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ADDRESS

of

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THE SECURITIES AND EXCHANGE COMMISSION -
SOME OF ITS PROBLEMS

Every speaker who will address you at this the twenty-fourth annual convention of your association will be tempted facetiously to remind you that it is the sixth anniversary of your eighteenth meeting when chaos came to rule--October, 1929. This meeting can consider that sad but inevitable event in retrospect with mingled feelings and from many viewpoints. Since that time a lot of water has gone under the bridge and, may I add, a lot of water has gone out of the security markets. That catastrophe and the consequent investigations, I think it fair to state, were the decisive factors in the creation of the Securities and Exchange Commission and in the passage of the legislation subject to its administration. The fates were sadistic in arranging the coincidence of that noteworthy convention and an economic collapse in Wall Street. I know that for this convention all of you have left your cares behind, firmly convinced that with the Securities and Exchange Commission on the job, misfortune will come no more. As Mr. Kennedy remarked a year ago, the Commission has an impossible task to perform. To those long of securities we must see to it that prices rise but at the same time we must be tender to the "shorts" by giving them their share of "new lows". Indeed, when one reflects upon the variety of groups many of which have parasitic desires on the preserves of others, for whom the Commission must interpret and regulate, it is really remarkable that the Commission has been able to keep high its reputation for wisdom and fairness.

In the past 16 months there has been a good deal of speech-making by the Commission and by some of the more articulate members of its staff. So much, in fact, that I fear the public might well expect that by now we ought to be talked out. It is also one of my fears that the concept of cooperation has been stressed so frequently that the very mention of the word will start an audience groaning, "What, again!" However, I take a good deal of courage from the realization that cooperation has not been an idle wish but rather has been a helpful reality with resultant benefit to the security business, the Commission, and to the investor. The relationship of underwriters and dealers with the Commission on the whole has been marked by respect and toleration. Out of this atmosphere, there has come a goodly amount of protection for investors which is the purpose of the law and the only justification for the Commission.

The program on page 3 informs me that I "presumably will be in a position to explain and clarify many matters to be discussed at the forum including particularly the rules for the regulation of over-the-counter markets which become effective January 1st". I will have to disappoint the draughtsman of the program so far as over-the-counter regulations are concerned. In the first place, the regulations thus far promulgated under Section 15 are of a very simple nature and involve nothing startling in concept or in method. I would be glad to discuss them at the forum which is to be held later in the morning.

In this field, the Commission has stepped very warily because of the inherent difficulties involved in any system of control of this vast and complex area. It has postponed the effective date of these first regulations in order that adequate opportunity for defense be given to those applicants for registration against whom charges have been filed. I am not free at this time to discuss the broad problems involved in the Commission's task of regulating the over-the-counter markets. Although it would be premature to speak today about the details of our plans for exercising control under Section 15, I should perhaps repeat an observation made many times before: to wit that it is the objective of the Commission to provide as effective a control over those markets as has been imposed upon the organized exchanges. Within the limits of our power and with as much despatch as the difficulties of the problems permit, we hope to attain our ends.

Probably the most baffling problem of the Securities Act of 1933 with which we have been engaged of late, involves the effectiveness of the 20-day waiting period required by law and its value as a deterrent to the evils which the statute aims to correct. From the Commission's point of view administratively, this period of delay is highly desirable, in fact essential in order to allow sufficient time for a proper examination of a registration statement. The much discussed problem of "beating the gun" is itself a phase of a larger and more complicated problem involved in the relationship between underwriter and dealer.

The problem of the underwriter and the dealer is a most elusive one. The provisions of the Securities Act, including the definition of underwriter and the 20-day waiting period represent the best judgment of Congress at the time the Act was passed. There is no one who seriously contends that the present law and its practical operation is satisfactory. In our "fan mail" we have had many complaints regarding the plight of the small dealer, the unfairness of the distribution methods and this all too common practice of "beating the gun". It should be kept in mind that most of these complaints are sincere and sensible and are urged with the utmost good faith. However, out of a loyalty that characterizes your fraternity or possibly because of a fear of the consequences of disclosure, we are not told the names of the culprits.

The term "beating the gun" is not a product of the Securities Act. In fact the practice is one which has bothered the investment banking business for years. It is worth noting that in its origin, the term involves a judgment of unsportsmanlike conduct by the fraternity itself. If we could impose sanctions against this illegal conduct, not only in the legal sense but in the business sense, the problem would not be difficult. It must be confessed that your associates do not indulge in an outburst of indignation when the topic is discussed. On the contrary, a showing of moral condemnation against the current practice of "beating the gun" would be regarded by most of you as sheer hypocrisy. We must

begin by recognizing that it is the statute and not the Commission which prohibits the solicitation of customers prior to the effective date of the registration statement. We must keep in mind that the term "sale" as defined in the Act is extremely broad in scope, including "every -- attempt or offer to dispose of, or solicitation of an offer to buy a security". It must also be recognized that one element in making possible these abuses has been the fact that the registration statement is a public document immediately upon filing. Another consideration which should not be lost sight of is that by action of the Commission the use of the "red herring" prospectus, so called, is encouraged on the ground that the philosophy of the Act is to make available pertinent information prior to the occasion for exercising investment judgment. Those who condone the present practice say flatly that we are trying to change the basic qualities of human beings, in effect to controvert the laws of human nature, when we seek to enforce the law which permits discussion but forbids solicitation. The situation is aggravated, they say, because in many cases it is their customers who take the initiative prior to the effective date, who refuse to be shocked by the charge that they are acting illegally and who, despite solemn protestations, close the interview by saying "Quit your kidding, you better save me 20 bonds". They urge the hopelessness of selling people the idea that the 20-day period should be kept inviolate. Frankly they admit that the law is not being observed. The small dealers are particularly resentful because they feel that the 20-day period loads the dice for the underwriters and the large dealers with the result that the legislation which was largely in their interest is proving to be a boomerang. Even if one were to admit the existence of all the evils and the reasonableness of the complaints, it does not at all follow that the 20-day period should be repealed so that solicitation would be proper from the date of filing. To advocate such a change is to forget the lesson of yesterday and to be heedless of the necessities of tomorrow. In the first place, let me suggest very seriously that this section of the statute still has vitality. I am sure that no matter how tolerant the investment banker may be about violations of this rule, he still has sense enough to respect the eleventh Commandment - "Don't get caught". In a business where good will is so essential, where the loss of a reputation for decency and law obedience is tragic, one expects that there would be a great deal more bending over backwards to observe the law than the complaints we receive appear to indicate. It is one thing to advocate the unreasonableness, the impracticability of the law. It is another thing to disobey it deliberately.

It must be admitted that the condition of the capital markets obtaining presently and for sometime past go far to explain many of the evils I have mentioned. We are in a seller's market and the pressures are different. The small dealer's natural disadvantage is of course tremendously emphasized when there is such a scarcity of investments as we have witnessed recently. Perhaps I might observe at this juncture my regret that

your business could not develop a conviction about the worth of the 20-day period to the extent that violations thereof would result in business ostracism instead of receiving as now a shrug of indifference.

Frankness also compels me to say that if it be established that the waiting period as presently drawn be unenforcible in fact, even with the weapons with which the law has armed the Commission, then it would be the part of wisdom to seek a more realistic, a more satisfactory solution of the problem. It is claimed that this part of the law is like prohibition, i.e., it goes beyond the limits within which the law can effectively control human conduct. It is, so they tell us, palpably unenforcible. Well, we will have to be shown. In view of the legislative history of this section, it is most unlikely that its actual repeal would take place in the absence of a conclusive case against the present law. Reform will come only when the futility of the law has been demonstrated or when more ingenious sanctions have been evolved.

The report of the House Committee on the Securities Act discloses that the present law was designed to eliminate or reduce the evil of blind buying. Whatever its effectiveness, there is no doubt about the objective of the draughtsmen. The pertinent language is as follows:

"The compulsory 30-day inspection period before securities can be sold is deliberately intended to interfere with the reckless traditions of the last few years of the securities business. It contemplates a change from methods of distribution lately in vogue which attempted complete sale of an issue sometimes within 1 day or at most a few days. Such methods practically compelled minor distributors, dealers, and even salesmen, as the price of participation in future issues of the underwriting house involved, to make commitments blindly. This has resulted in the demoralization of ethical standards as between these ultimate sales outlets and the securities-buying public to whom they had to look to take such commitments off their hands. This high-pressure technique has assumed an undue importance in the eyes of the present generation of securities distributors, with its reliance upon delicate calculations of day-to-day fluctuations in market opportunities and its implicit temptations to market manipulation, and must be discarded because the resulting injury to an underinformed public demonstrably hurts the Nation. It is furthermore the considered judgment of this committee that any issue which cannot stand the test of a waiting inspection over a month's average of economic conditions, but must be floated within a few days upon the crest of a possibly manipulated market fluctuation, is not a security which deserves protection at the cost of the public as compared with other issues which can meet this test."

Theoretically, perhaps, some might say that if the law declares certain conduct to be unlawful, the discussion is ended. One has but to choose his place with the saints or sinners. But as a practical matter, we all recognize that the statutory regulation of human conduct must lean heavily upon the normal attitudes and actions of men and that the sanction of law rests largely on the inherent reasonableness of the statute itself.

Recently the attention of the Commission has been directed to the possibility that the practice of "beating the gun" has been accelerated by the fact that the registration statement is a public record from the date of filing. It is claimed that the services and the newspapers publish reports during the waiting period, as a result of the statement being a public record, which, although incomplete, suffice to inform those desirous of anticipating the effective date with enough details to make it a successful process. It has been proposed that the registration statement and the prospectus be not regarded as a public document when filed, but that it be treated as a private document until three days before the effective date. It is urged that when on the seventeenth day the statement becomes public, the underwriters be permitted to advise the dealers of the amount of the issue which the dealers will be offered, and at that time the dealers be permitted to solicit orders from their customers. However, it is proposed to provide that no transaction in this 3-day period between the underwriter and the dealer or between the dealer and the customer be final until confirmation after the effective date of the registration statement.

The proponents of this suggestion contend that such a program will help the investor and the dealer in appraising the worth of a security, because what is in practical effect the final prospectus will be normally available for a period of 3 days before commitment, whereas under the present high speed system the extent to which an examination of the prospectus is at all possible is sometimes very slight. It is expected that this plan would result in reducing to a minimum the present evils of "beating the gun", because anyone soliciting in advance of the seventeenth day would be easily exposed and would be regarded as an outlaw by the trade. The present handicap of the small dealer is expected to be overcome by this reform, the spirit of the law will still be preserved, and the unfortunate tolerance of law violation will be eradicated.

This program has been offered merely as a basis for discussion. It would obviously require a good deal of exploratory work before the contentions of its sponsors could be substantiated. It is to be hoped that it will be the subject of much critical analysis from all groups in the security distribution field. No scheme should be sanctioned by law which results in the unfair ascendancy of any particular group in the investment field. And before final judgments are made on any proposal, its effect on all groups should be clearly appraised.

At the very outset one is struck by the optimistic expectation that illegal practices will be at a minimum under this scheme. I find it difficult to share this optimism regarding the change in sentiment of your fraternity toward a "gun jumper". It may be that the three-day opportunity will so satisfy the majority that they will see virtue in law obedience, but such conviction must rest on nothing better than a hunch until actual trial. Fundamentally, of course, the suggestion implies that the investor's interest is not affected by the fact that upon filing, a registration statement becomes a public document. I, for one, believe that there are distinct advantages in having the information subject to public inspection during the period of Commission examination. We have had many instances where this availability for public inspection has resulted in the detection of important discrepancies.

You will appreciate that the suggestions I have mentioned do not attempt to consider to what extent the problems are caused by the traditional methods of underwriting on the part of the large houses of issue in this country, i.e. by the system itself. The outstanding characteristic of American underwriting is its whirlwind speed. Unless the syndicate books are closed almost in a matter of minutes, the venture has the stigma of failure. No great power of analysis is necessary for one to realize that this process of almost instantaneous commitment is responsible for many of the evils which thoughtful men deprecate in your business. I know full well that it is unsound to contrast the English system of distribution with ours and draw a sweeping conclusion adverse to the American method. England is a small nation. Its financing is confined almost to a single city. It has had a different tradition and the temperament and training of its people are much more conducive to a leisurely method than are the tempestuous qualities of the average American. Nor is it sound to say that the English system would work for the capital needs of this country. But it would be helpful if we should strive for some of the incidents of the British system. Their method of distribution does not stimulate an artificial demand. I do not believe than an Englishman, for instance, desiring 5 bonds asks for 25. Under the American plan with its high degree of artificiality it is hard to know for certain how well an issue has gone until long after the syndicate books have been closed. A dealer in this country will sacrifice much to hide from the large underwriters a lack of placing power lest his quota next time be reduced. You are all familiar with the recent issue of excellent repute which went "sour" when approximately 11 percent of it turned back from a supposedly firm placement. The whole market for this issue was spoiled by the incidents of artificiality. In England, with a true underwriting, without the driving speed for confirmation, without artificial stimulants to origination and to the market and with a good deal more time the whole venture would have been a more stable one. The digestive capacity of the market would not have been strained by forced feeding and the investor's market would reflect a natural and not an artificial condition. Let me repeat, I do not advocate the English analogy because the differences of place and temperament, etc. are quite distinct. But comparative criticism is a valuable process and we are not without the opportunity for improvement by a reflection on the ways of our more tranquil brethern.

As you know, the Commission has no power to pick and choose its registrants. It must take all comers and that means the best and the worst. Many of the critics of the Act are prone to look at the problems solely in the light of their particular problems. The Commission, however, must consider the implications for proposed changes not only as they affect the reputable underwriters and dealers with prime issues, but also as they may affect the numerous questionable financings sought to be palmed off on the trusting public by shrewd promoters. The very fact that upon filing, the registration statement is a public document operates as a corrective against fraudulent misrepresentations. However, I don't propose to attempt the final answer this morning. In fact the answer will not be forthcoming on any morning in the near future. The issues are of surpassing importance involving as they do the bread and butter of thousands of dealers. The task is particularly delicate because, as the distribution is currently conducted there is such a sharp conflict of interests. It is too much to hope for a speedy adjustment without a period of trial and error.

A judgment about the effectiveness of a given law is not an easy one to make in any scientific sense, unless there has been a long period of time during which the Act is in effect. It therefore would not be timely to appraise the contribution of the legislation of 1933. Particularly is this true of an appraisal of the extent to which the law has been an effective agency in raising the ethical standards of the investment business, in furthering the philosophy of disclosure, in reestablishing in the minds of corporate officials the conception of the fiduciary nature of their office. Mr. Crane, your shrewd and capable retiring president, still thinks the Act is a monstrosity although he very generously hands the Commission a gorgeous bouquet by stating that sanity in administration saved the law. But only in the verdict of time after a testing under a variety of circumstances of good times and bad will one make a final judgment with any confidence.

In some important aspects, however, there is tangible evidence that the Securities Act has realized the expectations of its sponsors particularly in the antifraud provisions. Here we can furnish actual testimony of real accomplishment, and this despite the limitations on our injunctive powers which permit a Federal Court to enjoin only from violations of law and despite the recent attitude of criminal juries to "let bygones be bygones".

You will be surprised to know that even in the golden age of security swindling less than a dozen "big shots" conducted the bulk of the interstate swindling in this country, practically immune from state interference because of the restrictions of state lines and because they operated through "fronts". These fraud specialists had developed a very successful technique including a little stock exchange finesse and a large army of trained and highly paid mercenaries to prey upon the gullible investor. Some of these gentry ride unconquered but their ranks are thinned. One of them has recently been on trial, is subject to four indictments and is but prolonging the trip to the penitentiary. A second is a fugitive from justice with the law treading on his very shadow. A third member of the crew has been indicted in a city far removed from his political influence. A pair of rascals are now fighting extradition to the scene

of their crimes. Another offers to submit to a permanent injunction enjoining him from ever going into the security business in any form. He will even post a substantial bond to insure his agreement to keep out of the security business. I am far from contending that the problem is at an end or for that matter that our program will be entirely successful. However, our experience demonstrates that with reasonable efficiency we can eliminate large scale interstate fraudulent stock schemes. The powers of the Commission for speedy investigation, for concerted activity with state authorities, for simultaneous examination in several places have added tremendously to the risk of swindling. It is also true that the capital expended in preparing the customers for the "kill" is more than ever a risky investment since an investigation by the Commission with a subsequent equity suit will ruin the promoters' costly and well laid plans. Our investigation tends to indicate that there is a growing sales resistance on the part of the public to questionable promotions. Although our figures are not exact because the test was more in the nature of a spot check and although there are numerous factors which limit the validity of any generalization the trend is very evident. Out of a total of \$60,488,000 involving 31 registrants only \$2,781,000 have been sold in a period of 18 months, or less than 5 percent. Making all proper allowances, it is perfectly clear that some prophylactic forces are at work, be it the Securities Act or the general attitude of the public consequent on the losses following 1929. Our investigation also indicated the absolute need of some escrow provision in promotional financing. It would require an amendment to the law but the added protection is vital and no honest promoter would oppose this elementary safeguard. Many ventures never get started. On the one hand, not enough money is realized to start operations. On the other hand, there are not enough creditors to force bankruptcy. The venture lies between life and death while the promoters aid its decline by taking regular salaries. As our statistician puts it, their undertakings turn out to be a modified dole for the promoters, a specialized form of relief.

Recently the Commission secured a permanent injunction against a promoter whose literary qualities flowered in the most lurid kind of copy for the sale of securities by mail. The other day I received the following letter from the respondent who had been enjoined:

"You Win! - I don't know how others feel, but for myself I am going back to selling books. It seems to be the only field in which my particular type of talent is safe".

The need of Commission Control in the interest of national honesty has been established beyond all reasonable doubt. Although a large section of the Nation raises its hands in horror at such a grant of Congressional power, the complete justification is found in the absolute necessity that the Commission possess a reasonable margin of discretion. The perspicacity of Congress if multiplied a thousand fold could not provide in advance for those cases where the general rule would work serious hardship. Although the Securities Act of 1933 is notoriously rigid (in fact its inelasticity was intentional in order that the Act be Commission proof) since its passage there have been promulgated approximately 40 releases of rules and regulations, and 25 forms and amendments thereto. Of course, under the Securities Exchange Act of 1934 where the problem is dynamic, a task largely

of supervision where the phrase "in accordance with the rules and regulations of the Commission" appears over 100 times, action by the Commission has been more frequent. In a period of about one year, there have been over 125 releases covering rules and regulations and interpretations of the '34 Act and over 30 releases applicable to forms.

Not only is this dispensing power essential to prevent injustice in individual cases but it is of the utmost importance to enable the Commission to shift with the changing fashions in fraud. If we were too rigidly restricted by the statute, the ingenuity of the racketeer would find a way to avoid the letter and evade the spirit of the law. Many of the brethren finding the share business dangerous have enlisted under the banner of oil royalties. This has been a fertile field because the blue sky laws of many states are deemed not to apply to the oil interests and also because the immediate return to the victims lulls them into a false sense of security. Few, if any, of those purchasing oil royalties realized the nature of their investment - that they have bought an interest in a constantly wasting asset if any.

A fortnight ago during an investigation of an oil royalty conspiracy we came across a postscript to a letter written by an oil royalty broker to a dealer in the East:

"P.S. The value of an oil well is apt to increase in exact ratio to the distance you are away from it. The other day out in the country we picked up an old farmer who was walking along the road. After we had ridden a mile or so in silence X pointed out some derricks and asked the old boy what they were producing. He spit a couple of times and said, 'Wall if your from the East they are producing 100 bbls. a day. If you'r from Tulsie they are running about 15 bbls. but if you live around here they ain't worth a damn'."

Service with the Commission is a rare privilege because of the high mindedness and ability of the Commissioners and of their staff, but one must be prepared in the service for all sorts of criticisms from all sorts of people. In these days of social and economic confusion, it has become the fashion to "peg" the persons who serve in the public interest. Most of the judgments are based upon that curse in Washington -- backstairs gossip - much is purely partisan; most of it is uninformed. In the minds of many critics the pendulum never stops in the middle. One is either a wild pop-eyed radical committed to a program of revolution or a cringing, timid, spineless slavey to the Wall Street money barons. There is no gray in their color scheme. Such critics are unable to believe that public servants can be interested in carrying out the legislative will in a temperate way; striving only to administer impartially with wise and courageous action important acts of Congress. After a time one develops immunity; your hide thickens so that you don't mind the accusation that the Commission has become the tool of this or that group.

One instance of the difficulties which the Commission encounters from the extremists is indicated by the reaction in some quarters to the recent collaboration between the Commission and members of the investment banking fraternity looking toward an improvement in the standards of business conduct. We were promptly charged with abandoning our control of the over-the-counter market. It was implied that the negotiations amounted to an

attitude of defeatism on our part or possibly a downright "sell out". It is not necessary for me to point out the true nature of the negotiations between you Committee and the Commission, nor for that matter need I dwell upon the undoubted merits of the plan which aims to professionalize the business. There is no attempt by the government to control this organization of your own business. There is no attempt by your Committee to secure in some clandestine manner a jurisdiction over the dealer which is unlawful. It is a commendable attempt at voluntary self discipline to eliminate the notorious evils which right thinking men deplore. It is quite apparent that under the proposal which has received a hearty response the legal situation is unchanged and the Committee does not in any way derive its authority from the Securities and Exchange Commission. It is the Commission's desire that the experiment be given hearty cooperation on the part of all the members of your industry. In this program of voluntary self-regulation and self-discipline there is reason to expect that the investing public and the dealers themselves will be greatly benefited -- the public because there will be a responsible body to help them where they have been imposed upon; the dealer because this plan will aid materially in the detection and discipline of those "chiselers" whose sneid activities have given the fraternity a bad name.

It is to be hoped that the organization proceeds with caution, that it maintains a democratic tone, that it does not evolve into an oligarchy of chosen ones not truly representative of the dealers as a whole. There should be strict adherence to the democratic ideal in the method of choosing your leaders. Failing this, you risk the confidence of the dealers and without a high degree of confidence from the vast majority, the plan will not succeed. The organization difficulties will be numerous. The task of securing members of ability with a willingness to give unselfishly of their time and energy is not going to be easy. But the goal is a desirable one and its successful growth should enlist the active interest of all members of your association.