

**SEC, BUSINESS AND THE INVESTOR**

**Address by**

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**Before**

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It is much more than a formal pleasantry when I say how very happy I am to have the opportunity to address this fine group. Your luncheons are known across the nation. Moreover, it is a pleasure for a non-Californian Federal office-holder to address an audience of Californians on something having to do with the Federal Government.

Your great State has contributed a wealth of outstanding talent to the national government. Former President Herbert Hoover is a familiar Washington figure, working on his second Commission on Organization of the Executive Branch of the Government, seeking to simplify and make more efficient the enormously complicated Federal establishment. The Vice President is another. The fine public career of Chief Justice Warren is being climaxed by his distinguished service as head of the Federal Judiciary. Your two Senators, Minority Leader Knowland and Senator Kuchel, are men whose stature is recognized and honored in the councils of the nation. I hope you will excuse me, however, when as a Pennsylvanian, I raise my eye-brows a little at the thought that on occasion California has three votes in the Senate. As an appointee of the Eisenhower Administration, however, I am glad to see that they are Republican votes.

I mentioned a few minutes ago the enormously complicated Federal Government which the second Hoover Commission is analyzing. The complexity of the Federal Government is a phenomenon which has developed over the last 70 years, more particularly over the last 45 years. The reasons are many. One, of course, is the growth in size, population, and strength of the country. Another is the series of problems created by modern technology - industrial expansion, improved means of communication, and the like. The clock cannot be turned back to the simple days when the only Federal office-holders that most people knew were the postmaster and the mail man.

Let us remember one thing, though, whether something is done in Los Angeles, in Sacramento, or in Washington, it is only human beings who do it. The more remote the person is who exercises administrative power, the more difficult it is to keep track of how the power is being exercised. The effectiveness of administration from Washington depends upon the administrative machinery which communicates to the Capitol what the problems are out in the country, upon the administrative machinery which communicates to the people in the country what their rights and obligations are, and upon the administrative machinery by which the policies formulated on paper in Washington are carried into effect on the local scene.

All of that involves a lot of people and a lot of paper.

All the law and rules and regulations in the world mean very little unless the people whom those laws affect know about them in a general way. In more specialized fields, such as securities regulation, the complexity of the subject matter makes it hard to maintain the kind of public understanding that is really necessary to protect the public interest and to make the system work. It is for that reason that I felt you would not consider it amiss if I indicate just where our Commission and the laws we administer fit into the picture.

That is a long introduction to the subject of my remarks - "SEC, Business and the Investor." I introduced my remarks that way, however, because of the fact that many well informed people have only vague and nebulous ideas about what the Securities and Exchange Commission does. There is a general idea, for example, that the SEC approves or vouches for issues of securities and keeps the stock market steady. As I shall explain, neither of these ideas is correct.

This widespread misunderstanding and lack of knowledge about the functions of the SEC is more than an interesting statistical fact. It is symptomatic of something that needs correction in our complicated scheme of Government today. It is a symptom, in part, caused by the complexity itself.

The SEC and the laws it administers have a heavy impact on the whole process of capital formation through the

sale of securities. They have an impact on all trading in securities; they have an impact on the duties of management of corporations to stockholders and other security-holders; they have an impact on the day-to-day operations of brokers and dealers. Most business people have learned to consider tax consequences before they enter into a deal. I suggest that to only a slightly lesser degree is it necessary to look to consequences under the Federal securities laws. In other words, the Federal securities laws have resulted in a whole new body of business jurisprudence.

It is inherent in the nature of things that there must be some legal controls imposed on one man who gathers together and administers capital furnished others.

When we look at the function of the modern corporation in gathering and administering capital, what ends do we desire? What abuses do we seek to prevent? -

- (1) We want to encourage investment - money in the mattress, jewelry in a vault are static wealth.
- (2) We want opportunity for initiative and imagination to develop the full economic potential of an enterprise.
- (3) We want no foolish, meaningless obstacles to the accumulation of capital.

But there are other things that we want also. Let me mention a few of them and indicate how the securities laws aim to achieve them.

- (4) The investor should know what he is getting into when he buys securities. The Securities Act of 1933, the so-called "truth-in-securities law" requires the disclosure of information in the sale of securities and prescribes standards for such information. The Securities Exchange Act of 1934 provides for periodic reports by companies listed on national securities exchanges.

- (5) The owners of an enterprise are entitled to current information. The reports under the Securities Exchange Act of 1934 provide this in the case of listed companies.
- (6) Financial information should be presented to investors with reasonable completeness and in accordance with generally accepted accounting principles. Under each Act administered by the Securities and Exchange Commission, the Commission is given power to prescribe accounting rules.
- (7) The investor should have a remedy against someone who deceived him by misrepresentation or concealment. The Securities Act of 1933 and the Securities Exchange Act of 1934 in the aggregate provide for civil remedies against a number of types of fraud and concealment in the sale and purchase of securities.
- (8) A stockholder should have a chance to vote intelligently at corporate meetings - not blindly. The Securities Exchange Act and the proxy rules thereunder provide, in the case of listed companies, for information as to management's stewardship and for an explanation of matters to be acted upon by listed companies at corporate meetings for which proxies are solicited.
- (9) The markets for securities should be free of manipulation. The Securities Exchange Act provides for the regulation of national securities exchanges. It provides penalties for manipulative activity and provides for some controls of the over-the-counter market.

- (10) People with inside information should not be allowed to make use of such inside information to the disadvantage of their fellow security-holders, and transactions between such persons and the corporation should be subjected to careful scrutiny. The Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935 provide, in the case of listed companies and companies subject to the Holding Company Act, for corporate recapture of short-swing trading profits made by officers, directors and controlling stockholders.
- (11) People engaged in businesses involving recommendation of investments, sale of securities, handling of other people's money and securities, should be registered and should be required to file publicly available information about themselves. These things are required of broker-dealers and investment advisers by the Securities Exchange Act and the Investment Advisers Act.

The Federal statutes which I have briefly referred to were passed in a period when our national economy was unhealthy. They have worked well both during a period of convalescence and during a period of robust, energetic health.

Too many of us think of the Federal securities laws in terms of the conditions existing at the time they were enacted in the 30's. They were directed against abuses which had developed as a result of a popular speculative orgy and abuses resulting from insufficiently developed legal standards relating to the raising and management of capital.

But these laws are not something designed either as a temporary recovery measure or as a short-lived reform bill.

As a matter of fact, almost 70 years ago when accumulation of great fortunes and of great industrial and financial power by a comparatively few stimulated controversy and demand for more Federal control, there were serious discussions of Federal

incorporation of companies in interstate commerce and of Federal licensing. In the early part of the century an Industrial Commission created by the Congress recommended Federal incorporation and suggested that corporations should be required to publish information about themselves and their promoters in the raising of capital and to furnish financial reports to their stockholders.

I mention those facts to indicate first that the type of Federal regulation which we now have is not the exclusive intellectual property of the early New Deal and second, to make the point that the same kind of medicine which was suggested to cure the growing pains of a cantankerous economy near the turn of the century was in fact prescribed to help cure the moribund economy of the 1930's.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the two statutes administered by the Securities and Exchange Commission which have the broadest applicability to corporate business generally.

The good result produced by the Securities Act came in great measure from the fact that the issuer and underwriter of securities being sold to the public must come forward and make a public statement concerning the issuer's business, its finances, its securities, and the proposed offering, and all of this under stern statutory liabilities both penal and civil. The Securities Exchange Act in turn is designed to provide a continuing flow of information to investors in listed securities and securities which have been registered under the Securities Act. Thus, generally speaking, the Securities Act is directed to the protection of the investor before he makes his investment, and the Securities Exchange Act provides certain protections to the investor after he has made his investment.

This concept of disclosure as the basic protective technique is in accord with American tradition. It represents an application to the financial markets of the basic American principle: "Give the people the facts and let them decide for themselves."

When I point out that disclosure of facts is the basic technique by which the Federal securities laws protect the public, I must also point out the conclusions which must be drawn from that fact. First, the Securities and Exchange Commission does not approve or pass upon the merits of a security. It is the investor's own responsibility to form an investment judgment whether he will buy a particular security at a particular price. Second, the Securities and Exchange Commission does not either fix or control prices of securities whether on original offering or in the trading markets. That is, the Securities and Exchange Commission does not have power to impose any overall economic controls on price fluctuations or market movements.

When I say that the Commission does not approve or pass upon the merits of a security or a company, I mean that the Commission's activities are limited to providing an administrative review of statements made in material filed by the issuing company with the Commission. When a company files a registration statement and prospectus covering an offering of securities or when its management files a proxy statement for a corporate meeting, that material is filed with the Commission before it is circulated to the public so as to give the Commission a chance to see whether it contains the required information, whether it presents material in a misleading manner, whether it contains obvious half truths or obvious untruths. Basically, the review of material is limited to an inquiry as to whether on its face the material conforms to the requirements of law and the Commission's rules.

If the Commission's staff finds something to which it takes exception, it tries, in most cases successfully and amicably, to work out with the issuing company appropriate changes. The alternative to that kind of procedure would be to eliminate the element of discussion and resort immediately to injunctions and stop-orders and that sort of thing. That alternative would be unthinkable.

This type of administrative procedure - the comment, the suggestions, the discussion - has given rise to the belief that the Commission does pass on the merits of securities or vouches for the accuracy of information in a prospectus or proxy statement. That public misunderstanding is hard to

kill off, but if you stop to think for a minute, it is not sensible to suppose that any agency could have a detailed knowledge of the facts about a particular business. Think of the staff that would be required to make a detailed on-the-spot audit type of examination to check the facts which a company tells about itself or its management. The responsibility for giving the investor information is basically that of the issuing company.

As to the market price of securities, whether on an exchange or in the over-the-counter market, the Commission's powers are granted in terms of defining and restricting unlawful activities rather than in terms of prescribing controls on price movements as such.

It has certain inspection and enforcement powers on margin requirements but it does not fix those requirements. That is done by the Federal Reserve Board. The Commission has powers to define fraudulent and manipulative market activities and to impose administrative penalties or recommend criminal prosecutions for unlawful manipulation. It has some power over the rules of securities exchanges:

Summarizing, and greatly over-simplifying, the Commission's basic function is that of an agency to enforce adequate disclosure and to prevent unlawful manipulative activity.

That leaves a great deal of free play to the individual judgment of the investor so far as selection of securities is concerned, and so far as market price is concerned, the thrust of the securities laws is toward the protection of a free, unmanipulated market in securities.

I have gone into this detail today as much to tell you what the Commission does not do as to tell you what it does do. Conversations with many people over many years have convinced me that a vast number of business people think of the laws relating to the capital markets as so much black magic and mumbo jumbo. I know, for example, that Small Business Administration gets many applications from good sound businesses which should be seeking equity capital in the public capital

market rather than borrowing money. There are, of course, many reasons, some good and some bad, why the owners of some closely held enterprises don't want to sell stock to the public and there are many risks to minority public investors in closely held enterprises. Nevertheless, part of the reason for the success of our American system of private enterprise has been the continued infusion of new equity capital. Understanding of the system of capital formation, understanding the methods of capital formation are responsibilities of those who lead and espouse private enterprise. There is no great mystery about the Federal securities laws. They are a part of the climate in which American business lives.

I am grateful for the opportunity of telling you just a little bit about those laws, not only because I enjoy talking about what we are trying to do, but because I have a profound belief that the broad diffusion of wealth all over this country and the urgency, if we are to survive, of maintaining a strong economy make necessary a more widely diffused knowledge of the processes of capital formation. Investors need to know how to invest intelligently; business people need to know the alternative methods of raising needed capital.

Once upon a time too much of the knowledge on this subject was concentrated on one particular street - not located near the Pacific Ocean. California needs no instructions in how to grow, whether in capital assets or population, but I know you will agree that as we work together maintaining and strengthening the economy of this great land, you who are in private business, you who are in education, you who are in the professions, and we who are in Government, must have some understanding of what each of us is about.

Hence what I have said today!

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