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FEDERAL SECURITIES REGULATION

SECURITIES ACTS AMENDMENTS

On August 20, 1964, the President signed the Securities Acts Amendments of 1964.[1] This legislation extensively amends the Securities Exchange Act of 1934,[2] and amends one section of the Securities Act of 1933.[3] It is the product of the Special Study of Securities Markets,[4] which Congress authorized the Securities and Exchange Commission to make in September 1961.[5] The report of the Special Study showed:

> that neither the fundamental structure of the securities markets nor of the regulatory pattern of the Securities Act requires dramatic reconstruction. . . . At the same time, the report makes very clear that important problems do exist, grave abuses do occur, and additional controls and improvements are much needed.[6]

The 1964 act is designed to protect investors, especially those in securities traded over-the-counter,[7] by extending the disclosure provisions of the Exchange Act to issuers of such securities and by strengthening disciplinary controls and qualification standards for brokers and dealers. The disclosure provisions insure that more complete and accurate financial information is available to investors in the over-the-counter market. The regulatory controls enable the SEC to provide investors with more qualified investment assistance.

[1] 78 Stat. 565 (1964).

[2] 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a—78hh-1 (1958).

[3] 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a—77aa (1958).

[4] A staff of sixty-five men, composed of Securities and Exchange Commission personnel, lawyers, economists, university professors, and other government personnel devoted nineteen months to a complete study of the securities industry. The report itself, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), is a monumental work of over 4,000 pages, issued in three segments on April 3, July 17, and August 8, 1963.

[5] Act of Sept. 5, 1961, ch. 196, 75 Stat. 465 (1961).

[6] Hearings Before a Subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789, H.R. 6793, S. 1642, 88th Cong., 1st & 2d Sess. 3 (1964).

[7] Unlike an exchange market which is conducted in a central place by a limited group of professional participants who trade in a selected list of securities, the over-the-counter market is neither operated in any building nor are there any real limitations as to professional participants or securities traded. All securities not traded on an exchange are traded over-the-counter. Whereas the auction method prevails on the exchange, over-the-counter securities are traded by individual bargaining.

Essential to an appreciation of the importance of this legislation is knowledge of the explosive growth of this market during the 1950's. Sales of corporate stocks in this market have increased about 700% in 12 years—from $4.9 billion in 1949 to $38.9 billion in 1961. The average number of quoted prices for over-the-counter companies reported in the National Quotation Bureau sheets has increased from 5,000 in 1946 to 8,200 in 1962. The dollar value of over-the-counter transactions in 1929 comprised 16% of the volume of exchange transactions, while in 1961 they comprised 61%. S. Rep. No. 379, 88th Cong., 1st Sess. 14 (1963).

Disclosure[8]

Prior to this legislation, companies whose securities were listed on a national securities exchange and those whose securites were traded over-the-counter were not subject to equivalent regulation.[9] While all companies issuing securities to the public had to file a detailed registration statement with the SEC, in accordance with Section 6 of the Securities Act,[10] only those whose securities were listed on a national exchange were required to keep the registration information current through periodic supplemental reports to the SEC.[11] Section 15(d) of the Exchange Act was designed to require similar periodic reports from companies whose securities were traded over-the-counter, but it only applied to those companies whose securities of any class[12] had an aggregate value of $2,000,000 or more.[13] Thus, if a company's securities were traded over-the-counter and not listed on a national exchange, and if the aggregate value of any class of its securities did not exceed $2,000,000, it was not required to file periodic reports under either Section 13 or 15(d) of the Exchange Act. Moreover, only those companies whose securities were listed on a national exchange were subject to the SEC rules regarding the solicitation of proxies from shareholders,[14] as provided by Section 14 of the Exchange Act,[15] and to SEC controls over dealings by "insiders"[16] in the company's securities, as provided by Section 16 of the Exchange Act.[17]

[8] Federal securities regulation is based upon the disclosure theory. Sound investment decisions result from full disclosure of financial information by the issuer. Successful investment breeds confidence and increases the availability of capital for expanding business. At the same time, disclosure acts to safeguard against fraud by revealing the financial condition of a company to the SEC, investment personnel and investors themselves.

[9] In 1934, the over-the-counter market accounted for but a small portion of securities transactions. It was principally a market for special securities, such as government and industrial bonds, foreign securities, and bank and insurance company stock. In view of its small volume and limited nature, Congress did not devise provisions, applicable to the over-the-counter market, as specific as those relating to the exchange markets. Hearings Before a Subcommitee of the Senate Banking and Currency Committee on S. 1642, 88th Cong., 1st Sess. 10 (1963).

[10] 48 Stat. 78 (1933), as amended, 15 U.S.C. § 77f (1958).

[11] "Periodic reports" refer to the information and documents which the SEC requires to keep the registration statement current, and such annual and quarterly financial reports as the SEC may prescribe. Such reports must meet SEC requirements as to their form, the details to be included therein, and the methods to be followed in the preparation thereof. Securities Exchange Act § 13, 48 Stat. 894 (1934), as amended, 15 U.S.C. § 78m (1958); 17 C.F.R. § 240.13a-1-15.

[12] "Class" refers to all securities of the issuer which have similar characteristics and the holders of which enjoy similar rights and privileges.

[13] Section 15(d), added by 49 Stat. 1379 (1936), 15 U.S.C. § 78o(d) (1958).

[14] All persons solicited must be furnished a written proxy statement describing the matters for which proxies are solicited, and a proxy form. If the proxy relates to an annual meeting at which directors are to be elected, all persons solicited must be furnished an annual report with such financial statements as reflect the financial position of the issuer. 17 C.F.R. § 240.14a-1-11.

[15] 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78n (1958).

[16] "Insiders" refers to the directors and officers of the company and all beneficial owners of more than 10% of any class of the company's securities.

[17] 48 Stat. 896 (1934), as amended, 15 U.S.C. § 78p (1958).

A brief look at the XYZ Corporation,[18] a hypothetical concern whose securities are not listed on a national exchange, will illustrate the inadequacy of the Securities Act and Exchange Act to achieve disclosure from most over-the-counter companies.[19] When XYZ first issued securities to the public, in 1940, it was required to file a detailed registration statement with the SEC in order to avoid the restrictions of Section 5 of the Securities Act. All new issuers of securities to the public since 1933 have been required to submit such items in the registration statement as certified balance sheets showing all assets and liabilities in detail, and a profit-loss statement listing income and expenses for the preceding three years.[20] The registration requirements to which XYZ as a new issuer was subject were sufficiently demanding to satisfy the loudest cries for disclosure. However, in order for investors in XYZ to be protected, the registration information should have continued to reflect XYZ's financial situation through supplemental reports to the SEC. XYZ was not required to file periodic reports with the SEC. Since its securities were not listed on a national exchange, it was not subject to 13(a). It was not subject to section 15(d) because neither of its issues, that of $1,500,000 or $750,000, had an aggregate offering price of $2,000,000, nor could the aggregate value of the two issues be added to exceed $2,000,000 since they were of different classes, preferred and common. XYZ was not subject to the SEC proxy rules or insider controls since its securities were not listed on a national exchange. The corporation often failed to solicit proxies, or failed to fully inform its holders as to corporate matters which were decided by proxy vote. The directors and other insiders freely sold XYZ securities for their personal profit, taking advantage of their intimate knowledge of the company's affairs, and were not required to report these transactions to the SEC. The actions of XYZ can be considered typical of a substantial number of over-the-counter issuers who were not subject to continuing federal regulation.[21] The experience of the past thirty years has proven that without a statutory base of responsibilty, companies whose securities are traded over-the-counter are not willing to assume the expense and effort of disclosure.[22]

Due to the failure of prior legislation to require full disclosure from

[18] XYZ Corporation has 1,100 shareholders, 800 holders of common and 300 of preferred stock, and assets of $8,000,000. It issued common stock in 1940 whose aggregate value was $1,500,000, and preferred stock in 1950 whose aggregate value was $750,000.

[19] Section 15(d) of the Exchange Act did require about 1,500 companies whose securities were traded over-the-counter to make periodic reports to the SEC. These companies were the largest in the over-the-counter market. However, even these companies were not subject to the proxy rules or insider controls.

[20] See Schedule A, 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1958).

[21] Of 600 over-the-counter companies responding to an SEC questionnaire in 1961, 17% furnished no proxy material to holders; of the others, 62% sent proxy forms for the election of directors without listing the nominees. As regards periodic reporting, 25% did not send any financial reports to stockholders; of the others, 23% did not have the reports certified. Hearings on S. 1642, supra note 9, at 13.

[22] The expense involved in hiring a technical staff to compile such supplementary reports, and in printing and distributing such information is a considerable burden to the smaller companies. Hearings on S. 1642, supra note 9, at 145.

companies whose securites are traded over-the-counter, investors in such securites do not receive protection equivalent to that received by investors in securities traded on an exchange. Investors in securities listed on an exchange enjoy the double benefits of full disclosure—the availability of adequate information for informed decisions, and the protection which periodic reports, proxy solicitation rules and insider trading controls provide against fraud. Disclosure enables the SEC to detect fraudulent activities, if not through the registration statement then through later periodic reports or in the monthly reports of insider transactions. It also enables the investor himself to check representations made by issuers, or by brokers concerning issuers, since the financial condition of a company is available from the SEC records. Moreover, it removes the opportunity for brokers and dealers who have made false statements about certain securities to place the blame on the failure of the issuer to provide adequate financial information.

Investors in securities traded over-the-counter receive only the barest financial information on which to base their investment decisions. Shareholders are at the mercy of those issuers who furnish false proxy information,[23] since over-the-counter issuers. are not subject to the SEC proxy rules which provide for inspection and approval of such statements by the SEC. Investors must rely solely on the representations, or misrepresentations, of brokers and dealers concerning the assets and earnings of companies whose securities are traded over-the-counter, since such companies are not required to file periodic and annual reports which investors could check for themselves. The issuer is itself susceptible to the trading practices of "insiders" in the issuer's stock since the holdings of insiders need not be reported monthly and are thus not under SEC scrutiny. The Senate Committee report concluded, with respect to practices in the over-the-counter market, that:

> The entire Report of the Special Study is a documented analysis of the necessity for disclosure. The report demonstrates that irresponsible selling tactics, reckless investment advice, extravagant financial public relations and erratic markets for new issues thrive best where lack of information is most marked.[24]

The 1964 act, through six amendments to the Exchange Act, extends the protection of full disclosure to investors in companies, such as XYZ, whose securities are traded over-the-counter. The key provision is section

[23] One case is especially illustrative of the ease with which fraud is perpetrated. Promoters misrepresented that the American Equities Corporation owned certain properties and businesses. They prepared false balance sheets and used them to generate public interest. One of the promoters was also President of the Verdi Development Company. He persuaded the shareholders of Verdi Company by false and misleading proxy solicitations to approve the merger of American Equities and Verdi. As a result, 40,000 shares of worthless American Equities stock was distributed to the holders of the valuable Verdi stock, while the insiders of American Equities received the Verdi stock. Here, periodic and annual reports would have frustrated the merger, proxy rules would have prevented the fraudulent solicitations, and the insider controls would have alerted the SEC to the President's dual interest. Hearings on S. 1642, supra note 9, at app. A.

[24] S. Rep. No. 379, supra note 7, at 9.

12, as amended by the addition of subsection 12(g)(1). It requires issuers with total assets of $1,000,000 and a class of security held by 750 persons[25] to register with the SEC within 120 days after the last day of its first fiscal year ended after July 1, 1964.[26] The information required is that of Schedule A of the Securities Act. Once registered, the issuer would be made subject to the other five amendments.

All issuers meeting the standards of section 12(g)(1) will now be subject to sections 15(d) and 13(a), as amended, which provide for the filing of periodic financial reports. The $2,000,000 exclusionary standard of section 15(d) has been eliminated. Section 15(d), as amended, automatically requires issuers filing registration statements under the Securities Act after August 20, 1964 to meet the periodic reporting requirements of the Exchange Act for that fiscal year, and to continue such disclosure as long as the issuer has 300 holders of any class of security.[27] While 15(d), as amended, requires periodic reporting for all new issuers, section 13(a), as amended, requires all issuers meeting the standards of section 12(g)(1) to file periodic reports. Therefore, such issuers as XYZ which now must register under section 12(g)(1) must also periodically report changes in their financial condition under section 13(a).

In addition, those issuers meeting the standards of section 12(g)(1) must conform to SEC rules regarding proxy solicitation. Section 14, as amended, extends the power of the SEC over such additional issuers as XYZ corporation.[28] Moreover, a new subsection 14(c) provides an additional safeguard for the small investor. It states that unless proxies are solicited from the shareholders, prior to any meeting of the holders, the issuer must file with the SEC and send to all holders information "substantially equivalent" to that which would be required if the issuer had solicited proxies. This subsection will further enlighten small shareholders as to important corporate matters, even when their small number of shares-votes are not needed to determine such matters.

The third aspect of disclosure which the 1964 act extends to those companies meeting the standards of subsection 12(g)(1) relates to insider trading controls. Section 16(a), as amended, now provides that the directors, officers and the beneficial owners of more than ten per cent of any class of security of any issuer registered pursuant to section 12(g)(1) must file with the SEC, at the time of registration, a statement of the amount of all securities of the issuer which he holds, and, within ten days after the close of each calendar month, such insiders must report any changes in their holdings.[29] The amendment will allow recovery by issuers of securities traded over-the-counter of any profits made by insiders through dealings in the issuers' securities.

The final disclosure provision applies to listed, as well as over-the-counter

[25] After two years, the number of holders drops to 500, so as to allow the SEC time to adjust administratively to the new burdens.

[26] 78 Stat. 566 (1964).

[27] 78 Stat. 574 (1964).

[28] Section 14(b), 78 Stat. 569 (1964).

[29] 78 Stat. 579 (1964).

securities. Issuers seeking listing on a national exchange or who are required to register with the SEC under section 12(g)(1) must now file with the exchange and/or the SEC copies of all "material contracts not made in the ordinary course of business" which were made not more than two years before the application or statement was filed or which are to be performed after such filing.[30] Previously, only management and service contracts were included in the registration and listing statements.[31] The new provision could prove very significant to XYZ shareholders if, for example, disclosure revealed that the corporation was heavily dependent on one substantial government contract to maintain its present level of production and earnings.[32]

Regulation of Securities Personnel[33]

The most significant provisions of the 1964 act in this area are those imposing standards for entrance into the securities business.[34] The 1964 act provides for standards as administered by the National Association of Securities Dealers[35] for its members, and by the SEC for non-members.[36] Section 15A(b), as amended by the addition of new paragraph 15A(b)(5), provides, in effect, that the NASD, or any other national securities association, will be required to adopt appropriate standards with respect to the training, experience and other qualifications of its members in order

[30] Section 12(b)(I), 78 Stat. 565 (1964).

[31] Securities Exchange Act § 12(b)(1)(G), 48 Stat. 892 (1934), as amended, 15 U.S.C. § 781 (1958).

[32] See Hearings on S. 1642, supra note 9, at 34.

[33] Federal legislation in this area reflects the desire that industry organizations, such as exchanges and associations of dealers, impose self-regulation as an alternative to government control. Self-regulation is less expensive to the taxpayer and eliminates duplication which would result from dual administration of controls; it also checks unethical conduct as well as illegal conduct. However, brokers and dealers who did not trade securities listed on an exchange and who did not join a national association of dealers were only required to register with the SEC. These brokers and dealers escaped the regulation which the exchanges and associations exercised over their members.

[34] Only through qualified investment advisors can full disclosure be translated into benefits and protection for investors. The exchanges and the National Association of Securities Dealers (NASD) have established standards regarding competence, experience and capitalization for their members and registered representatives. The 1964 act provides the basis upon which the national associations may adopt additional safeguards, and, more importantly, it empowers the SEC to prescribe qualifications for those brokers and dealers who were not subject to the rules of an exchange or a national association.

[35] NASD is an association of over-the-counter brokers and dealers, established in 1938 to provide regulation equivalent to that exercised by exchanges over their members. Section 15A of the Exchange Act authorized the registration of such an association if its rules were designed to promote high standards of trade and to discipline those members found guilty of violating the securities acts or the association rules. Its membership, as of October 1963, was 4,545 members and 85,093 registered representatives of members. Since 1956, the NASD has required that new members pass an examination dealing with various aspects of the business. Hearings on S. 1642, supra note 9, at 66.

[36] The Senate version of the bill would have made membership in NASD compulsory for all over-the-counter brokers and dealers. As passed, such brokers may either join or be subject to equivalent regulation by the SEC.

to comply with the registration requirements.[37] Such standards will classify members, with respect to the number and type of securities sold, for example, and require certain classes to pass examinations. Also, the NASD must establish standards of financial responsibility for its members. Section 15(b)(8), as amended, empowers the SEC to prescribe similar standards for non-members of the NASD, if they do not deal in securities listed on an exchange.[38]

The 1964 act also enlarges the power of the SEC in handling disciplinary matters involving brokers and dealers, and their employees. The enforcement power has been enlarged so that the SEC can now proceed directly against an individual member or employee of a securities firm who has violated the federal securities regulations.[39] Previously, the SEC could take disciplinary action only by proceeding against the firm.[40] Furthermore, when proving a violation of the securities acts, the SEC need no longer demonstrate that the mails or the means of interstate commerce were used.[41] The 1964 act, section 15(b), as amended by the addition of subsection 15(b)(5), also grants the SEC discretion to impose sanctions such as suspension for as long as one year, or formal censure.[42] Previously, the SEC could only deny or revoke registration, or expel from membership in the NASD or from membership on an exchange.[43] Additional grounds for the Commission to deny or revoke the registration of a broker or dealer are provided in section 15(b)(5).[44]

CONCLUSION

The Special Study of Securities Markets and the 1964 act have produced marked side effects already. The American Stock Exchange has completed an extensive re-organization. The New York Exchange has initiated a program to improve its controls over selling practices and qualification standards, and the NASD has made a comprehensive revision of its by-laws and rules of fair practice.[45] The attitude already demonstrated is the first stride toward one of the major goals of federal securities regulation, improved self-regulation.

The long-range effects are difficult to assess. Although the 1964 act extends disclosure requirements to only about thirty per cent of the companies whose securities are traded over-the-counter, it has been suggested that many of the companies not affected will voluntarily make adequate disclosure.[46] In view of the cost involved, it is unlikely that very many companies will voluntarily comply with the disclosure provisions. At least equally

[37] 78 Stat. 576 (1964).

[38] 78 Stat. 572 (1964).

[39] Section 15(b)(7), added by 78 Stat. 572 (1964).

[40] Securities Exchange Act § 15(b), added by 49 Stat. 1377 (1936), 15 U.S.C. § 78o (1958).

[41] Section 15(b)(4), added by 78 Stat. 571 (1964).

[42] 78 Stat. 571 (1964).

[43] Securities Exchange Act § 15(b), added by 49 Stat. 1377 (1936), 15 U.S.C. § 78o (1958).

[44] 78 Stat. 571 (1964).

[45] Hearings on H.R. 6789, supra note 6, at 420.

[46] Hearings on S. 1642, supra note 9, at 289.

probable is that many over-the-counter companies will so act as to avoid meeting the coverage of the act, such as keeping its securities closely held and thereby avoiding the 750 shareholders standard.

The 1964 act will probably lead to the listing of most of the over-the-counter issuers who can meet the listing requirements of the New York or American Exchange, since they will be subject to equivalent disclosure and could enjoy the benefits of an exchange listing.[47] The inevitable result is informed investment decisions guided by qualified brokers and dealers, which will strengthen investor confidence in the over-the-counter market.

The 1964 act insures that investors in those companies, meeting the standards of section 12(g)(1), whose securities are traded over-the-counter will receive protection from fraud equivalent to that received by investors in companies whose securities are traded on an exchange. The disclosure provisions will open the financial records of companies to the scrutiny of the SEC, investment advisors and investors themselves. The regulatory provisions will allow the SEC to police a greater number of companies with more flexible disciplinary power.

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[47] In order to be listed on the New York Exchange, an issuer must meet standards of minimum assets, earnings and aggregate market value of common shares. The benefits from such listing are extensive daily publicity and a ready value placed on the security.