

**SOME OBSERVATIONS ON THE ADMINISTRATION  
OF THE SECURITIES LAWS**

**Address by**

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## SOME OBSERVATIONS ON THE ADMINISTRATION OF THE SECURITIES LAWS

One of the important services that the American people expect their Federal government to perform is requiring adequate and fair disclosure in the public sale of corporate securities and regulation of the trading of securities on national securities exchanges and in the over-the-counter markets. The Securities and Exchange Commission has been entrusted with these responsibilities.

In its administration of the various securities laws, the Commission is responsible, and reports directly, to two permanent Congressional committees, namely, the Banking and Currency Committee of the Senate and the Interstate and Foreign Commerce Committee of the House of Representatives. To these two standing committees having the responsibility of watchfulness over this Commission, the House of Representatives in the 85th Congress recently created a third committee, known as the Committee on Legislative Oversight. This committee has been vested with authority to review, study and examine the execution of the laws entrusted to approximately 20 independent agencies - one of which is the Securities and Exchange Commission. The stated purpose of this investigation, which will proceed during the ensuing year and a half, is "to see whether or not the laws as intended by the Congress were being carried out or whether they were being repealed or revamped by those who administer them."

Differences of opinion, of course, exist respecting interpretations by the Commission of the statutory standards prescribed in the securities laws. Evaluation of the Commission's administration of these statutes by members of the Congress, by various groups in the regulated industries, by lawyers and accountants practicing before the Commission and other interested critics is not always consistent. However, the day-to-day record of the Commission, reflecting a multiplicity of decisions in the administrative, quasi-judicial, and rule-making areas, sustains the reasonable conclusion that the laws committed to its trust have been vigorously and fairly administered in the interests of the investing public.

### Three Guiding Principles

In the performance of its statutory responsibilities under the securities laws, the decisions of the Commission are guided by three fundamental principles. First, it must be vigilant in requiring timely and adequate disclosures of all material investment facts regarding securities being offered to the public or traded on national securities exchanges and vigorous in prosecuting wrongdoers when fraud in the purchase, sale or trading of securities has occurred. Second, it must be scrupulous in respecting the constitutional rights and privileges of all persons subject to its enforcement and regulatory powers. Third, it must be punctilious in rendering administrative interpretations that are consistent with the statutory standards intended by the Congress.

### Disclosure and Enforcement

The appraisal of the record of the Commission in applying the principle of vigorous enforcement should be considered in the context of current market conditions. As a result of the high level activity in the securities markets during the past few years, certain questionable practices have germinated to avoid the registration and reporting requirements of the securities laws.

One stratagem involves the illegal use of the Commission's rule interpreting the statutory definition of "sale." Rule 133 excludes from the definition, and makes the registration provisions inapplicable to, certain mergers and consolidations effected under state laws. This interpretation has been abused by some promoters to make public distributions of securities without the disclosure of essential business and financial facts concerning the issuer. By using the merger technique the securities of the surviving company are transferred to the shareholders of the disappearing company who do not take the securities for investment but rather with the purpose of making a public distribution. The shareholders of both the surviving and disappearing companies are often the same persons, the disappearing company having been formed simply to serve as a conduit for the distribution of the securities of the surviving company. In certain instances involving listed companies, the true nature of these transactions has been concealed by filing incomplete and misleading reports with the national securities exchanges and with the Commission.

Another artifice for avoiding registration is the misuse of the private offering exemption. Issuers of securities and controlling persons have relied without justification upon representations made by offerees in transactions purporting to be private to hold the securities for investment when, in fact, their real intent is to make a public distribution of the securities.

A third practice that is employed to avoid the disclosure requirements involves the use of foreign financial institutions. There have been cases where controlling persons of an issuer have transferred large blocks of its securities through foreign banks and trusts to boiler-room brokers and dealers for resale to the public. The anonymous, numbered accounts of these institutions shield the identities of the controlling persons and make it more difficult for the Commission to detect those responsible for violations of the registration and anti-fraud provisions of the securities laws.

In order to achieve more effective control over these illegal activities by fringe operators, the Commission is attempting to clarify the situations where the "no sale" theory embodied in Rule 133 may appropriately be used. It is certainly not applicable to merger transactions which constitute a subterfuge for distributing securities without adequate disclosure. The Commission has also intensified its enforcement program by using the following techniques.

First, it has used its power to suspend trading in, or to withdraw the registration of, securities listed on national securities exchanges where it has reason to believe that an issuer has filed false, misleading or incomplete reports with the exchanges and with the Commission or has violated the registration requirements. The Commission has also summarily suspended trading in such securities for successive periods of ten days both on the listed and in the over-the-counter markets pending final determination of the proceeding on withdrawal or suspension.

Second, the Commission has been immediately instituting stop order proceedings against issuers of new securities to prevent registration statements from becoming effective where it has reason to believe that a registration statement is instinct with fraud or was not filed in good faith compliance with the disclosure provisions of the Securities Act.

Third, the Commission has employed its denial and suspension powers against issuers filing under Regulation A, which exempts offerings of \$300,000 or less from the full registration requirements, where it appears that the issuer has falsely represented material facts or has not fully complied with the terms and conditions of the Regulation.

Fourth, the Commission has greatly accelerated the tempo of its inspections of brokers and dealers, and has substantially increased the number of judicial and administrative proceedings against brokers and dealers. This aspect of the enforcement program is particularly important due to the attraction into the securities industry of a law-breaking element which has engaged in the practice of distributing to the public large blocks of securities in violation of the registration requirements.

Fifth, the Commission has adopted a streamlined procedure for preparing and referring to the Department of Justice for prosecution certain types of criminal actions.

#### Respect for Constitutional Rights and Privileges

The second fundamental principle that underlies the decisions of the Commission is to respect the rights and privileges of all persons subject to its regulatory jurisdiction. The Commission has always been keenly sensitive to observe the constitutional guarantees of due process in exercising its prosecutory, quasi-judicial, rule-making and administrative functions.

Prior to issuing formal orders of investigation, which create the authority to subpoena witnesses and to take testimony under oath, the Commission carefully considers the facts obtained by its staff in the course of a preliminary examination of a matter that point to possible violations of the securities laws. The function of the Commission in instituting formal investigations is similar to the action of a United States District Court Judge or United States Commissioner in determining that there is probable cause to hold a defendant for grand jury action.

When a quasi-judicial proceeding is instituted by its order noticing an administrative hearing before one of its hearing examiners, the Commission is careful to treat all parties to the proceeding in exactly the same manner. It does not consult ex parte on any phase of the proceeding with the members of its staff who are handling the case, nor does it associate itself with any of the prosecutory functions once an administrative proceeding has been commenced. After the evidentiary hearing is completed, the record is referred to the Commission. On the basis of an independent review of the entire record, including proposed findings and conclusions, exceptions to the recommended decision and briefs in support thereof, and oral argument, the Commission makes its decision. Its decisions, of course, are subject to review by the federal appellate courts.

In the exercise of its broad rule-making powers under the statutes committed to its jurisdiction, the Commission promulgates its proposed rules for public comment prior to their adoption. A liberal time period of at least 30 days is usually afforded to interested parties to prepare and submit to the Commission their written comments on the proposals. Frequently, where proposals are controversial, the Commission may give interested parties a further opportunity to express their views on the subject in a public hearing before the Commission. If the proposal is materially revised in the light of these comments, the Commission may again circulate it for additional consideration by the public.

Two administrative procedures of the Commission have occasionally been criticized. One procedure is prescribed in Regulation A. Under this Regulation the Commission has the power to issue a temporary order, prior to holding a hearing, to deny or suspend the use of the exemption, where it has reason to believe that the terms and conditions of the Regulation have not been complied with or where fraud appears to be involved in the offering. These temporary orders, which are issued ex parte, are similar to restraining orders that have historically been used by courts of equity to stop summarily further alleged violations of law pending a hearing on the merits. The Commission issues these temporary orders only after appropriate investigation by its staff has indicated that there is reasonable basis to believe that the provisions of the exemptive regulation have been or are about to be abused. An order does not become permanent if the issuer requests a hearing and the Commission fails to establish the existence of a violation of the statute and the regulation. The remedy of issuing temporary orders, so that the commencement or continuance of illegal offerings may be immediately restrained, serves the paramount interest of the investing public. If the Commission had to wait until the completion of a formal administrative hearing before it could prevent an offering from being made, the securities could, in the meantime, be sold and investors could be injured.

The second procedure involves an administrative practice where the Commission has instituted a stop order proceeding to prevent a registration statement from becoming effective. The Commission has been criticized for refusing in some instances to consider amendments to the registration statement filed after the commencement of the proceeding. Instead of amending

the issues raised in its original notice ordering the stop order proceeding in the light of changes presented in amendments to the registration statement, the Commission has generally exercised its discretionary power to try the case on the basis of the issues presented by the initial filing.

There are at least four substantial reasons which justify this practice. First, the Commission is not always able to determine the truth and accuracy of a proposed amendment or whether it corrects all of the alleged deficiencies in the registration statement until the record in the evidentiary hearings has been fully developed. Second, the consideration of amendments before the conclusion of the hearing may cause infinite confusion regarding the issues to be decided by the Commission. Third, it may delay the final solution of the controversy. Orderly procedure and expeditious determination of what pertinent facts should be disclosed in the registration statement require that the hearing go forward on the basis of the issues raised in the initial order for hearing. Fourth, the public interest would not be served if amendments are offered as a means of terminating the proceedings and foreclosing public disclosure of misstatements in a registration statement that the Commission would make in its published opinion, particularly if there is an existing public interest in securities of the issuer.

#### Some Important Interpretations Dealing with Registration

The third fundamental principle that guides the Commission is to make fair and consistent interpretations of the provisions of the securities laws to particular factual situations within the statutory standards prescribed by the Congress. Many of the most significant interpretations made by the Commission deal with the necessity for complying with the registration and prospectus requirements of the Securities Act.

#### What Constitutes a Public Offering?

The first basic consideration in determining the applicability of the registration provisions is whether the transaction by an issuer, or any person controlling or controlled by an issuer, involves a public offering. The standards enunciated in the Ralston Purina case are observed by the Commission in its day-to-day interpretations of this question. In this case, the Supreme Court rejected a numerical test of offerees as the sole criterion for determining whether an offering is public or private. However, it did approve the adoption by the Commission of some kind of minimum figure, as a matter of administrative convenience, in deciding if a claimed private offering exemption might be available. The principal test is whether the particular class of offerees needs the protection afforded by registration. This determination turns on the knowledge of the offerees about the affairs of the issuer or their access to the same kind of information about the issuer that would be contained in a registration statement.

As a rule of thumb, the Commission has considered that an offering made to not more than 25 or 30 persons, who take the securities for

Investment and not for distribution, is generally a private transaction not requiring registration. Where an offering is made solely to institutional investors, such as large banks and insurance and investment companies, the Commission, in some instances, has not required registration even though the number of offerees may have been as large as 80 or 90. The issuance of a "no action" letter by the Commission concerning an offering to such a large number of institutional investors, however, is by no means automatic since the facts and circumstances of each case vary and it does not necessarily follow that all institutions of that type are capable by themselves of obtaining the pertinent information about the issuer that would be provided in a registration statement.

Where an offering is made solely to the employees of an issuer of securities, the Commission does not give a "no action" letter if the number of employees to be solicited exceeds 25 unless there is a showing that the offering is limited to executive or management personnel who are acquainted with and have access to the business and financial information concerning the issuer. Except for a relatively few very large corporations, the Commission has been of the view that most issuers have not more than 100 employees who can qualify under the Ralston Purina standards.

In the case of offerings made to more than 25 or 30 persons who are neither institutional investors nor management type employees, the issuer must make a showing of special circumstances to justify the conclusion that the offering may be exempt from registration as a private transaction. The Commission considers several factors. One is the relationship of the offerees to the issuer - such as close affiliation with directors and officers, existing financial interest in the issuer through securities ownership, and debtor-creditor customer or attorney-client relationships. The Commission also takes into account the investment experience of the offerees, the price of the units being offered, and the relationship of the offerees to the issuer and to each other. Under these standards, if a few of the offerees, although not sophisticated investors themselves, are closely connected with other offerees who are knowledgeable about the affairs of the issuer, the private offering exemption might still be available. The Commission has seldom given a "no action" letter where the number of offerees in this category substantially exceeds 25 persons. It is difficult for an issuer to make a persuasive showing to the Commission that all the offerees in a large group are so sufficiently informed about the issuer that none needs the protections afforded by the registration and civil liabilities provisions of the Act.

In applying any numerical test it is not the number of purchasers who finally agree to invest but the number of offerees to whom the offer is made which is the significant factor. Thus, an offering by newspaper advertisement to sell only to 25 persons would necessarily be a public offering, since it is addressed to the public generally. Even an offering to sell to the first 25 institutional investors who express an interest in buying would be public, if addressed to large groups of institutional investors without reference to their relationship to the issuer or their knowledge of the issuer.

In any event, before a "no action" letter will be given, the Commission must be satisfied that the offerees will take for investment and not for distribution. The term "taking for investment" is not equated with the holding of a security for the capital gains period under the tax laws. If an offeree intends to sell the security after six months or even after a year, he is not really taking for investment. Sometimes a "no action" letter is requested by a purchaser who presumably took for investment initially but alleges a "change of circumstances" to justify selling the securities within a short time after making the investment. A bona fide change in circumstances to support a claim that the purchaser did not take down the securities with the intent to effect a distribution, and thus be an underwriter, is difficult to sustain. Certainly it is not a bona fide change of circumstances that the stock has either increased or decreased in value.

### What is Control?

A second basic consideration in deciding whether registration of a securities offering is required may involve the question of control. The registration provisions are applicable only to issuers, underwriters and dealers, and the offeror of securities may, in the ordinary sense, be none of these persons. However, a so-called controlling person of an issuer cannot make a distribution of his shares through a broker or dealer without registration, for the reason that the definition of underwriter in the Securities Act includes any person who engages in distributing securities for a controlling person.

The meaning of "control" is "not a narrow one, depending upon a mathematical formula of 50 percent of voting power, but is broadly defined to permit the provisions of the Act to become effective wherever the fact of control actually exists." <sup>1/</sup> The question whether control exists is, of course, dependent upon the facts in any particular case. At best, the resolution of the question is difficult because of the many subtle factors involved in any appraisal of all the surrounding circumstances.

The criteria which may be significant in a particular case in making a determination of control include the following: first, whether the person is or has been an officer, director or promoter of the issuer or has or had representation on the board or has the power to obtain representation; second, whether any member of his family group has been or is presently represented in the management of the issuer; third, the percentage of securities owned of record, beneficially, in a representative capacity, or otherwise, by him and his family group and by persons in a close relationship to him or his family group; fourth, whether there are any large blocks of stock held by others who appear to play a more dominant position in the management or who are in a position to outvote him; fifth, whether his and his family's stock has been necessary to establish a quorum at annual meetings; sixth, whether there has been any proxy contests or other evidence of

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<sup>1/</sup> H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 12



dissatisfaction or conflict between him and the management; seventh, whether he or his family group has received substantial payments or benefits from the issuer; eighth, existence of voting trusts, protective committees, re-organization or bankruptcy proceedings and similar matters. The question of control becomes more difficult in cases where other persons hold an equal or larger amount of stock. These cases frequently involve a determination whether or not the persons act in concert and are in effect in joint control of the issuer or whether they are totally independent of each other.

### Registration of Convertible Securities

The applicability of the registration requirements to convertible securities is often misunderstood by the financial bar and by industry. An issuer must register both the convertible security and the security to be issued upon conversion if the conversion privilege is immediately effective. The rationale is that the issuer is making an immediate public offering of both securities. However, if the conversion right is not exercisable until some future date, the securities to be later issued on conversion need not be registered at the time of the initial public offering of the convertible security. Registration is intended only for securities that will be offered in the near future and not for securities that will be offered at some distant future date.

Whether or not there has been registration of either the convertible securities and the securities to be issued on conversion, or both, at the time of the initial offering of the convertible securities, Section 3(a)(9) of the Securities Act may operate to exempt from the registration or prospectus requirements the actual issuance of new securities when the conversion right is exercised. The actual conversion is an exchange of securities "by the issuer with its existing security holders exclusively" within the meaning of Section 3(a)(9). However, if commissions are paid to anyone to solicit such conversions, Section 3(a)(9) by its very terms would not be available. If such paid solicitation is not limited to a few holders of the outstanding convertible securities it would constitute a new public offering and require registration of the securities to be issued upon conversion. Delivery of an up-to-date prospectus would be required even if an earlier registration statement had been filed covering the securities to be issued upon conversion, if that registration statement is out of date or if the persons solicited include some who acquired their convertible securities in the trading market without having been furnished the earlier prospectus.

Furthermore, if there is a plan or agreement participated in by the issuer, or of which the issuer has knowledge, that a sizeable amount of the securities issued upon conversion are to be distributed to the public, and are not to be held for investment, by the holders of the convertible securities, Section 3(a)(9) would not be available to exempt the public distribution. The transaction would then become an underwriting and the securities to be issued upon conversion would have to be registered.

This principle is particularly applicable to the situation where the initial offering of the convertible security, being a private placement, was not registered. For example, a private placement of convertible bonds is made with insurance companies which are not permitted by state law to hold common stock of the issuer as "admitted assets." When their bonds are converted into common stock the insurance companies must sell the stock and invest the proceeds in "admitted assets." Prior to selling the common stock taken on conversion of the bonds, registration of the stock is required because the conversion is made with the view to distributing the stock.

Another illustration would involve the situation where the conversion price is below the market price at the time the convertible security is offered. Even though the initial offering may have been made to a limited group of institutional or other sophisticated investors so as to be an exempt private offering, it is apparent that such purchasers can make a quick profit by converting and then selling the new security at the market price which is higher than the conversion price. Unless the entire group purchasing the convertible security takes with an intention to hold for investment, even after conversion, an underwriting is involved and registration would be required.

#### Prohibited Activities in Pre-filing Period

Related to the fundamental interpretative problems concerning the necessity for registering a proposed securities offering are the restrictions imposed upon the activities of a prospective issuer in the period prior to filing its registration statement. The dissemination of information about the issuer in the form of brochures or letters, prior to the contemplated filing of a registration statement, may violate the registration provisions, if the publication is designed to "condition the market" or to facilitate the sale of a securities issue to be registered in the near future. In determining the appropriateness of these activities, factors such as the nature and content of the publication, the scope of the distribution of the publication, the length of time between the dates of publication and the subsequent filing of the registration statement, and the relationship of the issuer to the person responsible for such publication are considered.

An issuer may send its customary periodic reports to stockholders without violating the law provided the reports do not contain an express offering of securities or refer to an impending securities offering in a manner designed to solicit from stockholders and others pre-filing offers to buy. However, the publication, at or about the time a registration statement is to be filed, of special brochures dealing with the prospects of the issuer should be avoided. These documents often contain the kind of puffing statements that are not permitted in statutory prospectuses. Similarly, advertisements that are published by an issuer which are other than routine statements as to its financial condition or operations, just prior to the filing of a

registration statement or during a distribution, are often a thinly veiled attempt to arouse interest in the issuer's securities rather than in its products or services and might be deemed the first step in a securities offering.

Where an officer of a prospective issuer makes a speech about the operations of the company in a public forum - such as a security analyst group - shortly before a registration statement is to be filed, the speaker should take appropriate precautions to avoid any possible inference that his remarks were designed to condition the market for the imminent financing of the issuer. In a number of recent cases the Commission has advised the issuer that widespread distribution of reproduction of such speeches would raise questions as to possible violation of the registration provisions. Prediction of dollar amounts of profits or projections of earnings are particularly objectionable since these types of estimates cannot be included in a prospectus on the ground that they involve too many unknowns to be factual in nature.

Apart from publications by the issuer itself or its officers and directors, publications by underwriters in regard to the financial condition and future prospects of an issuer may, likewise, violate the registration provisions, if the timing of such publications is close to the filing of a registration statement. Even though an underwriting group may not have been formed, a broker-dealer who has participated in previous underwritings for an issuer may reasonably anticipate that his firm may be invited to participate in an impending offering. Consequently, any market letters distributed by his firm shortly before the filing should not include information concerning the prospective issuer. Furthermore, the broker-dealer should not prepare special reports on the issuer after he has learned about his probable participation in a contemplated financing. The consequence of the publication of pre-filing material which conditions the market or of making sales during the pre-effective period (known as gun-jumping) may be the denial by the Commission of acceleration of the effective date of the registration statement.

### Conclusion

The ultimate purpose of the securities laws is to create and maintain a healthy climate for the vital processes of capital formation. The Commission has based its administration of these salutary laws upon sound principles. The interests of the investing public are being protected by an increasingly vigorous enforcement program. At the same time, the important Constitutional safeguards against impairment of the rights and privileges of individuals are being strictly respected. And lastly, the Commission is making a determined effort to interpret the provisions of the securities laws consistently and fairly within the framework of the statutory standards prescribed by the Congress.