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PHILADELPHIA

November 10, 1942

Hon. Lyle R. Boren
House of Representatives
Washington, D. C.

My dear Congressman Boren:

I regret the delay in answering your letter of September 23, 1942. It has been caused by my desire to give the very careful consideration which the various questions you have raised require.

You have expressed the belief that a review of the hearings on S. 3255 and H.R. 9634, which in 1938 amended the Securities Exchange Act of 1934, will demonstrate that it was the definite intent of the Securities and Exchange subcommittee of the Interstate and Foreign Commerce Committee to exempt municipal securities completely from the regulatory powers of the Commission.

The hearings to which you refer are those held in 1938, preceding the adoption of the so-called Maloney Act, now Section 15 A of the Securities Exchange Act of 1934, and Sections 15 (c)(2) and (3) of the same Act. These sections did exclude transactions in municipal securities from the regulatory powers therein granted to the Commission. On the other hand, other statutory provisions conferring power on this Commission to regulate security transactions do not exempt municipal securities. I realize that you addressed yourself in your letter to the amendments which were made subsequent to your becoming a member of the Securities and Exchange subcommittee in 1937. I do feel, however, that I should discuss briefly the other provisions to which I refer and which were enacted prior to that time.

The Securities Act of 1933 exempts municipals from that statute's registration requirements. It should be noted, however, that Section 17 of the same Act, denouncing fraud and fraudulent practices, extends to sales of all types of securities, including United States Government, state, and municipal securities.

Although municipal securities are also exempted from the registration requirements of the Securities Exchange Act of 1934, Section 10 (b) of that Act empowers the Commission to adopt rules and regulations regarding manipulative or deceptive devices and contrivances with respect to "any security registered on a national securities exchange or any security not so registered," which, of course, includes municipals.

Furthermore, while Section 15 of the Securities Exchange Act of 1934, as originally enacted, excluded exempted securities from the regulatory powers therein granted to the Commission, in 1936 an amendment was adopted by Congress which clearly brought municipal securities within the powers of the Commission under that section. This amendment as originally proposed authorized the Commission to prescribe all necessary rules and regulations to prevent fraud, concealment, unfair discrimination, or manipulative or deceptive practices in transactions in all types of securities. At the hearings held in 1936 in connection with this amendment James M. Landis, then Chairman of the Securities and Exchange Commission, in commenting upon objections to this amendment raised by dealers in municipal securities, said:

“The objection arises from the inclusion of municipal bonds within Section 15 (c). Section 15 (c) does not exempt municipal securities from its provisions. The reason why it does not do so is because control by the Commission is something that is already established under the existing legislation.

“Section 17 of the Securities Act, as it stands, does not exempt from its provisions municipal securities. It makes it a crime under the Federal law to use the mails or instrumentalities of interstate commerce to commit fraud in the sale of municipal securities.

“Again, Section 10 (b) of the Securities Exchange Act, as it now stands, gives the Commission power to prevent manipulative practices with reference to any security, whether it is listed on an exchange or not so listed, and whether it is exempt or not exempt.

“So far as the phraseology is concerned, it intends merely to give the Commission a power to deal with fraudulent practices, such as concealment, unfair discrimination, and manipulation, with reference to transactions in all securities, whether they are municipal securities, or whether they are ordinary corporate securities.”

Following Mr. Landis' testimony and after an extended conference with municipal bond dealers, as well as representatives of banks and of the National Mayors' Association, he proposed a redraft of Section 15 (c) which met with the approval of those groups and which made manipulative, deceptive, and other fraudulent devices or contrivances in connection with the purchase and sale of securities violative of the Act if carried on through the use of the mails or facilities of interstate commerce. This gave the Commission the administrative power to define by rules and regulations such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent. Municipal securities were not exempted from this provision. When the Securities Exchange Act of 1934 was amended in 1938, Section 15 (c) was preserved unchanged and is not Section 15 (c)(1) of the present statute.

From consideration of the foregoing it seems quite clear that the Congress did not intend to exclude dealings in municipal securities, as distinguished from the issuance thereof, from the authority of the Commission to define by regulations manipulative, deceptive and other fraudulent devices and contrivances. In view of the provisions which I have just discussed and their legislative history, I cannot agree with you that the proposed rule is "a positive evasion of a directive of Congress". I feel sure that these sections - - enacted as they were before you became a member of Congress - - cannot have been called to your attention.

In this connection I would like to refer you to the case of United States v. Central Securities Corporation, in which that corporation; Edwin H. Dickmeyer, its president; Louis F. Conter, treasurer of Lake County, Indiana; and Edward L. Reil, an employee of said county, were found guilty, after pleas of nolo contendere, by the United States District Court for the Northern District of Indiana of unlawfully and feloniously conspiring to violate Section 15 (c)(1) of the Securities Exchange Act of 1934 in the purchase of municipal securities from the customers of that corporation.

You also express the view that in the proposed rule the Commission "assumes the power to set up a new class of exempted securities as distinguished from the exempted securities as defined by Congress." The rule proposed by the Trading and Exchange Division exempts from its operation transactions in securities issued or guaranteed by the United States Government and primary distributions of state and municipal securities. This exemption is, of course, available to underwriters and dealers in transactions which are part of such a distribution. It would appear that such exemption preserves to state and municipal governments complete freedom with respect to the issuance of securities. The proposed rule affects only those transactions in state and municipal securities which take place in the course of ordinary day-to-day trading as distinguished from those which are part of an initial distribution.

The Commission has the power under both Section 10 (b) and Section 15 (c)(1) of the Securities Exchange Act of 1934 to adopt appropriate rules embracing all classes of securities (other than commercial paper, bankers' acceptances, or commercial bills, which are excluded from the Commission's powers under the latter section). In the proposed rule the Trading and Exchange Division is not proposing that the Commission create a new class of exempted securities; it is merely suggesting that the Commission not exercise all of its powers under those sections. It is not proposed to extend the rule to all types of securities, since the Commission's experience has not demonstrated the need for such a rule with respect to United States Government securities and primary distributions of state and municipal securities. On the other hand, many cases have occurred in which dealers have been found to have purchased and sold municipal securities at prices bearing no reasonable relationship to the current market therefor and, accordingly, the Division has concluded that the protection of a rule such as the one proposed should be extended to buyers and sellers of such securities.

In suggesting that certain transactions be exempted from the proposed rule the staff relied upon the following provisions of Section 23 (a) of the Securities Exchange Act of 1934:

I believe that I should make it clear that the Commission itself has as yet taken no position with respect to the proposed rule. It has merely permitted the Trading and Exchange Division to send its suggestions for comment to various representatives of the securities industry. The rule was drafted by the staff of the Division as a result of studies of the over-the-counter market which have made the Division increasingly aware of a practice of dealers to buy from or sell to their customers at prices which bear no reasonable relationship to prevailing market prices. Moreover, it appears that this practice is followed not only in connection with the purchase and sale of securities which are traded exclusively in the over-the-counter market, but also in connection with over-the-counter transactions in listed securities. It also appears that this practice is not uncommon among dealers in municipal securities.

In the past two years the Commission has instituted many proceedings against dealers to determine whether their registrations should be revoked for having indulged in such questionable activities. The Trading and Exchange Division, however, feels that adequate protection to the public in matters of this kind requires the adoption of appropriate regulations designed to make available to customers current information about market prices, or some other equivalent type of information, to assist them in making an informed judgment on each transaction of purchase and sale. They take the position that such a rule would be particularly appropriate at this time when many persons who are uninformed concerning securities find themselves in the possession of excess cash which they are prepared to invest. Moreover, they point out that to police transactions in the over-the-counter market in a manner which will achieve comparable protection to that which will be afforded by the proposed rule, it would be necessary to enlarge materially the Commission's staff and thus increase administrative expenses.

Another consideration which the Trading and Exchange Division puts forward is that the public interest is better served by adopting rules which will forestall fraudulent transactions than by instituting administrative proceedings against dealers who have been guilty of such practices. Not only are such proceedings time consuming and expensive to the Commission and the registrant, but also they do not restore the property of a customer who has been defrauded. Recovery of such property is made additionally difficult because customers frequently find that their rights at law are nullified by the fact that the dealer is without sufficient assets to satisfy their claims. In seeking to protect customers before they have parted with their securities or money, the staff in the proposed rule has followed the disclosure principle of regulation, which is the basis of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Without in the least degree committing myself or my associates to the proposed rule, I sincerely feel that some appropriate means should be found to prevent the purchase

and sale of securities by dealers in the over-the-counter market at prices which bear no reasonable relationship to the prevailing market prices thereof.

You will appreciate, I am sure, that I have not attempted in the foregoing paragraphs to give you my views on all problems which exist with respect to the proposed rule, but have confined myself to those raised by your letter. If you have any additional comments with respect to the proposed rule, I shall be pleased to hear from you further.

Sincerely yours,

Ganson Purcell
Chairman