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A REPORT ON THE SEC

Address by

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A Report on the SEC

A quarter a century ago life was breathed into the SEC. By July 1934 the first two statutes included in the complex of securities regulation had been enacted. Much needed disciplines were imposed upon the processes of distributing and trading in corporate securities. The vulnerable and uninformed public investor was given an attentive protector.

For 25 years the SEC has steadfastly implemented the investor safeguards conceived in this reform legislation. At times in its early days, the Commission had to grope for practical solutions to the intricate financing problems that had become subjected to governmental regulation. Sharp disagreements between the Commission and the financial community on objectives and methods had to be resolved. All the while, the Commission vigorously pressed to protect the interests of the investing public, and, eventually, issuers of securities and the investment industry became reconciled to the necessity and efficacy of the statutory plan.

The battles for adequate disclosure and fair trading practices that commenced with the birth of the SEC have continued to the very present. However, the problems of who, what and when to register securities with the Commission and the nature of the required disclosures persist in constantly changing forms as new financing patterns develop. For example, the three year struggle to establish that variable annuities are securities and their issuers are investment companies was terminated by a recent decision of the United States Supreme Court subjecting both to the panoply of federal securities regulation. The holding in this landmark case has raised extremely complex questions relating to compliance with both the Investment Company Act and the Securities Act, which representatives of the Commission and variable annuity companies have been attempting to resolve for several months. The most basic problem centers on the form of organization of such companies; specifically, whether the insurance operations have to be conducted by a corporate entity separate from their investment company activities.

By now, the Commission's labors to achieve an informed investment climate which will protect the unsuspecting, innocent investor from plundering stockateers and, at the same time, support confidence in the burgeoning economy, is generally endorsed. Of all groups within the securities industry, the securities analysts perhaps have the most to gain by the effective implementation of the disclosure requirements. In fact, both you and the Commission function as a team, in a complementary relationship, to produce and disseminate the material facts about the investment opportunities which sustain the economic growth of America. Our part of the job in eliciting the facts, which you analyze and then interpret for the investing public, just begins when a registration statement is filed. Frequently, our examiners, accountants and lawyers are forced to prod reluctant issuers to disclose unfavorable information and to ferret out additional facts that are necessary to make the description of their operations accurate and meaningful. This facet of our activities--the processing of registration statements--has increased so greatly, so rapidly, especially in recent years, that delays in meeting the time

schedules for financing plans have, on occasion, become inevitable. While in 1935, the total volume of new financings amounted to less than 1 billion dollars, last year the dollar value of securities registered with the Commission was almost 17 billion dollars and for the 6 months ending June 30, 1959, the number of filings increased 52% over the same period in the previous year.

Because of the increasing importance of California as a financial center, the significance of the Commission's heavy workload in protecting the investing public through vigorous application of the full disclosure concept is, unquestionably, well recognized by members of the California securities industry. Last year California enterprises alone filed registration statements covering more than 1 billion dollars. The aggregate number of California broker-dealers registered with the Commission is second only to New York. California also ranks second to New York in the number of American stockholders of publicly-held corporations. One out of every 10 persons in this state presently owns corporate securities and in San Francisco approximately 1 of every 7 persons is a public stockholder.

It is just two years ago that I last addressed your organization. On that occasion, I discussed certain postulates underlying the Commission's administration of the securities laws and some of the important interpretative problems that perplex the investment industry. Among the basic assumptions mentioned was the belief that the vast majority of the business and financial community is honest and conscientiously tries to adhere to the requirements of the securities laws, provided the standards are understood. Accordingly, in exercising its mandate to protect the investing public, the Commission must frequently and clearly explain the obligations and responsibilities imposed by the securities statutes. In particular, the Commission can help persons subject to its jurisdiction to comply with these laws by discussing its recent rule changes.

Most of you are probably familiar with the Commission's Form 8 K required to be filed by certain companies, principally those whose securities are listed on national securities exchanges. The information submitted on this form is designed to reflect, on a current basis, the happening of materially important corporate events. As the result of its investigations of a variety of fraud cases involving mergers, transfers of control, and sales of unregistered securities, the Commission recently proposed important amendments to expand the type of information to be disclosed in this form. These amendments would require the filing of detailed data relating to changes in control and capital structures, acquisitions or dispositions of significant amounts of assets, pledges or hypothecation of securities, and transactions with insiders. If any securities have been issued under an exemption from registration, a statement of all material facts justifying the exemption is required. The proposal, which will probably be adopted by the Commission in the near future, has the dual purpose of providing prompt information to public investors of all significant changes in corporate operations and facilitating the efforts of the Commission to enforce the registration provisions of the Securities Act.

Misunderstanding of the prohibitions against gun-jumping has been largely eliminated by the Commission's opinion involving the Arvida offering. In this case, the managing underwriters had issued a press release describing the proposed public offering prior to the filing of the registration statement. In the revocation proceedings instituted against the two responsible broker-dealers, the Commission concluded that the announcement constituted an illegal attempt to offer the securities for sale. In our opinion we said:

> "We accordingly conclude that publicity, prior to the filing of a registration statement by means of public media of communication, with respect to an issuer or its securities, emanating from broker-dealer firms who as underwriters or prospective underwriters have negotiated or are negotiating for a public offering of the securities of such issuer, must be presumed to set in motion or to be a part of the distribution process and therefore to involve an offer to sell or a solicitation of an offer to buy such securities prohibited by Section 5(c).
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> "What is presented in this case is no mere technical controversy as to the time and manner of public disclosure concerning significant business facts. On the contrary, the issue vitally concerns the basic principle of the Securities Act that the health of the capital markets requires that new issues be marketed upon the basis of full disclosure of material facts under statutory standards of accuracy and adequacy and in accordance with the procedural requirements of Section 5. If actual investment decisions may be brought about by press releases, then compliance with the registration requirements may be reduced to little more than a legal formality having small practical significance in the marketing of new issues."

Notwithstanding this strict proscription against pre-filing offers, the Commission has had a rule providing that a notice or communication sent by an issuer, in accordance with certain prescribed conditions, to security holders to inform them of the proposed issuance of rights to subscribe to additional securities shall not be deemed to offer a security for sale. A few weeks ago, the Commission amended Rule 135 by extending its application to similar notices where an issuer proposes to offer securities to its own security holders, or to the security holders of another issuer, in exchange for securities presently held by them, or proposes to make an offering of securities to its employees or to the employees of an affiliate. These notices must state that the actual offering will be made only by a prospectus to be furnished in the future.

In an effort to encourage the dissemination of information among prospective investors regarding securities registered or in the process of

becoming registered, the Commission has expanded the summary prospectus rule. Prior to this amendment last month, the rule restricted the use of summary prospectuses to issuers filing annual and current reports with the Commission. Now, this type of streamlined offering document may be used by companies, whether or not they file such reports, if they meet certain net asset and net income standards. Net assets must amount to at least 5 million dollars and net income for the past three years must be at least 500 thousand dollars. This amendment represents another example where the Commission is attempting to expedite the orderly distribution of securities in a free market.

The Commission is also on the threshold of adopting amendments to Rule 133, dealing with the application of the registration provisions to the resales of securities issued in merger and similar corporate reorganizations.

The magnitude of our anti-fraud enforcement program continues its sharp rise. In this period of accelerated prosperity and expanding interest in the securities markets, confidence men have increased their activities to lure the uninformed and gullible into get-rich-quick schemes. Boiler-room operators peddling speculative and perhaps entirely worthless securities through high pressure methods over the long distance telephone still find receptive audiences despite the redoubled efforts of the Commission to warn the public and to prosecute stockateers.

Some of these fraudulent schemes appear to be absolutely incredible. Nevertheless, investor losses have been great. Let me illustrate.

Suppose you were offered a share in a company which is developing a spaceship to fly throughout the universe utilizing "free energy". The design of the vehicle is so far advanced that it is predicted that a trip to the moon will commence on December 7, 1959, and the return to earth will be made on December 15 of the same year. The machine, to be constructed in the form of a flying saucer, is called the X-1 Circular Foil spaceship. It will be propelled by Utron electric accumulator batteries employing a new source of energy drawn from the natural elements, including the solar air. Incidentally, the power plant to harness the atmospheric energy is to be produced by an affiliated company, which will also fabricate such spaceship machinery as the "Electro Magnetic Traction and Lift Device", and the "Primary Voltaic Electric Cell". Propulsion is to be accomplished by using the pressure energy of the earth's gravity in such a manner as to spin at the velocity of the external craft which will be recharged by its own motion.

Possibly you and I might not fully understand this language, but it appears that hundreds of investors thought that they did. Early last month, the Commission obtained an injunction to stop any further sales in this promotion. In the injunctive action, the Commission submitted affidavits obtained from a number of investors which showed the following modus operandi of the promoters. Lectures were organized in small eastern cities which were advertised by newspapers and handbills. A charge of $1.50 per seat, euphemistically referred to as an "expense donation", was levied for admission. The promoters

would lecture on the subject of the universe, persons on other planets, the magnitude of the solar system and would eventually proceed to describe their proposed spaceship and give a sales pitch for their organization. Obscure, pseudo-scientific language of the type just referred to was used in these talks, and the promoters strongly hinted that they had close connections with the Government. Since the matters were "secret", only persons with a clear vision of the future would be permitted to participate in the enterprise. Members of the audience would then be solicited at approximately $1 a share. The results appear to be astounding. While many investors purchased only one share, others contributed many thousands of dollars.

In addition to the solicitation of stock, plans for the spaceship and for toy models were sold at prices ranging from $5 to $10. A lucrative source of income for the promoters were the various groups organized on the east coast to study the phenomenon known as U. F. O.--Unidentified Flying Objects. At these meetings, the promoters would identify themselves as military men connected with "saucer intelligence in Washington".

As money poured in, the ambitions of the promoters increased. They announced plans to construct a metropolis to be called "Space City" located, naturally enough, not far from Washington. It, of course, would be ultra-modern in every respect, including direct contact with communities on other planets and stars. Apparently, this related promotion was based on the theory that forward-thinking citizens would hurry to purchase lots in this seat of progress before the land rush began.

The inaugural flight of the proposed spaceship of X-1 Circular Foil was scheduled to commence in April 1959 from, appropriately enough, an amusement park in Oklahoma City. This plan failed to materialize due to "technical difficulties" and was postponed until December 7, 1959. For the projected flight to the moon, the promoters published a timetable giving take-off time, altitude at various hours, activities on the moon and the date of the return to earth, scheduled to occur on December 15.

Many of the investors interviewed by our staff were completely uncooperative, expressing great hostility at our investigation. Being intensely interested in flying saucers, science fiction, metaphysics and esoteric mysticism, some even claimed to have met and spoken to men from outer space and to have ridden on flying saucers. It is conservatively estimated that at least one half a million dollars had been collected by the promoters of this scheme from public investors. I wish I could tell you where the money is today. I cannot.

Some currently prevailing aspects of the securities markets seriously concern the Commission as well as responsible leaders in the financial community. Increasing market speculation by amateurs, who can ill-afford possible losses of their savings by gambling in unseasoned, glamour enterprises has accompanied the greatly expanding popular interest in corporate securities.

In some instances, securities prices have been artifically raised through the dissemination of baseless tips and rumors and other manipulative activities. Substantial losses have been suffered by a credulous public, who irresponsibly succumb to the ruthless hoaxes of securities con men. Accordingly, in April the Commission issued a statement, unprecented in its history, cautioning prospective investors to purchase securities, not on the basis of unconfirmed gossip, but on known facts.

In the interests of securing honest and orderly markets, the Commission is expanding these efforts to warn the investing public. A broad publicity campaign utilizing spot radio and TV announcements will soon be instituted. These will stress that investors should beware of buying stock from strangers and be skeptical of promises of making quick and easy profits. On the affirmative side, they will emphasize that investors must at all times get the facts and should seek sound investment advice from trustworthy, experienced persons. In addition to these announcements, the Commission has prepared a brochure entitled "Investigate Before You Invest", listing ten protective measures that an investor should take prior to purchasing stocks, which will be available on request free of charge.

Responding to the needs of the times, which require vigorous and aggressive execution of its enforcement responsibilities, the Commission has submitted to the Congress a comprehensive legislative program. The proposed amendments are designed to strengthen the Commission's capabilities to protect the investing public by closing loopholes without altering the fundamental policies of the securities statutes. Extensive hearings on the Commission's bills have been held before committees of both the House and Senate over the past several months,

Finally, in view of the recent decision of the Court of Appeals in the Gilligan, Will Case, in which the court held that the private offering exemption was unavailable in the Crowell Collier financing in 1955-56, a brief discussion of some of the principles that underlie this exemption is appropriate.

The vital concept of adequate disclosure embodied in the registration requirements is directed at new offerings of securities and to redistributions having the characteristics of a new offering. The Congress did not require registration of securities offerings where no practical need exists or the public benefits are too remote. Accordingly, it provided an exemption from registration for "transactions not involving a public offering".1/

From its earliest days, the Commission has taken the view that the availability of the exemption depends on all the circumstances surrounding the transaction. The entire process by which the securities are disposed and ultimately come to rest in the hands of "permanent" investors must be considered. The over-all purpose and effect of the transaction is the decisive factor.

1/ Securities Act of 1933, Section 4(1), second clause

The availability of the exemption cannot be resolved by using any rigid mathematical formula. While offerings to a substantial number of persons would rarely be exempt, in no sense can the question be determined exclusively by the number of prospective offerers. What elements are necessary to qualify an offering as a transaction not involving a public offering?

First, it must be restricted to a limited group of persons chosen on the basis of their common interests and characteristics bearing a sensible relationship to the purposes of the selection. The number of offerees must be sufficiently confined so as to constitute a class of persons having such a privileged status to the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection. Second, the placement of the securities to this restricted class of original purchasers must not constitute merely a step in the process of effecting a distribution to the public. Accordingly, the purchasers must take the securities with the intent, at the time of acquisition, of holding for investment.

The existence of an investment intent is determined by weighing objective evidence, not by subjective self-serving representations. The type of security involved, the financial condition of the purchaser at the time of purchase and at the time that resales are considered, the manner of the original offering, and the length of the holding, constitute some of the important factors in testing investment intent. In Gilligan, Will the court concluded that investment intent was not satisfied where the dealer speculatively purchased unregistered securities in the hope that the financially weak issuer had "turned the corner" and then unloaded them on an unadvised public.

Conclusion

In reaching its silver anniversary, the SEC has always fought hard for the interests of public investors. With undiminished vigor, it purposefully continues to exert a wholesome influence on the financial community. Its work in sustaining honest, orderly and informed securities markets is essential to the basic strength and unremitting expansion of our economy, on which national survival depends.

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