For Release June 6, 1957, Noon Chicago Time

HIGHLIGHTS IN CURRENT FINANCIAL REPORTING

Address of

J. SINCLAIR ARMSTRONG

Former Chairman
Securities and Exchange Commission
Washington, D. C.

before the

1957 Annual Meeting

of the

ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Chicago, Illinois

June 6, 1957

It is a great pleasure for me, as a Chicago lawyer who has practiced in the field of corporation law and finance and has served for two years as Chairman and four years as a member of the Securities and Exchange Commission, to have an opportunity to discuss with the Illinois Society of Certified Public Accountants "Highlights in Current Financial Reporting." The observations I am about to make were written at a time when I was Chairman of the Commission, but as I deliver them here today I speak not for the Commission. I will express my own views and these may not necessarily reflect the views of the Commission, and, as must be obvious, they have not been submitted to or reviewed or approved by the Navy Department.

I will discuss a number of topics which may appear more or less unrelated, but which are all vitally important to the accounting profession and to the continued development by the profession and the Commission, working in cooperation and harmony, of high accounting and auditing standards in the United States. This in turn is vitally important to our free enterprise system in which our productive facilities in this country are owned, through the medium of corporate securities, by the investing public.

First, I will speak of developments with regard to audits of brokers and dealers in securities. The statement of financial condition required of certain brokers or dealers who file reports with the Commission on the annual reporting form for brokers and dealers[1] is required to be certified by an independent public or certified public accountant. The Commission's rules prescribe what are referred to as "Minimum Audit Requirements." These requirements are practically identical with the minimum requirements of the New York Stock Exchange.

The difficulties experienced by the Commission's staff over the years in obtaining properly prepared statements of financial condition of registered broker-dealer firms and the number of defalcations in such firms have demonstrated a need for a more specific guide for the auditing of these firms. The auditing of broker-dealers is a very limited and specialized field of accounting and auditing in which there is little authoritative literature. The staff found in examining these reports that many accountants were simply not familiar with the brokerage business and brokerage accounting and auditing. The processing of the reports also indicated that the accountants were inclined to regard the minimum requirements as a complete audit program and failed to vary or supplement the auditing procedures as appropriate under the circumstances of the audit.

From time to time the Commission's staff discussed with representatives of the accounting profession ways and means of alleviating the situation. In 1951 the staff suggested to the Committee on Relations with the Securities and Exchange Commission of the American Institute of Accountants that a brokerage audit case study be prepared. This suggestion was followed and a case study prepared by a member of the Committee was submitted to our staff in August 1952. It developed that the problem was larger than could be covered in a case study based on current practice. It involved rather the delineation and extension of procedures deemed necessary and appropriate in an audit

---

1 Form X-17A-5.

made for the purpose of safeguarding the securities and funds of customers and to discourage, if not forestall, defalcation.

This larger assignment was undertaken and assigned to a special subcommittee of the Institute's Committee on Auditing Procedure, composed of representatives of six leading accounting firms.

Facts covering various problems encountered by our staff, after a review of 4,000 filings, were furnished to the subcommittee. From time to time representatives of our staff and the New York Stock Exchange commented and made suggestions on preliminary drafts. Finally, in October 1956 the American Institute of Accountants published the booklet, "Audits of Brokers or Dealers in Securities." This booklet is concerned with the operation of brokerage concerns. It describes the special accounting records used and suggests auditing procedures and forms of reports for the audit of brokerage concerns. While this booklet may not be a final solution of the problem, it does represent a long, forward step.

Early in the process of drafting forms to obtain fair disclosure of financial facts and accounting information, the Commission adopted the policy of prescribing the forms' content and extent of detail required, but leaving the form, order and terminology to the discretion of the registrant within the framework of generally accepted accounting principles, practices and procedures. In auditing, the Commission initially relied upon the independent accountant for assuming the responsibility for the adequacy of the audit under generally accepted auditing standards. Over the years the Commission has worked with the accounting profession, industry, and the financial community in evolving better standards of auditing and financial reporting. An exception to this policy, and one which looks in the direction of codification of auditing standards by the regulatory agency, was the adoption by the Commission of the "Minimum Audit Requirements" pursuant to our reporting requirements for brokers and dealers in securities.[2]

In the discussion with the Institute committee, our Chief Accountant[3] suggested that if a comprehensive program covering the audit of broker-dealers, rather than a case study, was prepared which would include detailed instructions for examining the system of internal checks, or the lack of checks, with a view to safeguarding the securities and funds of customers, and which would discourage if not forestall defalcations, were adopted, consideration would be given to the elimination of the minimum audit requirement from the rules. This suggestion was in line with our policy of relying upon established auditing standards.

The recommendation that the minimum audit requirement be eliminated was made to the Commission. However, at the present time the Commission is waiting to see what influence the booklet has on brokerage auditing practice, and is considering the advisability of this recommendation.

---

[2] Rule X-17A-5.

[3] Earle C. King, who has since resigned from the Commission's staff.

Consideration of this booklet has again brought into relief the fiduciary nature of the brokerage business and the fact that certified statements are required, in compliance with the intent of the Congress expressed in the statutes, in order to safeguard the securities and funds of customers rather than to protect the owners of the business. This purpose entails care and responsibility beyond that of the ordinary industrial audit. My opinion is that the Commission should not rescind the minimum audit requirements. If it does, it will thereby remove the specific provisions which look to the safeguarding of customers' securities and funds and will lend support to the argument that industrial auditing standards are sufficient.

Second, I will speak of developments with respect to foreign accounting and auditing. The Securities Act of 1933 provides for the filing of balance sheets and profit and loss statements in such form and detail as the Commission prescribes[4], certified by an independent public or certified accountant. The Act specifies the information required to be included in a registration statement and gives the Commission considerable latitude to expand or modify the information requirements of the Act as they apply to problems presented by particular classes of issuers or securities.[5]

An instruction as to financial statements which provides for the filing of other statements in certain cases[6] is written under this authority, and has been relied upon in many instances, to permit the Commission to substitute, increase or omit the financial statement disclosures specified in the form when necessary or appropriate to an adequate and fair presentation of a particular financial problem.

The Securities Exchange Act of 1934[7] and the Investment Company Act of 1940[8] have substantially the same financial and certification requirements.

The statutes by their terms make no distinction between domestic private issuers and foreign private issuers. The statutes likewise make no distinction between domestic accounting firms and foreign accounting firms. There is nothing in the Congressional debates or Committee reports on the Acts to indicate that the acceptability of certificates of foreign accountants was ever considered. The statutes merely use the term "independent public or certified public accountant."

However, if a foreign private issuer, other than a North American or Cuban issuer, registers securities under the Securities Act, which requires certification, and the undertaking to continue to file annual and interim reports under the Exchange Act is operative, as in most cases it is[9], the issuer is required to file such supplementary and

---

[4] Schedule A, paragraphs 25 and 26.
[5] Section 7.
[6] Instruction 13, Form S-1.
[7] Sections 12 and 13.
[8] Sections 8 and 30.
[9] Section 15(d)

periodic information, documents and reports as may be required by the Exchange Act.[10] As our regulations have been construed, foreign issuers filing annual reports under them need not follow our accounting rules in preparing financial statements unless the issuer, at the same time or subsequently, lists its securities on a national securities exchange and furnishes to the exchange financial statements complying with the Commission's accounting regulations.

This situation comes about because in 1934, when the Commission began drafting its forms for registration under the Exchange Act, it was faced with the situation that a number of foreign private issues of securities had been distributed in the United States and were listed and traded on exchanges. The Commission had no authority over these issuers except to delist the securities from national securities exchanges. The Commission prescribed that the required financial statements give at least the amount of detail as that previously given in financial statements filed with any securities exchange in the United States, or, if no such filing had been made, the amount of detail which had been given in statements made available to security holders of the issuer.

Since certification by foreign issuers has not been required under the Exchange Act, the problems under that Act have been confined largely to dealing with certification of foreign subsidiaries of domestic companies. In most instances such companies represented a minor portion of the assets and income of the business. In the early days of the administration of the Acts by the Commission, there was found to be great variety in the quality of the reports of such foreign subsidiaries. Each situation has been dealt with by the staff on an individual basis. It has been the Commission's policy to encourage foreign accountants to follow American standards of auditing and accounting with respect to statements filed under the Exchange Act. With respect to the United Kingdom and Holland, we believe that we have had considerable success. The American accountants, who are the principal accountants in these situations, have also been of great help in obtaining better reports.

With respect to statements filed by foreign issuers under the Securities Act, the Investment Company Act and on the reporting form for brokers and dealers under the Exchange Act, it has been the Commission's policy to require that American standards of auditing and financial reporting be followed. The greater portion of such filings have been made by Canadian companies. Until recent years the problem has not been of great importance and the staff has been generally successful in its endeavor to obtain compliance with American standards.

It is clear that the Congress intended that the foreign private issuer should meet the same standards of disclosure as the domestic private issuer if the foreign private issuer seeks to raise capital in the American markets. The desirability of encouraging American investments abroad, which has been encouraged by some, is not so great that the encouragement of foreign investments should be made at the cost of lowering these standards.

---

[10] Section 13.

While the Commission has followed the practice of insisting upon substantial compliance by the foreign private issuer with the disclosure requirements applicable to the domestic issuer in connection with the registration of securities under the Securities Act, there have been a few instances in which the Commission has accepted registrations by a foreign private issuer in which there were some variations from American practices, either in auditing procedures or in the application of accounting principles.[11] These variations have met with a mixed reception in this country, being criticized by some members of the accounting profession and accepted by others as reflecting a reasonable and practicable solution to the particular financial problem.[12]

In a recent case of a foreign company registering its outstanding stock under the Exchange Act and listing the stock for trading on a national securities exchange, the staff refused to accept the certificate of the company's auditors because they were not in fact independent by our standards and the auditing procedures followed, particularly with respect to accounts receivable and inventories, did not meet our standards.

In December 1956, we promulgated for public comment under the Administrative Procedure Act a notice of proposed amendment to the general registration form[13] regarding rights offerings by certain foreign private issuers.[14] The proposal would have relaxed the certification requirements with respect to pro-rata offerings by foreign issuers to their stockholders of securities of the same class as those registered on a national securities exchange, where the offering price was not more than 60% of the market value and the amount offered to stockholders in the United States did not exceed 5% of the total offering, and where the issuer had been in business more than 25 years and had total assets of at least $100 million or its equivalent.

The issues involved concerned the rules of the Commission under the Securities Act and not the status of private issuers. We deemed it necessary for the proponents of the revision to establish to the Commission's satisfaction that there was an overriding public interest in relaxing the requirements. Of particular concern to us was that no physical verification of inventories or confirmation of accounts receivable conforming to American auditing standards would be assured, and this startled some old ghosts in the Commission yard.[15] The public response to this proposal demonstrated, to the contrary, that there was a strong opposition to setting up, even in this limited area, a different standard for foreign reporting, and the proposal was withdrawn.[16]

---

[11] See prospectuses for "A.K.U.", December 2, 1953; Simca, April 30, 1956; KLM Royal Dutch Airlines, May 1, 1957.

[12] The "A.K.U." Prospectus, Journal of Accountancy, April 1954, p. 483.

[13] Form S-1.

[14] Securities Act Release 3735, December 21, 1956.

[15] In the Matter of McKesson & Robbins, Inc. – Summary of Findings and Conclusions, Accounting Series Release No. 19, Dec. 5, 1940.

[16] Securities Act Release No. 3782, April 30, 1957.

In the United States corporate securities are widely held and our capital market is the largest in the world. Investors who place their savings at the disposal of industry in new issues of corporate securities are entitled to rely on the accounting rules developed by the Commission over nearly a quarter of a century and the principles and practices developed by the American accounting profession. Any failure to require financial statements of foreign corporations registering new issues of securities for sale to the American investing public to be certified by independent auditors in accordance with the standards applicable to American corporations would establish a double standard for reporting by domestic and foreign issuers. Such statements could also be misleading because the public, other than financial experts, might have the impression that American standards had been adhered to simply because the financial statements had been filed with the Commission in a registration statement under the Securities Act.

The staff has been directed to consider whether the Commission's forms should be revised to require foreign private issuers filing new registration statements under the Securities Exchange Act to meet the accounting and certification requirements of the Commission's regulations.[17] As a matter of principle, I believe that any relaxation of the standards which the Commission has built up over the years under the Federal securities laws merely to accommodate the raising of capital by foreign corporations from public investors in this country would be most unwise.

It also is my view that when a business organization reaches the size where it operates in and sells its securities in several countries, it should have its accounts audited by an international firm of accountants which also practices in those countries and has firsthand knowledge of the business, accounting and financial reporting practices of those countries. It is my belief that in our own national interest and the interest of American investors, and the interest of the American accounting profession to which the success of the capital markets owes so much, that the Commission should require, in statements filed with it, such companies to adhere to our auditing, certification and financial reporting standards.

This problem has been dealt with in part by the Commission under the Investment Company Act.[18] Our rules prescribe the specification of conditions and arrangements for Canadian management investment companies requesting an order permitting registration. The rule under the Investment Company Act provides that the applicant will appoint an accountant, qualified to act as an independent public accountant, who maintains a permanent office and place of business in the United States.

Third, I will speak of the so-called Fulbright Bill. The Securities and Exchange Commission is currently interested in reports to stockholders in connection with S. 1168, a bill introduced by Senator J. W. Fulbright, Chairman of the Committee on Banking and Currency, on February 11, 1957. This bill would extend the reporting, proxy and insider-trading provisions of the Exchange Act to certain large publicly-held corporations in

---

[17] Regulation S-X – Form and Content of Financial Statements.
[18] Rule N-7D-1, Item (b)(8)(G).

which there is a large public interest but the securities of which are not listed on a stock exchange. The Commission believes that the broad principles and objectives of S. 1168 are sound. The Commission supports them.

S. 1168 with one exception is identical with the Committee Print dated August 5, 1955, of S. 2054, 84th Congress, originally introduced by Senator Fulbright and which was on that date favorably reported to the Committee by the Subcommittee on Securities. The exception is that the exemption for insurance corporations contained in that Committee Print does not appear in S. 1168.

The Commission made a factual study of the financial reporting and proxy soliciting practices of those corporations which would come within the scope of S. 2054 (as amended to exempt insurance companies from the bill's coverage) and the trading practices of officers, directors, and 10% stockholders of a sampling of such corporations. On May 17; 1956, we submitted to the Committee our report setting forth the results of that study.[19] Our study indicated that the bill (as amended to exclude insurance companies) would apply to approximately 1,200 corporations with total assets of about $35 billion. Thereafter, on June 22, 1956, during the hearing before the Committee on the bill, the Commission was requested by Senator Fulbright to make a further study of those insurance companies which would come within the provisions of the amended bill if the specific exemption for insurance companies should be removed.[20] On February 6, 1957, a supplementary report setting forth the results of this further study was submitted to the Committee.[21]

In our letter of February 6, 1957, transmitting to the Committee the supplementary report of the Commission, we stated that, on the basis of our study of financial reporting and proxy soliciting practices of the 169 insurance companies which would be subject to the bill if the exemption should be deleted and the bill enacted, the Commission was of the opinion that it would be consistent with the purposes of the Federal securities laws and of S. 2054, 84th Congress, that the exemption be deleted and the bill passed (subject to two other suggestions for amendment not related to financial reporting which had been made by the Commission). Subject to the suggested revisions the Commission believes that enactment of the bill would provide important additional protection to investors, that its effect upon the capital markets of the country would be favorable and that it would not unreasonably burden corporations subject to its provisions. In expressing this view, we limited ourselves to a consideration of the

---

[19] Report of the Securities and Exchange Commission on S. 2054 (84th Congress) to the Committee on Banking and Currency of the United States Senate, Committee Print of May 25, 1956.

[20] Hearing before the Committee on Banking and Currency, United States Senate, 84th Congress, 2d Sess. on S. 2054, June 22, 1956. Part 2-A, pp. 1270-71, 1283.

[21] Supplementary Report of the Securities and Exchange Commission on S. 2054 (84th Congress) of the Committee on Banking and Currency of the United States Senate, Committee Print Feb. 11, 1957.

Congressional purposes expressed in the Federal securities laws and did not express views as to any other areas of Federal or State regulation of the insurance industry.

The Commission's supplementary report indicated that 169 insurance corporations, having total assets of approximately $24 billion, will be subject to the bill. Of these, 44, having total assets of approximately $5 billion, are now required to file reports pursuant to Section 15(d) of the Act, and 125, having total assets of approximately $19 billion, which do not now report would become obligated to do so.

The Commission's staff examined the reports to stockholders of 161 of these insurance corporations in the light of generally accepted accounting principles and standards of fair disclosure. It was found that 61 of the 161 insurance corporations gave only a balance sheet often with little detailed classification of assets and liabilities. Of the 117 reports to stockholders of corporations not presently required to file reports with the Commission, 63% were materially deficient in that they omitted to furnish a profit and loss statement, a surplus statement, or both, or the statements were so brief as to be inadequate. On the other hand, of the 44 reports to stockholders of insurance corporations subject to the bill which are presently required to file financial data with the Commission pursuant to Section 15(d), 30% were so deficient. The comparable percentages for the first study, which did not include insurance companies, were 21% and 4%, respectively. The over-all percentages for materially deficient reports were 54% for insurance companies and 13% for other companies.

The more significant finding, however, is the fact that only 6% of the insurance corporations attempted to give the additional information required by the Commission's accounting regulation[22] and sound accounting principles and practice in order to make the financial statements of insurance companies comparable to other companies. This information is necessary to an understanding of the financial statements and to proper financial analysis.

With respect to the evaluation of proxy soliciting material of insurance corporations studied, we found that this material likewise suffered by comparison with that of the other corporations in the first study.[23] As Chairman of the Commission, I testified again on behalf of the Commission before the Subcommittee on Securities of the Committee on Banking and Currency on May 21, 1957, and reaffirmed our previous position that the broad principles and objectives of the bill are sound and that the Commission supports them, and stated that the Commission is of the opinion that it would be consistent with the purpose of the Federal securities laws and of the proposed bill that the insurance companies exemption be deleted and the bill passed, subject to the two suggestions for amendments which have been made by the Commission.

---

[22] Regulation S-X

[23] A fuller discussion of the problems in connection with insurance company reports and the Fulbright Bill may be found in my article entitled "Insurance Company Reports to Stockholders," which will appear in an early issue of THE SPECTATOR, the media for insurance marketing and management.

I also stated on behalf of the Commission that the legislation would provide additional protection to investors in corporate securities in which there is broad public investor interest and which are sold and traded in the interstate securities market by requiring disclosure of the business and financial facts pertaining to the corporation issuing them, and would strengthen the protections against fraud afforded to investors. Furthermore, it is believed that the effect of the bill, if modified in accordance with our suggestions, on the integrity of the capital markets of the country would be favorable, both from the standpoint of the trading in the over-the-counter and exchange markets and the markets for the raising of new capital.

Finally, we do not believe that the duties which the bill would place upon such corporations would be unreasonably burdensome; it has not proven so in the case of listed corporations. Furthermore, the requirements of the securities acts have a tendency to cause corporations subject to them to reexamine their financial policies and practices and often have the salutary effect of the institution of sounder policies and practices by such corporations.

At the hearing before the Subcommittee Senator Prescott Bush made two well-taken points, that there has been no public demand for inclusion of insurance companies in the coverage of the bill and that its administration would require at least a $500,000 increase in the Commission's annual appropriation. I testified, in the light of the cut of $478,000 made by the House of Representatives in the Independent Offices Appropriation Bill in the provision of $7,178,000 for the Commission's operation in fiscal 1958 made in the President's Budget (one third of which is reimbursed to the Treasury in statutory fees), that I would rather see the Congress provide $500,000 annually for administration of the Commission's existing statutory responsibilities, including particularly anti-fraud work, than impose new statutory responsibilities. However, as this was given in a colloquy at the hearing, it was an expression of my own views in answer to a question not earlier considered and my answer does not represent a position taken by the Commission. The Commission staff today is at 65% of its 1947 strength and is less than its 1953 strength, but its volume of work is about triple that of 10 years ago and is at an all-time high.

Fourth, I will discuss the Commission's problem with our so-called "No Sale" rule.[24] The application of the registration requirements of the Securities Act to mergers, consolidations, recapitalizations and sales of corporate assets in consideration for securities of another corporation, presents practical and legal problems which have been of increasing concern to the Commission. Typically, in these situations, a corporation will issue securities, often in large quantities, either to the stockholders of another corporation the assets of which are being acquired either by merger or by sale of assets, or to its own stockholders in connection with a recapitalization. The transactions are effectuated pursuant to a vote of stockholders of one or both of the participating

[24] Rule 133 under the Securities Act.

corporations in accordance with state law. The question immediately arises whether the securities so issued must be registered under the Securities Act.

Early in the Commission's history, the position was taken as a matter of interpretation that for the purposes of the registration requirements of the Act, at least, no "offer" or "sale" of a security was deemed to be involved so far as stockholders of a corporation were concerned, where proposals of this character were submitted to them for a vote. This concept – familiarly known as the "no sale" theory – is embodied in Commission Rule 133 under the Securities Act.[25] This theory and rule disposed of many serious practical and legal problems, both for the Commission and for corporations contemplating such transactions. At the same time, however, its practical effect was to exempt, or exclude, from the registration requirements of the Securities Act a large number of cases in which securities were in fact distributed by issuers to the investing public.

Recent events have forced the Commission to reconsider the soundness of this doctrine. For example, the Commission's opinion and order withdrawing the registration on the American Stock Exchange of the capital stock of Great Sweet Grass Oils Limited and Kroy Oils Limited[26] describes a deliberately calculated scheme to dispose of millions of shares of highly speculative stock to the investing public without any of the disclosures which would be called for by registration, and to divert most of the proceeds to insiders rather than to productive use. The Commission found that Rule 133 had no application to these transactions, for several reasons. In the first place, the exchange of assets was merely a step in a pre-existing plan for distributing the securities through underwriters to the investing public.[27] Rule 133 may provide an exemption insofar as stockholders are concerned, but it does not mean that subsequent sales of the stock so issued are necessarily exempt from registration. Some other exemption must be found for such subsequent sales, such as the exemption available under Section 4(1) for casual sales by non-controlling stockholders. That exemption, of course, is not applicable to a distribution through underwriters, such as occurred here. In any event, these transactions were not corporate action in any real sense, since the persons negotiating the transactions had sufficient control of the voting stock to make the vote a mere formality.

Reliance in the Great Sweet Grass and Kroy Oils cases and similar transactions on Rule 133 represented, of course, a misapplication of the "no sale" theory. Beyond that,

---

[25] The 'no sale" theory was expressed as a footnote to Form E-1 under the Securities Act from 1935 to 1947, when it was rescinded. It continued to be followed as an administrative policy until 1951, when it was adopted as a Commission rule (Securities Act Release 3420, Aug. 2, 1951).

[26] Securities Exchange Act Release No. 5483, (April 8, 1957).

[27] In the case of SEC v. Micro-Moisture Controls Inc. the United States District Court for the Southern District of New York, when faced with a somewhat similar set of circumstances, concluded that Rule 133 is not applicable to an exchange of assets for stock which is "but a step in the major activity of selling the stock." (CCH Fed. Securities Law Service, Par. 90, 804 (1957).

however, the basic question of whether the rule is consistent with the statutory phraseology and purpose must be faced, and the Commission's difficulties in the proper enforcement of the law illustrated by these cases point up the importance of this question. This really resolves itself into two questions: first, whether the Commission has authority to adopt a rule of this character, and secondly, whether the particular rule is sound.

Section 19(a) of the Securities Act grants to the Commission broad rule-making power, as follows:

> "The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical and trade terms used in this title."

Rules under this section may be of several types. There may be what could be called "substantive rules" prescribing the procedures to be followed and the requirements to be observed in connection with registration and other matters. There may be "defining rules," which define accounting, technical and trade terms. And finally there may be interpretive rules.

The first two classes of rules – the substantive and defining – become in effect a part of the law since they represent an exercise of a rule-making power expressly granted by the Congress to the Commission, and such rules, in effect, supplement the statute. Interpretive rules rest on a slightly different foundation. The Commission must necessarily interpret the statute in order to perform its duties, and rules embodying such interpretations may therefore become necessary in order for the Commission to carry out the provisions of the Acts.[28] Rule 133 is of this character. Upon its adoption in 1951, the Commission classified it as an interpretive rule for the purposes of the Administrative Procedure Act, which specifies that the procedure of public notice and comment provided for in Sections 4(a) and 4(b) thereof shall not be applicable to interpretative rules except as otherwise required by law. In addition, the rule on its face clearly appears to be an interpretation of the statute.[29]

---

[28] Compare the interpretive rules frequently issued by the Commissioner of Internal Revenue pursuant to Section 805 of the Internal Revenue Code, rule-making provisions of which are no broader in this regard than Section 19(a) of the Securities Act. The authority of the Commissioner to adopt such rules has been upheld by the Supreme Court. (See Morrissey v. Commissioner, 296 U.S. 344 (1935) and Helvering v. Wilshire Oil Co., 308 U.S. 90 (1939)).

[29] Rule 133 might also be regarded as an exercise of the Commission's power to define accounting, technical and trade terms. It is arguable, however, that the term "sale", which is one of the basic legal terms clearly defined in Section 2(3) of the Act, does not fall into the category of an accounting, technical or trade term.

Considered as an interpretive rule it next becomes necessary to determine whether the rule is a correct interpretation. In my view it is not. The declaration which it contains that certain transactions therein specified do not involve an offer or sale seems hard to reconcile with the statutory definitions of these terms. The terms “offer” and “sale” are specifically defined to include every contract of sale or disposition of a security for value, and every attempt to dispose of a security for value.[30] That definition in my opinion applies to the solicitation of stockholders’ votes for a plan of merger or like transaction which will involve the issuance or exchange of securities for value and the solicitation of such votes in my opinion is an “attempt . . . to dispose of . . . a security or interest in a security for value.”

Moreover, in Section 3(a)(9) of the Act, the Congress expressly exempted exchanges by an issuer with its existing security holders where no remuneration is paid and in Section 3(a)(10) the Congress expressly exempted securities issued in exchange for outstanding securities, claims or property interests where the transaction has court approval. Rule 133 cuts a broad swathe across both of these express exemptions, operating to exclude from the coverage of the registration provisions of the Act securities issued in exchanges or in reorganizations despite the fact that the conditions provided by the Congress for such exemptions are not satisfied and, to this extent, it is inconsistent with the statute. Rule 133 does not purport to exempt from the anti-fraud provisions[31], and here, too, the Congress showed itself capable of stating what exemptions it intended and what it did not, as it specifically exempted a number of classes of securities from the registration but not the anti-fraud provisions.[32] Moreover, the legislative history of Section 3(a)(10) shows that Congress contemplated that mergers, consolidations and reorganizations without judicial supervision should be subject to registration, a result directly contrary to that reached under Rule 133.[33]

Rule 133 has the practical effect of adding a substantial category of transactions to those expressly exempted from the registration requirements. This is obviously unsound as a matter of statutory construction. The Congress did not give any power to the Commission to add to the classes of securities exempted by the Act except in the narrow area of issues the amount of which is “small”, and the character of the public offering of which is “limited.” Here, the Congress gave the Commission the power to prescribe classes of securities which might be exempted on a finding by the Commission

---

30 Section 2(3) of the Securities Act.

31 Section 17.

32 Sections 3(a).

33 H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 16 states in part: “…This paragraph (Sec. 3(a)(10) also exempts the distribution of securities during a bona fide reorganization of a corporation when such reorganization is carried on under the supervision of a court. “Reorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the Act. For the same reason the provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision.”

that enforcement of the registration provisions with respect to such classes of securities "is not necessary in the public interest and for the protection of investors." The exemption granted by the Commission is subject to such rules and regulations and terms and conditions as the Commission may prescribe. Originally, the maximum amount of securities that could be exempted under this provision was $100,000, which was enlarged to $300,000 by an amendment to the Act in 1945.[34]

By concluding that Rule 133 is an unsound interpretation of the Act and that the Commission is under a duty to rescind it. I do not mean for a moment to suggest that an unreasonable additional burden will be placed upon corporations which are presently furnishing to their security holders the necessary information in connection with mergers, consolidations, reclassifications or transfers of assets. Rather, I believe that by developing a few variations in its present forms for registration under the Securities Act the Commission can adapt the material which is presently filed by corporations subject to the proxy rules under the Exchange Act to registration under the Securities Act and that this can be accomplished without any unnecessary or undue burden. True it is that the existing registration procedures were not designed with reference to the problems presented where stockholder consent to mergers, consolidations, reclassifications or transfers of assets is sought. But this is only because under Rule 133 registration has not been required, and there is no reason why registration forms cannot be developed for these purposes, which would put into effect procedures consistent with the statute.

In the case of a merger or a consolidation, procedures could be devised under which the proxy statement required of listed corporations under the statute when soliciting proxies or consents could be made to serve in effect as a registration statement under the Securities Act. In case the securities issued in the transaction were to be redistributed to the public, such a proxy statement with appropriate supplements might be used as the prospectus to be delivered to persons to whom the securities were offered in such redistribution.

Reclassifications of securities would probably often be exempt under Section 3(a)(9) as an exchange by an issuer with its own security holders, assuming that paid solicitors were not used, and in other cases where such a reclassification involved no material change in the rights of any security holders, it could perhaps be argued that security holders were not being asked to give up any value and that accordingly there was no sale. This, for example, would certainly be true of the ordinary stock split or stock dividend. Where these exemptions were not available, the proxy statement could be employed as in the case of a merger or consolidation. The issue of securities in consideration for a transfer of corporate assets would present certain technical problems, but these do not appear to be a fatal objection to the employment, where necessary, of the same techniques suggested for the other categories of transactions.

In these circumstances there would not be any substantial additional burden on issuing corporations where these corporations were already subject to the proxy rules of

---

[34] Section 3(b) of the Securities Act.

the Commission, and corporations which are not presently subject to the proxy rules ought to be under a duty at least to furnish something resembling a proxy statement to the stockholders whose approval they solicit. This result is clearly consistent with the underlying purpose of the Securities Act – that investors, including stockholders, should not be solicited to acquire securities for value without disclosure to them of material facts concerning the enterprise in which they are asked to invest.

The Commission traditionally, and particularly since the enactment of the Administrative Procedure Act of 1946, has given full and ample opportunity for persons affected by its rules and regulations to present their views and participate in the rule-making function. Both corporations effected by proposed rules, their counsel, and investors and their representatives can thus give us the benefit of their experience and judgment. Investors have only recently had any substantial organized representation. Securities analysts societies have recently been taking part in the rule-making process and we welcome their participation. Public hearings have been held on the problem of Rule 133. Taking into consideration the legal problems involved, we have also engaged in correspondence and conferences with representatives of the American Bar Association and the Association of the Bar of the City of New York, and the Commission is available for any suggestions or comments which they and other professional and industry representatives may submit for the purpose of working out feasible procedures or statutory amendments to deal with this problem. But the Commission has not indicated, and I hope the Commission will never indicate, any desire to participate in amending its rules or in recommending any legislative amendment to the Congress that would weaken or water down the registration provisions of the Act which I believe to be so vital to the public investor and the integrity of the capital markets in connection with the sale to the public of new issues of corporate securities.

One of the dangers which in the comments submitted to the Commission by lawyers and industry organizations on this problem appears to be generally unrecognized is the question of the legal position in which corporations and their directors and officers would find themselves in the event that a court, rather than the Commission, should hold Rule 133 invalid. Years ago the Court of Appeals for the Ninth Circuit "without going into the matter" indicated approbation of the rule[35], but I wonder in the light of the application of the rule in the intervening years, particularly considering the recent abuses, and in the light of a full and careful legal analysis of the statutory foundation for the rule, whether a United States Court of Appeals today, or the Supreme Court of the United States, would stand for this doubtful construction of the basic statute intended by Congress for the protection of public investors.

Indeed, my premonitions in this regard are fortified by the position taken by the spokesman for the Association of the Bar of the City of New York in the public hearing before the Commission who based his argument against repeal of the rule not on its legal validity or soundness but on the fact that it was an interpretation of long standing, the

---

[35] National Supply Co. v. Leland Stanford, Jr., University, 134 F. 2(d) 689 (9th Cir., 1943).

rescission of which would be unsettling to business and which therefore should not be rescinded except by Act of the Congress. I find here a startling recognition, sub silentio, of the underlying legal difficulty with the rule as it now stands. I believe that the least unsettling effect on business and the soundest approach by the Commission charged with administering the statute would be to face the problem squarely and provide appropriate registration forms and procedures for those transactions which the Securities Act by its terms and purpose requires to be registered.

In this connection, I would like to say that the Congress placed upon the Commission a great responsibility when it entrusted to it the duty to make available to the public the information necessary for the protection of the investors in all phases of the investment process -- that is, in buying, holding for investment or selling securities.

In conclusion, let me say that good accounting, auditing and reporting is the cornerstone of financial integrity. The requirements of the Securities and Exchange Commission under the Federal securities laws with respect to accounting rules and independence have been of immense value to the profession, to industry and to the investing public. In 1936 the Commission said, ". . . The insistence of the Act [Securities Act of 1933] on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedures and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. . ."[36] Time and again we have reiterated this view and it is as true today as it was two decades ago. The enormous amounts of capital which American industry must raise in the securities markets in the years ahead cannot possibly be raised if the investing public does not have confidence in the integrity of the capital markets. Confidence in the integrity of the markets depends on the maintenance and continued improvement of American accounting and auditing standards.

---

[36] In the Matter of Cornucopia Gold Mines, 1 S.E.C. 364, 367 (1936).