

THE REGULATION OF SECURITIES MARKETS IN THE UNITED STATES

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Introduction

I have had the good fortune, both while I was a member of the United States Securities and Exchange Commission and since then, to visit many countries, including a number of developing countries, and discuss with regulatory officials and members of the security industry the problems of regulating securities markets. It is evident that any country wishing to secure any significant portion of its capital needs from private sources must necessarily be concerned with the quality of regulation of its securities markets. Potential investors will commit their resources only if they are persuaded the distribution process is accompanied by full disclosure, at a minimum. Further, liquidity is a vital necessity if investors are to be motivated to commit their capital resources; organized and orderly securities markets are essential to that liquidity; and only if those markets are believed to be honest and fair will public participation be widespread. Unless investors are confident that the information upon which they base their investment decisions is "the truth, the whole truth and nothing but the truth," unless they are confident that the markets in which they purchase and sell securities are not manipulated by forces other than supply and demand, they will be reluctant to participate in those markets, and their absence will grievously burden the effort to raise capital from private sources. In countries in which private capital is extensively raised, there has developed a demand for pooled investment mechanisms -- investment companies and the like. The existence of these is a powerful magnet for investment by many who feel they lack the expertise to make solid judgments with regard to investments and who find in these media the means of availing themselves of the expertise of others. Again, the willingness of people to invest through such media depends largely upon their confidence in the integrity of those who run them.

These few simple propositions, of course, cloak a large number of complex issues; regulation of accounting profession, the regulation of takeover bids, the mode of securities market organization, the proper role of government, the extent to which self-regulation is appropriate, and the means best suited to accomplish the objectives.

While the United States has developed a highly sophisticated and extraordinarily intricate scheme for regulating securities and securities markets, I would not suggest that its approach is in any sense a model which others might desirably emulate or that alternative modes of regulation are not as good or better. The United States' system has grown out of its own historical experience, including the traumas of the depression which commenced in 1929, the advent of an activist reform political administration in 1933, and the form of federalism that has evolved in the United States over the years.

There are obviously lessons that other countries can learn from the United States. Similarly, there are lessons the United States can learn from other countries; for instance, I have long admired, and have on occasions publicly advocated that the United States adopt, with appropriate modifications to reflect the differences in the financial institutions and practices and the political climates of the two countries, the way in which the United Kingdom regulates tender offers.

Obviously, it is impracticable to condense a semester's or a year's course on United States securities law into these remarks. However, I would like to summarize for you the principal features of the United States system of securities regulation and then, briefly comment on the way the systems in other Western countries address these same problems.

History of Securities Regulation in the United States

The United States is a common law country. As I am sure you all know that means that many of our legal doctrines and legal mandates have developed through judicial decisions rather than legislation.

As the pace of the world has quickened and as our economy, as well as the world's, has become more complex, we have not been able to afford the luxury of developing law principally through the slow evolving process of judicial decisions and hence a much greater portion of our law is now made by statute. This has been particularly true with regard to securities law.

The first regulation of securities in the United States was indeed a creature of the common law. Traditional common law doctrine forbade fraudulent conduct in the sale of goods, including securities, and generally by statute fraud, if committed with the necessary state of mind, was also a criminal offense. The elements of a fraudulent claim were fairly strict: generally there had to be "privity" between the buyer and the seller, i.e., a direct relationship; there had to be a false representation of a material fact which the defendant knew was false; the defendant had to have made the statement for the purpose of inducing the plaintiff to rely on it; and the plaintiff must justifiably have relied on it and suffered damages as a consequence.

Until 1911, the only relief available to a defrauded securities purchaser was a claim for fraud under either common law (which, it should be noted, had by that time often been codified in statutes). In 1911 one of the less commercially oriented states in the country adopted the first statute regulating securities transactions; this enactment quickly became known as a “blue sky law” since it was, in the words of one of the sponsors, designed to eliminate the practice of promoters promising “blue skies” if an investment was made in their scheme. Between 1911 and 1933 virtually all of the states adopted blue sky laws of one sort or another. In 1933, following the stock market collapse in 1929 and highly publicized, dramatic and disquieting disclosures during Congressional hearings about practices which had been engaged in by ostensibly reputable financial institutions in the marketing and trading of securities, Congress, prodded by the newly elected President, Franklin D. Roosevelt, adopted the first federal securities law having general application, the so-called Securities Act of 1933. During the campaign, President Roosevelt had promised in strong terms that one of his earliest reforms would be of the practices by which securities were distributed and traded on the nation’s exchanges.

The Securities Act of 1933

The 1933 Act was strictly a disclosure act. It was very carefully crafted to avoid giving to any federal authority the power or authority to make any qualitative judgment with regard to securities offered. Unless a security or a transaction was exempt under the terms of the statute, any security offered by interstate means or the mails had to be registered, and mandated information had to be made available to the offerees and purchasers of such securities. In extremely summary form, the statute provided that no security, unless the security or the transaction was exempt, could be offered either verbally or in writing prior to the filing of a registration statement; that between the time of the filing of the registration statement and its “effective” date, only verbal and limited written offers could be made, but no sales could be made; and after the effectiveness of the registration statement, sales could be made, but offers still could only be made orally or through carefully regulated written means.

The 1933 Act contained a list of information which should be included in a registration statement and be made available to investors. This list has been significantly expanded by the Securities and Exchange Commission during the last near half-century and is now considerably more formidable than it was in 1933.

In recent years, significant strides have been made by the Commission, utilizing its rulemaking authority, to simplify the registration and distribution process under the statute, particularly with respect to larger companies about which large amounts of information are available and circulated in financial circles. Thus, a large corporation, such as General Motors, can now file a registration statement consisting of only two or three pages describing the securities offered and the

method of distribution proposed to be used, and the statement can become effective and sales consummated within a couple of days from the time of filing. With the exception of the registration of securities such as those underlying warrants or convertible securities, it was, until last year, the generally accepted rule that only securities which were expected to be offered and sold almost immediately could be registered. By means of a highly controversial rule adopted on a temporary basis last year, it is now possible to register securities that are expected to be offered within the ensuing twenty-four (24) months. In that connection, the Commission has adopted detailed rules governing the updating of disclosure documents and related matters.

The Registration of Securities under the 1933 Act

The “full disclosure” policy expressed in the 1933 Act is presently seen most vividly in the case of a company which is making its first public interstate offering of securities. Such a company must prepare a “registration statement” which contains extensive information concerning the company, its organization, its capitalization, the identity and backgrounds of its officers and directors, the compensation of the highest paid ones, the benefit plans which have been adopted for officers and directors, the properties owned or leased by the issuer, the proposed method of distribution, any material litigation, transactions between the issuer and officers and directors since the beginning of the issuer’s last fiscal year, and, most important, prescribed financial statements, together with an analysis by management of such statements, with particular attention to liquidity, capital resources and results’ of operations. These statements must include balance sheets as of the end of the two most recent fiscal years, and income statements and statements of changes in financial position for the three most recent fiscal years, and in some cases there must be included statements covering the period from the end of the last fiscal year to a date reasonably close to the time of the offering. The full year statements must be accompanied by an opinion of the company’s auditor and must be prepared, not only in accordance with generally accepted accounting principles, but also in accordance with special regulations of the SEC incorporated in what is called Regulation S-X.

The registration statement consists basically of two parts. The first, which contains the information mentioned in the preceding paragraph, is called the “prospectus” and is the document that is widely circulated among potential investors and to purchasers. The second part, which is available to the public but which is not widely circulated, contains certain supplemental information, including schedules supplementing the financial statements, which is not regarded as essential to the decision-making process of investors. In addition, there must be filed with the Commission certain documents, such as the certificate of incorporation and bylaws of the issuer, the agreements relating to the distribution of the securities, material contracts and so on.

Once the registration statement is filed, the securities registered may be offered either orally or by means of prescribed writings. The principal written material used to make offerings during the period before the registration statement becomes effective is the so-called "red herring" prospectus which is contained in the registration statement as filed. This document has acquired its quaint title because of the tradition, originated by rule, that such a document must carry on its face in red letters certain warning information indicating that the document may not be complete and that it is subject to amendment.

Following the filing, the document is reviewed meticulously by the Securities and Exchange Commission. There was a time when to register securities for offering, even seasoned issuers, such as American Telephone and Telegraph, had to file a long, detailed document containing the sort of information described above, and all such documents, even those of issuers which had registered securities frequently, were meticulously scrutinized by the SEC staff and comments made asking for changes which they thought were required either under Commission rules or the more general precept that full disclosure had to be made. Over the last fifteen years the bulk of the documents required to be filed by "seasoned" issuers has been steadily reduced, and in many cases the filings are not examined at all by the Commission staff before they become effective and the sales of the securities made. However, in the case of companies making an interstate public distribution for the first time, it is still customary for the Commission staff to review their filings with intense care and comment, frequently at great length, with respect to changes that should be made to bring them into compliance both with SEC rules and the perceptions of the Commission with regard to disclosures investors need.

If the documents are reviewed by the Commission and comments made, generally any disagreements between the issuer and the Commission staff with regard to disclosures are worked out in conference and then amendments acceptable to the staff are incorporated in a second (sometimes third or fourth) filing. Ultimately, a so-called "pricing" amendment is filed incorporating for the first time the price at which the securities are proposed to be offered and the compensation to be paid to underwriters and dealers in connection with the distribution, and generally promptly after that filing the registration statement is declared "effective," which simply means that sales of the securities may be made. Only the prospectus and certain supplemental information consistent with the contents of the prospectus may be used after the effectiveness of the registration statement in making written offers. Such supplemental information must be filed with the Commission, but it is not usually reviewed in the manner in which registration statements are reviewed and the Commission tends to leave the integrity of disclosures in those documents largely in the hands of the issuer and its counsel.

An initial first offering is usually an expensive undertaking. It is not uncommon for attorneys' fees to run anywhere between \$25,000 and \$100,000, accountants'

fees between \$25,000 and \$75,000, printing bills in the neighborhood of \$15,000 to \$40,000 and other expenses anywhere from \$10,000 to \$50,000. All of these amounts are, of course, in addition to compensation to underwriters and dealers, which in first public offerings of common stock are usually in the neighborhood of 7% to 12% of the offering price. At the present time it generally requires nearly two months from the time of initial filing until sales of the securities may be made.

I would emphasize again that the Securities and Exchange Commission has no authority to pass judgment on the quality of any security as an investment or the fairness of any aspect of the offering; its sole function is to police the disclosure process and to assure that its disclosure rules have been followed and that in general the documents filed and used in the course of the offering do not suffer from any material omission or material misstatement, at least such as would appear on the surface of the document. The Commission does not engage in an investigation of the issuer to determine what the true facts are with regard to it. Generally, the information it has with regard to the company is limited to that which is contained in the filings with it, although it will on some occasions consult industrial manuals and other filings to learn more about the industry in which the issuer is engaged. This limited function is so deeply embedded in the law that each prospectus must carry on its cover a statement that the Commission has neither approved nor disapproved the document and that any representation to the contrary is a criminal offense.

Exemptions from 1933 Act Registration

Not all securities offered and sold need to be registered in the manner prescribed above. The 1933 Act contains a number of security and transaction exemptions. Certain securities are exempted from its registration and prospectus requirements for a variety of reasons, usually because Congress did not regard it as feasible or necessary to subject certain issuers to the disclosure requirements of the Act because of the nature of the issuer or the protections which exist under other laws. For instance, securities issued by the federal, state and municipal governments are not required to be registered; securities issued by banks and savings and loans that are regulated by state or federal authorities do not have to be registered; most commercial paper maturing in nine months or less does not have to be registered; and so on. In addition to the security exemptions, there are also exemptions for certain types of transactions involving securities, which, if offered or sold in different kinds of transactions, might have to be registered.

For instance, offerings of securities by an issuer incorporated, say, in the state of New York which has its business activities largely confined to that state, may be made without registration if the offering is confined to bona fide residents of such state. Lore (and law) familiar to every securities lawyer says that the offer of a security to a single non-resident corrupts the entire offering and in effect gives each purchaser a right to either rescind the transaction or, in lieu of that, recover damages from the issuer. Additionally, so-called "private placements" are

exempt. These are offerings that are limited in scope and number and kind of offerees. The Commission has recently elaborated at considerable length the requirements that must be satisfied if such offerings are to be secure against allegations that the security should have been registered. Generally today offerings may be made to a limited number of institutional and other investors who meet certain financial tests, plus a limited number of other persons who do not meet such tests. With regard to certain types of private offerings there is a requirement that non-institutional buyers be “sophisticated” or have the assistance of someone who is “sophisticated” with regard to financial matters.

In addition, routine transactions on securities exchanges or in the over-the-counter market are not required to be registered.

Since distributions of securities in the United States are generally done “over-the-counter” and not as is the practice in London, through the facilities of an exchange, what is the significance of this exemption? That leads us into another characteristic of the 1933 Act: not only must securities offered through interstate means by issuers be registered under the 1933 Act, but generally there must also be registered securities involved in such offerings made by so-called “controlling persons.” In brief, if a person is regarded as in “control” of an issuer, or is a member of a group which controls the issuer, then, absent an exemption, securities offered by interstate means by that person must be registered in the same manner as securities offered by the issuer. This requirement of the 1933 Act was introduced to preclude issuers from bypassing the registration requirements of the Act by selling large blocks of securities to controlling persons who would then undertake to distribute them. Thus, major shareholders of corporations, principal executive officers, often directors, and others must cause their securities to be registered before they may be offered. As mentioned, routine transactions, limited in amount and manner of sale, do enjoy an exemption, so that such controlling persons can usually dispose of significant amounts of securities through routine securities transactions on exchanges or in the over-the-counter market. Other exemptions comparable to those available for issuers are also available for controlling persons.

In addition to the exemptions discussed there is another exemption known generally as the “small issue exemption.” Under this exemption issuers may offer and sell publicly and in more than one state within a year up to \$1,500,000 of a class of securities without registration (and each controlling person, discussed above, may offer up to \$100,000 in a year); however, a disclosure document similar to, but somewhat shorter than, a registration statement must be filed and used in connection with the offering. The liability exposures are somewhat less in the case of such an offering, but the perils remain nonetheless substantial if the applicable rules are not complied with or the documents related to the offer suffer from a material misstatement or omission.

Penalties under the 1933 Act

The penalties for failure to register securities which are required to be registered before sale and for failure to use the statutorily required prospectus in the manner prescribed are severe. For a period up to three years, the purchaser of such a security may sue to, in effect, rescind the transaction, or, if he no longer holds the security, to recover the difference between what he paid for the security and what he sold it for. In the event that the registration statement at the time it became effective suffered from a material omission or contained a material misstatement, each person who purchased the security, as well as anyone who repurchased the security from him, may sue, again for a period up to three years, to recover damages, not only from the issuer, but from the directors, principal executive officers and underwriters, and, with respect to information contained in the registration statement on their authority as experts, from the accountants or other experts who have consented to the inclusion of their reports in the registration statement. The liability of the issuer is virtually absolute. The others may escape liability if they establish that they made a reasonable investigation and had reasonable grounds to believe and did believe that at the time it became effective the registration statement did not suffer from a material omission or misstatement. There is generally no need for a buyer to show that he relied on the registration statement.

Antifraud Provisions of the 1933 Act

In addition to the provisions relating to the registration of securities and penalties for the violation of those provisions, the 1933 Act also contains an express provision prohibiting the use of misrepresentations and half truths in connection with any offering and sale of securities, regardless of whether the securities are registered or not, and provides a civil remedy for aggrieved purchasers. In addition there is another antifraud section prohibiting such misrepresentations and half-truths, as well as manipulations, schemes to defraud and engaging in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. There is a presently unresolved disagreement among courts as to whether this latter provision provides a private remedy for defrauded purchasers. It is agreed that at a minimum it provides a basis for SEC administrative and judicial proceedings, as well as criminal proceedings.

The Securities Exchange Act of 1934

The 1933 Act did not exhaust the desires of Congress for regulation of the securities industry and securities markets, and it did not exhaust the determination of President Roosevelt, expressed during his 1932 campaign for the presidency, to reform the securities markets. Thus, Congress in 1934 enacted the Securities Exchange Act of 1934. Unlike the 1933 Act which was relatively focused in its approach, the 1934 Act did many things: it created the Securities and Exchange Commission as the agency to administer the federal

securities laws; it established a civil remedy for insider trading; it required the registration of brokers and dealers engaged in interstate commerce and of exchanges; it gave the Commission broad power to regulate securities markets, both exchange markets and over-the-counter markets, and to regulate exchanges and the securities industry in general; it prohibited manipulative practices on securities exchanges; it gave the Commission power to adopt rules governing the solicitation of proxies relating to securities of listed companies; it provided a statutory mechanism for the establishment and enforcement of margin requirements in securities transactions; it required periodic reporting by companies with securities listed on exchanges; and it gave the Commission an extremely broad power to adopt rules to prohibit deception and manipulative practices in connection with the purchase or sale of securities.

Regulation of Exchanges

Prior to 1934 the various exchanges in the United States (and there were some thirty of them in 1934, of which the New York Stock Exchange was by far the largest) were self-regulatory organizations free of any governmental regulation or control, much as, for instance, the London Stock Exchange is now. The exchanges had adopted various rules governing the conduct of their members and, with varying degrees of vigor and effectiveness, sought to enforce them. The hearings which preceded enactment of the federal securities laws clearly indicated that the self-regulatory efforts of the various exchanges had indeed been lax and they were found severely wanting. As a result, in 1934 Congress established the Securities and Exchange Commission as the overseer of the securities exchanges and gave the Commission power to monitor the activities of the exchanges. Notwithstanding this legislation, however, the exchanges were left with a goodly amount of authority and opportunity to exercise self-regulatory functions. In 1975, after a number of securities firm failures, largely because of their inability to handle the volume of transactions which developed in the late 1960s and early 1970s, Congress gave the Commission even broader power to regulate the exchanges, including the power to compel them to adopt any rule which the Commission determined in an appropriate proceeding was necessary.

Regulation of Broker-Dealers

The 1934 Act requires that virtually all securities brokers and dealers engaged in interstate commerce (and this phrase is construed very broadly) register with the Securities and Exchange Commission. Registration may be denied by the Commission on a number of grounds, including a criminal record or the entry of an injunction or administrative order arising out of securities activities within a stipulated period in the past, or for other reasons related to integrity. The Commission has the power to, and does, impose minimum capital requirements on broker-dealers. The Commission's power extends not only to the broker-dealer firm itself and its principals, but also to those who are employed by it in any capacity other than simply a clerical one.

The Commission has adopted a host of rules governing the manner in which broker-dealers conduct their business, including rules with respect to the manner in which their books are maintained, the filing of periodic reports with the Commission, dealings with customers, conflicts of interest, trading activity and a number of other subjects. As discussed below, in addition to these rules the various exchanges and the National Association of Securities Dealers have also adopted rules governing the conduct of their members. And beyond that, as we will discuss in a moment, many states have adopted rules governing in some respects the activities of broker-dealers who operate within them. And finally, in some areas, such as conflicts of interest, the broker-dealers are also governed by common law rules pertaining to the fiduciary responsibilities of agents.

Insider Trading

One of the problems which virtually all countries concerned with securities regulation have wrestled with is that of insider trading. In many countries today such conduct is a criminal offense; Great Britain has recently made it so there. The 1934 Act requires that officers, directors and beneficial owners of more than 10% of a class of equity security of a listed company (in 1964 these and other requirements of the 1934 Act were extended to companies with securities traded over-the-counter which had more than 500 shareholders and \$1 million in assets) to file reports with respect to their holdings and any changes in them. In addition, the 1934 Act provides that in the event such an "insider" profited by buying and selling, or by selling and buying, securities of his company within a period of six months, then the issuer can recover the amount of his gain from him, and in the event that the issuer refuses to bring suit, then any shareholder can on behalf of the corporation. The inducement for shareholders to monitor the conduct of officers, directors and substantial shareholders and to ferret out violations of these sections is the provision that authorizes courts to award attorneys fees when a suit is successful. Today for the most part recoveries are secured under these provisions only when there has been heedlessness or carelessness on the part of an officer, director or shareholder, or when a purchase and sale, or sale and purchase, is found in an "unconventional" transaction. It should be noted that liability under this section of the 1934 Act does not depend at all on whether the one charged actually had or used "inside" information; the test is quite mechanical, with the result that undoubtedly in many instances "insiders" have been found liable when they really had not misused undisclosed material information. These sections act as very strong deterrents to insiders engaging in transactions that run afoul of them.

In addition to this rather mechanical approach to insider trading, the Commission, pursuant to its authority to adopt rules to prohibit manipulative and deceptive conduct, in 1942 adopted what has become the famed Rule 10b-5 which has been a strong tool in securing redress by the Commission and investors for insider trading violations. Rule 10b-5 in language almost identical with one of the

antifraud provisions of the 1933 Act prohibits the employment of any device, scheme or artifice to defraud, the use of untrue statements of material facts or material omissions, or engaging in any act, practice or course of business which operates or would operate as a fraud or deceit, in connection with the purchase or sale of securities. One of the most distinctive characteristics of this rule is that it extends the protections provided in a number of places in the federal securities laws to buyers to defrauded sellers as well.

Rule 10b-5 is a scant two hundred plus words long. However, it has been the source of a staggering amount of civil litigation, both privately and SEC-initiated, and in many cases criminal proceedings. The language of the Rule is extremely broad and it contains no procedural guidelines, such as a statute of limitations, identification of those who are entitled to recover, specification of those who may have liability, the measure of damages and so on. The result has been a profusion of judicial opinions seeking to supply the missing elements in the Rule, and because of our court system, different courts in different parts of the country have reached different conclusions with regard to a number of extremely important issues, including, for instance, how damages should be determined.

Unlike § 16(b) which operates mechanically and regardless of whether the defendant had knowledge of inside information which had not been disclosed, a plaintiff in a Rule 10b-5 action must establish that the defendant purchased or sold securities while in possession of material information which had not been disclosed to the plaintiff or to the public at large. There have been some very substantial recoveries by plaintiffs under these provisions, and in some cases the recoveries have been on behalf of classes of investors who engaged in securities transactions on exchanges or in the over-the-counter market at about the time the defendant was engaging in the allegedly wrongful transactions, even without a showing that the plaintiff and the defendant had engaged in any transaction with each other.

Exactly what constitutes misconduct giving rise to a claim under Rule 10b-5 is still being worked out in the courts. Recent decisions suggest that the defendant must have some sort of “duty” to the plaintiff to be liable for failure to disclose the undisclosed information.

Regulation of Proxy Solicitations

The Commission was also given power in the 1934 Act to adopt rules with regard to the solicitation of proxies to vote the securities of listed companies (again, in 1964 these rules were extended to the issuers of securities traded over-the-counter which met certain threshold standards). Under this authority, the Commission has adopted a complex and far-reaching series of rules which govern any solicitation of proxies on other than an extremely limited scale. These rules prescribe the information which must be furnished to the shareholders solicited. This information includes, in the case of a solicitation for the annual

shareholders' meeting, information about the security holdings, employment history and current occupation of nominees for directors and, if any directors are not up for election, similar information about them, and information about the compensation of top executives and directors and with respect to benefit plans the issuer has for them. If the proxies are sought in connection with an acquisition, merger or similar transaction, extensive information concerning the transaction, including financial statements of the parties, must be included and distributed. There are special rules that govern proxy contests, and whenever such a contest develops, the Commission in effect acts as a referee between the parties, informally resolving many disputes, and in some cases commencing formal proceedings against a participant if it feels its rules have been violated.

An integral part of the proxy solicitation process is the annual report to shareholders. In the United States it has been said that the annual report to shareholders has become a separate "art form." These reports are generally characterized by dramatic photography, expensive paper, attractive typeface and fulsome descriptions of the triumphs (and less fulsome descriptions of the defeats) during the last year.

At one time, the Commission was extremely reluctant to regulate the contents of the annual report to shareholders. However, it has gradually realized that the annual report is a handy vehicle through which to assure that certain minimal information is furnished to shareholders. Thus, the Commission now requires that annual reports contain certified balance sheets for the preceding two fiscal years and income and change in financial position statements for the three preceding fiscal years, an analysis by management of the financial statements, a description of the company's business, information with regard to segments of the company's business, dividend and stock price data and other information. The annual report is linked with the proxy statement in several ways, including a requirement that the proxy statement must be accompanied by or preceded by an annual report containing the required information and by the provision that certain of the proxy statement requirements can be satisfied by "incorporating by reference" information contained in the annual report.

Shareholder Proposals

A novelty in American securities law is the express provision of a right to shareholders to submit proposals at shareholder meetings. This right has been availed of frequently by shareholders, in most instances by shareholders who are carrying the banner for one cause or another. Many of the proposals have direct relevance to the affairs of the corporation, such as proposals to require the grant of preemptive rights to shareholders, to limit options awarded to executives, and to provide cumulative voting for directors. Many proposals are socially oriented, such as proposals that the shareholders adopt a resolution barring the company from doing business with South Africa; requiring disclosure with regard to hiring policies; forbidding the company to manufacture certain types of armament; and

so on. Fashions in shareholder proposals vary from year to year, depending upon the topics which have been newsworthy and noteworthy in recent times. While rarely, if ever, does a shareholder proposal command a sufficient majority to be adopted, nonetheless it is the opinion of commentators and observers that they have frequently created pressures upon management to bring about substantially the changes sought by the resolution. The Commission has adopted rules governing the length of statements which can accompany proposals, the length of the company's statement in opposition to them, the time when they must be submitted and the like. The Commission has adopted standards as to what kinds of proposals can be submitted (e.g. , resolutions seeking redress of personal grievances are forbidden). As you may well guess, there is frequently controversy between proponents and issuers about these matters, and again the Commission acts as an informal arbiter. Sometimes this role fails and litigation ensues. The Commission's attitude toward proposals has been fairly liberal, but notwithstanding that, there is generally in corporate circles fairly widespread satisfaction with the way in which the Commission has administered these rules.

Periodic Reports

The 1934 Act also gave the Commission power to require listed companies (and again after 1964, the larger over-the-counter companies) to file periodic reports. These consist presently of an annual report which in effect updates the information which would be required in a full registration statement for the distribution of securities, and a quarterly report which principally consists of interim financial statements. In addition, upon the occurrence of certain events of significance, such as material acquisitions and mergers, an issuer is required to file promptly a report giving detailed information about the event.

Regulation of Accounting

An important aspect of the Commission's policing of disclosure is its authority to prescribe the contents and format of financial statements included in documents filed under the 1933 and 1934 Acts. This is generally construed to give the Commission authority to, in effect, establish accounting principles insofar as SEC-filing companies are concerned. Since 1938 the Commission has delegated the responsibility for establishing accounting principles to the accounting profession, subject to Commission oversight. Very rarely has the Commission overridden the determinations of the accounting profession, notwithstanding contentions in Congress and among academics that the Commission has improperly abandoned its Congressionally-mandated responsibility to establish such principles. There is a continuing dialogue between the Commission staff and members of the accounting profession, especially those with responsibility in the standard setting area, which has resulted in Commission sensitivity to the practical concerns of the accounting profession and the profession's sensitivity to the public interest concerns of the Commission.

As a part of its involvement with the accounting profession the Commission has asserted, with the support of several court decisions, the right to discipline accountants who participate in securities law violations or violate their professional standards of ethics. In such proceedings the Commission may bar an accountant from opining with respect to financial statements filed with the Commission or in any other way practicing before the Commission either permanently or for a stipulated period of time. As a part of settlements in such proceedings the Commission has secured agreement by firms charged that their SEC personnel will attend continuing education programs, that they will institute second partner review of SEC filings, and that the firm will not take on new SEC engagements either firm-wide or in specific offices.

The National Market System

As a consequence of increasing pressure for the development of a national market system which would link all exchanges and over-the-counter market makers, in 1975 the Congress awarded to the Commission extensive power to take measures to facilitate the development of such a system. Thus, the Commission now has power to make and enforce rules for depository institutions in which securities are deposited and for securities processors, who have responsibility for transferring shares. Without attempting a great deal of detailed discussion, it might be noted that progress toward a national market system, while it is occurring, is presently moving at a very slow pace and increasingly voices are heard suggesting that perhaps the enormous effort which has been expended so far to accomplish a national market system has produced very minimal benefits to investors.

Margin Regulation

Under a complicated compromise developed in 1934, responsibility for the development of margin rules and their enforcement was lodged in the Securities and Exchange Commission and the setting of margin requirements in the Federal Reserve Board. At the present time in the United States the minimum margin required for equity securities is 50%.

Regulation of Tender Offers

In 1968 the Congress amended the 1934 Act to deal with the increasingly urgent problem of tender offers. Its purpose was to assure a fair balance between offeror and offeree corporations and protect investors. In doing this Congress took two approaches: one, disclosure; and two, substantive regulation. It prescribed certain minimal disclosure requirements and empowered the Commission to expand them, and it laid down certain rules with regard to the manner in which tender offers should be conducted. For instance, it prescribed by indirection a minimum period during which an offer had to remain open; periods during which securities tendered might be withdrawn; and that securities

deposited during a stipulated period had to be purchased on a pro rata basis if the offer was for less than all shares of the class and more than the amount proposed to be purchased were tendered. These specific disclosure and substantive requirements apply only to listed companies and the larger over-the-counter companies.

In addition, the Commission was given broad power to adopt rules to prevent fraud, manipulation and deception in connection with all tender offers, regardless of whether they related to companies registered under the 1934 Act or not. The Commission also received power to prescribe rules governing repurchases of securities by issuers, and it has exercised that power by adopting several rules governing tender offers by issuers for their own shares and market repurchases. There has been an increasing concern with the effectiveness of the statutory and regulatory prescriptions with regard to tender offers, with the result that the Commission has now organized an advisory committee, consisting principally of people expert in such activities, to make recommendations with regard to these matters.

To assure disclosure when someone was building a position in the securities of a company, perhaps with an eye to the commencement of a tender offer, the statute also requires disclosure of certain information by anyone, or any group, which acquires more than five percent of a class of equity securities of an issuer registered under the 1934 Act (that is, one with securities listed on an exchange or having more than \$1 million of assets and 500 shareholders).

The Securities and Exchange Commission

The 1934 Act created, as the administrative and enforcement mechanism for the federal securities laws, the Securities and Exchange Commission and gave it broad powers. The Commission consists of five persons, appointed by the President and subject to confirmation by the Senate, who are appointed for staggered terms of five years. One of the Commissioners is designated by the President as chairman, who serves as such at the pleasure of the President. Not more than a majority of the Commissioners can be members of the same political party, with the result that typically there will be three Republicans and two Democrats, or vice versa. The Commission has a staff of approximately 2,000 persons, including large numbers of attorneys, accountants, economists and financial analysts. It operates from a headquarters in Washington, and has at the present time nine regional offices. The Commission has the power to take a variety of actions related to its responsibility to monitor and oversee the securities markets, public distributions of securities, the securities industry, investment companies, public utility holding companies, investment advisors and activities related to the securities industry. It may, in appropriate cases, initiate so-called "administrative proceedings." These are complaints brought by the Commission, usually against persons registered with it or associated with persons registered with it, or against professionals, such as attorneys and accountants. These

proceedings can result in a person or a firm being barred from the securities industry or practice before the Commission permanently or for a specified time, or the imposition of some lesser penalty. Particularly controversial has been the Commission's use of administrative proceedings to discipline attorneys whom it charges were involved in client securities violations or failed to conform with ethical standards of the profession.

The Commission may also bring an action in the United States federal courts seeking appropriate relief, which usually consists of an injunction against the continuation of prohibited activity and, in some cases, notably those involving insider trading, disgorgement of the gains resulting from the prohibited actions. The Commission has recently asked Congress to permit it to bring actions seeking triple damages in the insider trading cases.

The Commission can also in an appropriate case issue a "stop order" with respect to a registration statement, thereby preventing it from becoming effective until whatever deficiencies of disclosure it suffered from are remedied, or if the action is instituted after the effectiveness of the registration statement, the continuation of the offering. The Commission may also under the 1934 Act initiate an administrative proceeding to compel correction of false filings under that Act.

Finally, if the Commission regards a violation of the federal securities laws as sufficiently serious, it may recommend to the Justice Department that it bring a criminal action against the alleged culprit. While such proceedings have not been frequent in insider trading cases, nonetheless, the Commission has recommended criminal proceedings in some cases and secured convictions.

The Investment Company Act of 1940

In 1940 Congress enacted two additional securities laws: the Investment Company Act of 1940 and the Investment Advisors Act of 1940. The former was an outgrowth principally of perceived conflicts of interests and abuses of fiduciary duty by some of those engaged in managing investment companies.

The statute is a complicated one and combines extensive substantive regulation with disclosure requirements. Central to the regulatory scheme are the provisions which require Commission approval of any transactions between the investment company and its adviser, underwriters, directors, officers or other affiliates or persons deemed under the statute to have a "controlling influence" over the affairs of the investment company. This substantive regulation extends not only to transactions between the investment company and various parties, but also those in which the investment company and such a party have a joint interest.

The advertising practices of investment companies are in part regulated by the Commission and in part by the National Association of Securities Dealers. There

have been enduring and persistent complaints from the investment company industry about the restrictions on advertising imposed by the Commission and the NASD. In response to these complaints, the Commission has recently proposed a substantial loosening of the restraints on investment companies, a reform instigated at least in part by the developing competition between investment companies (particularly money market funds) and banks and savings and loans, which as the consequence of recent legislation have been permitted to pay market rates of interest with respect to many accounts.

Investment companies are subject to significant restrictions on the number of directors they may have who are "interested." The management contract between the adviser and the investment company must be approved by the independent directors and the contract must be periodically reapproved by the shareholders of the investment company. Investment company advisers are subject to suit if their fees are in amounts which constitute a breach of fiduciary duty, and there have been a number of suits charging that. The Commission has recently proposed that the investment company industry organize a self-regulatory organization to perform inspections of investment companies which have heretofore been done by the Commission at lengthening intervals. The investment company industry is presently considering this proposal, and if arrangements can be developed to avoid what some in the industry regard as a likely duplication of fees, it is likely that such a self-regulatory organization will be undertaken.

The Investment Advisors Act of 1940

The Investment Advisors Act of 1940 is perhaps the least restrictive of the statutes administered by the SEC. Basically it is simply a registration statute: any investment adviser having fifteen or more clients must register under the Act. Registered advisers are subject to certain restrictions with regard to the fees that they may charge (while they may charge fees based upon the size of the accounts which they manage or advise, they may not be compensated on the basis of their performance except under a very limited formula). As a consequence, less because of the Investment Advisors Act than Rule 10b-5 and common law fiduciary principles, investment advisers are held to a high standard of conduct in their dealings with those whom they advise and funds which they manage. For instance, they are prohibited from "scalping," a practice whereby an adviser managing substantial amounts of money purchases a security in advance of purchasing it for the accounts he manages, which purchases may create a demand pushing the price up. Unlike non-clerical employees of broker-dealers, there is no necessity for investment advisers to pass any examination or give any proof of competence.

In addition to the statutes discussed above, the Commission also has administrative responsibility with respect to the Securities Investor Protection Act under which brokerage accounts are insured and with respect to public utility

holding companies engaged in a gas and electrical distribution activity. The Commission also has responsibilities under the bankruptcy law when the bankruptcy or reorganization involves a company with publicly held securities.

State Regulation of Securities

Had the United States only a federal system of securities regulation, I think we would agree after this review that indeed it would be complex enough. However, the United States is characterized by a federal system of government, and, as I remarked earlier, the first statutory regulation of securities occurred at the state level. At the present time all 50 states have some sort of state securities regulation. Basically, these state laws fall into three categories. The first type is simply an antifraud statute which prohibits fraudulent conduct in connection with the purchase or sale of securities. Generally there is no administrative agency established to administer the law, although usually some enforcement powers will be vested in the state's attorney general.

A second type of state law prohibits anyone from acting as a broker or dealer in connection with securities transactions unless the person or organization is registered as a broker-dealer under the state law. This type of regulation is frequently accompanied by an antifraud provision similar to that mentioned above.

Finally, a substantial number of states have in one degree or another what is referred to as "merit regulation." These states prescribe disclosure requirements in connection with the distribution of securities which are generally parallel to the federal requirements. In addition, such states vest in an administrative agency the power to prohibit the offering of securities in the state if the offering fails certain tests. Depending on the particular state, an administrator may, among other reasons, refuse to allow the offering to be made if underwriters' compensation is excessive, if the offering price is excessive in relation to the historic earnings of the issuer, if insiders and underwriters are given too large an amount of options, or if substantial amounts of securities were sold to promoters and insiders at prices substantially below the public offering price. Sometimes state administrators will require that securities purchased by insiders and promoters at low prices in relation to the public offering price be escrowed, that is, held in a sort of trust beyond the reach of the owners, until certain conditions are satisfied, usually the attainment of a prescribed earnings level by the issuer.

States with this kind of regulation have been particularly active in dealing with specialized kinds of offerings, such as interests in oil and gas promotions, interests in real estate, investment companies and similar investment media.

States which have "merit" regulation usually also have antifraud statutes and broker-dealer registration statutes.

Increasing efforts have been made to coordinate state requirements and practices with those of the federal government. For instance, usually the disclosure requirements of the states can be satisfied by filing the registration statement filed with the SEC. Similarly, a good deal of progress has been made in coordinating the broker-dealer registration requirements of the states and the federal government. And finally, a strong effort is underway, but with no assurance of ultimate success, to coordinate the so-called "private offering" exemption provided by the Securities Act of 1933 and the rules adopted by the Commission thereunder with similar exemptions under state law.

The effectiveness of state regulation varies in vigor and competence. Some states have long-standing reputations for being "tough" states with severe rules and strong enforcement.

Beginning in 1969, some 37 states adopted statutes intended to regulate in one degree or another tender offers. In many instances the statutes went considerably beyond the federal statute and required additional disclosures and pre-offer publication and notification to the issuer, and provided for administrative proceedings to determine the adequacy of disclosure and, in some cases, the fairness of the offer. Recently, the United States Supreme Court determined that one of these statutes was unconstitutional because it improperly interfered with interstate commerce. It is probable that the scope of this decision is broad enough to embrace a number of the state statutes. However, there are indications that efforts will be made at least by some states to find a formulation which will withstand constitutional attack.

Self Regulation in the Securities Industry

In addition to federal and state regulation, a good deal of regulation of the securities industry is done through self-regulatory organizations. Prior to 1934 the exchanges were the principal mechanisms by which the conduct of the securities industry was regulated. They prescribed capital requirements for their members, adopted and enforced rules with regard to relationships of members with the public and developed rules governing trading practices on their floors.

The Securities Exchange Act of 1934 preserved this self-regulatory function of exchanges, but placed many of their activities under the oversight of the SEC. In 1938 Congress amended the 1934 Act to promote the organization, without infringement upon the antitrust laws, of national securities associations which would have certain characteristics. The only association organized under this provision has been the National Association of Securities Dealers which in many ways performs a function with respect to over-the-counter trading and broker-dealers engaged in it similar to the functions of the exchanges. It is also the operator of the NASDAQ quotation system and the newly-emerged National Market System, which is an extension of the NASDAQ system and provides last

sale information with respect to a growing list of companies which are traded over-the-counter; that number is now approximately two hundred.

The exchanges (of which there are now ten registered with the SEC) and the NASD conduct examinations with respect to the competence of those who wish to become "registered representatives" and in numerous respects govern activities of broker-dealers. They periodically examine the operations of broker-dealers to determine whether they are in compliance with the securities laws, and they investigate alleged violations of the federal securities laws and their own rules, including a rule that members abide by "just and equitable principles of trade." These organizations have the power to expel or suspend a member or any of its registered representatives or officers and other affiliates and to bar for a stipulated period an individual from being associated with a broker-dealer. They are empowered to conduct hearings with respect to alleged violations and to impose these penalties. Their determinations are appealable to the Commission, and from the Commission to the courts. It might be noted that the Commission itself also conducts examinations of broker-dealer firms and has the power to suspend or revoke licenses which it has granted to broker-dealers and their non-clerical employees. These proceedings are conducted in what are known as "administrative proceedings," that is, they are not conducted in a formal court but rather before an administrative law judge who is, notwithstanding his employment by the Commission, expected to be impartial as between the agency and those charged by it. Determinations of administrative law judges are also appealable to the Commission and after that to the courts.

All rule changes proposed by self-regulatory organizations must be approved by the Commission, and in addition, the Commission has the power to compel exchanges and the NASD to modify their rules and to adopt rules which the Commission determines to be necessary or desirable. The Commission periodically examines the exchanges and the NASD to determine their compliance with federal securities law and the extent to which they are exercising properly and effectively their self-regulatory functions.

The relationship between the Securities and Exchange Commission and the exchanges, particularly the New York Stock Exchange, has not always been smooth. During the late 1960s and early 1970s many New York Stock Exchange firms failed largely because of inadequacy of capital to handle the surge of business during that period, which was accompanied by severe difficulties in handling the paper work associated with that volume. As a result, the Commission tightened its oversight procedures and Congress responded by adopting the Securities Acts Amendments of 1975 which broadened the powers of the Commission over self-regulatory organizations and subjected those organizations to new restraints and requirements.

Various procedures have been worked out among the self-regulatory organizations and between them and the SEC to avoid duplication of functions

and overlap of activities. Notwithstanding these efforts, there still remains a good deal of such duplication and overlap, but efforts to reduce it are continuing.

Of course, in addition to their regulatory functions, the exchanges and the NASD also operate hotly competitive marketplaces, in the case of the NASD, the National Association of Securities Dealers Automated Quotation System which utilizes advanced electronic means to communicate quotations on over-the-counter securities and increasingly is developing electronic means of execution.

Conclusion

A few brief remarks in conclusion. The reach of the federal securities laws is wide. While the registration provisions of the 1933 Act only relate to distributions, and while many of the provisions of the 1934 Act apply only to companies that are publicly held, nonetheless several provisions of both those Acts impact any securities transaction, regardless of the size of the enterprise, the number of shareholders or the kind of transaction, as long as it involves a purchase or a sale of securities. Thus, as an example, a merger between two privately held companies is regarded as entailing a sale of securities on the part of the acquiring company, and shareholders of the acquired company may maintain an action in the federal courts alleging that they were misled or defrauded in connection with their consent to the transaction.

A principal means of enforcement of the federal securities laws has been the so-called private right of action. In a number of instances in the federal securities laws it is specifically provided that persons allegedly harmed may maintain an action against the alleged culprit, and if they are able to prove their case, secure relief. In other cases the courts have implied the existence of such a right even though it was not specifically provided. An example is Rule 10b-5, which has been the source of endless complex and voluminous litigation. While the Supreme Court has shown a tendency in recent years to refuse recognition to implied causes of action, it recently strongly affirmed that there was an implied cause of action under § 10(b) of the 1934 Act with respect to fraud, deceit, manipulation, misrepresentation, omissions and the like used in connection with the purchase or sale of securities.

I indicated at the beginning that the mode of regulation in the United States may indeed be inappropriate for other countries. I am sure that after listening to this recital of the complexities of our securities regulation, many of you will conclude that indeed that judgment was eminently correct.