

THE RELATION OF THE
INFORMATION OBJECTIVES OF THE SEC
TO THE
PROBLEMS OF INVESTMENT AND CAPITAL RAISING

Address

of

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It is a real pleasure for me to be with you today and to direct some remarks to the formidable, mouth-filling topic which Dr. Waterman and others of you have set before me. It is an appropriate subject in view of the high level of business activity in our country today and the correspondingly large demand for more and more capital. If investors are to supply the necessary funds they must, of course, have confidence in the securities offered or, at the least, have confidence in their appraisal of the risks involved. It is at this crucial point that the SEC seeks to lubricate the gears of capital formation with pertinent facts upon which sound judgment can be based. Perhaps I can best approach this subject by attempting brief descriptions of what the Commission's information objectives are and how they are embodied in the various statutes we administer.

The Securities Act of 1933 is designed to provide the investor with full and fair disclosure of significant information and, conversely, to prevent misrepresentation and fraud in the sale of publicly offered securities. Such disclosure consists, in general, of two main requirements: (1) the filing with the Commission of a registration statement by the issuer of securities, containing full and complete information concerning the offering, and (2) the condition that the seller of the registered securities must use and deliver a statutory prospectus reflecting the information on file with the Commission to all persons solicited or sold the securities. Quite naturally, full disclosure of the many complex situations facing American business is a demanding task. It reaches at times to the very roots of accounting theory and practice, into technology, and in fact into every consideration germane to the valuation of a security. I want to discuss, at a later point, some of these problems of the Act's day-to-day operation.

While most difficulties under the Securities Act involve honest shortcomings rather than deliberate attempts to becloud the facts, yet instances of misrepresentation or fraud are not rare. Within the past year or so the Commission has encountered attempts to conceal advantages to parents or insiders which would have been detrimental to investors; failure to disclose cease and desist orders outstanding in several states against sale of the company's stock; overstatement of inventories, understatement of losses, write-ups of fixed assets; gross exaggeration of the indicated productivity of mining property, to name only a few.

One flagrant example set forth in the Commission's 15th Annual Report deals with a proposed investment company. Among the serious misrepresentations in its prospectus was the description of the business experience of the promoters. I quote from the annual report:

". . . the prospectus stated that 'after successfully accumulating sufficient capital' they 'organized a distributing agency for soft beverages during 1929;' that 'they subsequently organized' a company 'for the manufacture of textiles and integrated products

from the raw yarn through a nationwide retail distribution; and that 'during 1943 and 1944 they liquidated their operations in the textile field and principally engaged in trading and investing in stocks, bonds and debentures for their own account and for the account of the members of their immediate family.'

". . . (The Commission's) investigation disclosed that the beverage business in which they had engaged consisted of the sale of soft drinks to factory workers when they were still no more than 13 years of age. The company which was engaged in the business of 'manufacturing textiles and integrated products from the raw yarn through a nationwide retail distribution' was in fact a small enterprise engaged for the most part in the business of selling ladies' blouses. The reference to their trading in securities was no less misleading. . . . The investigation disclosed that during the period referred to in the prospectus the promoters traded extensively in securities and suffered a net loss as a result of their operations."

The registration statement, I might add, was withdrawn.

The Securities Exchange Act of 1934 is another important implement of disclosure. It requires companies whose securities are registered on a national securities exchange to file annual reports, showing financial statements and other pertinent information, with the exchange and with the Commission. Trading in a company's equity securities by its officers, directors and principal stockholders must be disclosed in reports which are summarized and circulated widely. Regulation of brokers, dealers and exchanges, while going considerably beyond disclosure, also serves to bring more information to light which is important to the investor. Higher standards of conduct in these quarters have done much to insure the investor fair treatment.

Among the chief information objectives of the Commission have been clarity and completeness in proxy solicitations. Whether the question is one of electing directors, of a security issuance, a reorganization, merger, or modification of the by-laws, the Commission tries to see to it that the stockholder is given full and accurate information so that he may determine his best interest. Provision is also made for counter-solicitations of proxies by minority groups, subject to the same rules of disclosure.

The Investment Company Act and the Public Utility Holding Company Act go considerably beyond the problem of disclosure. Yet each of them brings to light many facts which enable the investor to arrive at more intelligent appraisals of a company's operations. In the case of the Investment Company Act, as I will discuss more fully, disclosure has taken on a new importance in view of the tremendous expansion of the mutual funds. Whenever popular interest swells to these proportions, particularly when coupled with commissions very attractive to distributors, there is real danger of runaway, irresponsible representations to the investing public.

These various Acts serve to bring together a wealth of valuable information covering a majority of the publicly financed corporations in our country today. However, the Commission is in no sense a Fort Knox with a hoard of sterilized treasure. Vast amounts of information are disseminated in prospectuses, for example. Each year thousands of interested persons use the facilities of the Commission's public reference room, and nearly 3 million pages of photocopies have been purchased by members of the public during the past 15 years. The various financial services, such as Moody's, Standard & Poors, or Dun & Bradstreet, purchase large quantities of these photocopies and, in turn, convert such information into the summary reports which are relied upon throughout our economy. This is in striking contrast to the paucity of information generally available twenty or twenty-five years ago. Equally striking is the relatively small expense to which business has been put in providing the public with this great body of facts. By and large, financial information disclosed under the Securities Exchange Act has been available to management all along; the question is not one of preparing it but rather of publicly disclosing it. The additional facts flowing from disclosure under the Securities Act do at times involve added expense to business, but this is one of the smaller segments of cost entailed in raising capital and is, in any event, an expenditure which has been demonstrated to be socially necessary.

It might be inferred from these remarks that the coverage of the various Acts and hence of available information is well-nigh complete. This is not the case, however. The various Acts have, in fact, discriminated against those security holders whose securities do not happen to be registered on a national securities exchange and do not come within the specific legislation adopted between 1935 and 1940. Clearly, there is no basis in logic for a system in which protection or lack of protection for the investor is dependent upon such irrelevant factors as type of industry and type of market. The Commission has proposed legislation to correct this inequity, and I want to tell you more about that later.

Obviously, the raw unclassified data about any business are not particularly useful either to investors or management. The art of accountancy was, therefore, developed to digest and classify business data according to some working rules which will ordinarily produce reasonably intelligible information about a business. When business enterprise was small the bookkeeper-accountant devoted his energies to helping management understand its business and to presenting reports designed primarily for creditors interested in "pounce" value. Newer uses of accountancy developed with the growth of the modern corporation. The separation of ownership from management created a need to report to the owners, present and prospective, as to the results of management's stewardship. The passage of Federal income tax laws immediately gave the Government a direct pecuniary interest in accounting practices. Large-scale business enterprise necessarily created important responsibilities to society as a whole and accountancy was required to convey and interpret business data to people only indirectly connected with the enterprise.

These new and great responsibilities were rather suddenly thrust upon accountancy and it is no wonder that it failed in many respects to meet them adequately. Many of you still remember, I think, the brilliant book by William Z. Ripley of Harvard, "Main Street and Wall Street," which described accounting practices of the '20s. Professor Ripley proved pretty well that lack of adequate disclosure, misleading data, and the endless variety of accounting practices even among companies in the same industry resulted in those years, generally speaking, in accounting reports to stockholders which were unintelligible and frequently dangerously deceptive. The accounting profession, by and large, then conceived its principal responsibility to be to management. Of course, the economics of the profession, whereby management hires and fires the independent public accountant, was in no small part responsible for the accountant's limited concept of his responsibilities.

Moreover, what source could the conscientious accountant draw upon for accounting principles which business should follow? By and large, the only source of guidance for the accountant, apart from convictions grown out of his own experience, was the accounting textbooks. Many of these, in turn, were largely descriptive and thus appeared to sanction the existing practices. There were other texts, however, which were analytical rather than merely descriptive and from these, increasingly, high standards of accounting began to take shape. Our colleges deserve much of the credit for accounting theory as we know it today.

During periods of economic strain and stress, there is great pressure from business upon the accountant to interpret business facts in a manner which management believes will help it meet those strains and stresses. In the period of the '20s, management and accountants united in accounting practices which magnified the speculative activities of the time-write-ups of assets, overstatement of earnings, inadequate

disclosure, etc. In the period of the '30s, during the strains of the Depression (despite certain efforts by the New York Stock Exchange Committee on Stock Listing to stem the tide), there were equally confusing and distorting accounting practices. A number of companies, for example, wrote down their assets to one dollar to avoid "burdening" their income account with depreciation charges.

It became necessary, therefore, in 1933 and 1934 to invent new techniques to meet these problems. The Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940 gave the Commission powers as to accounting practices of companies subject to these Acts. The SEC's activities haven't led to the millennium in accounting practices, but any book like Ripley's "Main Street and Wall Street," written today, would be in a much lower key. The stand of the SEC on many accounting questions gave the public accountant a basis for saying "No" to an insistent client and thus gave the profession a dignity and status which it never had before. Significantly, at about the same time that the SEC in 1938 released its Accounting Release No. 4, which stated that the SEC would refuse to accept in reports to it accounting practices which had no "substantial authoritative support," the American Institute of Accountants set up committees to formulate and publish its very valuable Accounting Bulletins, now 42 in number. It's very fortunate, I think, that these new developments affecting accounting practices occurred prior to World War II and the postwar period. It is only by relatively vigorous and timely action by the SEC and by the organized societies of accountants that we have been saved, during these periods of stress, from a wide variety of accounting practices which could have led to a repetition of the write-ups of the '20s, to various unjustifiable charges or credits to income or surplus, and to considerable confusion about depreciation, inventory practices, and special reserves. The result might well have discredited accountancy for many years to come. If investors lose faith in accounting reports to stockholders, they will certainly balk at putting new money in on a "pig-in-a-poke" basis.

The Commission, in its accounting work, has had most important cooperation from the teaching profession, other government agencies, professional accounting groups, professional analysts, and many others. The American Accounting Association and the American Institute of Accountants in particular have made important contributions to the improvement in financial accounting and reporting gained in the last fifteen years.

In main outline the Commission's objectives have been accomplished through rules and regulations promulgated, in each instance, in cooperation with the accounting profession. In many instances, however, because filings necessitated immediate action, the Commission had to reach a solution in a particular case before the accounting profession could give proper consideration to the matters involved. Without attempting to furnish a complete list, it is appropriate, I think, to mention a few of the major accounting problems which have engaged the attention of the Commission.

Accounting for donated stock, stock issued for promotion services and other transactions with promoters.

Accounting for par value stock issued in non-cash transactions.

Accounting for, and the necessary disclosures with respect to, quasi-reorganizations (culminating in our Accounting Series Releases Nos. 15, 16 and 25).

The charging to current income of amounts in excess of depreciation based on cost of plant facilities to provide for their replacement at higher prices.

Write-ups of plant and other accounts.

Accounting for compensation resulting from the granting of stock options (as to which the American Institute of Accountants issued its Accounting Research Bulletin No. 37).

The "all inclusive" type of income statement versus the "current operating performance" type.

Maintenance of the full integrity of the income and earned surplus accounts through restriction of the use to be made of paid-in or capital surplus (of which the Commission's Accounting Series Releases Nos. 1, 45 and 50 are related steps).

Accounting for general and contingency reserves and the adequate disclosure of the purposes thereof.

A more recent illustration of the manner in which the Commission seeks to have corporate financial reporting keep pace with changing conditions, and thus further encourage the belief that the risk element of investment does not include ignorance of the company's financial condition, is shown by the standard of disclosure developed with respect to pension plans. Our present policy on pension disclosure strikes, I feel, a reasonable balance between possible extremes, seeking to avoid, on the one hand, the overly frugal disclosure which produces misleading financial statements, and on the other hand, the too extensive disclosure that overwhelms the ordinary person not equipped to digest technical detail.

It was not a difficult matter to conclude that if a company were irrevocably committed to the future payment of pensions, any unfunded liability for past service benefits, actuarially determined, should, under accepted accounting principles, be set up in the accounts. At the date of adoption of the plan such liability would, of course, relate not only to employees actually retired or qualified to do so but also to the past service of those employees who would not qualify for retirement until a future date.

Such completely irrevocable commitments apparently occur rarely, if at all. However, we feel that even though there is no contract, or the contract runs for only a short period, it would be unrealistic to ignore the probability that, once having installed a plan or entered into a short-term contract, the company will continue it. Accordingly, it is our view that there should be disclosed in a brief footnote to the balance sheet not only the important terms of the plan, including estimates of the amounts payable annually, but also the company's best estimate of the amount that would be necessary to fund, or complete the funding of, past service obligations at the balance sheet date on the assumption that the plan is to be continued. In the case of employees who have retired or are eligible to retire an equally realistic approach seems to require that, apart from any question as to legal liability, balance sheet provision should be made in an amount equal to the sum necessary to fund the obligation.

A second problem dealt with recently by the Commission concerns the disclosure appropriate where a company occupies properties under long-term leases. Although our disclosure principles apply with respect to conventional leases, I now refer primarily to the use of the rather popular sell-and-lease-back transaction as a means of financing business property expansion. A common example of such a transaction involves the construction of a building, followed immediately by the sale to some person with available capital, often an insurance company, and the concurrent return of the property to the seller under a long-term lease. Often these leases contain a renewal option, ordinarily at a reduced or somewhat nominal rental. The lessee, as a rule, assumes the usual obligations incident to ownership such as the payment of taxes, insurance, maintenance, etc. The most recent use to which this general form of financing has been put was disclosed through the announcement a short time ago by Pullman, Inc. that it would sell freight cars to a large insurance company which in turn would lease them to railroads.

To a considerable extent our disclosure requirements applicable to such transactions have been in existence for a number of years. Thus, Item 5 of our "Supplementary Profit and Loss Information" schedule prescribed by Rule 12-16 of Regulation S-X requires that there be furnished the aggregate annual amount, if significant, of the rentals upon all real property then held by the registrant and its subsidiaries under lease for terms expiring more than three years after the date of filing, and the number of such leases. Where rentals are conditional there is to be stated the minimum amount of rental.

In addition to the foregoing, the very important nature of the financing accomplished by this means calls for a brief reference in the balance sheet to the rental or other obligations, preferably as a footnote, indicating the principal details of significant transactions occurring within the year or years of the report.

This is a simplified discussion of what may be termed the ordinary type of sell-and-lease transaction. There are other types in which the lessee has the option to, or must, purchase the property after certain periods. In some of these it is clear that the transaction is not at the outset intended as a lease but rather as a purchase. In others a careful study of all the facts may lead to the conclusion that in substance, if not in form, a purchase is effected. Where this is true, the purchase must, of course, be accounted for as such with appropriate disclosure of pertinent details.

In view of the fixed character of the commitment undertaken by this form of financing, the necessity of a disclosure of the facts much in the manner that I have indicated seems incontrovertible; and the American Institute of Accountants has taken the same position in its Accounting Research Bulletin No. 38 issued in October 1949.

Problems in accounting go, of course, to the question of how data should be presented to the investor in order to give him the most accurate picture of the security before him. Disclosure problems of another sort have arisen to new importance in the last few years and may well require rather drastic measures to keep them within bounds. These are centered around so-called institutional advertising, particularly as it relates to open-end investment companies.

Investment companies provide a medium by which groups of small investors may consolidate their savings into one centralized channel and thereby achieve some of the advantages of diversification. From a purely theoretical point of view, the economic desirability of such diversification for the small investor, through shares representing an undivided pro rata interest in an extensive list of portfolio securities, is generally unquestioned. But theory must always be tested by practical considerations. Investment companies are organized and operated for profit by their promoters and managers, who are generally compensated by a fixed percentage of the net asset value of the company. This charge may become excessive. Further, distribution is usually handled through security dealers and salesmen who receive substantial commissions. These commissions may also become excessive.

Security holders of open-end companies may redeem their shares at any time upon tender and receive their current net asset value less any charge for redemption. Practically all such companies are continuously engaged in offering new securities for sale every day in the year in order to offset redemptions and to increase the aggregate assets. Thus, practically without exception the securities of all these companies are continuously subject to the prospectus requirements of the Act. (Closed-end companies, i.e., those in which no right to redemption of shares is available, have with one or two minor exceptions stopped selling new securities and do not have the same problem.)

Furthermore, while there may be some individual bases for distinguishing many open-end companies (such as size, speculative or conservative character, specialized or "balanced" portfolios, sales loads, operating expenses, and the like), in a broad sense they all are offering relatively similar services. Almost without exception, they purchase a diversified selection of securities listed on national securities exchanges. There is, accordingly, intense and avid competition between companies and between the distributors of these securities. As a result, the commissions offered dealers to sell open-end shares is considerably greater than those in other types of securities. For example, the sales commission earned on effecting a round lot transaction in securities listed on a stock exchange will generally be less than $3/4$ of 1 percent of the price of the security. In open-end investment companies, the commissions are closer to 9 percent, although some companies have lesser charges and a very few have no sales load, as such charges are called. These pressures, combined with the inherent attractiveness of the investment company concept, have resulted in enormous growth; the assets of open-end companies now aggregate almost \$2 billion and sales in the first quarter of this year approximated \$100 million. Significantly enough, this trend has also led to the establishment of additional investment companies. In less than two years, 22 new management open-end investment companies have registered with the Commission in addition to 6 closed-end companies and 4 unit companies. There are now a total of 145 registered open-end companies out of a grand total of 368 investment companies.

Against this background, institutional advertising has been employed with telling success. Instead of using a prospectus with its detailed facts on a specific security, salesmen commonly use generalized advertising matter based upon the entire industry. I don't mean to imply, of course, that all institutional advertising, as such, is suspect. It is quite another matter, however, when such advertising becomes the primary material used in making sales of securities, emphasizing all the virtues and assiduously avoiding unfavorable factors of the open-end investment companies. The picture thus created in the investor's mind may be but little affected by the more pointed disclosures in the prospectus when it is finally given to him in technical satisfaction of the statutory requirements.

When the Commission first encountered this general problem it attempted to solve it by being reasonably lenient in institutional advertising so long as there was no intent to sell specific securities subject to the prospectus requirements. It used certain formulae in trying to determine such intent. In general, it assumed as necessary conditions that the advertiser had not made up his mind as to what securities he actually would offer to potential customers but would first evaluate

such client's circumstances, objectives, and preferences and then attempt to fit his needs by specific recommendations. In the event the choice should by chance involve a security subject to the prospectus requirement, it was contemplated that one would be immediately furnished. On the other hand, if the advertising were purposely designed to facilitate the sale of securities of a particular company subject to a pending registration statement, then irrespective of its generality it might be properly construed to be an illegal prospectus.

There is increasing evidence that the lush profits available from the sale of investment company stocks plus the effectiveness of institutional advertising in promoting sales have carried the situation well beyond the depth of our original attitude. There is now a very strong feeling among some members of our staff that a continuation of this trend will lead to violations of Section 5 of the Securities Act, and perhaps of the anti-fraud sections as well.

It is well known, for example, that under the Securities Act and the Investment Company Act, the Commission does not approve or disapprove of any particular company nor does it in any way supervise or regulate the day-to-day management operations of investment companies. There are, of course, certain provisions which permit the Commission to prevent over-reaching on the part of corporate insiders and the like, but it has no control, in the absence of gross abuse of trust, over the investment policies, selection of securities for purchase or sale, declaration of dividends, selection of investment advisers, distributors and accountants, or other prerogatives of management.

Nevertheless, a good deal of literature disseminated appears purposely slanted to create the impression that investment companies are extensively regulated and supervised by the Federal Government. In much the same manner, extensive and inapposite comparisons are made to laws relating to insurance companies, banks, and cooperatives.

Another especially reprehensible example is the comparison of investment company securities to U. S. Savings Bonds. It is like comparing oranges to cows. Nothing is more dissimilar. One is a stable debt security, having behind it the full faith and credit of the U. S. Government -- the safest security in the world that money can buy; the other is a participation for the most part in common stocks subject to constant price fluctuations. Other literature attempts to liken the redemption aspects of the security to savings bank deposits, an extremely misleading analogy.

There is, of course, a good deal of other information disseminated in the guise of institutional advertising that is not demonstrably incorrect or inherently misleading in respect to some companies. Yet the same

literature applied to other investment companies would be an outrageous distortion of facts. Its inclusion in the prospectus of some companies might be grounds for a stop order. To the extent that securities of this latter type of company are sold through the appeal of generalized institutional advertising, the investor may be grossly misled and seriously injured.

Aside from the problems of disclosure inherent in the use of institutional advertising, the impetus which it has helped to impart to the growth of investment companies has implications which could affect appreciably our entire economy. With more and more companies in active competition to perform essentially the same service, there may come a point of time when certain artificialities will appear. By channeling vast amounts of savings into open-end companies which in turn confine their purchases largely to higher grade listed securities, a price structure for such securities may be produced inflated out of all proportion to their earning capacity. Conversely, repercussions may be felt upon the relative cost and availability of equity financing for other business enterprises, particularly smaller or localized companies.

Furthermore, the larger the funds grow in size and the more heavily invested in listed securities they become, the less flexible their investment policy can be. It is quite obvious, for instance, that an investment company cannot overnight liquidate large holdings of a particular company's securities without serious risk of producing a severe effect upon the market price and possibly creating adverse effects on other portfolio securities as well. The ability to adjust promptly to changes in particular companies, industries, or in the market climate itself tends to be lost with growth.

It is also possible that compensation of promoters and managers may become disproportionate to total income actually received. Generally, the compensation of investment advisers of the open-end companies is based on a fixed percentage of net assets, such as 1/4 of 1 percent per annum, and on this basis would now amount to approximately \$5,000,000 per annum. As yields decline, compensation geared to asset value becomes, by its very nature, a continuously heavier charge upon income. At some point this can become a serious burden, and the force of current selling methods pushes the industry inexorably toward that point.

In this connection, Congress apparently foresaw the possibility that some of these situations might develop, for Section 14 (b) of the Investment Company Act provides:

"The Commission is authorized, at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress."

While I do not wish to have my remarks construed as indicating that this point has been reached, the Commission is increasingly aware of the fact that certain aspects of the increasing size of these companies are presenting more and more difficult problems in relationship to other general purposes of the Act.

We are not alone in this concern. Quite recently, a subcommittee of the NASD has been set up to formulate a program of self-regulation by the industry. The NASD has been very effective in maintaining high standards of conduct in the securities business generally and we are hopeful that its efforts in the particular field of mutual funds will prove equally fruitful.

You will recall that I mentioned earlier a gap in the coverage of existing legislation which exposes stockholders of many sizable companies to the hazards resulting from lack of disclosure and other largely archaic practices. I should now like to comment upon the pending legislative amendment to the Securities Exchange Act designed to correct this situation. This legislation is designated in the U. S. Senate as the Frear Bill (S. 2408) and its counterpart in the House of Representatives is the Sadowski Bill (H.R. 7005). Hearings in the Senate have already been concluded.

Briefly, the bills require all corporations with over \$3 million of assets and over 300 security holders to make the type of basic disclosure now required by the Securities Exchange Act, the Public Utility Holding Company Act, and the Investment Company Act. These acts require periodic financial statements to be filed with the Commission which are open to public inspection, full disclosure in connection with the solicitation of proxies, and full disclosure whenever insiders trade in their own company's securities.

The need for this legislation arises from circumstances deeply rooted in our corporate form of business enterprise. I need not tell you that the corporation has long since become the dominant instrument of such enterprise, nor need I discuss at any length the problems arising from the separation of management and ownership. Some of you may recall that Adam Smith emphatically repudiated the stock corporation for this very reason; in "The Wealth of Nations" he said:

"The directors of such companies . . . being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." (Everyman's Library edition, Vol. II, p. 229)

To a surprising extent, Adam Smith's observations have held good. True, the fiduciary responsibilities of management have been more clearly defined and probably the interests of management and ownership have more nearly coincided than he anticipated. Nevertheless, we have found that, in the absence of disclosure requirements, management ordinarily holds its cards very close to its vest. The stockholder in such companies seldom has sufficient information to exercise any sort of intelligent, effective control over management's actions.

We estimate that some 1800 corporations will be affected by the proposed legislation. A representative sample of these companies was studied by the Commission, and the facts uncovered were transmitted to the Congress during 1946 and again, after revising it to date, earlier this year. It was found that on the whole the financial statements of these companies were seriously inadequate, often to the point of being misleading. Many companies did not furnish their stockholders with even the three basic statements -- balance sheet, profit and loss statement, and statement of surplus -- which are essential to any analysis of the worth of a corporate security.

Thus in one instance a company claiming earnings of \$10,000,000 per year released no balance sheet, either to stockholders or to any of the financial services. Treatment of reserves, too, was often arbitrary and inadequate. A number of companies set up reserves without mentioning their purpose. One company with assets of \$6,500,000 set up a reserve for contingencies of \$2,200,000 without mentioning any particular contingency for which provision was being made. Similar violations of sound accounting practices were evident with respect to capital stock, sales, income, and fixed assets; one company, for example, listed 95% of its assets under the single caption "Property, Plant and Equipment, including intangibles." Almost invariably lacking was the explanatory material which should clothe the naked figures with meaning.

Abuses were even more evident in connection with the practices of many unregistered companies in solicitating proxies. Seldom did a proxy solicitation for the election of directors mention the names of the persons for whom management proposed to vote. In no instance was there any disclosure of management remuneration. Frequently, stockholders were simply requested to sign a proxy ratifying all acts of management since the last meeting without any specification of the nature of the acts. And almost invariably stockholders had either to vote for a management proposal or be disfranchised. There was no provision for a "No" vote on the ballot.

The Investment Dealer's Digest recently carried a story under the heading "News You'll Never Read," which was intended as a comic parody upon corporate proxy practice. It read:

"Philadelphia -- The Mongol Manufacturing Co. of this city is receiving congratulations from corporation officials all over the U. S. on a new proxy form introduced in advance of its annual meeting to be held next Friday.

"Instead of a separate form, Mongol printed the proxies on the backs of dividend checks sent to shareholders last week, making it necessary for the holder to sign a favorable proxy and insure its return to the company, in order to cash or deposit his check."

The author of that story probably does not know that this imaginative device for obtaining proxies was actually used a few years ago by a Baltimore concern -- and there was nothing anyone could do about it.

I have heard no argument against this proposed legislation that withstands analysis. Its obvious merit has attracted the almost unanimous support of the financial community, and the President of the United States sent a special communication to both houses of Congress endorsing the legislation. On this issue the Commission sees eye-to-eye with the Investment Bankers Association, the National Association of Securities Dealers, the National Securities Traders Association, the New York Society of Security Analysts, the National Association of Investment Companies, the New York Stock Exchange, the New York Curb Exchange, and the Wall Street Journal.

Most of the arguments advanced against the legislation have been emotional rather than rational. The spectre of government bureaucracy is raised and opponents of the legislation attempt to combine this with the sympathetic aura which surrounds small business, urging that it will, in some incompletely articulated fashion, be hampered by the pending legislation.

The Commission, as its regulations will show, is extremely sensitive to small business problems and endeavors to simplify its requirements in so far as they may affect such business. Thus, under the Securities Act, where financing involves less than \$300,000, no registration statement need be filed; only a letter of notification is required. In suggesting the figures of \$3,000,000 of assets and 300 security holders as the minimum level for regulation under the Frear Bill, the Commission has again leaned over backwards to avoid burdening smaller companies. Actually, some 500 companies, about 20% of all those now registered with the Commission, have less than \$3,000,000 in assets. These companies have filed financial statements and met the various other requirements for many years without apparent difficulty. Thus; I think it is quite evident that the coverage proposed by the new bills is very moderate.

The spectre of government bureaucracy is more difficult to lay, for protestations by persons in government are usually dismissed as self-serving declarations. I assure you, however, that the Commission approached this problem gingerly and with a bias opposed to more laws. The studies in 1946 and 1950 were undertaken to determine whether the very evident logical disparity in the law resulted in real abuses. I have already pointed out the conditions which were revealed. Under the circumstances a "do-nothing" policy would have betrayed the Commission's trust to the investor and to the economy.

I believe that all the other arguments I have heard against the proposed legislation are either based upon a misunderstanding of its language or constitute an attempt to reargue the merits of the Securities Exchange Act of 1934. For instance, in a resolution recently passed by an organization called "Conference of American Small Business Organizations," opposition to the Commission's proposal is expressed on the grounds (1) "The SEC would invade the intra-state field of control," (2) the SEC would have the power of "life and death over small enterprises through dictating of information required in proxy forms," (3) Competitors would be able to take advantage of information filed with the Commission.

The proposal does not invade the intrastate field; Federal jurisdiction must be grounded upon either interstate commerce or use of the mails. But even where such grounds for jurisdiction exist the bill expressly states that companies substantially all of whose securities are held within a single state may be exempted from the provisions of the bill by rule of the Commission. Since the Commission is also granted general exemptive powers, this special exemption must be read as a mandate that the Commission shall consider that problem and adopt appropriate rules. I can state unequivocally that it is the Commission's purpose to grant exemptions of this character.

I find it difficult to comment upon the Conference's second objection, that requiring adequate information in proxy solicitations amounts to the power of "life and death" over small enterprises. The average proxy statement required by the Commission is about 4 pages in length. It is neither technical nor difficult to prepare. Commission rules simply require that when a proxy is solicited the stockholder be told the essential information about the proposals to come before the meeting for which the proxy is sought. How this information can be a matter of "life or death" I am unable to understand except in so far as true statements may mean the "death" of incompetent and irresponsible management. However, I doubt that the Conference of Small Business Organizations is attempting to defend the right of such management to continue in office.

Finally, it is charged in the resolution that competitors would use the information filed with the Commission "against each other in a constant war among small businesses." Such a charge disregards the provisions of the Securities Exchange Act governing the release of secret or confidential information. Section 24 of that act contains an

absolute prohibition against revealing trade secrets or processes and whenever an application for confidential treatment of any item or report is made the Commission may make that information public only when such a disclosure is in the public interest.

Many requests for confidential treatment have been granted during the 16 years the Commission has administered the Securities Exchange Act, and I have no doubt that many more will be granted in the future. From refusals to grant confidential treatment there may, of course, be an appeal to the courts. Generally speaking, we have found that much so-called confidential material is in fact rather well known to competing companies. We know of no case where operation of the Act has given any material advantage to competitors.

We have been heartened by the reaction of investors to our proposal as we have been disappointed by the opposition of some of the corporations affected. The very cleavage between management and ownership which the proposal is designed to reduce is emphasized by these two reactions, for we have heard from no investor in opposition to the principle of the bills.

Of course, the great majority of corporations have preferred to remain on the sidelines, neither opposing nor supporting the legislation. I should like to suggest, however, that it would be to their interest, in the long run, to support the proposal. It is the kind of legislation under which every one will gain. The 1,800 corporations affected will directly benefit from improved stockholder and customer relations, for there is no better advertising than the financial story of a sound business. Moreover, when additional public financing is necessary, it will be found that the availability of information about the business, made relatively uniform by Commission rules, will improve and facilitate the financing. This is particularly true of smaller and lesser known businesses who now have difficulty in generating sufficient investor confidence in their securities.

By and large, a sound and growing company of substantial size has little difficulty in securing debt capital. Institutional investors such as the insurance companies and banks have tremendous funds for such investment. The primary capital-raising problem is to secure an adequate portion of new capital needs from the sale of new common stock. Of course, companies cannot continue to borrow, for debts, unfortunately, come due.

We are all aware that there are great numbers of people with funds who will not consider a direct, non-controlling investment in the common stock of American business. I do not speak now of those dissuaded by the present tax structure which, parenthetically, I should like to see reexamined with particular attention given such question as double taxation of dividends and the status of tax-exempt securities. The operating results and management record of many companies do not, of course, merit entrusting hard-earned dollars to them. But, as we all know, there are many other companies whose long record of success and good management justify the conclusion that a prejudice against common stock investments as such and at any price level is irrational. We do not, however, seem to be progressing in making people with funds to invest more equity-conscious. A recent SEC study indicates that purchases by private investors of equity securities actually declined in 1949, as compared with three previous years, although purchases of bonds by private investors rose.

In a more restricted area of investment, however, the appetite for equity securities is almost insatiable. I am told that there is great demand for equity investments which carry with them control of the enterprise in question. This is a situation which Adam Smith would undoubtedly note with interest. Certainly, full disclosure is fundamental to any progress in bridging the gap between the relative attractiveness of management-controlled and stockholder-controlled enterprises. No company can, with any consistency, complain about the lack of equity capital and still refuse to give its common stockholders adequate financial information.