MAY 1, 1950

Honorable Burnet R. Maybank
Chairman, Committee on Banking
and Currency
United States Senate
Washington, D. C.

Re: S. 2765

Dear Senator Maybank:

This is in further reply to the letter of Mr. Joseph P. McMurray requesting the opinion of the Commission on the merits of S. 2765, "A Bill to amend certain provisions of the Securities Act of 1933, and section 3 of the Securities Exchange Act of 1934." We regret the delay, but we have waited until now for clearance from the Bureau of the Budget. The Commission believes that adoption of the bill would not be in the public interest, for the reasons stated below.

The first section of the bill provides as follows:

> Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (a) of section 3 of the Securities Act of 1933, as amended, is amended by adding thereto a new paragraph as follows:
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> "(12) Any security the issuer of which is engaged in the exploration and development of natural mineral resources: Provided, That the issuer shall file with the Securities and Exchange Commission, before a public offering is made, a written statement containing substantially the following information: The full name and complete mailing address of (a) the issuer, (b) the directors and officers of the issuer, (c) the person by or on behalf of whom the offering is to be made, and (d) the principal underwriter of the securities to be offered; the title and amount of the security to be offered; the amount of the offering and of the underwriting discounts and commission; the date of the proposed offering; the States in which it is proposed to sell the security; the purpose for which the net proceeds are to be used; and three copies of every written communication, advertisement, or radio broadcast to be delivered thereafter to investors by the issuer or the principal underwriter of any such security to more than twenty-five persons."

Section 3(a) of the Securities Act exempts from the registration and prospectus requirements of that Act government securities, securities issued by charitable and educational institutions, and securities issued by railroads and banks, which are closely regulated by federal and state agencies. The proposed amendment, it will be noted, would give exempted status to securities the issuers of which are as a rule not subject to such regulation.

Senator Malone, the bill's sponsor, inserted into the Congressional Record of October 19, 1949 (pp. 15350-55), in support of the bill, a report of the National Resources Economic Committee, a special subcommittee of the Senate Interior and Insular Affairs Committee. The subcommittee, under the chairmanship of Senator Malone, conducted hearings in 1947 and 1948 into the problems of the mining industry, and one of its findings was that "The Securities Act of 1933 and the Securities Exchange Act of 1934, with the rules and regulations which have been made by the Securities and Exchange Commission under the act, have been administered in such a fashion as to seriously retard the investment of private venture capital in mining enterprises in the United States" (p. 15354). Unfortunately, the factual matters which led to this finding are not set forth in the report, so that we cannot meet the specific problems or objections of the subcommittee except as they are indicated by the terms of the bill which Senator Malone has introduced. This bill, incidentally, is identical to S. 2897, which was introduced by Senator Malone in the 80th Congress, but which was not acted upon by that Congress or by this Committee.

Initially, it may be observed that, as drafted, the bill could be construed as exempting securities issued by such companies as United States Steel Corporation and the Aluminum Company of America, as well as foreign corporations developing mineral resources in other countries. Securities issued by the great oil and natural gas companies presumably also would be exempted, for the term "natural mineral resources" in its customary usage is deemed to include oil and natural gas. Indeed, it could be argued that the exemption would be available to any large corporation that is substantially "engaged in the exploration and development of natural mineral resources" as an incident to its regular business.

Actually, companies engaged primarily in mining or oil and gas exploration and development are for the most part not subject to the registration provisions of the Securities Act but are subject rather to the Commission's Regulation A, promulgated under Section 3(b) of the Act. That Section permits the Commission, by the adoption of rules, to grant administrative exemptions from the registration provisions in the case of securities issues not exceeding $300,000 in amount in any one year; prior to a 1945 amendment to that section the maximum limit set by the statute was $100,000. In Regulation A the Commission has granted an exemption in the full amount of $300,000. As a condition to the exemption, Regulation A requires that there be filed with the Commission at least five days prior to the day the securities will be offered to the public a simple letter of notification containing substantially the same items of information as are set forth in S. 2765. Copies of any written communications, advertisements or broadcasts

proposed to be used must also be filed with the Commission five days in advance of their use, although there is no requirement that any particular form of prospectus be used.

Thus, Section 1 of S. 2765 is largely similar to Regulation A. While, as will be noted, the Regulation contains certain protections for investors not present in the bill, the difference between the two does not lie in the amount of information required to be filed

Of 162 securities issues floated during the calendar year 1949 by companies primarily engaged in mining (other than coal companies), all but 7 were subject to the Commission's Regulation A. Of these 7, 4 were foreign issues, for which a Regulation A exemption is unavailable regardless of amount. Similarly, in the case of oil and gas companies, only a small minority of the issues were required to be registered. The reason, of course, is that promotional ventures in the extractive industries, particularly of the exploratory kind, are commonly of a type in which $300,000 of new financing in any one year is sufficient.

Thus the great majority of these companies enjoy an exemption generally similar to the one the bill would provide. But Regulation A was promulgated pursuant to a general rule-making authority which permits changes to be made from time to time in the light of administrative experience. Casting the Regulation into rigid statutory form is itself undesirable. More serious, however, is the fact that the bill makes a number of departures from Regulation A which we think would be detrimental to the interests of investors and which we do not think can be justified as relieving small issuers of undue hardship.

1. Under Regulation A, any written communications, advertisements or radio broadcasts employed by or on behalf of the issuer or principal underwriter must, whatever else they say, contain the following information: (a) the name of the person or persons for whom the securities are being offered; (b) data as to underwriting discounts and commissions and other distribution expenses; (c) a statement of the purposes for which the proceeds from the securities are to be used, if the securities are being sold for the issuer; and (d) a statement that the securities have not been registered with the Securities and Exchange Commission because believed to be exempt, but that such exemption, if available, does not indicate that the Commission has approved or disapproved the securities or that the Commission has considered the accuracy of the statements made in the communication. S. 2765 is similar to Regulation A in requiring copies of written communications, advertisements and radio broadcasts to be filed with the Commission, but the bill is silent as to the contents thereof.

2. Regulation A, as previously noted, requires the letter of notification to be filed with the Commission five days in advance of the offering date, and copies of sales literature five days in advance of their use. Our experience has shown that, particularly in the case of selling literature, an advance examination by the staff is highly desirable. Where statements in the selling literature appear to be materially misleading, the persons employing such literature are immediately notified and afforded an opportunity to make

appropriate correction. Under the statute, the Commission cannot issue stop orders in Regulation A cases as it can in the case of misleading registration statements, but must resort to the Courts through injunctive actions or make recommendations for criminal prosecution to the Department of Justice. Such consequences are largely avoided by the Commission's practice of bringing to the attention of issuers, in advance, the pitfalls inherent in the use of misleading sales literature. This procedure has the effect also of preventing losses to investors.

3. The exemption afforded by Regulation A is inapplicable if the issuer or its promoters or certain other affiliated persons have a record of misconduct in connection with previous securities transactions. There is no such provision in S. 2765.

4. The Regulation A exemption is also inapplicable if the issuer is a foreign person or corporation. The principal reason for this provision is that persons not resident in this country cannot be reached by process, and anti-fraud proceedings are therefore made more difficult, if not impossible, in such cases. The use of a statutory registration statement and prospectus has been found to reduce the opportunities for fraud. Under the bill, foreign persons and corporations would be on the same footing as domestic issuers.

5. It may also be noted that the Commission has adopted special rules to meet the peculiar problems involved in the sale of fractional undivided interests in oil or gas rights and assessable shares of mining stock (Regulation B and A-M). There has been no serious complaint that these special regulations are a cause of undue hardship to the persons affected. To scrap them would be to forego the advantage of the Commission's administrative experience in this field.

Thus it appears that, even in extending the Commission's Regulation A practice to all mining and oil and gas companies, large and small, the bill abandons certain of the safeguards for investors which are now present in Regulation A.

In the case of the larger issuers which do not now have a Regulation A exemption, the loss to the investor would be even greater. Such companies may not issue securities to the general public unless (1) they have first filed with the Commission a registration statement containing certain basic information, and (2) they employ in connection with any sale of securities a prospectus containing by and large the same basic data. Regulation A represents a recognition of the fact that the disclosure requirements of the Act, however desirable in principle, cannot as a practical matter be applied in their entirety to the very smallest corporations. In the case of the larger corporations such considerations are inapplicable.

The Commission, it may be noted, does not take the position that a promotional mining venture should be required to file a registration statement comparable to that required of a large industrial corporation simply because its capital needs are in excess of $300,000 for any one year. The Commission has amended its registration forms from time to time in the light of experience. It has adopted a simplified form, S-3, for mining

companies in the promotional stage, in which many of the items of information usually called for in registration statements are omitted, and an even more simplified form, S-11, for exploratory mining companies which do not have any material reserves of proven or probable ore.

It is said in the report of Senator Malone's subcommittee that mining company representatives charged the Commission with "a tendency to substitute its judgment in place of that of private mining corporations in regard to the economic feasibility of a given mining venture for which the right of selling securities is requested" (p. 15352). The subcommittee, it must be noted, has not itself endorsed this charge. Actually, the Securities Act of 1933 permits all securities to be sold, regardless of how speculative their character, provided that the truth be told about them. Section 23 of the Securities Act specifically makes it unlawful for anyone to represent that the Commission has passed upon the merits of or given approval to any security. It must be admitted that the Commission has not always seen eye to eye with registrants on the data relevant in the interest of full disclosure, but this is indeed a far cry from any attempt by the Commission to dictate what may or what may not be sold.

The report suggests too that the sort of amendments embodied in S. 2765 would stimulate the development of new mineral resources. Even if it be assumed that dropping present protections for investors would bring more money to exploratory and developmental enterprises, with a beneficial result to our national economy and national defense, we question whether accomplishing such a result by depriving the investor of information is the only way or the best way. In any event, it is not unlikely that the assumed advantages of the bill would be outweighed by the loss in investor confidence which we think would result from the creation of a special exemption of the character contemplated by the bill after some sixteen years of federal securities regulation. In this connection it may also be noted that mining and oil and gas ventures unfortunately lend themselves to fraudulent securities practices by unscrupulous and unethical promoters. A disproportionately high amount of the Commission's fraud cases have been of this character. Securities in this class are therefore particularly unsuitable for exemption.

As previously indicated, Section 1 of S. 2765 would largely have the effect of exempting mining and oil and gas securities from all provisions of the Securities Act other than the anti-fraud provisions. However, even the anti-fraud provisions would, in our judgment, be weakened by certain limitations on the Commission's investigatory powers set forth in Sections 2, 3 and 4 of the bill. These sections re as follows:

> SEC. 2 Subsection (b) of section 19 of the Securities Act of 1933, as amended, is amended to read as follows:
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> "(b) When in possession of material written evidence and facts which, in the opinion of the Commission clearly justify an investigation for the enforcement of this title, and upon its written order, any member of the Commission, or any officer or officers designated by it, is empowered to administer oaths and

affirmations, subpena witnesses, take evidence, and require the production of any books, papers, or other documents which the Commission deems relevant or material to the inquiry. Such hearings and investigations as may be required shall be held in such place or places as the Commission may designate, but no witness shall be required by subpena to appear at a place outside the Federal judicial district in which he may reside without his consent."

SEC. 3, Subsection (a) of section 20 of the Securities Act of 1933, as amended, is amended to read as follows:

"(a) Except as otherwise provided in section 8 of this title, the Commission shall investigate only such violations of the provisions of this title or of any rule or regulation prescribed under authority thereof, as shall be based upon a written complaint of a person outside the staff of the Commission setting forth material facts and circumstances showing that a substantial violation has occurred or is about to occur, and the Commission may thereupon, if in its opinion the public interest will thereby be served, authorize an investigation by written order, and a copy of such order and written complaint shall be made available promptly to the person subject to the investigation."

SEC. 4. Section 21 of the Securities Act of 1933 is amended by adding thereto a new sentence to read as follows: "Any person who is under investigation and who shall testify in such hearings or in any preliminary investigation shall be permitted to obtain at cost a copy of his testimony and to be represented by counsel."

The subcommittee report discusses certain investigatory practices of the Commission which concededly have been upheld by the courts, while other practices which are said to be abuses are discussed in general terms without reference to specific cases (pp. 15352, 15354). Indeed, much of the criticism is apparently based on the fact that the Commission's investigations are conducted very much like grand jury investigations; yet the courts have consistently held that the Commission's investigatory functions are essentially similar to the investigatory functions of the grand jury. Consolidate Mines of California v. S.E.C., 97 F. 2d 704, 708 (C.A. 9, 1938); In re S.E.C., 84 F. 2d 316, 318 (C.A. 2, 1936), rev'd as moot, 299 U.S. 504; S.E.C. v. Bourbon Sales Corp., 47 F. Supp. 70, 73 (W.D. Ky. 1942); Woolley v. United States, 97 F. 2d 258 (C.A. 9, 1938); cf. Oklahoma Press Publishing Co. v. Walling, 327 U.S. 185, 216 (1946); Perkins v. Endicott-Johnson Corp., 128 F. 2d 208, 214 (C.A. 2, 1942), aff'd. 317 U.S. 501 (1943); President v. Skeen, 118 F. 2d 58, 59 (C.A. 5, 1941). We now turn to the principal changes which the Bill would make in the existing provisions of the Securities Act dealing with investigations:

1. The proposal that the Commission should not institute an investigation except upon the basis of a "written complaint of a person outside the staff of the Commission," and the further proposal that such written complaint "shall be made

available promptly to the person subject to the investigation," would seriously impede the Commission in its enforcement of the anti-fraud provisions of the Act. Experience has shown that victims of securities frauds are often most reluctant to submit their complaints in writing, particularly at the preliminary stage of an investigation, when they do not know whether the government will follow through with a civil or criminal proceeding against the persons they are accusing. A statutory requirement that the "written complaint" be turned over "promptly to the persons accused, would be even more detrimental to the Commission's enforcement activities. The communications of an informed have, for very good reasons, traditionally been privileged in Anglo-Saxon jurisprudence, VIII Wigmore on Evidence (3rd Ed. 1940) § 2362, 2374, and it is submitted that an exception should not be made in the case of this Commission. No steps can be taken to affect the legal rights of a person under investigation except in an adversary proceeding, administrative or judicial, in which he has a right to confront the witnesses against him and to cross-examine them. Until then, he has an adequate remedy against unwarranted investigations in that he can simply refuse to comply with a subpena, thereby compelling the agency to apply to a court of competent jurisdiction for its enforcement, at which time there may be put in issue the legality of the investigation. Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186, 217 (1946).

2. The proposed new subsection (b) of Section 19 provides in part that "no witness shall be required by subpena to appear at a place outside the Federal judicial district in which he may reside without his consent." As a matter of practice, the Commission so far as feasible does seek to avoid hardship to persons called to testify. In an attempt to decentralize its activities and to bring its services more directly to the public, the Commission has established ten regional offices and five sub-regional offices in various sections of the country, and it is from these offices that virtually all our investigations are conducted. Moreover, our investigators do not confine themselves to the regional offices but travel extensively to gather evidence and to interview witnesses. A statutory requirement that appearances be limited to the federal judicial district of residence would be unduly rigid. Thus, an investigation being conducted principally in Manhattan might in some circumstances have to be convened successively in Newark, N. J., and Brooklyn, N. Y., because these places, while within easy commuting distance of Manhattan, are nevertheless in different judicial districts.

3. The proposed amendment to subsection (a) of Section 20 of the Securities Act would require that a copy of the written complaint and a copy of the Commission's written order of investigation be made available to the persons subject to the investigation. The problem of the written complaint has been discussed, supra. As for the order of investigation, our practice is in general to show such orders to the person under investigation. We do not believe, however, that we should be required to surrender such orders. The Commission's investigations are usually conducted in complete privacy, with a view to protection not only of the witnesses but also of the persons under investigation. (Some of the Commission's investigations under the other Acts which it administers have been conducted publicly, particularly where the purposes have included the obtaining of information to provide a basis for the promulgation of new rules and

regulations, or the recommendation of additional legislation to the Congress – investigatory purposes which are expressly recognized by those Acts.) An order of investigation may implicate persons other than the individual requesting such order, and the publication of certain statements in the order could in some cases be most detrimental to the persons involved.

4. The proposed amendment to Section 21 of the Securities Act provides that any person testifying in an investigation "shall be permitted to obtain at cost a copy of his testimony and to be represented by counsel." Section 6(a) of the Administrative Procedure Act, 5 U.S.C. §1005(a), already accords a right to representation by counsel. As to the transcript of testimony, Section 6(b) of the Administrative Procedure Act, 5 U.S.C. §1005(b), provides in pertinent part as follows:

> Every person compelled to submit data or evidence shall be entitled to retain or, on payment of lawfully prescribed costs, procure a copy or transcript thereof, except that in a nonpublic investigatory proceeding the witness may for good cause be limited to inspection of the official transcript of his testimony.

It may be noted that an earlier draft of the Administrative Procedure Act (S. 7, 79th Cong.) gave to witnesses the right to obtain a copy of the transcript whether the investigation was public or private. We believe that the deletion of this provision was wise for we have on some occasions found it necessary to refuse a request for a transcript in a private investigation where there has been reason to fear that the witness would make it available for the purpose of coaching other witnesses still to be examined or of revealing to a prospective defendant in a criminal proceeding just what evidence was in the possession of the government. Where there has been no such problem we have furnished transcripts upon request.

The Commission also opposes Section 5 of S. 2765. That section provides as follows:

> SEC. 5. Section 3 of the Securities Exchange Act of 1934, as amended, is amended by adding thereto a new subsection as follows:
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> "(d) No provision of this title shall apply to, or be deemed to include, any market place or facilities for the purchase and sale of securities of an issuer engaged exclusively in the exploitation, development, or operation of mines, or in the exploitation, development, and production of oil, gas, or other natural mineral resources."

The Securities Exchange Act, Section 3(a)(1), defines the term "exchange" to include any organization which maintains "a market place or facilities for bringing together purchasers and sellers of securities." The proposal to exclude certain "market places" or "facilities" from all provisions of the Act serves in the first instance to exclude from the term "exchange" any market place or facilities for the purchase or sale of

securities of mining companies and oil companies. This exclusion would have a dual effect.

In the first place, the proposal would exclude any such stock exchange from the requirements of the statute relating to the registration of exchanges. The proposal might therefore serve to remove from the stock exchange registration requirements of the Act certain existing stock exchanges which deal almost exclusively in securities of these types and also to exclude from registration any new stock exchanges which provide a market place for trading in such securities.

In the second place, the statute contains various provisions applicable to the securities which are traded on registered exchanges, and the proposal would therefore exclude from various provisions of the Act mining securities and oil securities which are traded on certain existing exchanges, as well as those which might be admitted to trading on the new exchanges which presumably would be organized to take advantage of the proposed exemption.

First I shall take up the impact of the proposal on the provisions of the statute relating to registration of stock exchanges.

Section 5 of the Securities Exchange Act provides for the registration of "national securities exchanges" and for the exemption from registration of exchanges having only a limited volume of transactions. The requirements for registration are that the exchange file information with the Commission regarding its organization, constitution and rules and that the exchange provide for the disciplining of its members for conduct inconsistent with just and equitable principles of trade (Section 6 of the Act). Section 19(a) provides that the Commission may suspend or revoke the registration of an exchange for violations of the law and that it may suspend or expel officers and members of the exchange for such violations. Finally, Section 19(b) gives the Commission some supervision over the rules of registered exchanges- -for the protection of investors and to insure fair dealing in securities and fair administration of the exchanges.

The Commission feels that the need for supervision over stock exchanges is certainly no less where they afford a market place for the securities of mining companies and oil companies than it is in other cases, and there appears to be no justification whatever for the proposed blanket exemption from the exchange-registration requirements. As I have mentioned earlier, the Commission already has authority under the statute to exempt exchanges which have only a limited volume of transactions, and 4 of the 20 exchanges of this country are now operating under conditional exemptions of this sort; that is, a procedure has been worked out to minimize any burden on the exchanges while at the same time providing the public with certain basic information regarding the securities traded on them.

Apart from the immediate effect of removing the registration requirements from stock exchanges which provide a market for mining and oil securities, the proposed

amendment to Section 3 of the Securities Exchange Act would operate, indirectly, to exempt the securities themselves and their issuers and various other persons from certain additional provisions of the statute. For example, Sections 12 and 13 of the statute require that issuers of securities which are listed on any national securities exchange keep current information regarding their financial position and activities on file with the particular stock exchange where the securities are traded and with the Commission in order that the public may have a reliable source of information upon which to base evaluations of the securities. In addition Section 14 of the statute and the Commission's rules under that Section require that information be given to holders of listed securities when their proxies or consents are solicited in connection with matters affecting such securities. Section 16, in general, regulates certain trading abuses in listed securities by corporate insiders.

At the present time there are roughly 200 mining companies and a large number of oil companies which have securities listed on national securities exchanges and the stockholders of which have the benefit of the information and protections provided by Sections 12, 13, 14 and 16 of the Act. To the extent that these companies are "exclusively" engaged in the operation of mines or the production of oil or gas, the bill would permit the managements of such companies to avoid their obligations to public stockholders, if they chose to do so, simply by transferring the listing of their shares to some new stock exchange devoted exclusively to such securities. While it is almost impossible to determine whether a company would or would not fall within the language of the bill, it might be interpreted to provide a complete exemption for all of the large mining companies and oil companies as well as the small ones.

The various mining and oil companies whose securities are not now traded on stock exchanges are perfectly free to list them on any national securities exchange which cares to afford a market place for them. Essentially, the requirement is simply that the company make public its financial affairs and business prospects. Listing is available as well to the promotional enterprises as to the more stable companies. But whether a company is well established or new, stable or speculative, a money maker or a money loser, information must be made available from which these facts may be determined. Similarly any group is free to organize and register a national securities exchange under the Act or to apply for the status of an exempted exchange if it can show ability to comply with the applicable provisions of the Securities Exchange Act.

Apart from the provision already discussed, the proposed amendment to Section 3 of the Act would serve to exempt securities of mining and oil companies from various other provisions of the Act which by their terms are limited to securities listed on a national securities exchange. Among the more important provisions of this type are the prohibition of Section 9 of the Act against the manipulation of the market for securities listed on a national securities exchange and the limitations on short selling of such securities contained in Section 10(a) of the Act.

The Commission is not opposed to the creation of stock exchange markets for securities of mining and oil companies. On the contrary it favors the creation of public auction markets provided, of course, that the trading is based on public information and is shielded against the abuse of "inside information by officers, directors and large stockholders, and against manipulation and improper short selling.

The Bureau of the Budget, in its letter to us clearing this report, stated that "enactment of the legislation would not be in accord with the program of the President."

Sincerely yours,

Richard B. McEntire
Acting Chairman

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