CURRENT PROBLEMS IN SECURITIES REGULATION

Address of

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The subject matter of this talk is, according to the program, "Current Problems in Securities Regulation." The advantage of this subject is that it allows me to talk about almost anything I want. We have problems galore and to spare. The disadvantage is that a discussion on this subject is in danger of becoming a potpourri of unrelated observations. Unfortunately, such a mixture could be an indigestible aftermath to even the most delightful dinner. Bearing this in mind, but without promising not to touch on a number of unrelated topics, I will try to keep my presentation within reasonable bounds.

We are now in the proxy season, and it seems appropriate to begin with a few words about current stockholder proposals. I suppose that most of you have read that Wilma Soss was successful recently in an application to compel U. S. Steel to insert a proposal for a secret ballot in its proxy material. This decision came somewhat as a surprise after proposals generally regarded as similar had been refused for a couple of years. First, I want to allay any fears you may have that this action signals the beginning of some sort of administrative orgy. We are not going to insist in the future any more than we have in the past that the pet plans of every stockholder be submitted to a vote at annual meetings. Then again, I thought that you would be interested in going over with me a few of the basic guides to decision which the Commission has adopted in dealing with cases of this type.

In most of these cases, the basic question is whether or not the matter is appropriate for stockholder action. Of course, we are copiously supplied by management with opinions of counsel in each case that the proposal is manifestly legally improper. With all due deference to the bar, our proxy rules would be quickly rendered nugatory if we gave conclusive weight to each and every one of these opinions. In the U.S. Steel case, counsel's opinion was based squarely on the alleged inconsistency of this proposal with New Jersey law. However, Mrs. Soss had learned from experience and had carefully specified that the Board was to take only such measures as were consistent with the law to accomplish this purpose. This leaves a great deal of latitude. For example, it might include petitioning the legislature for enabling statutes. At any rate, the question remains whether we should give decisive weight to counsel's opinion as to the illegality of such a proposal. If there is any doubt as to the applicable law, as we see it, it is necessary in each case for the Commission to make

an independent analysis of the proposal and of its legal effect. If we are wrong in the law, as we may quite possibly be, there are other avenues open to the corporation to prove it.

One of the questions suggested in this area is what action the Commission should take if it concludes that a proposal is not clearly illegal but might be open to some legal question. It is extremely tempting to take the position that the Commission should not require inclusion of a proposal which might result in a violation of law. However, one basic difficulty in such a position suggests itself immediately. What may, in the most careful opinion of able counsel, be of doubtful legality today may be of accepted legality tomorrow. The only way to resolve the legal problem may be through a court contest, but there will certainly be no court contest if we sweep the matter under the rug. In short, where the question of legality is raised, the Commission will require a clear showing that the stockholder proposal will lead to useless or illegal action before acquiescing in its omission.

Another problem suggested by the U. S. Steel case relates to the way in which the Commission should look at a stockholder proposal from the standpoint of construction. For instance, when Mrs. Soss proposes a "secret ballot," does she mean a ballot which would be insulated from challenge and which would be secret from all the world, including the courts? After all, the validity of a given ballot in most cases depends upon the personal eligibility of the stockholder to vote, unlike political voting where this determination has already been made, and some review of this fact must be permitted which will at the same time identify and link together the stockholder and his ballot. Or is the proposal better to be construed as calling for a ballot which would be as secret as possible? Without going into detail, it might possibly be practical to adopt a scheme whereby the votes would remain confidential so far as management was concerned, but would be available for the scrutiny of a reviewing court.

Whether or not a strict or a more lenient reading is given to a proposal may have a direct bearing on its legality and thus its propriety for shareholder action. I doubt that you will be surprised when I say that it is Commission policy to give a sympathetic reading to stockholder proposals. After all, to hold the shareholder to the standards of an expert draftsman is hardly consistent with the statutory policy to encourage and to implement corporate democracy.

A recent significant development in the proxy area has been the adoption of new proxy rules with respect to investment companies. Where the solicitation relates to the election of directors or action on an advisory contract, the new rules require fairly detailed information concerning the investment advisor. I suppose that it is clear that the new rules reflect a belief that shareholders in a mutual fund should not be deprived of information concerning management simply because management, at least in part, is insulated from the fund as a partnership or a separate corporate entity which carries on management functions under a contract.

I suppose that it is also fairly clear that the rules reflect a certain state of malaise at the Commission concerning the existing scheme of things in the investment company world. Basically, this uneasiness stems from the anomaly presented by the management contracts which delegate to another entity many of the functions normally performed by the corporate board of directors. The normal inertia of corporate shareholders seems, in investment companies, to be intensified both by this delegation of functions and by the fact that the average investment in a mutual fund is relatively small. Thus, for example, the size of management fees is rarely brought into issue, though some litigation has recently been instituted which indicates that even this sacred cow is about to be questioned. It is rarely asked whether another advisor might be able to render equally competent service at lower cost. Control of investment advisors has been transferred and non-voting stock issued at prices obviously based on the expectation that the advisor will continue its services to a particular fund at what might be termed monopoly prices. Despite the fact that these prices suggest that the fund might strike a better bargain elsewhere, the directors and shareholders of the fund have usually approved these contracts without the slightest visible qualms.

These phenomena of the investment company world have raised a question in the minds of some observers as to whether mutual funds have become captives of particular advisors, and whether directors of or investment advisors to the funds are fully acquitting their duty to shareholders. Whatever the truth may be, it seems clear that increased stockholder participation in the affairs of mutual funds is a consummation devoutly to be wished. Incidentally, I might mention that the Commission has in mind to publish in the near future for comment proposed forms for registration of mutual funds under the 1933 Act which will embody much the same approach as that taken in the proxy rules.

While the Commission has approved these new proxy rules, there are a number of other matters which have appeared in proposed form but on which no final action has been taken. For instance, you may be curious about what has happened to our proposed revision of Form 8-K. We naively invited comments on this proposed revision, and the comments descended on us with, as so vividly expressed recently, all the subtlety of a stone cornice falling through a skylight. I trust that the staff will be able to dig its way out of the debris in the near future and come to the Commission with its final recommendations. The chief target of criticism seems to be the proposal for notification of any agreements made with respect to the acquisition or disposition of assets. I am sure that you must be aware of the inspiration for this proposal. It is really not a part of some unholy bargain with the Justice Department as a devious implementation of the antitrust laws. It stems in large part from the fact that rumors of mergers and major purchases have become the fashionable means of whipping up stock prices, and such situations, unless promptly publicized, may be used for the personal advantage of management. The instant proposal suggests that one possible way to cope with such problems may be a full public disclosure of negotiations as soon as they become reasonably choate.

The draftsmanship of our forms and regulations has been made increasingly difficult by problems in the enforcement field. By and large, these forms and regulations are designed for the use of honest men. The trouble comes when they are subjected to the acid test of a criminal mind.

Our experience with what has come to be known as the "Guterma gap" is an example of what I mean. This terminology refers to the dismissal by the trial court of several counts against Alexander L. Guterma which were based on his failure to file Form 8-K reports. Specifically, the problem relates to Instruction 3 to Item 2 of Form 8-K. The form itself is to be filed within 10 days after the close of each month during which any of certain specified events occur. One of these specified events is the disposition of a significant amount of assets otherwise than in the ordinary course of business. In this connection, the term "significant amount of assets" is defined to include assets which have a net book value in excess of 15% of the registrant's total assets or which were sold for a price in excess of that amount. Information with respect to such a disposition is required to be given "as to each transaction or series of related transactions of the size indicated."

The obvious purpose of this item is to make sure that an 8-K is filed when a series of related transactions, regarded in the aggregate, reaches the 15% mark. However, it was Mr. Guterma's wide-eyed contention that the instruction simply did not say this. He admitted that the instruction called for information on a "series of related transactions" but argued that an 8-K was not required unless the entire series was confined within the space of one month. Apparently, the Judge accepted this argument or at least concluded that Instruction 3 was not sufficiently precise on this point for criminal prosecution.

It spares both the Commission and the industry a good deal of labor if the reporting forms can be kept as simple as possible, and it avoids the necessity for apologizing for what might be called administrative gobbledygook. On the other hand, Form 8-K and any other of our forms will lose a good deal of efficacy unless they are tight enough to stand up in criminal trial. I can assure you that we are not going to spill industry blood in order to wash away the sins of Alexander Guterma, and it turned out that we had ample counts on him without these. However, so far as our consideration for house counsel will allow, we will try to tighten up our forms to avoid such problems as the "Guterma gap."

You have very recently received for comment a revised proposed Rule 16b-3, relating to exemptions from the inside trading restrictions. In short, this proposal contemplates removing the shelter of a stated exemption from the acquisition of stock under a stock option plan. Although the Commission is by no means convinced that it lacks the power to create such an exemption, it proposes, as a matter of policy, to restrict the scope of its present rules in view of the attitude of the Second Circuit as expressed in Greene v. Dietz and as later applied in Perlman v. Timberlake. At the same time, it reinstates some of the procedural requirements as to the underlying corporate authorizations which were deleted in 1956.

The fact is that we had reservations about the desirability of our rules as applied to stock options even before Greene v. Dietz, which were shared by a number of practitioners. Certainly, the presence in our rules of an exemption the legality of which has been questioned by such respectable authority ought not to be permitted, since it would only serve seriously to mislead one who was not familiar with the development of the law as to these option plans. I may say that the corporate bar generally agrees that, in the present state of the law, there is a real question as to the propriety of retaining our rule in its present form. I can do no

more than recommend that careful study be given to the resulting legal situation when a restricted stock option plan is being considered.

Among other matters awaiting Commission action is the proposed Rule 155. As you know, this proposal concerns itself with private placements of convertible securities and the effect of Section 3(a)9 of the 1933 Act. It requires that registration be effected when recipients of convertible securities in a private placement make a public distribution thereof, assuming that the securities are immediately convertible at the time of distribution. Further, it requires that registration be effected when such a holder converts and then wishes to distribute the underlying security, unless the stock was acquired under such circumstances that the holder thereof would not be an underwriter.

The members of one prominent law firm complained to us that in reading the proposal and the accompanying release they were seized by the feeling that they were having a bad dream from which they would shortly awaken, and characterized the release as imbued with an Alice-in-Wonderland quality. I am charmed by their allusion and admit that it brings up some fascinating pictures, but I am afraid that I am unable to accept the characterization. On the other hand, I am ready to admit that the first part in particular of the proposed rule gives rise to some legal difficulties.

This suggestion of the staff deals with the distribution of convertibles received in a private placement rather than the distribution of the underlying security subsequent to conversion. It is based largely on the hypothesis that a convertible security carries with it a continuing offer of the underlying security. When the recipient of convertibles in a private placement sells his securities to the public, he translates the issuer's offer of the underlying securities into an offer to the general public. The issuer is, at that moment, in the position of making an offer of securities which falls within the ambit of Section 5 of the Securities Act and which is not entitled to any specific exemption. On this theory, the private placee is responsible for the offering whether or not he meets the technical definition of "underwriter." That is, he is engaged in a step necessary to the distribution of securities, and would come within the rationale of such venerable holdings as that in SEC v. Chinese Consolidated Benevolent Association.

According to some of the comments filed with us, this proposed Rule 155 is part of a monstrous effort to destroy the private placement

as an institution. This comes as news to the Commission. This proposed rule is an attempt to solve the peculiar problems inherent in the private placement of convertible securities. In no way does it indicate any hostility on the part of the Commission or its staff to private placements generally. There are other approaches to this problem which I might detail, but it would seem a poor return to your superb hospitality to subject you to further analysis of this highly technical subject. I understand that The Business Lawyer contemplates printing some discussion of the matter in its current issue, from which you may get a fairly detailed argument pro and con.

Along much the same line, it has been suggested that recent court and Commission pronouncements have made drastic inroads on the so-called private offering exemption. I can hardly admit that there are any substantial grounds for such an accusation. On the other hand, history teaches us that under almost any regulatory statute, there is a constant tendency for the regulated industry to encroach upon the borders of the regulatory jurisdiction, establishing a foothold first, and then pushing forth at the first opportunity from that point of departure. The private offering exemption is no exception. I will admit that the Commission has recently made an effort to highlight the limitations of the Section 4(1) exemption, but those limitations have been tacitly understood for many years and it is only recently that issuers and underwriters have sought to extend them. Thus, in our release in the Crowell-Collier matter, we tried to define the statutory restrictions and to make it clear that there was no particular holding period which would be accepted as establishing investment intent and that only a truly long range investment would meet the requisites of the exemption. You will recall that the Commission there stated that "Holding for the six months' capital gains period of the tax statutes, holding in an 'investment account' rather than a 'trading account,' holding for a deferred sale, holding for a market rise, holding for a sale if the market does not rise, or holding for a year, does not afford a statutory basis for an exemption."

The Commission is constantly barraged with requests for no-action letters in situations of this nature. A company will issue shares to officers or promoters in a purported private placement who will subsequently announce their desire to dispose of the stock. They will earnestly argue that they really bought the securities originally with an intent to hold them forever and ever and with not the slightest view to their distribution, and that their present desire to sell is completely attributable to

an unforeseen and usually lugubrious change in circumstances or else that they have from any point of view held the stock a sufficiently long time adequately to evidence their original investment intent. Accordingly, these officers or promoters call on us to admit that when they dispose of their stock, we will not look on them as underwriters but merely as private holders who are casually selling a part of their portfolio.

One example will probably be enough to illustrate the type of case with which we are constantly confronted. Mr. Proteus, as we will call him, is the president of a small manufacturing concern and the grateful recipient of restricted stock options which have turned out to be of considerable value. Unfortunately, his ambitious nephew has clandestinely bought control, and he is threatened with loss of his position. Needless to say, when he finds out the sharpness of the serpent's tooth, he hastens to exercise his options prior to the request for his resignation or within the limited period thereafter permitted by the option contract. When he buys the stock, he is immensely solvent, is presumably in the very best of health and blithely executes a letter of investment intent.

A short time thereafter, however, the Commission is notified that Proteus wants to sell his holdings. Counsel describes his pathetic plight in heart-rending terms. It appears that the old gentleman has invested a large part of his fortune in valuable oil and gas properties and he is now placed in the position where he must forthwith drill a series of off-set wells or else see his oil drained away from his land as water is squeezed from a sponge. Choking with emotion at his plight, his lawyers will explain that Proteus is already in debt and that the only way for him to pay the drilling company is to sell his stock. Somehow, it does not occur to him to sell his oil fields. However, the issuing corporation will be pictured as strangely aloof and unmoved by this tale of woe, being in the hands of his stony-faced nephew who regards his old uncle with deep-seated hostility. In fact, the company is not prepared to assume the responsibilities of registration in order to help him out, and it may have financing of its own in view which might be stultified by such a course of action. Consequently, the company has rather peremptorily directed its transfer agent not to complete the transfer of this stock until the SEC has indicated that it feels that no violation of the statute is involved.

The Commission, of course, could easily conclude that poor Proteus could not reasonably have foreseen the evil ways which have beset him, and might possibly be justified in issuing a no-action letter,

dampened, if you will, by a furtive tear. However, to be completely realistic about it, a change of circumstances is fairly easy to adduce in almost every case, and, not ununderstandably, this synthetic tragedy tends to leave us unmoved. More and more, the Commission and its staff have felt impelled to look at the context in which the securities were issued for an objective assurance that they were not acquired merely because they were available at bargain basement prices and that they did not constitute simply a part of a portfolio of speculative securities, subject to the usual vicissitudes of such paper. In the hypothetical case which I have outlined, the securities were speculative in nature, were acquired in order to take advantage of valuable options and were acquired in anticipation of a separation from the issuer. It may seem fairly cold-blooded to deny a no-action letter under the circumstances, but I think that the Commission would be doing something less than its plain duty were it to condone this course of action.

In my discussion here of current regulatory problems, I have failed to touch seriously on the field of enforcement. In a sense, the Commission's work is divided between two worlds. On the one hand, we are working in the regulatory field with an honest and cooperative industry. On the other hand, we are policing the capital markets against fraud and manipulation. I have deliberately restricted my remarks to matters which are relevant to the first rather than the second area of responsibility, on the natural supposition that in talking to members of the Boston Bar I am talking to lawyers who will never cross over into that shadow land where a pledge is not a pledge but is a device for distributing unregistered securities and where a trust is not a trust but a passport to anonymity.

One final matter which deserves a few words is the Commission's present situation with respect to the processing of registration statements. I doubt that it is news to you that an issuer can no longer rely on receiving its first letter of comment within 14 days and on obtaining clearance within 24 days. These were averages during 1958. By December 1959, the average elapsed time between the date of filing of a registration statement and its clearance had increased to 41 days, and initial letters of comment were then coming out in about 26 days.

Our problem, of course, is that we have been subjected to an unprecedented flood of financing, that much of this financing comes from unseasoned business, and that we simply lack the funds and manpower to

process all of these registration statements with the desired dispatch. I thoroughly expect that the figures which I have given you for December 1959 will shortly be viewed with nostalgia as reflecting the golden days of easy registration. This last month has placed us on an emergency basis. In March of this year 260 registration statements were filed, as compared with the previous high for the month of 171 filings in March 1959. As of a few days ago, the backlog of pending matters in the Division of Corporation Finance stood at 410. Only a few months ago, the normal backlog was about 100 cases. We have asked that inquiries concerning the status of cases be held to a minimum during this month and that we be notified immediately of cases involving time problems of peculiar urgency. We will try to handle such cases in a way which will avoid hardship.

As far as regular financing is concerned, I can only advise you to start planning well in advance, keep your schedules as flexible as possible, and cross your fingers. Of all the problems in the field of securities regulation, this is one problem which the SEC cannot solve itself. We will have to rely on not only a sympathetic attitude from the Committee on Appropriations but also on a substantial measure of industry understanding and cooperation.

As I started out by saying, a discussion on the subject assigned to me tonight tends to become somewhat disjointed. Of course, we have plenty of problems, and those I have mentioned are only those few of them which seemed pertinent to your particular interests. I am sure that I have missed many of the really important ones, and I hope, if these neglected questions will keep that long, that you will find my present dereliction to be adequate reason for repeating your invitation to revisit this, my home territory.

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Highlights

S. E. C. Criticizes Mutuals Rule

The question as to whether mutual funds have become captives of their advisory concerns was raised last week by Edward N. Gadsby, chairman of the Securities and Exchange Commission. It is a question that probably will haunt the mutuals for a long time to come—until some answers are given.

Mr. Gadsby said the S. E. C.'s "uneasiness" stemmed from the tendency of the mutual funds to turn over to separate advisory organizations director-like functions—for a fee. "It is rarely asked whether another adviser might be able to render equally competent service at lower cost," Mr. Gadsby said in a talk before the Boston Bar Association. He added that the contracts often specified advisory services for "what might be termed monopoly prices."

Such agreements raise the question as to whether "mutual funds have become captives of particular advisers and whether directors of, or investment advisers to, the funds are fully acquitting their duty to shareholders," he declared.

Open Invitation to Trouble

The financial seas abound with pirates on the prowl. We suspect many such are currently appraising the booming $16 billion mutual fund industry as likely prey. It would not be surprising were SEC Chairman Edward N. Gadsby's recent speech before the Boston Bar Association interpreted as an invitation to fire away.

If so, the financial opportunists will descend upon investment companies with an array of suits that could prove a source of great expense to their shareholders as well as a waste and diversion of time by managements -- time that might better be devoted to constructive uses.

This speech also could have the effect of undermining the confidence of personnel associated with these funds in their long-range future. It might well cause many experienced and highly-trained investment management people to look elsewhere for more secure berths -- perhaps with life insurance companies, trust companies and banks, private investment counsel firms, etc.

The questions raised by Mr. Gadsby in connection with mutual fund operations could quite as readily apply to banks or insurance companies or, for that matter, any corporation. For the efficiency and costs he mentioned affect the financial health of any and all. Unduly restrictive legislation suppresses competition -- and never benefits the public.

Mr. Gadsby mentioned the "uneasiness" of the SEC stemming from "the management contracts (of investment companies) which delegate to another entity many functions normally performed by the corporate board of directors:" He said "The size of management fees is rarely brought into question..it is rarely asked whether another advisor might be able to render equally competent service at lower costs." He referred to the transfer of control of advisors with stock prices based upon expectation of continuing service to a particular fund at "monopoly prices." He also referred to mutual funds as "captives of particular advisors" and emphasized the need for "increased stockholder participation in the affairs of mutual funds."

It is unfortunate Mr. Gadsby did not publicize his views on investment companies prior to the time his staff cleared the registration statements for many of the mutual fund management companies that came to market only a few months ago.

The implication of SEC criticism of the investment company industry, recently reaffirmed by Mr. Gadsby, has already cost investors in these mutual fund management companies millions of dollars of loss of market value. All of which, ironically enough, is in direct contrast to as clean a record as just about any industry can cite since passage of the Investment Company Act of 1940.

Fortunately, the public has confidence in these managements as evidenced by the ever-increasing purchase of mutual fund shares and thus willingly pays historically accepted management fees to obtain the kind of management it desires.

Edward D. L. du Cann, a member of Parliament and manager of one of the leading British unit trusts, now visiting here, made a significant comment on Government regulation of British trusts. He stated at a recent luncheon, that "it is the responsibility of Government to safeguard the public against fraud as vigorously as it can -- but not to regulate the details and costs of operations which are purely management functions and subject to the competition of free enterprise."