THE S.E.C. - SMALL CORPORATE ORGANIZATION AND PROCEDURE

Address of

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MEMBERS OF THE MARICOPA COUNTY BAR ASSOCIATION

I was indeed happy to have been extended the invitation of appearing before this Association. While welcoming the opportunity to address you, it soon became apparent however that the selection of a suitable topic posed a problem of some magnitude. It would be impossible, of course, to do credit to or be reasonably informative respecting all or any of the various laws administered by the Securities and Exchange Commission within the time permitted.

Further, there is perhaps no single facet of the administration of the Commission which could be covered with reasonable adequacy in the allotted time that would be of appreciable interest or value to all or even a substantial portion of those present.

In the circumstances I have chosen briefly to outline the organizational features of the Commission and the broad scope of its functions and to then comment upon certain aspects of corporate organization and procedure. It is hoped that the first will be found interesting at least in the abstract, and that the latter may provide more concrete and useable food for thought.

The Securities and Exchange Commission is composed of five members who are appointed by the President with the advice and consent of the Senate. The Chairman is designated by the President from among the five Commissioners. The Commission is bi-partisan in composition as prescribed by law and is an independent agency having certain prescribed administrative, quasi-judicial, quasi-legislative and advisory functions.

It is directly charged with administration of the Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940, and Investment Advisers Act of 1940.

Under each act it also has certain quasi-judicial duties, and long before enactment of the Administrative Procedure Act of 1946 it had established procedure by which the Commission itself became effectively insulated from its staff in all cases where a duality of functions was involved. It has thus gained an enviable reputation for the rationale of its decisions, many of which have been tested before the Appellate and Supreme Courts.

Under each act the Commission has certain rule-making powers, some of which are quite broad as a result of recognition by the Congress that complex situations in securities regulation would require great flexibility and should provide rapidity of action which could hardly be encompassed within the language of the statute itself. For example, Section 14 of the 1934 Act permits the Commission to prescribe such rules governing the solicitation of proxies, respecting securities listed on a national securities exchange, which are necessary or appropriate in the "public interest" or for "protection of investors." Judicial recognition has been afforded these standards as providing reasonable and sufficiently definite guides for promulgation of rules by the Commission, but the exercise of this quasi-legislative authority implies nothing which derogates from Congressional legislative power.

The Commission serves in an advisory capacity to both the Congress and the Courts in certain prescribed areas.

In addition to making special studies for, and testifying before, various Committees of both Houses of the Congress for their information in legislative matters, the statutes administered by the Commission in some instances provide for specific advisory services to be performed. For example, when the Investment Company Act of 1940 was enacted the effect of the size of investment companies upon the securities markets could not be predetermined and no limitation upon size, which had been seriously considered by the Congressional committees, was therefore imposed. In lieu of such limitation provision was made whereby the Commission could later make a study of those companies based upon actual operation under the 1940 law and report the results of that study to Congress. Early this year the Commission engaged experts connected with a large western university to undertake a preliminary study for the purpose of outlining a course of inquiry designed to yield the information necessary to evaluate the effect of the size of these companies upon the securities markets. The question is far too complex and too broad in scope to attack directly. In effect it is necessary to make a study to find the best method to be employed in making a study.

The Commission serves in an advisory capacity to the Federal courts in certain proceedings under Chapter X of the Bankruptcy Act wherein there is wide distribution of the securities of the debtor.

Of this function Chief Judge Charles E. Clark of the Court of Appeals for the Second Circuit said on behalf of all of the active judges:

> "We regard the service being rendered by the Commission to the Courts in connection with the reorganization of corporations to be most valuable, if not indispensable, for the proper disposition of this vital segment of court business according to the Congressional intent. The Commission affords the necessary expert knowledge, the skill, and the uniform approach which individual judges cannot have; and to the district judges in particular, the assistance is unique in its usefulness, and not otherwise to be obtained. The judge is not bound to observe all suggestions of the Commission, but the very fact that he has them before him is assurance of his complete preparation for adjudication, with the public interest adequately protected. * * *"

The experience of the Commission gained in reorganization proceedings before it under the Public Utility Holding Company Act has contributed materially to its ability to be of service to the Court in Chapter X proceedings as described by Judge Clark.

I have reviewed for you the character of some of the functions of the Commission, and I would now like to give you some idea as to the scope and volume in terms of number of proceedings and in dollars involved.

Under the 1933 Act there were filings, for fiscal 1956, aggregating $13.3 billions. Of this amount $273 million were represented by offerings under Regulation "A". It is anticipated that this amount will continue on the increase since the forecast of corporate capital needs for the coming year reaches an all time high.

Under the 1934 Act there were, for calendar 1955, more than 4,000 stock and bond issues traded on 15 national and 4 exempt exchanges in an aggregate amount of $40 billion (up $11 billion from 1954). The total market value of listed issues amounted to $340 billion. There were 4,400 brokers and dealers registered with the Commission during the year.

Under the 1935 Act there were at the end of fiscal 1955, 25 public utility holding company systems, 23 registered holding companies operating solely as such and 7 which were also operating companies, 171 gas and electric utility companies and 137 non-utility companies, or a total of 338 companies. Aggregate assets of these companies, less valuation reserves, amounted to some $10 billion.

The number of holding companies has of course been greatly reduced since the 1935 Act became effective. Many of those which were formerly holding companies have, upon relinquishment of control of their subsidiaries, become investment companies and are presently registered as such with the Commission.

While the number of holding companies has diminished the work load in this field is still heavy. For example, one holding company which has petitioned for a change of status has, in the course of divestment of its subsidiaries which it commenced upon order of the Commission in 1938, involved the issuance of over 400 releases exclusive of routine notices, 65 lengthy opinions and orders, of which 20 were appealed and of which 8 reached the Supreme Court for final determination.

Under the Trust Indenture Act of 1939, during fiscal 1955, 157 indentures were qualified in an aggregate amount of $3-3/4 billion.

Under the Investment Company Act of 1940, at the end of fiscal 1955, there were 387 registered investment companies having assets of approximately $12 billion.

Under the Investment Advisers Act of 1940, at the end of fiscal 1955, there were 1,203 registered investment advisers.

Under Chapter X of the Federal Bankruptcy Act, during fiscal 1955, the Commission participated in 38 proceedings involving 61 companies and having stated assets of $671 million. Thirty Chapter X proceedings are presently before the Commission in active status.

A large part of the work of the Commission is in the field of enforcement of the various acts which it administers, particularly the 1933 and 1934 Acts. In addition to a stepped-up broker-dealer inspection program the enforcement personnel in all regional offices is being expanded. This is made possible by a favorable appropriation which permits bringing the staff of the Commission close to the 800 mark. From a peak of 1,800 in 1942 employment dropped to 666 in 1955. Between 1951 and 1955 there was a drop from 1,040 to 666 even though activity in the financial markets during the period, and the responsibilities of the Commission, were on the increase.

It is fortunate that our staff may be augmented during the current fiscal year, for in the past several months a small but increasingly active element in the securities industry have been expanding their business through the medium of high pressure boiler room tactics. One house which was recently inspected had been "plugging" 4 stocks by telephone during the past 6 months - this house had amassed $1,900,000 in commissions for the period, had paid out to its super salesmen $600,000, and had spent $200,000 on telephone calls alone.

This type of solicitation usually involves flagrant misrepresentation of facts and frequently relates to securities of questionable merit. In some instances, however, stock of a legitimate company may be "plugged," and the issuer innocent of any participation in the activity affecting the market.

Since the 1st of July of this year the Commission's investigations have resulted in one indictment and 10 civil complaints seeking injunctions against broker-dealer firms. In several of the latter the appointment of a receiver was requested to preserve the defendant's assets for the protection of his customers.

During that period 3 additional indictments were returned and one permanent injunction obtained, involving both issuing companies and promotors; these actions were based upon misrepresentation in the sale of the securities. Three other injunctions were obtained involving violation of the registration and disclosure requirements of the 1933 Act. Additionally, since July 1st the Commission authorized stop-order proceedings to be instituted in five cases, issued final stop-order decisions in three other cases, and issued 38 denial or suspension orders respecting securities proposed to be offered under Regulation "A" which regulation was promulgated under the 1933 Act.

Again, under the 1934 Act and for the same period, denial or revocation proceedings were instituted against 5 broker-dealers, the registration of 10 firms was denied or revoked after hearing, and 12 proceedings involving the net capital rule were dismissed when the broker-dealers involved brought themselves into compliance.

From the foregoing summary of the general functions and responsibilities of the Commission, and the preceding list of recent enforcement matters, which list does not include a substantial number of unfinished investigations which are still in progress, it becomes evident that there is considerable activity within the agency. Since so many of these matters must be passed upon by the members of the Commission it is not difficult to understand why the Commissioners must meet in formal session almost daily, and these sessions rarely consume less than 4 to 6 hours time per day.

Going on to my second topic, I would like to make a four point observation on corporate organization and internal operation. These comments are particularly applicable to small businesses in the organizational or transitional stages, and encompass areas in which you, in your professional capacities, may exert some effort to influence your client for his own benefit.

1. Try to make the capital structure of the new corporation as simple as possible.

Intricate and complex structures with multiple classes of stock are not necessary for the small "family" type corporation and are unbecoming to most others.

They make more difficult the problem of obtaining capital if and when needed. Those who contribute to finance of small corporations in private transactions look with suspicion upon a complex structure and various classes of stock embodying special and frequently unconventional terms and conditions. Many sound broker-dealers will not underwrite, even on a best efforts basis, any issue for the smaller company having unusual features of capitalization.

The Securities and Exchange Commission, under the Holding Company Act, is charged with simplifying the capital structure of companies subject to that Act, many of which companies are quite large.

Care is exercised by the Commission in the reorganization of these companies to provide adequate representation and protection for all investors - to institute what might be summed up as "corporate democracy" in the reorganized company. This has not been found detrimental to the large corporations, which class would have greater reason for a more intricate pattern of capitalization than the smaller and unknown organization.

It is not enough merely to supply a client with articles of incorporation and by-laws framed to meet his expressed wishes - but he should be urged to consider simplification whenever possible.

2. Try to impress the need for adequate and accurate records of corporate procedure.

All too frequently it is found that minute books and basic corporate records are not maintained and that officers and directors have assumed responsibilities and taken action in matters for which they had no specific authority. A comprehensive and current minute book serves, among other things, as a protective device for the executive officers who are conducting the affairs of the corporation.

I was impressed by a statement made by one of the speakers at the American Bar Association meeting at the Westward Ho some two years ago. His topic was the selection of an appropriate form of organization for a small business and he pointed out the trend toward the corporate form. The speaker said of the small businessmen, however, that they all too frequently wanted to be incorporated and enjoy the individual protection afforded, but did not want to act like a corporation.

Neither ignorance, negligence nor individualism should be allowed to defeat the maintenance of good corporate records.

3. Try to impress the need for good accounting practices and maintenance of books of account.

The small businessman will frequently maintain that his company cannot afford expert help in setting up and auditing financial

records. As a rule the contrary is so, for he can hardly afford not to know his costs and his financial position at all times. Lending institutions, suppliers and stockholders are favorably impressed by full and complete financial statements even if such statements might disclose an operating loss, for they are evidence that management is not proceeding blindly but is fully informed.

Properly prepared financial statements are, of course, necessary if the corporation proposes to make a public offering of securities. The standards of accounting prescribed by the Commission have been worked out over a period of many years, and there is a close liaison maintained with the national organization of the accounting profession. The impact of the Commission's rules relative to accounting has, in fact, extended far beyond the scope of the laws under which they were promulgated. Many of the practices upon which the Commission insisted, in connection with the process of registration of securities or broker-dealers, have been uniformly adopted and applied by the accounting profession to the records of companies that have not, and perhaps never will, come within the jurisdiction of the Commission.

4. Try to impress the urgency of a full and accurate disclosure in connection with any public offering of securities.

Sanctions under the Federal act, and under most of the State Blue Sky Laws, may be quite severe in cases of inadequate disclosures.

We need not dwell upon the nature of those sanctions, but either or both civil or criminal liabilities may arise and, at best, the ability to obtain capital may be curtailed by stop-order or similar administrative proceedings.

I should point out here another problem which is reaching significant proportions and to which, in some instances, the attorney may be a party. I refer to the filing of a hopelessly deficient registration statement under the 1933 Act or a schedule under Regulation "A" in reliance upon receiving a lengthy letter of deficiency which would recite in some detail the matters to be inserted in the record. This practice, in effect, would have the staff of the Commission doing the drafting and detail work which should properly be performed by the registrant and his counsel.

I urge you to get all of the facts from your client, and to clearly set them out in the very first filing. It will save you time in the end - and will certainly save the time of our staff so that they may distribute their time to better advantage and serve more applicants.

The Commission has been entertaining the idea of instituting stop-order proceedings forthwith in extreme cases where the filing is so inadequate and is made in apparent disregard of the instructions issued as a guide for applicants that they might file appropriate statements. It is hoped that the problem may be resolved by means less drastic than stop-order proceedings.

I have covered these items of corporate organization, procedure, and financing in the light of my past experience as an industrial consultant and as state administrator, where they were frequently found to rise and plague small business. More recent experience as a member of the Securities and Exchange Commission only serves to confirm the existence of these areas in which more careful consideration could be employed to great advantage and in which counsel for the small businessman might perform an added and useful service.