

SPEECH  
of  
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THE SECURITIES AND EXCHANGE COMMISSION -- FROM  
THE ANGLE OF ENFORCEMENT

In a setting such as this, one's mind, in searching for a suitable keynote, inescapably meets up with the word "cooperation". A perusal of your reported proceedings for the last few years indicates that not only in the field of federal activity, but also in the area of state action the speakers have stressed the desirability, in fact the necessity, of cooperative action in a common cause, a cause which begot the legislation you Commissioners administer and similarly a cause that sponsored our Commission and our present activities. On Friday of this week you will hear The Honorable James M. Landis, Chairman of our Commission. He will speak on that subject of cooperation, old to be true, but ever timely and appropriate to an occasion of this nature. Later on in the same day Mr. O'Brien of the Registration Division of our Commission will discuss the subject entitled "Mining Securities and Registration", a topic which for this section of the country has more than a passing interest. We expect that this form of functional cooperation will be provocative of an interesting and profitable discussion.

There appears in your records of the year 1924 a resolution urging the passage of a federal act regulating the interstate sale of securities. Your Association from time to time, confronted with the problem of regulating interstate frauds effected by the use of the mails, the telephone, the telegraph and the radio, has urged congressional intervention. Your officers in 1933 approved the Securities Act as finally enacted. Thus we come not as hostile, alien forces intruding upon the rights and privileges of the sovereign states jealously guarded by provincial ministers, but rather as allies specially invited to assist in a cause honorable in motive and socially most worthy.

Over a century ago, Chief Justice Taney expounded that sensible principle of our constitutional system whereby the state and the national government may legislate and administer on similar matters, each within an appropriate sphere, each attaining a similar objective where experience and reason disclosed that joint action was expedient or appropriate. We are, like you State Commissioners, a product of the inexorable laws of corporate evolution. This association was quick to recognize that new economic forces, modern styles of fraud, the pervasive influence of the giant corporation in our national life, demanded that your efforts be supplemented by congressional action. No academic concept of a divided sovereignty could obscure your sense of reality that, in seeking to ensnare the swindler and to protect the "sucker" (who, like taxes, we know will be always with us), there was an absolute need of a strong and cooperative federal agency. Despite the growing conviction as represented by the action taken by your association in 1924 that some degree of federal control in the blue sky field was inevitable, Congress did not respond. Doubtless its inaction was occasioned by the mirage of prosperity which obscured all our social thinking during the last decade. We were all foolishly unwilling to appreciate the force of an ancient law of economics as well as of gravitation that what goes up must come down. And, so, out of the travail of the market crash and the consequent deflation came the forces which impelled the enactment of the Securities Act of 1933.

The second and very important legislative act committed to our administration is the Securities Exchange Act of 1934. This had been preceded by years of popular demand for governmental supervision of the

New York Stock Exchange. The Pujo Committee in 1910 revealed a growing concentration of wealth in the hands of a few. It also disclosed the stock exchange as an important link in the ramification of concentrated wealth. Although it brought reform in our banking laws it just missed producing a regulating measure affecting the stock exchange. The collapse of October, 1929, and the incredible revelations of overreaching, breach of fiduciary obligation, unconscionable imposition, and downright cheating as disclosed by the Senate Committee on Banking and Currency brought on swiftly congressional regulation in the form of the present statute. The national scope of the activities of the investment and trading business showed clearly that sensible regulation required the exercise of the federal power. It is possible after two years of effort to be categorical regarding the interstate character of the problem. The regulation of trading in the public interest in the over-the-counter markets as well as on the national securities exchanges can effectively be accomplished only by the joint efforts of state and federal agencies. A repeal, legislative or judicial, of federal legislation would but stimulate the return of the flagrant and tragic abuses which begot so much unhappiness in the past.

There is, of course, another act we administer called the Public Utility Holding Company Act of 1935. This also was the child of a national scandal. An investigation showed that the corporate device termed the holding company, though innocent enough in itself, had been frequently prostituted in order to defraud investors and rob consumers and to make state regulation in many instances a mockery. This Act has been the target of constitutional attacks by most of the large holding companies.

Although in many respects it is an integral part of the President's plan to give realistic protection to investors, I shall not address myself to a discussion of this statute because it is not a specialty of most of the members of your association and because of the absence of enforcement experience to date. I might however generalize to this extent - the platforms of the major political parties indicate that these reforms have come to be regarded as a permanent part of our governmental system.

Among the special activities of the Commission which hold great promise for reform may be mentioned the studies conducted pursuant to the mandate of the Congress. Under the brilliant direction of Commissioner Douglas the Commission has looked into the practices of Protective Committees, so-called. Already sections of this report have been forwarded to the Congress. The record discloses a sad tale of unconscionable greed on the part of those who wear the garb of fiduciaries holding themselves out as "protectors" of the distressed security holders. Hardly a student of this problem fails to agree that special legislation by the Congress is necessary if the abuses thus revealed are to be eliminated.

The Commission, pursuant to another request of the Congress, is examining the history, creation, the operation and social utility of various types of investment trusts for the purpose of a report to Congress of its findings and recommendations. That study is being conducted currently and makes interesting reading for those who believe that the crash chastened our financial community.

This afternoon I would like to discuss the enforcement activities of the Commission and in particular the resources, statutory and administrative, available to us, the efforts we have made in the field of enforcement, and a word or two about the results in terms of the statutory objectives. Such a topic makes it difficult to escape a charge of boastfulness and yet that risk must be assumed in order to make available an understanding of the enforcement processes of this new and far-reaching agency.

Let us look at the Securities Act of 1933 first of all. Despite a great deal of misrepresentation, particularly in the form of frenzied fear about the liability sections, this statute is amazingly simple. From its inception it has been blamed for the absence of new financing which to the informed economist is an inevitable concomitant of a serious depression. Even today there are some so thoroughly unregenerate that they declaim against the Securities Act as a barrier to recovery even though more than eight billion dollars worth of securities have been registered since its passage.

In order to understand the process of enforcement one must appreciate that our Act is not a licensing or approval statute. The Commission is without authority to make any investment judgment regarding the worth of a particular issue. The statute provides simply that no public offering of securities may be made through the mails or in interstate commerce unless the securities are exempted by the statute or there is a registration statement in effect prior to such offering. The registration statement must contain information regarding the enterprise, particularly financial data which experience has taught to be essential to the exercise of an informed investment judgment. The statute further provides that it shall be unlawful to use the mails or the facilities of interstate commerce in the sale of a security through misrepresentation or fraudulent schemes. Thus the sanction of the Act is found in two provisions -- Section 5 which requires an effective registration statement prior to sale, and Section 17 which makes unlawful a sale of securities by misrepresentation. The latter is but an extension of the mail fraud statute whereby the federal prohibitions now embrace the telegraph, telephone and radio.

Where in a registration statement there has been a misrepresentation or failure to state a required item, the Commission may prevent such a statement from becoming effective. Even after such a statement has become effective, The Commission is empowered to initiate stop order proceedings. As enforcement measures, these are very effective, particularly in the case of an issuer or underwriter who possesses any sort of standing in the business world, principally for the reason that the resultant stop order stamps the offering in the minds of the public as "non-genuine". In addition such an order subjects the seller to severe penal and civil liability for subsequent sales when the statement has been declared ineffective. However, our experience has shown that for certain types of issuers and promoters, the stop order technique is in and of itself too mild a measure to be effective. The out and out security racketeer has too little reputation to lose which cannot be regained under an alias, for him to be deterred by the threat of a mere Commission order. We must

also keep in mind that by a timely withdrawal of the registration statement an unscrupulous promoter may under certain circumstances render a stop order proceeding thoroughly futile. Notwithstanding these weaknesses, remembering that the philosophy of the statute is basically that knowledge of the truth through appropriate publicity will effectively protect the public against deception, the stop order method is admirable in furthering the processes of disclosure and in "preventing certificates masquerading as securities from passing current in the market."

There is another and very important arm of enforcement which the statute grants to the Commission and that is the power to secure an injunction in the Federal Courts restraining a defendant either from selling an unregistered security or from using deception in his attempted sales. Obviously such a technique enjoys the advantages of publicity. Such a court proceeding is frequently an adequate warning to the world of prospective purchasers who are thus put on their guard. There is a distinct advantage to the cause of enforcement whenever a fraudulent promoter has been placed under the guns of a contempt proceeding. Of course, among the respectable elements in the trade, the very thought of an injunction is generally sufficient to insure a high standard of law obedience.

Just as in the case of a stop order, however, to a certain type of security cheat, an injunction represents a very slight risk. Time and time again we have observed that a disreputable security distributor would be agreeable to a consent decree, particularly if he suspected that by such a consent he might make criminal prosecution less likely. So true is this that we seriously considered seeking a general amendment to the Act which would permit a Federal Court, upon proper showing of wilful violation of the statute, to issue a decree enjoining the respondent from using the mails or facilities of interstate commerce in any kind of a security venture; in other words, to close him up as a factor in the interstate security business. Bear in mind that under the present statute the court enjoins a defendant against whom appropriate findings are made only from selling a security in violation of the registration provisions of the Act or in violation of the fraud provisions of the statute found in Section 17 thereof. We were affected somewhat by our admiration for the efficacious technique of the postal fraud order whereby, when an addressee is found guilty of obtaining money through the mails by false pretenses, in a hearing before an Assistant Postmaster General the order is directed to the local postmaster requiring him to stamp all mail of such addressee fraudulent and return to the sender even though it be a romantic "To My Valentine". However, by an amendment to Section 15 of the 1934 Act enacted late in the Spring of this year, it was provided that no broker or dealer could use the mails to effect any transaction in a security, with certain exceptions, unless he were registered with the Commission and further, that registration is to be denied or revoked if the Commission finds the applicant to be temporarily or permanently enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities.

Thus, even a temporary injunction in connection with a securities transaction may result in excluding a violator from conducting any kind of a substantial security business. This, it is only fair to state, is a more deadly sanction than was found anywhere in the original statute.

Time and the rather general subject matter of my discussion this afternoon will not permit my dwelling upon the interesting phases of the 1936 amendments to the federal legislation. They are of far reaching importance to a number of branches of the business. However, because of the similarity which this type of control bears to many of your own statutes, I think it would be appropriate if I but mentioned the other statutory bases justifying the Commission in a denial or revocation of this most valuable broker-dealer registration. These are as follows: if the broker or dealer or any partner, officer, director or branch manager of such broker or person occupying a similar status or performing similar functions, or any person directly or indirectly controlling or controlled by such broker or dealer first, has wilfully made or caused to be made in any application for registration or in any proceeding before the Commission with respect to the registration, any false statement; second, has been convicted within ten years preceding the filing of any such application, or at any time thereafter, of any felony or misdemeanor involving the purchase or sale of a security or arising out of the conduct of the business of a broker or dealer; and third, has wilfully violated any provision of the Securities Act of 1933 or the Securities Exchange Act of 1934 or any rule or regulation thereunder.

There is, of course, a penal section whereby a wilful violator subjects himself to the risk of a fine of \$5,000 or imprisonment for not more than five years or both. The responsibility for prosecution by the statute is appropriately given to the Department of Justice. The Attorney General has designated one of his assistants to take care of the task of handling security frauds. Our staff has worked closely with this assistant in complete harmony and with satisfying results. There can be little doubt but that in many cases the fear of vigorous and vigilant prosecution is the most effective agency for law obedience by the security "racketeers".

The Securities Exchange Act of 1934 is a far different Act in concept and philosophy. In the first place, it is much more complex than the earlier Act and for the simple reason that it had to be. The problem of control as revealed by the Pecora investigation could not be met with a simple requirement of disclosure, although issuers of securities registered on national securities exchanges are required to meet high standards of disclosure.

The evils which had to be met in this legislation involving such things as abuses of inside information, weird inter-company transactions, rigged markets and excessive speculation, required in addition to high standards of "Thou shalt nots" a broad discretion and a close and continuous supervision. In other words, the problem was dynamic rather than static.

For the Exchange Act there are numerous methods of enforcement. We may, for example, refuse to register a stock exchange if after a hearing it is determined that the exchange is not adequately organized to insure the protection of the investor. By such an order the Commission can effectively close any exchange.

As it turned out in the early days of the Act this extraordinary power did not have to be invoked. During the course of our investigation of some of the exchanges, so much in the nature of illegality was disclosed that five stock exchanges voluntarily closed their doors. During the course of one investigation, every member of the exchange who appeared claimed his immunity against self-incrimination which was indeed an illuminating commentary upon the pre-existing standards of conduct and the type of protection afforded the public. In one case we found wash sales so frequent an occurrence that a visitor might well suspect that he was in a laundry. Needless to say, the passing of these exchanges can be regarded as fortunate developments from the viewpoint of the investor.

The Commission is also given the power to delist a security registered on a national securities exchange subject to terms to be imposed for the protection of the investor. In the enforcement of this statute the power of delisting has not been a conspicuous factor although it is conceivable that it may be a very serviceable weapon in the armory of the Commission.

Under the 1934 Act the Commission is given the power to seek injunctions identical with the power conferred under the earlier act. Thus the injunction may extend only against acts violative of the statute and is therefore subject in this respect to the comments made about the earlier statute. We have found it to be very effective in our work, largely because of the desire on the part of most of the stock exchange members and their associates to guard jealously their good name. I state but a truism to you gentlemen when I declare that for a certain group in the security business the most effective device for promoting ethical conduct is the indictment. The fly-by-night crook is seldom affected by civil penalties, but for an aggressive prosecutor he has genuine respect.

Perhaps the most interesting power granted to the Commission by the 1934 Act affecting misconduct in trading on a registered exchange is found in Section 19(a)(3) whereby the Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors, after appropriate notice and hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of this title or the rules and regulations thereunder, or has effected any transaction for any other person who he has reason to believe, is violating in respect of such transaction any provision of this title or the rules and regulations thereunder. As one might expect, this power is exercised usually in connection with violations of Section 9 - the so-called anti-manipulative clauses of the Act.

Already in our short history the Commission has caused to be instituted proceedings under this section in five cases. Because a number of these cases are still in the process of determination, I deem it inappropriate to discuss them on the merits or even to mention the respondents or the securities involved. Among other defenses practically all the respondents have raised the issue of the constitutional validity of this statute so that an interesting court review seems quite likely.

But I think it would not be inappropriate if I adverted generally to a criticism which I have heard and read about lately emanating from the "Street so-called", regarding the delay attendant upon the trial of proceedings under this section. In the first place, it can be shown that the continuances granted by the Commission were in most cases requested by the respondents. No general norm can be used as a basis of criticism in this respect unless it be that a lawyer without a continuance is probably a contradiction in terms. In the second place, let me emphasize what to the informed needs no demonstration; to wit, that the proof of a stock manipulation is a man's size job. In a case of any proportion, there is involved the examination of hundreds of witnesses and thousands of records. To be sure, the Business Conduct Committee of the Stock Exchange can be more expeditious. The setting, however, is that of a club and the member who is disciplined is practically without recourse to a higher tribunal. Our Commission, on the other hand, is an administrative agency of the federal government subjected at every step of the proceedings to the stern requirements of judicial review, subject also to the necessity of notice, hearing and the other incidents of due process.

Because we are a new Commission and because our supervision concerns some of the most important financial aspects of American life, because of the grave consequences involved in the administration of the statute, we have attempted to establish our case in these Section 19 proceedings strictly in accordance with the principles governing trials at common law. We have been animated by considerations of fairness, even in the face of the most technical and skillful opposition. We have sought to rest our case on the basis of common law evidence - the kind of evidence properly admissible in a criminal prosecution.

And, so, to the charge of delay, even if it be true, we urge our superior claim based on the desire to be scrupulously fair. If criticism is inevitable by reason of our conforming to the strictest standards of the judicial technique, I would much prefer this charge of delay than that we had acted in a manner arbitrary and unfair.

It should not be forgotten that the statute gives our Commission no coercive power in its own right. The Commission must, after the most solemn determination, go as a party litigant to a court and seek the judicial imprimatur before the sanction of law attaches. Moreover, every person made subject to an order of the Commission is permitted to have every step of the proceeding reviewed by a circuit court of appeals of the United States. The factual determinations of the Commission are given finality only when the reviewing court finds them to have been supported by a substantial evidence. This is conformable to the established processes of the law and furnishes unanswerable arguments to any charge that our present method of control is revolutionary.

There is one phase of our detection work which might hold interest for a gathering such as this. It is not necessary to press the obvious conclusion that the detection of a market jiggle is a difficult and protracted assignment. One can readily appreciate that the perception of manipulation and the gathering of factual data can hardly ever be developed by a confession from the culprit.

All of us appreciate that the great stimulus to enforcement comes from the complaints of the "moochers". In some fields, however, a reliance exclusively on complaints gives the culprits a sizable start. This is true for instance of oil royalties where a victim is lulled into a false sense of security by a monthly return which gives no indication to the "sucker" that he is securing a partial return of his capital. It is strange how few investors of this type appreciate that they have bought an interest in a constantly wasting asset. So, also, in manipulation the detection process requires more aggressiveness than is to be expected in the orthodox complaint division. To meet the difficulty and to attain a degree of efficiency necessary for adequate supervision, the Commission has set up a unit charged with the responsibility of exercising a vigilant supervision of trading in securities both on exchanges and in over-the-counter markets. The various types of securities have been classified by industries. The trained personnel has been developed, assigned to observe and analyze the trading in securities of a particular industry. Thus, certain experts are concerned exclusively with trading in securities of transportation and communication companies; others devote their time to scrutinizing trading in utilities securities; still others in mining and petroleum companies, etc.

By this method the economic background of a particular industry is understood and is related to the price moves. An intelligent appraisal of fluctuations in price and volume is thereby possible in the light of current financial conditions and general market trends. Where unusual activities or wide price moves are disclosed, an intensive study of the security is begun. Price and volume figures over a considerable period of time are charted and this information is compared with trading in other securities of the same group; specific financial and statistical information regarding the security under investigation is related to the underlying economic trend of the industry; recent information found in press reports and standard services is collated; reports of trading by "insiders" furnished to the Commission in accordance with Section 16 of the 1934 Act are examined; an inquiry is made for outstanding options, calls, etc.; and finally tipster information, complaints and similar data are scrutinized.

If a study of these various items indicates a likelihood of manipulative activity, a "spot" investigation of the situation is undertaken. An examination is made of all transactions within a reasonable time. On this record the Commission determines whether there is sufficient basis to invoke the legal powers to conduct a formal inquiry. It is only after such careful and scientific inquiry that the extraordinary powers of Section 19(a) are invoked. Of course, the system in operation is far from perfection, but the plan we believe to be excellent. We think the approach sound and workable. We feel confident that in the years to come it will be an indispensable adjunct to an efficient enforcement staff.

One other service given by the Commission might be mentioned. Many of you not only are acquainted with this function, but by your actions

show an appreciation of its value. That is the Securities Violation File established over a year ago by the Commission as an aid to all agencies, official and semi-official engaged in anti-fraud work in the securities field. A record is kept in this file of all official proceedings affecting law violators and securities. This includes indictments, injunctions, stop orders, suspensions, revocations, arrests, and similar information of vital importance to our common cause. The Commission prepares monthly a bulletin of this violation information. I would like to extend to all the Commissioners an unrestrained hymn of praise for cooperation in this very realistic form of mutual assistance, but unfortunately the record prevents my stating this is a fact. A recent examination of our files shows that the officials of twenty states furnish regular reports and the agencies of twenty-seven states have failed to furnish such regular reports. We have special reports from time to time from twenty-three states and none from twenty-four. And, from twelve states we have yet to receive a single inquiry or contribution. Like the pastor to his flock about the collection last Sunday-- no names should be mentioned but the matter must rest in the solemn counsels of your consciences.

It occurred to me that perhaps the details of some of the cases which have enlisted the energies of the Commission might make appropriate telling on an occasion like this. But time compels me to eliminate the flesh and bone and to summarize statistically. The record of the Commission is eloquent on the subject of the propriety of federal action in this field. In the two years of our existence, approximately 25,000 complaints have been received. The sifting of these alone has been a tremendous task. To be sure, many were groundless, very many were the sad tales of the malpractices of the 20's, - some did not involve the mails or interstate commerce, so in turn we had to burden you gentlemen. But approximately one-third of them had to be investigated and from these there have resulted suits to enjoin over 350 individuals and companies; about half the cases have resulted in permanent injunctions against a continuance of fraudulent practices. About 150 individuals now belong to the select group of the permanently enjoined. Nearly 100 more have been put under the shadow of temporary injunctions or have stipulated to discontinue the acts and practices alleged in the bill of complaint. Already 33 indictments have been returned for violations of the Securities Act and numerous other indictments for postal fraud violations have been occasioned by the activities of our staff. Forty-seven individuals have been convicted and sentenced. These statistics obviously do not take into account numerous instances where securities violators have left the business as a result of the Commission's activities. In addition, the closing of the notorious securities exchanges has removed cancerous spots in the investment field.

The Commission by its stop order technique has prevented the sale of approximately \$100,000,000 worth of new securities which failed to meet the truth requirements of the statute. Over \$500,000,000 worth of proposed offerings were withdrawn by the issuers after registration statements had been filed with the Commission largely because of intensive examination. In numerous cases registration of new issues has been permitted to become effective only after important supplementary information has been furnished at the insistence of the Commission. An outstanding example of this work

was seen in the case of a large public utility system registration. The Commission, after investigation, required this great public utility system to set up in its financial statements an adjusted balance sheet which disclosed that had proper accounting and financial practices been followed, the company's assets would have been \$153,000,000 less than the figure shown in the original balance sheet as filed, and that in place of the capital surplus of \$111,000,000 and an earned surplus of \$12,000,000, the company would have a corporate deficit of \$30,000,000.

This exposition of enforcement as I have indicated can hardly avoid the touch of self-glorification, but I hope that it will be a factor to convince you that the work of the Securities and Exchange Commission is a desirable adjunct to your efforts in behalf of honesty in selling and fairness in trading. Personally, I am convinced that the crack of doom has sounded for the large scale interstate swindler. My observation discloses that they are abandoning the business, not, I am sure, in a spirit of reform, but rather because the threat of jail sentence and the heavy expense involved in combat, plus the increased sales resistance of the public, has made them acutely aware of the downward spiral of their enterprises. As for the stock exchange manipulators, I suggest the testimony of an eminent financial writer who a few months ago in a syndicated article, in overtones almost of sadness, told of the hard times that have befallen the large scale operators.

"Lacking any stimulus from Industry's side, the markets have grown stagnant under the influence of a certain amount of trader baiting on the part of SEC designed to protect the investing public...

"Actually the lifting of margin requirements and the inclination of the SEC authorities to regard trading of a support nature as illegal manipulation, the constant investigations of stock movements, the publicity given operations and pool agreements by corporation directors, management and large operators have combined to drive out the speculator. He finds if he is operating on a large scale that it is no longer easy to draw in that public following without which he can get in but cannot get out....."

This record has made all of us in Washington optimistic. We believe that with due allowance for the limitations on effective legal action and the shortcomings of all human beings, the hopes and aspirations of the high-minded sponsors of these Acts are being realized.