CURRENT LEGISLATIVE AND RELATED PROBLEMS

Address of

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Just about a year ago, your organization honored me by asking me to address you. At that time, I described briefly the adoption by the Securities and Exchange Commission of certain rules and amendments 1/ and gave some passing attention to Rule 133, proposed amendments to which had at that time been withdrawn from official consideration by the Commission and were under study by the staff. As some of you may recall, I then directed my principal attention to the Fulbright Bill, which in general would have imposed upon every unlisted company having $10,000,000 of assets and over 1,000 stockholders, approximately the same disclosure requirements as are now imposed upon a company listed on a national securities exchange.

To bring you up to date on this last topic, I may say that the Fulbright Bill has not as yet been reintroduced in this Congress. Whether this situation will continue, I do not know. There is no visible inclination on the part of the Commission itself to submit this legislation for introduction, though, as I said last year, it is convinced that fair and effective control of the securities market and adequate protection to the investing public can be achieved in no other way. There are various reasons for this attitude, not the least of which is a reluctance to recommend legislation which, to stand much chance of passage, would doubtless be essentially emasculated by meaningless exemptions.

It has occurred to me that you might be interested this evening in hearing about some recent developments in what might be called administrative legislation, particularly as to Rule 133, to which amendments have again been proposed and on which comments have been received from interested persons, and also about the somewhat related field of our legislative activities in the first session of the 86th Congress.

Turning first to the latter subject, let me remind you that the Commission is specifically required by statute to make such legislative recommendations to the Congress as it may from time to time deem desirable in the public interest. Pursuant to this mandate, the Securities and Exchange Commission in the summer of 1957 submitted to Congress certain proposals

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1/ Rule 434A and Note to Rule 460

to amend an aggregate of 87 subsections of five of the six statutes which we administer. 2/ For various reasons, when Congress adjourned in August, 1958, no action had been taken upon the bills embodying these proposals. During the inter-session period, the Commission has re-examined and re-appraised these legislative suggestions in the light of its further experience. Accordingly, in January we submitted revised recommendations to the Congress, which were duly referred to the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce, which groups are respectively charged with the duty of exercising watchfulness over the administration of the federal securities laws. These recommendations, which would amend an aggregate of 88 subsections of all the statutes we administer except the Public Utility Holding Company Act, were introduced in January and February of this year in the House of Representatives by Representative Oren Harris, Chairman of the House Committee as H. R. Nos. 5001, 2480, 5002, 2481 and 2482. Companion bills embodying the same proposals were introduced in the Senate in February, 1959 by Senator A. Willis Robertson, Chairman of the Senate Committee, as Senate Bills 1178 to 1182, inclusive. The overall purpose of these recommendations is to strengthen the safeguards and protections afforded the public by tightening the jurisdictional provisions of the statutes, correcting certain inadequacies, and facilitating criminal prosecutions and other enforcement activities. We are hopeful that hearings on these bills will be scheduled in the very near future. In the meantime, we are engaged in attempting to delineate any areas of conflict with the industry so as to simplify our presentation at the hearings.

A complete analysis of all of these proposals would carry this talk to inordinate lengths. I do think, however, that the Securities and Exchange Commission owes it to organizations such as yours which have been so helpful over the years to explain just what it is up to. Within these limits, I would like to go over some of what I conceive to be the more significant changes we propose, in the hope that we can prevent any conflict with you or even enlist your active support.

First let me take up the Securities Act of 1933. One of our proposals would increase from $300,000 to $500,000 the size of offerings which may

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2/ 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.

be exempted from registration by the Commission pursuant to Section 3(b), under which our Regulation A was adopted. We believe that this change is necessary under present day conditions in order to facilitate access to the public capital markets by small and medium-sized businesses. At the same time, we propose to amend Section 12 to add a new subsection which would impose civil liability upon those persons who may be responsible for untrue statements of, or omissions to state, material facts in any document filed with the Commission in connection with offerings exempt under Section 3(b) or Section 3(c).

Section 11 of the Act now provides for civil liability in the event of material misstatements or omissions in a registration statement, and Section 12(2) contains civil liability provisions applicable to the fraudulent sale of securities generally, regardless of whether they are registered. Section 12(2) provides that "any person who . . . offers or sells" a security by false and misleading statements is liable "to the person purchasing such security from him." However, under this provision, where, as very often happens, an issuer sells to a dealer and the dealer in turn sells to an investor, there is doubt whether the investor can go beyond his immediate seller (the dealer) and recover from the issuer, who may be the person actually guilty of uttering the misleading information.

On the one hand there should be no defense of lack of knowledge of any untruth or omission by the issuer in a document filed with the Commission. On the other hand, it does not seem reasonable to impose liability for misleading statements or omissions in an exempt offering upon an officer, director or other individual associated with the offering who can sustain the burden of proof that he acted in good faith and did not know of the untruth or omission. Thus we propose that those individuals would be liable only for actual misconduct or bad faith, whereas the issuing corporation would be absolutely liable. We think that enactment of this proposal would furnish investors with the additional protection which seems to be required in Section 3(b) exempt offerings.

In this same general connection, we propose to amend Section 24 to extend criminal liability for documents filed with the Commission to cover exempt offerings made pursuant to Section 3(b) or 3(c) and even further. This Section now makes it a criminal offense for any person wilfully to falsify a registration statement filed under the Act. The Commission now suggests that this section apply not only to a registration statement, but to any application, report or other document filed under the Act.

A further amendment of Section 12 is in our program, inserted in order to resolve a troublesome question which has arisen concerning the jurisdictional basis of the civil liabilities provisions of this section. It has been held in some jurisdictions that in order for such liability to attach, the mails or interstate facilities must be used in making the misrepresentation. Other courts have, we think more properly, held that the use of mails or interstate facilities in any part of the transactions is sufficient to create liability. We propose that the jurisdictional language be separately stated so as to make it clear that the section would be applicable if there has been any use of the mails or interstate facilities in connection with the transaction, thus conforming the jurisdictional requirements to those contained in Section 17(a), the anti-fraud provision of the statute of which Section 12(2) is essentially a counterpart.

Section 20(b) of the Securities Act now provides in short that the Commission may obtain an injunction when it appears that any person is engaged or about to engage in any acts or practices which constitute, or will constitute, a violation of the Act or any rule or regulation thereunder. The legislative program recommends amendments to this section which would authorize injunctions on a showing that a defendant "has engaged" in acts constituting a violation, instead of making us show that the defendant "is" so engaged. While past violations are considered a sufficient basis for an injunction by many courts, on the ground that they indicate the possibility of future violation, there have been some dissidents, and it would materially assist the Commission in its enforcement activities if it were made very clear that Congress intends a past violation to form the basis for an injunction against future misconduct. In the last analysis, of course, the issuance of the injunction would still be a matter within the discretion of the court.

Finally, a new section would be added which would specifically prohibit persons from doing acts indirectly which they may not do directly, and would make it specifically unlawful for any person to aid, abet or procure a violation by another.

Changes are proposed in the Trust Indenture Act essentially to conform certain provisions of that statute to certain of the recommendations made in connection with the Securities Act.

Amendments concerning injunctions, indirect acts, and aiders and abettors similar to those proposed to the Securities Act are proposed to the Securities Exchange Act of 1934.

In addition, we propose to add a new Section 35 to the latter Act which would prohibit the embezzlement of money or securities entrusted to the care of an exchange member or a registered broker or dealer. The Act now contains prohibitions against fraudulently obtaining customers' funds or securities, but does not contain an express provision against embezzling or converting. Inasmuch as the distinction between fraudulently obtaining customers' funds or securities and embezzling or converting them frequently depends upon the technical question of whether the defendant had a wrongful intent at the time he induced a customer to entrust securities to him or whether the idea of converting the securities first occurred to him after he got possession, the Commission has recommended provisions which would prohibit such actions in words which will leave no doubt as to their being a violation of the 1934 Act.

A further proposed amendment to this Act would clarify and strengthen the statutory provisions relating to market manipulation without altering their general purpose or effect. We have recommended changes in the wording of Section 9(a)(1) concerning prohibition of manipulation by the use of so-called matched orders in order to overcome the effect of an extremely restrictive judicial interpretation, which would greatly narrow its scope.

Our program also suggests the amendment of Section 15(b) of the '34 Act with respect to the bases on which registration of brokers and dealers may be denied or revoked, the sanctions which the Commission may impose, and the procedures involved in postponing the effectiveness of registration. Under these proposals, the grounds for a denial or revocation of a broker and dealer registration would be broadened to include conviction of any "financial type" crime. As presently limited, convictions justifying such action by us must arise out of securities transactions or from conducting a broker or dealer business.

The Commission has also proposed that it be given the power to suspend the registration of a broker-dealer when, in its view, the testimony does not warrant the extreme sanction of revocation. Under present law, curiously enough, we have power only to revoke registration with the SEC or to suspend or expel from membership in the NASD. There are situations which come before us where revocation is really not called for, but where mere suspension or even expulsion from membership in the Association would not afford an adequate sanction. In some instances, where the broker-dealer is not a member of the NASD, the only alternative is revocation of

registration. As it stands, when there are mitigating circumstances we are forced to revoke the registration and then hold a second administrative proceeding on the question of whether an application for new registration should be denied. The Commission might have no objection to readmission but a record must be made and the public given an opportunity to object. In appropriate cases, this cumbersome maneuvering could be eliminated by granting to the Commission specific power to suspend the broker's registration for a period of time.

We have further recommended that Congress extend the Commission's existing authority summarily to suspend a security from trading on a national securities exchange for a period not exceeding ten days when necessary in the public interest. Lately, this grant of power has been used to keep in effect a suspension of trading pending final disposition of delisting proceedings under Section 19(a)(2) of the Act. It has been useful where it has appeared that the current information available to the public concerning a security is misleading or is inadequate to permit investors to make informed judgments with respect to its purchase or sale, and it appears that the additional necessary information cannot be obtained and made available to investors until all the facts are elicited through the 19(a)(2) proceedings. These proceedings, because of their complexity, often cannot be completed within a single 10-day period, and it has been found necessary to renew the suspension for successive 10-day periods. No express authority for such action is contained in Section 19(a)(4), and its proposed amendment codifies the current interpretation under which the Commission has acted.

The present statutory power of suspension of trading applies only to transactions on a national securities exchange and does not explicitly extend to securities traded only in the over-the-counter markets. Among the Commission's recommendations is included a new Section 15(c)(4) which will give to the Commission comparable statutory power summarily to suspend trading in a security on the over-the-counter markets.

The Commission has also proposed a new section which would authorize the Commission, in its discretion, to institute action on behalf of the United States to recover $100 per day in civil penalties for failure to file any required information or reports. A similar provision now covers delinquencies in filing reports under Section 15(d), and its extension to other reports is designed further to strengthen the hand of the Commission in enforcing timely filings. The present remedies, principally that of mandatory injunction,

have shown themselves to be effective only after substantial additional delay and after cumbersome technical litigation.

In addition to the foregoing, we have proposed other amendments to the Securities Exchange Act of 1934, the details of which would probably not interest you particularly. Briefly, they would:(1) clarify and strengthen the statutory provisions relating to the financial responsibility of brokers and dealers; (2) authorize the Commission by rule to regulate the borrowing, holding or lending of customers' securities by a broker or dealer; (3) make it clear that mere attempts to purchase or sell securities are covered by the anti-fraud provisions of the statute; (4) authorize the Commission to suspend or withdraw the registration of a securities exchange when the exchange has ceased to meet the requirements of original registration; and (5) provide for the adjudication of an insolvent broker or dealer as a bankrupt in an injunctive proceeding instituted by the Commission.

The Investment Advisers Act of 1940 has, ever since its enactment, been least effectual of any of the Securities Acts in protecting investors and the public, due to certain patent inadequacies. For example, unlike the Securities Exchange Act of 1934 the Investment Advisers Act gives the Commission no authority to require that adequate books and records be maintained by the regulated persons. In fact, the Commission has no adequate means of determining whether any investment adviser is mishandling his customers' funds or securities or engaging in other fraudulent practices in connection with his business. What is perhaps even more important, the anti-fraud provisions of the Act do not apply to investment advisers who have failed to register with the Commission.

Proposed amendments have been submitted which, in addition to remedying the foregoing inadequacies, would expand the basis for disqualification for registration because of prior misconduct; authorize the Commission to require the filing of reports; empower the Commission by rule to define, and prescribe means reasonably designed to prevent, fraudulent practices; extend criminal liability for a wilful violation of a rule or order of the Commission; and revise the provisions relating to the postponement of effectiveness and withdrawal of applications for registration. There is a very substantial place in the financial world for investment advisers, and they can be of immense assistance to the untutored public. We believe, however, that they have far too delicate a fiduciary relationship with their clients to permit us to condone the present rather ineffective regulatory pattern.

The Commission has also recommended a number of amendments to the Investment Company Act. However, you as officials of issuing corporations would probably have no more than a passing interest in these proposals, and I shall not give them more than brief attention. They are, however, of great interest to the investment companies who are substantial investors in your securities and are of major importance to the investing public and to the Commission in its enforcement efforts. These proposals would: (1) require the statement of policy of a registered investment company, which cannot be changed without the consent or approval of the holders of a majority of its voting securities, to include its fundamental investment objectives and investment characteristics; (2) strengthen the statutory provisions requiring that at least 40% of the members of the board of directors be persons who have no pecuniary interest in the operations and management of the investment company and who are not members of its operating staff; (3) require that if an investment company chooses to keep its securities and investments in the "custody of the bank" such custodianship shall include the cash assets of the investment company; (4) impose limitations upon the proportion of common or preferred stock that may be acquired by face-amount certificate companies issuing fixed obligations (face-amount certificates) to prevent such obligations from becoming unduly speculative; (5) clarify and make more meaningful the definition of an "advisory board" of an investment company and the substantive provisions requiring such a board to have a certain number of independent members; (6) clarify certain exceptions to the definition of an investment company required to register under the Act; (7) eliminate the exception from the definition of an investment company for a company subject to regulation under the Interstate Commerce Act when this Commission finds and by order declares that such company is primarily engaged in the business of investing, reinvesting, owning, holding or trading in securities; and (8) clarify the terms "depositor" and "share of stock" used in the statute by adding specific definitions of these terms.

As you will note, few of the matters covered in this legislative program are, or at least should be, controversial in nature. We hope that we will not encounter any very serious opposition to their enactment. Such opposition would be a little difficult to support since it has the flavor of being in favor of sin. It may be, however, that a positive attitude taken by an influential organization such as your own might be of material assistance, and we would most certainly welcome any help which the appropriate committee of your body might be able to give.

I would like to turn for a moment to the subject of rule making, and to direct your attention to the amendments to Rule 133 under the Securities

Act of 1933 which the Commission has under consideration. You will recall that this rule, as it now stands, is interpretative in character and, for the sole purpose of considering whether it is necessary to register such securities under the Act, provides that the issuance of securities to stockholders in connection with certain mergers, consolidations, reclassifications of securities or transfers of assets is not deemed to constitute a sale of such securities to the stockholders of the corporations concerned. The problem presented by the issuance of securities in such transactions arose almost as soon as the Act was adopted. In 1934, the Commission concluded that the issuance of securities in these transactions did not involve a sale thereof to the voting stockholders for the purpose of registration, and a statement to that effect was included in a note to the form covering the registration of securities issued in a "reorganization." In 1947, the use of this particular form was abandoned, and for several years thereafter this interpretation was continued administratively. In order to allay any doubts that the interpretation was still being followed, it was promulgated as Rule 133 in 1951, and has continued without substantial amendment to the present time.

Because of what it deemed to be abuses of the rule, the Commission published in October, 1956, an invitation for comments on a proposal to rescind the rule. This would have had the effect of compelling the registration of securities issued in connection with such corporate activities, in the absence of an otherwise available exemption. Numerous comments were received in regard to this proposal and a public hearing was held on the matter in January, 1957, at which some grave legal and practical difficulties were pointed out. Thereafter, in March, 1957, the Commission announced that it was deferring action on the matter pending further study.

The limitations which the Commission considered to be inherent in the applicability of Rule 133 were discussed in the findings and opinion in the Great Sweet Grass Oils Limited and Kroy Oils Limited cases, issued in April, 1957, and in Release No. 3846, published in October, 1957. In substance, the Commission there indicated that Rule 133, where applicable, merely provides that registration of the securities and presentation of a prospectus to the security holders is not required in connection with the submission for vote of the stockholders on a plan of merger or other transaction specified in the rule and in connection with the receipt of securities in consummation of the plan. It pointed out, however, that the securities

issued in such a plan are by no means "free" securities, which need not be registered in connection with subsequent offers and sales of such securities by stockholders of the merged corporation. On the contrary, registration would be required for any subsequent offer and sale unless such activity were limited to what are described as casual sales by security holders who were not in a control relationship with the issuer of the securities, which transactions might fairly be described as trading transactions not involving a distribution, or unless some other exemption were available. Thus, Rule 133 provides no exemption from the registration and prospectus requirements of the Act with respect to any distribution of the securities received by security holders who might be deemed to be statutory underwriters.

At the direction of the Commission, the staff has made a comprehensive review of this Rule and a re-examination of all pertinent legislative and other statutory materials, and of prior actions taken at both the Commission and staff levels. The views expressed as to the 1956 proposal, both in writing and at the public hearing, were carefully studied. On the basis of the conclusions reached by the staff and as the result of careful consideration by the Commission of the matter, proposed amendments to Rule 133 were issued on September 15th of last year and public comments were invited.

These proposed amendments would retain the existing rule, but would incorporate into it certain additional provisions designed to make it clear that registration is required in certain cases where a public distribution of the securities initially acquired in transactions described in the rule is subsequently made by a person defined as a statutory underwriter in the proposed amendments.

This definition of a statutory underwriter appears in two new sections of the proposal. The first section defines as an underwriter a person who makes arrangements with the surviving corporation in a Rule 133 transaction, or with a person in a control relationship with that corporation, to resell to the public the surviving corporation's securities on behalf of any stockholder of the merged corporation who has received such securities. The second section provides that where any person in a control relationship with any constituent corporation at the time of the transaction acquires securities of the issuer in a Rule 133 transaction with a view to the distribution of such securities, such person is to be deemed to be an underwriter. The proposed

amendments do not deal with distribution through an underwriter by persons who, after the merger or other transaction, are in a control relationship with the surviving issuer. Registration in such cases is expressly required by the terms of the Act, in the absence of some specific exemption.

In order to make clear that registration is not required in connection with any and all transactions by persons who would otherwise be deemed underwriters under the proposed amendments, provisions have been included which make such registration unnecessary in the case of subsequent transactions which answer the description of unsolicited brokerage transactions within the purview of Section 4(2), and which are essentially trading transactions.

In order that registration may be effected as expeditiously and economically as possible where it would be required by the amended rule, the Commission has under consideration a registration form which would, in effect, permit an issuer to use as the prospectus the proxy statement which will have been used in soliciting the vote of stockholders for the Rule 133 transaction. Of course, it would be necessary to add supplementary data in regard to the underwriting and distribution of the securities. This procedure has been followed in similar situations in the past, and appears to be feasible and to accomplish the disclosure purposes of the Act.

In response to our request of last fall for comments on the proposed amendments, we received a number of letters, most of them submitting one or more suggestions or raising some question of interpretation. Generally speaking, our commentators indicated approval of the Commission's attempt to crystallize and codify its views. Some correspondents observed, apparently with approval, that the proposed amendment does not go as far as certain of the statements contained in the Great Sweet Grass opinion seemed to indicate. It was suggested that the rule be reviewed after a year and views then be solicited as to its operation and effect. Others wished to withhold final comment until they have had an opportunity to review the proposed form permitting use of a proxy statement as the major part of the registration statement. The Commission's staff has reappraised this entire situation in the light of these comments made by interested members of the public, and it will submit to the Commission revised proposals together with a proposed form of registration statement. Following this step, the Commission will again publish a notice of rule making and give an opportunity to interested

persons to submit their views, preparatory to final adoption. We hope to receive such mature criticism of this final proposal as to enable us to settle this long-standing controversy at an early date.

Finally, let me say a word about some of the administrative problems which we are facing, and which may particularly concern persons in your position. As we announced a few days ago, both the number of registration statements filed and the aggregate value of the securities offered thereunder have recently reached new highs. Taking the filings over various periods of time, we are running from 15 to 70 per cent in number and 15 to 47 per cent in value ahead of comparable periods a year ago. We expected a substantial increase in this field and provided for it in our budget estimates for the current fiscal year. Two considerations are, however, now endangering our policy of giving issuers the prompt and efficient attention to their problems to which they are entitled. One is, of course, that we did not expect the increase to reach the proportions of the veritable avalanche of new issues which has descended on us. The other is the danger of a substantial reduction in the pending supplemental budget and perhaps even in the budget for the fiscal year beginning July 1, 1959. The Securities and Exchange Commission is not prepared to relax its efforts to fulfill its statutory duties, and the eventual result of any forced retrenchment might easily be some delays in processing which would be embarrassing to us and give rise to hardship to the issuers and to their underwriters. We had a foretaste of this last December when a mass of new issues was filed at a most inopportune time, and we were obliged to give notice that some processing delay would be inevitable.

The Commission is striving diligently to meet the situation I have outlined in order to avoid the contingencies at which I have hinted. If we are unsuccessful in this effort, I sincerely trust that you will not blame the Commission itself for ineffective administration, and will not change the attitude, which I and my colleagues most certainly share, of admiration for our hard-working, underpaid and efficient staff.

Nevertheless, whatever the near future holds for us, the Securities and Exchange Commission sincerely hopes for a continuance of the satisfactory relationship which we have enjoyed with representatives of American business such as your own organization. We appreciate your cooperation so generously given in the past, and look forward to working with you in meeting the myriad problems which experience tells us will face us in the future.