88th Congress, 1st Session - - - - - House Document No. 95, Pt. 3

REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION

PART 3

CONSISTING OF

CHAPTER IX.—OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES

OF THE

REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, RELATING TO THE ADEQUACY OF INVESTOR PROTECTION IN THE SECURITIES MARKETS, PURSUANT TO SECTION 19(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 87-196)

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CHAPTER IX

OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES

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CHAPTER IX

OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES

A. Introduction

The keystone of the entire structure of Federal securities legislation is disclosure. Making available to investors adequate financial and other information about securities in which they might invest or have invested is the best means of enabling them to make intelligent investment decisions and of protecting them against securities frauds. The Senate Committee on Banking and Currency in its 1934 report on stock exchange practices put it this way: [1]

> It is universally conceded that adquate information as to the financial structure and condition of a corporation is indispensable to an intelligent determination of the quality of its securities. The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price. Insofar as the judgment is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of supply and demand. One of the prime concerns of the exchanges should be to make available to the public honest, complete, and accurate information regarding the securities listed.

Although the quoted statement singles out the exchanges, it applies and was intended to apply to all securities, listed or unlisted. Because too little was known about the over-the-counter market in 1934 to enable Congress feasibly to devise provisions as specific as those relating to listed securities (see pt. B.1.a below), it resorted in the original section 15 of the Exchange Act to a grant to the Commission of rulemaking power in relation to the over-the-counter market. In doing so it expressly declared its purpose to be "to insure" to investors in over-the-counter securities "protection comparable" to that provided investors in listed securities. The sanctions made available, however, proved inadequate and as a result there are currently vast differences in the degree of investor protection in the two markets. In part B.1 of this chapter these differences are detailed and prior attempts to eliminate them are related.

There has been widespread agreement on the need to extend to unlisted securities the disclosure and other safeguards applicable to listed securities, and the problems involved in previous legislative efforts to do so have been largely those of (1) the precise scope and standards of coverage and (2) the impact of the insider trading provisions on broker-dealers who are directors of issuers of securities in which they make primary markets. The Special Study's efforts, therefore, have been directed, as Chairman Cary indicated that they would be early in the course of the study, not to establishing the need and worth of

[1] S. Rept. 1455, 73d Cong., 2d sess., p. 68 (1934).

extending the protections of sections 13, 14, and 16, but to answering the unresolved questions. In an address before the Investment Bankers Association the chairman said:

> This problem [of the extent to which reporting requirements, proxy regulation, and restrictions on insider trading should be applicable to issuers whose securities are traded in the over-the-counter market] has already been extensively analyzed and we do not intend to retrace our steps. On the basis of prior studies, it is difficult to avoid the conclusion that, in principle, investors in over-the-counter securities should be protected by the same type of measures governing listed securities. * * * Thus further studies may be needed to settle some of the more controversial questions involving concrete application of the provisions of the Exchange Act.[2]

Accordingly, except for a brief review of past and current studies of issuers' practices, the present chapter is devoted primarily to scope rather than need. In a broad sense, however, much of the rest of the Report is a demonstration of need. The discussion of selling and advisory practices in chapter III, of "aftermarkets" in chapter IV, of over-the-counter markets and transactions in chapter VII, of choice of markets in chapter VIII, of corporate publicity in part C of this chapter, and even of credit and margin provisions for over-the-counter securities in chapter X—all have relevance and lend support to the conclusions expressed here as to the compelling need for extension of sections 13, 14, and 16 to unlisted securities.

Not only is there this need, there is also a need to improve the effectiveness of the protections themselves and to provide for wider dissemination of officially filed information. Parts B.8 and B.9 of this chapter are devoted to a discussion of possibilities along those lines.

A related aspect of investor protection is given separate treatment in part C, which is devoted to financial public relations. Although many corporations conduct their shareholder and public relations programs responsibly and within both the letter and spirit of the securities laws—indeed, in furtherance of the disclosure philosophy of those laws—some corporate public relations departments and their consultants have prepared and disseminated material that has been quite at odds with the basic philosophy and purpose of full disclosure for investors.

B. Protections for Investors in Listed and Unlisted Securities

1. DIFFERENCES IN PROTECTIONS—EXCHANGE AND OVER-THE-COUNTER MARKETS

a. Provisions with respect to listed securities

(1) *Statutory controls*

Under the Securities Act most new issues of securities offered to the public by the use of the mails or other interstate means must be registered with the Commission, and a prospectus containing financial and other material information must be furnished to the purchaser. The act applies whether or not the securities offered are part of an issue listed on an exchange. If a company resorts to the public to raise new capital, therefore, investors will in most cases be given the information they need to reach an informed investment decision.

Once the distribution process has been completed and securities are outstanding, however, the safeguards applicable to listed and unlisted

[2] Speech of Nov. 28, 1961, at Hollywood Beach, Fla.

securities are quite different. For listed securities, the Exchange Act, which was intended to regulate trading markets and to provide protections in those areas in which State corporation statutes and the common law had proved largely ineffective, goes beyond merely prohibiting fraud and manipulative practices and provides other and even more effective safeguards. The additional safeguards, embodied in sections 12, 13, 14, and 16, rely upon the principles of disclosure and self-protection and may be briefly summarized:

(*a*) *Reporting requirements.*—As a prerequisite to listing, section 12 requires the filing with both the exchange involved and the Commission of a registration statement. This consists of financial statements and other material information essential to a determination of the merits of the security, and is similar to that required for registration of a new issue under the Securities Act. Section 13 requires that the information in the registration statement be kept up to date by annual and other periodic reports.

Regulations of the Commission under section 13 currently provide for the filing of the following reports:

Annual report (form 10–K).—Required data include (1) principal holders of voting securities, (2) name, principal occupation, and shareholdings of directors, (3) remuneration, including amounts accrued in retirement plans, of each director and principal officer, (4) stock options outstanding and the exercise of options, (5) any interest of an officer or director in a material transaction of the corporation, and (6) a balance sheet and profit and loss statement, prepared in accordance with the Commission's accounting regulation and certified by an independent public accountant.

Semiannual report (form 9–K).—Only short forms of uncertified profit and loss and earned surplus statements are required.

Current report (form 8–K).—Filing is required on the occurrence of an unusual event of immediate interest to investors, e.g., (1) changes in control of the issuer, (2) acquisition or sale of a significant amount of assets, (3) changes in amount of securities outstanding and any change in the rights of security holders, including any defaults upon senior securities and the issuance of new options, (4) the institution of material legal proceedings, and (5) any matter which requires a vote of security holders.

Quarterly report (form 7–K).—Statements of profit and loss, cash flow, and cash distributions to shareholders are required of certain real estate companies.

All materials filed pursuant to sections 12 and 13 are public and copies are available to investors and other interested persons upon payment of reproduction fees.

(*b*) *Proxy controls.*—Section 14 and Commission regulations under it govern the form, content, and manner of solicitation of proxies relating to listed securities to provide shareholders with accurate and adequate information on the basis of which to exercise their corporate franchise. Proxy statements must include information about the persons on whose behalf proxies are solicited, nominees for directorships, and any other matters to be voted on. Thus, if the management of a listed company solicits proxies, shareholders must be furnished a proxy statement containing information with respect to such matters as management compensation, including

bonuses, pension and profit-sharing plans, loans to directors and officers, and material transactions between the corporation and its officers, directors and principal shareholders. If the shareholders are asked to vote on a merger or other corporate change, they must be given an opportunity to vote for or against the proposal and may not be put to the option of either voting as the management proxy indicates, attending the meeting—which may be many miles away—or forfeiting their votes. A shareholder, subject to certain limitations, may also require the management to place in the proxy statement a proposal of his own for action at the meeting, as well as his brief statement in its support. If the proxy relates to a meeting at which directors are to be elected, the shareholders must be supplied with an annual report, containing such financial statements for the preceding fiscal year as will, in the opinion of the management, adequately reflect the financial position and operations of the company.

The proxy regulations also supply protection where persons outside of management seek representation on the board of directors, and thus incidentally against corporate "raiders." Any person attempting to wage a proxy fight for representation in or control of a listed corporation must file with the Commission proxy solicitation material that contains disclosures similar to that required of management.

(*c*) *Insider trading.*—Section 16 is aimed at the use by corporate officials of "inside" information for the purpose of speculating in the stock of their corporations. The objective is sought by three separate approaches:

First, consistent with the disclosure philosophy inherent in all of the securities laws, section 16(a) of the Exchange Act requires each officer, director, and beneficial owner of more than 10 percent of any listed class of equity security to file with the Commission and the exchange an initial statement of his holdings of all equity securities of that issuer, and monthly reports reflecting any changes in his holdings.

While disclosure is obviously of great prophylactic value, it was recognized that disclosure alone might be insufficient to prevent the types of short-swing trading shown to have been practiced before the Exchange Act was adopted. Short-swing trading profits were not only all too often regarded "as one of the emoluments of office,"[3] but at common law and under existing State statutes investors could not recover unless they not only established motive and actual misuse of confidential information but also sustained the burden of proving damages, an undertaking especially difficult to meet in non-face-to-face transactions. Congress therefore adopted a second technique and provided in section 16(b) for the recovery, by or on behalf of a corporation, of all profits realized by an insider from a purchase and sale of the corporation's stock within any period of less than 6 months. One of the draftsmen of the Exchange Act explained the rationale of section 16(b) in these words:

> That is to prevent directors' receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security

[3] Hearings before House Committee on Interstate and Foreign Commerce, on "Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934," 77th Cong., 1st sess., pt. 1 at p. 26 (1941).

within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.[4]

A third technique that Congress adopted to deal with the insiders trading problem is embodied in section 16(c). That section attacks what the Exchange Act hearings showed to be favorite manipulative techniques of insiders—short-selling and selling against their position—by prohibiting insiders of listed corporations from both selling shares they do not own and selling shares and failing to deliver certificates within 20 days after the sale.

Together, sections 13, 14, and 16 provide valuable protections for the investor in a listed company. In conformance with the basic philosophy of Federal securities legislation their purpose is not to insure investors against losses, but to provide them with data sufficient to the making of sound investment decisions and to protect them from various forms of abuse.

(2) *Stock exchange controls*

Certain of the stock exchanges supplement the statutory protections afforded investors in listed securities through controls exercised over issuers under listing agreements. The New York and American Stock Exchanges require all listed companies to issue to shareholders annual, independently audited financial statements, and to submit copies to newspapers, wire services, and statistical services. In addition, both exchanges require companies newly listing securities to publish quarterly statements of earnings, unless conditions peculiar to the type of company or to the particular company would make quarterly statements impracticable or misleading. Similarly the NYSE requires issuers of its listed stocks to solicit proxies for all meetings of shareholders and the American Stock Exchange is in process of extending the same requirement to all of its issuers who have securities listed. See part B.8 below.

Two regional exchanges—the Midwest Stock Exchange and the Pacific Coast Stock Exchange—were queried by the study concerning regulatory controls over the dissemination of corporate news. Both exchanges require listed companies to send their stockholders independently audited annual financial statements, and in 1962 the Pacific Coast Stock Exchange adopted a requirement that listed companies publish semiannual statements of earnings. The Pacific Coast Stock Exchange, like the American Stock Exchange, is in the process of extending the requirement that proxies be solicited for all shareholders' meetings to all of its listed issuers.

b. Provisions with respect to unlisted securities

(1) *Statutory controls*

Despite the intention of Congress to insure investors in the over-the-counter market "protection comparable" to that provided investors in listed securities, the important safeguards provided by sections 13, 14, and 16 apply to only a small segment of all unlisted securities and even to that small segment their applicability is not consistent.

In 1935 Congress made all three safeguards applicable to registered public utility holding companies and their subsidiaries. In 1936,

[4] Testimony of Thomas G. Corcoran, "Hearings Before Senate Committee on Banking and Currency on Stock Exchange Practices," 73d Cong., 1st sess., pt. 15 at p. 6557 (1934).

when Congress repealed the part of the original section 15 of the Exchange Act that gave the Commission broad rulemaking powers over the over-the-counter market (an action it took because of the inappropriateness of applying sanctions to broker-dealers as a means of controlling issuers), it added present section 15(d), which imposes upon certain companies newly registering securities under the Securities Act the duty to comply with the reporting requirements of section 13.[5] So-called section 15(d) companies, 2,435 in number[6] on December 31, 1961,[7] are not, however, subject to proxy regulation or to the insider trading rules. The Trust Indenture Act of 1939 gave the Commission power to require companies which qualify indentures under it, but are not otherwise under a statutory duty to report under the provisions of sections 13 and 15(d) of the Exchange Act, to comply with such of the reporting requirements of section 13 as the Commission might prescribe.[8] The most recent extension of the principle of equivalent treatment is to be found in the Investment Company Act of 1940, where Congress made the essential safeguards of sections 12, 13, and 14 of the Exchange Act applicable to all registered investment companies and additionally, to registered closed-end investment companies, those of section 16 as well.

(2) *NASD controls*

In the case of the limited group of over-the-counter companies (approximately 1,500) whose securities are quoted in the national and regional "retail" quotation lists compiled by the NASD, at least minimum disclosure protection is provided by a requirement that quoted companies send annual certified financial statements to shareholders and to the NASD. The NASD, however, has no direct control over issuers and its only sanction is omission of the securities of a delinquent or recalcitrant issuer from its lists.

(3) *Prior remedial efforts*

The inadequacy of the investor protections described persists in the over-the-counter market despite the fact that there has been widespread agreement both within and outside Congress that "as a general policy, it is in the public interest that companies whose stocks are traded over the counter be required to comply with the same statutory provisions and the same rules and regulations as companies whose

---

[5] Sec. 15(d) of the Exchange Act requires that a registration statement filed under the Securities Act contain an undertaking on the part of the registrant to file the periodic and other reports prescribed by sec. 13 if the aggregate offering price of the issue, plus the aggregate value of all other securities of the same class outstanding, amounted to $2 million or more. The obligation is suspended if the aggregate value of all outstanding securities of the class to which such issue belongs is reduced to less than $1 million, computed upon the basis of the offering price of the last issue of securities of the class offered to the public. The purpose of this standard was to extend the reporting requirements to "what may truly be regarded as national issues of securities" (H. Rept. 2601, 74th Cong., 2d sess., p. 4 (1936)).

[6] Included are partnerships, voting trusts duplicative of listed shares, stock purchase and employees savings plans, companies with only bonds in public hands, registered investment companies, and numerous issuers for whose shares no quotation was available, including a considerable number registering in 1961 but not offering their shares until 1962. There were 715 such issuers all told.

[7] SEC data (unpublished).

[8] Sec. 314(a)(1). The scope of this authorization to the commission is of limited operation since sec. 304(a)(8) of the act permits an issuer to forgo the use of an indenture if the principal amount of the debt securities issued does not exceed $250,000 in any 12-month period, and sec. 304(a)(9) exempts indenture securities if the aggregate principal amount does not exceed $1 million. The Commission has never exercised the power granted.

stocks are listed on national securities exchange."[9] There have indeed been differences of opinion as to the precise scope and standards of coverage of the needed legislative measures, and the several prior legislative efforts have left these differences unresolved. Conversely, failure to resolve the differences has been the major stumbling block to the needed reform.

The first major legislative effort came in 1949 when a bill was introduced by Senator J. Allen Frear, Jr., of Delaware.[10] No committee report on that bill was rendered because, as Senator Frear explained in a Senate speech, "urgent legislation of tremendous national importance," largely arising from the Korean war, took precedence.[11] Several other bills were introduced during the following few years, but the next major effort came as a result of the stock market study conducted by the Senate Banking and Currency Committee in 1955,[12] and by 1957 a bill to extend sections 13, 14, and 16 to certain issuers of over-the-counter securities had progressed to the point of being favorably reported by the full committee.[13]

The 1957 bill, however, did not proceed beyond the Senate committee report, no time for legislative action being left in that session of Congress. The hearings reflected some dissatisfaction with the standard of coverage—750 shareholders and $2 million of assets. There were also questions about exempting specific classes of issuers, such as banks and insurance companies. There was considerable question, moreover, about the desirability of applying the insider-trading provisions to broker-dealers who were directors of issuers in whose stocks they made primary markets. The bill as approved by the committee therefore called for further study of the latter question.

Since extension of reporting, proxy and insider-trading protections to over-the-counter securities was an important area of study mentioned in the hearings preceding inauguration of the Special Study, and since the major unresolved problems were those surrounding the scope and standards of coverage and the effect of section 16(b) on market makers, attention has been concentrated primarily on those problems. The basic need for extension, however, is more pressing now than ever.

2. THE NEED FOR ADEQUATE PROTECTION FOR INVESTORS IN OVER-THE-COUNTER SECURITIES

The basic principles which impelled Congress to establish the disclosure, proxy, and insider-trading protections for investors in listed securities are equally applicable to the over-the-counter market.

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[9] The quotation is from the majority report of the Senate Committee on Banking and Currency in connection with its "1955 Stock Market Study" (S. Rept. 376, 84th Cong., 1st sess., p. 9 (1955)). The minority report concurred in recommending "further study by the committee on over-the-counter markets * * * with the objective of developing specific legislation, if needed." Id. at p. 18.

[10] S. 2408, 81st Cong., 2d sess. (The most complete history may be found in 2 Loss, Securities Regulation 1149–1164 (2d ed., 1961). And see the statement of Commission Chairman Armstrong in the Senate hearings on the Frear-Fulbright bill. Hearings on S. 2054 before a subcommittee of the Senate Committee on Banking and Currency, pp. 1037–1048 (1955); S. Rept. 700, 85th Cong., 1st sess., pp. 8–13 (1957).

[11] 96 Congressional Record 15109 (1950); S.E.C., 16 Ann. Rep. XIII (1950).

[12] "Stock Market Study," S. Rept. 376, 84th Cong., 1st sess. (1955). And see "Staff Report on Factors Affecting the Stock Market," S. Rept. 1280, 84th Cong., 1st sess. (1955).

[13] S. Rept. 700, on S. 1168, 85th Cong., 1st sess. (1957).

There is nothing in the mechanics of the marketplace which calls for protection in one case and not in the other. The need for accurate information as a basis for investment decisions and as a bulwark against fraud and manipulation, the desirability of providing a basis for at least minimum corporate democracy, and the dangers of misuse by insiders of confidential corporate information are as great in one as in the other.

a. Disclosure as it relates to investor protection

President Roosevelt, in his message to Congress of March 29, 1933, stated the philosophy of disclosure under the Securities Act as follows:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.[14]

What President Roosevelt said about new issues applies, as Congress later recognized in the Exchange Act, with equal force to already outstanding issues. Indeed, all responsible members of the financial community agree that securities should be bought and sold on the basis of reliable information about their issuer. Thus, Graham, Dodd & Cottle[15] define the objectives of security analysis as:

> First, * * * *to present the important facts* regarding a stock or bond issue, in a manner most informing and useful to an actual or potential owner.
>
> [and]
>
> Second, * * * to reach dependable conclusions, *based upon the facts* and applicable standards, as to the safety and attractiveness of a given security at the current or an assumed price. [Emphasis supplied.]

Similarly, in a recent work sponsored by the Financial Analysts Federation, "Corporate Reporting for the Professional Investor," the author, Dr. Corliss Anderson, chairman of the Finance Department of the Graduate School of Business Administration, Northwestern University, states as one of the guiding general principles:

> We believe that no responsible management wants to have among its shareholders those who have paid too much for the stock of their company due to inadequate or poorly timed information.
>
> Unfounded rumors grow better in darkness than in the light of facts. The policy of providing complete information at the usual periodic reporting times has the definite advantage of precluding great "surprises" to the shareholders and, perhaps more importantly, it lessens the likelihood of excessive overvaluation or undervaluation of the company's common stock in the marketplace.

Moreover, far from applying only to listed corporations and the few categories of closely regulated or relatively substantial over-the-counter issuers that now are subject to sections 13, 14, and 16 or their equivalents, the principle of reaching investment decisions on the basis of fact applies with even greater urgency, if that is possible, to the rest of the over-the-counter market. The heterogeneity of that

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[14] S. Rept. 47 at pp. 6–7 and H. Rept. 85 at pp. 1–2, 73d Cong., 1st sess. (1933).
[15] "Security Analysis" (4th ed., 1962).

market is noted elsewhere in this report; [16] it includes not only issues of widely known, substantial, seasoned corporations like most of those in the listed market, but also the residue of all issues that have evoked investment and trading interest. Relatively unknown, insubstantial, and unseasoned issues should be subjected to *more*, not less, light than their fellows.

The need for full disclosure in relation to outstanding over-the-counter securities could hardly be more forcefully expressed than it has been both orally and in writing by a senior partner of one of the largest brokerage houses of the country. A written statement he submitted to the study reads in part as follows:

> *Disclosure.*—Full disclosure of essential facts and frequent progress reports have proven to be the most effective tool for bringing to the attention of buyers and sellers the official facts concerning an enterprise. Though the facts are often not read or studied by buyers and sellers, they are at least available to those who will read them and, moreover they are useful to the professional analyst as a basis for his studies. When I was an analyst in the twenties and could not learn from management the true rate of their business activities, I had to go to the plant gate at stated intervals to count the number of employees reporting for work at various intervals in order to establish a series of reliable statistics on the company's trend of activity as reflected by employment. Today, the reporting requirements of the New York Stock Exchange to which a company must agree as a condition of listing, and the requirements of the SEC with regard to insiders' trading and proxy notices, provide most of the information that is essential to an intelligent evaluation.
>
> Unfortunately, these requirements apply only to the relatively small number of issues listed on that exchange. The securities so listed are, with few exceptions, companies that are mature and well seasoned and probably have the best and most experienced managements and board of directors. They are generally the type of companies in which less disclosure could be more easily condoned than in that vast field of unlisted securities. The listed companies are generally large enterprises and they have and can afford better accounting controls, more sophisticated, adequately paid executives; they use the highest grade public accountants and their annual reports nowadays are a veritable mine of information that goes way beyond the requirements of the rules to keep their stockholders informed.
>
> On the other hand, small companies, often undercapitalized, with new or untried and unseasoned managements, engaged in new and hazardous fields of endeavor, often with new products in a growing competitive field, many with nothing more than a new idea or a newly developed but untried product, are not required to make any disclosure or reports to stockholders beyond that of the original registration statement if they sold new securities, and not even such information if no new securities were issued, despite the fact that they may have many stockholders. There are presently no requirements for the publication of annual reports, quarterly reports (or monthly statements of sales as in the case of retail trade); no requirement for proxy notices with appropriate disclosures of salaries, bonuses, etc.; no requirement as in the case of listed securities to advise the public promptly of any significant changes in their business, acquisitions, changes of management, etc. It is almost incredible that in this vast field where the hazards are greater and where the need for information is essential for intelligent evaluation and for discrimination between securities that there is this vacuum, while in the area where such disclosures are less essential they are made public as required by listing agreements.
>
> In my judgment, the requirements for a flow of information should at least be equal for all publicly owned securities to those required by the New York Stock Exchange. In fact, it would be my judgment that newly organized, promotional enterprises with little or no record of business performance, whether they be regulation A or otherwise, should be required to make *monthly* progress reports to their stockholders to keep them informed as to how their money is being used—just as it would be in the case of a partnership. Such monthly reporting should be required until they have reached a stage where their size

[16] See ch. VII.

and maturity and everything about them were such that they would be qualified for listing if they so desired. At that point the requirements could be relaxed to the standards of listed companies.

The need for disclosure in the over-the-counter market, moreover, surpasses even the demands of intelligent investing; disclosure is the stoutest shield against fraud and manipulation. As the House Committee on Interstate and Foreign Commerce put it in 1934:[17]

> There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance in the market. * * * Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculates on inside information.

The correlation between fraud and lack of disclosure unfortunately can be shown still to exist. The study has surveyed every case of fraud under either the Securities Act or the Exchange Act which was reported in either a litigation release or other Commission release during a period of 18 months beginning January 1961. Included were broker-dealer revocation cases and cases in which non-broker-dealers were defendants. Of 107 proceedings in which the name of the security was mentioned, all told 99 (93 percent) involved issuers that were not subject to the continuous reporting requirements of the Exchange Act. Sixty-five involved companies of which the Commission had no record whatsoever and 34 involved issuers that had offered a fully registered or regulation A offering at some time but were not required to file periodic financial reports. It is of course true that fraud is possible and does exist even when there is complete disclosure by the issuer; the records demonstrate, however, that during the period surveyed the preponderance of fraud cases related to securities about which the public had no accurate data. To the extent that companies which have publicly traded over-the-counter issues outstanding are allowed to operate in the dark, the very conditions that encourage a resort to fraud and manipulation are fostered.

b. Reporting practices in the over-the-counter market

Many companies that are not now required to file financial reports with the Commission have on their own initiative provided financial data to the financial manuals and to their shareholders. Many such companies, on the other hand, either make no reports to shareholders at all or their reports are meager and inadequate. Almost half of the approximately 300 public complaint letters received by the principal office of the Commission in an average month in 1961, for instance, were from investors whose complaints were that they either could not obtain information about a company in which they had invested or that the information sent to them was not adequate. Such complaints are entirely consistent with, indeed corroborate, the results of surveys of over-the-counter shareholder reporting practices made by the Commission on several past occasions and confirmed by the Special Study.

In 1946 the Commission examined the annual reports of an objectively selected group of 70 issuers of over-the-counter securities that

[17] H. Rept. 1383, 73d Cong., 2d sess., p. 11 (1934).

had at least $3 million in assets and 300 or more security holders.[18] It was found that 52 percent of the balance sheets examined were materially deficient when judged by Commission standards; 13 percent of the companies did not furnish a profit and loss statement and 20 percent did not furnish an analysis of surplus. The Commission concluded that on the whole the reports of the 70 companies were seriously inadequate, often to the point of being misleading.[19]

In 1949 the Commission brought its 1946 study up to date by a supplementary study of 159 issuers, each of which had assets of at least $3 million and at least 300 security holders.[20] It was found that 12 percent did not publish one or more of the three basic statements—the balance sheet, the profit and loss statement, and the statement of surplus—and 56 percent of the balance sheets and 52 percent of the profit and loss statements were inadequate by Commission standards.

In 1956 the Commission checked financial reports of 1,161 issuers that all had $2 million or more in assets and 750 or more shareholders, or debt securities in excess of $1 million.[21] Again it was found that only approximately half of the issuers in the group surveyed substantially complied with the Commission's accounting standards, and about 13 percent were judged materially deficient.[22]

A survey conducted by the Special Study produced similar results. Half of the 1,965 issuers included in the survey described in section 3, below, were asked to submit copies of all financial reports submitted to shareholders in the year 1961.[23] The reports submitted were then analyzed as indicated below. Perhaps the most significant finding, however—one which the nature of prior studies made impossible—was that more than 25 percent of the issuers responding did not disseminate any financial information to shareholders at all.

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[18] SEC, "A Proposal To Safeguard Investors in Unregistered Securities," H. Doc. 672, 79th Cong. (1946).

[19] Immediately thereafter, to check on the results of the above study the Commission asked the Marvyn Scudder Financial Library of Columbia University to solicit annual reports from a group of 90 companies having the same characteristics as the earlier group of 70. Of these 90 issuers, 51 cooperated and submitted annual reports, 5 sent letters of refusal, and 34 made no reply at all. Analysis of the 51 reports brought to light serious deficiencies almost identical with those of the earlier group of 70.

[20] SEC, "A Proposal To Safeguard Investors in Unregistered Securities," supplemental report to Congress (1950).

[21] SEC, "Report on S. 2054," Senate committee print, 84th Cong., 2d sess. (1956).

[22] Corporations that file financial statements with the Commission pursuant to sec. 15(d) are required to furnish the Commission with copies of reports sent to stockholders; but such reports are not considered as filed with the Commission and are not subject to Commission accounting standards. Of the 1,161 issuers, 580 were sec. 15(d) companies and currently filing data with the Commission. The reports of only 5 percent of these issuers were found to be materially deficient by Commission standards. On the other hand, of the 581 issuers not required to file reports with the Commission, 21 percent were found to be materially deficient. Some of the major inadequacies noted were the failure of issuers to show sales or cost of sales, and an omission of either the profit and loss or earned surplus statement.

[23] See sec. 3.b, below, for bases of sample receiving OTC–4. Of those requested to send financial data, 771 issuers responded with a completed questionnaire and either submitted the financial data or answered that they had not sent any material to shareholders. Of these, 171 were banks, 44 insurance companies, and 556 industrial and others. The following analysis refers only to the 556 industrial and others; banks and insurance companies are discussed separately in sec. 4 below. In almost all instances the material examined was for 1961. If an issuer submitted material for 1960 or 1962 only, however, the material submitted was deemed to represent its current reporting practice. In no case was any material prior to 1960 examined. To judge the adequacy of the material submitted, a check list was used consisting of 18 items that are basic to an adequate financial report. These items were classified as "adequate" or "inadequate," depending upon their compliance with regulation S–X, the Commission's basic accounting regulation, which prescribes the form and content of financial statements filed with the Commission. In all cases of minor deficiencies or questions of doubt the item was classified as "adequate," and in most instances a finding of "inadequate" meant the item was missing entirely.

Reports of the issuers that did distribute financial data to shareholders contained deficiencies as follows:

1. Forty-four percent failed to classify inventories. The failure to classify inventories in such categories as raw materials, work in process and finished goods, prevents an investor from properly evaluating the issuer's position as compared to prior statements, and also makes it difficult to assess the liquidity of its assets.
2. Twenty-six percent failed to state the method of valuing inventories. If inventories are substantial, the method of valuation (e.g., lower of cost or current market value, last-in first-out, or first-in, first-out), can change the representation of financial condition and results of operations materially.
3. Thirty-three percent failed to include explanatory notes. Almost all financial statements need notes to explain such items as depreciation methods, long-term contractual obligations, outstanding options, contingent liabilities, significant nonrecurring items, etc.
4. Twenty-three percent were not certified. Despite the fact that certification does not alone guarantee investors adequate information, lack of certification is considered a serious shortcoming in any financial report.

It is thus clear that the need for improvement in the financial reporting practices of over-the-counter issuers is urgent.

c. Proxy solicitation

At the time of the enactment of section 14 of the Exchange Act, it was contemplated, in the words of one congressional report—

> * * * that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts.[24]

Here again disclosure was the weapon, but the objective was to enable shareholders ultimately to control the destinies of the enterprises of which they are the owners, to insure a measure of corporate democracy. An informed and concerned electorate is as essential to corporate as to political democracy and the Commission by its rules has therefore sought both to provide shareholders with adequate information when their proxies are solicited, so that they can cast their ballots intelligently, and to provide individuals or groups not affiliated with management with opportunities for solicitation and submission of proposals for vote equal to those of management. The proxy rules have been described by Professor Loss, while he was Associate General Counsel of the Commission, as "* * * the single most effective disclosure device in our whole statutory arsenal." [25]

The proxy solicitation practices of issuers of over-the-counter securities, however, present a striking contrast to those required of issuers of listed securities. Past surveys by the Commission have demonstrated, and the Special Study has confirmed, the urgency of extending the applicability of the Commission's proxy rules to all issuers regardless of the nature of the marketplace in which their securities are traded.

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[24] S. Rept. 1455, 73d Cong., 2d sess., at p. 77 (1934).
[25] Speech by Louis Loss to New York Young Republican Club, Apr. 28, 1949.

The Commission in its 1946 study examined all proxy materials sent out in 1943 and 1944 by a sample group of over-the-counter issuers.[26] The material studied related to 152 meetings [27] and can be summarized as follows: Proxy materials relating to 126 of 142 annual meetings did not even name the persons who were nominated as directors. None of the proxy statements stated the remuneration of the management. In 59 of the 142 annual meetings, one of the items of business was stated to be the approval and ratification of all acts of the management since the last annual meeting, but in no case was the nature of those acts disclosed. Some 95 percent of the companies did not afford shareholders an opportunity to vote "yes" or "no" on specific items through a convenient ballot or box type proxy. An annual report was not sent to shareholders in 28 of the 142 cases, until after the meeting had been held.

The Commission in its 1949 study checked the proxy-solicitation practices of 96 companies that were not subject to the Commission's proxy rules.[28] Only 4 of the 96 companies furnished shareholders with all of the information that would have been required by the Commission's rules.

The Commission in its 1955–56 study examined the proxy-solicitation practices of 663 companies.[29] Analysis of the material showed the following major deficiencies:

1. Seventy-three percent of the companies solicited proxies for the election of directors but failed to state the names of nominees.
2. Fifty-two percent of the proxies relating to major proposals did not have a place for a "yes" or "no" vote.
3. Seventy-five percent of the proxies relating to bonus, profit-sharing, and management-remuneration plans failed to state the cost of such plans.
4. Forty percent of the proxies relating to mergers, consolidations, acquisitions, and similar matters failed to state the effect of the proposed transaction on present security holders.

The Special Study made a similar survey. The same issuers that were asked to submit financial data (see sec. 2.b above) were asked to submit copies of all notices of meetings, proxy forms, proxy statements, and all other proxy solicitation materials sent to shareholders during the period from January 1, 1961, to December 31, 1961. The material submitted related to 588 meetings, 535 annual and 53 special.[30]

One hundred-forty (24 percent) issuers did not solicit proxies, and no material at all was sent to shareholders. In another 31 instances

[26] See note 18, above.

[27] Of these, 142 were annual meetings and 10 were special meetings.

[28] See note 20, above. The material examined was for 202 meetings.

[29] See note 21, above. All issuers studied had at least $2,000,000 in assets and 750 or more shareholders, or a debt security registered pursuant to the Securities Act of 1933 of which the outstanding principal amount exceeded $1,000,000.

The Commission in 1955–56 also studied the proxy-solicitation materials of 333 companies that had assets of $2,000,000 but less than 750 shareholders. Those companies had a higher percentage of failure to present pertinent information than the group discussed above. Report, note 21, above, at p. 9.

[30] Banks and insurance companies are discussed separately in sec. 4, below. Almost all of the material examined was for the year 1961, and in no instance did it include material before 1960. If a company submitted material for 2 annual meetings, only the later material was examined.

To evaluate the proxy-soliciting practices of these companies, a checklist had all major items that could come before a stockholders' meeting, and listed below each proposal the important items of disclosure required by the Commission's proxy rules. These items were classified as either "adequate" or "inadequate" depending upon compliance with the Commission's proxy rules. In almost all cases "inadequate" means that the item was missing entirely. In any situation of a doubtful nature the answer was resolved in favor of the soliciting company.

(5 percent), a notice of the meeting was the only information made available to the shareholders. Thus, for only 417 (71 percent) of the meetings was there even a solicitation and an opportunity for the shareholder to have his vote counted.

The election of directors is the most frequent matter voted on by shareholders, and 379 (90 percent) of the 417 proxy solicitations examined involved such elections. In 275 (73 percent) of the 379 cases the shareholders were not told the names of the nominees, and in 44 of the remaining 104 instances in which nominees were named their experience was not given. The remuneration of management was not given in 95 percent of the solicitations for election of directors. In short, in a large majority of the solicitations for election of directors, shareholders were asked to vote blindly for the present management or their nominees.

The Commission's proxy rules require that, except for an election of directors, shareholders be given an opportunity for a "yes" or "no" vote by a ballot or box-type proxy. Of the solicitations examined, 172 would, under Commission rules, require an opportunity for a "yes" or "no" vote. In 108 (62 percent) of those solicitations, the opportunity was not afforded.

In over 50 percent of the solicitations that related to bylaw or charter amendments, the reasons for the amendment were not stated. Forty-eight involved modifications of securities; in two-thirds of such cases the effects of the modification on the rights of existing security holders were not given. Options, warrants, or rights were to be authorized in 25 instances; in 14 of the 25, prospective management recipients were not named and in 21 of the 25, the provisions of the plans were not stated.

Here again, the inadequacies of present standards in the over-the-counter market are clear. Every reason of policy calls for extension of the benefits of section 14 of the Exchange Act and the Commission's rules to issuers of securities traded there.

d. The protection against insider trading

The need of investors in over-the-counter securities for protection against insider-trading abuses may be even greater than that of investors in listed securities. It is noted in chapter VII that the over-the-counter market as it now exists bears little resemblance in size and scope to the market of the early 1930's. Speculative excesses, moreover, have accompanied the remarkable increase in participation by the general public. The studies detailed above have shown that there is a great dearth of information about a substantial segment of the issuers of stocks traded over the counter, and much of the information available with respect to many others is unfortunately unreliable. If that absence of reliable and current information, which facilitates the planting of rumors and may actually foster insider trading, is considered along with the fact that many over-the-counter issuers are insider controlled (see sec. 3b(5), below), it will be clear that insiders now enjoy unparalleled opportunities for short-swing profits in over-the-counter stocks.

Experience with section 16 since its enactment in 1934 indicates clearly its value and effectiveness in limiting those opportunities and correcting abuses. During the Commission's fiscal year ended June 30, 1961, 38,821 ownership reports reflecting initial positions and

monthly changes were filed by insiders pursuant to section 16(a), another 286 reports were filed pursuant to section 17(a) of the Holding Company Act, and 1,456 reports were filed pursuant to section 30(f) of the Investment Company Act. All filed reports are available for public inspection both at the exchanges and at the Commission.

To further the original congressional objective of providing all interested persons with information as to the trading activities of insiders, the Commission publishes each month an Official Summary of Security Transactions and Holdings which summarizes the transactions contained in the various ownership reports filed that month. The summary is distributed through the Superintendent of Documents, and its regular circulation now exceeds 16,000 copies monthly, more than 400 of which are received by the press, libraries, and other similar sources of further public distribution such as investment advisory services.

Position and transactions report and the summary have proven to be of great public interest. On the basis of a 1950 Commission study of public use of the summary, which led to the conclusion that an average of 8.4 persons used each copy then subscribed for, it can be estimated that the more than 16,000 copies now subscribed for are consulted by more than 100,000 persons.[31]

Subscribers have indicated to the Commission, moreover, that they consider the transactions reported in the summary, insofar as they reflect or imply the opinion of the insiders as to the value of their corporations, as "valuable as corporate statements themselves," a fact to consider "before making an investment," and "one of the safeguards to investors." Indeed, as noted in chapter III.C above, some investment advisers give attention to the position and transactions of the insiders as one of the important factors to be taken into account in formulating their recommendations.

The requirement that insiders disclose their short-swing transactions, and the close attention given such disclosures by the interested public, themselves constitute important deterrents against insider-trading abuses. Where those deterrents fail to accomplish the objective, however, section 16(b), the "automatic" recovery provision, takes up the defense. Assisted by section 16(a) and a Commission requirement that insiders' contingent liabilities under 16(b) be disclosed on financial reports and proxy statements, section 16(b) has over the past 20 years amply demonstrated its effectiveness.[32]

Here again, the need for such protections in the over-the-counter market is, if anything, greater than in the listed market.

e. Effects of lack of investor protections in the over-the-counter market

The absence of financial reporting and the other investor protections provided in respect of listed securities has created special burdens and difficulties for broker-dealers and their customers in dealing with over-the-counter securities as compared with listed securities. A broker-

[31] See 16 S.E.C. Annual Report, p. 40 (1951).

[32] See, e.g., *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433, cert. denied, 346 U.S. 820 (1953); *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943); *Arkansas Louisiana Gas Co.* v. *W. R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark.) (1956); *Stella* v. *Graham-Page Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), remanded on other grounds, 232 F. 2d 299, cert. denied, 352 U.S. 831 (1956); *Carr-Consolidated Biscuit Co.* v. *Moore*, 125 F. Supp. 423 (M.D. Pa. 1954); *Magida* v. *Continental Can Co.*, 12 F.R.D. 74, 78 (S.D.N.Y. 1951).

dealer or financial analyst attempting to assess the investment worth of securities of a nonreporting company more often than not is unable to find adequate data in the financial manuals. In some instances the broker-dealer may have access to information through representation on the issuer's board of directors, but this entails its own difficulties in that he has the benefit of information not generally available to others, while he is dealing both for his own account and that of his customers.[33] In other instances he must take his chances with such information as the management chooses to make public, or else he must expend considerable effort and incur substantial costs in making his own investigation. A single such effort, moreover, will not suffice; investigation must be a continuing process if financial data once assembled are to be kept sufficiently up to date to be a reliable basis for advice. Broker-dealers that maintain a recommended list of numerous securities must therefore devote a disproportionate share of their research budgets to keeping themselves informed about over-the-counter securities, if they are to keep the worse alternative of recommending securities blindly. A higher cost of research and selling is often cited, in turn, as partial justification for higher markups in over-the-counter transactions.

For reason such as this, not to mention the more direct reason that the statutory protections are lacking, many investors draw a fairly sharp line between listed and unlisted markets, so that many over-the-counter securities fail to attract the degree of investor interest which they might enjoy if protections were available. Thus, the over-the-counter market itself, and the issuers of securities traded there, are disadvantaged by lack of the investor protections afforded in listed markets.

Providing the protections of sections 13, 14, and 16 for investors in the over-the-counter market would not only encourage a more healthy development of that market but would also eliminate the basic unfairness of the current double standard of regulation. At present an issuer is permitted to decide whether or not to comply with reporting, proxy and insider trading controls. Insofar as possible, regulation affecting issuers should be a neutral factor in the determination of whether a security is traded in the listed or over-the-counter market. Securities should gravitate to the market which is best suited for them without the arbitrary influence of extraneous factors of this kind.

Finally, lack of disclosure in the over-the-counter market has a potentially significant effect on the allocation of capital resources. Adequate disclosure tends to insure that sound companies will be the ones that will receive investors' funds. Since securities and the companies which issue them compete for the investment dollar, it is essential, as it is in other forms of competition, that there be fairness. The Federal Trade Commission demands honest labeling not only to protect the consumer, but also to protect the honest seller from unfair competition. Where there is an absence of continuous reporting, the financial and other material information necessary for investment decisions is in a sense closed off and hidden from the investor's view. Full disclosure, therefore, is an essential ingredient of fair competition and makes it possible for investors to make their decisions on

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[33] For a discussion of broker-dealers as corporate directors, see ch. III.F, above.

the basis of the actual merits of securities offered, and the price to be fairly determined by the laws of supply and demand.

Thus, from all points of view, from that of the individual investor to that of the Nation as a whole, the principle is unassailable, the need is clear. It is only in deciding the exact coverage of sections 13, 14, and 16 in respect of over-the-counter securities that there can be open questions.

3. ISSUERS TO BE INCLUDED

a. General criteria of coverage

Deciding to what issuers the requirements of sections 13, 14, and 16 of the Exchange Act should now be extended involves a balance of various theoretical and practical considerations. A standard of coverage has to be determined that is both reasonably reliable and easily enforceable and will bring within the statutory controls those issuers that are sufficiently significant from the point of view of the public interest to warrant the regulatory burden to be assumed by the Government and the compliance burden to be imposed on the issuers involved.

Theoretically and ideally, every security in which there is a public investor interest ought to be included. Under the *Ralston Purina* [34] case this is not necessarily a matter of large numbers; at least for Securities Act purposes, an offering to a very small number of persons may be "public" if they need the protection of disclosure, and by parity of reasoning it may be argued that any company with outside stockholders, however few, should be included in the protective legislation. Presumably on this reasoning, at least one past legislative proposal has used a standard of 10 stockholders and $500,000 of assets.[35] Congress itself has fixed 100 shareholders as the standard of coverage under the Investment Company Act.[36]

The results of the studies described below, however, indicate that it would be impracticable to key the over-the-counter coverage of sections 13, 14, and 16 to the Securities Act concept of "public" or to any rule of thumb as low as 25 or even 50 or 100 stockholders.[37] Unlike the Securities Act, which requires filing only on the occasion of an offering, these sections of the Exchange Act require at least annual filings. It is, therefore, necessary on purely practical grounds to limit the number of issuers required to comply in some manner so that the flow of reports and proxy statements will be manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served.

Where to draw the line has been the subject of considerable uncertainty in the prior legislative history. Past studies were apparently confined to issuers included in standard financial manuals or already reporting to the Commission pursuant to section 15(d) of the Exchange Act. The Special Study determined at the outset, therefore,

[34] *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953).
[35] H.R. 7955, 82d Cong., 2d sess. (1952).
[36] Investment Company Act, sec. 3(c)(1).
[37] For example, merely on the basis of indications of broker-dealer interest in the National Quotation Bureau service covering the last 3 months of 1961, it is estimated that some 8,500 issuers would be covered by a 25-shareholder standard; and to that figure would have to be added the unquestionably large number of corporations with 25 or more stockholders that had not evoked broker-dealer trading interest during that period. For a 100-shareholder standard, the comparable figure would be 7,300. See table IX–e, below.

that its most useful contribution would be to assemble more comprehensive and detailed data that might serve to delineate more clearly the characteristics of issuers meeting potential coverage criteria and at the same time provide more reliable estimates of the numbers of issuers that might be included under any criterion or combination of criteria.

The characteristics that seemed prima facie most relevant—in addition to (i) number of shareholders and (ii) amount of assets, which had received primary attention in previous studies and exclusive attention in prior legislative proposals—were (iii) transfers of stock, (iv) concentration of holdings, and (v) trading interest in interdealer markets. Number of shareholders has always been recognized, and obviously is, the most direct and simple criterion of public-investor interest. The amount of assets would seem to be no more than a secondary criterion at best, since for many reasons there is an absence of clear or necessary relationship between total assets and the equity interest of investors to be protected; yet it may ultimately have relevance in defining a limit where burdens may be disproportionate to needs. Transfers of stock, the third factor mentioned above, measures the number of investors affected on a dynamic rather than a merely static basis and helps to distinguish actively traded securities from others. Concentration, on the other hand, is pertinent in appraising the significance of mere numbers of shareholders at any given time and also in weighing the significance of proxy and insider-trading protections. Dealers' trading interest is of some importance in relation to insider-trading protection where the dealer is also an insider and, of course, is of major significance in distinguishing actively traded from other securities.[38]

All of these characteristics have, accordingly, been made the subject of specific inquiry and study, separately and in relation to each other. Detailed results and relationships are set forth below. However, inasmuch as the criterion of numbers of shareholders has emerged, perhaps not surprisingly, as the single most workable and most meaningful criterion, the data with respect to the other characteristics are analyzed below primarily in this frame of reference.

b. Questionnaire OTC-4

The study's primary source of data was questionnaire OTC-4. This was addressed to a representative sample of issuers selected as follows:

As described in chapter VII, the National Quotations Bureau, Inc., in addition to publishing daily interdealer quotations, publishes monthly summaries that are considerably more comprehensive than any daily list and in fact constitute the most comprehensive and readily available indication of issues as to which any degree of dealer interest has been manifested during the period covered by each monthly summary. Accordingly, one of the monthly summaries—that issued in January 1962—was chosen. It presented a list of 13,335 issuers in whose securities the broker-dealer community had shown interest during the last 3 months of 1961. For most domestic over-the-counter listings, approximately 75 percent, at least one broker-dealer had entered a price quotation—as distinguished from an OW (offer wanted)

[38] Further discussion of the significance, and limits thereof, of certain of these characteristics is set forth at various places below.

or BW (bid wanted) or a name entry only—in the daily sheets on at least 1 day during that period. The others, approximately 25 percent, were included only in the monthly summary—undoubtedly overlapping in part, but to an unknown degree, the OW or BW category in the daily sheets—and presumably were securities in which there was less active interest. Because of the unusually high interest in over-the-counter securities at the time, this particular summary was, if anything, more comprehensive than a typical one and might have included a somewhat higher than normal proportion of smaller, less well-known corporations.

From the list of 13,335 issuers, published in alphabetical order, every 5th issuer was chosen. From the resulting group of 2,667 issuers, 427 domestic listed and 275 foreign issuers were then withdrawn. To the 1,965 issuers thus selected the questionnaire designated "OTC-4" was sent.[39] The principal data requested were. (1) Amount of assets on December 31, 1961; and, for each class of stock outstanding on December 31, 1961, (2) number of shares outstanding, (3) number of shareholders of record, and (4) number of transfers of record during 1961. At the same time certain subsidiary and collateral information was sought: (5) Data about any public offerings during 1960–61, (6) numbers and holdings of bank and broker-dealer shareholders, (7) outstanding debt securities, (8) indication of any directors or officers who were associated with broker-dealers, and (9) concentration of holdings.

Of the 1,965 [40] issuers to which OTC-4 was sent, 1,618 supplied substantially complete answers. These issuers consisted of 96 insurance companies, 358 banks, and 1,164 industrial and other corporations. Their characteristics are discussed in another context in chapter VII, and are analyzed here only as pertinent to the question of possible coverage of recommended legislation to extend sections 13, 14, and 16 to issuers of over-the-counter securities.

(1) *Classification by numbers of shareholders*

Of the 1,618 companies submitting information, 1,610 reported the number of shareholders, and for this total group there were 2,865,000.[41] Since all other data are analyzed with respect to the number of shareholders of record, the 1,610 issuers were first classified by this measure. For this purpose, number of shareholder-class intervals were established, somewhat arbitrarily, but with some reference to standards proposed in various prior bills, as follows: 1 to 24, 25 to 99, 100 to 199, 200 to 299, 300 to 499, 500 to 749, 750 to 999, 1,000 to 1,999, 2,000 to 2,999, 3,000 to 4,999, and 5,000 and over.

In order to portray the distribution of the 1,610 issuers into the class intervals chosen, part A of chart IX-a [42] contains a bar divided on the basis of the percentage of issuers in each class. It will be ob-

[39] See app. A.

[40] This number was reduced to 1,773 because 192 issuers turned out to be out of business, merged, wholly owned subsidiaries, etc.

[41] Only the class held by the largest number of record holders is considered and multiple ownership is ignored. By expanding the figure to "universe" proportions, it might be estimated that the comparable number of shareholders of all issuers quoted in the January 1962 Monthly Summary (excluding domestic listed, foreign, merged, and such other companies), was 15,757,000.

[42] See chart IX-a, below. (Tables and charts which are integrally related to the discussion are included in the text and are identified by a lowercase letter (e.g., table IX-a). Other tables appear at the end of the chapter but may be referred to in the text. These are identified by an arabic numeral (e.g., table IX-1).

served for example, that 51 issuers, representing 3.2 percent of the total, had 1 to 24 shareholders;[43] 234 issuers, representing 14.5 percent of the total, had 300 to 499 shareholders; and 199 issuers, representing 12.3 percent of the total, had 1,000 to 1,999 shareholders. Part B of chart IX–a is made up of a series of bars that show the numbers and percentages on a cumulative basis. Thus, there are 1,005 issuers, or 62.3 percent of the total, that had 300 or more shareholders: and 463 issuers, or 28.7 percent of the total, that had 1,000 or more shareholders. In short, the cumulative figures indicate the total number of issuers in the sample that would be embraced by a designated standard, i.e., the number of issuers that would be covered by a standard of 300 or more shareholders, by a standard of 1,000 or more shareholders, etc.

All of these numbers are in terms of record holdings, as distinguished from beneficial. As a general rule, therefore, they presumably understate the numbers of investors affected, since a single record holding is more likely to represent several beneficial holders than vice versa. While table IX–1 shows that 40 percent of all issuers had from 10 percent to 29 percent of their shares registered in names of broker-dealers or bank nominees, it is impossible to state the exact extent to which taking account of the underlying beneficial holdings would shift the distribution of companies and result in different numbers of companies covered at different shareholder levels.

(2) *Number of shareholders versus number of record transfers*

The first relationship to be considered is that between number of shareholders and number of transfers of record during the calendar year 1961. Transfers of record are at least a rough indication of activity and, of course, each transaction may add a party to the group for whom the statutory protections become available.[44]

Not surprisingly, comparison of numbers of record shareholders with numbers of record transfers revealed a general correspondence between the two. The correspondence is portrayed by table IX–a and chart IX–b, below. Thus, at the two extremities of the ranges, 95.5 percent of all reporting issuers that had less than 25 shareholders reported less than 25 transfers of record during 1961 and 68.1 percent of all responding issuers that had 5,000 or more shareholders reported 2,000 or more transfers of record. Between the extremes the general correspondence continues to obtain. Thus as attention progresses from the smallest shareholder family size to the larger, at first only a negligible proportion of issuers show 25 or more transfers (7.9 percent in the 25-to-99 shareholder category), then a larger proportion (30.3 percent in the 100-to-199 shareholder cate-

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[43] Unless otherwise stated, all data related to the class of stock outstanding held by the largest number of shareholders. On the basis of OTC–4 sample data it would appear that the effect of considering numbers of holders of multiple issues is likely to be minimal. Thus, only 22.4 percent of all companies surveyed had more than one issue outstanding, and in only a very few cases would the consideration of issues other than the largest have resulted in shifts from one category to another. A comparison of multiple issues would increase the number of issuers of 300 or more shareholders from 1,005 to only 1,026; of 500 or more, from 771 to only 798; of 750 or more, from 592 to 611; and of 1,000 or more, from 463 to only 484.

[44] Actual trading volumes for over-the-counter issues are, of course, unavailable and any attempt to obtain them for a representative group of such issues over and extended period of time did not seem feasible. A reasonable measure of activity seemed to be transfers of record, although it must be recognized that many such transfers would not reflect actual trades and that many actual trades could take place without record transfers. In this connection the data referred to above concerning record holdings of broker-dealers and bank nominees are relevant.

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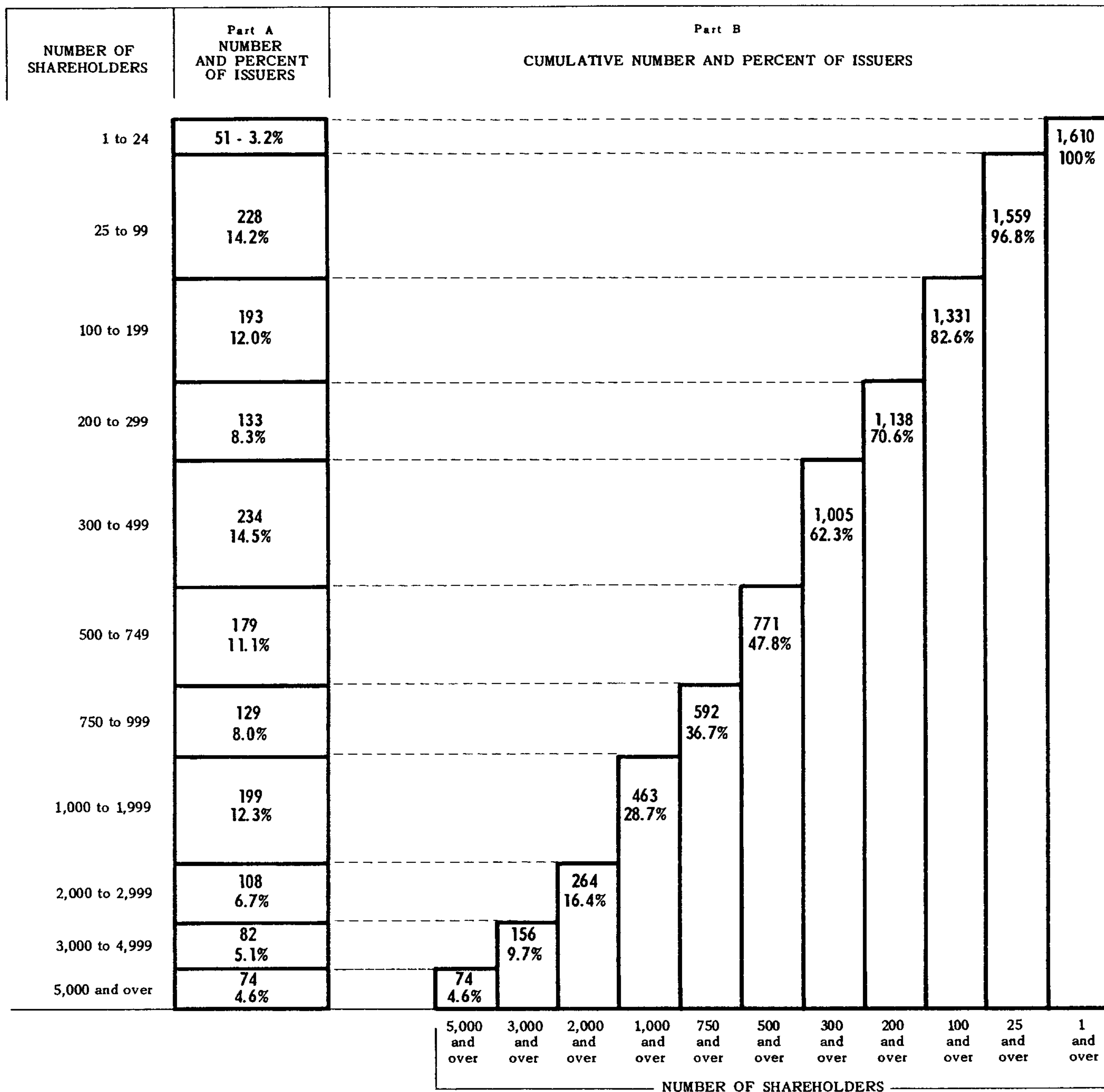
CHART IX-a

SAMPLE OF ISSUERS OF OVER-THE-COUNTER STOCK CLASSIFIED BY NUMBER OF SHAREHOLDERS OF RECORD

December 31, 1961 [1/]



NOTE: Sample includes approximately 1 out of 5 issuers listed in The National Quotation Bureau, Inc., The National Monthly Stock Summary (January 1, 1962). Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

[1/] *In a small number of instances the information shown is as of a date close to December 31, 1961.*

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gory), and then a clear majority (61.1 percent in the 200-to-299 shareholder category). In the middle range, from 300 to 1,999 shareholders, a clear shift from preponderance of less active to more active stocks occurs; for example, beginning at the 300 shareholder level a majority of companies show at least 100 transfers.

TABLE IX–a.—*Sample of issuers of over-the-counter stock classified by number of shareholders of record and number of stock transfers, 1961*

Number of shareholders [2]	Number of stock transfers [1]								
	All issuers	1 to 24	25 to 49	50 to 99	100 to 199	200 to 499	500 to 999	1,000 to 1,999	2,000 and over
	Number of issuers								
Total	[3] 1,489	429	127	122	118	178	174	157	184
1 to 24	22	21	--------	--------	--------	1	--------	--------	--------
25 to 99	189	174	11	2	1	--------	1	--------	--------
100 to 199	188	131	32	10	11	3	1	--------	--------
200 to 299	126	49	26	21	10	11	4	5	--------
300 to 499	226	33	35	38	29	39	40	11	1
500 to 749	176	10	15	28	34	23	30	28	8
750 to 999	124	3	4	9	14	33	25	23	13
1,000 to 1,999	189	6	4	9	15	34	39	41	41
2,000 to 2,999	100	1	--------	2	--------	21	23	21	32
3,000 to 4,999	80	1	--------	2	2	9	7	17	42
5,000 and over	69	--------	--------	1	2	4	4	11	47
	Percent of issuers in each transfer category falling in each shareholder category								
Total	--------	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1 to 24	--------	4.9	--------	--------	--------	.6	--------	--------	--------
25 to 99	--------	40.6	8.7	1.6	.8	--------	.6	--------	--------
100 to 199	--------	30.6	25.2	8.2	9.3	1.7	.6	--------	--------
200 to 299	--------	11.4	20.5	17.2	8.5	6.2	2.3	3.2	--------
300 to 499	--------	7.7	27.6	31.2	24.6	21.9	23.0	7.0	.6
500 to 749	--------	2.3	11.8	23.0	28.8	12.9	17.2	17.9	4.3
750 to 999	--------	.7	3.1	7.4	11.9	18.5	14.4	14.6	7.1
1,000 to 1,999	--------	1.4	3.1	7.4	12.7	19.1	22.4	26.1	22.3
2,000 to 2,999	--------	.2	--------	1.6	--------	11.8	13.2	13.4	17.4
3,000 to 4,999	--------	.2	--------	1.6	1.7	5.1	4.0	10.8	22.8
5,000 and over	--------	--------	--------	.8	1.7	2.2	2.3	7.0	25.5
	Percent of issuers in each shareholder category falling in each transfer category								
Total	100.0	28.8	8.5	8.2	7.9	12.0	11.7	10.5	12.4
1 to 24	100.0	95.5	--------	--------	--------	4.5	--------	--------	--------
25 to 99	100.0	92.1	5.8	1.1	.5	--------	.5	--------	--------
100 to 199	100.0	69.7	17.0	5.3	5.9	1.6	.5	--------	--------
200 to 299	100.0	38.9	20.6	16.7	7.9	8.7	3.2	4.0	--------
300 to 499	100.0	14.6	15.5	16.8	12.8	17.3	17.7	4.9	.4
500 to 749	100.0	5.7	8.5	15.9	19.3	13.1	17.1	15.9	4.5
750 to 999	100.0	2.4	3.2	7.3	11.3	26.6	20.2	18.5	10.5
1,000 to 1,999	100.0	3.2	2.1	4.8	7.9	18.0	20.6	21.7	21.7
2,000 to 2,999	100.0	1.0	--------	2.0	--------	21.0	23.0	21.0	32.0
3,000 to 4,999	100.0	1.2	--------	2.5	2.5	11.3	8.8	21.2	52.5
5,000 and over	100.0	--------	--------	1.4	2.9	5.8	5.8	16.0	68.1

[1] The number of stock transfers covers the period from Jan. 1, 1961, to Dec. 31, 1961, except in a small number of instances. Excludes transactions not involving changes of ownership: e.g., in mergers, consolidations, recapitalizations, stock dividends, stock splits, etc.
[2] The number of shareholders is shown as of Dec. 31, 1961; in a small number of instances the information shown is as of a date close to Dec. 31, 1961.
[3] Excludes 129 issuers who did not report shareholders and/or stock transfers.

NOTE.—Sample includes approximately 1 out of 5 issuers listed in the National Quotation Bureau, Inc., the National Monthly Stock Summary (Jan. 1, 1962). Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

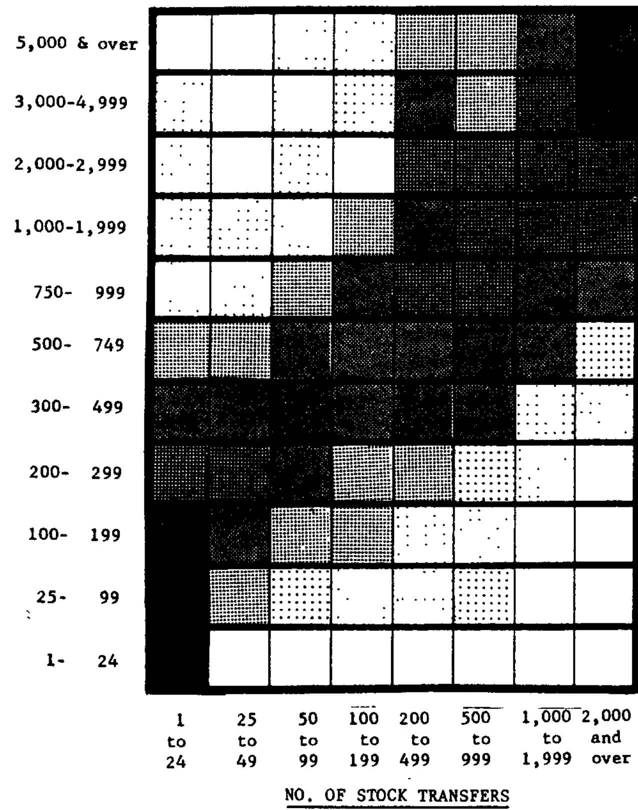
CHART IX-b

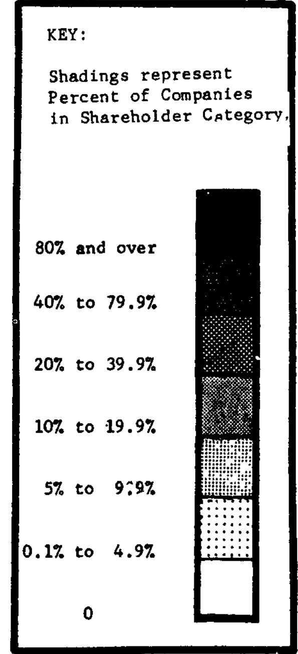
SAMPLE OF

ISSUERS OF OVER - THE - COUNTER STOCK

Classified by Number of Shareholders and Number of Stock Transfers

1961





Source: Table IX-a

Chart IX–b makes the relationships between shareholders and transfers plainly evident and vividly illustrates how a number-of-shareholders criterion can be used both to measure the size of the group most immediately to be protected and to indicate the level at which the need for protection is substantially increased by a significant degree of trading activity.

(3) *Number of shareholders versus number of broker-dealers quoting shares wholesale*

Comparisons of the numbers of broker-dealers entering wholesale quotations in the sheets of the National Quotation Bureau with numbers of shareholders are shown in table IX–b and chart IX–c, below. The significance to be attributed to the comparisons is subject to the important qualification that a numerical count of quotations in the Monthly Summary necessarily ignores the large qualitative differences between them: A single appearance of a large New York City wholesale market maker presumably indicates a greater likelihood of active trading than does a similar appearance of a more obscure broker-dealer. Moreover, the method of compiling quotations in the Monthly Summary results in showing one broker-dealer entry, whether the particular broker-dealer appeared only on a single day or every day in the period.[45] Similarly, public offerings during or shortly preceding the precise period might slightly distort the significance of the numbers shown.[46]

[45] For example, the appearance of 3 different broker-dealers' quotations might indicate, at one extreme, 3 separate, single-day entries and, at the other, 3 simultaneous entries on every business day of the 3-month period (i.e., 3 actual quotations versus 180 actual quotations in full period).

[46] As noted above, respondents were asked for data relating to recent public offerings. In several instances these turned out to be useful to explain away what would otherwise have appeared to be mere aberrations. See note 47, below. Analysis demonstrates, however, that any distorting effects that recent offerings may have had were relatively uniformly distributed over all shareholder size categories, so that relative relationships were undisturbed. See table IX–2.

TABLE IX–b.—*Sample of issuers of over-the-counter stock classified by number of shareholders of record and number of broker-dealers "entering quotations," Oct. 1 to Dec. 31, 1961*

Number of shareholders [2]	Number of broker-dealers "entering quotations" [1]					
	All issuers	None	1	2 to 4	5 to 9	10 and over
	Number of issuers					
Total	[3] 1,610	712	167	274	273	184
1 to 24	51	46	1			4
25 to 99	228	204	13	5	2	4
100 to 199	193	150	27	14	2	
200 to 299	133	82	21	20	7	3
300 to 499	234	88	39	55	37	15
500 to 749	179	65	19	43	40	12
750 to 999	129	30	14	31	34	20
1,000 to 1,999	199	30	15	53	70	31
2,000 to 2,999	108	6	7	32	40	23
3,000 to 4,999	82	4	7	13	23	35
5,000 and over	74	7	4	8	18	37
	Percent of issuers in each quotation category falling in each shareholder category					
Total		100.0	100.0	100.0	100.0	100.0
1 to 24		6.5	.6			2.2
25 to 99		28.7	7.8	1.8	.7	2.2
100 to 199		21.1	16.2	5.1	.7	
200 to 299		11.5	12.5	7.3	2.6	1.6
300 to 499		12.3	23.3	20.1	13.5	8.2
500 to 749		9.1	11.4	15.7	14.7	6.5
750 to 999		4.2	8.4	11.3	12.5	10.9
1,000 to 1,999		4.2	9.0	19.3	25.6	16.8
2,000 to 2,999		.8	4.2	11.7	14.7	12.5
3,000 to 4,999		.6	4.2	4.8	8.4	19.0
5,000 and over		1.0	2.4	2.9	6.6	20.1
	Percent of issuers in each shareholder category falling in each quotation category					
Total	100.0	44.2	10.4	17.0	17.0	11.4
1 to 24	100.0	90.2	2.0			7.8
25 to 99	100.0	89.4	5.7	2.2	.9	1.8
100 to 199	100.0	77.7	14.0	7.3	1.0	
200 to 299	100.0	61.6	15.8	15.0	5.3	2.3
300 to 499	100,0	37.6	16.7	23.5	15.8	6.4
500 to 749	100.0	36.3	10.6	24.0	22.4	6.7
750 to 999	100.0	23.2	10.9	24.0	26.4	15.5
1,000 to 1,999	100,0	15.1	7.5	26.6	35.2	15.6
2,000 to 2,999	100.0	5.6	6.5	29.6	37.0	21.3
3,000 to 4,999	100.0	4.9	8.5	15.9	28.0	42.7
5,000 and over	100.0	9.5	5.4	10.8	24.3	50.0

[1] Limited to broker-dealers who entered both a "bid" and "offer" in the National Quotation Bureau, Inc., the National Monthly Stock Summary (Jan. 1, 1962).
[2] In a small number of instances the number of shareholders shown is as of a date close to Dec. 31, 1961.
[3] Excludes 8 issuers who did not report shareholders.

NOTE.—Sample includes approximately 1 out of 5 issuers listed in the National Quotation Bureau, Inc.' the National Monthly Stock Summary (Jan. 1, 1962). Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

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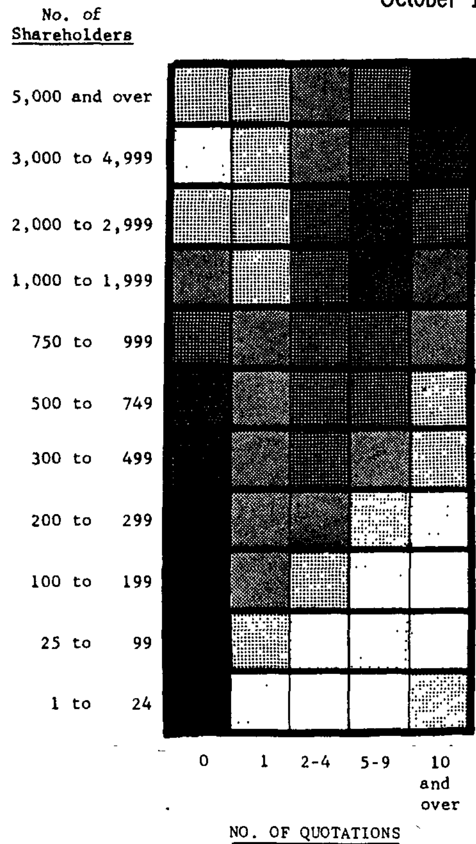
CHART IX–c

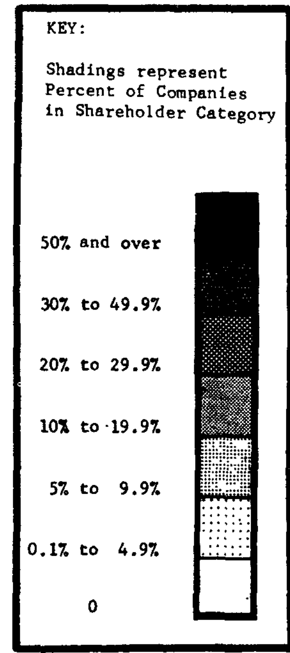
SAMPLE OF

ISSUERS OF OVER - THE - COUNTER STOCK

Classified by Number of Shareholders and Number of Broker-Dealers "Entering Quotations"

October 1, 1961 - December 31, 1961





Source: Table IX-b

In a general way, nevertheless, the number of different broker-dealers that appear in a monthly summary covering a limited period is apparently related to the shareholder size of the issue. Thus the securities of 90.2 percent of the smallest issuers (in terms of numbers of shareholders) were not quoted at all, whereas those of 50 percent of the largest issuers were quoted by 10 or more broker-dealers. With some minor deviations, moreover, the number of quoting broker-dealers increases progressively with shareholder size.[47]

(4) *Number of shareholders versus assets*

When numbers of shareholders are related to issuers' asset sizes, no significant relationships are evident. The data are presented in table IX–c and chart IX–d, below. It is true that only one issuer in the smallest shareholder category is of the largest asset size and two-thirds of the issuers in the largest shareholder category are of the largest asset size; but until the very large shareholder categories (2,000 and above) are reached, where very few companies have less than $1 million of assets, no discernible shareholder-to-assets pattern emerges. The graphical presentation in chart IX–d makes the wide dispersion evident. Because of this dispersion, the inclusion of an asset test in addition to a shareholder test would have the effect of reducing coverage at all shareholder levels, but, of course, particularly at the lower end of the scale.

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[47] The few issuers in the smallest class that were quoted by the surprisingly large number of 10 or more broker-dealers, made public offerings late in 1961, apparently too late to affect their share registers by Dec. 31, 1961, but not too late to affect the daily sheets.

TABLE IX–c.—*Sample of issuers of over-the-counter stock classified by number of shareholders of record and size of assets, Dec. 31, 1961* [1]

Number of shareholders [2]	All issuers	Assets									
		$1,000 to $249,999	$250,000 to $499,999	$500,000 to $749,999	$750,000 to $999,999	$1,000,000 to $1,999,999	$2,000,000 to $2,999,999	$3,000,000 to $4,999,999	$5,000,000 to $9,999,999	$10,000,000 to $19,999,999	$20,000,000 and over
	Number of issuers										
Total	[3] 1,601	104	110	102	58	187	138	155	245	162	340
1 to 24	51	9	5	5	2	9	7	5	5	3	1
25 to 99	227	19	17	12	10	37	27	28	44	16	17
100 to 199	193	9	12	14	11	28	19	23	29	27	21
200 to 299	132	13	5	11	3	12	14	10	22	19	23
300 to 499	232	20	31	27	10	19	21	21	26	17	40
500 to 749	179	13	21	13	8	27	16	14	18	12	37
750 to 999	128	4	9	5	8	19	7	16	28	12	20
1,000 to 1,999	197	12	8	6	6	23	15	20	38	23	46
2,000 to 2,999	106	3	2	3	----------	5	6	10	14	18	45
3,000 to 4,999	82	1	----------	4	----------	4	5	4	14	9	41
5,000 and over	74	1	----------	2	----------	4	1	4	7	6	49
	Percent of issuers in each asset category falling in each shareholder category										
Total	----------	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1 to 24	----------	8.7	4.5	4.9	3.4	4.8	5.1	3.2	2.0	1.8	.3
25 to 99	----------	18.2	15.5	11.8	17.3	19.8	19.6	18.1	18.0	9.9	5.0
100 to 199	----------	8.7	10.9	13.7	19.0	15.0	13.8	14.8	11.8	16.7	6.2
200 to 299	----------	12.5	4.5	10.8	5.2	6.4	10.1	6.5	9.0	11.7	6.8
300 to 499	----------	19.2	28.2	26.5	17.2	10.2	15.2	13.5	10.6	10.5	11.8
500 to 749	----------	12.5	19.1	12.7	13.8	14.4	11.6	9.0	7.4	7.4	10.9
750 to 999	----------	3.8	8.2	4.9	13.8	10.2	5.1	10.3	11.4	7.4	5.9
1,000 to 1,999	----------	11.5	7.3	5.9	10.3	12.3	10.9	12.9	15.5	14.2	13.5
2,000 to 2,999	----------	2.9	1.8	2.9	----------	2.7	4.3	6.5	5.7	11.1	13.2
3,000 to 4,999	----------	1.0	----------	3.9	----------	2.1	3.6	2.6	5.7	5.6	12.0
5,000 and over	----------	1.0	----------	2.0	----------	2.1	.7	2.6	2.9	3.7	14.4

See footnotes at end of table.

TABLE IX-c.—*Sample of issuers of over-the-counter stock classified by number of shareholders of record and size of assets, Dec. 31, 1961* [1]—Continued

Number of shareholders [2]	All issuers	Assets									
		$1,000 to $249,999	$250,000 to $499,999	$500,000 to $749,999	$750,000 to $999,999	$1,000,000 to $1,999,999	$2,000,000 to $2,999,999	$3,000,000 to $4,999,999	$5,000,000 to $9,999,999	$10,000,000 to $19,999,999	$20,000,000 and over
	Percent of issuers in each shareholder category falling in each asset category										
Total	100.0	6.5	6.9	6.4	3.6	11.7	8.6	9.7	15.3	10.1	21.2
1 to 24	100.0	17.6	9.8	9.8	4.0	17.6	13.7	9.8	9.8	5.9	2.0
25 to 99	100.0	8.4	7.5	5.3	4.4	16.3	11.9	12.3	19.4	7.0	7.5
100 to 199	100.0	4.7	6.2	7.3	5.7	14.5	9.8	11.9	15.0	14.0	10.9
200 to 299	100.0	9.8	3.8	8.3	2.3	9.1	10.6	7.6	16.7	14.4	17.4
300 to 499	100.0	8.6	13.4	11.6	4.3	8.2	9.1	9.1	11.2	7.3	17.2
500 to 749	100.0	7.3	11.7	7.3	4.5	15.1	8.9	7.8	10.1	6.7	20.6
750 to 999	100.0	3.1	7.0	3.9	6.3	14.8	5.5	12.5	21.9	9.4	15.6
1,000 to 1,999	100.0	6.1	4.1	3.0	3.0	11.7	7.6	10.2	19.3	11.7	23.3
2,000 to 2,999	100.0	2.8	1.9	2.8	----------	4.7	5.7	9.4	13.2	17.0	42.5
3,000 to 4,999	100.0	1.2	----------	4.9	----------	4.9	6.1	4.9	17.0	11.0	50.0
5,000 and over	100.0	1.4	----------	2.7	----------	5.4	1.4	5.4	9.4	8.1	66.2

[1] In a small number of instances the information shown is as of a date close to Dec. 31, 1961.

[2] Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

[3] Excludes 17 issuers who did not report assets and/or shareholders.

NOTE.—Sample includes approximately 1 out of 5 issuers listed in the National Quotation Bureau, Inc., the National Monthly Stock Summary (Jan. 1, 1962).

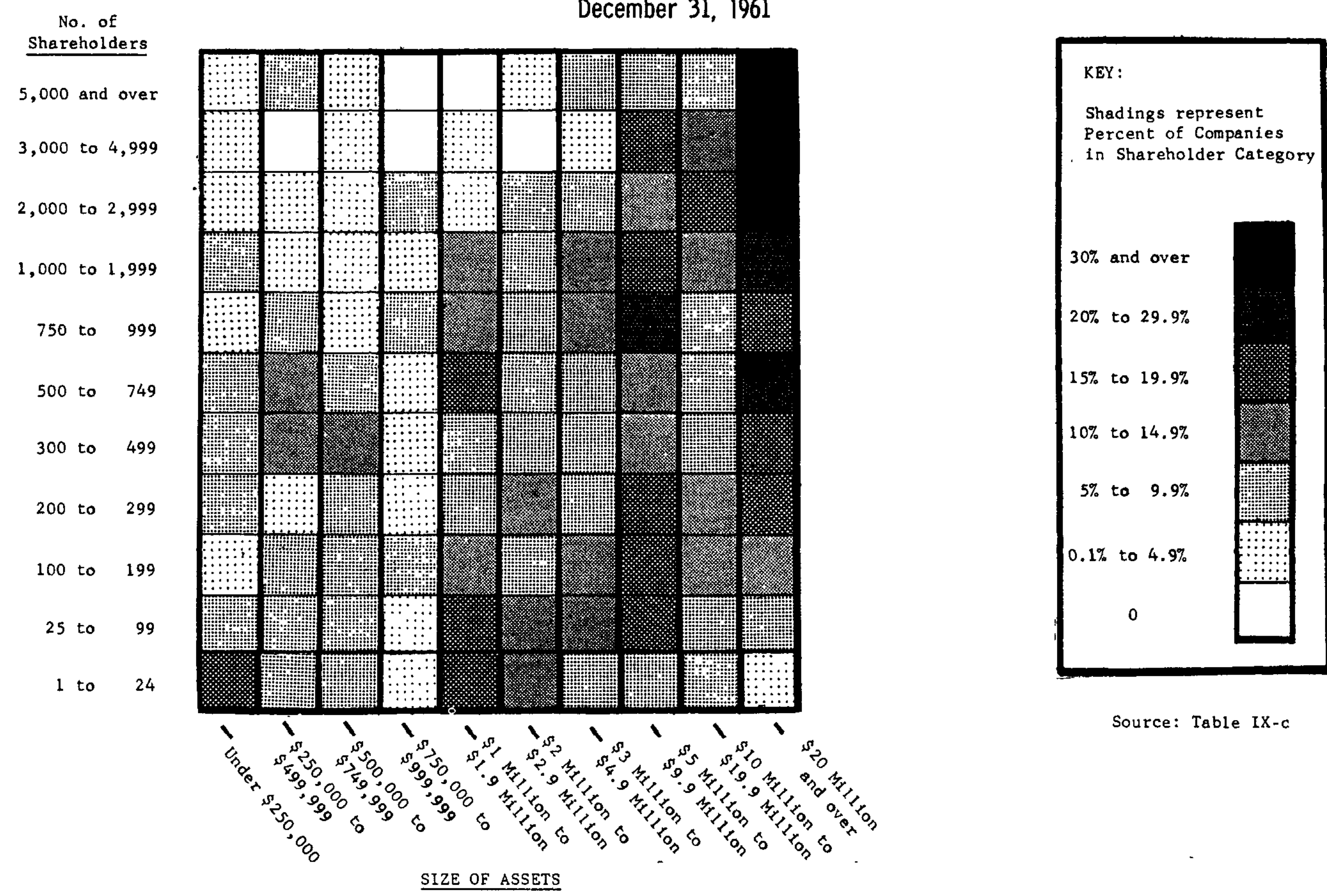
CHART IX-d

SAMPLE OF

ISSUERS OF OVER-THE-COUNTER STOCK

Classified by Number of Shareholders and Size of Assets

December 31, 1961



Source: Table IX-c

(5) *Number of shareholders versus concentration of holdings*

When numbers of shareholders are arrayed against degrees of concentration of holdings a striking picture emerges. The data are presented in table IX–d, below. Until the 1,000-shareholder level is reached, more than half of the companies in each category are more than 50-percent owned by the 10 largest holders [48] except that in the 500-to-749 shareholder category, the number of companies thus owned is just under one-half of the total. If 40-percent ownership is considered, the group of companies in the less-than-1,000 shareholder categories is significantly increased and more than half of the 1,000-to-1,999 shareholder companies are added. More than 65 percent of all companies that have less than 3,000 shareholders are at least 30-percent owned by the 10 largest holders. Even many of the very widely held corporations show substantial concentrations: Thus almost 30 percent of the over-the-counter companies that had 5,000 or more shareholders were at least 30-percent owned by their 10 largest shareholders of record, and the comparable figure for 40-percent ownership was almost 20 percent.

TABLE IX–d.—*Sample of issuers of over-the-counter stock classified by number of shareholders and percent of stock held by 10 largest record holders, Dec. 31, 1961* [1]

[Number of issuers]

Number of shareholders	All issuers	Percent of stock held by 10 largest record holders [2]			
		1 to 29	30 to 39	40 to 49	50 and over
Total	[3] 1,530	305	220	180	825
1 to 24	46				46
25 to 99	183	2	4	3	174
100 to 199	182	11	19	23	129
200 to 299	127	15	19	22	71
300 to 499	230	37	36	27	130
500 to 749	179	42	29	23	85
750 to 999	128	17	25	20	66
1,000 to 1,999	197	50	41	27	79
2,000 to 2,999	106	37	22	18	29
3,000 to 4,999	80	43	17	11	9
5,000 and over	72	51	8	6	7

[1] In a small number of instances the information shown is as of a date close to Dec. 31, 1961.
[2] Includes holdings in street name and in names of bank nominees. The figures therefore are an overstatement of the amount of concentration of holdings.
[3] Excludes 88 issuers who did not report shareholders and/or 10 largest record holders.

NOTES.—Sample includes approximately 1 out of 5 issuers listed in the National Quotation Bureau, Inc., the National Monthly Stock Summary (Jan. 1, 1962). Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

(6) *Recapitulation*

To recapitulate some of the analyses above in terms of the classification of companies by numbers of record shareholders: In the group of 472 companies having fewer than 200 shareholders, there is a wide dispersion as to amount of assets, which tends to be true of all but the very largest categories, the number of record transfers tends to increase slightly in proportion to the number of shareholders; and there is a considerable preponderance (85 percent) of companies showing no

[48] Only record holdings are considered; it was not possible to determine numbers of beneficial owners.

quotations. In the 200-to-299 category the number of transfers increases further and there is a rather distinct indication of more active dealer interest as shown by the fact that 38.4 percent have one or more quotations. From this point upward in the shareholder classifications, except for the fact that there is still a considerable dispersion of asset sizes, the indexes of public interest and trading activity become quite marked. Thus, in the 300-to-499 and 500-to-749 categories, more than 60 percent have one or more quotations, and above the 300-shareholder level more than 69 percent of the issuers have 200 or more transfers. As one continues to move up the shareholder levels, a roughly corresponding increase in activity and broker-dealer interest is evident.

c. Number and characteristics of companies included

(1) *On the basis of OTC-4 shareholder data*

Since the criterion for coverage of the proposed legislation must ultimately be determined in terms of practicality, consideration must next be given to the number of companies likely to be included if the criterion is in terms of any specified number of shareholders. As mentioned above, this was one of the prime objectives of the OTC-4 study, since prior estimates of numbers of companies had been based only on more limited lists and analyses. The method of establishing the sample for OTC-4 has been described above. Briefly it consisted of taking 1 in every 5 of the 13,335 listings in the Monthly Quotation Summary for January 1962, and excluding listed companies and foreign issuers. It follows from the method, and from the fact that about 82 percent of usable responses were received, that out of the total of 13,335 issuers in the Summary (excluding domestic listed, foreign, merged, and such other issuers), the number of companies in each size bracket should be 5.5 times[49] the respective numbers shown for the sample in chart IX-a, above, that is to say: In other words, it may be concluded that with a size standard of 300 shareholders, for example, approximately 5,500 of those in the Monthly Stock Summary would have been covered; with a standard of 500 shareholders, approximately 4,250 companies would have been covered; and with a standard of 1,000, approximately 2,550 companies.

TABLE IX-e.—*Sample of issuers of over-the-counter stock classified by number of shareholders and multiplied by 5.5, Dec. 31, 1961*[1]

Shareholder categories	OTC-4 sample	Multiplied by 5.5	Shareholder categories	OTC-4 sample	Multiplied by 5.5
All issuers	[2] 1,610	8,855	500 and over	771	4,241
			750 and over	592	3,256
25 and over	1,559	8,575	1,000 and over	463	2,547
100 and over	1,331	7,321	2,000 and over	264	1,452
200 and over	1,138	6,259	3,000 and over	156	858
300 and over	1,005	5,528	5,000 and over	74	407

[1] In a small number of instances the information shown is as of a date close to Dec. 31, 1961.
[2] Excludes 8 issuers who did not report shareholders.

NOTE.—Sample includes approximately 1 out of 5 issuers listed in the National Quotation Bureau, Inc., the National Monthly Stock Summary (Jan. 1, 1962). Where an issuer had several classes of stock, the one selected refers to that with the largest number of shareholders.

[49] $\frac{\text{1773 recipients}}{\text{1610 respondents}} \times 5 = 5.5$. (See note 40, above.)

The cumulative effect of differing shareholder-size coverage criteria should also be considered.[50] It will be observed that a standard of coverage of 300 or more shareholders would include well over half (62 percent) of all companies; would include only a small proportion of all very inactive companies [51] (13 percent of those with less than 25 transfers and 32 percent of those not quoted)[52] and would include almost all of the active companies. As the minimum shareholder size increases, the proportion of all companies decreases from 62 percent at 300 shareholders to 48 percent at 500, 37 percent at 750 and 29 percent at 1,000, a decrease between the lowest shareholder category mentioned and the highest of 33 percent points. As might be expected, as shareholder size increases a smaller and smaller percentage of very inactive companies is included, but that result is achieved at the expense of losing an increasing percentage of quite active companies.

(2) *In light of other factors*

The estimates in table IX-e, above, are not the final answers as to the total numbers of companies to be covered, since they are confined to companies whose securities were quoted in the 3-month period in the particular Monthly Quotation Summary. It is known that many companies having "public" shareholders are not actively traded or else are not regularly quoted by any dealer. For this category of companies reliable statistics are not available. Depending on the definition used, the total number of "over-the-counter" companies has been estimated by various persons at various times at two or three times the number included in the Monthly Quotation Summary used in OTC-4. It must be assumed, however, that the vast majority of such companies would fall outside the coverage of legislation in any event, since the widening of share ownership is generally accompanied by a widening of dealer interests; thus it has been seen that dealer interest evidenced by 2 or more dealers is often found among companies with 300 to 499 stockholders, and dealer interest of 5 or more is quite common among companies with 500 or more stockholders. As one measure of the number of the companies not quoted regularly enough to appear in a given Monthly Summary but nevertheless likely to appear occasionally, the study compared monthly quotation summaries covering 7 months in addition to the 3 covered by the one used for OTC-4 (using the letters C and S as samples) and found that the number of issuers quoted at any time during the entire 10-month period was 25 percent greater than the number in the single summary originally used. Taking into account the fact that the additional companies are likely to have relatively few shareholders and be relatively inactive, it is believed that a 25-percent increase of numbers previously arrived at would constitute a reasonable allowance for the companies that were not included in the original monthly summary but that would be covered by a criterion expressed in terms of a specific number of shareholders.

On the other hand, inclusion of an asset test along with a shareholder test might significantly reduce the numbers indicated above. On theoretical grounds it is very difficult to justify an asset limit unless expressed in quite modest amount: an investor in a small enterprise

[50] See chart IX-a.
[51] See table IX-3.
[52] See table IX-4.

is as entitled to solicitude as one in a large and, indeed, in most instances needs it more (see pp. 9–10, above). Although it may be true that, speaking very generally, larger companies are better able to bear the burden of compliance than smaller ones, any issuer that has considered itself worthy of public financing cannot well be heard to say that its public shareholders are not worthy of statutory protection. Moreover, as noted above, amount of assets is at best only a crude indication of the amount of equity interest of shareholders. Nevertheless, the effect of an asset test in conjunction with shareholder test can be shown from the data in table IX–5. It appears that a $1 million asset limit would remove about 22 percent of all companies at the 300-or-more shareholder level, 17 percent at the 500-or-more shareholder level, and 13 percent at the 750-or-more shareholder level. On the other hand, if the asset limit were $500,000 these figures would become aproximately 12, 10, and 7 percent.[53]

If, however, only numbers of shareholders are considered, the numbers of companies that would be affected, taking into account all of the considerations discussed above, would be as set forth in table IX–f below. Since some of the companies are already required under section 15(d) to comply with section 13 and, at least insofar as reporting is concerned, would not constitute an additional administrative burden, the number of sections 15(d) companies has been indicated at each level.

TABLE IX–f.—*Estimated number of issuers covered at various shareholder levels*

Shareholder categories	OTC–4 sample multiplied by 5.5	Additional 25 percent added for extension of quotation period [1]	Total	Estimated number of sec. 15(d) issuers included [2]	Total of new reporting issuers
All issuers	8,855	2,214	11,069	1,526	9,543
25 and over	8,575	2,144	10,719	1,520	9,199
100 and over	7,321	1,830	9,151	1,493	7,658
200 and over	6,259	1,565	7,824	1,451	6,373
300 and over	5,528	1,382	6,910	1,438	5,472
500 and over	4,241	1,060	5,301	1,328	3,973
750 and over	3,256	814	4,070	1,210	2,860
1,000 and over	2,547	637	3,184	1,011	2,173
2,000 and over	1,452	363	1,815	619	1,196
3,000 and over	858	215	1,073	399	674
5,000 and over	407	102	509	214	295

[1] See discussion above.
[2] Includes sec. 15(d) issuers in OTC–4 sample, multiplied by 5.5 and 25 percent added.

d. Conclusions as to coverage of over-the-counter issuers in terms of shareholders

The conclusions of the Special Study, in light of the foregoing analyses, are as follows: Ideally all issues held by "public" shareholders should comply with sections 13, 14, and 16. If the "pubic" standard were as sweeping as under the Securities Act, however, the total number of corporations subjected to controls would be so great that the regulatory administrative burden might be disproportionate and something less than ideal coverage must be accepted in the interest

[53] It is, of course, impossible to estimate how many issuers might elect to bring their securties into the "OTC-listed" categories under the recommendations in pt. B.6, below.

of feasibility. In theory, a criterion expressed in terms of market activity might be appealing, but it is difficult to conceive of any direct test that could ever be meaningful and workable in practice and it has been seen that the shareholder criterion itself is at least a rough, indirect measure of activity. The data set forth above indicate that at and above the 300-shareholder level trading activity, as measured by transfers and dealer interest, becomes significant for a majority of the issuers affected. It is clear also that under any definition of "public" for purposes of protections of the securities laws, a company with 300 or more shareholders of record is to be deemed public.

Even at the level of 300 shareholders, however, the data tend to indicate such a large number of companies covered—in addition to those now covered by section 15(d)—that the Commission would be unable immediately to shoulder the administrative burden that would be involved. The most feasible course would therefore be to adopt a phased program: for perhaps the first 2 years, issuers with at least 750 shareholders might be covered; for the next 2 years issuers with at least 500 shareholders; and thereafter and permanently, an appropriate standard would be 300 shareholders.[54] During the intervening period it may be expected that necessary facilities and methods of administration to handle the full volume would be completely developed.

As mentioned before, some of the prior bills have been based on a dual test of assets and number of stockholders. It is not believed that an asset test is a necessary or even an appropriate one for the reasons summarized above.

It is not believed, moreover, that over-the-counter applicability of sections 13, 14, and 16 need be extended, as proposed in some prior bills to debt securities.[55] Sections 14 and 16 are designed to protect shareholders (and the "quasi-shareholders" subsumed by the term "equity security").[56] The solicitation of proxies and insider trading are only rarely problems related to debt secuities and, then, most probably in insolvency cases when other protections are available. The Commision now has the power, moreover, to require annual and peri-

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[54] It is assumed that the statutory amendment or appurtenant regulations would define "shareholders" to include known beneficial holders.

The deficiencies recounted above in reporting and proxy soliciting practices for the OTC–4 sample are prevalent in substantially the same degree in the case of those companies in the sample having at least 300 shareholders.

[55] One of the OTC–4 questions sought information about outstanding debt securities and their amount and number of holders. This was to determine whether debtholders independently needed the protections of secs. 13, 14, and 16, but the question was obviously widely misunderstood, in that many respondents gave the aggregate par value of their outstanding stock and repeated the number of shareholders in response to the request for number of debtholders. The small number of apparently correct responses (218) indicate that more than 50 percent of the issuers answering had less than 100 debtholders and a 300-shareholder coverage standard would include 73 percent of all 218 issuers. Of those issuers with less than 300 shareholders (58 of the 218), 45 percent had less than $250,000 face amount of debt outstanding, 60 percent less than $500,000, and 76 percent less than $1 million. The number of persons affected appears to be small; the shareholder standard proposed would make available public financial reports to a large majority of them and the aggregate sums lent by the others tend to be modest.

[56] The term "equity security" refers to "any stock or similar security; or any security convertible, with or without consideration, into such a security; or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security" (Exchange Act, sec. 3(a)(11)).

odic reports from issuers of substantial debt issues, those qualified under the Trust Indenture Act.[57] If that power were exercised, most debt security holders would presumably be adequately protected. The proposed legislation should therefore apply to equity securities and the issuers of such securities.

4. SPECIAL CATEGORIES OF ISSUERS

In connection with prior proposals to extend the requirements of sections 13, 14, and 16 to over-the-counter securities, a recurrent question has been whether banks and insurance companies should be included.

The statutory pattern of Federal securities regulation is one of broad coverage with limited exemption, but banks have always been exempted from prior proposals and insurance companies sometimes have, on the ground that Federal and State regulation eliminates the need for the disclosure which would be required. History, therefore, suggests a brief separate treatment of banks and insurance companies. In each instance there is considered briefly (1) the current regulatory status under the securities laws; (2) the present Federal and State regulation as it relates to disclosure, proxy solicitation and restrictions on insider trading; and (3) the need for coverage.

a. Banks

On December 30, 1961, there were 13,959 banks in the United States.[58] Of these, 13,445 were insured with the Federal Deposit Insurance Corporation; 6,114 were member banks of the Federal Reserve System, of which 4,520 were national banks. There were also 514 noninsured State banks not under the authority of any Federal agency.

Bank securities are an integral and important part of the over-the-counter market. Of the approximately 13,000 issuers listed in the January 1962 Monthly Summary of the National Quotation Bureau (which, as already noted, is prima facie an index of all securities in which there was a broker-dealer trading interest in the 3-month period preceding its date), about 20 percent of the domestic over-the-counter issuers were banks.

Banks were included in the Special Study's sample of issuers which received questionnaire OTC-4, described above. The questionnaire was sent to 378 banks and complete responses were received from 358.[59] Of the respondents, 42 percent (151) had 300 or more shareholders, 32 percent (115) had 500 or more, and 27 percent (100) had 750 or more. Forty-three percent (156) of the banks had assets of $20 million or more and 61 percent (220) had $10 million or more. As a group, bank securities showed slightly less trading activity, as measured by record transfers and quotations, than those of other types of issuers. Corporate and other characteristics of the responding banks are given in chapter VII. Although a standard of 300 shareholders would include only about 1,000 out of the 13,445 banks in the United States, it would include the larger and more actively traded bank stocks.

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[57] See note 8, above.
[58] Federal Deposit Insurance Corporation 1961 Annual Report, table 14, p. 45.
[59] For the detailed results of the bank responses see ch. VII.

(1) *The current regulatory status under the securities laws*

Section 3(a)(2) of the Securities Act exempts from registration—

> * * * any security issued or guaranteed by any national bank, or by any banking institution organized under the laws of any State or territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; or any security issued by or representing an interest in or a direct obligation of a Federal Reserve bank. * * *

The legislative history of the Securities Act indicates that the registration exemption for bank securities was provided because it was felt that regulatory bodies other than the Commission exercised adequate supervision over the issuance of bank securities.[60] A consequence of the exemption is that the reporting requirements of section 15(d) of the Exchange Act, which relate only to certain issuers registering securities with the Commission under the Securities Act, are inapplicable to banks.

The status of banks under the Exchange Act is different. The draftsmen of the later act thought it necessary to provide the protections of sections 13, 14, and 16 to all issuers of securities registered under section 12 and listed on a national securities exchange, including all banks in that category. The Commission, however, issued a "temporary exemption" from such registration for all listed bank securities until adoption of an appropriate registration form.[61] Because the Commission has never provided such a form for registration under section 12, the "temporary" exemption continues today and reporting under section 13, proxy regulation under section 14, and insider-trading controls under section 16, all geared to registration pursuant to section 12(a) of the Exchange Act, still do not apply to the very few banks whose securities are now listed.

Before the passage of the Exchange Act in 1934, a tendency for banks to have their securities delisted from exchanges had set in, and at the present time the securities of only five banks are listed on any registered national exchange, all on the Philadelphia-Baltimore-Washington Exchange. The exempt exchanges—Honolulu, Richmond, and Wheeling—account for an additional 15 bank-security listings.[62]

(2) *Federal and State regulation of banks as it relates to the protection of investors*

The Comptroller of the Currency

Every national bank must make at least four reports of condition annually to the Comptroller.[63] Reports of condition, which must be published, are statements of assets and liabilities and do not include a statement of income. Under the general power of the Comptroller to require special reports[64] there is currently a requirement that annual reports of earnings and dividends be filed, but such reports are confidential and not available to the public.

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[60] See H. Rept. 85, 73d Cong., 1st sess., p. 14 (1933).

[61] Exchange Act, rule 12a-1.

[62] The small number of banks that are listed explains the Commission's failure to adopt a reporting form. It should be noted, however, that the fraud provisions of both the Securities Act and the Exchange Act apply to all securities including those issued by a bank.

[63] 12 U.S.C. 161.

[64] Ibid.

Every national bank is examined at least once a year. The scope of examination is reported to be extensive, but again, the information derived from the examinations is confidential. Recently the Comptroller has promulgated new regulations that take a step toward providing protections for investors in bank stocks similar to those provided by sections 13, 14, and 16 of the Exchange Act. In essence, the new regulations require that annual reports be sent to shareholders; that "adequate" information be provided if proxies are solicited; and that reports of ownership of capital stock be filed when changes of control occur. The Comptroller's regulations are contrasted with sections 13, 14, and 16 at page 39 below.

Federal Reserve Board

As a condition of membership in the Federal Reserve System, banks must make four reports of conditions a year [65] and be subject to examination.[66] The statements of conditions are similar to those required of national banks and show assets and loans outstanding. Examinations are conducted by the Federal Reserve district banks and provision is made for accepting examinations of State authorities.[67] Member banks must also report dividends to, and file annual reports of earnings with, the Federal Reserve district banks of which they are members. The reports of earnings and dividends, however, are not available to the public. There are no provisions specifically relating to proxies or insider trading, regardless of the number of security holders.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) insures each depositor of insured banks to a maximum of $10,000. National banks and State banks that are members of the Federal Reserve System are admitted to insurance automatically. Nonmember State banks must apply for insurance. After admission they are subject to examination, and must submit reports.[68]

The FDIC examines State nonmember banks and reviews examinations of national banks and Federal Reserve member banks made by the Comptroller and Federal Reserve district banks. Specific provisions give the FDIC access to the examinations and reports of the two latter.[69]

Each insured bank must submit a statement of condition four times a year to the appropriate Federal agency [70] and a statement of earnings at least once a year.[71] The required statements are not available to the public.[72] There are no provisions relating to proxies or insider trading.

State regulation

Regulation of banks by the States varies. Generally, State banks are required to publish a statement of conditions similar to that required of national banks and are subject to at least one examination

[65] 12 U.S.C. 324.
[66] 12 U.S.C. 325.
[67] 12 U.S.C. 326.
[68] 12 U.S.C. 1815, 1817.
[69] 12 U.S.C. 1817(a) (1), (2).
[70] 12 U.S.C. 1817(a)(3).
[71] 12 CFR 304.3(m).
[72] See 12 CFR 309.1.

each year. As in the case of Federal agency supervision, however, the examinations are principally for the protection of depositors rather than investors and their results are not available to the public in many jurisdictions. Provision for the protection of investors in the areas of proxy solicitation and insider trading are also absent from most State banking regulations.

(3) The need for coverage

Apart from the Comptroller's recently adopted regulations, which are applicable only to national banks, the protections available to investors in bank stocks are largely limited to those that might inhere in bank examinations and statements of condition designed for the protection of depositors. The latter, although published, are of limited value to investors, and unpublished reports and reports of examinations, being unavailable, are at most only of indirect benefit. In the great majority of cases, protection for investors comparable to sections 13, 14, and 16 of the Exchange Act are nonexistent.

Such protections are clearly needed. The Commission has not, in the past, examined the financial and proxy-solicitation practices of banks and the Special Study therefore took the opportunity presented by OTC-4 to do so. Included among those OTC-4 issuers that were requested to submit copies of their financial reports and proxy materials were 191 banks. One hundred and seventy-one either complied or reported that nothing was sent to shareholders during the period studied.

Analysis of the financial reporting and proxy-solicitation practices of banks reveals that they fall far short of the standards imposed under sections 13, 14, and 16 of the Exchange Act.[73] Twenty percent (34) of the responding banks did not send any financial material to their shareholders at all. Of the 137 banks that did send financial material, 92, or 67 percent, failed to include a profit-and-loss statement. Thus, 126, or 74 percent of all respondents, failed to supply a most significant basis for investment decisions.

Even when banks issue complete reports there is difficulty in interpreting them. As the Bank Stock Quarterly of March 1962 put it:

> A number of banks issue informative annual and quarterly reports to stockholders. But these reports have, in most instances, evolved over a period of time with new information being added whenever management decided it was time to tell the stockholders. In the absence of uniform standards, banks differ in the way they report to shareholders, both in terminology and accounting procedures. Sometimes the same bank will vary its method of reporting from year to year. The results have not helped the individual shareholder or the security analyst to determine how banks are doing, or to make valid comparisons.

The bank proxy material examined related to a total of 180 meetings, 165 annual and 15 special. In 92 percent of the solicitations that involved elections of directors, the names of the nominees were not stated and in 97 percent of such cases their experience was not stated. In 98 percent the remuneration of management was not given.

Other deficiencies included failure to state reasons for the amendment of bylaws or charters (93 percent of the cases) and failure to provide shareholders with an opportunity for a "yes" or "no" vote on

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[73] The study also examined Standard & Poor's "Standard Corporation Descriptions" and Moody's "Bank and Finance Manual" and found that financial information was not available in respect of 69 percent (247) of the 358 banks that responded to questionnaire OTC-4.

major proposals, as would be required by the Commission rules (43 percent of the cases). Absence of bank proxy-solicitation controls and inadequate proxy-solicitation practices on the part of banks take on increased significance when they are viewed in the light of the recent extensive merger trend among banks. From May 18, 1960, through February 1962, there were a total of 314 mergers by banks which submitted merger applications to the Justice Department.[74]

In 274 of the 314 cases, a stock of at least one of the two banks involved was quoted in the monthly or semiannual summary of the National Quotation Bureau. A breakdown of the number of shareholders in the largest of the merging banks at the time of each of the 274 cases is as follows: Under 300 shareholders—13; 301 to 500—26; 501 to 1,000—48; over 1,000—90; shareholder information not available—97.

Most of the specimens of proxies in bank merger proceedings examined by the study proved to be wholly inadequate. A shareholder asked to approve a merger needs to know, at the very least, the financial condition of the companies involved and the terms of the proposed merger plan if he is going to be able to evaluate the effects of the merger on him. By contrast, of nine bank-merger proxy solicitations examined, five were cases in which shareholders were not furnished financial statements of the merging banks, and two were cases in which they were asked to approve a merger plan not even briefly described.

The recent efforts of the Comptroller to improve the lot of bank shareholders, moreover, affect only national banks, a minority (4,520 out of 13,959 banks on December 31, 1961) of all banks, and even as to those affected take only a modest step toward the full protections afforded by sections 13, 14, and 16. The Comptroller has required national banks to send annual reports to their shareholders. The Exchange Act and Commission rules under it require annual reports be sent to shareholders when proxies are solicited, but additionally more detailed and more frequent financial reports are required to be filed with the Commission. The Comptroller's proxy regulation requires either less complete disclosure in relation to options for officers and directors and transactions of such persons with the bank or no disclosure at all. No provision is made, moreover, for examination of proxy materials before their use. Similarly, no provision is made for the presentation of proposals by persons not affiliated with management. The insider-trading provisions, finally, are mere reporting provisions; nothing like the recovery provision of section 16(b) is included.

Clearly, therefore, the protections of sections 13, 14, and 16 are needed for bank shareholders as well as other shareholders. Existing regulation of banks is either designed to protect depositors or provides only a part of what is essential for investors. Subject to exemptive powers to take care of categories where equivalent protections may otherwise be provided, banks meeting the recommended criterion should be included in the recommended legislation.

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[74] The supervising agency (the one having jurisdiction over the resulting bank) was the Comptroller of the Currency in 174 of the mergers, the Federal Reserve in 77, and the Federal Deposit Insurance Corporation in 63.

b. Insurance companies

Of the 1,965 issuers who were selected to receive questionnaire form OTC-4, 110 were insurance companies, 96 of which responded. It is estimated that approximately 5 percent of the domestic issuers listed in the January 1962 Monthly Summary of the National Quotation Bureau were insurance companies. Eighty-two percent of the respondents reported that they had 300 or more shareholders; 73 percent, 500 or more; and 59 percent, 1,000 or more. Only 7 percent of the respondents had less than $1 million in assets, whereas 59 percent had assets of $5 million or more. The characteristics of the insurance companies are given in chapter VII.

(1) *The current regulatory status under the securities laws*

Insurance companies' securities are not exempt from the Securities Act or the Exchange Act. On December 31, 1961, there were 110 insurance companies reporting to the Commission, 108 pursuant to section 15(d) of the Exchange Act and 2 by reason of being listed on exchanges. The Commission has attempted to recognize the particular accounting problems of insurance companies, and those required to file reports under section 13 of the Exchange Act are exempted from filing semiannual reports.[75] Annual reports may be filed without certification,[76] and other reporting requirements differ from those applicable to other companies.

(2) *State regulation of insurance companies as it relates to the protection of investors*

The operations of insurance companies are not supervised by any Federal agency, but are regulated by the States in varying degrees. The emphasis, however, is consistently upon the solvency of the company, the adequacy of its reserves and the legality of its investments, rather than upon disclosure. In other words, State regulation of insurance companies is directed to the protection of the holders of insurance policies, not investors in insurance company securities, as to whom the State regulation has been described as "less and less meaningful" when matched against the "more and more relevant" disclosure policy of the Securities Act.[77]

While the States require licensed insurance companies to file annual reports with the appropriate State supervisory body on a form adopted by the National Association of Insurance Commissioners, which also prescribes standards for the examination conducted by most States, the reports are voluminous (running as high as 300 pages in length), extremely complicated, and designed principally to obtain information on the funds available for policyholders. It is doubtful that many shareholders or investors would be able to comprehend the mass of data that is required. Few if any States offer investors any protection in the areas of proxy solicitation and insider trading.

(3) *The need for coverage*

The interests of the policyholder and the investor are quite distinct. While the need for protection of policyholders stops short after ascer-

[75] Exchange Act, rule 13a-13.
[76] Form 10-K: "Instructions as to Financial Statements," instruction 7.
[77] *S.E.C. v. Variable Annuity Co.*, 359 U.S. 65, 85 (1959) (Brennan J., concurring).

taining that reserves are not impaired, investors in insurance companies are no different from those of other types of issuers in the investor-oriented protections they need. There is really nothing at all about State regulation of insurance companies—any more than about State regulation of public utility companies, for example—that differentiates these companies from all others in respect of the need for protection of investors as such.

The need for protection of investors in insurance stocks has been established. In 1956, the Commission undertook a study of the financial reports and proxy solicitation practices of insurance companies [78] with assets of at least $2 million and 750 shareholders. There were 169 companies that met those criteria and also either appeared in the standard financial manuals or reported under section 15(d) of the Exchange Act. That study disclosed numerous deficiencies by Commission standards.

In 70 percent of the proxy solicitations for the election of directors, the names of the nominees were not given, and 80 percent did not indicate the experience of the nominees. In about 50 percent of the solicitations, stockholders were not given an opportunity to cast a ballot for or against the proposals.

Among the major deficiencies in financial reports were failure to furnish a profit or loss or surplus statement or failure to give statements in adequate detail; 47 percent gave only a balance sheet. The reports to shareholders of the companies reporting pursuant to section 15(d) were of a much better quality than the others.

The inadequacies revealed in the prior study are demonstrated again by the current study. Of the insurance companies that received OTC-4, 53 were asked to submit financial and proxy materials distributed to shareholders in 1961. Forty-four insurance companies responded to this request and an analysis of the material received follows:

Of the 44 issuers studied, 14 percent (6) failed to send any financial reports to their stockholders; 50 percent (19) of the issuers that sent financial material failed to include a profit and loss statement; 87 percent (33) failed to include any explanatory notes to their financial reports.

Fifteen percent (7) of the issuers did not send any proxy material at all to shareholders. The proxy material examined related to 37 issuers—who held 36 annual and 4 special meetings. In the majority of instances in which shareholders were given an opportunity to vote, the information provided was inadequate by Commission standards. There were 36 elections of directors; in 78 percent (28), the names of the nominees were not given and in 86 percent (31), the experience of the nominees was not stated.

In 15 instances, matters other than election of directors were to be voted on—mergers, options, retirement plans, etc.; there was not one solicitation which contained information approaching that required by the Commission's proxy rules.

The insurance business has grown rapidly in recent years. During the 10-year period from 1951 to 1961, the number of life insurance companies in the United States increased from 659 to 1,457. During

[78] SEC, "Supplementary Report on S. 2054," 85th Cong., 1st sess. (1957).

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that same period, the number domiciled in Texas alone increased from 120 to 280 and the number in Arizona from 4 to 116.[79]

Many of the new insurance companies which emerged during this period were inevitably promotional to some degree and their operations have presented problems of investor protection. In its 23d annual report, the Commission, describing the most pressing enforcement problems confronting it, included this statement:

> Recent economic conditions have been relatively favorable for the sale of promotional stocks of new ventures, particularly in fields in which the securities of established enterprises have shown marked gains. For example, many new insurance and financial ventures have been promoted, particularly in the south central, southwestern, and southeastern parts of the country, and their securities have been distributed either through registration or regulation A, or more commonly, in reliance upon the intrastate exemption. Many of these issues and the sales techniques employed in their distribution appear to involve abuses and possible violations of the antifraud and other provisions of the Securities Act or the Securities Exchange Act, which require extensive investigation. The large number of these promotions and the rapidity with which they have increased has placed a most serious burden on the Commission's field enforcement personnel charged with the conduct of such investigations.[80]

Similar statements were made in the 22d and 24th annual reports of the Commission.[81]

The assets and liabilities of insurance companies are often of an intangible nature and, despite the vigilance of many State insurance commissioners, opportunities do exist for manipulation of these assets and liabilities by insiders in a manner detrimental to the interests of investors. Testimony before a Senate subcommittee in 1960 concerning the operations in the insurance field of Lowell Birrell and Stuart Hopps presents striking examples.[82]

Thus, insurance companies do not present a case for special treatment in relation to sections 13, 14, and 16. State regulation of insurance companies, however thoroughgoing and salutary it may be, is not designed to protect investors; it is intended for the benefit of policyholders. Insurance companies as a group, moreover, exhibit all of the inadequacies in reporting and proxy solicitations characteristic of the total group studied. They should not be exempted when the benefits of those sections are extended to unlisted securities.

5. THE PROBLEM OF SECTION 16(b)

A much-discussed but unresolved question in connection with prior proposals to extend sections 13, 14, and 16 to unlisted securities has been the potential impact of applying section 16(b)—providing for recovery of short-swing trading profits of insiders—to those broker-dealers who make markets for the stocks of certain issuers while represented on their boards of directors.

In chapter VII the mechanics of the over-the-counter market are discussed at length. From the data presented there it appears that in the over-the-counter market as a whole, a majority of transactions for customers are effected by broker-dealers as agents on a commission basis. In many other instances, broker-dealers handle customers' or-

[79] Institute of Life Insurance, Life Insurance Fact Book, 1962, p. 99.
[80] 23 S.E.C. Annual Report 4–5 (1957).
[81] 22 S.E.C. Annual Report 6 (1956); 24 S.E.C. Annual Report 5–6 (1958).
[82] Hearings pursuant to S. Res. 238 on the insurance industry, before a subcommittee of the Senate Committee on the Judiciary, 86th Cong., 2d sess., pp. 5709–5803 (1960).

ders on a principal basis, charging a markup over their own cost, even though they are not making a market and have no inventory position. This type of "riskless" transaction, however, is unlikely to occur where the broker-dealer is represented on the board of directors. Thus, neither of the above practices presents any problem under section 16(b).

Apart from these, however, there is the important fact that many broker-dealers "make markets" in over-the-counter securities—in fact, over-the-counter markets consist essentially of such market making. This means that these broker-dealers stand ready to buy or sell as principal in dealings with other broker-dealers or in retail transactions with the public. When a broker-dealer making a market is also a corporate insider—most commonly because of a directorship [83]—and only in such case, the problem of the application of section 16(b) arises. Under that section, the market-maker-insider's interest in any short-swing profits realized in the trading of the corporation's stock would be recoverable by the corporation.

It may be assumed that this would be deemed an intolerable result in most instances.[84] Thus, the director-market-maker would presumably be forced to the choice of resigning as director or else terminating his trading as principal. The question for consideration here is the effect of a broker-dealer's electing one or the other alternative, or stated another way, whether it is desirable on balance to achieve the protection of section 16(b) if it means forcing that kind of choice.

The question is undoubtedly controversial. While the problem is extremely limited in scope, confined as it is to only those situations where interlocking director-market maker relationships exist, it cannot be lightly dismissed. In chapters III, IV, and VII it is pointed out that many underwriters of new issues of securities follow the practice of placing representatives on the issuer's board of directors. It is also noted that the avowed reasons for doing so are various, including the protecting of customers who have purchased the issue and providing of guidance to inexperienced companies with regard to matters of finance and shareholder relations. At the same time, many investment bankers contend that their responsibility to the issuer, to their customers, and to the investing public generally also requires that they provide a trading market for any over-the-counter stocks they underwrite.

Broker-dealers are by no means unanimous, however, in recognizing and accepting any such dual responsibility arising from having underwritten an issue. Many firms, including several of the leading names in the underwriting field, simply do not maintain over-the-counter trading operations. Still others, while carrying on general over-the-counter trading, expressly avoid making trading markets for stocks they have underwritten when they are also represented on the issuers' boards. And, of course, many firms make such markets without being represented on the boards of the issuers.[85]

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[83] While this would be the most common situation, sec. 16(b) would also apply if the broker-dealer were a 10-percent shareholder or were represented among the corporate officers.

[84] As will be seen in the discussion in subsec. d, below, it would not necessarily be found intolerable in all situations: some broker-dealers have been willing to make markets for certain small business investment companies notwithstanding possible accountability for trading profits.

[85] See discussion at subsec. b, below.