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"A FOOL AND HIS GOLD ARE SOON PARTED": DO THEY HAVE TO BE?

An Address By

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Securities and Exchange Commission

North American Securities
Administrators
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During the past sixty plus years we have constructed in this country unquestionably the most comprehensive and sophisticated system of securities regulation ever known. Beginning with the Kansas Blue Sky Law in 1911, the development of regulatory schemes in state after state, reaching perhaps a new level of maturity with the passage of federal legislation in 1933, 1934 and 1940, and continuing down to the adoption of a blue sky law by Delaware in 1973, the sweep of these laws has been constantly extended. Initially drawing upon the experience of the English, where securities regulation goes back as far as 1258 when Edward I moved against unlicensed brokers, we have fashioned our regulatory tools out of our own experiences and those of other countries. Now we find ourselves the objects of imitation. At the Commission we have recently been visited by several people from Great Britain, including a television crew, inquiring how we do our work, for there is presently in Great Britain serious attention being given to the establishment of a regulatory mechanism like ours, including, interestingly and most importantly, explicit criminal penalties for insider trading. Other countries have inquired about the structures and procedures we have developed in this country and have expressed concern over the adverse impact upon their capital markets of laxity in regulation.

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As we have done in other areas - the regulation of barriers, the operations of our courts, the control of public utilities - we have achieved effectiveness in securities regulation notwithstanding the added level of complexity necessitated by our federal system of government. To a stranger looking for the first time at our system of regulation it must appear terribly cumbersome, duplicative, burdensome and wasteful. There was a time when I shared some of those convictions. Why should a document found to be sufficient by the federal authority need to pass muster in dozens of states as well? Why must an offering in more than one state be shaped so that it conforms to the most stringent requirements even though other states are less stringent? Why must a broker duly licensed by the SEC also satisfy a multitude of local requirements - including examinations - before he can do more than gloat over his federal license to friends?

It is the genius of our system of government that, notwithstanding the apparent impossibility of it, we have pragmatically proven that this system can function, but more than that, perhaps perform better than a simpler, more homogeneous system. In some measure that has always been true, but today it is more than ever true that the dual system of securities regulation is functioning well. As all of you know, there is probably more cooperative effort going on today than there ever has been among not only federal and state regulators, but among those governmental authorities and the self-regulatory agencies as well. We are coordinating our enforcement efforts by exchanging information, by selflessly deferring to one another lest there be duplication of effort, by sharing our experiences and by distilling that

accumulation of experience into training courses from which all benefit. We are eliminating unnecessary paperwork by developing a uniform application for registration, membership or license of broker-dealer firms and the financial and operational combined uniform single report (FOCUS): in that effort our initiative has been most generously assisted by you through Hugh Makens, a member of our Reports Coordinating Group. Our regional securities law conferences, jointly sponsored with state authorities, have continued to grow in size and importance. Commenced years ago by my predecessor, Hugh Owens, as liaison to this group, each year has found them better attended - and bigger bargains. When I learned the modest fees charged those attending, being new to the non-profit world of government regulation, I was sorely tempted to put them on a sounder financial footing. My public service instincts prevailed and they will continue to be literally the biggest bargains in securities continuing education to be found.

The proposed American Law Institute Federal Securities Code contemplates a continuation and extension of this spirit of cooperation. It recognizes the duality of our system and rejects the counsel of many that this duality should perish and we should put in its place a single federal system of regulation. I think the Code rejects that approach, not because of political expediency, but because of the recognition of the contribution both the federal effort and the state effort make in the total effort. Recognizing the expertise of the Securities and Exchange Commission born of forty years of pouring over an endless stream of registration statements (although it must be confessed, with the new issue market as it is, some think that stream may be

approaching its end!), proxy statements, periodic filings, and all the other paper that comes to it, the Code would give the Commission primacy with respect to disclosure matters and limit state concern with disclosure to those matters necessary for the implementation of their regulatory function. Nothing would interfere with that regulatory function; states could, as they do now, pursue their own policy decisions with respect to such matters as underwriter compensation, "fair, just and equitable" considerations, and the host of other matters which influence the judgments of state administrators concerning the admissibility of offerings into their jurisdictions. This proposed division of responsibility is founded upon an expectation of continuing an enhanced cooperation and communication among federal and state administrators and would be a ratification of a relationship that already partially exists as a consequence of registration by coordination and other devices. As Professor Loss has said in his comments to the proposed code:

"...[the states'] inability...to require the prospectus to include material not required by the SEC is premised on the assumption that suggestions they may make to Washington by letter or telephone will receive careful and respectful attention of the staff, and that the state personnel will be given ready access to key staff people when the initial examiners do not adopt their suggestions."

I am pleased to see the preservation in the states of their regulatory jurisdiction. Despite my strong advocacy of a strengthened disclosure system, nonetheless it seems apparent to me that disclosure is not enough, that just as we prohibit absolutely the vending of harmful substances having no useful purposes, so someone should have the power to make those judgments with regard to securities having no

value to anyone, and someone should be able to restrict the distribution of securities, just as we limit the distribution of drugs which wrongly used cause harm. While from the vantage point of Washington it is tempting to suggest that the Commission's role should be expanded to encompass this kind of regulation, I think it is better to leave it to the states which are closer to the people and the problems and have proven their ability to deal with such matters.

The inadequacy of disclosure alone in protecting the public is amply demonstrated by events of recent years. Compelling issuers to put "This is a speculative security" or "This is a high risk security" on the prospectus has probably done little except whet the appetites of speculators for quick gains; after all, you don't hit it big unless you speculate or take big risks! Very often the prospectuses put in the hands of investors fail to make the most essential disclosure of all: that management is covering up. The Equity Funding filings with the Commission and the New York Stock Exchange didn't tell the most important fact: that over two billion dollars of alleged insurance didn't exist, that over \$140,000,000 of the assets on the books were just that - on the books and nowhere else. The filings of another glamour company omitted a most important fact: that the heads of the company were phonying the books to soup up earnings.

Every year new and appealing means are found to part people from their money always with assured benefits to the promoter. A couple of years ago it was pyramid schemes and commodity options; now there are confusing and complex real estate deals and coin deals; there are tax shelters with glittering promises. In one, over 3,000 investors

put over \$100,000,000 into something that had all the earmarks of the old Ponzi scheme. As Fortune Magazine remarked, the disclosure the investors got consisted of "...a copy of the 'black book', a simple explanation of ...[the company's] annual program that stressed the tax advantages and the tremendous profits investors would make, all signed, 'Very truly yours'. The calculations in the black books were egregiously simple and optimistic and it does seem remarkable that sophisticated investors would read them without snickering."

Despite our disclosure system and regulatory efforts, billions of dollars are frittered away in this country every year, not in honest speculative ventures that don't turn out well - many of those are the engines that keep an innovative society advancing - but in outright frauds; oil schemes where the proceeds go not into drilling, but into Cadillacs and mansions for the promoters; real estate deals that offer the traditional acreage under the ocean; interests in mines that have lain dormant for years and will continue to lay dormant because they are simply no good.

The bitter fruits of this are social and personal. As Chairman Needham of the New York Stock Exchange and other prominent commentators have told us in recent years, this nation is moving from a time of capital abundance to capital shortage. Mr. Needham estimated that something approaching \$650 billion dollars is the "projected gap between the domestic supply of investment capital expected to be available between 1974 and 1985, and the amount of investment capital that...will be needed to meet our national economic requirements". The plight of the utilities is now well-known. It is a social tragedy that so much wealth goes into the pockets of promoters and knaves instead of into constructive investment the country needs.

And then there is the other cost; the personal cost. The Washington Post described the hardships inflicted upon countless Northern Virginia residents by a smooth-talking promoter who sold them notes with "guarantees" of 25% to 50% return annually, the gain to be derived from dealing in "Portugese industrial wine". There is, the investors know now to their sorrow, no such thing as "industrial wine." One of those who learned this costly lesson was a young lady who had carefully saved up \$5,000 to advance her higher education. Recognizing the escalating cost of schooling, she felt she needed more to assure her continuation in school, so she snapped at the opportunity for a return equal to a quarter or a half of her fund each year. The sad result: a young person whose life and opportunity have been permanently blighted by a securities fraud of outrageous brazenness - and deceptive simplicity.

The Wall Street Journal, after the Equity Funding scandal broke, told the poignant story of an elderly couple which had invested their life savings in Equity Funding in hopes that its extraordinary prosperity and growth would be their lifeline in their declining years. Their reward: penury and lives broken forever.

These poignant and pathetic stories could be multiplied by the hundreds and the thousands! Trusting Americans, despite all the Commission's forty years of endeavor, and even longer for some of your states, bilked out of their dreams, their hopes, their savings, their comforts, their security. We can perhaps take consolation in the fact that probably without our efforts the numbers of these unfortunates would be greater and the losses to the nation more, but nonetheless the memories of these poor victims cannot help but haunt us.

What can be done, not to help these people, for help to them is too late, but to preserve others from this kind of tragedy?

First, I think we should do more to warn investors of the signals, almost universally present, that they are in danger of being taken. Some years ago the Commission prepared and publicized a checklist for investors. Our urgings were these:

- "1. Before buying -- think.
2. Don't deal with strange securities firms. Consult your brokers, banker or other experienced person you know and trust. [This sounds less assuring since several bank presidents were among those bilked in the Northern Virginia scheme!]
3. Beware of securities offered over the telephone by strangers.
4. Don't listen to high pressure sales talk.
5. Beware of promises of spectacular profits.
6. Be sure you understand the risks of loss.
7. Don't buy on tips and rumors--get all the facts!
8. Tell the salesman to: Put all information and advice in writing and mail it to you - Save it!
9. If you don't understand all the written information-- Consult a person who does.
10. Give at least as much consideration to buying securities as you would to buying other valuable property."

We have recently updated and restated these principles and added a series of earmarks of fraud which should alert people, e. g., promises of spectacular returns, pressure to make a quick investment decision, claims that the prospect has been specially selected to get in on the ground floor, etc.

I think all of us must step up our efforts to acquaint people with the signals that warn of fraud. The gains to be had from fraud in selling securities are so great - after all, the overhead and cost of goods are practically zero - that men will take great risks to get the gains. Only if people have been educated to detect the evidences of fraud can they act, as their own guardians against the crooked, the seamy, the sneaks.

I would suggest that every securities regulatory agency give thought to the allocation of some of its resources to an educational effort directed at telling people how they can smell fraud coming at them and what they should do when they get the sniff. It may be that newspapers, radio and television stations (particularly public service ones), and other media can be persuaded to donate space and time on a regular basis to help this program. If access to the public cannot be gained gratis, then perhaps a portion of the budget should be dedicated to that effort.

Second, we all must increasingly impress on attorneys and accountants their responsibilities. No longer may they regard themselves simply as impersonal purveyors of mechanical skills with no responsibility for the use to which their clients put those skills.

Third, our enforcement efforts must be strengthened and promoted vigorously. There is, other than education, nothing that can serve the public better than ferreting out the frauds and putting them out of business, throwing sand in their schemes, making the risk too heavy as compared to the potential gains. This can only be done if we

persuade our respective sources of funds, our executive and legislative authorities, that prevention and punishment of securities fraud is a matter of high priority, that the social cost of it is too great to be borne with equanimity, and then we must show that that money can be used prudently and with maximum benefit.

I should here pay sincere tribute to Congress which is, of course, the authority which finally approves our budget and appropriates funds to meet it. In the last two years the Congress has authorized the full amount we have asked. A goodly portion was intended for the enhancement of our enforcement program: In 1973 the salary budget for enforcement was \$8.3 million, in 1974 \$9.2 million and in 1975 is budgeted for \$10.9 million. Translated into people, it meant about 63 additional people during the year ended June 30, 1974, and it will mean about 104 more in the year ending June 30, 1975. During our budget hearings before the Congressional Committees the sense of importance and urgency which Congress attaches to effective and forceful enforcement of our securities laws was apparent. For instance, Senator Proxmire, during this year's budget hearings, after indicating general opposition to budget increases, said, "In your case, however, I think it is so important that we provide protection in our securities markets, that we provide the fullest possible disclosure, that we provide the assurance to the American people that they are being fully protected, and the cost is relatively so modest . . . For those reasons, frankly, the tenor of my questioning is going to be, why has there not been a larger expansion of the Securities and Exchange Commission to meet the very serious problems which we have, rather than why it has expanded so much."

You and we have many tools with which to cope with malefactors. Through administrative proceedings we can throw them out of the securities business; through injunctions or cease and desist orders (a technique denied to the Commission) we can make the consequences of a repetition of the illegal conduct serious.

But there is another tool that has been, I think, underutilized which can do what civil means like administrative remedies or injunctive proceedings cannot do nearly as well, deter the next would-be crook from preying on the public. This tool is the criminal proceeding.

If one were to judge by the statutorily prescribed penalties for securities law violations, one would conclude the law took such misconduct pretty seriously. For instance, any violation of the federal Securities Exchange Act of 1934 can result in two years imprisonment and a ten thousand dollar fine. A willful violation of the Ohio Securities Law can result in imprisonment for one to five years and a fine up to five thousand dollars. The California Securities Law provides for penalties up to ten years and a ten thousand dollar fine for a violation.

Obviously, since most securities fraud schemes entail more than a single violation and frequently violations into the tens and twenties, the possibility of putting securities crooks away for long periods is substantial.

And yet, that rarely happens. We have the spectacle of the mastermind of a scheme that ruined a bank and two insurance companies,

resulted in numerous indictments of state officials, and bilked the public out of millions of dollars (after pleading guilty to a few of the less sinister offenses) being told by the judge that he was going to give him probation so he could resume his good works for the community and help apprehend the real wrongdoers!

Then there was the promoter of an ill-fated, heavy-with-fraud nursing home venture, who managed to plead guilty to a single count and got a one year sentence (eligible for parole in four months), even though he has reportedly retained much of the gain he realized from his scheme which he will be able to enjoy when he finishes his brief vacation in the federal custody.

I say to you, if we are ever to break the back of the disgusting misuse of the American people by crooks peddling securities, this sort of thing has to stop. Otherwise, year after year, we will "tsk, tsk" anew and lament over the newest victims.

I would suggest the means by which this can be stopped.

First, I think the Commission and state regulators should bring or recommend many more criminal proceedings than they do now. I would particularly like to see this in insider trading cases and other cases in which the harm to the public is direct, immediate and costly.

Second, we must convince federal district attorneys and state prosecutors that these are serious crimes that deserve severe punishment, that it is an incredible inequity, a profound unfairness to society, to send a man to jail for ten years for armed robbery when he steals a few hundred dollars, while a white-collar executive bilks the public out

of millions and either gets probation or a few months in jail. We must encourage the vigorous and relentless prosecution of these cases and not plea bargaining for taps on the wrist. Often prosecutors shy from securities cases because they involve complicated accounting and technical matters which they are not well-trained to deal with. We must persuade them the gain to the public is worth the effort and then lend them every assistance we can in preparing and trying the cases.

Third, we must likewise persuade judges of the seriousness of these matters. The spectre of securities defrauders being sentenced to double-digit years in prison, not rarely, but often, would probably do as much to curtail outright fraud as a doubling of your and our enforcement budgets. Unfortunately, judges, too, often shy away from the lengthy trials that accompany securities cases and countenance plea bargaining followed by minimal sentences. They, too, must realize that the essential harm done the victim of the securities slicker may be the same as or more than that done by the armed robber or the bandit upon whom judges unhesitatingly inflict severe punishment. The consequences of an IOS or Equity Funding or "Portugese industrial wine" fraud are, as a matter of fact, usually worse than the consequences of a robbery; rarely does a robber get a person's life savings, his passport to an education, his assurance of a comfortable old age, but not infrequently the securities crook does. We must translate the tragedy of securities fraud into the terrified eyes of a seventy year old man made destitute, a widowed mother confronted with a lifetime of insecurity, a young couple planning their first home robbed of their thrill. Then perhaps we will truly get a punishment that fits the crime.

Today punishment is a meagre deterrent to those tempted to commit fraud. I think Justice Charles E. Whittaker in 1965 well summarized what must be done:

"There are, of course, first duties of citizenship, but there are also first duties of government. It is undoubtedly true, as recited in the theme of the presidentially proclaimed Law Day, 1965, that 'a citizen's first duty is to uphold the law', but it is also a first duty of government to enforce the law - to do so by prosecuting and punishing those who violate our criminal laws.

"In no other way can our people be secure from assaults and trespasses upon their persons and property or maintain an ordered and moral society.

"Because some of our citizens will not voluntarily perform their 'first duty' to uphold the law, our governments, State and Federal, have the paramount duty of at least making them obey.

"We have all along been told, and many of us have preached, that crime does not pay, but the recent rash and spread of law defiance, and the success - however tenuous and temporary - of that philosophy in attaining goals, seems to compel a reappraisal of that concept, for, from what we see currently happening, one could reasonably believe that certain types of crime are being permitted to pay."

Securities crime must quit being well paid. The consequences of being caught must more and more not be just an injunction, or a license suspension, or even a bar from the securities business, but rather a stiff prison sentence. Then, perhaps, we can claim real success for our enforcement programs.