti-fraud provisions of the securities acts against the crooked. Nevertheless, the threat of investigation and of administrative, civil or criminal proceedings instituted by the Commission against wrongdoers in the securities business constitutes an immeasurable protection to the public by deterring many malpractices.

In recent years, the Commission has successfully prosecuted many dishonest salesmen who have cheated the public of large sums of money through the use of fantastically fraudulent misrepresentations concerning the assets of the company whose securities are being hawked. For example, a conviction was obtained in connection with the sale of unregistered securities of a company purportedly manufacturing a so-called "magnetic logger" device which was misrepresented to investors as assuring 100 percent accuracy in the location of oil pools. In another case, the spurious invention consisted of an alleged fuel-less self-energizing power unit and a machine which would keep people alive forever. Recently, a promoter was convicted for fraud in selling unregistered securities of a company which he misrepresented as successfully manufacturing and marketing a number of ingenious electronic devices, one of which would enable the blind to see, and another being a cigarette lighter requiring no fuel, flint or wick.

An unusual promotion successfully prosecuted by the Seattle Regional Office involved the alleged rediscovery of a famous and rich legendary mine. The promoter broadcast by radio that he had found a decaying wheelbarrow containing large pieces of gold-bearing ore, an old, rusty rifle, and the skull and bones of a human being, all of which he represented as conclusively proving his rediscovery of this fabulous mine. He falsely represented to investors that the property was one of the richest mines in America and that its ore assayed at \$8,000 per ton, when in fact it was merely an undeveloped prospecting claim with no commercial ore. Recently, the promoter of a California company, which purportedly could manufacture a wingless aircraft capable of flying 4,000 persons non-stop around the world, cheated the public out of about \$200,000.

Considering the outrageously fanciful nature of these schemes and the marked success of promoters in peddling such securities to a gullible public, it is evident that the Commission has a most difficult job in protecting public investors from their own follies. It is sad but true that many members of the public are willing to throw away their money on any type of enterprise that the ingenuity of crafty promoters can conjure up.

In addition to such imaginative contrivances, the Commission encounters fraudulent activities in more conventional enterprises. Securities of mining promotions are being sold upon oral representations that engineering tests have disclosed the presence of specified large quantities of ore when no real tests have been made - someone has simply dug a hole in the ground and found a trace of some mineral. Salesmen talk glowingly of dividends and stock splits by promotional companies which in fact are losing money. Assets are written up and manipulated, and there is a calculated failure to mention such interesting facts as the insolvency of the company. Investors are led to believe that they are providing capital for a promising enterprise when in fact they are buying promoters' stock, and their money goes straight into the promoters' pocket without the company ever seeing it.

These types of frauds present more difficult enforcement problems. On the surface, there may be little or nothing to arouse the suspicion of the investor. Once suspicion is aroused and the Commission learns of the deceit, long, careful and painstaking work may be required to develop the facts in a form which will stand up in court. The books and records of the company, the promoters, and others must be examined and discrepancies detected and explained. Investors must be interviewed and prevailed upon to reveal the details of their transactions. The explanations of participants must be obtained and checked against other sources of information. Not infrequently, investigation shows that a complaint or suspicion is unfounded, and, consequently, our investigators must be careful to avoid unjust reflections upon reputation and character. A good securities investigator must combine the talents of a Sherlock Holmes, a lawyer, a certified public accountant, and a diplomat. Nevertheless, once on the trail of a fraud artist, our investigators generally get their man.

The requirements for registration of new issues of securities not only gives the public pertinent information about securities issues; it also assists the Commission in the conduct of its anti-fraud enforcement activities. The Commission has been able to control

effectively the written statements used in the sale of new issues of securities. The prospectuses and offering circulars, which are required by law to be delivered to purchasers before the completion of a sale in a distribution of securities in interstate commerce, are carefully scrutinized by the Commission to eliminate all statements that might mislead an investor, such as unfounded assertions regarding the existence, amount or quality of ore in a company's mining claims. If a distribution of securities is legally made in accordance with the registration requirements or pursuant to Regulation A (which prescribes the simplified procedures for small public offerings of securities in interstate commerce not exceeding \$300,000), the investing public is informed of the essential facts of the enterprise by the disclosures contained in the prospectus or offering circular.

Thousands of full registration statements and Regulation A filings are made by issuers and billions of dollars of new securities are legally sold to the public every year. These issues have been distributed to the public after a careful analysis of the material filed with the Commission has been made and the offering has been cleared. However, since the Commission does not purport to pass upon the merits of securities, the fact that the Commission has permitted an offering of securities to become effective does not mean either that the disclosures are guaranteed to be accurate or that the investing public would be fairly treated.

To illustrate the extent and limitations of the protection afforded to the public by the processing of offering material, consider a filing by a uranium company under Regulation A. Assume that the offering circular correctly states, among other matters, that the mining claims which had been owned by the promoter, though of unknown value, were duly transferred to the issuing company in consideration of \$100,000 in cash and an option to buy, at a low price, half of the securities of the company. It further states that the sales price of the claims to the company had been arbitrarily determined, absent arms-length bargaining. To the Commission and to the careful buyer, this offering would appear to be heavily loaded in favor of the promoter and against prospective purchasers. However, since the unfairness of the deal is not hidden from the investor, under the limitations of the disclosure philosophy, the Commission possesses no authority to prevent the offering from being made.

Assume, now, that the promoter falsely stated that he had had clear legal title to the mining claims. If the Commission discovered this deliberate misstatement of a material fact while processing the offering circular, it would instantly prevent the offering from being made ~~by~~ entering its order temporarily denying the exemption and

promptly ordering an administrative hearing to make the order permanent. However, in its analysis of the document, the Commission may not have had knowledge of, or access to, certain facts necessary to challenge the untrue statement. The techniques used in processing offering documents to obtain the disclosure of pertinent facts are designed to catch statements which, on their face, appear to be misleading or incomplete. It would be impossible for the Commission to establish the truth of every statement made in the offering circular or to conduct an independent investigation to determine the validity of every mining claim. Absent some reason to suspect the falsity of the statements made by the registrant, no such investigation would be made by the Commission. The securities acts contemplate that the registrant must assume responsibility for the truthfulness of the facts presented. The critical examination of filings by the Commission, which catches most, though not all, misleading and fraudulent statements that appear in offering literature, is one of the important anti-fraud preventative measures used by the Commission.

The ingenuity of unscrupulous promoters and of the fringe element in the securities industry, however, has fostered a variety of schemes designed to avoid the disclosure requirements of the securities acts. One common device for effecting a distribution without registration is reliance on the intrastate exemption. Although all sales are purportedly made within the state where the issuer is incorporated and doing business, the distribution of a large block of stock usually enters the channels of interstate commerce. Another ruse is to limit the sales to a small number of persons who profess to take down the securities for investment purposes. Although they frequently arm the issuer with an investment letter, they engage almost immediately in reselling the securities to the public - often at a higher price. A third device involves corporate mergers where the securities of the surviving corporation are distributed to the stockholders of the merged corporation primarily for the purpose of effecting a distribution of securities of the surviving corporation.

The disclosure philosophy of the securities acts is also administered in connection with the registration of securities on the national securities exchanges and the filing of annual and semi-annual reports by listed companies. If the analysis of these documents discloses inaccurate or misleading representations, the Commission might suspend further trading in the securities of the company, or, through a mandatory injunction action, compel the registrant to file correct reports, or prosecute the wrongdoer for criminal fraud. In a recent case, the Commission prevented a company from listing its securities on an exchange because it was unable to support its claims regarding ore reserves.

Similarly, in the processing of proxy soliciting material, the Commission may detect misleading statements regarding matters to be

voted on at meetings of shareholders. If the person filing such material insists on using it in deficient form, the Commission would promptly institute injunctive proceedings to prevent its use. The power of the Commission to restrain the use of proxies obtained through fraudulent and misleading statements by the contestants in a fight for corporate control was recently upheld in an important case brought by the Commission.

The program of the Commission for making periodic inspections of brokers and dealers is another basic technique used to enforce the securities acts. These inspections have two basic purposes: first, to determine whether or not broker-dealers are conducting their business in accordance with the regulations of the Commission that are designed to insure compliance with established and orderly practices in the industry, and in conformity with applicable legal requirements, and, secondly, whether they are dealing honestly and fairly with customers. Included under the first heading are such matters as the maintenance of adequate and current books and records, the prompt delivery of confirmations and of prospectuses, where required, observance of the margin rules of the Federal Reserve Board, and compliance with the Commission's net capital rule. These requirements are not mere "red tape"; they are essential to the proper conduct of a business which involves the handling of other people's money and property. Our inspections, however, are more than a review of books and records. Dealings with customers are also carefully examined. Inspectors check for misuse of customers' funds, hypothecation of customers' securities, taking secret profits in agency transactions, purchases and sales to customers at prices having no reasonable relation to the market, and abuses of trust and confidence, such as the practice of churning, that is, excessive trading in the account of a confiding customer in order to reap an illegal harvest of commissions and markups.

In the event that violations are uncovered, the registrant is either notified in writing and warned of the transgression, or, in the more serious cases, an administrative proceeding is instituted to revoke the registration of the broker-dealer or civil or criminal action is instituted. Believing that careful supervision of broker-dealer practices is essential to protect the public from malpractices in the sale of securities, the Commission has energetically increased the tempo of its inspection program during the past year. To certain areas, such as Denver, Salt Lake City and Fort Worth, where there has been unusual activity in low-priced, speculative stocks and many broker-dealers have recently become registered with the Commission, special task forces of inspectors have been dispatched. In the

fiscal year 1956, which has just ended, the Commission completed more broker-dealer inspections than in any year since 1942, and even more are expected to be made during the current fiscal year.

The federal securities acts prohibit not only fraud but also manipulation of the trading markets resulting in sudden and unreasonable fluctuations in the prices of securities. The ideal is that market prices shall be determined by the free judgment of buyers and sellers in an honest and unmanipulated market. There are, however, some misconceptions as to the extent of the Commission's authority in this area. The Commission does not, of course, have authority to set the prices of securities or to determine that a particular market price is too high or too low. Furthermore, not every practice which causes the price of a security to move suddenly or unreasonably constitutes illegal manipulation. Such illegitimate devices as wash sales, matched orders, or running up the price in order to unload at a profit are, of course, proscribed in the statute. But if a man, or a group of men, commence buying a particular stock in order to acquire control of the company, or because they simply think it is a good investment, there is no illegal manipulation even if their buying forces the price up. If it subsequently goes down again, investors who bought for the rise may suffer losses, but, absent fraud or misrepresentation, this type of activity is just the normal working of a free market. Incidentally, it is always advisable for the securities industry to warn investors clearly that investing in securities is not a one-way street to riches and that all stocks can go down as well as up.

The Commission watches carefully for evidences of possible manipulation. Price movements, not only on the national securities exchanges but also in the over-the-counter market, are observed by our market surveillance unit and our regional offices. Where a movement is observed for which there is no readily available explanation, an investigation may be instituted to ascertain the reasons and the identities and activities of persons concerned. Although some cases may slip by our investigators, there does not appear to be a significant amount of illegal manipulation at this time. However, there is undoubtedly too much irresponsible tipping and rumor mongering. Free speech is the privilege of Americans and differences of opinion may make a market, but in the securities industry great harm may be done by passing on unfounded or incomplete information with respect to a security or by expressing opinions not based on knowledge of the facts.

The enforcement techniques that have been described involve the exercise of the Commission's administrative functions. These include the power to conduct investigations, subpoena witnesses, issue stop orders preventing the distribution of securities and to institute civil or criminal proceedings. Effective enforcement of the securities acts also requires the efficient use of its quasi-legislative and quasi-judicial powers.

In the legislative area the Commission is empowered to make rules to implement the purposes of the statutes which it administers. The Commission is constantly reviewing its rules with the view to strengthening its enforcement activities. For example, in order to secure the power to inspect the books and records of Canadian brokers and dealers who are registered with the Commission, a rule has been proposed, but not yet adopted, requiring every non-resident broker-dealer to maintain in the United States complete and current copies of the prescribed books and records, unless a written undertaking to produce copies upon demand is filed with the Commission.

In carrying out its quasi-judicial responsibilities, the Commission sits as a court of law. As a practical matter, because it is impossible for the Commission, as a body, to take evidence in all cases conducted in many parts of the country at the same time, the evidentiary record is made before one of its hearing examiners. The case is then briefed and argued before the Commission itself, and the Commission makes its findings of fact and conclusions of law. The question of whether it is in the public interest to revoke or deny the registration of a broker-dealer or to make permanent a suspension order issued under Regulation A would be decided on the basis of the record made in the evidentiary hearing and of the briefs and oral argument before the Commission.

A discussion of the present enforcement activities of the Commission would be incomplete without referring briefly to the bill sponsored by the Commission which contains a number of technical amendments to the securities acts. These proposals are designed to make the Commission's enforcement work more effective by eliminating or minimizing various technical problems that arise in prosecuting cases. For example, federal jurisdiction over brokers and dealers would be based on their status as registrants with the Commission or as members of registered exchanges in addition to the use of instrumentalities of interstate commerce. Another amendment would expressly limit the right of a registrant proposing to offer new securities to withdraw a registration statement by requiring the consent of the Commission to the withdrawal. A similar limitation

would be imposed on the right of brokers and dealers to withdraw their registration statements. The penalty section of the Securities Act of 1933 would be changed to make the filing of any misleading material under Regulation A a criminal offense. Another significant amendment would be the codification of the Commission's anti-fraud rule known as Rule X-10B-5, relating to fraud in the purchase as well as the sale of securities, to make it a more effective instrument for criminal prosecution.

From this brief review of the Commission's enforcement powers and its techniques in regulating the securities markets, you have perhaps realized the complexity and difficulty of the task assigned to the Securities and Exchange Commission. Operating within the framework of the full disclosure philosophy, its power to protect the public from inequitable deals is severely and, in my opinion, quite properly limited. The investing public must learn to guard itself from the alluring gimmicks and sweet talk of the hoods and stockateers. If, however, the registration and other filing requirements of the securities acts are strictly enforced - and the Commission is trying to execute them with increasing vigor - and if crooked promoters and dishonest broker-dealers' salesmen are promptly tracked down by a vigilant Commission, the confidence of American investors in the securities markets will be sustained and the enormous flow of capital into the legitimate industries of an expanding and prospering America will continue.

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