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STATEMENT BY LOUIS LOSS, PROFESSOR OF LAW, HARVARD UNIVERSITY, IN HEARINGS BEFORE THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE OF THE HOUSE OF REPRESENTATIVES ON S. 2846, A BILL TO AMEND CERTAIN PROVISIONS OF THE SECURITIES ACT OF 1933, THE SECURITIES EXCHANGE ACT OF 1934, THE TRUST INDENTURE ACT OF 1939 AND THE INVESTMENT COMPANY ACT OF 1940

For a period of almost fifteen years, I was on the legal staff of the Securities and Exchange Commission -- for the last four years as its Associate General Counsel. On September 1, 1952, I resigned to accept an appointment as Professor of Law at the Harvard Law School, where I am working in the general area of corporation law with particular emphasis on the SEC field.

In the long negotiations with the representatives of the securities industry which preceded the hearings before this Committee in the months immediately before and after Pearl Harbor, I was a member of the Commission's staff committee. During my last few years with the Commission I was chairman of a similar legislative committee, and in that connection I had the privilege of appearing several times before this Committee and the Senate Committee on Banking and Currency.

This background has given me, I think it fair to say, an intimate knowledge of the problems which are sought to be solved by the present bill and the long effort to achieve an appropriate legislative solution. It is therefore a particular pleasure for me to give this bill my wholehearted endorsement, for whatever value that expression of view may have to the Committee. By solving a number of troublesome problems of an essentially technical character,

the enactment of this legislation should improve the administration of the statutes, especially the Securities Act. It involves no conflict, so far as I can see, between the interests of those who are regulated and the interests of the public. And -- perhaps as important as anything -- this is by far the simplest bill which has come out of the last fourteen years of negotiation.

Almost from the very enactment of the Securities Act, it has been apparent that there is inherent in Section 5 a basic conceptual conflict. On the one hand, any form of solicitation by use of the mails or interstate facilities before the effective date of the registration statement is categorically forbidden. On the other hand, the whole theory of the waiting or "cooling" period is that the information contained in the registration statement will be disseminated, so that the investing public will be able to make an intelligent determination whether to buy when the statement becomes effective. But it is rather unrealistic to expect that people who have things to sell will "educate" prospective buyers as to their merchandise without in any way puffing their wares. As I have elsewhere had occasion to point out, the concept of a reluctant salesman is probably as visionary as the dream of a Nation without a thirst. And I am afraid that the effect of the present Section 5 has been much the same as the effect of our late Prohibition experiment so far as concerns enforceability and respect for law generally.

In order to make Section 5 work at all, the Commission has had to invent the fiction of the "red herring prospectus." I call it a fiction because I deem it self-evident that, from any realistic point of view, the dissemination of "red herring prospectuses" is

the first step in the successful distribution of an issue of securities. To call the "red herring" device a fiction is not to condemn it. Legal fictions are sometimes necessary in our complex civilization, and this Committee itself pointed the way to this solution of the Section 5 dilemma in its 1933 report on the bill which became the Securities Act. But so long as the law makes it unlawful to offer securities before the effectiveness of a registration statement -- with the possibility always present of serious civil liabilities even if we disregard the fact that after all a willful violation is declared to be a felony -- there will not be that degree of dissemination of information which is essential to the successful operation of a statute based on the disclosure philosophy.

I am afraid, too, that so long as the present Section 5 stands there will always be violations through interstate telephone conversations. I shall not say that the prohibition against pre-effective selling effort by interstate telephone could not be enforced if there were really a will to enforce it. But I don't think that anyone in a free society would relish the methods that would have to be used if the enforcement of such a prohibition were to be made effective.

The present bill, by frankly legalizing pre-effective offers when made orally or by means of the so-called "tombstone ad" or a short form of prospectus processed by the Commission, will make it unnecessary to resort to cumbersome fictions in order to accomplish the very aim which Congress had in mind when it enacted the Securities Act. It simply calls a spade a spade. And it is a reform which is long overdue.

It is true that this bill, while discarding the old distinction

between solicitation and diseemination, substitutes a new distinction between making offers and making contracts to sell. But this latter distinction is much clearer, and one with which the common law has had a great deal of experience. It will simply be necessary for the seller to stop short of making "offers" in the common-law sense of the term, so that he will not put it in the power of the prospective buyer to accept and thus create a contract. Sellers will in substance solicit offers to buy, which <u>they</u> will then accept after the effective date. This, it seems to me, should cause very little trouble.

Perhaps the next most serious problem in the administration of the Securities Act has been the difficulty of achieving a relatively concise and readable prospectus. This again is a difficult problem, because it is unrealistic to expect to be able in the modern financial world to form an intelligent investment decision on the basis of a document which will make good bedtime reading for the average investor. Furthermore, so long as Section 11 imposes civil liabilities for omissions to state material facts, issuers and underwriters and their lawyers are going to be reluctant to cut and condense. On the other hand, civil liability cannot be the only explanation for the long prospectus. In England, too, there is much the same civil liability. Indeed, our Section 11 was largely modeled on the comparable provision in the British Companies Act. But in England there is no SEC. Prospectuses are merely filed with the Registrar of Companies and after a three-day waiting period the seller is free to offer. So perhaps both industry and government must share the blame for the longer prospectuses in this country, just as both can share the credit for the progress that has been made in the last ten or fifteen years in

cutting down the prospectus. Nevertheless, much remains to be done and this bill should make the job easier. Certainly it would make a good deal of sense to require less information in respect of those companies which have filed annual reports for a period of years in connection with the listing of their securities on an exchange, and which have maintained a minimum earnings and dividend record.

Another sore point has been the requirement in Section 4(1) that all dealers use a prospectus for one year after a registered offering. The proposal to cut this substantially to forty days seems to me to be sound. As I have told the Commission, I do have some trouble with the language of the amendment to this section. But this is purely as a drafting matter.

It seems to me that there is also a good case for increasing the Commission's authority to promulgate exemptive rules under Section 3(b) from $300,000 to $500,000. Of course, everybody wants to help small business, and, although studies indicate that their higher cost of financing is due primarily to the greater expense of merchandising small issues than the expense incident to registration, nevertheless the increased exemption should help somewhat. But it should not be forgotten that, almost in the nature of things, this is also the area in which most of the fraud problems are apt to arise. I think, therefore, that it would be a grave mistake to permit public financing in these amounts without the modicum of disclosure and control which are afforded by substantially the present Regulation A, as distinct from the very lax regulation which was in effect from 1941 until about a year ago.

I shall not comment on the other proposals unless members of

the Committee have any questions to ask me. In my opinion they are all steps in the right direction -- particularly the amendment of the provision on the thirteen-month prospectus and the new procedure for registering investment company securities. I might add that I was happy to learn that the Commission apparently plans to correct the _Haupt_ doctrine by appropriate rule. It has seemed to me since shortly after the _Haupt_ case was decided in 1946 that the solution there attempted to the problem of using the brokerage exemption as a device for making a secondary distribution without registration was not worth the difficulties which it created.

There are three points which I should like to make in conclusion:

First: This bill, important as it is, should be viewed not as the end but as the beginning of a much-needed legislative reform in this area. The Securities and Exchange Commission, apart from its advisory duties in corporate reorganizations under Chapter X of the Bankruptcy Act, administers six highly complex and novel statutes which were passed at six different sessions of the Congress. However well they may have been drafted and administered, it would be incredible not to expect a certain number of overlappings, gaps and ambiguities after fifteen or twenty years of actual experience. Ideally these six statutes should be reexamined and integrated into a Federal Securities Code. Here we could learn a lesson from the English, whose legislation in this field does not go nearly as far as ours but is much older. Every twenty years or so the Board of Trade has appointed a distinguished committee to perform the difficult and technical task of reexamining the Companies Act and suggesting amendments to Parliament. The last committee was the so-called Cohen Committee, whose

comprehensive report in 1945 led to the amendments of 1947 and the new Consolidated Companies Act of 1948. It is my impression that these periodic reexaminations are handled essentially on a non-partisan basis in England, just as, happily, a non-political approach to this highly technical legislation has been developing in our own country. A few years hence, when the integration and simplification program under the Holding Company Act has finally been completed, might be a good time to institute a general reexamination and codification of all the SEC statutes.

Secondly: Any such reexamination should be a two-way street. It should seek to eliminate not only unnecessary overlappings and complexities but also illogical gaps in the overall statutory scheme. Today, for example, if an electric or gas subsidiary wants to float a bond issue, it must comply separately with the Securities Act, the Holding Company Act and the Trust Indenture Act -- all of which have different definitions, exemptions, rule-making sections, appeal provisions and whatnot. And if the bonds are to be listed on an exchange there must be a registration under the Exchange Act. The Commission has done a good deal by rule to permit incorporation by reference and so on. But in an integrated Securities Code there would presumably be one registration, with suitable amendments and supplements. On the other hand, just as there are needless overlappings, there are senseless gaps in the present scheme of things. It makes no sense to me, for example, to regulate the proxy solicitations and insider-trading practices of Company A just because its shares happen to be listed on a stock exchange, but not the similar solicitations and practices of Company B, which has as many assets and as many stock-

holders but has never listed (perhaps for the very purpose of avoiding such controls). If the proxy rules or any other statutory provisions or regulations are bad, they should be amended or repealed. But if they are sound they should be applied equally to all companies of a given size and a given degree of public ownership.

Thirdly: Although a certain degree of positive regulation will continue to be necessary -- especially in the holding company and investment company fields -- there should be no departure from the basic philosophy of disclosure so far as the Securities Act and much of the Exchange Act are concerned. A regulatory type of Securities Act, which permits government to decide which companies shall have access to public capital, may be all right for those individual states which want it. But I shudder to think of its implications on the national scene. With all its faults I think the disclosure scheme of the 1933 and 1934 Acts has been basically successful. Certainly it is more consistent with the traditions of a free enterprise system. All it needs is an occasional overhaul.