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"REVISION OF THE RULES AFFECTING REGISTRATION UNDER THE SECURITIES ACT AND THE SECURITIES EXCHANGE ACT"

ADDRESS

of

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"Revision of the Rules Affecting Registration
under the Securities Act and the
Securities Exchange Act"

As you are undoubtedly aware, there has been in course for some time a general revision of the rules and regulations and forms affecting registration of securities under the Securities Act and the Exchange Act. The purpose of this talk is briefly to discuss some of the problems which have arisen in that regard.

The design of the revision is to reduce in content the volume of formal regulation and, at the same time, to profit by the experience gained in the administration of the statutes and to cover matters as yet unprovided for. It is hoped also to obtain uniformity in the requirements through being guided by the principle that, so far as possible, any provision applicable to the same subject matter be stated only once.

Before undertaking a discussion of the various new rules and forms, it may be noted that the length of the regulations and the difficulty in their preparation spring from the complexity of the forms of organization of the enterprises whose securities are being registered. A study of the regulations will clearly demonstrate that fact.

With the presently existing forms the classification was largely based upon the kind of business done. The revision has departed from this principle, insofar as creating separate forms is concerned, and has sought to apply, with certain minor exceptions, only the following norms: First, to divide the registration of securities representing interests in a going business from those representing a direct interest in property. As to the first category, the classification further reposes upon a division of going businesses into two classes; those still in a promotion stage and those not so. The second category, that is those providing for the registration of securities representing only an interest in property, has been divided into several classes, each clearly peculiar, such as certificates of deposit and oil interests.

There has been much difference of opinion as to specific problems involved in the above classification. There may be cited, for example, the difficulty of separating out a promotional enterprise. At first blush, it would seem that the more exact manner of effecting the segregation should be in terms of promotion itself; for example, to provide simply that the promotion form should be used by all companies still in the promotion stage. This would seem, however, to present material disadvantages, due to the great difficulty of determining the point at which the promotion stage of an enterprise ceases. In consequence, the draft of the regulations as sent out for comment took the other horn by providing a point of time in the life of an enterprise as the basis of differentiation. It is believed that the certainty thus attained outweighs the disadvantages.

There are many other similar problems involved in the classification. For example, there can be no doubt, in principle, that forms for in rem claims against property which represent no interest against a going business should be segregated from those that do so represent an interest, and this because of the essentially different rights and duties involved. But on the other hand, if we will take oil royalties as an example, some persons have

thought that a single form should be made applicable not only for oil royalties themselves but for the general securities of companies, whether in corporate form or otherwise, whose principal assets consist of oil royalties or other direct oil interests, and indeed also for fixed trusts, the underlying portfolio of which consists principally of such oil interests; so that a single form would apply to all such interests, whether the ownership be direct or indirect.

We may now briefly consider the present status of the revision. Some time ago there were sent out for comment and criticism the following drafts of amendments to the regulations under the Securities Act:

(1) Amendments to the Rules and Regulations.

(2) A general form for going businesses other than those in the promotion stage.

(3) A form for companies in the promotion stage.

(4) A form for fixed investment trusts.

(5) A general regulation governing the form and content of financial statements and schedules. This regulation is to be made applicable also to the Exchange Act.

A great volume of comment, both oral and written, has been received on these proposed regulations. The digesting and collation thereof have now been about completed, so that the material will soon be submitted to the Commission for its further consideration. This work of digestion has been arduous, in view of the extent and care with which the comments were made. There have in the meanwhile been prepared, and will successively soon be sent out for comment, the forms for registration of the following securities under the Securities Act; oil and gas interests, certificates of deposit, voting trust certificates, American certificates against foreign issues, other securities representing primarily an interest in property, and securities of foreign governments. Drafts have also been prepared for correlative forms under the Exchange Act, both for original registration and annual reports; these have been drafted on the principle of adhering as closely as possible to those under the Securities Act so that issuers will, in principle, not have a variety of provisions applicable to them.

We may now briefly discuss certain of the problems which have been presented in the regulations which were sent out for comment.

First, as to the amendments to the rules under the Securities Act. The definitions constitute one of the principal parts of these rules. An attempt was made to create certain terms of art, as an aid to precision. This was particularly true insofar as relationships between a company and its subsidiaries and predecessors were concerned. In consequence, definitions were made of "significant subsidiary","majority-owned subsidiary," totally-held subsidiary", "predecessor", "significant predecessor", "major predecessor", "succession" and "promoter". Although no one doubts the utility of the definitions, there has been a great contrariety of opinion as to what should be their actual content. For example, should a significant

subsidiary in relation to the registrant be defined in terms of 3%, 5% or some higher percentage? This definition has particular application in indicating what information shall be filed as to subsidiaries, particularly financial statements. A similar problem is presented in regard to the definition of "totally-held subsidiary", a novel term, as far as I know, and not meant to be synonymous with the commonly accepted meaning of "wholly-owned subsidiary". In principle, the new forms treat "totally-held subsidiaries" as if they were merely branches. The definition of what is a totally-held subsidiary is, therefore, of considerable consequence, and should, in practical effect, define that kind of subsidiary which, in its essence, is the same as a branch. Many people have thought that "funded debt" held by outside persons should not prevent a company from being deemed such a "totally-held subsidiary". This position, it would seem, is not correct, for "funded debt" involves just as distinct claims against the enterprise as do equity securities. Time is lacking to discuss the other definitions, but they have presented similar difficulties.

Further, as to the rules, consideration is being given as to whether there should not be introduced a novel one, to the effect that matter contained in a prospectus may be incorporated by reference in the registration statement, so as to obviate, so far as practicable, the necessity of double presentation and double printing. There would seem, however, to be certain considerations that may militate against the making of such a rule.

A few points may be discussed in turn as to the form for non-promotion companies but, before doing so, mention may be made that much effort has been spent, in general, to provide cut-offs so that detail without consequence will not be given. We all know that inconsequential data has often hidden the real story.

A great disparity has existed in the descriptions of the business and property of the registrant. As to property, for example, a great mass of uncorrelated detailed data has been given in many cases, so that its interpretation by an investor is practically impossible. In the hope of remedying this situation, the items concerning business and property were combined; it was thought that there would then be a greater incentive to make an economic and integrated description, in which matters of similar kind would be reduced to their common factors, and stated in totals.

Particular consideration has been given to the question of distinct lines of business. It is clear that if a registrant has several lines of business, each materially important, but subject to underlying different business conditions, some indication of their relative import should be given or else the investment analyst is not left with tools to work. There has been, however, here again a great difference of opinion as to the extent to which there should be a breakdown and as to whether, for example, it should extend through to gross profits or on to net profits or be limited only to sales.

The form as sent out for comment had a novel requirement concerning the distribution of share ownership. A number of critics made the point that this information was not of utility. The criticism is not well taken, it would seem; for clearly an investment, whether in the form of debt or equity securities, in a company whose securities are widely distributed is one quite distinct from an investment in a company whose securities are closely held,

both from the standpoint of control and from the standpoint of potential market. In view, however, of the comments, further study has been given as to the kind and degree of information which should be furnished concerning this matter.

As to such items as securities held by officers, remuneration of officers and directors, and the description of securities, consideration has been given to what steps should be taken by rule to limit the information; for example, not to require a description of the charter provisions concerning preferred stock if the preferred stock is to be retired. In this regard a number of suggestions have been made, some of which it seemed could not be put into application. For example, one was made to the effect that if the securities being registered were equity ones no description should be obtained of equity securities junior to the ones being registered. This would seem wrong, however, for the relative rights between several classes of equity securities are in function of one another, so that the description of one must, in principle, involve the description of the other.

As pointed out above, the segregation of the promotion form was based on the principle of a definite period of time, which would necessarily leave out of its orbit certain companies as to which information concerning the manner of organization would still be of material consequence. On that account, as contrasted with A-2, there has been introduced into the new form a general caption concerning this head of information. If the company was organized within five years, a description of the organization is required, and particularly an indication of any promotion reward. In a number of internal reorganizations, however, this information would not be of value, since the reorganizations were accomplished solely to clarify the structure, without any change of rights of the security holders. An attempt has been made to cover this exceptional case.

A study has also been made in regard to the part entitled "Historical Financial Information" as to whether certain exceptions should not be made as to public utility companies which have reclassified their property accounts in accordance with regulations requiring the segregation of original cost, as that term is presently defined by the Federal Power Commission.

Certain innovations, again as contrasted with A-2, were made in the draft form concerning the question as to what financial statements have to be filed. Some persons have thought that these innovations were not correct. They concerned principally the filing of statements for significant 50% owned companies, statements of businesses recently acquired, and statements of issuers the securities of which are pledged as security for the issue registered. We may discuss each of these briefly in turn. As to the first, that is a 50% owned company, it would seem clear that for the purpose of investment analysis a 50% owned person should, in principle, be treated as a subsidiary. Certainly the one degree of difference in ownership could not affect in any substantial way the financial stake of the issuer in its investment in the other person. As to control, the equal division of ownership between two persons would seem to demonstrate that the particular enterprise is a joint venture in which both owners have participation in management. As to a business recently acquired, if of material significance, the pertinence of statements would not seem to be in function solely of whether the proceeds of the issue being registered are used for its acquisition. If acquired within such time as not yet to be integrated in the

business of the acquiring person, statements should be furnished, it would seem, in order to throw light upon the possible effect of the new material acquisition. Again, if the securities being registered are secured by the pledge of other securities, it must be assumed, in principle, that the pledge gives value, or else the pledge is a mere gesture. If giving value, the financial statements are requisite in order to appreciate the quantity of the added value springing from the pledge. In some instances, however, a pledge tends to be a formal act due to the nature of the intercorporate relationships, in which case the separate statements would only serve to clutter up the registration statement. An attempt has been made to meet this complex problem and to obtain the individual statements only when of material consequence.

Under the existing forms under the Securities Act a separate form is provided in case the securities being registered are being offered in exchange for other securities. Clearly the purchase of securities for cash is a distinct act from the barter involved in the exchange of a security for other securities. In the proposed new form a special section is added to be answered in case the latter be the transaction. The exact provisions of this section have presented difficulty. In pure theory, as much information is needed to determine whether a person should give up a position in a security as to determine whether he should take a position in another security, because both acts involve a determination of present investment value. There are many diverse situations, however; for example, the offer of a going company to exchange its issue of preferred stock for the common stock of another going company is manifestly a different kind of transaction from an exchange for certificates of deposit in the process of an insolvent reorganization. In the latter case, for example, should there be required the same financial statements as in the first, and should there be obtained statements of the committee accounting for its receipts and disbursements during the life of the committee?

As to the prospectus, the regulation as sent out provided for three forms of prospectuses: A normal one, provisions for which were essentially the same as those contained in A-2; a newspaper prospectus, provisions for which, again, were essentially the same as in A-2; and a novel one, to be used only for certain evidences of indebtedness. We may now discuss briefly the first and third forms of these prospectuses.

As to the first, it has always been hoped that as the statute became more seated there would be greater attention paid to the manner and form of presentation so that trifling data would be eliminated. I personally believe that has been the case. The regulations as sent out contain the permission to omit certain financial statements which had been required to be included in Form A-2. They were to the effect that, if a company, although having subsidiaries, was in essence a non-holding company, only a single set of statements for it need be included in the prospectus, which set could be either on the consolidated or individual basis.

The third form of prospectus was designed for the evidences of indebtedness of companies as to which there were conditions tending to make the issuer a sound one. Patently, no conditions can be found which would enable you to determine, by mathematical calculation, whether a company was of the kind above described. The best condition, if practicable, would be one predicated upon some ratio between debt service and net income. The establishment of such a ratio, however, is impossible, owing to the fact that it would

have to be different, necessarily, for every category of business. In consequence, a series of conditions were set forth which were thought, in the sum total of their effect, to make a reasonable approximation of accomplishing the object desired. These conditions related to such matters as the life of the company, its being listed on a national securities exchange, the unconvertibility of the issue, and other factors of a similar nature. There was much comment as to this novel proposal. This rule left largely to the discretion of the issuer, subject always to the general provisions of the Act, what data should be included in the prospectus, there being borne in mind that there would always lie at the base of the prospectus the registration statement on file. In the limited class of issues falling within the conditions the rule would tend, it is believed, to make for a very much shorter form of prospectus than that presently used. Certain persons, however, thought that some of the conditions would prevent its receiving any real use, so that those conditions have been re-examined.

As indicated above, the accounting regulation is to be made applicable to all filings under both the Securities Act and the Exchange Act. It is limited to the indication of the form and content of statements required to be filed. The several forms under the two acts will contain the indication as to what financial statements are to be filed. The purpose is to have all accounting rules in one place, to facilitate the work of the accountants and others on the outside, and the administrative work within the Commission. In this general review there is time to mention only a few of the points which have been taken into consideration in this regulation. It has been subjected to a minute and detailed examination, in view of the comments received. Much effort has been spent, likewise, in an endeavor to get a clearer and more lucid presentation. It may be mentioned that consideration is being given to including permission to make a single statement of accounting principles and practices followed in the financial statements in lieu of making footnotes to the respective statements. The regulation is also designed to give a greater dignity to the analysis of surplus. Provisions are introduced to make unavailable to corporations organized within a certain period of time the permission to use book figures as to certain elements of the balance sheet; as contrasted with A-2, this is necessitated by the fact that the non-promotion form will have a very much wider application than A-2. In the regulation, as it went out, there was a provision for the furnishing of a schedule to consolidated and combined statements, the prime purpose of which was to show, in broad outline, the breakdown by significant members. There was some misunderstanding as to the conditions under which this schedule was to be filed, and many persons thought that it was without utility. It would seem clear, however, that a consolidated balance sheet does not furnish a complete picture when there are large and varied securities of the subsidiaries outstanding in the hands of the public. The provisions concerning the schedule have, however, been re-examined with the view to more clearly defining the occasion for its use.

The form for promotion companies calls for only small comment, although a number of difficult problems have been presented in regard to it. The fundamental thought controlling its structure was that there must be obtained a complete and clear analysis of promotion and promotion reward. One of the problems remaining, however, is the final determination of what kind of financial statements should be included. The form, as presently constructed, calls for schedules in place of a balance sheet, and a cash receipts and

disbursements statement instead of a profit and loss statement. Since the form can be used by companies having a life of less than three years, it is possible that certain of the companies falling within its province should properly furnish balance sheets and profit and loss statements, as having passed from a period of promotion to a period of effective operation. The line of demarcation, however, is so difficult to draw that it would seem that the furnishing of profit and loss statements and balance sheets should be left to the discretion of the registrant and not be required.

The essential problem presented in the form of investment trusts was that the form be so devised so as to obtain a clear and lucid exposition of all the load involved in the issuance of the securities. Particular attention was paid in this regard to the incidence of a double load, and its proper mode of presentation.

In conclusion, I should like to point out the reasons why it seems certain things requested by persons commenting cannot be done. There is a desire on the part of many persons for an unattainable precision in language. It is impossible to use language which will not be subject to interpretation. To attempt to make the regulation such as to be capable of mechanical application would certainly, even if possible, lead to undue length and to a too great rigidity. Some people have thought that there was already in the existing regulations too much detailed provision. The general tone of comment, however, has been for more. Many requests have also been made for detailed instructions as to mechanical details, which it would seem should be left to common sense and judgment. Along the same line were requests for additional instructions in terms of percentages, which, it is believed, likewise should not be included, since they always have the possibility of error due to the limits of providing in the abstract for the given instance; as an example, many people have thought that additional instructions should be made as to what contracts should be furnished. The norms which have been provided show that insignificant contracts need not be furnished and that, it would seem, is all that can be done.

Many other comments have as their basis that information should be left out as being private in character. Certainly in principle, nothing essential for investment understanding can be private in a public company offering its securities for general distribution. The only limitation along such lines would be not to require the information if the furnishing thereof would harm the business of the issuer and if that harm outweighs its theoretical advantage for investment analysis.

All the other comments and criticisms have been carefully weighed and, if they are not followed, it will be because of what are thought to be good reasons, taking the problem as a whole, for not doing so.

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