THE SECURITIES ACTS AMENDMENTS OF 1964

Address by

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It may be of interest to you that in September 1934, having received my legal degree just three months before, I embarked on my legal apprenticeship with a Chicago law firm which was general counsel for the H. M. Byllesby Public Utility Holding Company System. My first and exclusive assignment during the fall of 1934 and the year 1935 was the registration of the securities of 13 operating public utility companies which were subsidiaries of the Byllesby-Standard Gas and Electric Company System in pursuance of the then, of course, brand new Securities Exchange Act of 1934. It can be readily seen, therefore, that I started my legal career trying to learn something about the operations of the Exchange Act. Almost exactly thirty years later, I stand before you still pursuing that same course of action, albeit in a somewhat different context.

Prior to the announcement of my appointment to the Securities and Exchange Commission by President Johnson on March 7 of this year, I had been administering the Oklahoma Securities Act since October 1, 1959. Prior to this time, I was engaged in the general practice of law, but was recruited by a three-man commission appointed by the Governor to administer Oklahoma's new Securities Act. This law was passed largely as a result of a securities scandal in which a great amount of the life savings of our State's citizenry went down the drain due to the failure of a large publicly-owned financial institution. This tragic occurrence was made possible by an inadequate securities law and less than effective administration of what did exist on the statute books. Happily, this situation has now been rectified due to a sound Securities Act, properly implemented with regulatory safeguards and administrative policy.

Despite this background with respect to State and Federal laws, I would be less than candid if I failed to confess that I have approached this occasion with some feeling of trepidation. Many of you have long and distinguished careers in securities regulation, both as administrators and as advocates, while I stand

before you having been a member of the S.E.C. for less than seven months. These seven past months, however, have been busy and even historic ones from the standpoint of securities legislation and regulation, and perhaps I can pass on to you some observations in both of these areas which might be helpful.

I might first observe that the Oklahoma Securities Act, being basically an adaptation of the Uniform Securities Act, bears many close similarities to the Federal securities laws. Of course, as in the case of most state blue sky laws, it is to a degree paternalistic. Without arguing the merits and demerits of paternalism at the state level, I would point out that disclosure, the keystone of the Federal securities laws, is also first and foremost in the Uniform Act. The scope of the statutes administered by the S.E.C. is, of course, infinitely broader than that of any state enactment, and the policies under which this administration takes place naturally are national rather than local. The basic goals sought to be achieved, however, are the same, and the transition has been, therefore, less burdensome. I should add that the counsel of such outstanding colleagues as Manuel Cohen and Byron Woodside has been a major factor in this transition. The wealth of experience and knowledge possessed by these two fine gentlemen, which they have so generously imparted to me, has provided an insight into the myriad problems before the Commission which could never have been gleaned from any other source.

As indicated at the outset, the Oklahoma Securities Act came into being as the direct result of the failure of one publicly-owned company, and the scandal which followed disclosure of the fraudulent activities basic to its operations. Similarly, the Federal securities laws had for their primary impetus the great depression and disclosures of substantial fraudulent activity throughout the national securities markets. The Securities Acts Amendments of 1964 have no such earthshaking basis.

In September 1961, Public Law 87-196 added a new Section 19(d) to the Exchange Act. This single paragraph was to be the most important legislative enactment in the field of securities markets in over twenty years. It was, as you know, the Congressional mandate for the Special Study of Securities Markets, which was to consume almost two years--and, incidentally, $750,000. The Report of the Special Study, submitted to Congress in three segments during the

spring and summer of 1963, provided by far the most comprehensive examination and analysis of prevalent conditions in the securities markets of this country since the Congressional inquiries of the 1930s. The Special Study Report in and of itself is ample justification of the time, effort and money spent on its accomplishment. Although the Study did not report the unearthing of pervasive fraudulent activity which was so apparent in the earlier inquiries, nevertheless, it is clear that the phenomenal growth of the securities markets in the thirty intervening years, as the Commission stated in its letter of transmittal to the Congress, had "imposed strains on the regulatory system and revealed structural weaknesses."

The Special Study Report encompassed all major areas of S.E.C. authority, and it made both specific and general recommendations for Commission rule-making action, Congressional amendatory action and action by the self-regulatory entities such as the National Association of Securities Dealers and the national securities exchanges. Many of these recommendations have been carried out in their entirety, while others have been modified in varying degrees and brought to fruition. Examples in the latter category are the floor trading and specialist rules now in effect on the New York and American Stock Exchanges. Many of the recommendations are under continuing study by the Commission and its staff, in recognition of the fact that there can be precious few questions of policy which are wholly black or white. We deal in numberless shades of gray, and all effects of our actions must be carefully weighed. One example is the new statutory requirement that the N.A.S.D. have rules governing form and content of quotations and insuring that they be fair and informative. Implementation of this provision is now being given intensive study both by the N.A.S.D. and the Commission.

A great many of the Special Study recommendations are found in the Amendments which President Johnson signed into law on August 20, 1964. At the signing ceremony, which I was privileged to attend, the President said: "The law signed today should further strengthen the securities markets and public confidence in them. Industry and government have worked together in the writing of these laws. Industry and government will work together in making these measures succeed." I might add that I not only heartily subscribe to this statement but can unhesitatingly say that its theme has been the basic tenet of my regulatory philosophy for the past five years.

Many of you who have thoroughly studied these Amendments, either during their passage through the labyrinthian halls of Congress or since their enactment, will probably hear nothing new here today. I shall, nonetheless, proceed upon the assumption that you would not be here if you were not interested in the basic changes which have been effected in the structure of the Federal securities laws. I believe all practicing attorneys who have corporate clients will, at some point, find it necessary to determine whether or not a client is subject to the securities laws.

The broad purpose of the Amendments is stated, in a masterpiece of over-simplification, in the title to the Act itself: "To extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes." It will be seen from this that we have, on the one hand, the application of a proven regulatory tool to a virtually unregulated area of securities markets and, on the other hand, the application of new and improved regulatory tools to an area which, since 1934, has been subject to some degree of regulation. The two approaches complement each other admirably in achieving the ends primarily sought; namely, consistency in disclosures to investors and prospective investors, and quality in securities firms and their personnel.

On the theory that persons who have had little or no previous contact with Federal securities laws will be in greater need of advice and counsel, I shall concentrate upon the first of these objectives while treating of the latter in less detail.

Chapter IX of the Special Study Report points out that there is no logical basis for the distinction made by the Exchange Act between listed and unlisted securities. Issuers of securities listed on national securities exchanges must register these securities with the S.E.C. and keep the registration statement current by periodic financial reports and by current reports upon the happening of significant events. They must employ proxy material which is truthful and which does not distort the issues to be voted upon. Further, shareholders must be given the opportunity to vote either _aye_ or _nay_ on any proper proposal, rather than simply allowing the solicitor to vote their shares as he sees fit.

Insiders, being defined as officers, directors and holders of more than 10% of an equity security, are required to report their holdings of, and transactions in, all equity securities of the issuer. Here, as is true to a limited degree in the proxy requirements, the Exchange Act goes beyond the traditional disclosure requirements. Any profits made by insiders on purchases and sales within a six-month period inure to the issuer, and may be recovered in a civil action either by, or derivatively for, the issuer.

In contrast to this highly standardized statutory procedure relating to issuers of listed securities, the Special Study found, to no one's surprise, that the disclosures voluntarily made by unlisted companies left a great deal to be desired. While there are unquestionably many instances where full and complete information is disseminated to shareholders, nevertheless, the public investor in unlisted securities was being given, on the whole, substantially less information than the person who invested in listed securities. Not only did the volume of information delivered to shareholders vary considerably, but the candor with which it was presented was highly variable.

It is abundantly clear that the over-the-counter markets are not now, if indeed they ever were, insignificant in their scope and economic impact. They involve thousands of corporations and hundreds of thousands of investors. The Securities Acts Amendments of 1964 effectively remove the distinction which has existed as to a large number of the companies whose securities are traded over-the-counter.

The 1964 Amendments extend [by the addition of a new Section 12(g)] the registration, reporting, proxy and insider provisions of the Exchange Act to issuers with total assets of more than $1,000,000 and a class of equity securities held of record by 750 or more persons. After July 1, 1966, the shareholder requirement will be reduced to 500. Exemptions are provided for listed securities, investment company securities, securities of savings and loan associations and similar institutions (other than stock generally representing non-withdrawable capital), and certain cooperative associations.

In the case of insurance companies and banks, the Congress recognized the need for safeguards such as those provided by the reporting, proxy and insider provisions of the Exchange Act. It was felt, however, that the substantive requirements should be administered

by the agencies now exercising regulatory functions over these two classes of companies. Insurance companies are traditionally subject to supervision by the Insurance Commissioners of their respective domiciliary states. This supervision is greatly aided by the National Association of Insurance Commissioners, which has prescribed numerous standardized forms and procedures universally employed by the state commissioners. It is provided, therefore, that an insurance company will be exempt from the requirements of Section 12(g) and, therefore, from the reporting, proxy and insider provisions, if it is subject to state regulation of its reporting and proxy solicitation activities in accordance with N.A.I.C. standards and if, after July 1, 1966, there are regulations of the domiciliary state substantially similar to Section 16 of the Exchange Act, which comprises the insider reporting and recoupment provisions. The two-year delay is allowed so that the various state legislatures may enact the requisite provisions and they may be put into effect by the various state authorities. At this time, only 17 states have statutes which will permit immediate implementation of those requirements for insurance companies. The Congress has indicated that it will want to take another look at the effectiveness of this procedure in the coming years.

As to banks, a new Section 12(i) was added which, rather than conditionally exempting the securities of banks, vests the powers, functions and duties of the S.E.C. under the registration, reporting, proxy and insider provisions in the applicable Federal banking authority.

While the Commission felt that the type of controls needed to insure that the requirements of the Exchange Act are met could best be provided by the S.E.C., due to its experience in the same fields with listed securities, our primary concern was that shareholders in these large industries be provided with information sufficient to allow them to reach informed investment judgments. It is apparent that the Congress shared this concern, as it refused to exempt unqualifiedly either industry. Whether the administrative paths chosen by the Congress to achieve the goal will prove the most efficacious and the least burdensome remains, of course, to be seen.

Prior to the enactment of the 1964 Amendments, the only successful, albeit limited, effort to extend the reporting requirements of the Exchange Act into the over-the-counter markets was Section 15(d), which has been in effect since 1936. This provision

brought companies filing registration statements pursuant to the Securities Act of 1933 under the reporting requirements of Section 13 of the Exchange Act. Section 13 requires periodic financial reports and reports of significant corporate events. The requirement was operative only when the securities offered, plus the outstanding securities of the same class, valued at the public offering price, amounted to $2,000,000 or more. The Amendments retain Section 15(d) but in a slightly modified form. The requirement of an undertaking in the registration statement to file the reports is eliminated, as is the $2,000,000 test. The obligation for report filing will be suspended if the class of securities registered comes to be held of record by less than 300 persons. As indicated, this provision is limited to classes of stock for which registration statements have been filed, and relates only to the reporting requirements of Section 13. By contrast, it is immaterial to the applicability of the new Section 12(g) whether a registration statement under the Securities Act has ever been filed.

The first responsibility of a corporate counsel in connection with Section 12(g) will be to advise his client whether or not it is subject to the registration requirement. In the great majority of cases there will be substantially no question. Either the client has total assets in excess of $1,000,000 and 750 or more shareholders of record or it does not. It is anticipated, however, that there will be borderline cases. This is pointed up by the fact that our preliminary estimates indicate that approximately 900 issuers will be brought under Section 12(g) when the shareholder requirement is reduced to 500 in July 1966. In order to assist issuers and their counsel in determining the applicability of these requirements, we have published for comment proposed Rules 12g5-1 and 12g5-2, which will define the terms "held of record" and "total assets," respectively. Since the effective date of Section 12(g) was July 1, 1964 and the Act was not signed into law until August 20, we have adopted Rule 12g-1, which grants an extension of time for issuers subject to registration. Under this rule, no registration statement need be filed until April 30, 1965. It should be noted that this rule does not exempt issuers whose fiscal years close after July 1, 1964, but merely allows them additional time in which to prepare. The rule also suspends applicability of the proxy rules until two months after the last date on which a registration statement is due, or December 31, 1965, whichever is earlier.

The registration statements do not become effective until 60 days after filing, or such shorter time as the Commission may direct. The reporting, proxy and insider provisions are not applicable until

the securities become registered. It is clear, therefore, that these provisions will have no direct application upon issuers subject to Section 12(g) until well into the year 1965.

This does not mean, however, that these issuers may simply sit back and wait for their time to come. In many cases, accounting procedures will require adjustment to conform to our Regulation S-X. While I am the first to admit that not all practicing attorneys may be expected to understand thoroughly Regulation S-X at first reading, I am reliably informed that it does simply what its title page says it does; namely, govern the form and content of financial statements required to be filed in connection with our forms. This is a task to be undertaken in conjunction with the company accounting department, or its auditors, or both. The corporate counsel should, at a minimum, oversee to make certain that this job is being done, and done properly, in preparation for the compiling of the financial statements required by the registration statement.

While it is true that the proxy requirements will not be applicable in many, if not most, cases until the "proxy season" in the spring of 1966, nevertheless, preparations will need to be made for this occurrence as well. Our Regulation 14 outlines what is expected of proxy statements. Those of you who are familiar with this Regulation will agree that the subject matter is treated in some detail. Many over-the-counter companies have found it unnecessary to solicit proxies due to the fact that voting securities may be held in substantial measure by a relatively small control group. Others solicit proxies without providing any definitive description of the subject matter to be voted upon, and without giving the shareholder an opportunity to express a preference as to the manner in which his shares are voted. As I have noted, the proxy rules require, among other things, that disclosure of the subject matter be complete and clear, and that the shareholder be provided an opportunity to have his shares voted either way on each proposal. The 1964 Amendments added a new Section 14(c), which authorized the Commission to promulgate rules requiring an issuer to send information substantially equivalent to the information which would be required in a proxy solicitation, even if proxies are not solicited, allowing us to fill many of the gaps outlined above.

An amendment to Section 14(b) allows the Commission to promulgate rules governing the conduct of registered broker-dealers concerning the giving or refraining from giving proxies with respect to any security registered under Section 12, and carried for the

account of a customer. Section 14(b) will now apply to all registered broker-dealers rather than merely to those who are members of a national securities exchange. We now have implementing rules relating to these provisions under study.

The insider provisions will open a new field under the statute for corporate counsel, and for the insiders themselves. Section 16(a) and the rules thereunder require that a report be filed by every officer and director and holder of more than 10% of an equity security of an issuer registered under Section 12 [in the case of securities subject to Section 12(g), when the securities become registered]. This report must reveal the amount of all equity securities of the issuer of which he is the beneficial owner. He must also report changes, if any, in such ownership during each month in a statement to the Commission. Our Form 3 is provided for the initial report, and Form 4 for the statements of change. Section 16(b), of course, provides that any profits made by an insider, on a purchase and sale (or a sale and purchase) of an equity security of the issuer within 6 months, inure to the issuer, and can be recovered by the issuer or on its behalf by any shareholder. It has recently been said by a knowledgeable Washington attorney that in view of the applicability of this provision to persons and firms who may be completely unaware of its consequences, the best advice he could give a client would be that no insider should buy or sell a share, exercise an option or a conversion privilege, or so much as consider any such action, or any other action remotely related to securities of the issuer without consulting counsel <u>before the fact</u>. This is probably not only very good advice for the client, but also for the attorney by whom it may be given. Counsel should also study the specific exemptions from the operation of Section 16(b) which have been granted by Commission rules to certain types of transactions. It may well be that individual situations thought to pose problems in this area have been heretofore resolved by the Commission pursuant to its exemptive authority.

Most certainly it shall not be my intention of arguing here the merits and demerits of the Section 16 philosophy, as I have conceived no possible discussion of this subject which would not elicit strong views on both sides of the question. Suffice it to say that Section 16 is a reality of life in the Exchange Act and that it will probably remain there.

One change in the "system" was made by the 1964 Amendments, however, and it should be at least briefly discussed here. This change pertains to the so-called "sponsors" of over-the-counter issues. The "sponsor" is a broker-dealer who undertakes to make a market in the

securities of a particular issuer. Generally he is one who underwrote or participated in the original offering of these securities. It is quite common for such a person to be represented on the board of directors. Of course, Section 16(b) severly inhibited such functions, since any profits made by the director would be recoverable by the issuer. The Special Study recommended no exemption for this situation. Following the Special Study, further consideration was given to this subject. The Commission concluded not to disrupt the established institution of sponsorship, since the 16(a) reports, when employed in conjunction with the disciplinary powers of the Commission, would provide a surveillance tool sufficient to prevent abuses in this area. The Commission, therefore, submitted, and the 1964 Amendments provide, an exemption for "market-makers" from the provisions of Section 16(b). This exemption is limited to securities _not_ then or theretofore held in an investment account, and to securities held in the ordinary course of business and incident to the establishment or maintenance by him of a primary or secondary market for the security. The Commission may define the terms used in this exemption.

The 1964 Amendments provide that a Section 12(g) registration may be terminated upon certification that the securities are held of record by less than 300 persons. This brings the Section 12(g) situation in line with that under Section 15(d), and allows the reporting, proxy and insider trading requirements to be removed when the securities of a company become narrowly held.

As pointed out in the definition of the scope of the 1964 Amendments, there are numerous provisions which directly affect broker-dealers, and they will be treated in some detail by a panel discussion scheduled for tomorrow morning. For this reason, and for the reason that this facet of securities regulation is more specialized and, therefore, of direct interest to a smaller contingent of those present, I shall treat of these provisions in a more or less skeletal manner.

The Amendments give the Commission authority, for the first time, to proceed administratively against _individuals_ who have violated the Federal securities laws without being required to join their employers or associates. The N.A.S.D. is also given this express authority for the first time. They also allow the Commission to impose sanctions other than suspension or expulsion from a national securities association or revocation of registration. These include formal censure, bar or suspension from association with a broker-dealer and suspension of registration, in addition to the "all-or-nothing" alternatives in the prior

provisions of law. These two changes make it possible to cull out the individual "bad apples" without injuring innocent co-workers or supervisors, and to impose sanctions upon individuals, as well as upon firms and their principals, which more nearly fit the offense charged. The Amendments make it clear that supervisors may not be found to be responsible for violations committed in spite of reasonable efforts on their part to prevent them.

The Commission originally proposed, in furtherance of the Special Study recommendation and in the interests of uniform self-regulation, that membership in a national securities association (the N.A.S.D. is the only such organization) be compulsory for all brokers and dealers registered under the Act. This proposal was greeted with mixed reactions, upon which I shall not dwell at this point. Suffice it to say that the Congress determined that this was not the proper approach. Enacted instead were the new Sections 15(b)(8), (9) and (10), which grant the Commission power to regulate those registered broker-dealers who choose not to join the N.A.S.D. These provisions themselves, and the House Committee Report, make it clear that the Congress felt that non-members should not be free from regulation to which other brokers and dealers were subject. On the other hand, while the language of these provisions is similar to that found in Section 15A, which prescribes the authority and responsibility of the N.A.S.D., it is equally clear that Congress did not intend that the Commission precisely mirror every action taken and interpretation made by the N.A.S.D. The regulation, therefore, will be comparable, but should not be expected to be identical. We have created a special group from our staff to develop implementing regulations under these very important provisions. A questionnaire has been sent to each registered, non-NASD broker-dealer so that we will have complete information upon which to base our actions in this area.

The Amendments have also substantially strengthened the power of both the Commission and the N.A.S.D. in denying registration or membership to persons who are not qualified. The standards for such denial, and for removal of the privilege once granted, have been broadened considerably. It has been said that the Amendments, once and for all, scuttle the philosophy that there should be "free entry" into the over-the-counter market. If such philosophy was extant, it undoubtedly has been scuttled! The Special Study made it clear that the distinction between the exchange markets and the over-the-counter markets in this area, as in the disclosure area previously discussed,

simply has no justification. In fact, it demonstrated that the public interest requires that standards for entry into the over-the-counter markets should be at least as exacting as those applied to the exchange markets. After all, the marketplace itself, being the entire nation, is not as susceptible to constant oversight by regulatory authority, whether it be the Commission or a self-regulatory body.

All in all, the Amendments make it crystal clear that Congress wants the standards for entry into the securities business raised, and the authority conferred upon the Commission and upon the N.A.S.D. is far more mandatory than it is precatory. The best illustration of this is that Sections 15 and 15A require both the Commission and the N.A.S.D. to establish as to all broker dealers, and all persons associated with them, "specified and appropriate standards with respect to training, experience and such other qualifications" as may be necessary or desirable.

We at the S.E.C. do not consider these Amendments as a panacea for all the problems which face the securities industry. As in any other vital industry, there will always be problems. No statute or rule could be written which would wholly preclude abuses. Even if such could be done, it would necessarily be so restrictive that the industry would smother by the weight of its own safeguards.

Our function, and that of the industry and its spokesmen, such as yourselves, is to operate within the framework of the Federal securities laws. This framework, as I have noted, has as its keystone the principle of disclosure. It also has as a large portion of its basis the philosophy that self-regulation and cooperation are not only workable in the national scheme of things, but are superior to any other alternatives which may present themselves. The N.A.S.D. and the national securities exchanges have proven that this philosophy is correct, and I am certain that they will continue to do so.

Thus, government and industry, under well conceived laws and regulations, working in concert can help America propel itself onward and upward to even greater heights during the next thirty years than it has since 1934. This might be epitomized in an incident I heard about shortly after arriving in Washington. It seems a taxi cab came to a halt in heavy traffic on Constitution Avenue. The passenger, a foreigner, looked out of the window to the imposing edifice of the Archives Building and noted carved in the masonry the words: "The Past is Prologue." He asked the driver the meaning of the words and the cabbie, wiser than his colloquial reply would seem to indicate said: "Why, Mister, that applies to America and it simply means 'you ain't seen nothing yet!'"