SECURITIES & EXCHANGE COMMISSION

FIVE YEARS OF FEDERAL SECURITIES REGULATION

By William O. Douglas.

Five years of Federal regulation have introduced into the nation's security markets and into financial affairs generally a new standard of conduct and a new concept of responsibility. This concept has been best described by President Roosevelt who told the Congress in 1933 that "What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others." It is the concept which underlies the Securities and Exchange Commission. It is the theme of the laws which the Commission administers. After five years, it has begun to take root in the mores of the financial community.

In the Securities Act of 1933 the principle is applied to the public offering of new issues of securities, in the Securities Exchange Act of 1934 it is applied to trading in outstanding securities, and in the Public Utility Holding Company Act of 1935 to public utility finance. In these laws the principle finds expression in requirements demanding the performance of certain duties and in prohibitions which outlaw specific abuses and malpractices.

The Securities Act of 1933 seeks to safeguard the public in the purchase of new offerings of securities. It demands that before such securities may be offered for sale the issuer must give investors adequate opportunity to know the essential facts which determine the investment value of the securities. It does not place the stamp of government approval or guarantee upon securities. The investor remains the judge of values; the law gives him a greater opportunity to make a judgment. This is accomplished

by requiring the issuer of securities to place on file with the Securities and Exchange Commission a registration statement containing the necessary data. Dealers who participate in the sale of the securities must provide their customers with a prospectus which summarizes the information on file at the Commission.

The operation of the Securities Act of 1933 during the five years since it became law has meant that some thirteen billion dollars worth of securities issued during that period have been offered to the public only after all the facts had been made publicly available. It has meant that investors have been spared the glib talk of salesmen of several hundred million dollars of securities the issuers of which were unwilling, or unable to reveal the true picture of their various propositions. It has meant further the discouragement of the fake stock promoter whose attempts to pass muster before the Securities and Exchange Commission have again and again proved fruitless.

These are the tangible results, measurable in dollars and cents. More significant, however, are the changes in attitude that have taken place on the part of those who seek the investment of public funds in private enterprise. The passage of the Securities Act was followed by over a year and a half of stubborn resistance by bankers, underwriters and others who comprise the nation's machinery for the issuance of securities. There was a determined unwillingness to accept the very proper legal and moral responsibilities which the Act places upon those who participate in public security offerings. Ultimately the futility of this position became apparent and, as the standards of the Securities

Act began to find recognition and acceptance in the financial community, capital financing under the Act was begun on a large scale. The new requirements of public accounting and disclosure, which at one time drew such bitter and vehement protest, are gradually becoming a part of routine business practices.

The Securities Exchange Act of 1934 grew out of the investigations made by the Senate Banking and Currency Committee into the practices which had formerly prevailed on our stock exchanges. The framers of the Act sought three objectives. Credit must not be abused to finance excessive speculation, manipulation in all its forms must be outlawed, and there must be adequate public information on all securities traded on exchanges. These requirements were later to be applied as well to securities traded off the exchanges.

The use of credit for speculative purposes is now under the control of the Board of Governors of the Federal Reserve System whose margin regulations restrict borrowing by investors to finance security purchases. On our stock exchanges, the trading malpractices, such as pools, wash sales, matched orders and other methods of influencing prices unfairly which had once been generally accepted as a recognized business technique are now violations of the statute and as such they have been reduced to a minimum. A further system of regulation for the vast and loosely organized markets outside the exchanges, known as the over-the-counter markets, is in the making.

The third purpose of the Exchange Act is to demand for the investing public the type of information necessary for intelligent evaluation of

securities listed on exchanges. To that end, all listed issuers are file regular reports with the Commission. In many cases, this requirement has for the first time made available to the average investor information that theretofore had been within the reach only of insiders. As a result of the filing of these reports there is growing up at the Commission a large and authoritative volume of information concerning American business.

But the Act has had an even more profound effect. It has brought home to American business the obligations of corporate management to its vast and scattered ownership. There have been advances in the field of voluntary corporate reporting. Most important, fidelity to fiduciary standards, born of legal necessity, is more and more becoming a part of American business life. This is best illustrated by a new movement which at the present time appears to be shaping itself on the country's stock exchanges. These markets have now begun to recognize the necessity for accepting a new standard of public responsibility.

The history of the Public Utility Holding Company Act of 1935 is but another illustration of early resistance followed by later acceptance of the standards of trusteeship demanded by the law. No piece of legislation in recent times has aroused such intense antagonism in the halls of Congress. The passage of the Act, moreover, was followed by organized refusal on the part of the utility industry to accept the law of the land. This open rebellion was met by government not with punitive measures but rather with reason and with a proper regard for the interests of security holders and the public whose welfare might have endangered by such open defiance of the law.

The Holding Company Act gives the Securities and Exchange Commission supervision over the financing operations of public utility holding companies, insisting that such operations must be justified in advance on economic grounds. It is the Commission's duty to pass on the issuance of securities, on mergers, reorganizations, consolidations and other means for acquiring utility assets or securities. The Act bars those financial practices which have destroyed so much investment in public utility companies; for example, misuse of mark-ups or write-ups of asset accounts, upstream loans in a holding company system, and the diversion of earnings from operating companies to the pockets of the inside few who owned the "service" and "construction" companies. The Commission has power to prevent the dispersion of capital through the wrongful payment of dividends and can supervise the accounting practices followed in holding company systems.

In one outstanding provision the Act expresses the determination of Congress that the holding company relationship has become so complicated as to make mere disclosure of financial facts meaningless as a method of control. To achieve simplification, the Act directs that each system shall take steps to limit its operations (with certain broad exceptions) to a single interconnected and coordinated system confined to a single geographic area in one or more states. But the Act applies a rule of reason and merely directs the Commission to require that such steps be taken as soon as practicable after January 1, 1938, thus permitting flexibility and ease of adjustment to that requirement of the statute.

This provision became the target for the greatest part of the attack upon the Act both in Congress and since its enactment. The industry in the heat of passion unwisely labeled the provision a "death sentence." More recently, upon sober reflection, forward-looking groups in the industry have come to regret the use of the term "death sentence". It now becomes apparent to everyone that, as the framers of the Act well understood, no <u>real</u> utility values would be destroyed or diminished. Striking evidence of this is to be found in the voluntary filing by the major holding company systems of plans for simplification under the provision once termed a "death sentence".

There are other frontiers into which the government has not yet penetrated in its role as the pace-setter of business standards. The first of these is the field of corporate reorganization. The Commission has completed a broad and exhaustive investigation, authorized by the Securities Exchange Act and begun in 1934, of the practices of protective and reorganization committees. Six volumes of an eight-volume report have already been sent to Congress and made public. As a result of the recommendations made in these reports, three bills have been introduced in Congress: the Barkley Bill which deals with the corporate trustee and the trust indenture, the Lea Bill which deals with the solicitation of deposits, proxies and assents in reorganization situations, and Chapter X of the Chandler Bill containing a complete revision of the corporate reorganization provisions of existing law.

A second financial area which must soon be made subject to standards prescribed by law is that occupied by investment trusts and investment companies. A comprehensive study on this subject was authorized in the Public Utility Holding Company Act and is now virtually completed.

From a practical point of view Federal securities regulation is a reality. To date the Courts have upheld the fundamentals of the statutes all along the line. Yet, there is a further and ultimate test of this regulatory effort. If it is true that "that government is best which governs least" then the success of these laws must ultimately be measured by the acceptance of their basic principles into the business and financial life of the country. The struggle to bring about a return to ancient standards of trusteeship is won not with the passage of legislation nor yet by the imposition and enforcement of regulations. It is won in the long and arduous conquest of old habits; it is won finally when these standards of trusteeship and responsibility are at last woven into the very fabric of our financial and business life.

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