

SALES OF SECURITIES AND USE OF A PROSPECTUS UNDER THE SECURITIES
ACT OF 1933

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OF CUSTOMERS BROKERS

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Let me say at the outset that I deeply appreciate this opportunity of speaking before your association. It is particularly gratifying to talk to a group which is thoroughly familiar with the securities business and with the day-to-day problems which constantly arise in connection with the distribution of securities to members of the investing public. Each one of you, I am sure, has been well trained in this business, either through actual experience or by attendance at one of the various schools specializing in courses in finance. And nearly every one of you, I understand, has passed the exacting examinations required by the Exchange.

You are all aware of the S.E.C. and its work. Consequently, I do not propose to discuss in detail the Acts administered by the Commission and the various rules and regulations adopted under them. I lay no claim to an intimate or extensive knowledge of such matters, since I have been a member of the Commission for but a brief period of seven months. However, in that space of time I have absorbed some useful knowledge about the Commission and its work. Concerning one particular phase of that work I have been especially impressed and have made it the basis of my discussion with you today.

More specifically, my subject relates to the desirability of having brokers and dealers clearly explain to their customers the information contained in prospectuses covering offerings of securities under the Securities Act of 1933.

The general purpose of the Securities Act, as you well know, is to provide full and fair disclosure of material facts concerning the character of securities. This disclosure is accomplished by means of registration statement which must be filed with the Commission prior to the public offering or sale of any security by use of the mails or in interstate commerce. The registration statement contains information with respect to the issuer's business, its securities, its management and the manner in which the securities are to be offered. This document is a matter of public record available for inspection at the Commission's office. Of greater significance, however, in providing a prospective investor with ready access to adequate information, is the requirement that each purchaser receive a copy of the statutory prospectus.

If these objectives of the Act are to be attained, it is desirable that the information in the prospectus in every instance reach the prospective investor before he buys so that he can make an informed judgment as to the risks involved in the purchase. As Chairman Caffrey indicated in his address before the Investment Bankers Association on December 4,

1946, this end can best be achieved if you customers' brokers will literally sit down with an investor, open the prospectus for him, explain what it is, what it contains and actually guide him through it. The information the customer needs is nearly always to be found in the prospectus and your explanation should make crystal clear to him just what the offering is about.

Of course from an ideal standpoint, the prospectus to be fully informative should be written so simply and concisely that any investor can understand it without technical advice. It should contain only material information in summarized form. All irrelevant data should be excluded. As we all know from the experiences we have had, this ideal is not always possible to achieve. However, it is a goal to which the S.E.C., issuers, underwriters and their counsel must constantly direct their efforts.

At the Commission we are doing all we can to make this ideal a reality. We have undertaken a program to simplify our forms. And, to facilitate the registration process, the staff is always available for conferences with issuers and underwriters before and after registration statements have been filed. We have constantly urged the use of a concise and readable document. Unfortunately, our efforts in this respect have not always been as successful as we wish them to be. Frequently, the prospectus is an almost complete copy of the text of the registration statement and contains a number of irrelevant items which tend to becloud rather than reveal the salient, necessary information. I am thoroughly convinced that as a general rule the material facts concerning almost any security offering can be digested in a prospectus of not more than 20 printed pages. Within recent months you have seen examples of this type where a few large corporations with extensive holdings have made offerings of securities to the general public and have boiled down the data in the prospectus to approximately that number of pages and less.

In this connection you no doubt have noticed the Commission's recent announcement concerning a revision of registration statement Form S-1 and the elimination of two pre-existing forms, A-1 and A-2. The new Form S-1 is part of the Commission's program to see to it that registration statements and the prospectuses filed with them are clarified, simplified and stripped of surplusage. You may rest assured that, if, at any time, we are satisfied that the public interest and the protection of investors will be adequately served by a further reduction in the quantum of information required in a registration statement or prospectus, such reduction will be effected immediately.

Very likely you will recall that in 1940 the Commission and representatives of the securities industry got together and worked out certain proposals to amend the Securities Act of 1933 and the Securities Exchange Act of 1934. On many points complete agreement was reached while on others alternative suggestions were offered. These recommendations were submitted to the Congress but the hearings were interrupted because of the war emergency. You may have noticed in the papers recently that this

program has now been resumed. Some of the problems confronting us in 1940 and 1941 have been solved by amendment and administrative action, while others have arisen since that time and must be considered in the light of present conditions. Representatives of the industry, other interested parties and the Commission are now giving serious study to ways and means of arriving at a common agreement as to changes, where possible and desirable in the public interest and consistent with the protection of investors. Among the major problems to be considered will be some simplification of the registration process and the use of a preliminary limited prospectus to be circulated among members of the investing public during the "cooling period" between the filing and effective dates of the registration statement. In the not too far distant future it is hoped that appropriate and workable proposals will be submitted for consideration by the Congress.

Since the Commission is interested in the views of all persons who feel they can contribute helpful comments, I suggest that you men, who know the securities business and the needs of investors so well, cooperate with us in this endeavor. Any views you may present, either for or against amendments to these Acts as they now stand, will receive careful consideration.

When speaking of investors in this discussion let me now point out that I have reference only to persons who buy securities to hold for an indefinite period of time, persons who are interested chiefly in the protection of their capital investment and the receipt of dividends or interest. I do not refer in any way to the so called gambler who buys for a short-swing profit and who is primarily concerned with inside "tips" rather than sound long term investments.

When sitting down with a potential investor I believe that you, as customers' brokers, might well keep in mind two basic principles which should be made clear to him. (1) The purchase of a security is the purchase of a general or restricted interest in the future earnings of a business; a general interest if the security is a common stock and a restricted interest if it is a preferred stock, a note or a bond. (2) A person who invests in a security puts money at a risk: and the greater the risk entailed, the greater should be the return on his investment.

He should be made to understand that securities are intricate merchandise which is not to be bought blindly and that the data contained in the prospectus are placed there so that he may, before buying an interest in a business, evaluate its future earnings and estimate the risks involved, and then and only then decide whether to buy. "Before you invest-investigate" is by now a hackneyed phrase, but to my mind it is one which not only bears repeating but one which should be instilled into the mind of every investor until, like the alphabet, it becomes part of his mental equipment.

If I were in your position, discussing the contents of a prospectus with a customer I would be inclined to adopt the following procedure.

After considering and explaining the information concerning the offering appearing on the facing page, I would turn to the financial statements. Despite the reactions of some few persons to the contrary, these statements are furnished not to baffle or conceal, but to clarify and reveal the financial condition of the issuer as of the time of the offering. I would explain that these statements are the keystone of the prospectus and that all other information in the prospectus is built around and is explanatory of them. The balance sheet, the profit and loss statement and the statement of surplus should be analyzed and explained. A comprehension of each is necessary for a full understanding of the financial condition and operations of the enterprise. Each portrays a different part of the company's financial picture and a study of each is necessary for a complete understanding of the others. From them alone the investor can learn whether the company is currently financially sound and operating on a profitable basis.

Next we would turn to the summary of earnings for past years, because the investor should know not only whether the company is making money at the present time but also whether it has a favorable history of successful operation over an extended period and its present earning position is not merely a fortuitous circumstance.

The past earning record, however, is again only a part of the story. The investor should know the background of that record so that he will be able to judge whether there is reasonable probability of its continuance. By turning to that part of the prospectus covering the history of the business he will receive some assistance on this score. There he may learn what part of the earnings' record was based on ordinary peace-time production as contrasted with war-time operations or other extraordinary conditions. He will also find information concerning the company's organization and structure, the nature and diversification of its activities, a description of its plants and other facilities, its source of materials, the nature of its products, the manner in which they are distributed, its proposed activities and the extent of competition in the same field. With a knowledge of these factors, he may make some estimate of the issuer's ability to operate profitably in the future.

After discussing the history of the business, I would turn to that portion of the prospectus covering the management and control of the issuer. If the company has enjoyed a favorable record of earnings, it is important for the investor to know whether the officers and directors who successfully guided the business in the past are to continue to direct it in the future. If a successful and experienced management has been succeeded by one without experience a glowing record of past earnings might well go glimmering and the capital investment risk be substantially increased.

From the foregoing the investor may judge whether the condition of the business is sound and whether the company's prospects for future earnings are favorable.

I would next refer to the general capitalization and a detailed description of the security being offered by the prospectus. It should be explained to the investor whether a debt or an equity security is involved and whether, in the event he purchases, he will become a creditor of the company or a part owner of the business subject to the risks thereby entailed. If an equity security is offered, his attention should be directed to the dividend record of the company and it should be explained whether his rights to dividends are contingent upon the prior payment of dividends or interest on other securities which have been or are being issued by the company.

To the extent that such a discussion is pertinent I would indicate and explain the voting rights given to a holder of the security, and whatever conversion, redemption or liquidation features the security may possess. I would also point out any provisions which might permit dilution of his interest in the business and, in any case where a debt security is being offered, the manner in which his investment is secured or subject to the prior claims of senior security holders.

I would indicate what the terms of the offering are, and in this connection, I should think the investor would be particularly interested in and should know just how much of his capital investment is going into the business, as contrasted to the amount that will be absorbed by payments to underwriters and selling group members and by other expenses entailed in the offering and distribution of the security. If the offering price of the security is being stabilized during the distribution period, this fact should be noted as well as its significance.

Lastly, I would refer to the statements concerning the proposed use to be made by the issuer of the proceeds from the offering, so that the investor may know whether his money will be spent upon new financing and further development of the enterprise or utilized for the payment of past obligations. If the offering is made on behalf of selling stockholders, the investor should be advised of the implications of a bail out, if such may be inferred.

The foregoing represents but a brief review of the elementary factors concerning a security offering in which I believe every investor is or ought to be vitally interested. As you appreciate, it constitutes merely a skeleton outline of such factors and the approach which I would take, if I myself were explaining the contents of the prospectus to a potential purchasing customer.

When you sit down with your customer, try to place yourself in his position or, in other words, put yourself on his side of the table. By trying to think from his point of view, you will be sure to offer him only what is suitable for his portfolio. It might be well, at that time, to ask yourself these questions: What type of security would I want if I were in this fellow's shoes? And, Is this particular security the one which I would buy under the same circumstances?

If such a procedure were followed by brokers and dealers in offering to customers securities which are subject to the prospectus requirements of the Act, I believe the resulting benefits would inure not only to the customer's but to your own advantage as well. You and I know that the securities business would be benefitted immeasurably by the education of investors. I know of no way in which such education may be better achieved than by this process of sitting down with the investor and explaining to him the basic, necessary facts concerning proposed investments. I feel certain that if such an education program were adopted and actively practiced by members of the securities business generally, the gains which would accrue to it in good will alone would be tremendous. You and I have learned by now that a satisfied customer is the best customer and one who will return to do business in the future. We have also learned that the more securities are held by informed investors, the less danger there is of panic sales and manipulation.

Now, before relinquishing the rostrum, let me stress a word of caution. I appreciate that you men represent a very high type in the securities business and that you are intent upon lifting that business to a lofty professional plane. All of you, I am sure, aim to make and keep the business one in which only the highest standards of commercial conduct are observed between brokers and their customers. Like the Commission, you must realize that abusive practices in the sale of securities should stop and that uninformed customers should be effectively protected against the overreachings of those who are familiar with the securities market. If this is not your viewpoint, I say it should be. It must not be the Commission's responsibility alone, but yours as well, to see to it that all unworthy representatives of the business are removed from the field.

We all know that, like the chain with the weak link, the securities business, in the eyes of the public, is often only as respectable as its most disreputable representatives. If sharp and abusive practices are engaged in by your members, not only the reputation of the crooked salesman is involved, but the reputation of the industry as a whole.

For at least the past five years the Commission has taken the view that, because of certain inherent characteristics in the securities business, special obligations are owed by dealers to their customers. The dealer, by holding himself out to be a person skilled in security and investment matters, cultivates his customer's trust and confidence. From this confidential relationship rises an implied representation that he will deal fairly with his customer. The Commission's conclusion in this respect was affirmed by the United States Court of Appeals for this Circuit in the case against Charles Hughes & Co.* In his opinion, Judge Clark said that in propounding this theory, the Commission had "correctly interpreted its responsibilities to stop * * * abusive practices in the sale of securities." Now, if a dealer can be said to have this obligation

* 193 F (2d) 434 (C.C.A. 2, 1943), cert. den. 321 U. S. 768 (1944).

to deal fairly with his customer in principal transactions, certainly a broker acting as his customer's agent and occupying a fiduciary relationship to him owes at the very least a duty to deal fairly with him.

If you and your compatriots will recognize and strictly adhere to the obligation of fair dealing which each of you owes to his customers, you will perform a public service for investors, greatly enhance the standing of your fraternity and, incidentally, lighten beyond measure the administrative and enforcement burden now borne by the Commission.