39TH ANNUAL REPORT
OF THE
SECURITIES AND EXCHANGE COMMISSION

For the Fiscal Year Ended June 30th, 1973

SECURITIES AND EXCHANGE COMMISSION
Headquarters Office
500 North Capitol Street
Washington, D.C. 20549

COMMISSIONERS

RAY GARRETT, JR., Chairman

HUGH F. OWENS [On November 20, 1973, the resignation of Mr. Owens as Commissioner became effective. On November 21, he assumed the duties of chairman of the Securities Investor Protection Corporation.]

PHILIP A. LOOMIS, JR.

JOHN R. EVANS

A. A. SOMMER, JR.

GEORGE A. FITZSIMMONS, Secretary

LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

Sirs: On behalf of the Securities and Exchange Commission, I have the honor to transmit to you the Thirty-Ninth Annual Report of the Commission covering the fiscal year July 1,1972 to June 30,1973, in accordance with the provisions of Section 23 (b) of the Securities Exchange Act of 1934, as amended; Section 23 of the Public Utility Holding Company Act of 1935; Section 46 (a) of the Investment Company Act of 1940; Section 216 of the Investment Advisers Act of 1940; Section 3 of the Act of June 29,1949, amending the Bretton Woods Agreement Act; Section 11 (b) of the Inter-American Development Bank Act; and Section 11 (b) of the Asian Development Bank Act.

Respectfully,

RAY GARRETT, JR.
Chairman

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES,
Washington, D.C.

COMMISSIONERS AND PRINCIPAL STAFF OFFICERS

(As of November 1, 1973)

COMMISSIONERS

RAY GARRETT, JR., of Illinois, Chairman – Term expires June 5, 1977
HUGH F. OWENS, of Oklahoma – Term expires June 5, 1975
PHILIP A. LOOMIS, JR., of California – Term expires June 5, 1974
JOHN R. EVANS of Utah – Term expires June 5, 1978
A. A. SOMMER, JR., of Ohio– Term expires June 5, 1976

Secretary: GEORGE A. FITZSIMMONS
Executive Assistant to the Chairman: HARVEY L. PITT

PRINCIPAL STAFF OFFICERS

ALAN F. BLANCHARD, Executive Director

ALAN B. LEVENSON, Director, Division of Corporation Finance
THOMAS N. HOLLOWAY, Associate Director
RALPH C. HOCKER, Associate Director
RICHARD H. ROWE, Associate Director

IRVING M. POLLACK, Director, Division of Enforcement
STANLEY SPORKIN, Deputy Director

LEE A. PICKARD, Director, Division of Market Regulation
JOHN M. LIFTIN, Associate Director
SHELDON RAPPAPORT, Associate Director
ROBERT C. LEWIS, Associate Director

ALLAN S. MOSTOFF, Director of Investment Company Regulation
ANNE P. JONES, Associate Director

AARON LEVY, Director, Division of Corporate Regulation

LAWRENCE E. NERHEIM, General Counsel
WALTER P. NORTH, Associate General Counsel
DAVID FERBER, Solicitor

CHILES T. A. LARSON, Acting Director, Office of Public Information

JOHN C. BURTON, Chief Accountant
A. CLARENCE SAMPSON, JR., Associate Chief Accountant

GENE L. FINN, Chief Economist, Office of Economic Research

BERNARD WEXLER, Director, Office of Opinions and Review
ALFRED LETZLER, Associate Director
MAX O. REGENSTEINER, Associate Director

WARREN E. BLAIR, Chief Administrative Law Judge

ANDREW P. STEFFAN, Director, Office of Policy Planning

FRANK J. DONATY, Comptroller

CHARLES A. MOORE, Director, Office of Records

RICHARD J. KANYAN, Director, Office of Service

ALBERT FONTES, Director, Office of Personnel

JAMES C. FOSTER, Director, Office of Registrations and Reports

RALPH L. BELL, EDP Manager

REGIONAL AND BRANCH OFFICES

REGIONAL OFFICES AND ADMINISTRATORS

Region 1. New York, New Jersey. – William D. Moran, 26 Federal Plaza, New York, New York 10007.

Region 2. Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, Maine. – Floyd H. Gilbert, 150 Causeway St., Boston, Mass. 02114.

Region 3. Tennessee, Virgin Islands, Puerto Rico, North Carolina, South Carolina, Georgia, Alabama, Mississippi, Florida, part of Louisiana. – Jule B. Greene, Suite 138, 1371 Peachtree St., N.E., Atlanta, Georgia 30309.

Region 4. Illinois, Indiana, Iowa, Kansas City (Kansas), Kentucky, Michigan, Minnesota, Missouri, Ohio, Wisconsin. – John I. Mayer, Room 1708, Everett McKinley Dirksen Bldg., 219 S. Dearborn St., Chicago, Ill. 60604.

Region 5. Oklahoma, Arkansas, Texas, part of Louisiana, Kansas (except Kansas City). – Robert F. Watson, 503 U.S. Court House, 10th & Lamar Sts., Fort Worth, Texas 76102.

Region 6. Wyoming, Colorado, New Mexico, Nebraska, North Dakota, Utah. – Donald J. Stocking, 7224 Federal Bldg., 1961 Stout St., Denver, Colo. 80202.

Region 7. California, Nevada, Arizona, Hawaii, Guam. – Gerald E. Boltz, Room 1043, U.S. Court House, 312 North Spring St., Los Angeles, Cal. 90012.

Region 8. Washington, Oregon, Idaho, Montana, Alaska. – James E. Newton, Room 810, 1411 4th Ave. Bldg., Seattle, Wash. 98101.

Region 9. Pennsylvania, Maryland, Virginia, West Virginia, Delaware, District of Columbia. – William Schief, Room 300, Ballston Center Tower No. 3, 4015 Wilson Blvd., Arlington, Va. 22203.

BRANCH OFFICES

Cleveland, Ohio 44199. – Room 899 Federal Office Bldg., 1240 E. 9th at Lakeside.

Detroit, Michigan 48226. – 1044 Federal Bldg.

Houston, Texas 77022. – Room 6617, Federal Office & Courts Bldg., 515 Rusk Ave.

Miami, Florida 33131. – Suite 701 DuPont Plaza Center, 300 Biscayne Boulevard way.

Philadelphia, Pa. 19106. – Federal Building, Room 2204, 600 Arch St.

St. Louis, Missouri 63101. – Room 1452, 210 North Twelfth St.

Salt Lake City, Utah 84111. – Room 6004, Federal Reserve Bank Bldg., 120 South State St.

San Francisco, California 94102. – 450 Golden Gate Ave., Box 36042.

BIOGRAPHIES OF COMMISSIONERS

RAY GARRETT, JR., Chairman

Chairman Garrett was born on August 11, 1920, in Chicago, Illinois. In 1941 he was graduated from Yale University and he received his 11.B from Harvard Law School in 1949. Immediately prior to joining the Commission as Chairman, Mr. Garrett was a partner in the Chicago law firm of Gardner, Carton, Douglas, Children and Waud where he had been since 1958. From 1954 to 1958, he was on the staff of the Securities and Exchange Commission, serving for most of that period as Director of the Division of Corporate Regulation. In 1965, Mr. Garrett was Chairman of the Section of Corporation Banking and Business Law of the American Bar Association and has also served as Chairman of the ABA Committee on Developments in Corporate Financing. He is presently Chairman of the Advisory Committee for the Corporate Department Financing Project of the American Bar Foundation, a member of the Board of Editors of the American Bar Association Journal, and consultant to the "Reporter" for Codification of Federal Securities Laws Project of the American Law Institute. Prior to joining the SEC staff, he was a teaching fellow at Harvard Law School and Assistant Professor of Law at New York University. For several years he was a visiting lecturer at the Northwestern University School of Law. Mr. Garrett was sworn in as Chairman of the Securities and Exchange Commission on August 6, 1973, for a term expiring on June 5, 1977.

HUGH F. OWENS

Commissioner Owens was born in Muskogee, Oklahoma, on October 15, 1909, and moved to Oklahoma City in 1918. He graduated from Georgetown Preparatory School, Washington, D.C., in 1927, and received his A.B. degree from the University of Illinois in 1931. In 1934, he received his 11.B. degree from the University of Oklahoma College of Law, and became associated with a Chicago law firm specializing in securities law. He returned to Oklahoma City in January 1936, to become associated with the firm of Rainey, Flynn, Green and Anderson. From 1940 to 1941, he was vice president of the United States Junior Chamber of Commerce. During World War II he attained the rank of Lieutenant Commander, U.S.N.R., and served as Executive Officer of a Pacific Fleet destroyer. In 1948, he became a partner in the firm of Hervey, May and Owens. From 1951 to 1953, he served as counsel for the Superior Oil Company in Midland, Texas, and thereafter returned to Oklahoma City, where he engaged in the general practice of law under his own name. He also served as a part-time faculty member of the School of Law of Oklahoma City University. In October 1959, he was appointed Administrator of the then newly enacted Oklahoma Securities Act and was active in the work of the North American Securities Administrators, serving as vice president and a member of the executive committee of that Association. He took office as a member of the Securities and Exchange Commission ton March 23, 1964, for the term expiring June 5, 1965, and was reappointed for the terms expiring June 5, 1970 and 1975. Since June 1964, he has served on the executive committee of the National Association of Regulatory Utility Commissioners.

PHILIP A. LOOMIS, JR.

Commissioner Loomis was born in Colorado Springs, Colorado, on June 11, 1915. He received an A.B. degree, with highest honors, from Princeton University in 1938 and an 11.B. degree, cum laude, from Yale Law School in 1941, where he was a Law Journal editor. Prior to joining the staff of the Securities and Exchange Commission, Commissioner Loomis practiced law with the firm of O'Melveny and Myers in Los Angeles, California, except for the period from 1942 to 1944, when he served as an attorney with the Office of Price

Administration, and the period from 1944 to 1946, when he was Associate Counsel to Northrop Aircraft, Inc. Commissioner Loomis joined the Commission's staff as a consultant in 1954, and the following year he was appointed Associate Director and then Director of the Division of Trading and Exchanges. In 1963, Commissioner Loomis was appointed General Counsel to the Commission and served in that capacity until his appointment as a member of the Commission. Commissioner Loomis is a member of the American Bar Association, the American Law Institute, the Federal Bar Association, the State Bar of California, and the Los Angeles Bar Association. He received the Career Service Award of the National Civil Service League in 1964, the Securities and Exchange Commission Distinguished Service Award in 1966, and the Justice Tom C. Clark Award of the Federal Bar Association in 1971. He took office as a member of the Securities and Exchange Commission on August 13, 1971, for the term of office expiring June 5, 1974.

JOHN R. EVANS

Commissioner Evans was born in Bisbee, Arizona, on June 1, 1932. He received his B.S. degree in Economics in 1957 and his M.S. degree in Economics in 1959 from the University of Utah. He was a Research Assistant and later a Research Analyst at the Bureau of Economics and Business Research at the University of Utah, where he was also an Instructor of Economics during 1962 and 1963. He came to Washington in February 1963, as Economics Assistant to Senator Wallace F, Bennett of Utah. From July 1964 through June 1971 Commissioner Evans was a member of the Professional Staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs serving as minority staff director. He took office as a member of the Securities and Exchange Commission on March 3, 1973, for the term expiring June 5, 1978.

A. A. SOMMER, JR.

Commissioner Sommer was born in Portsmouth, Ohio on April 7, 1924. He received his B. A. degree from the University of Notre Dame in 1948 and 11.B. degree from Harvard Law School in 1950. At

the time he was appointed to the Commission, he was a partner in the Cleveland law firm of Calfee, Halter, Calfee, Griswold & Sommer. Mr. Sommer was formerly Chairman of the American Bar Association's Federal Regulation of Securities Committee and a member of the Committee on Corporate Laws and Committee on Stock Certificates. He was also a member of the Board of Governors of the National Association of Securities Dealers, a lecturer on securities law at Case-Western Reserve Law School and a lecturer at various institutes and programs dealing with securities law, corporation law and accounting matters. Commissioner Sommer was formerly a member and Past-Chairman of the Corporation Law Committee of the Ohio State Bar Association. He has authored articles dealing with corporate reorganization, conglomerate disclosure and other securities and accounting topics. He took office as a member of the Securities and Exchange Commission on August 6, 1973, for the term of office expiring June 5, 1976.

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MARKET STRUCTURE AND REGULATION

In the past few years, increasing stresses on the nation's securities markets have made necessary the consideration of broad changes in the structure of those markets. Among the many factors contributing to the stresses observed were: increased institutional dominance of our markets; a substantial increase in the number of so-called "block transactions;" and the fragmentation of trading in listed securities.

As previously noted,[1] the Commission has assumed the initiative in defining structural changes in the securities markets. These initiatives began in 1968, with administrative hearings concerning the commission rates which all national securities exchanges require their members to charge.

In October 1971, the Commission held hearings which focused specifically upon the issue of an appropriate structural blueprint for the further development of our securities markets. Based in part upon these hearings, the Commission, in February 1972, issued its Policy Statement on the Future Structure of the Securities Markets in which it discussed the major policy issues confronting the nation's capital market system, and delineated the directions in which the

Commission intended to go in order to alleviate those problems. The Commission recommended that the following steps be taken to develop and implement the policies enunciated in the Policy Statement:

1. the formation by the Commission of Advisory Committees which would study, report on, and make recommendations with respect to (a) the development of a comprehensive market disclosure system; (b) the structure, regulation and governance of a central market system; and (c) rules designed to ease the impact and improve the handling of large blocks of securities;

2. the reduction of the level above which commission rates would be negotiated from $500,000 to $300,000;

3. the formulation and promulgation by the NASD, at the Commission's direction, of rules designed to prohibit the use of portfolio executions by investment company managers to reward broker-dealers which sell the investment company's shares;

4. the prompt adoption by all exchanges of rules excluding from membership any organization whose primary function is to route orders for the purpose of rebating or recapturing commissions, directly or indirectly; and

5. consultation with exchanges and other interested persons with the object of formulating exchange rules designed to require that exchange members engage in a "predominantly public" brokerage business.

During fiscal 1973, the Commission took important and major steps to implement the recommendations in its Policy Statement – these are set forth below. At the same time, in response to the recommendations set forth in its Study of Unsafe and Unsound Practices of Brokers and Dealers,[2] and the Congressional mandate expressed in the Securities Investor Protection Act of 1970, the Commission embarked upon a program designed to strengthen the financial responsibility of brokers and dealers in securities and to

ensure a broader measure of protection to the investing public. These efforts to increase the professional quality and capabilities of participants in the brokerage industry were combined with a program designed to avoid duplication with respect to their reporting requirements or other responsibilities which may impair the efficient functioning of the brokerage industry.

During the last fiscal year, the Commission and its staff have also been increasingly preoccupied with legislative efforts by subcommittees of both houses of the Congress. The Commission's actions foreshadow basic changes in the structural and regulatory framework of the securities industry. It is anticipated that these changes will result in a truly competitive and efficient capital market system – one capable of providing public investors a broad range of services with a minimum of risk.

Industry Advisory Committees

Following the issuance of the Commission's February 1972 Policy Statement, three industry advisory committees were established to provide the Commission with detailed recommendations for implementation of some of the Statement's major proposals. These committees were asked to analyze and make recommendations concerning the effective dissemination of information to investors, block trading and the structure, regulation and governance of a central market system.

(1) *Advisory Committee on Market Disclosure* – The Advisory Committee on Market Disclosure met from April through September 1972, and issued two reports. The first specified a recommended format and method of operation for a composite last sale reporting system. The second made similar recommendations with respect to a composite quotation system.

The report on the last sale reporting system recommended that there be two separate "streams" of data, one consisting of all trading in stocks listed on the New York Stock Exchange and the other consisting of all trading in all other qualified listed stocks, in each

case on a real-time basis. All domestic transactions in listed securities involving a registered broker-dealer as principal or agent would be reported, with certain exceptions for transactions such as underwritings. The report contemplated a central processor or service bureau, which would be free from the control of any particular market center and which would receive, validate, sequence and retransmit last sale reports from the various participating self-regulatory organizations. The report also discussed conditions under which access to and retransmission of last sale reports could be regulated, and recommended a review procedure for those denied access or the right to retransmit. The information to be reported would include the price, size and location of each transaction, and this information would be displayed by means of both moving tickers and interrogation devices. It was also recommended that the maximum time from the execution of a trade until its entry in the system should be one minute, after which the trade would be considered as reported out of sequence.

The report on a composite quotation system recommended that the system be open to all listed securities and be available for use by all market makers prepared to undertake certain responsibilities with respect to each stock for which they would enter quotations. Generally, a market maker would be required to deal in a particular security in a stabilizing manner for a specified minimum period of time, such as one year, and would not be permitted to cease such dealings except for good cause. Other broker-dealers would have to insert quotations through eligible market makers, whether on their own behalf or for customers. Surveillance and capital requirements for participating market makers were also discussed.

The Committee recommended that the quotation system be administered by the same central processor recommended for the last sale reporting system. The information to be displayed would include a designation representing the market maker, or the exchange, and its respective bid and offer. Market makers would be permitted, but not required, to indicate the number of shares their bids and offers covered, if in excess of one unit of trading. Quotations would have to be "firm" for at least one unit of trading, or whatever

size was shown, unless a market maker could demonstrate that he was in the process of updating his market after having consummated a transaction. The Committee recommended that the quotation system be an exclusive system: all quotations in listed securities would have to be stored in a common data bank to which all users of the system would have access and all elements of the system would be governed by a single set of rules. The quotation system would be compatible with existing communications equipment and would thus encourage the development of improved equipment and methodology. In closing, the report emphasized the importance of the auction process generally in trading listed securities and specified limited criteria for denials of access, with a right of appeal to the Commission.

Many of the recommendations of the Committee's report on a last sale reporting system are embodied in Securities Exchange Act Rule 17a- 15, adopted on November 8, 1972, which is discussed below.

(2) *Advisory Committee on a Central Market System* – The Advisory Committee on a Central Market System met from April through December 1972, and also issued two reports. The first specified the minimum regulatory changes deemed necessary to implement a composite last sale reporting system. The second contained the Committee's recommendations on the structure, regulation and governance of a central market system.

The first report recommended three prerequisites to full operation of a composite tape: (1) adoption of a uniform rule regulating short sales in all markets for listed securities; (2) adoption of a uniform rule by all exchanges to prevent use of the tape for manipulative purposes; and (3) development of a mechanism to coordinate trading suspensions in cases where a security is traded in more than one market. The report analyzed the problems raised by a uniform short sale rule in considerable detail, and set forth various specific recommendations. The Commission adopted those recommendations in its Policy Statement on the Structure of a Central Market System, issued on March 29, 1973. The Statement is discussed more fully below.

The report on a central market system, presented two distinct points of view analyzing the best means of developing such a system. Several members of the Committee were in favor of introducing the composite last sale and quotation reporting systems and permitting regulatory and operational rules to evolve as dictated by experience with the new equipment. Other members of the Committee, however, expressed the view that the regulatory Jinks between market centers would never evolve adequately without affirmative Commission rulemaking at the outset, in conjunction with the introduction of communication ties. Another principal point of difference between the two groups was that those who favored the first approach also believed that all trades in listed securities should ultimately be limited to exchanges – that is, they supported the eventual elimination of the "third market" in listed securities.

(3) *Advisory Committee on Block Transactions* – The Advisory Committee on Block Transactions submitted its report to the Commission on August 7, 1972. The report reviewed the rapid trend toward the institutionalization of the nation's securities markets and studied the manner and method of integrating block transactions into a central market system. The Committee considered the possibility of directly restricting an institution's freedom to buy and sell blocks of particular securities as well as restrictions that would accomplish the same thing indirectly – for example, by limiting price changes in the trading markets. The Committee concluded, however, that institutions should remain free to purchase and sell in a future central market system "in a manner and at a time of their own choosing," although the Committee did note that the ability of the market to absorb large blocks of stock should be strengthened.

In its report, the Committee specifically recommended: (1) that the Commission re-examine present regulation over the alternative means for disposing of blocks of securities in order to facilitate their use; (2) that institutions be permitted to disclose their interest to specialists who could explore the size and timing of blocks coming into the market and might be encouraged to participate in a forthcoming block transaction; and (3) that block positioners be permitted, after the implementation of a composite tape and on a trial

basis, to register in securities as an "upstairs market maker." The Committee also recommended that a specialist be permitted this same privilege in stocks other than those in which he is registered.

The Committee rejected a suggestion that separate markets for institutions and individuals be maintained, the so-called "two-tier concept." Instead, it explored alternatives intended to permit the small public investor to participate in the block trading process. The Committee recommended that, at a minimum, pre-existing orders should be permitted to displace a block order in any block sale at a discount or block purchase at a premium. The Committee also indicated its view that the Commission should confirm that the normal handling of a block transaction does not involve a "distribution"

within the meaning of Exchange Act Rule 10b-6.

In line with its recommendation that the Commission reexamine its regulations affecting the disposition of blocks of securities with the object of facilitating such disposition, the Committee urged a re-examination of Exchange Act Rule 10b-2. That rule generally prohibits the practice of stimulating exchange activity in securities which are the subject of a distribution by prohibiting payment of extra or special compensation for soliciting purchases of the securities being distributed. On April 9, 1973, the rule was amended to permit a broker or dealer who is participating or financially interested in a distribution to pay compensation to regular employees for such solicitation not only in the form of regular salary (as previously permitted) but also in the form of usual and customary commissions.[3]

The Committee concluded that the evolutionary nature of the block trading process makes impracticable any definitive mandate to create a block trading market structure, but indicated its willingness to meet with and advise the Commission on a case-by-case basis as special problems arise.

Central Market System Policy Statement

On March 29, 1973, the Commission issued its Policy Statement on the Structure of a Central Market System – setting forth the results of its extensive review of the recommendations contained in the advisory reports just discussed, two recent Congressional studies[4] and an analysis by its staff with respect to the development of a central market system for listed securities. The Policy Statement is intended to give direction to the development of the structure and regulatory framework within which such a system would operate. In the Commission's view, a central market system, by bringing together all existing markets for listed securities, would produce the beneficial results of equalizing the regulation of those markets and making their transactions visible to all. At the same time, competition would be encouraged, resulting in a substantial benefit to investors.

At the heart of the central market system described in the Policy Statement would be a comprehensive communications linkage between market centers consisting of a real-time composite last sale reporting system, a composite quotation system displaying the bids and offers of all qualified market makers in listed securities, and a central electronic repository for limit orders. Implementation of such a communications system would necessarily precipitate major changes in the way securities are traded today. Rather than let such changes occur without direction, the Commission anticipated some of the problem areas and sketched out a broad regulatory framework within which the new communications network could operate efficiently.

The major proposals may be grouped into three broad categories: first, regulation to maintain the integrity of the communications linkage, such as eligibility criteria for securities to be included, short sale regulation and anti-manipulative rules; second, regulation of competing market makers within the system, particularly with regard to their responsibilities to maintain a fair and orderly market; and third, regulation to ensure that the system will maintain the best auction features of the exchange markets and thereby provide a favorable environment for individual public investors. These auction features include an "auction trading" rule and a "public preference" rule, both of which are designed to maximize the opportunity for public orders to meet without the intervention of a dealer. These rules

should have the effect of centralizing all buying and selling interest in listed securities and eliminating the fragmentation which heretofore has plagued our markets.

The Policy Statement sets forth in detail the Commission's preliminary conclusions and the steps it plans to take, or to request the self-regulatory bodies to take, for their realization. The Commission emphasized, however, that because of the complexity of the issues and the unique efficiency already attained by our domestic capital markets, any major structural changes must be analyzed in detail before, and monitored closely after, their implementation. Therefore, the Commission requested comments from all interested persons – including investors, self-regulatory bodies, broker-dealers and government agencies – on all aspects of the views expressed in the Policy Statement.

Work towards implementing the concrete steps recommended in the last section of the Policy Statement is currently underway, and it is anticipated that a considerable amount of progress will be achieved during the present year.

Commission Rates

In its February 1972 Policy Statement, the Commission indicated its determination to require that fixed commission rates on that portion of orders above $300,000 be eliminated, and this objective has been accomplished. Fixed rates on the portion of orders over $500,000 had previously been eliminated at the Commission's urging.

In March 1973, the Commission announced that it would not seek any further reduction in the breakpoint until April 1974, when it would be reduced from $300,000 to $100,000. The Commission considered an interim reduction at that time imprudent in light of, among other things, the capital and operational pressures to which the member firm community had been subjected in recent years, and the immediate financial stresses produced by a combination of inflated costs and declining profitability.

On September 11, 1973, the Commission announced that it would not take the halfway measure of seeking a further breakpoint reduction in April 1974. Instead, it will act promptly to terminate entirely the fixing of commission rates by stock exchanges after April 30, 1975, if the exchanges do not adopt rule changes achieving that result.[5]

NASD Reciprocal Brokerage Rule

The Commission's February 1972 Policy Statement noted the widespread practice by investment company managers of using portfolio brokerage of mutual funds to reward broker-dealers for sales of fund shares. It reviewed the regulatory problems and abuses related to this practice and urged the NASD to initiate measures designed to end its members' participation in such practices. Subsequently, the NASD filed with the Commission proposed amendments to its Rules of Fair Practice which were designed to accomplish that result. On May 14, 1973, the Commission announced that it had reviewed and would not disapprove the proposed amendments." The amendments, which became effective July 15, 1973, are intended to prohibit members from favoring or discriminating against the distribution of shares of open-end investment companies (mutual funds) on the basis of brokerage commissions received, soliciting or making promises of an amount or percentage of brokerage commissions in connection with the distribution of such shares, and seeking orders for the execution of portfolio transactions on the basis of sales of fund shares. While the Rule does not, by its terms, apply to possible reciprocal brokerage practices in connection with the distribution of shares of other types of investment companies, such as closed-end funds, variable annuities and variable life separate accounts, the Commission has requested the NASD to consider the question of whether or not comparable regulatory measures should be adopted in these areas. The appropriate NASD committees are currently considering such measures.

In order to assure equality of treatment for all broker-dealers, the Commission, on June 27, 1973, issued a release proposing the

adoption of Rule 15b10-10 under the Exchange Act to prohibit similar reciprocal brokerage practices by SECO broker-dealers – those registered broker-dealers which are not members of the NASD.[7] The comment period on this rule expired July 31, 1973, and the Commission's staff is currently considering the comments received.

Rule 19b-2

In its February 1972 Policy Statement, which reflected the culmination of more than four years of study of various aspects of the operations of the nation's securities markets, the Commission outlined the specific problems it had observed in the functioning of the securities industry and their relationship to the development of a central market system. The problems noted by the Commission included: the growing "institutionalization" of the securities markets; dispersion of trading, resulting in an erosion of the public's ability to know whether best execution of orders has been obtained and impairment of marketplace liquidity; proliferation of reciprocal practices; and increased trading in listed securities not disclosed to the public. The Statement committed the Commission to a program of upgrading competition in the securities industry. In addition to reaffirming the Congressional goal that exchange membership should be used for public purposes,[8] the Commission also called for elimination of the so-called "parent test" – the means by which some exchanges had precluded some institutional affiliates from gaining direct access to the exchange marketplace.[9]

On May 26, 1972, the Commission requested each national securities exchange to adopt, no later than July 31, the substance of a proposed rule dealing with the appropriate utilization of exchange membership. On August 3, 1972, after it had become apparent that most of the exchanges had not adopted the rule suggested by the Commission, the Commission published proposed Exchange Act Rule 19b-2 for public comment.[10] In light of its importance, requests for comments were directed not only to the exchanges but to their members, financial institutions and all other interested persons. Thereafter, oral hearings on the Commission's proposed rule were

held, at which time interested persons presented their views and were questioned by the Commission and its staff.

On January 16, 1973, the Commission adopted Rule 10b-2.[11] Pursuant to the , rule, each securities exchange registered with the Commission must adopt rules which require every member of that exchange "to have as the principal purpose of its membership the conduct of a public securities business." For purposes of the rule, it is presumed that a member is conducting a public securities business if at least 80 percent of the volume of exchange securities transactions effected by it (a) is effected for or with other than affiliated persons,[12] or (b) consists of certain kinds of transactions which contribute to the liquidity or stability of the markets, such as those effected by a stock exchange specialist in a security in which he is registered, or a bona fide arbitrage transaction. A phase-in period was included in the rule whereby exchange members, who acquired their membership prior to January 16, 1973, were given up to three years to comply fully with its provisions. The Commission stated that, following the adoption of the Rule, all exchanges would be expected to amend their access provisions to the extent necessary to eliminate any parent or related test.

Subsequent to the adoption of the rule, various parties, including the Philadelphia-Baltimore-Washington Stock Exchange (PBW), sued to test its validity.[13] On March 19, 1973, the United States Court of Appeals for the Third Circuit stayed the effectiveness of the rule as to PBW members whose membership antedated the rule's adoption. On March 22, the Commission announced that all exchanges which had not yet adopted Rule 19b-2 would be required to do so subject to these conditions: (1) all members who joined an exchange after January 16, 1973, the date of the rule's adoption, would be expected to comply fully with its terms; (2) those members who joined prior to that date could continue in membership, if their exchange so decided, without complying with the rule's public business requirements, provided that their volume of business did not increase substantially pending the outcome of the litigation as to the rule's validity.[14]

Rule 19b-2, as adopted by the New York and American Stock Exchanges, requires all members to abide by the public business requirement, no matter when they joined the exchange. The rule as adopted by the other exchanges applies that requirement only to members who joined on or after January 16, 1973.

On September 28, 1973, the Court of Appeals for the Third Circuit granted the Commission's motion to dismiss for lack of jurisdiction the lawsuit seeking to test the validity of Rule 19b-2.

Consolidated Tape

One of the more significant steps taken by the Commission during the past fiscal year to implement its Policy Statement on the Future Structure of the Securities Markets was the adoption of Rule 17a-15 under the Exchange Act.[15] That Rule requires registered national securities exchanges, national securities associations and broker-dealers who are not members of such organizations, to make available on a composite basis price and volume reports as to completed transactions in listed securities.

Rule 17a-15 contemplates that registered securities exchanges and associations (and nonmembers thereof) will file "plans," on a joint basis if desired, which will specify the manner of disseminating the required information. In order to become effective, such plans must be approved by the Commission. The New York, American, Midwest, PBW and Pacific Stock Exchanges, and the NASD, filed a joint plan with the Commission pursuant to the Rule on which the Commission invited public comment. Near the close of the fiscal year, the Commission announced that it had sent a letter to the sponsors of the plan commenting on certain of its aspects. The Commission made the text of its letter public and invited further comment from the sponsors and other interested persons.[16]

Option Market Regulation

A significant event of the past year was the registration of the Chicago Board Options Exchange, Inc. ("CBOE") as a national

securities exchange.[17] The Commission determined to permit the CBOE, as a new exchange and the first national securities exchange to experiment with the trading of options, to test the market for such options within a controlled environment. The CBOE operation is currently limited to trading in call options[18] in approximately 20 underlying stocks but it intends gradually to increase that number and to extend operations to other types of options as experience is gained, and the market and its regulatory arrangements are tested. The CBOE not only provides a market place for the initial buying and selling of option contracts but has also established a secondary market for the resale of options during their lifetime. Prior to the formation of the CBOE, options initially were bought and sold over-the-counter, with only a very limited secondary market. The options traded on the CBOE are registered under the Securities Act,[19] and relate to underlying stocks which are listed on another national securities exchange. The initial option registration related solely to the underlying common stocks of companies listed on the New York Stock Exchange.

For the period of the CBOE's experimental status, and in line with the need to maintain flexibility in regulating this new kind of exchange market, the Commission decided to postpone a definitive determination as to whether the CBOE should be required to include in its rules a non-member access provision. The Commission also determined, pending further consideration regarding the viability of existing fixed commission rates and the nature of the CBOE's actual operations, to permit the CBOE to structure its commission rates in a manner analogous to those provided by other national securities exchanges.

On April 26, 1973, the date upon which the CBOE's registration as a national securities exchange became effective, the Antitrust Division of the Department of Justice filed suit alleging that the maintenance of minimum commission rates, floor brokerage and other fees by the CBOE violated Section 1 of the Sherman Act.[20] The CBOE, it is alleged, is engaged in an unlawful combination to restrain trade and commerce in the providing of brokerage services for the trading of options.

Interest in the trading of put and call options has increased markedly the past few years causing the Commission to assess the adequacy of existing protections available to public investors who participate in this activity. In an effort to ensure that investors in options are afforded protections similar to those provided investors in more common debt or equity securities, the Commission has already promulgated some rules[21] and proposes to adopt other rules relating to trading in options. Thus, on January 9, 1973, the Commission announced that it was considering the adoption of Rule 9b-1 under the Exchange Act.[22] The rule, as proposed, specifies procedures to be followed in connection with the adoption or alteration of rules of a registered national securities exchange relating to acts and transactions in options on the exchange. The Commission is considering the comments it has received on proposed Rule 9b-1 and expects to act with regard to this subject in the near future.

In addition to overseeing exchange rules relating to trading in put and call options, the Commission has proposed rules directed to the options themselves as well as those persons who deal in them.

On February 8, 1973, the Commission published for comment proposed Securities Act Rule 238.[23] That rule would exempt put and call options from the registration requirements of the Securities Act if certain conditions were met. These conditions are: (1) that the security underlying the put or call option is either registered on a national securities exchange or meets certain criteria if traded only over-the-counter; (2) that the gross proceeds from the sale of related options

received by the writer or by all writers with the same endorser do not exceed $500,000 (all puts or all calls on the same underlying security and having a last possible expiration date in the same calendar month are considered to be related); (3) that the writer of the option is not the issuer of the underlying security, an affiliate of the issuer, or an underwriter with respect to the security; and (4) that the endorser of the option is a broker-dealer who is registered with the Commission.

On the same day, the Commission also published for public comment proposed Exchange Act Rule 9b-2.[24] That rule, among other things, would require that prior to the execution of a customer's initial option transaction, a broker or dealer would be required to furnish the customer a disclosure statement which clearly explained the obligations and risks attendant upon writing or purchasing an option. In addition to this requirement, the proposed rule specifies standards of suitability for customers dealing in puts and calls; requires endorsers of options to report their option transactions and outstanding endorsements on a weekly and monthly basis; and requires that endorsers maintain net capital of not less than $50,000.

The Commission is currently considering revisions in proposed Rules 238 and 9b-2 based upon the many comments it has received on the rules as originally proposed.

Legislative Initiatives (1) H.R. 5050

In 1972 the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce completed a comprehensive examination of the securities industry.[25] After taking a voluminous amount of testimony, the Subcommittee issued a report setting forth the information and analysis obtained along with conclusions and legislative recommendations concerning almost every aspect of the securities industry with which the Division of Market Regulation is concerned.[26] On March 1, 1973, a bill entitled the Securities Exchange Act Amendments of 1973, designated H.R. 5050, was introduced in the House and referred to the Committee on Interstate and Foreign Commerce.

Title II of H.R. 5050 is designed, among other things, to conform Section 6 of the Exchange Act to Section 15A of that Act so that national securities exchanges and national securities associations, as well as their members, would be subject to substantially identical regulation. In this connection, Title II would expand the oversight authority of the Commission to include exchange rule-making and disciplinary actions. It would also phase-out fixed commission rates

on national securities exchanges, prohibit persons from providing both management and brokerage services for the same institutional account, direct the Commission to take the necessary steps to establish a central market system, prohibit exchanges from preventing their members from executing transactions for customers in other markets, and require the Commission to adopt rules designed to ensure best execution.

Title III of H.R. 5050 would amend Exchange Act provisions relating to the regulation of brokers, dealers and exchange members. The revisions, among other things, would modify financial responsibility requirements; the broker-dealer application, registration and examination process; and certain of the reporting requirements. They would clarify the Commission's authority to require a composite transaction tape and a composite quotation system, and grant the Commission expanded authority over the accounting procedures of broker-dealers and exchange members.

Title IV of H.R. 5050 provides for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions and includes provisions relating to the regulation and registration of clearing agencies, securities depositories and transfer agents. It also directs the Commission to eliminate the use of the stock certificate as a means of settlement by December 31, 1976, and clarifies the Commission's authority to deal with missing or stolen securities.

Provisions of Title IV would designate the Commission as the sole regulator of clearing agencies, depositories and transfer agents, regardless of whether certain of these entities were incorporated and authorized to operate as banking organizations. The Commission would be authorized to set standards for such entities, administer registration requirements, conduct inspections and ensure compliance with the standards it had set.

By way of contrast, the Senate version of Title IV (S. 2058) would provide for dual regulation of securities depositories, clearing agencies and transfer agents.[27] The Commission would have general

oversight responsibility with respect to those entities and would coordinate its activities, to the maximum possible extent, with the Federal bank regulatory authorities, i.e., the Federal Reserve Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation. With regard to depositories, transfer agents and clearing agents incorporated as banks, however, the Federal bank authorities would have the primary responsibility to conduct inspections and enforce the bill's provisions.

(2) S. 470

On June 18, 1973, S. 470 was passed by the Senate and sent to the House of Representatives for consideration. This bill would grant the Commission authority to regulate or prevent trading by members on national securities exchanges, either on or off the exchange floor, for the member's own account or the account of any affiliated person, and make it unlawful for a member to trade in contravention of rules the Commission might adopt. The bill would also make it unlawful after a prescribed period, for a member of a national securities exchange to effect any transaction on such exchange for or with its own account or that of any affiliated person or managed institutional account.

Such prohibition would not become effective prior to the last date on which any national securities exchange maintains or enforces any rule fixing rates of commission, or prior to April 30, 1976, whichever is later. Moreover, the prohibition would not be absolute until the expiration of two years from the date that fixed commission rates are totally eliminated, or April 30, 1976, whichever is later.

S. 470 would also amend the Investment Company and Investment Adviser Acts: (1) to provide that under specified conditions, it would not be unlawful or a breach of fiduciary duty for an investment adviser to pay a higher commission to a broker for effecting a transaction than that charged by other brokers for effecting similar transactions; and (2) to establish standards with respect to the sale of an interest in an investment adviser. The latter section is designed to remedy certain problems raised by a recent court decision,[28] which held that

the general principle in equity that a fiduciary cannot sell his office for personal gain is impliedly incorporated into Section 15 (a) of the Investment Company Act requiring shareholder approval of any new investment advisory contract. For a more detailed discussion, see Part 5.

Tax Shelters

During the fiscal year, the NASD and the Commission's staff gave extensive consideration to the regulatory problems associated with the public offering of tax-shelter programs. Shortly after the close of the year, the Commission announced that it was requesting public comments on proposed NASD Rules of Fair Practice which would establish a system of regulation for the distribution of such programs.[29] The proposed rules, among other things, would prohibit NASD members from participating in the distribution of tax-sheltered programs which did not meet prescribed standards of fairness and reasonableness. These standards relate to the underwriting and other terms and conditions of the public distribution, including all elements of compensation to be paid to sponsors or broker-dealers, and to the operation, structure and management of such programs. Suitability standards for investment in such programs, and requirements concerning the content and filing with the NASD of advertising and supplemental sales literature would also be established.

The Commission has requested public comment on the NASD's proposals not only to aid in its consideration of the specifics of the NASD's proposed plan, but also to provide it with a broadened base upon which to develop its own policies in the area of tax shelter programs.

DISCLOSURE-RELATED MATTERS

"Hot" Issues

In February 1972, the Commission began public, fact-finding investigatory proceedings on "hot issues" securities markets (i.e.,

markets in which new issues have experienced substantial price rises in their after-markets) to determine the adequacy of existing disclosure and regulatory protection for investors.

On July 26, 1972, following completion of the first phase of the hearings, the Commission requested the registered national securities exchanges and the NASD to consider the establishment of appropriate standards to alleviate some of the problems found to exist in such markets – particularly with respect to the adequacy of investigations by underwriters and the suitability for customers of the securities being distributed. As a result of this request, the NASD established a committee to review the Commission's comments and to make appropriate recommendations designed to strengthen regulatory and disclosure control over the sale of new issues of securities to public investors. On March 14, 1973, the NASD's Board of Governors requested membership and public comments on the committee's recommendations that: (1) special customer suitability rules be adopted with respect to first time offerings of companies in a promotional stage; (2) a rule be adopted to require that written procedures be established and followed by underwriters in conducting due diligence investigations; (3) a new category of qualification and registration for broker-dealer personnel be established ("underwriter principals"); and (4) the NASD's regulations stress a member's obligation to make a bona fide public offering in all new issues. At the end of the fiscal year, the numerous comments received concerning these recommendations were reviewed and considered by the NASD.

On June 1, 1973, the Commission published a number of releases dealing with the first phase of the "hot issues" hearings.[30]

The amendments to the registration and reporting forms adopted in these releases require more meaningful disclosure relating to all registrants, including information concerning the status of new product development and general competitive conditions, the position of the issuer in the industry in which it operates, and, in the case of certain registrants offering securities to the public for the first time, a description of their plan of operation.

The amendments added a new guide, 59, to the Guides for Preparation and Filing of Registration Statements under the Securities Act requiring that all prospectuses on Forms S-1 and S-2 include, immediately following the cover page, a summary highlighting the salient features of the offering with appropriate cross references to the prospectus.

Guide 5, "Preparation of Prospectuses," as amended, notes that stock phrases or "boiler plate" relating to subjects such as the company's chances of success or competition often do not provide meaningful disclosure and, therefore, should usually be accompanied by a brief explanation of the basis for the statement and the effect such conditions may have on the registrant's business. In addition, it now requires disclosure in preliminary prospectuses actually circulated of the estimated maximum offering price and number of shares or other units to be offered, or, with respect to debt securities, the estimated principal amount to be offered for first time public offerings. In addition, disclosure is now required of factors that were considered in establishing the offering price, and an estimate, with appropriate caveats, of the value placed on outstanding securities of the registrant as a result of the estimated offering price. Such bare bones statements as "the initial public offering price has been arbitrarily determined by the company" or "such price has been established by negotiations between the underwriter and the registrant" are no longer sufficient.

Guide 16 was amended to deal specifically with the due diligence inquiry required of underwriters of new or speculative issues.

The second phase of the "hot issues" proceedings which began in September 1972 and focused on distribution and aftermarket trading is continuing. In November 1972, the Commission announced that three new issues of securities which were distributed during calendar year 1972 had been selected for analysis during public hearings scheduled to be held beginning December 11, 1972 in New York.[31] The selection of the three issues was based solely on the fact that

they experienced a price increase of approximately 100 percent or more from the initial offering price.

Forecasts of Economic Performance

On November 1, 1972, the Commission announced a public rulemaking proceeding relating to the use, both in filings with the Commission and otherwise, of estimates, forecasts or projections of economic performance by issuers whose securities are publicly traded.[32] Hearings were ordered by the Commission for the purpose of gathering information relevant to a reassessment of Commission policies relating to disclosure of projected sales and earnings. The Division of Corporation Finance conducted public hearings from November 20 to December 12, 1972, and received testimony from 53 witnesses, including representatives or publicly-held corporations, the securities industry, the academic community, the self-regulatory organizations, and the accounting and legal professions. In addition, letters from over 200 persons were received and made part of the public record.

On February 2, 1973, the Commission indicated that it plans to take the first steps toward integrating projections into the disclosure system.[33] In summary, the Commission determined that:

1. Disclosure of projections in Commission filings should not be required except under the circumstances set forth in paragraphs 7 and 8 below.

2. Issuers which are reporting companies and meet certain standards relating to their earnings histories and budgeting experience should be permitted to include projections in filings made with the Commission pursuant to the Securities Act and the Exchange Act.

3. Projections disclosed in Commission filings should meet certain standards. For example, the underlying assumptions should be set forth, the projection should be of sales and earnings and expressed as a reasonably definite figure, and the projections should be for a reasonable period of time.

4. Any issuer which files projection information should be required to update the filed projection on a regular basis and whenever the issuer materially changes its projection.

5. Any issuer which has previously filed projection information should be allowed to stop filing such information if it discloses its decision and the reasons therefor.

6. No statement of verification or certification of the projections by any third party should be permitted in any filing with the Commission at this time.

7. Any issuer which discloses projections outside of filings with the Commission, whether through financial media, financial analysts or otherwise, should be required to file such projections with the Commission on a special projection form.

8. Any issuer subject to the reporting requirements of the Exchange Act which discloses a projection, whether in a Commission filing or not, should be required to include in its annual report on Form 10-K for the fiscal year during which the projection was made a statement of the projection, the circumstances under which it was disclosed, and a comparison of the projection with actual results.

9. The Commission should adopt rules under the securities laws to define the circumstances under which a projection would not be considered a misleading statement of a material fact.

10. The Commission should issue a release setting forth certain standards for the preparation and dissemination of projections by the management of public companies, financial analysts, and other members of the financial community. The release should highlight the Commission's reservations as to whether anyone who makes a projection with respect to an issuer having a limited history of operations can meet the standards necessary to avoid liability. In addition, the adverse consequences of selective disclosure of material information such as projections should be emphasized.

The staff of the Division of Corporation Finance is currently preparing specific releases and the rule and form changes necessary to implement the foregoing conclusions. The rule and form changes will be published for comment prior to adoption.

Rule 144

In April 1972, Rule 144, "Persons Deemed Not to be Engaged in a Distribution and Therefore Not Underwriters," became effective. It provides a method of resale for securities acquired in private placements and for securities held by affiliates. During the first months of the rule's operation, the Division of Corporation Finance received a number of requests for interpretations of the rule. In September 1972, the Division consolidated some of the more important interpretations in question and answer form and, with Commission approval, published them.[34] Among the significant interpretations were those dealing with securities acquired by an underwriter in connection with a public offering, the solicitation of customers' orders, and the use of a moving average of trading volume for calculating the amount of securities that might be sold under the rule.

In addition, the Commission proposed for comment an amendment to the rule which would permit brokers to continue their quotations in an interdealer quotation service while selling securities pursuant to the rule, subject to certain conditions.[35] Under the proposal, quotations could be continued provided they were incident to the maintenance of a bona fide interdealer market. To insure that a broker was a bona fide market maker, the proposal would require him to have published quotations on at least 15 out of the last 20 trading days, and 4 out of the last 5, prior to receipt of the order. To insure that the predominant percentage of a market maker's transactions on a given day in the particular security were unrelated to Rule 144 transactions, the proposal suggested a limitation on the number of shares to be sold pursuant to Rule 144 based on a percentage of the dealer's average daily trading volume in that security over a prior period of time.

The Commission received numerous comments on this proposed amendment and its staff is currently reviewing them.

On June 14, 1973, the Commission reminded persons selling securities pursuant to Rule 144 of their obligation to file a duly completed Form 144.[36] It pointed out that Form 144 must be filed at the time an order to sell is placed, not after the sale. Other common mistakes in using the form were also noted, and sellers were reminded that strict compliance with the rule is necessary.

Rule 145

The Commission's 1969 Disclosure Policy Study[37] recommended the rescission of Rule 133 under the Securities Act, which exempted from registration securities issued in certain types of business combinations under a "no sale" theory, and adoption of a special form for registration of securities issued in such transactions.

In October 1972, the Commission in accordance with that recommendation, rescinded Rule 133, adopted Rule 145, and took other related actions.[38] Rule 145 provides that the submission to a vote of security holders of a proposal for certain mergers, consolidations, reclassifications of securities or transfers of assets is deemed to involve an "offer" or "sale" of the securities to be issued in the transaction. The effect of the rule is to require registration of such securities unless an exemption is available.

In order to facilitate the registration of securities issued in transactions of the kind referred to in Rule 145, the Commission revised Form S-14. This form permits the prospectus to be in the format of a proxy or information statement.

Rule 145 and the other actions taken in connection with its adoption became effective January 1, 1973.

Rule 146

The so-called "private offering" exemption from registration under the Securities Act provided by Section 4 (2) has long been a source of uncertainty for issuers wishing to sell their securities in private placements. In November 1972, the Commission released for comment proposed Rule 146 under the Securities Act, "Transactions by an Issuer Deemed Not to Involve Any Public Offering."[39] The proposed nonexclusive rule is intended to provide more objective standards for determining when the offer or sale of securities by an issuer is a transaction not involving any public offering within the meaning of Section 4 (2). In general, the proposed rule would require that (1) no general advertising be used in the offer and sale of the securities; (2) all offerees, or their representatives, be persons with knowledge and experience in financial and business matters; (3) all offerees be able to bear the economic risk of the investment; (4) all offerees, or their representatives, have access to the type of information that registration would disclose; (5) there be no more than 35 purchasers of the issuer's securities in any 12 month period; and (6) that certain steps be taken to prevent resale of the securities in violation of the registration provisions. In addition, a Form 146 would have to be filed describing the transaction. In connection with Rule 146, the Commission proposed an amendment to Rule 257 to allow an offering under Regulation A not in excess of $100,000, without use of an offering circular, for certain employee benefit plan offerings. The Commission is presently considering the comments received on the proposed rule.

Rule 147

The application of Section 3 (a) (11) of the Securities Act, which exempts from registration securities that are part of an issue offered and sold only to persons resident in a specific state by an issuer that is also resident and doing business within that state, has also been a source of inquiry and uncertainty for many years. In January 1973, the Commission released for comment proposed Rule 147 which is intended to define certain terms in, and clarify certain conditions of, the intrastate offering exemption.[40] In general it would define "part of an issue" to include all offers and sales of securities by an issuer and its affiliate within a six month period. In addition, it would define

"person resident" and "doing business within" for purposes of the exemption, and would also place certain limitations on reoffer and resale. The Commission Is presently considering the comments received on the proposed rule.

Advisory Committee on Industrial Issuers

On September 26, 1972, the Chairman appointed an Advisory Committee on Industrial Issuers to review the reporting and other paperwork requirements of the Commission and self-regulatory bodies with respect to industrial companies. In its report to the Commission, submitted December 22, 1972, the Committee made a series of recommendations relating to the annual report to shareholders, interim reporting to the Commission, discretionary releases to the public, and certain other areas. With regard to the annual report, the Committee recommended that issuers be required to include, among other things, line-of-business disclosure and summary of operations information similar to that required in the annual report on Form 10-K. In the areas of discretionary releases and interim reporting, the Committee observed that guidelines would be useful and made some specific suggestions for improving dissemination of information. The Committee also made recommendations relating to the use of Forms S-7, S-8 and S-9, coordination of disclosure by the stock exchanges and the Commission and by the states and the Commission, guidelines for filing documents under the Exchange Act, and improved line-of-business reporting.

On January 22, 1973, a Task Force on Forms and Reports was appointed from the Commission staff to develop specific proposals based on the recommendations of the Advisory Committee.

Quality of Earnings

In December 1972, the Commission announced that it was proposing to amend Guide 22, "Summary of Earnings", of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933.[41] The proposed amendment is designed to

make more meaningful and understandable disclosure of financial information presented in prospectuses. Item 6 of Forms S-1 and S-7 requires that, in addition to the columnal presentation of summary financial data, registrants must supply information of material significance to investors in appraising the results shown. The proposed amendment would clarify the type of supplementary information and data to be included in order to enable investors to appraise the quality of earnings reported in the summary. A non-exclusive list of examples that registrants should consider in making disclosure would be set forth. The Commission announced that it is considering adoption of the substance of the amended Guide 22 as Guide 1 of proposed Guides for the Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934. The comments received on these proposals are being studied by the staff.

Real Estate Matters

The applicability of the Federal securities laws to the sale of real estate units is an area of evolving interpretation and practice. The Commission has undertaken a number of actions to state its position on questions in this area, and has sought the advice of the industry regarding future actions.

(a) *Real Estate Advisory Committee* — On May 3, 1972, the Real Estate Advisory Committee was established by the Commission to examine disclosure procedures and policy objectives in the area of real estate security interests. The Committee, in its report dated October 12, 1972, concluded that proper investor protection can best be achieved through informative, understandable and uniform economic disclosure in real estate security offerings. The report stated that such a process should result in more competition among various types of real estate securities and between real estate securities and all other types of securities in the equity markets. The Committee also stated that the various regulatory agencies involved in regulating the offer and sale of real estate securities should act so as to facilitate an equitable, competitive flow of funds into such securities from the investing public.

The committee recommended, among other things, that the Commission establish a "staffed permanent real estate advisory committee, composed of representative state regulators, securities associations, the real estate industry, attorneys and accountants." Although it urged the Commission to continue its enforcement of applicable provisions of the Securities Act and the Exchange Act, it recommended that the Commission refrain from developing new regulatory procedures with respect to real estate securities pending the formation and recommendations of the committee.

In addition, the Committee made specific recommendations in areas relating to the offer and sale of real estate securities such as sales literature, fees, conflicts of interest among promoters and managers, the applicability of Regulation "T", and the broker-dealer registration, net capital and reporting requirements of the Exchange Act as they may relate to those who sell real estate securities such as condominiums and cooperatives.

Since publication of the Committee's report, the Commission has taken a number of steps relating to the offer and sale of real estate securities. For example, as discussed below, the Commission has issued guidelines with respect to the applicability of the Federal securities laws to offers and sales of condominiums or units in a real estate development, and, as noted above, has asked for public comments on NASD proposals relating to tax shelter programs, including those involving real estate. The Commission's staff is currently studying other recommendations made by the Committee.

(b) *Interpretations Regarding Condominiums and Other Real Estate Units* — In January 1973, the Commission issued guidelines as to the applicability of the Federal securities laws to offers and sales of condominiums and other types of units in a real estate development.[42] The Commission stated that an offering of condominiums or other units will be viewed as an offering of securities in the form of investment contracts if they are offered and sold: (1) with emphasis on the economic benefits to the purchaser to be derived through the managerial efforts of the promoter, or a third

party designated or arranged for by the promoter, by rental of the units; (2) in connection with an offering of participations in a rental pool arrangement; or (3) in connection with the offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent, or is otherwise materially restricted in his occupancy or rental of his unit. The Commission noted that there might be other types of arrangements, not presently anticipated, that might render an offering of condominiums an offering of securities and stated that the staff of the Commission will respond to written inquiries on such matters.

In April 1973, the Commission issued a release[43] emphasizing the applicability of certain requirements of the Federal securities laws to advertising and sales practices in connection with units of real estate which are deemed to be securities. The release discusses the effect of Rules 134 and 135 under the Securities Act on the types of communications which may be used before, during and after the registration process. The release also notes the prohibition on acceptance of purchase price payments, deposits or purchase commitments prior to the time a registration statement is effective and a statutory prospectus delivered to a purchaser.

Accounting

During the year the Commission issued proposals for supplemental disclosure by registrants of their accounting policies and any changes made in those policies, and of data concerning income tax expense, leased assets, and items affecting liquidity. Studies are being conducted to determine whether improvements can be effected for the benefit of the investing public in other areas, including line-of-business reporting, pro forma financial statements, and reporting and audit requirements for broker-dealer firms.

The Commission is also studying ways to assist accountants practicing before it to maintain their independence, and to aid in improving their audit procedures and practices. In cooperation with the accounting profession, the Commission has developed a new

approach in its continuing effort to correct deficient auditing practices. This approach, which was applied during the year in disciplinary proceedings against an accounting firm,[44] calls for an investigation to be made of an accounting firm's professional practice to insure that the firm is following proper auditing standards and procedures. The investigation may be made either by the staff of the Commission, or by a team of qualified professional accountants selected either by the American Institute of Certified Public Accountants (AICPA) or by the Chief Accountant of the Commission from persons the AICPA designates.

INVESTMENT COMPANIES

Mutual Fund Distribution

During the last fiscal year, the Commission, after reviewing the Study of the Potential Economic Impact of the Repeal of Section 22 (d), conducted by its staff, and the Economic Study of the Distribution of Mutual Funds and Variable Annuities, conducted for the NASD, determined that it would be appropriate to re-examine traditional administrative positions and explore new possibilities in order that mutual funds may be marketed more efficiently at a reasonable cost to investors. Section 22 (d) requires, in part, that in the sale of a mutual fund security to the public, the principal underwriter and any dealer must sell the security at the current public offering price – net asset value plus stated sales charge – set forth in the prospectus.

In order to obtain a wide range of viewpoints with respect to the justification for this retail price maintenance provision, the options which would be open to the industry if Section 22 (d) were eliminated, and industry adjustment to such a change, the Commission solicited the views of all interested persons.[45] The notice also requested comments with respect to the following matters: further liberalization of mutual fund advertising rules; simplified and more readable mutual fund prospectuses; group sales; and reduction of paper work in small transactions.

More than 100 written submissions were received in response to the Commission's notice and placed in the record.

The public hearings included 15 days of testimony from 72 witnesses. Individuals from all facets of the mutual fund industry participated and expressed a broad range of opinions. At the end of the fiscal year, the Commission's staff was in the process of analyzing the views and information presented.

Variable Life Insurance

On January 31, 1973, the Commission announced its conclusions on regulation of variable life insurance.[46] Variable life insurance refers to insurance contracts in which the death benefit, cash surrender value and other benefits vary to reflect the investment experience of a life insurance company's separate account which invests primarily in equity securities. The Commission's action stemmed from public hearings last year on rules proposed by the American Life Convention and the Life Insurance Association of America which would have exempted certain variable life insurance contracts, issuers and related persons from the securities acts.

In brief, the Commission determined that: (1) the investment character of variable life contracts would make them securities, so that any public offering of the type of contracts contemplated in the hearings would have to be registered under the Securities Act; (2) people selling these variable life contracts would generally have to register as broker-dealers under the Exchange Act; (3) the separate account of a company engaged in issuing and selling these variable life contracts would fall within the definition of an investment company under the Investment Company Act; and (4) an insurance company or other entity providing investment advice incidental to the issuance of variable life contracts would be an investment adviser under the Advisers Act. However, the Commission determined to exempt by rule such separate accounts from the elaborate regulatory requirements of the Investment Company Act in deference to state regulation of insurance and because of complex administrative problems that would arise in providing the substantial exemptions

from the Act that would be necessary to make the operations of these accounts feasible. For essentially the same reasons, the Commission determined to exempt by rule from the Advisers Act insurance companies or affiliated companies acting as advisers to these accounts.

In determining not to adopt an exemptive rule with respect to variable life contracts under the Securities Act, the Commission in its release said: " (T)he important investment features of the contract – the opportunity to participate in the investment experience of the separate account in order to achieve increased life insurance benefits including death protections and cash value – require that contract-holders be afforded the protections of full disclosure which would be developed by registration of the contracts under the Securities Act."

At the same time, the Commission decided not to exempt these contracts from the provisions of the Exchange Act because the complex nature of the investment elements of variable life insurance make it particularly important that the disclosure made be communicated by salesmen and firms subject to Commission regulation.

After the close of the fiscal year, the Commission proposed amendments to the rules granting exemptions from the Investment Company and Advisers Acts which would, if adopted, condition the exemptions on prior Commission determination that state law and regulations applicable to variable life insurance contracts provide investor protections substantially equivalent to those afforded by the acts.[47]

The Commission also announced that a registration statement covering the offer and sale of variable life insurance contracts would not be accepted for filing under the Securities Act in the absence of a prior determination by the issuer that such policies can be legally sold in the jurisdiction in which offers will be made. The Commission based its decision on its view that the Securities Act contemplates that, at the time a registration statement is filed, there must be a present intention to commence sales upon its becoming effective,

and a reasonable certainty that the securities to be offered can be legally sold.[48]

Proposed Offshore Fund Legislation

In April 1973, the Commission submitted to Congress legislative proposals which would enable creation of Foreign Portfolio Sales Corporations or Trusts to be organized in the United States for the sale of mutual fund shares to foreigners.[49] The legislation was prepared by the staff of the Commission with the assistance of the staff of the Treasury Department and would amend the Investment Company Act and the Internal Revenue Code. The proposals were developed by an inter-agency Offshore Fund Task Group assembled on the initiative of the Commission and comprised of representatives of the Commission, the Treasury Department, the State Department and the Federal Reserve Board. The Task Group also received valuable advice and assistance from an informal advisory group.

The Task Group was formed as a follow-up to recommendations in the Commission's Institutional Investor Study submitted to Congress in March 1971. In the Study the Commission noted the well-publicized difficulties experienced by certain offshore funds and their sponsors and stated its belief that foreign investor confidence in offshore funds investing in American securities could be significantly bolstered if they were to become subject to Commission regulation under Federal securities laws. The Commission further noted that offshore funds currently receive competitive advantages under the Internal Revenue Code over domestic, registered investment companies seeking to sell in offshore markets. It suggested that equalization of these advantages would enable United States registered investment companies to compete more effectively with unregulated offshore funds and that the net result would be beneficial to foreign investor protection and the United States securities markets, as well as to the United States balance of payments.

After reviewing existing United States laws with the assistance of the business advisory group, the Task Group generally agreed on the outline of a new proposal for a Foreign Portfolio Sales Corporation as

a new form of United States mutual fund, organized in the United States and registered with the Commission but directing its sales efforts at nonresidents and noncitizens of the United States.

Under the proposed legislation, the Investment Company Act would be amended to provide specifically for the registration and regulation of domestic investment companies organized for the sale of their securities to foreigners. Related amendments would provide the Commission with greater flexibility under the Act in allowing registration of foreign investment companies and would enable the Commission to deal with the problem of "shell" companies organized in the United States with foreign officers, directors, and trustees. This portion of the proposed legislation will be considered initially.

The Commission recommended that if the amendments to the Investment Company Act are considered favorably by Congress, Congress should then consider amending the Internal Revenue Code so that the United States mutual funds which register with the Commission could sell their shares exclusively to foreign investors with tax benefits to the latter comparable to those presently available to foreigners who invest in United States securities through offshore funds.

The portion of the legislative proposals involving amendments to the Investment Company Act was introduced in the House of Representatives in May 1973.[50]

ENFORCEMENT MATTERS

SEC-NASD Task Force

In the latter part of fiscal 1972, the Commission became aware of a substantial number of situations involving new issues of securities in which there was a substantial increase in the aftermarket price of the stock shortly after the public offering. The run-up in price was usually followed by an equally precipitous and dramatic decline, resulting in severe losses to the investing public. In a number of these situations,

the sharp drop in price resulted in a number of broker-dealers being forced out of business because of financial losses. The described pattern of activity indicated extensive manipulation which could not have occurred without the active involvement of broker-dealers who, because of their strategic position in the securities industry, are essential to the successful consummation of such schemes.

To combat this problem, the Commission and the NASD created a joint task force. Teams of Commission and NASD personnel were set up to conduct intensive examinations and investigations of selected broker-dealers, and a substantial number of serious violations were uncovered. To date, the Commission has brought six injunctive actions and two administrative proceedings as a result of the task force's efforts, and one criminal indictment has resulted. The Commission and the NASD expect to continue the program as long as circumstances warrant.

One of the actions which best exemplifies the accomplishments of the task force is the administrative proceeding brought against the broker-dealer firm of Cohen Goren Equities, Inc., seven other broker-dealers, and certain of their principals and associated persons. The order for proceedings in that case alleges, among other things, that a substantial portion of a public offering of securities was withheld from public sale and placed in nominee accounts by persons associated with Cohen Goren, the underwriter. It is further alleged that the price of the stock was arbitrarily inflated from the offering price of $10 a share to a high of $26 a share, and that the stock withheld from the offering was then sold at a substantial profit. As part of the effort to inflate the price of the security, certain broker-dealers allegedly agreed to make a market in the stock pursuant to arrangements whereby they were guaranteed profits. The Commission accepted an offer of settlement under which Cohen Goren's registration was revoked, and its two principals barred from association with any broker-dealer with a right to apply for association in a limited capacity after two years.[51]

Swiss Treaty

On May 25, 1973, the United States and Switzerland signed a Treaty on Mutual Assistance in Criminal Matters. The signing was the result of more than four years of difficult negotiations, largely caused by substantial differences between the two legal systems. A representative from the Commission has participated in the negotiations since they began early in 1969.

The treaty contains 41 articles grouped into 9 chapters and a schedule listing 35 categories of offenses to which the treaty is applicable. In general, it provides for broad cooperation between the two countries in criminal matters. Provision is made for assistance in locating witnesses, obtaining witnesses' statements and testimony, the production and authentication of business records, and the service of judicial and administrative documents. The treaty also provides for special assistance in cases involving organized crime.

The treaty should be of assistance to the Commission where Swiss financial institutions are utilized to engage in securities transactions in the United States, or where funds resulting from illegal activities are secreted in such institutions.

Significant Cases

On November 27, 1972, the Commission filed an injunctive action in Federal District Court in Manhattan against *Robert L. Vesco, International Controls Corp. ("ICC"), IOS, Ltd. ("IOS")*, and 41 other corporate and individual defendants associated with IOS and Vesco alleging violations of antifraud, filing, and proxy provisions of the Federal securities laws.[52] IOS is a non-resident Canadian corporation which acts principally as a holding company for offshore mutual fund management companies. ICC, listed on the American Stock Exchange, is 25 percent owned by Vesco and was the corporate vehicle for Vesco's assumption of control over IOS.

The complaint alleged a scheme by Vesco and others to mulct four IOS offshore mutual funds of millions of dollars by liquidating marketable securities of established companies in their portfolios and placing the proceeds in companies in which Vesco and his associates

had an interest. The four affected mutual funds, which invested primarily in U.S. markets, had more than $300,000,000 in assets in the spring of 1972 which were primarily invested in substantial companies listed on the New York Stock Exchange. Vesco and his associates allegedly caused the funds to sell all their U.S. investments with a value of around $224,000,000 and invest over $120,000,000 of this money in newly formed Costa Rican, Panamanian and Bahamian shell corporations. It is further alleged that in connection with his takeover of IOS, Vesco caused a shell company to purchase Bernard Cornfeld's control block of 6,000,000 IOS shares for about $5,500,000, and made false reports to the public and the SEC regarding this transaction.

On September 21, 1973, the district judge announced that he was granting most of the preliminary relief requested by the Commission, including the appointment of temporary receivers for the funds and their management companies and preliminary injunctions against Vesco and a number of individual corporate defendants associated with him. The district judge also stated he was granting a default judgment: (a) appointing a receiver for certain Bahamian corporate defendants controlled by the Vesco group; (b) enjoining these defendants and defendant LeBlanc, a close associate of Vesco; and (c) ordering LeBlanc to render an accounting for and to disgorge misappropriated fund monies.

Prior thereto the district court had issued certain preliminary injunctions which were designed to maintain the status quo. These included a consent order restricting new investments by the funds; an order freezing $6,000,000 on deposit in United States banks that had originated with one of the funds; an order freezing $47,000,000 in bank deposits belonging to a closed-end real estate fund under the control of the Vesco group; and an order restraining the disposition of substantial real estate assets in this country.

The Commission has been working closely with other government regulatory authorities, particularly the Banking Commissioner of Luxembourg, the Ontario and Quebec Securities Commissions and the Canadian government in a concerted effort to protect investors in

the IDS world-wide enterprise. A cooperative program designed to recover and protect the assets of the funds and to achieve an orderly liquidation is presently under way.

In April 1973, the Commission filed an action against Equity Funding Corporation of America seeking an injunction and the appointment of a new board of directors and a special investigative counsel in a case which involves one of the most massive frauds ever perpetrated on the investing public.[53] The essence of the fraud was Equity Funding's creation and maintenance of nonexistent insurance policies, and its sale of those policies to reinsurers for immediate cash. The most recent estimates are that over $2 billion of the approximately $3 billion face amount of life insurance purportedly written by a life insurance subsidiary of Equity Funding was fictitious. Elaborately falsified records and reports were made regarding non-existent insureds, as well as non-existent assets and earnings.

The Commission obtained an injunction and Equity Funding's board resigned. Subsequently, the company filed a petition for reorganization under Chapter X of the Bankruptcy Act, and the Commission is participating in the reorganization proceeding. In addition, its investigation is continuing along with investigations by other state and federal law enforcement and regulatory agencies. The investigations have a twofold purpose; to gather information in order to hold the wrongdoers accountable in civil and/or criminal proceedings, and to determine whether there are areas in which the laws (State or Federal or both) should be changed to make it less likely that this type of situation will recur.

In May 1973, the Commission instituted an injunctive action in the United States District Court for the Southern District of New York charging Weis Securities, Inc., a member firm of the New York Stock Exchange, and certain associated persons with violations of antifraud and other provisions of the Federal securities laws.[54]

The Commission charged that Weis failed to disclose to its customers, broker-dealers and the investing public its serious financial problems, particularly the fact that it had engaged in

business while not in compliance with the Exchange's financial responsibility rules. The complaint also alleged that the firm's serious financial problems had been masked by a deliberate falsification of its books and records and financial reports.

In addition to seeking an injunction against each of the defendants, the Commission requested the appointment of a temporary receiver of Weis's assets and books and records in order to ascertain the firm's true financial condition and to obtain a report as to measures necessary to protect the investing public. On May 30, 1973, the court, pursuant to the provisions of the Securities Investor Protection Act, appointed a trustee for Weis. On June it permanently enjoined the firm, with its consent, from further violations.

On July 16, 1973, a Federal grand jury in New York City returned indictments against individual defendants in the Weis injunctive action in connection with the alleged falsification of Weis's books and records. Among other things, the indictment alleged that the defendants caused a false financial report to be filed with the Commission which showed a $1.7 million profit for Weis in fiscal 1972, when in fact the firm had lost more than $1.5 million. The defendants were also charged with mailing false financial statements to the firm's customers, and Arthur Levine, Weis's chairman, was charged with falsely stating under oath that the 1972 financial report was, to the best of his knowledge, true and correct.[55]

All of the defendants pleaded not guilty to the charges.

In June 1973, the Commission ordered public administrative proceedings against *Merrill Lynch, Pierce, Fenner and Smith, Inc.*, persons in its research department and 47 account executives, arising from the sale to approximately 4,000 Merrill Lynch customers of more than 400,000 shares of Scientific Control Corporation at prices ranging from $24 to $70.

The proceedings are based upon staff allegations that Merrill Lynch prepared research reports and wire flashes recommending Scientific stock which were misleading and without a reasonable basis. Much of

the information on which the recommendation was based allegedly emanated from Scientific's management and was not verified through independent analysis or inquiry. The order alleges that Merrill Lynch failed to conduct a diligent analysis of, among other things, the financial condition, business activities and prospects of Scientific.

It is further alleged that, in the offer and sale of Scientific stock, the 47 account executives made a series of material misstatements and omissions concerning, among other things, projections of the future price of Scientific shares, the likelihood of the shares being listed on a national securities exchange, and comparisons of Scientific with highly successful and well established companies in the computer industry.[56]

NEW OFFICE OF REGISTRATIONS AND REPORTS

On October 29, 1972, the Commission created the Office of Registrations and Reports (ORR) in order to concentrate in a single organization the receipt, initial examination and distribution of over 150,000 filings and reports received by the Commission annually.

ORR is also responsible for performing the substantive examination of (1) ownership ("insider") reports, (2) reports of sales of unregistered stock pursuant to Rule 144, and (3) applications for registration as a broker-dealer or investment adviser (and amendments to such applications). In addition, ORR is responsible for analyzing and responding to investor complaints; extracting data from all filings for computer input; preparing certain data-based publications and directories; and determining which registrants are delinquent in filing required reports.

Since it was established, ORR has made significant progress toward the goals set by the. Commission which include (1) one-stop service to the filing public; (2) the elimination of duplicative effort; (3) a unified system of processing; (4) the assignment of personnel to areas of peak workload; (5) streamlined computer input; (6) prompt service to operating divisions, regional offices and other staff offices; and (7) a

single authoritative source of information respecting the processing of all filings and reports.

NOTES TO PART 1

[1] 38th Annual Report, pp 7-10.

[2] H. Doc. No. 92-231, 92d Cong., 1st Sess. (1971). See 38th Annual Report, pp 4-5.

[3] Securities Exchange Act Release No. 10088, 1 SEC Docket No. 11, p. 9.

[4] Securities Industry Study, Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93rd Cong., 1st Sess. (Comm. Print, 1973); Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, H. R. Rep. No. 92-1519, 92nd Cong., 2d Sess. (1972).

[5] Securities Exchange Act Release No. 10383, 2 SEC Docket 425.

[6] Securities Exchange Act Release No. 10147, 1 SEC Docket No. 16, p. 3.

[7] Securities Exchange Act Release No. 10246, 2 SEC Docket 39.

[8] See H. R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934).

[9] The so-called "parent test," employed by a number of exchanges, required that the "parent" of any exchange member have as its primary purpose the transaction of business as a broker or dealer in securities.

[10] Securities Exchange Act Release No. 9716.

[11] See Securities Exchange Act Release No. 9950.

[12] The term "affiliated person" is defined in the rule to include, among others, "any person directly or indirectly controlling, controlled by or under common control with such member, whether by contractual arrangement or otherwise…"

[13] *PBW stock Exchange, Inc. v. S.E.C.*, C.A. 3, No. 73-1116 (February 8, 1973); *Equity Services, Inc. v. S.E.C.*, C.A. 3, No. 73-1165 (February 20, 1973); *Connecticut Nutmeg Securities, Inc. v. S.E.C.*, C.A. D.C., No. 73-1233 (March 6, 1973); *Robert I. Berdon v. S.E.C.*, C.A. D.C., No. 73-1240 (March 7, 1973). By order dated April 2, 1973, the two actions filed in the District of Columbia Circuit were transferred by that Court to the United States Court of Appeals for the Third Circuit and consolidated with the actions pending there. In addition to the petitioners, a number of persons and organizations, including the Antitrust Division of the Department of Justice and the states of Pennsylvania, Ohio, Oregon and Kansas, filed briefs generally supporting the petitioners.

[14] Securities Exchange Act Release No. 10052 (March 22, 1973), 1 SEC Docket • No. 8, p. 3.

[15] See Securities Exchange Act Release No. 9850 (November 8, 1972).

[16] Securities Exchange Act Release No. 10218 (June 13, 1973), 1 SEC Docket No. 20, p. 6.

[17] The CBOE's application for registration was granted on February 1, 1973 and became effective on April 26.

[18] The term "call option" refers to a contract whereby the seller of the option, for a certain sum of money, grants to the buyer of the option the irrevocable right to demand, within a specified time, the delivery by the seller of a specified number of shares of a stock at a fixed price.

[19] Securities Act Release No. 5383 (April 9, 1973) (1 SEC Docket No. 11, p. 3) adopted new Rule 457 (k) under the Act relative to the registration fee required for put and call options traded on a national securities exchange and registered by such exchange.

[20] United States v. Chicago Board Options Exchange, Inc., N.D. Ill., No. 73C 1085.

[21] For example, the Commission has amended Exchange Act Rule Sal 1-1 to make it clear that the term "equity security," for purposes of the Act, includes put and call options. See Securities Exchange Act Release No. 10129 (April 27, 1973), 1 SEC Docket No. 13, p. 7.

[22] Securities Exchange Act Release No. 9930.

[23] Securities Act Release No. 5366, 1 SEC Docket No. 2, p. 2.

[24] Securities Exchange Act Release No. 9994, 1 SEC Docket No. 2, p. 6.

[25] See Study of the Securities Industry, Hearings Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 1st and 2d Sess, Parts 1-9 (1971, 1972).

[26] H. R. Rep. No. 92-1519, 92d Cong., 2d Sess. (Oct. 4, 1972).

[27] S.2058 was passed by the Senate on July 30, 1973.

[28] *Rosenfeld v. Black*, 445 F. 2d 337 (CA 2, 1971).

[29] Securities Exchange Act Release No. 10260 (July 2, 1973), 2 SEC Docket 82.

[30] Securities Act Release Nos. 5395 through 5398 (June 1, 1973), 1 SEC Docket No. 18, pp 1-20.

[31] Securities Act Release No. 5335 (November 24, 1972).

[32] Securities Exchange Act Release No. 9844 (November 1, 1972).

[33] Securities Act Release No. 5362 (February 2, 1973), 1 SEC Docket No. 1, p. 4.

[34] Securities Act Release No. 5306 (September 26, 1972).

[35] Securities Act Release No. 5307 (September 27, 1972).

[36] Securities Act Release No. 5403 (June 14, 1973), 1 SEC Docket No. 20, p. 1.

[37] See 35th Annual Report, p. 21.

[38] Securities Act Release No. 5316 (October 6, 1972).

[39] Securities Act Release No. 5336 (November 28, 1972).

[40] Securities Act Release No. 5349 (January 8, 1973).

[41] Securities Act Release Nos. 5342 through 5344 (December 18, 1972).

[42] Securities Act Release No. 5347 (January 4, 1973).

[43] Securities Act Release No. 5382 April 9, 1973), 1 SEC Docket No. 11, p. 1.

[44] See Securities Exchange Act Release No. 10172, (May 23, 1973) 1 SEC Docket No. 17, p. 11.

[45] Investment Company Act Release No. 7475 (November 3, 1972).

[46] Securities Act Release Nos. 5360 and 5361.

[47] Investment Company Act Release No. 8000 (September 20, 1973), 2 SEC Docket 481.

[48] Securities Act Release No. 5413 (August 2, 1973), 2 SEC Docket 218.

[49] Investment Company Act Release No. 7751 (April 3, 1973), 1 SEC Docket No. 10, p. 14.

[50] H. R. 8256 (93d Cong., 1st Sess.).

[51] See Securities Exchange Act Release Nos. 10252 (June 28, 1973) and 10261 (July 2, 1973), 2 SEC Docket 70 and 87.

[52] 72 Civ. 5001.

[53] 73 Civ. 714 (C.D. Cal.).

[54] See Litigation Release No. 5906 (May 25, 1973), 1 SEC Docket No. 18, p. 51.

[55] See Litigation Release No. 5988 (July 23, 1973), 2 SEC Docket 209.

[56] Securities Exchange Act Release No. 10233 (June 22, 1973), 2 SEC Docket 9.

PART 2
THE DISCLOSURE SYSTEM

A basic purpose of the Federal securities laws is to provide disclosure of material financial and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This aims at enabling investors to evaluate the securities of these companies on an informed and realistic basis.

The Securities Act of 1933 generally requires that before securities may be offered to the public a registration statement must be filed with the Commission disclosing prescribed categories of information. Before the sale of securities can begin, the registration statement must become "effective." In the sales, investors must be furnished a prospectus containing the most significant information in the registration statement.

The Securities Exchange Act of 1934 deals in large part with securities already outstanding and requires the registration of securities listed on a national securities exchange, as well as over-the-counter securities in which there is a substantial public interest. Issuers of registered securities must file annual and other periodic reports designed to provide a public file of current material information. The Exchange Act also requires disclosure of material information to holders of registered securities in solicitations of proxies for the election of directors or approval of corporate action at

a stockholders' meeting, or in attempts to acquire control of a company through a tender offer or other planned stock acquisition. It provides that insiders of companies whose equity securities are registered must report their holdings and transactions in all equity securities of their companies.

PUBLIC OFFERING: THE 1933 SECURITIES ACT

The basic concept underlying the Securities Act's registration requirements is full disclosure. The Commission has no authority to pass on the merits of the securities to be offered or on the fairness of the terms of distribution. If adequate and accurate disclosure is made, it cannot deny registration. The Act makes it unlawful to represent to investors that the Commission has approved or otherwise passed on the merits of registered securities.

Information Provided

While the Securities Act specifies the information to be included in registration statements, the Commission has the authority to

prescribe appropriate forms and to vary the particular items of information required to be disclosed. To facilitate the registration of securities by different types of issuers, the Commission has adopted special registration forms which vary in their disclosure requirements so as to provide maximum disclosure of the essential facts pertinent in a given type of offering while at the same time minimizing the burden and expense of compliance with the law. In recent years, it has adopted certain short forms, notably Forms S-7 and S-16, which do not require disclosure of matters already covered in reports and proxy material filed or distributed under provisions of the Securities Exchange Act. During the last year, certain amendments were made to Form S-16 to clarify the disclosure required, and to expand the situations in which the form may be used.[1]

Reviewing **Process**

Registration statements filed with the Commission are examined by its Division of Corporation Finance for compliance with the standards of adequate and accurate disclosure. Various degrees of review procedures are employed by the Division.[2] While most deficiencies are corrected through an informal letter of comment procedure, where the Commission finds that material representations in a registration statement are misleading, inaccurate, or incomplete, it may, after notice and opportunity for hearing, issue a "stop-order" suspending the effectiveness of the statement.

Environment and Civil Rights

As discussed in last year's Annual Report[3] the Commission has taken certain actions to require disclosure of civil rights and environmental matters which may have a material impact upon an issuer's business. A guideline release[4] issued in July 1971 stated that the disclosure requirements of the forms and rules under the Securities Act and the Exchange Act relative to legal proceedings and description of business are interpreted to include material environmental and civil rights matters. That release remains in effect with respect to disclosure of civil rights matters.

With respect to environmental matters, the Commission, in February 1972, stated that it was considering amendments to some registration and report forms. These would require, as a part of the description of an issuer's business, appropriate disclosure of the material effects which compliance with environmental laws and regulations could have on the capital expenditures, earnings and competitive position of an issuer and its subsidiaries. Information would also be required on pending government, and private enforcement proceedings under environmental laws or regulations, and any such proceedings contemplated by government authorities. Upon review of the letters of comment received on the proposals, the Commission adopted the amendments, effective July 3, 1973.[4a] Apart from disclosure of environmental matters, the amendments also reduced from 15 to 10 percent of current assets the standard of materiality with respect to disclosure of legal proceedings involving primarily a claim for damages.

In *Natural Resources Defense Council, Inc. v. S.E.C.*,[5] the petitioners had previously sought direct review in the Court of Appeals for the District of Columbia Circuit of the Commission's denial of their request that it adopt amendments to its rules to conform them to what the petitioners claimed to be the requirements of the National Environmental Policy Act [NEPA].[6] The court of appeals dismissed the petition, holding that the Commission's action in declining to adopt the requested rules was not a final order subject to review in a court of appeals under the review provisions of the Securities Act or the Exchange Act. It also stated that whether the Commission had improperly delayed action under NEPA or had improperly interpreted that Act were issues that could be resolved in a United States District Court.

Subsequently, the petitioners brought suit in the United States District Court for the District of Columbia[7] seeking, among other things, to compel the Commission to complete the review it was then conducting to determine whether its rules and regulations should be amended in light of the enactment of NEPA. Shortly thereafter, the Commission completed its review, and as noted above, adopted amendments to its forms and reports to comply with the mandates of

NEPA. The petitioners promptly petitioned the Court of Appeals for the District of Columbia Circuit to review the sufficiency of the Commission's amendments. That action[8] is presently pending, and petitioners' motion to stay the district court proceedings pending appellate review was granted by the district court.

Foreign Offerings

In February 1973, the Commission adopted Rule 434C under the Securities Act to permit United States issuers offering their securities simultaneously in Japan and the United States to use a different prospectus in each country, each prospectus complying with local law.[10] This rule was born of the fact that Japan requires offerings in that country to be made by a prospectus which differs in form and content from that required by the Securities Act. Thus, the rule recognizes both the appeal of the United States capital markets to Japanese investors, and Japan's interest in regulating its own securities markets.

Time for Registration

The Commission's staff tries to complete examination of registration statements as quickly as possible. The Securities Act provides that a registration statement shall become effective on the 20th day after it is filed (or on the 20th day after the filing of any amendment). Most registration statements require one or more amendments and do not become effective until some time after the statutory 20-day period. The period between filing and effective date is intended to give investors an opportunity to become familiar with the proposed offering through the dissemination of the preliminary form of prospectus. The Commission can accelerate the effective date to shorten the 20-day waiting period – taking into account, among other things, the adequacy of the information on the issuer already available to the public and the ease with which facts about the offering can be understood.

During the 1973 fiscal year, 3,281 registration statements became effective. Of these, 192 were amendments filed by investment

companies pursuant to Section 24 (e) of the Investment Company Act of 1940, which provides for the registration of additional securities through amendment to an effective registration statement rather than the filing of a new registration statement. For the remaining 3,089 statements, the median number of calendar days between the date of the original filing and the effective date was 41.

Organizational Changes

During the past fiscal year, the Division of Corporation Finance completed certain organizational and personnel changes necessitated in part by the Commission's reorganization of August 1972.[11] These changes involved disclosure procedures with respect to investment companies, and the creation within the Division of Offices of Disclosure Policy and Proceedings and International Corporate Finance.

Investment Company Disclosure Policy and Procedure

Beginning with the assumption of its responsibilities for investment company disclosure, resulting from the Commission's reorganization, the Division commenced a study of the substance, use, and review of investment company prospectuses and other filings. While this study is not yet complete and many of its findings will not be made public until fiscal 1974, some significant steps were taken.

In September 1972, the Commission published the Division's procedures for processing investment company post-effective amendments.[12] These procedures were designed to curtail the amount of time spent in review, and to separate matters of disclosure from matters of regulatory policy under the Investment Company Act during the review process.

This latter objective is reflected in the report of the Advisory Committee on Investment Companies and Advisers submitted to the Commission on December 29, 1972, which included recommendations for a simplified prospectus and an integrated reporting system. As a result of these recommendations and its own

independent judgment, the Division is considering a new registration form which will completely supplant those presently in use.

In addition, to make prospectuses more readable and understandable through visual aids and otherwise, the Commission made clear, during the past year, that investment company issuers could include in their prospectuses "sales literature" as defined in the Commission's Statement of Policy.[13]

The nature of investment companies which filed and had their registration statements declared effective during the past year is indicative of both the economy and of the types of business to which capital is currently allocated by investors. As a result of current interest rates, bond funds, primarily of the closed-end, management type, registered and offered to the public securities having a total offering price of over $2 billion. A substantial number of these companies were sponsored and managed by insurance companies or bank affiliates.

Secondly, a number of investment companies registered during the year proposed to engage substantially, if not exclusively, in real estate related investments. One such company, the Bache-Huntoon Paige Ginny Mae Trust Series 1, is a unit investment trust whose units represent an undivided fractional interest in a portfolio consisting of Ginny Mae securities. These mortgage-backed securities are guaranteed as to principal and interest by the Government National Mortgage Association. The REIT Income Fund, Inc. registered as a closed-end diversified company with a leveraged capital structure. This company offered approximately 1.4 million common shares and 215,000 cumulative preference shares, and invested a substantial amount of the proceeds of this offering in securities issued by real estate investment trusts.

Finally, during the past year the Ministry of Finance of Japan amended its ordinance on foreign investment to permit American investment companies to offer their shares in Japan and invest the proceeds of their offerings in United States issuers. The Ministry of Finance required that such investment companies register under the

Securities Act of 1933 and the Investment Company Act of 1940, as well as the applicable Japanese securities laws. As a result of the change in this ordinance, Merrill Lynch, Pierce, Fenner and Smith formed an underwriting syndicate with Nomura Securities Co., Ltd. to sell in Japan shares of Fundamerica of Japan, Inc. Further, IDS New Dimensions Fund, Inc. and the Dreyfus Fund, Inc., through their principal underwriters, offered their shares for the first time in Japan.

Office of Disclosure Policy and Proceedings

In October 1972, the Commission created the Office of Disclosure Policy and Proceedings within the Division. This Office has the responsibility for the continuous review and necessary revision of major disclosure policy, rules and regulations in the light of changing economic conditions, and for developing methods to anticipate disclosure problems and deal with them in their incipiency. This Office will also conduct informal and formal fact finding and analytical studies and proceedings (public and private) as a basis for proposed new rules or proposed amendments to existing rules.

Office of International Corporate Finance

In recognition of the increased internationalization of capital markets and the securities business, the Commission in January 1973 established the Office of International Corporate Finance within the Division. The establishment of the Office also conforms to the Commission's recent policy of structural organization along functional and specialized lines or areas of responsibility.

This Office is responsible for administration of the securities laws in situations involving:

1. offerings by U.S. companies of registered securities to foreign investors;

2. offerings by foreign issuers of registered securities to U.S. investors;

3. financial reporting by foreign issuers under the Exchange Act;

4. promulgation of special Securities Act registration forms and rules for U.S. issuers, including investment companies, who offer their securities in foreign markets;

5. offerings of American Depositary Receipts to U.S. investors;

6. development of guidelines as to when securities recently issued by foreign issuers and not registered under the Securities Act may be traded by U.S. broker-dealers in this country in reliance upon the exemptions of Sections 4 (3) and 4 (4) of the Act;

7. development of guidelines as to when offerings by U.S. issuers to foreign investors must be registered;

8. development of specialized forms, rules or regulations to encourage and facilitate the handling of offerings originating abroad or to be sold abroad;

9. the resolution of disclosure problems which may arise as a result of differences in disclosure, financial reporting and auditing requirements of various jurisdictions; and

10. a centralized collation of information on international capital markets.

Oil and Gas

In April 1971, the Division assigned to its Oil and Gas Section processing responsibility for all oil and gas drilling program filings as well as filings on Form S-10 covering fractional undivided interests in oil and gas rights. This assignment was the first attempt by the Division to concentrate all filings of one industry type in one processing unit. The result has been an improved handling of the registrations and more uniform and complete disclosure. Filed during the fiscal year were 105 registration statements for oil and gas drilling

programs, totaling $894 million, and 10 statements covering fractional undivided interests in oil and gas rights, aggregating $7.4 million.

Additional data regarding the types and amounts of oil and gas filings is contained in the information in this Part relating to Regulation B.

Tax Shelters

In February 1972, a branch of the Division of Corporation Finance was designated to process all registration statements covering tax shelter programs other than oil and gas and real estate investment trusts. These programs include real estate syndications, condominiums with an investment feature, cattle feeding, cattle breeding and citrus and pistachio groves and other agri-business.

The disclosure generally emphasized in tax shelter registration statements has included the compensation paid or to be paid to the program sponsors, the conflicts of interest inherent in such offerings, the record of the general partner in prior offerings of tax shelter investments, a delineation of investment objectives for the program to be offered, and the effect of Federal tax provisions.

In real estate syndications, the trend continues to be strongly in the direction of "blind pool" programs – i.e., programs with either no properties specified for purchase or construction programs with no economic history upon which to base an investment decision.

The U.S. Department of the Treasury, on April 30, 1973, submitted a number of proposals for tax change in this area to the Congress. The potential impact of these proposals on the number or types of filings in the tax shelter area cannot be assessed at this time.

In July 1973, the Division reorganized the non-oil and gas tax shelter registration statement processing responsibility into a two branch function with one branch having responsibility for cattle feeding and breeding, agri-business, and condominium offerings, and the second branch having responsibility for real estate and the other

miscellaneous tax shelters. A third branch has processing responsibility for all oil and gas tax shelter offerings.

See the discussion in Part 1 under the heading "Real Estate Matters" for a description of certain releases relating to condominiums and real estate units.

SMALL ISSUE EXEMPTION

The Commission is authorized under Section 3 (b) of the Securities Act to exempt securities from registration if it finds that registration for these securities is not necessary to the public interest because of the small amount offered or the limited character of the public offering. The law imposes a maximum limitation of $500,000 upon the size of the issues which may be exempted by the Commission.

The Commission has adopted the following exemptive rules and regulations:

Regulation A: General exemption for U.S. and Canadian issues up to $500,000.

Regulation B: Exemption for fractional undivided interests in oil or gas rights up to $250,000.

Regulation F: Exemption for assessments on assessable stock and for assessable stock offered or sold to realize the amount of assessment up to $300,000.

Rules 234-236: Exemptions of first lien notes, securities of cooperative housing corporations, and shares offered in connection with certain transactions.

Under Section 3 (c) of the Securities Act, the Commission is authorized to adopt rules and regulations exempting securities issued by a small business investment company under the Small Business Investment Act. The Commission has adopted Regulation E, which

conditionally exempts such securities issued by companies registered under the Investment Company Act of 1940 up to a maximum offering price of $500,000. The regulation is substantially similar to Regulation A, described below.

Regulation A

Regulation A permits a company to obtain needed capital not in excess of $500,000 (including underwriting commissions) in any one year from a public offering of its securities without registration, provided specified conditions are met. Among other things, a notification and offering circular supplying basic information about the company and the securities offered must be filed with the Commission and the offering circular must be used in the offering. In addition, Regulation A permits selling shareholders not in a control relationship with the issuer to offer in the aggregate up to $300,000 of securities which would not be included in computing the issuer's $500,000 ceiling. During the fiscal year, the Commission amended Regulation A, effective August 1, 1973, to require, in the case of new ventures, delivery of the offering circular to prospective purchasers 48 hours in advance of the mailing of a confirmation of sale. The Regulation was also amended to require dealers trading in securities offered under the Regulation where the issuers are not subject to the reporting requirements of the Exchange Act, to deliver an offering circular for a period of 90 days after commencement of the offering to any purchaser who has not previously received one.

During the 1973 fiscal year, 817 notifications were filed under Regulation A covering proposed offerings of $298,634,215 compared with 1,087 notifications covering proposed offerings of $404 million in the prior year. A total of 578 reports of sales were filed reporting aggregate sales of $106,395,501. Such reports must be filed every 6 months while an offering is in progress and upon its termination. Sales reported during fiscal 1972 had totaled $107 million. Various features of Regulation A offerings over the past 3 years are presented in the statistical section of this report.

In fiscal 1973, the Commission temporarily suspended Regulation A exemptions with respect to 20 issuers where it had reason to believe there had been noncompliance with the conditions of the regulation or with the disclosure standards, or where the exemption was not available for the securities. Added to 19 cases pending at the beginning of the fiscal year, this resulted in a total of 39 cases for disposition. Of these the temporary suspension order became permanent in 20 cases: in 7 by lapse of time, in 4 cases after hearings, and in 9 by acceptance of an offer of settlement. In one case the temporary suspension order was vacated. Eighteen cases were pending at the end of the fiscal year.

Regulation B

During the 1973 fiscal year, 725 offering sheets and 1,020 amendments thereto were filed pursuant to Regulation B and were examined by the Oil and Gas Section of the Division of Corporation Finance. During the 1972 and 1971 fiscal years, 1,124 and 941 offering sheets, respectively, were filed. A total of 17,076 sales reports were filed during the year, reporting aggregate sales of $29.8 million. Sales during the preceding year had totaled $21 million.

Major revisions of Regulation B rules were adopted by the Commission and became effective January 1, 1973.[14] Several were made because of changes in economic and industry conditions and because of abuses in past selling practices. The revisions included an increase in the dollar amount of the offering exempted from $100,000 to $250,000; a restriction on the use of sales literature and other forms of advertising; a requirement that the offering sheet be delivered 48 hours before any sale is made; a denial of the exemption to any person where he or certain related persons have been involved in violations of the Federal securities laws in connection with the sale of securities; a revision of the suspension procedure; and a requirement for a report to be made to the participants as to the results of the offering.

The Regulation B rules have not been revised significantly since 1937. The present revisions enable filings under this regulation to meet present economic conditions in a realistic manner.

Regulation F

During the 1973 fiscal year, 15 notifications were filed under Regulation F, covering assessments of stock of $408,374, compared with 17 notifications covering assessments of $398,025 in 1972.

CONTINUING DISCLOSURE: THE 1934 SECURITIES EXCHANGE ACT

The Securities Exchange Act of 1934 contains significant disclosure provisions designed to provide a fund of current material information on companies in whose securities there is a substantial public interest. The Act also seeks to assure that security holders who are solicited to exercise their voting rights, or to sell their securities in response to a tender offer, are furnished pertinent information.

Registration on Exchanges

Generally speaking, a security cannot be traded on a national securities exchange until it is registered under Section 12 (b) of the Exchange Act. If it meets the listing requirements of the particular exchange, an issuer may register a class of securities on the exchange by filing with the Commission and the exchange an application which discloses pertinent information concerning the issuer and its affairs. During fiscal 1973, a total of 239 issuers listed and registered securities on a national securities exchange for the first time and a total of 523 registration applications were filed. The registrations of all securities of 141 issuers were terminated. Detailed statistics regarding securities traded on exchanges may be found in the statistical section.

Over-the-Counter Registration

Section 12 (g) of the Exchange Act requires a company with total assets exceeding $1 million and a class of equity securities held of record by 500 or more persons to register those securities with the Commission, unless one of the exemptions set forth in that section is available or the Commission issues an exemptive order under Section 12 (h). Upon registration, the reporting and other disclosure requirements and the insider trading provisions of the Act apply to these companies to the same extent as to those with securities registered on exchanges. During the fiscal year, 908 registration statements were filed under Section 12 (g). Of these, 626 were filed by issuers already subject to the reporting requirements, either because they had another security registered on an exchange or they had registered securities under the Securities Act.

Exemptions

Section 12 (h) of the Act authorizes the Commission to grant a complete or partial exemption from the registration provisions of Section 12 (g) or from other disclosure and insider trading provisions of the Act where it is not contrary to the public interest or the protection of investors.

At the beginning of the fiscal year, 12 exemption applications were pending, and 12 applications were filed during the year. Of these 24 applications, 3 were withdrawn, 2 were granted, and 1 denied. The remaining 18 applications were pending at the end of the fiscal year.

Periodic Reports

Section 13 of the Securities Exchange Act requires issuers of securities registered pursuant to Sections 12 (b) and 12 (g) to file periodic reports, keeping current the information contained in the registration application or statement. From time to time, the Commission has issued statements calling attention to registrants' obligation to report current events and explaining procedures to be followed in certain unusual types of situations. For example, on June 30, 1972, the Commission issued a release[15] discussing the manner in which compliance with Section 13 may be achieved by registrants

which have ceased or curtailed operations, or have become the subject of proceedings under Chapter X of the Bankruptcy Act. Also, during the 1973 fiscal year, the Commission issued a release[16] expressing concern as to issuers' failure to file periodic and current reports timely and properly. The release discusses the possible actions available to the Commission in the event of non-compliance with these reporting provisions, and advises registrants of the means for requesting an extension of time.

In 1973, 49,596 reports – annual, quarterly and current – were filed.

Proxy Solicitations

Where proxies are solicited from holders of securities registered under Section 12 or from security holders of registered public-utility holding companies, subsidiaries of holding companies, or registered investment companies, the Commission's proxy regulation requires that disclosure be made of all material facts concerning the matters on which the security holders are asked to vote, and that they be afforded an opportunity to vote "yes" or "no" on any matter other than the election of directors. Where management is soliciting proxies, a security holder desiring to communicate with the other security holders may require management to furnish him with a list of all security holders or to mail his communication for him. A security holder may also, subject to certain limitations, require the management to include in proxy material an appropriate proposal which he wants to submit to a vote of security holders, or he may make an independent proxy solicitation.

Copies of proposed proxy material must be filed with the Commission in preliminary form prior to the date of the proposed solicitation. Where preliminary material fails to meet the prescribed disclosure standards, the management or other group responsible for its preparation is notified informally and given an opportunity to correct the deficiencies in the preparation of the definitive proxy material to be furnished to security holders.

Issuers of securities registered under Section 12 must transmit an information statement comparable to proxy material to security holders from whom proxies are not solicited with respect to a stockholders' meeting.

During the 1973 fiscal year, 7,023 proxy statements in definitive form were filed, 7,000 by management and 23 by nonmanagement groups or individual stockholders. In addition, 141 information statements were filed. The proxy and information statements related to 6,820 companies, and pertained to 6,744 meetings for the election of directors, 369 special meetings not involving the election of directors, and 28 assents and authorizations.

Aside from the election of directors, the votes of security holders were solicited with respect to a variety of matters, including mergers, consolidations, acquisitions, sales of assets and dissolution of companies (321); authorizations of new or additional securities, modifications of existing securities, and recapitalization plans (1,013): employee pension and retirement plans (37); bonus or profit-sharing plans and deferred compensation arrangements (261); stock option plans (899); approval of the selection by management of independent auditors (3,121) and miscellaneous amendments to charters and by-laws, and other matters (2,235).

During the 1973 fiscal year, 401 proposals submitted by 56 stockholders for action at stockholders' meetings were included in the proxy statements of 224 companies. Typical of such proposals submitted to a vote of security holders were resolutions on amendments to charters or by-laws to provide for cumulative voting for the election of directors, preemptive rights, limitations on the grant of stock options to and their exercise by key employees and management groups, the sending of a post-meeting report to all stockholders, and limitations on charitable contributions.

A total of 264 additional proposals submitted by 87 stockholders were omitted from the proxy statements of 117 companies in accordance with the provisions of the rule governing such proposals. The most common grounds for omission were that proposals were not

submitted on time or were not accompanied by a proper notice of intention to present the proposals.

In fiscal 1973, 23 companies were involved in proxy contests for the election of directors which bring special requirements into play. In these contests, 451 persons, including both management and nonmanagement, filed detailed statements required of participants under the applicable rule. Control of the board of directors was involved in 18 instances. In seven of these, management retained control. Of the remainder, six were settled by negotiation, four were won by nonmanagement persons, and one was pending at year end. In the other five cases, representation on the board of directors was involved. Management retained all places on the board in one contest, opposition candidates won places on the board in two cases, and two were pending as of June 30, 1973.

Takeover Bids, Large Acquisitions

Sections 13 (d) and (e), and 14 (d), (e) and (f) of the Securities Exchange Act, enacted in 1968 and amended in 1970, provide for full disclosure in cash tender offers and other stock acquisitions involving changes in ownership or control. These provisions were designed to close gaps in the full disclosure provisions of the securities laws and to safeguard the interests of persons who tender their securities in response to a tender offer.

During the 1973 fiscal year, 950 Schedule 13D reports were filed by persons or groups which had made acquisitions resulting in their ownership of more than 5 percent of a class of securities. Seventy-five such reports were filed by persons or groups making tender offers, which, if successful, would result in more than 5 percent ownership. In addition, 37 Schedule 14D reports were filed on solicitations or recommendations in a tender offer by a person other than the maker of the offer. Ten statements were filed for the replacement of a majority of the board of directors otherwise than by stockholder vote. One statement was filed under a rule on corporate reacquisitions of securities while an issuer is the target of a cash tender offer.

Insider Reporting

Section 16 of the Securities Exchange Act and corresponding provisions in the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 are designed to provide other stockholders and investors generally with information on insider securities transactions and holdings, and to prevent unfair use of confidential information by insiders to profit from short-term trading in a company's securities.

Section 16 (a) of the Exchange Act requires every person who beneficially owns, directly or indirectly, more than 10 percent of any class of equity security which is registered under Section 12, or who is a director or an officer of the issuer of any such security, to file statements with the Commission disclosing the amount of all equity securities of the issuer of which he is the beneficial owner and changes in such ownership. Copies of such statements must be filed with exchanges on which the securities are listed. Similar provisions applicable to insiders of registered public-utility holding companies and registered closed-end investment companies are contained in the Holding Company and Investment Company Acts.

In fiscal 1973, 111,689 ownership reports were filed. These included 17,850 initial statements of ownership on Form 3, 87,791 statements of changes in ownership on Form 4, and 6,048 amendments to previously filed reports.

All ownership reports are made available for public inspection when filed at the Commission's office in Washington and at the exchanges where copies are filed. In addition, the information contained in reports filed with the Commission is summarized and published in the monthly "Official Summary of Security Transactions and Holdings," which is distributed by the Government Printing Office to about 11,500 subscribers.

ACCOUNTING

The securities acts reflect a recognition by Congress that dependable financial statements are indispensable to informed investment decisions. A major objective of the Commission has been to improve accounting and auditing standards and to assist in the establishment and maintenance of high standards of professional conduct by public accountants. The primary responsibility for this program rests with the Chief Accountant of the Commission.

Under the Commission's broad rule-making power, it has adopted a basic accounting regulation (Regulation S-X) which, together with opinions on accounting principles published as "Accounting Series Releases," governs the form and content of financial statements filed under the securities laws. The Commission has also formulated rules on accounting and auditing of broker-dealers and prescribed uniform systems of accounts for companies subject to the Public Utility Holding Company Act of 1935. The accounting rules and opinions of the Commission, and its decisions in particular cases, have contributed to clarification and wider acceptance of the accounting principles and practices and auditing standards developed by the profession and generally followed in the preparation of financial statements.

However, the specific accounting rules and regulations – except for the uniform systems of accounts which are regulatory reports – prescribe accounting principles to be followed only in certain limited areas. In the large area of financial reporting not covered by its rules, the Commission's principal means of protecting investors from inadequate or improper financial reporting is by requiring a report of an independent public accountant, based on an audit performed in accordance with generally accepted auditing standards, which expresses an opinion whether the financial statements are presented fairly in conformity with accounting principles and practices that are recognized as sound and have attained general acceptance. The requirement that the opinion be rendered by an independent accountant, which was initially established under the Securities Act of 1933, is designed to secure for the benefit of public investors the

detached objectivity and the skill of a knowledgeable professional person not connected with management.

The accounting staff reviews the financial statements filed with the Commission to insure that the required standards are observed and that the accounting and auditing procedures do not remain static in the face of changes and new developments in financial and economic conditions. New methods of doing business, new types of business, the combining of old businesses, the use of more sophisticated securities, and other innovations create accounting problems which require a constant reappraisal of the procedures. It is anticipated that in fiscal 1974, a new publication series will be initiated. It will provide information to the public regarding informal administrative practices and guidelines developed by the accounting staff with respect to specific accounting and auditing problems considered in the review of the financial data filed.

Relations With the Accounting Profession

In order to keep abreast of changing conditions, and in recognition of the need for a continuous exchange of views and information between the Commission's accounting staff and outside accountants regarding appropriate accounting and auditing policies, procedures and practices, the staff maintains continuing contact with individual accountants and various professional organizations. The latter include the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB), the principal professional organizations concerned with the development and improvement of accounting and auditing standards and practices. The Chief Accountant also meets regularly with his counterparts in other regulatory agencies to improve coordination on policies and actions between the agencies. Because of its many foreign registrants and the vast and increasing foreign operations of American companies, the Commission has an interest in the improvement of accounting and auditing principles and procedures on an international basis. To promote such improvement, the Chief Accountant, in October 1972, participated in the 10th International Congress of Accountants in Sydney, Australia, and held informal

discussions with representatives of the Ministry of Finance in Tokyo. In March 1973, he conferred with foreign accountants in Mexico City. A committee to develop basic international accounting standards was recently formed by representatives of accountancy groups from nine countries. The Commission will cooperate closely with the committee in its efforts to promote improvements.

Accounting and Auditing Standards

The FASB has supplanted the Accounting Principles Board (APB) of the AICPA as the organization which establishes standards of financial accounting and presentation for the guidance of issuers and public accountants. A new organizational structure had been recommended by a committee appointed by the AICPA in early 1971 to explore ways of improving this function. Under the new structure, a financial accounting foundation consisting of representatives of leading professional organizations appoints the seven members of the FASB who serve on a salaried, full-time basis, and the members of an Advisory Council to the Board who serve on a voluntary basis. The Commission endorsed the new structure, which it feels will provide operational efficiencies and insure an impartial viewpoint in the development of accounting standards on a timely basis.

The Chief Accountant and the FASB have developed liaison procedures for consultation on projects of either the Board or the SEC which are of mutual interest. The Board has moved expeditiously in adopting an initial agenda covering seven topics which urgently require consideration. They include accounting for foreign currency translation, accrual of future losses, reporting by diversified companies, accounting for leases by lessee and lessor, accounting for such costs as research and development, materiality criteria, and broad qualitative standards for financial reporting.

Another committee was appointed in early 1971 by the AICPA to study and refine the objectives of financial statements. It has studied the basic questions of who needs financial statements, what information should be provided, how it should be communicated, and how much of it can be provided through the accounting process. The

committee's conclusions and recommendations will provide valuable guidance to the FASB in determining the direction and future priorities of its efforts.

During the fiscal year, the APB effected significant improvements in accounting and financial reporting standards through the issuance of seven opinions pertaining to accounting for stock issued to employees, early extinguishment of debt, accounting for lease transactions by manufacturer or dealer lessors, interim financial reporting, accounting for non-monetary transactions, reporting the results of operations, and disclosure of lease commitments by lessees. The Board or its chairman also approved for publication Accounting Guides prepared by other committees of the AICPA on the subjects of accounting for retail land sales, profit recognition on sales of real estate, and accounting for motion picture films all of which will improve practices in these areas of accounting. Improvements in auditing standards were also effected during the fiscal year by the AICPA's issuance of Audit Guides applicable to stock life insurance companies, savings and loan associations, broker-dealers, and investment companies.

Other Developments

During the fiscal year the Commission issued 18 Accounting Series Releases to provide interpretations or guidelines on matters of accounting principles and auditing standards, to require improved disclosure of financial information by amendment of reporting forms or Regulation S-X, or to announce decisions in disciplinary proceedings under Rule 2 (e) of the Commission's Rules of Practice concerning accountants appearing before it.

An advisory release[17] was issued which set forth current guidelines employed by the staff in resolving questions concerning the independence of accountants in relation to their clients who are registrants of the Commission. Two interpretative releases[18] were issued pertaining to the applicability of pooling-of-interests accounting in certain situations connected with Rule 145 under the Securities Act. Other interpretative releases dealt with the reporting of leases in

financial statements of lessees,[19] disclosure of contingent liabilities arising under the Economic Stabilization Act of 1970,[20] accounting for catastrophe reserves,[21] financial statements of life insurance companies,[22] and the reporting of cash flow and other related data.[23]

In conjunction with the Division of Investment Management Regulation, an advisory release[24] was issued discussing the development of an adequate economic data base for mutual fund sales charges. This release was intended to stimulate comments during hearings on mutual fund distribution and the potential impact of the repeal of Section 22 (d) of the Investment Company Act of 1940.

A general revision of Article 9 of Regulation S-X, pertaining to financial statements of banks and bank holding companies, was adopted[25] in consonance with major revisions made in the prior fiscal year in several other sections of the regulation. Subsequently, two releases[26] were issued containing interpretations of various items in the revisions and minor amendments to them.

Amendments to various registration and reporting forms were adopted in a release[27] to require more detailed and timely reporting, and timely review by independent accountants, of extraordinary or unusual charges and credits to income or provisions for material losses effected by registrants.

Additional proposals for amendments to Regulation S-X were issued for public comment which would require improved disclosures in registrants' financial data regarding accounting policies followed,[28] components of income tax expense,[29] leased assets and related lease commitments,[30] and compensating balances, effective interest rates on borrowings and other items affecting liquidity.[31] After comments on these proposals are received and considered, amendments to the regulations will be issued.

In connection with administrative proceedings under Rule 2 (e) of the Commission's Rules of Practice, the Commission permanently disqualified an accountant from practice before it,[32] accepted the

resignations of three others,[33] and censured one accountant.[34] In another action,[35] based upon the entry of a consent judgment of permanent injunction against an accounting firm in an action brought by the Commission, the Commission ordered that the firm be: (1) prohibited, for a period of 30 days, from accepting new professional engagements from new clients which could be expected to result, within a year, in filings, submissions or certifications with or to the Commission; (2) prohibited, for a specified period, from effecting any merger with or acquisition of any other accounting firm without first submitting to the Chief Accountant of the Commission evidence that its procedures respecting mergers or acquisitions are being followed; and (3) required to permit an investigation to ascertain whether it is conducting its professional practice in compliance with the standards and procedures required by the injunction.

EXEMPTIONS FOR INTERNATIONAL BANKS

Section 15 of the Bretton Woods Agreement Act, as amended, exempts from registration securities issued, or guaranteed as to both principal and interest, by the International Bank for Reconstruction and Development. The Bank is required to file with the Commission such annual and other reports on securities as the Commission determines to be appropriate. The Commission has adopted rules requiring the Bank to file quarterly reports and copies of annual reports of the Bank to its Board of Governors. The Bank is also required to file advance reports of any distribution in the United States of its primary obligations. The Commission, acting in consultation with the National Advisory Board on International Monetary and Financial Problems, is authorized to suspend the exemption for securities issued or guaranteed by the Bank. The following summary of the Bank's activities reflects information obtained from the Bank. Except where otherwise indicated, all amounts are expressed in U.S. dollar equivalents as of June 30, 1973.

Net income for the year was $186 million, compared with $183 million the previous year. At July 31, 1973, the Bank had taken no action regarding disposition of its net income for fiscal 1973.

Repayments of principal on loans received by the Bank during the year amounted to $455 million, and a further $123 million was repaid to purchasers of portions of loans. Total principal repayments by borrowers through June 30, 1973, aggregated $5.3 billion, including $3.3 billion repaid to the Bank and $2 billion repaid to purchasers of borrowers' obligations sold by the Bank.

Outstanding borrowings of the Bank were $8.9 billion at June 30, 1973. During the year, the bank borrowed $440 million through the issuance of 2-year U.S. dollar bonds to central banks and other governmental agencies in some 60 countries; D. M. 1.2 billion (U.S. $371 million) in Germany; 180 billion yen (U.S. $605 million) in Japan; SwF 100 million (U.S. $31 million) in Switzerland; KD 27.5 million (U.S. $84 million) in Kuwait; and the equivalent of U.S. $153 million in other countries outside the United States. The above U.S. dollar equivalents are based on official exchange rates at the times of the respective borrowings. The Bank also issued $10 million in bonds that had been sold in previous years under delayed delivery contracts.

These borrowings, in part, refunded maturing issues amounting to the equivalent of $518 million. After retirement of $60 million equivalent of obligations through sinking fund and purchase fund operations, the Bank's outstanding borrowings showed an increase of $1.9 billion from the previous year, of which $1 billion represented appreciation in terms of U.S. dollars of the value of the non-dollar currencies in which the debt was denominated.

The Inter-American Development Bank Act, which authorizes the United States to participate in the Inter-American Development Bank, provides an exemption for certain securities which may be issued or guaranteed by the Bank similar to that provided for securities of the International Bank for Reconstruction and Development. Acting pursuant to this authority, the Commission adopted Regulation IA,

which requires the Bank to file with the Commission substantially the same type of information, documents and reports as are required from the International Bank for Reconstruction and Development. The following data reflects information submitted by the Bank to the Commission.

On June 30, 1973, the outstanding funded debt of the Ordinary Capital resources of the Bank was the equivalent of $1.3 billion, reflecting a net increase in the past year of the equivalent of $230 million. During the year, the funded debt was increased through public bond issues totaling the equivalent of $71.4 million as well as private placements for the equivalent of $49.9 million including, with respect to Spain, $12.7 million of undrawn commitments at June 30, 1973, and $5.4 million of drawings under arrangements entered into during the previous year with Japan. Additionally, $53.3 million of 2-year bonds were sold in Latin America, essentially representing a roll-over of a maturing borrowing of $47.3 million. The funded debt increased by approximately $142.7 million due to upward adjustment of the U.S. dollar equivalent of borrowings denominated in non-member currencies. The funded debt was decreased through the retirement of approximately $21.9 million from sinking fund purchases and scheduled debt retirement.

The Asian Development Bank Act, adopted in March 1966, authorized United States participation in the Asian Development Bank and provides an exemption for certain securities which may be issued or guaranteed by the Bank, similar to the exemptions accorded the International Bank for Reconstruction and Development and the Inter-American Development Bank. Acting pursuant to this authority, the Commission has adopted Regulation AD which requires the Bank to file with the Commission substantially the same type of information, documents and reports as are required from those banks. The Bank has 40 members with subscriptions totaling $1 billion.

As of June 30, 1973, 12 countries had contributed or pledged a total of $242 million to the Bank's Special Funds. In addition to the $26.6 million set aside from Ordinary Capital in 1969 and 1971 by the Board of Governors for Special Funds purposes, another $51.6 million was

set aside in April 1973, making a total of $78.2 million set aside. In addition, Congress has authorized a $100 million U.S. contribution to the Bank's Special Funds, and is considering the appropriation of these funds in fiscal 1974. There have been indications from other countries of additional contributions.

Through June 30, 1973, the Bank's borrowings totaled the equivalent of $229 million. In 1972, the Bank issued obligations of the equivalent of $58.6 million in Japan ($32.5 million), Luxembourg ($8.9 million) and Italy ($17.2 million). The last U.S. borrowing, in 1971, was $50 million, half in 5-year notes at 6½ percent and half in 25-year bonds at 7¾ percent. Before selling securities in a country, the Bank must obtain the country's approval.

TRUST INDENTURE ACT OF 1939

This Act requires that bonds, debentures, notes and similar debt securities offered for public sale, except as specifically exempted, be issued under an indenture which meets the requirements of the Act and has been duly qualified with the Commission.

The provisions of the Act are closely integrated with the requirements of the Securities Act. Registration pursuant to the Securities Act of securities to be issued under a trust indenture subject to the Trust Indenture Act is not permitted to become effective unless the indenture conforms to the requirements of the latter Act designed to safeguard the rights and interests of the purchasers. Moreover, specified information about the trustee and the indenture must be included in the registration statement.

The Act was passed after studies by the Commission had revealed the frequency with which trust indentures failed to provide minimum protections for security holders and absolved so-called trustees from minimum obligations in the discharge of the trusts. It requires, among other things, that the indenture trustee be a corporation with a minimum combined capital and surplus and be free of conflicting interests which might interfere with the faithful exercise of its duties

on behalf of the purchasers of the securities, and it imposes high standards of conduct and responsibility on the trustee. During fiscal 1973, 345 trust indentures relating to securities in the aggregate amount of $14.1 billion were filed.

INFORMATION FOR PUBLIC INSPECTION; FREEDOM OF INFORMATION ACT

Registration statements, applications, declarations, and annual and periodic reports filed with the Commission each year, as well as many other public documents, are available for public inspection and copying at the Commission's public reference room in its principal offices in Washington, D.C. and, in part, at its regional and branch offices.

The categories of available materials and those categories of records that are generally considered nonpublic are specified in the Commission's rules concerning records and information which include the rule (17 CFR 200.80) adopted by the Commission to implement the provisions of the Freedom of Information Act (5 U.S.C. 552). That rule establishes the procedure to be followed in requesting records or copies and provides for a method of administrative appeal from the denial of access to any record. It also provides for the imposition of fees when more than one-half man-hour of work is performed by the Commission's staff to locate and make records available. In addition to the records described, the Commission makes available for inspection and copying all requests for no action and interpretative letters received after December 31, 1970, and responses thereto (17 CFR 200.81). Also made available since November 1, 1972 are materials filed under Proxy Rule 14a-8 (d), which deals with proposals offered by shareholders for inclusion in management proxy-soliciting materials, and related materials prepared by the staff (17 CFR 200.82).

The Commission has special public reference facilities in the New York, Chicago and Los Angeles Regional Offices and some facilities for public use in other regional and branch offices. Each regional

office has available for public examination copies of prospectuses used in recent offerings of securities registered under the Securities Act; registration statements and recent annual reports filed under the Securities Exchange Act by companies having their principal office in the region; recent annual reports and quarterly reports filed under the Investment Company Act by management investment companies having their principal office in the region; broker-dealer and investment adviser applications originating in the region; letters of notification under Regulation A filed in the region, and indices of Commission decisions.

During the 1973 fiscal year, 20,608 persons examined material on file in Washington; several thousand others examined files in New York, Chicago, Los Angeles, and other regional offices. More than 45,536 searches were made for information requested by individuals, and approximately 5,368 letters were written on information requested.

The public may make arrangements through the Public Reference Section at the Commission's principal office to purchase copies of material in the Commission's public files. The copies are produced by a commercial copying company which supplies them to the public at prices established under a contract with the Commission. Current prices begin at 12 cents per page for pages not exceeding 8½" x 14" in size, with a $2 minimum charge. Under the same contract, the company also makes microfiche and microfilm copies of Commission public documents available on a subscription or individual order basis to persons or firms who have or can obtain viewing facilities. In microfiche services, up to 60 images of document pages are contained on 4" x 6" pieces of film, referred to as "fiche."

Annual microfiche subscriptions are offered in a variety of packages covering all public reports filed on Forms 10-K, 10-Q, 8-K, N-1Q and N-1R Under the Securities Exchange Act or the Investment Company Act; annual reports to stockholders; proxy statements; new issue registration statements; and final prospectuses for new issues. The packages offered include various categories of these reports, including those of companies listed on the New York Stock Exchange, the American Stock Exchange, regional stock exchanges,

or traded over-the-counter. Reports are also available by standard industry classifications. Arrangements also may be made to subscribe to reports of companies of one's own selection. Over one hundred million pages (microimagery frames) are being distributed annually. The subscription services may be extended to further groups of filings in the future if demand warrants. The copying company will also supply copies in microfiche or microfilm form of other public records of the Commission desired by a member of the public.

Microfiche readers and reader-printers have been installed in the public reference areas in the Commission's headquarters office, and the New York, Chicago, and Los Angeles regional offices, and sets of microfiche are available for inspection there. Visitors to the public reference room of the Commission's headquarters office may also make immediate reproduction of material on photostatic-type copying machines. The cost to the public of copies made by use of all customer-operated equipment is 10 cents per page. The charge for an attestation with the Commission seal is $2. Detailed information concerning copying services available and prices for the various types of services and copies may be obtained from the Public Reference Section of the Commission.

PUBLICATIONS

In addition to releases concerning Commission action under the securities laws and litigation involving securities violations, the Commission issues a number of other publications, including the following:

Daily:

News Digest; reporting Commission announcements, decisions, orders, rules and rule proposals, current reports and applications filed, and litigation developments.

Weekly:

Statistical Bulletin

SEC Docket; a compilation of Commission releases.

Monthly:

Official Summary of Securities Transactions and Holdings of Officers, Directors and Principal Stockholders.

Annually:

Annual Report of the Commission.

Securities Traded on Exchanges under the Securities Exchange Act of 1934.

List of Companies Registered under the Investment Company Act of 1940.

Classification, Assets and Location of Registered Investment Companies under the Investment Company Act of 1940.

Directory of Companies Filing Annual Reports with the Commission under the Securities Exchange Act of 1934.

Other Publications:

Decisions and Reports of the Commission. (Out of print, available only for reference purposes in SEC Washington, D.C. and Regional Offices.)

The Work of the Securities and Exchange Commission.

Report of SEC Special Study of Securities Markets, H. Doc. 95 (88th Congress)

Institutional Investor Study Report of the Securities and Exchange Commission, H. Doc. 64 (92nd Congress)

Part 8 of the Institutional Investor Study Report, containing the text of the Summary and Conclusions drawn from each of the fifteen chapters of the report.

Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets, February 2, 1972.

The Financial Collapse of the Penn Central Company, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, August 1972.

Report of the Real Estate Advisory Committee to the Securities and Exchange Commission.

Report of the Industrial Issuers Advisory Committee to the Securities and Exchange Commission

Acts and General Rules and Regulations for all Securities Acts.

Compilation of Releases Dealing with Matters Frequently Arising under the Securities Act of 1933.

Compilation of Releases Dealing with Matters Arising under the Securities Exchange Act of 1934 and Investment Advisers Act of 1940.

Compilation of Releases, Commission Opinions, and Other Material Dealing with Matters Frequently Arising under the Investment Company Act of 1940.

FREEDOM OF INFORMATION ACT LITIGATION

The meaning of various exemptions from the general disclosure requirements of the Freedom of Information Act was the subject of litigation involving the Commission during the fiscal year.

In *Steadman Security Corporation v. S.E.C.*,[36] parties to a then pending administrative proceeding, who had been denied discovery of the contents of the Commission's investigatory file, sought to obtain access to the file pursuant to the Freedom of Information Act.[37] The United States District Court for the District of Columbia granted the Commission's motion for summary judgment and refused to enjoin the administrative proceeding, holding that the documents sought were exempt from the disclosure requirements of the act because they were "investigatory files compiled for law enforcement purposes . . . ."[38] The court further held that some of the documents were exempt because they were "commercial or financial information obtained from a person and privileged or confidential."[39] While the court recognized that it might, in a proper case, have jurisdiction to enjoin an agency proceeding pending resolution of a claim under the Act, it did not find this to be such a case. The court also held that it did not have jurisdiction to review the order entered by the administrative law judge in the administrative proceeding, which had denied the plaintiffs discovery of the documents they sought. That order was held to be reviewable only by the Commission and thereafter a United States Court of Appeals.

In *Moore v. S.E.C.*,[40] the United States District Court for the District of Columbia granted the Commission's motion for summary judgment in an action brought under the Freedom of Information Act to obtain disclosure of transcripts of testimony given in the course of the Commission's investigation into the collapse of the Penn Central railroad company. The Commission successfully argued that even though the non-public transcripts had been utilized in the preparation of a Commission staff study on the Penn Central debacle,[41] which study had been made public, the transcripts were, nonetheless, exempt from disclosure under the Act as "investigatory files compiled for law enforcement purposes . . . ," particularly since enforcement action was under active consideration at the time the disclosure request was made.

NOTES TO PART 2

[1] Securities Act Release No. 5265 (June 27, 1972); Securities Act Release No. 5265A (August 3, 1972); Securities Act Release No. 5346 (January 5, 1973).

[2] Securities Act Release No. 5231 (February 3, 1972).

[3] See 38th Annual Report, pp. 25-26.

[4] Securities Act Release No. 5170 (July 19, 1971).

[4a] Securities Act Release No. 5386 (April 20, 1973), 1 SEC Docket No. 12, p. 1.

[5] ['72-'73 Decisions] CCH Fed. Sec. L. Rep. 93,784 (C.A. D.C., 1973).

[6] 42 U.S.C. 4321 et seq.

[7] *Natural Resources Defense Council, Inc. v. S.E.C.*, Civ. No. 409-73.

[8] *Natural Resources Defense Council, Inc. v. S.E.C.*, No. 73-1591.

[10] Securities Act Release No. 5365 (February 7, 1973), 1 SEC Docket No. 2, p. 1.

[11] See 38th Annual Report, pp. 19-20.

[12] Securities Act Release No. 5305, (September 21, 1972).

[13] Securities Act Release No. 5359, (January 26, 1973).

[14] Securities Act Release No. 5314 (October 11, 1972).

[15] Securities Exchange Act Release No. 9660.

[16] Securities Exchange Act Release No. 10214 (June 11, 1973), 1 SEC Docket No. 20, p. 3.

[17] Accounting Series Release No. 126 (July 5, 1972).

[18] Accounting Series Release No. 130 (September 29, 1972) and Accounting Series Release No. 135 (January 5, 1973).

[19] Accounting Series Release No. 132 (November 17, 1972).

[20] Accounting Series Release No. 133 (December 14, 1972).

[21] Accounting Series Release No. 134 (Januarys, 1973).

[22] Accounting Series Release No. 137 (January 11, 1973).

[23] Accounting Series Release No. 142 (March 15, 1973), 1 SEC Docket No. 7, p. 1.

[24] Accounting Series Release No. 140 (January 18, 1973).

[25] Accounting Series Release No. 128 (September 20, 1972).

[26] Accounting Series Release No. 136 (January 11, 1973) and Accounting Series Release No. 141 (February 15, 1973), 1 SEC Docket No. 3, p. 3. (January 12, 1973).

[28] Securities Act Release No. 5343 (December 18, 1972).

[29] Securities Act Release No. 5344 (December 18, 1972).

[30] Securities Act Release No. 5401 (June 6, 1973), 1 SEC Docket No. 19, p. 1.

[31] Securities Act Release No. 5384 (April 12, 1973), 1 SEC Docket No. 11, p. 4.

[32] Accounting Series Release No. 127 (September 11, 1972).

[33] Accounting Series Release No. 129 (September 26, 1972), Accounting Series Release No. 131 (October 19, 1972), and Accounting Series Release No. 139 (January 17, 1973).

[34] Accounting Series Release No. 143 (March 20, 1973), 1 SEC Docket No. 8, p. 26.

[35] Securities Exchange Act Release No. 10172 (May 23, 1973), 1 SEC Docket No. 17, p. 11.

[36] ['72-73 Decisions] CCH Fed. Sec. L. Rep. fl 93,735 (D. D.C., 1973).

[37] 5 USC 552

[38] See 5 U.S.C. 552 (b) (7).

[39] See 5 U.S.C. 552 (b) (4).

[40] Civ. No. 2371-73 (D. D.C., 1973).

[41] Staff Report of the Securities and Exchange Commission, The Financial Collapse of the Penn Central Company (1972).

PART 3
REGULATION OF SECURITIES MARKETS

In addition to the disclosure provisions discussed in the preceding chapter, the Exchange Act assigns to the Commission significant regulatory responsibilities for securities markets and persons in the securities business. The Act, among other things, requires securities exchanges to register with the Commission and provides for Commission supervision of the self-regulatory responsibilities of registered exchanges. The Act requires registration and regulation of brokers and dealers doing business in the over-the-counter markets, and permits registration of associations of brokers or dealers

exercising self-regulatory functions under Commission supervision. The Act also contains provisions designed to prevent fraudulent, deceptive, and manipulative acts and practices on the exchanges and in the over-the-counter markets. Some recent developments concerning regulation of the securities markets are discussed in Part 1.

REGULATION OF EXCHANGES

Registration

The Exchange Act generally requires an exchange to register with the Commission as a national securities exchange unless the Commission exempts it from registration because of the limited volume of transactions. As of June 30, 1973, the following 13 securities exchanges were registered with the Commission:

American Stock Exchange, Inc.
Boston Stock Exchange
Chicago Board Options Exchange, Inc.[1]
Chicago Board of Trade[2]
Cincinnati Stock Exchange
Detroit Stock Exchange
Midwest Stock Exchange, Inc.
National Stock Exchange
New York Stock Exchange, Inc.
Pacific Stock Exchange, Inc.
PBW Stock Exchange, Inc.
Intermountain Stock Exchange
Spokane Stock Exchange

Delisting

Pursuant to Section 12 (d) of the Exchange Act, securities may be stricken from listing and registration upon application to the Commission by an exchange, or withdrawn from listing and registration upon application by an issuer, in accordance with the

rules of the exchange and upon such terms as the Commission may impose for the protection of investors.

The standards for delisting vary among the exchanges, but generally delisting actions are based on one or a combination of the following factors: (1) the number of publicly held shares or shareholders is insufficient (often as a result of an acquisition or merger); (2) the market value of the outstanding shares or the trading volume is inadequate; (3) the company no longer satisfies the exchange's criteria for earnings or financial condition; or (4) required reports have not been filed with the exchange.

During fiscal 1973, the Commission granted exchange applications for the de-listing of 100 stock issues and 32 bond issues. The largest number of applications came from the New York Stock Exchange (33 stocks and 30 bonds). The number of applications granted other exchanges are American (27 stocks); National (23 stocks); PBW (6 stocks); Midwest (5 stocks and 2 bonds); Pacific (3 stocks); Cincinnati, Detroit and Inter-mountain (1 stock each).

The Commission also granted the application of one issuer to withdraw its securities from listing and registration on the Pacific Stock Exchange.

In Commission review of a delisting action, the Commission granted the American Stock Exchange's application to delist the stock of Ecological Science Corp. (ESC).[3] The delisting application was based on ESC's failure to meet the exchange's guidelines for continued listing of its securities due to net losses in its two most recent fiscal years and a net tangible asset deficit. In its decision, the Commission reiterated its view that in evaluating delisting applications it is not the Commission's function to substitute its judgment for that of an exchange, and that where the rules of an exchange with respect to delisting have been complied with, the Commission is required to grant a delisting application, its authority in such cases being limited to the imposition of such terms for the protection of investors as it deems necessary.

Exchange Disciplinary Actions

Although the Exchange Act does not specifically grant the Commission authority to monitor disciplinary actions taken by exchanges,[4] each national securities exchange reports to the Commission action taken against members and member firms and their associated persons for violation of any rule of the exchange or of the Exchange Act or of any rule or regulation under the Act.

During the fiscal year, 6 exchanges reported 62 separate disciplinary actions including the imposition in 3 cases of fines ranging from $10 to $30,000; the revocation of the membership of 5 firms and the expulsion of 3 individuals; the suspension from membership (for periods ranging from 1 month to 1 year) of 6 member firms and 16 individuals; and the censure of 26 member firms. The exchanges also reported the imposition of various other sanctions against 13 registered representatives and other employees of member firms.

Exchange Rules

The Commission's staff continually reviews the rules and practices of the nation's registered securities exchanges to determine the adequacy and effectiveness of the self-regulatory scheme. To facilitate Commission oversight, each national securities exchange is required to file with the Commission a report of any proposed change in rules or practices not less than 3 weeks (or such shorter period as the Commission may authorize) before acting to effectuate the change.

During the fiscal year, 163 proposed changes in exchange rules and practices were submitted to the Commission. The following are among the more significant:

1. In 1935 all of the national securities exchanges adopted, at the Commission's request, a rule which provided that no specialist or odd-lot dealer, no firm in which such specialist or odd-lot dealer was a participant, and no partner of such firm, could acquire, hold or grant, directly or indirectly, any interest in a put, call, straddle, or option in

any security in which such specialist or odd-lot dealer was registered. All the national securities exchanges also prohibited a member while on the floor from initiating the purchase or sale of securities on the exchange for any account in which he or his firm or any participant for the firm held or had granted an option.

Several firms presently doing business on other exchanges as specialists or market makers applied for membership on the new Chicago Board Options Exchange (CBOE). Some of those exchanges have been considering changes in the above rules in order to permit such firms to act (and continue to act) as specialists, market makers or floor traders in the same securities that underlie options in which such firms would act as dealers on the CBOE and perhaps elsewhere. In view of the actual and potential abuses which led to the original adoption of those rules, the Division of Market Regulation has requested the exchanges not to change their rules to permit such activities pending the Commission's review of the issues raised by the proposed changes.[5]

2. All of the exchanges adopted rules in connection with the Commission's new Rule 19b-2 under the Exchange Act. For further discussion of these changes, see Part 1.

3. The New York Stock Exchange's wholly-owned depository and the Midwest Stock Exchange's wholly-owned clearing and depository entity submitted by-law and rule changes and other information to the Commission in connection with their respective proposals to operate as limited purpose trust companies. The proposals included the proposed rules under which the depositories would operate and the procedures and systems they would utilize. After consideration of the proposals, the Commission commented favorably on them, and they were adopted.

Litigation on Exchange Rules

Thill v. New York Stock Exchange – This case raises the issue of whether the NYSE's fixed minimum commission rate system, and the rules necessary to preserve the integrity of that system such as the

anti-rebate rule, are legal under antitrust laws. In 1970, the Court of Appeals for the Seventh Circuit reversed a district court order granting summary judgment to the Exchange.[6] The Commission and the Antitrust Division of the Department of Justice subsequently intervened in the district court proceedings. In 1972, during the course of those proceedings, the Exchange appealed to the Seventh Circuit the district court's denial of its motion to refer to the Commission the question of whether the NYSE's anti-rebate rule is "necessary to make the Securities Exchange Act work." The Commission opposed the NYSE's request for a primary jurisdiction reference on the ground that it had already implicitly found the exchange's rule "necessary or appropriate" under the standards of Section 19 (b) of the Exchange Act. The Seventh Circuit sustained the order denying referral, but stated that the Commission's argument that "the anti-rebate rule should be reviewed by the SEC under the standards of the Securities Exchange Act of 1934 rather than by a court [under the standards of the antitrust laws]" had been adversely decided to the SEC's position in the earlier appeal.[7] The case then proceeded to trial. While the Commission did not participate on a day-to-day basis, it did file post-trial briefs in which it took the position that the antitrust action was incompatible with its pervasive ongoing regulatory jurisdiction over national securities exchanges.

Inspection

An important element of the Commission's supervision of exchange self-regulation is its program of regular inspections of various phases of exchange activity. These inspections enable the Commission to recommend, where appropriate, improvements designed to increase the utility and effectiveness of self-regulation.

In fiscal 1973, the Commission's staff conducted 13 inspections. Included were general inspections involving the Boston, Cincinnati, Chicago Board Options, Midwest (two general inspections) and Pacific Stock Exchanges. Five separate inspections were made at the New York Stock Exchange covering its net capital rule, advertising rules, financial surveillance, stock watch and floor surveillance (including specialists), and disciplinary activities.

In addition an inspection was made of the Pacific Stock Exchange's depository.

SUPERVISION OF NASD

The Exchange Act provides for registration with the Commission of national securities associations and establishes standards and requirements for the registration and operation of such associations. The Act contemplates that such associations will serve as a medium for self-regulation by over-the-counter brokers and dealers. In order to be eligible for registration, an association must have rules designed to protect investors and the public interest, to promote just and equitable principles of trade, and to meet other statutory requirements. National securities associations operate under the general supervisory authority of the Commission, which is authorized, among other things, to review disciplinary actions taken by an association, to disapprove changes in association rules and to alter or supplement rules relating to specified matters. The National Association of Securities Dealers, Inc. (NASD) is the only association to have registered with the Commission under the Act.

In adopting legislation permitting the formation and registration of national securities associations, Congress provided an incentive to membership by permitting such associations to adopt rules which preclude members from dealing with a nonmember broker or dealer except on the same terms and conditions and at the same price as the member deals with the general public. The NASD has adopted such rules. As a practical matter, therefore, membership is necessary for profitable participation in underwritings since members may properly grant price concessions, discounts and similar allowances only to other members.

At the close of the fiscal year, the NASD had 3,884 members, reflecting a net loss of 346 members during the year. This loss reflects the net result of 228 admissions to and 574 terminations of membership. The number of members' branch offices nevertheless

increased by 206, to 6,790, as a result of the opening of 1,454 new offices and the closing of 1,248. During the fiscal year, the number

of registered representatives and principals (these categories include all partners, officers, traders, salesmen and other persons employed by or affiliated with member firms in capacities which require registration) increased by 7,125 to 205,028 as of June 30, 1973.[8] This increase reflects the net result of 28,203 initial registrations, 27,466 re-registrations and 48,544 terminations of registration during the year.

During the fiscal year, the NASD administered 72,142 qualification examinations of which 44,129 were for NASD qualification, 2,567 for the Commission's SECO program, and the balance for other agencies, including major exchanges and various states.

NASD RULES

Under the Exchange Act, the NASD must file for Commission review copies of any proposed rules or rule amendments 30 days prior to their intended effective date. Any rule changes or additions may be disapproved by the Commission if it finds them to be inconsistent with the requirements of the Act. The Commission also normally reviews, in advance of publication, general policy statements, directives, and interpretations proposed to be issued by the Association's Board of Governors pursuant to its powers to administer and interpret NASD rules.

During the fiscal year, numerous changes in or additions to NASD rules, policies and interpretations were submitted to the Commission for its consideration. Among the more significant which were not disapproved by the Commission were:

(1) Amendments to the Code of Arbitration Procedure to authorize the Board of Governors to compel a member to arbitrate any dispute arising out of or in connection with its securities business, including disputes between member firms and their associated persons, at the

instance of a member or an associated person. The Code previously provided for arbitration only of disputes arising out of a securities transaction at the instance of another member or a public customer. In addition, the eligibility period for the submission of a dispute to arbitration was extended from 3 to 5 years.

(2) Amendments to Schedule D of the NASD By-laws to provide for restructuring the daily lists made available to newspapers and other media of prices and volume in securities quoted on NASDAQ, the Association's automated quotation system. Under the new format, the NASD makes available for publication price and volume data of the 1,400 most active NASDAQ stocks as determined by trading volume,[9] and price data only for the 900 next most active NASDAQ stocks. Securities must also meet certain price criteria to be eligible for inclusion on either list.

At the end of the fiscal year, another significant rule proposal was pending before the Commission. This proposal, which would add a new Section 34 and Appendix C to Article III of the NASD's Rules of Fair Practice, would require NASD members to obtain blanket fidelity bond coverage. Every NASD member having employees which is required to join the Securities Investor Protection Corporation and is subject to the Commission's net capital rule, would be required to obtain such coverage.

Inspections

The Commission is charged with the general oversight of national securities associations in the performance of their self-regulatory functions, and the staff conducts periodic inspections of various phases of NASD activity. During the fiscal year, the staff inspected the overall operations of the Association's district offices in Atlanta, Cleveland, Philadelphia and New Orleans. These inspections included a broad review of the operations of each district office, including its examination program, financial monitoring and disciplinary policies and procedures in order to determine their effectiveness and, where appropriate, to make recommendations for changes in existing programs or the institution of new programs. In

addition, the staff reviewed the operations of NASDAQ and the NASD's Membership Department.

NASD Disciplinary Actions

The Commission receives from the NASD copies of its decisions in all cases where disciplinary action is taken against members and persons associated with members. Generally, such actions are based on allegations that the respondents violated specified provisions of the NASD's Rules of Fair Practice. Where violations by a member are found, the NASD may impose sanctions which include expulsion, suspension, fine or censure. If the violator is an individual, his registration with the Association may be suspended or revoked, he may be suspended or barred from being associated with any member, and he may be fined and/or censured.

During the past fiscal year, the NASD reported to the Commission its final disposition of 629 disciplinary complaints (including 210 complaints involving NASDAQ) in which 526 members and 451 individuals were named as respondents. Complaints against 62 members and 64 individuals were dismissed for failure to establish the alleged violations. Forty-two members were expelled from membership and 20 members were suspended for periods ranging from 1 day to 6 months. In many of these cases, a fine was also imposed. In 384 cases, members were fined amounts ranging from $25 to $25,000, and in 18 cases members were censured.

In disciplinary sanctions imposed on individuals associated with member firms, 98 persons were barred or revoked, and 78 had their registrations suspended for periods ranging from 1 day to 5 years. In addition, 211 other individuals were censured and /or fined amounts ranging from $100 to $25,000.

Review of NASD Disciplinary Actions

Disciplinary action taken by the NASD is subject to review by the Commission on its own motion or on the timely application of any aggrieved person. In these cases, effectiveness of any penalty

imposed by the NASD is automatically stayed pending Commission review, unless the Commission otherwise orders after notice and opportunity for hearing. If the Commission finds that the disciplined party committed the acts found by the NASD and that such acts violated the specified rules, the Commission must sustain the NASD's action – unless it finds that the penalties imposed are excessive or oppressive, in which case it must reduce them or set them aside.

At the beginning of the fiscal year, 25 proceedings to review NASD disciplinary decisions were pending before the Commission and, during the year, 22 additional cases were brought up for review. The Commission disposed of 25 cases. In nine cases, the Commission affirmed the NASD's action. It permitted the withdrawal of two applications for review and remanded one case back to the NASD. In nine cases, the NASD's findings and/or penalties were modified, and in four cases the NASD's action was set aside. At the close of the fiscal year, 22 cases were pending.

Review of NASD Membership Action

The Exchange Act and NASD By-laws provide that no broker or dealer can be an NASD member if he or any person associated with him is subject to specified disabilities. These disabilities can be waived only with specific approval of the Commission. Commission approval or a direction by it to admit a person to membership in the Association or to continue the membership of any person is generally made after initial submission to the NASD by the member or applicant for membership. The NASD in its discretion may then file an application with the Commission on behalf of the petitioner. If the NASD refuses to sponsor an application, the broker or dealer may apply directly to the Commission for an order directing the NASD to admit him to or to continue him in membership. At the beginning of the fiscal year, eight applications for approval of admission to or continuance in membership were pending. During the year, nine additional applications were filed, seven were approved and six were withdrawn, leaving four applications pending at the end of the year.

BROKER-DEALER REGULATION

Registration

Brokers and dealers who use the mails or other means of interstate commerce in the conduct of an over-the-counter securities business are required to register with the Commission.

As of June 30, 1973, 4,407 broker-dealers were registered compared with 4,734 a year earlier. This reduction resulted from the termination of 704 registrations as against only 377 new applications filed. For further comparative statistics, see the statistical section.

On July 3, 1973, the Commission issued a proposal to amend Form BD, the form used to apply for broker-dealer registration and for amendments to that application.[10]

The principal change would add an inquiry as to whether the registrant, applicant or certain associated persons were ever an officer, director, general partner, 10 percent shareholder or controlling person of a broker or dealer for which a Securities Investor Protection Corporation (SIPC) trustee was appointed. Under the SIPC Act the Commission may bar or suspend such persons if, after notice and opportunity for hearing, it finds such action to be in the public interest.

The Commission found that many broker-dealer failures which resulted in the appointment of a SIPC trustee have involved a gross failure to maintain proper books and records and substantial violations of financial responsibility rules. The proposed amendment is designed in part to detect an attempt on the part of persons who may have been responsible for such violations to effect reentry into the securities business, giving the Commission an opportunity to take remedial action prior to the effective date of registration.

Financial Reports

Registered broker-dealers are required to file annual reports of financial condition with the Commission. Generally, these reports

must be certified by an independent public accountant. During the fiscal year, 4,446 annual reports were filed, compared to a total of 4,224 filed during fiscal 1972.

Income and **Expense** Reports

In 1968, the Commission adopted Exchange Act Rule 17a-10, effective January 1, 1969.[11] The rule requires registered broker-dealers and exchange members to file income and expense reports for each calendar year with the Commission or with a registered self-regulatory organization (an exchange or the NASD) which has qualified a plan under the rule. The self-regulatory organizations are required to send copies of the reports filed with them to the Commission.

Since 1970, the Commission has approved plans of the NASD, the American, Midwest, New York and PBW Stock Exchanges.[12] These plans provide that the self-regulatory organization will adopt and implement appropriate internal procedures for review of the reports submitted by members, review all reports filed for reasonableness and accuracy, transmit edited reports to the Commission, and undertake certain other obligations.

The reports covering calendar year 1972 of SECO broker-dealers[13] and non-NASD members of those exchanges which have not qualified a plan have been received and reviewed by the Commission. The 1972 reports of all NASD members and of non-NASD members of those exchanges which have qualified a plan have been received by the Commission from the respective self-regulatory organizations. Information based on these reports is included in the statistical section.

Early Warning System

Rule 17a-11 was adopted to provide the Commission and the self-regulatory authorities with an adequate and timely flow of information on the financial and operational condition of broker-dealers. It is a

part of the early warning system that the Commission has developed to evaluate the condition of registered broker-dealers.

The rule has four major provisions: (1) immediate telegraphic notice to the Commission and to any self-regulatory organization of which it is a member, followed by a financial report within 24 hours, when a broker-dealer's net capital falls below the level required by any capital rule to which it is subject; (2) the filing of special monthly reports until its capital position shows improvement for 3 successive months when a broker-dealer ascertains that its aggregate indebtedness exceeds 1,200 percent of its net capital – or that its total net capital is less than 120 percent of the minimum net capital required of it by any capital rule to which it is subject; (3) telegraphic notice to the appropriate regulatory authorities, followed by a written report within 48 hours, when a broker-dealer's books and records are not current; and (4) notification to the Commission by a self-regulatory organization when it learns that a member has failed to give notice or file any report required by the rule.

During the past fiscal year, a total of 339 broker-dealers sent telegrams and/ or filed reports pursuant to the rule.

Advisory Committee on Reports and Registration

In September 1972, the Commission appointed an Advisory Committee on Broker-Dealer Reports and Registration Requirements composed of knowledgeable persons from the securities industry, the accounting and legal professions, and the Commission's staff to study methods of simplifying and standardizing reports and eliminating duplicative recordkeeping requirements.

In its report submitted to the Commission in December 1972, the Committee concluded that present regulatory reports submitted by broker-dealers require a wasteful duplication of effort by firms and regulators. The Committee made a number of recommendations for improvement including (1) the elimination of provisions requiring a broker-dealer to file reports concerning its financial condition and operational activities with more than one regulatory authority, and (2)

the adoption of the Joint Regulatory Report of the New York Stock Exchange, with appropriate modifications, as a replacement for other reports currently in use, such as Form X-17A-5 and Form X-17A-10.

In February 1973, the Commission appointed a task force composed of staff members to analyze the recommendations and to prepare specific proposals in regard to both the method and cost of implementing them. The Commission also sought the advice of self-regulatory authorities and SIPC as to the best methods for implementation of the Committee's proposals. During the next fiscal year, the Commission intends to develop and implement a coordinated report program with the objective of eliminating duplication.

Broker-Dealer Examinations

The Office of Broker-Dealer Examinations was established by the Commission in January 1972, in order to deal more effectively with the problems detailed in the Commission's 1971 "Study of Unsafe and Unsound Practices of Brokers and Dealers." By creating this new Office, the Commission has substantially strengthened its continuing efforts to prevent a recurrence of the crisis which confronted the securities industry in the years 1968 through 1970. During that period, there occurred widespread failures of broker-dealer firms, accompanied by substantial customer losses of cash and securities. One major outgrowth of these crises was the passage in 1970 of the Securities Investor Protection Act.

There are three types of examinations used in the Commission's nationwide program of broker-dealer examinations: routine, cause and oversight. Routine examinations cover all aspects of a broker-dealer's operations and generally involve broker-dealers which are not members of any self-regulatory organization (SECO broker-dealers), but members of the self-regulatory organizations are also subject to such examinations. The Office is working to establish a regular examination cycle in which each SECO broker-dealer is examined 30 to 60 days after it becomes registered with the Commission and on an annual basis thereafter.

Cause examinations are usually conducted as a result of a complaint received from a customer or another broker-dealer which indicates a need to review certain aspects of the operations of a particular broker-dealer. Cause examinations are usually limited to the subject matter of the complaint. The examiner, however, may enlarge the scope of the examination if he believes that the firm's operations warrant further study.

The oversight examination program is a two-fold operation consisting of (1) examinations of members of self-regulatory organizations to determine if they are in compliance with the securities laws, and (2) examination of a member of a particular self-regulatory organization together with a concurrent review of the report and working papers of the latest examination performed by that organization to determine whether its examination program is thorough and effective.

In conjunction with its oversight examination functions, the Office has instituted a program of continuous review of the policies and procedures used by the various self-regulatory organizations in examining their members to insure that stated policies and procedures are being implemented and that all areas of a broker-dealer's operations are being examined.

In fiscal 1973, the Commission conducted a total of 1,044 broker-dealer examinations which is a 17 percent increase over the previous year's total of 893. Of the 1,044 examinations conducted, 387 were routine, 451 were for cause and 206 were oversight examinations.

In an effort to improve the caliber of the examination staff of both the Commission and self-regulatory authorities, the Office developed a series of training courses for broker-dealer examiners. During fiscal 1973, it conducted or sponsored six such programs in various areas of the country. These programs were attended by members of the Commission's staff as well as representatives of the NASD, the several stock exchanges, the Federal Reserve Board, SIPC, and various law enforcement and related agencies.

The, Office also supervised the development of a computerized surveillance system. The implementation of Phase 1 of this system will provide data to be utilized in coordinating examinations conducted by the Commission's staff and the various other regulatory authorities. Work is continuing on improvements and expansion of this program in an effort to accumulate and organize pertinent data concerning all broker-dealers registered with the Commission.

In addition to the above-described activities, members of the staff of the Office serve on an Advisory Committee on a Model Compliance Program for Broker-Dealers. This Committee, which includes representatives of the various exchanges and the NASD, is considering the feasibility of developing a Model Guide to Broker-Dealer Compliance covering all aspects of a broker-dealer's regulatory responsibility to its customers.

Rule Changes

Uniform Net Capital Rule — On December 5, 1972, the Commission proposed the adoption of a uniform net capital rule for broker-dealers which will provide minimum standards for both exchange members and nonmembers.[14] The most significant feature of the proposed rule is a minimum equity requirement aimed at insuring permanency of broker-dealer capital. This provision would require that at least 30 percent of a broker-dealer's total capitalization consist of equity, thus limiting the amount of subordinate that could be incurred.

Among other things, the proposed rule would (1) eliminate the exemption from the Commission's present net capital rule for members of exchanges that have net capital rules deemed more comprehensive than the Commission's, (2) reduce the maximum permissible ratio of aggregate indebtedness to net capital from 20 to 1 to 15 to 1, (3) establish minimum capital requirements for market makers and writers and endorsers of options, and (4) include new provisions for the treatment of stock record differences, free shipment of securities and dividends and interest receivable.

The Commission has received comments on this proposal and its staff is currently analyzing those comments.

Reserve and Segregation Requirements — The Securities Investor Protection Act of 1970 authorized the Commission to prescribe rules regarding the custody and use of customers' funds and securities. On January 15, 1973, Rule 15c3-3 under the Exchange Act became effective.[15] The rule provides a formula for the maintenance by broker-dealers of basic reserves with respect to customers' cash and cash realized through the utilization of customers' securities, and enunciates standards for broker-dealers with respect to the physical possession or control of customers' fully-paid and excess margin securities.

The rule is designed, among other things: (1) to insure that customers' funds held by a broker-dealer are used only in safe areas of a broker-dealer's business relating to the servicing of customers, or deposited in a reserve bank account; (2) to require a broker-dealer promptly to obtain and maintain possession or control of all customers' fully-paid and excess margin securities; (3) to accomplish a separation of the firm's brokerage business from other activities; (4) to require a broker-dealer to maintain more current records; (5) to motivate the securities industry to process its securities transactions in a more expeditious manner; (6) to inhibit the unwarranted expansion of a broker-dealer's business through the use of customers' funds, and (7) to ensure that all fully-paid and excess margin securities in the possession or control of a broker-dealer will constitute property of the customers entitled thereto, as evidenced by the broker-dealer's records or as otherwise established.

Pending further study, the Commission subsequently suspended, with respect to exempted securities, the provision of the rule requiring a broker-dealer to buy-in securities sold for a customer when the broker does not obtain possession of the securities within 10 business days after the settlement date.[16] The Commission has published releases clarifying the rule for the guidance of the broker-dealer community and self-regulatory authorities.[17]

Margin Exemption for Credit to Market Makers and Block Positioners – Under the Exchange Act, the Board of Governors of the Federal Reserve System has authority to regulate credit in the securities markets while the Commission has administrative and enforcement responsibilities with respect to these credit regulations.

In 1969, the Board amended its Regulation U to exempt from specified margin requirements loans by banks to broker-dealers which make over-the-counter markets in securities placed by the Board on its list of OTC margin stocks. The Board deemed it desirable, in the interest of fair and orderly markets, to grant such an exemption if a broker-dealer met certain net capital requirements and was a bona fide market maker. In order to implement the Board's rule, the Commission adopted Rule 17a-12 under the Exchange Act to require reports from market makers in OTC margin stocks. During the fiscal year, the Commission amended its rule to eliminate the filing of reports by broker-dealers which do not use the credit exemption.[18]

In September 1972, the Board amended Regulation U to grant a similar exemption to over-the-counter market makers in listed securities ("third market makers") and broker-dealers who position blocks of securities in order to facilitate the sale or purchase by their customers of quantities which cannot otherwise be absorbed by normal exchange facilities. Simultaneously, the Commission adopted Rules 17a-16 and 17a-17 under the Exchange Act imposing certain minimum net capital and other requirements on broker-dealers who desire to use this exemption, and requiring them to file certain notices and reports with the Commission.[19]

As of June 30, 1973, 59 broker-dealers had filed notices that they were using or intended to apply for OTC market maker exempt credit under Rule 17a-12; 6 broker-dealers filed notices under Rule 17a-16 that they were using or intended to use third market maker exempt credit; and 14 broker-dealers filed notices under Rule 17a- 17 that they had applied or intended to apply for block positioner exempt credit.

Reports to Customers – On June 30, 1972, the Commission adopted amendments to Rule 17a-5 under the Exchange Act which require broker-dealers (other than mutual fund dealers and broker-dealers who do not carry customer funds or securities) to report their financial condition to customers.[20] Customers are to receive quarterly and annual balance sheets along with statements setting forth, among other things, the broker-dealer's net capital position.

In addition, the broker-dealer must make available to its customers for inspection a statement setting forth any comments made by the broker-dealer's independent accountant concerning material inadequacies in the broker-dealer's accounting system, its internal accounting control or its procedures for safeguarding securities.

The amended rule also requires broker-dealers to furnish additional financial statements to the Commission.

Mortgage Dealing Exemptions – The Commission has been working with the Federal Home Loan Mortgage Corporation (FHLMC) in connection with FHLMC's responsibility to expand the secondary market in conventional mortgages (not guaranteed or insured by a Federal or State agency) on residential property. As part of this effort, the Commission has adopted Rule 3a12-1 under Section 3 (a) (12) of the Exchange Act.[21] The principal impact of the new rule is that broker-dealers dealing solely in certain mortgages and other exempt securities are not subject to the registration, net capital and other provisions of the Exchange Act which are not by their terms applicable to "exempted securities." Transactions in securities exempted by Section 3 (a) (12) or Commission rules adopted thereunder are still subject to the antifraud provisions of the Exchange Act.

Employment Discrimination – In November 1972, a petition was filed with the Commission requesting that it promulgate rules requiring the securities industry to take affirmative action to eliminate discrimination in employment practices. Since the petition raised complex questions concerning the Commission's authority to adopt rules in this area as well as the merits of adopting the rules proposed,

the Commission invited public comment on the petition.[22] To aid further in its inquiry, the Commission sought and obtained the views of various governmental agencies, including the Department of Justice. The comment period, after one extension, expired on March 13, 1973.

The Commission has received a substantial number of responses from interested individuals and groups and those comments, along with possible statutory bases for adoption of rules of the type proposed, are currently being studied by the Commission's Division of Market Regulation which expects to submit its conclusions and recommendations to the Commission in the near future.

SECO Broker-Dealers

Under the Exchange Act, the Commission is responsible for establishing and administering rules on qualification standards and business conduct of broker-dealers who are not members of the NASD[23] in order to provide regulation of these SECO broker-dealers comparable to that provided by the NASD for its members.

During the fiscal year, the number of nonmember broker-dealers registered with the Commission decreased from 294 to 276 and the number of associated persons of such firms (i.e., partners, officers, directors and employees not engaged in merely clerical or ministerial functions) decreased from 20,600 to approximately 16.303.[24] (Investors Diversified Services, Inc., which joined the NASD in September 1972, accounted for a decrease of 5,902 SECO associated persons.)

On December 4, 1972, the Commission adopted Rules 15b10-8 and 15b10-9 under the Exchange Act relating to the public offering by SECO broker-dealers of their own securities or those of an affiliate.[25] Similar rules had been adopted by the NASD as described in the Commission's last annual report.[26]

Rule 15b-10-8 requires, with respect to public offerings of the securities of non-member broker-dealers, whether or not self-

underwritten, that: (1) certain financial statements be included in the prospectus; (2) sales by stockholders amount to no more than 25 percent of their respective equity interests; (3) the amount of the offering not exceed three times the nonmember's net worth; (4) the non-member's net capital ratio not exceed 10 to 1 after completion of the offering; (5) certain financial data be sent regularly to shareholders; and that (6) no subsequent offering be made to the public for at least one year.

Rule 15b-10-9 in general permits a nonmember to underwrite or participate in the distribution of its own securities or those of an affiliate if it obtains two qualified independent underwriters with at least 5 years' experience in the securities business, 3 of which have been profitable, to certify to the fairness of the offering price and to exercise due diligence in connection with the preparation of the registration statement. The independent underwriters are required to assume the full legal responsibility and liability of an underwriter under the Securities Act. In addition, the nonmember, the independent underwriters and a majority of the directors of their respective boards are required to have been in the securities business for at least 5 years, 3 of which must have been profitable.

The rule allows a nonmember to underwrite or participate in the distribution of its own or an affiliate's securities without the two qualified independent underwriters provided there is a bona fide active independent market for the securities. Otherwise, the nonmember can participate only to the extent of 10 percent of the distribution if there is a firm commitment underwriting.

Finally, in an offering of the nonmember's securities, the nonmember's associated persons and their immediate families are prohibited from selling any portion of their equity interest in the nonmember unless there is a bona fide active independent market for the securities and such securities are sold pursuant to a firm commitment underwriting by an independent underwriter.

Rule 15b9-2 imposes an annual assessment to be paid by nonmember broker-dealers to defray the cost of regulation. During

the fiscal year, the Commission increased the base fee from $150 to $175 and the fee for each associated person from $7.50 to $10.00.[27]

SIPC Litigation

S.E.C. v. Oxford Securities, Ltd.[28] – This was an appeal by the Securities Investor Protection Corporation ("SIPC") and the Commission to the United States Court of Appeals for the Second Circuit of an order of the district court denying an application of SIPC, under the Securities Investor Protection Act,[29] for the appointment of persons it had designated to be trustee and counsel to the trustee for the purpose of liquidating Oxford, a broker-dealer in securities. The district court had held that Section 5 (a) (2) of the SIPC legislation, which provides that a court supervising a liquidation under the Act is to appoint as trustee and attorney for the trustee such persons as SIPC may designate, was unconstitutional in that it imposed purely ministerial duties on the court, offending the separation of powers of the legislative, judicial and executive branches of the government. The court of appeals, per curiam, reversed the district court order, and on remand the persons designated by SIPC were appointed.

NOTES FOR PART 3

[1] See the report on the registration of this exchange in Part 1.

[2] In March 1971, the Executive Committee of the Board of Trade adopted a resolution to close the Board's securities market. However, it has not withdrawn its registration.

[3] Securities Exchange Act Release No. 10217 (June 13, 1973), 1 SEC Docket No. 20, p. 5.

[4] Under legislation proposed by the Commission and discussed in Part 1 of this report, the Commission would be given authority to review exchange disciplinary actions.

[5] See Securities Exchange Act Release No. 10312 (August 1, 1973), 2 SEC Docket 223.

[6] *Thill Securities Corp. v. New York Stock Exchange*, 433 F. 2d 264 (C.A. 7, 1970), cert, denied, 461 U.S. 994 (1971).

[7] *Thill Securities Corp. v. New York Stock Exchange*, 465 F. 2d 14 (C.A. 7, 1972).

[8] Investors Diversified Services, Inc., which joined the NASD in September 1972, accounted for an increase of approximately 5,900 registered representatives.

[9] Shortly after the close of the fiscal year, the NASD submitted for membership comment a proposal to use dollar rather than trading volume as the governing criterion in these lists.

[10] Securities Exchange Act Release No. 10262, 2 SEC Docket 65.

[11] Securities Exchange Act Release No. 8347 (June 28, 1968).

[12] Securities Act Release Nos. 8876 (Apr. 30, 1970); 8896 (May 28, 1970); 8946 (June 28, 1970); 8954 (Aug. 11, 1970); 9495 (Feb. 15, 1972).

[13] Those registered broker-dealers which are not NASD members are referred to as SECO broker-dealers.

[14] Securities Exchange Act Release No. 9891.

[15] Securities Exchange Act No. 9856 (November 10, 1972).

[16] Securities Exchange Act Release No. 9974 (January 31, 1973), 1 SEC Docket No. 1, p. 7. On March 1, 1973, the Commission extended the suspension period and, on April 10, further extended it indefinitely. Securities Exchange Act Release No. 10093, 1 SEC Docket No. 11, p. 13.

[17] See Securities Exchange Act Release Nos. 9922 (January 2, 1973); and 10178 (May 30, 1973), 1 SEC Docket No. 18, p. 27.

[18] Securities Exchange Act Release No. 9762 (September 12, 1972).

[19] See Securities Exchange Act Release Nos. 9760 and 9761 (September 12, 1972).

[20] Securities Exchange Act Release No. 9658.

[21] Securities Exchange Act Release No. 9865 (November 17, 1972).

[22] Securities Exchange Act Release No. 9908 (December 14, 1972).

[23] The Act does not specifically refer to members of the NASD but to broker-dealers which are not members of a registered "national securities association." The NASD however, is the only such association.

[24] Nonmember broker-dealers must file a prescribed form (SECO-2) with the Commission for each associated person.

[25] Securities Exchange Act Release No. 9883.

[26] 38th Annual Report, pp. 10-11.

[27] Securities Exchange Act Release No. 10125 (April 25, 1973), 1 SEC Docket No. 13, p. 6.

[28] C.A. 2, No. 73-1377 (April 11, 1973).

[29] 15 U.S.C. 78aaa, *et seq*.

PART 4

ENFORCEMENT

The Commission's enforcement activities, designed to combat securities fraud and other misconduct continued at a high level during the past year. These activities encompass civil and criminal court actions as well as administrative proceedings conducted internally. Where violations of the securities laws or rules are established, the sanctions which may result range from censure by the Commission to prison sentences imposed by a court. The enforcement program is designed to achieve as broad a regulatory impact as possible within the framework of resources available to the Commission. In light of the capability of self-regulatory and state and local agencies to deal effectively with certain securities violations, the Commission seeks to promote effective coordination and cooperation between its own enforcement activities and those of the other agencies.

DETECTION

Complaints

The Commission receives a large volume of communications from the public. These consist mainly of complaints against broker-dealers and other members of the securities community. During the past year, some 5,000 complaints against broker-dealers were received, analyzed and answered. Most of the above-mentioned complaints dealt with operational problems, such as the failure to deliver securities or funds promptly, or the alleged mishandling of accounts. In addition, there were some 4,000 complaints received concerning investment advisers, issuers, banks, transfer agents and mutual funds.

The Commission seeks to assist persons in resolving complaints and to furnish requested information. Thousands of investor complaints are resolved through staff inquiry to firms involved. While the Commission does not have authority to arbitrate private disputes between brokerage firms and investors or to directly assist investors in the legal assertion of their personal rights, a complaint may lead to

the institution of an investigation or an enforcement proceeding, or it may be referred to a self-regulatory or local enforcement agency.

Market Surveillance

To enable the Commission to carry out surveillance of the securities markets, its staff has devised procedures to identify possible manipulative activities. These include surveillance of listed securities, coordinated with the stock watching operations of the New York, American and regional stock exchanges.

The Commission's market surveillance staff maintains a continuous watch of transactions on the New York and American Stock Exchanges and reviews reports of large block transactions to detect any unusual price and volume variations. The financial news tickers, financial publications and statistical services are closely followed. Also, the staff has supplemented its regular reviews of daily and periodic stock watch reports of exchanges with a program for review of special surveillance reports providing a more timely analysis of the information developed by the exchanges.

For those securities traded by means of the NASD's NASDAQ system, the Commission has also developed a surveillance program, which is coordinated with the NASD's market surveillance staff, through a review of weekly and special stock watch reports. For those over-the-counter securities not traded through NASDAQ, the Commission uses automated equipment to provide more efficient and comprehensive surveillance of stock quotations distributed by the National Quotation Bureau. This is programmed to identify, among other things, unlisted securities whose price movement or dealer interest varies beyond specified limits in a pre-established time period. When a security is so identified, the equipment prints out current and historic market information. In addition, the Commission developed further programs this year which supplement this data by including sales of securities pursuant to Rule 144 under the Securities Act, ownership reports, and periodic company filings Such as quarterly and annual reports. This data, combined with other

available Information, is analyzed for possible further inquiry and enforcement action.

The staff also oversees cash tender offers, exchange offers, proxy contests and other activities involving efforts to change control of public corporations. Such oversight involves not only review of trading markets in the securities involved, but also filings with the Commission of required schedules, prospectuses, proxy material and other materials.

INVESTIGATIONS

Each of the acts administered by the Commission authorizes investigations to determine if violations have occurred.

Most are conducted by the Commission's regional offices. Investigations are carried out on a confidential basis, consistent with effective law enforcement and the need to protect persons against whom unfounded charges might be made. Thus, the existence or findings of a nonpublic investigation are generally not divulged unless they are made a matter of public record in proceedings brought before the Commission or in the courts. During fiscal year 1973, a total of 472 investigations were opened, as against 374 the preceding year.

Litigation

In *S.E.C. v. Brigadoon Scotch Distributing Co.*[1] the Commission had commenced a formal investigation to determine whether certain persons were violating registration and antifraud provisions of the Securities Act and the Exchange Act in connection with sales of whiskey warehouse receipts. In the course of the investigation, subpoenas were issued to three companies calling for documents from which it could be determined whether those provisions had been violated. After the companies declined to respond to the subpoenas, the Commission commenced a subpoena enforcement action against

them in the United States District Court for the Southern District of New York.

The district court enforced so much of the subpoenas as it thought would enable the Commission to make a determination whether the companies' products were "securities" within the purview of the Federal securities laws but refused to enforce the subpoenas any further without a showing that the products in fact constituted securities. In addition, the district court imposed a requirement on the Commission that it give to each subpoenaed person a statement prepared by the court describing the nature and scope of the investigation and the position asserted by each of the subpoenaed companies.

On cross-appeals by the Commission and the subpoenaed companies, the Court of Appeals for the Second Circuit, consistent with its decision in *S.E.C. v. Wall Street Transcript Corp.*,[2] held that since the subpoenas called for documents relevant to a properly authorized Commission investigation, the Commission need not demonstrate facts showing either the probability of coverage or the likelihood of violation of the statutes to secure their enforcement. The court further held that absent "evidence of abuse" by the Commission, it was entitled to conduct a full inquiry into both potential coverage and potential violation of the Federal securities laws. The court did state that the Commission was not at liberty to act unreasonably and that in appropriate circumstances a court could inquire into the reasons for an investigation and into its effects, but the burden of showing that an agency subpoena was unreasonable "remains with the respondent" and "is not easily met." Finally, the court agreed with the Commission that the district court's requirement that a statement be made to each witness was unjustified.

ENFORCEMENT PROCEEDINGS

The Commission has available a wide range of possible enforcement actions. It may in appropriate cases refer its files to the Department of Justice with a recommendation for criminal prosecution. The

penalties upon conviction are specified in the various statutes and include imprisonment for substantial terms and fines.

The securities laws also authorize the Commission to file injunctive actions in the Federal district courts to enjoin continued or threatened violations of those laws or applicable Commission rules. In injunctive actions the Commission has frequently sought to obtain ancillary relief under the general equity powers of the Federal district courts. The power of the Federal courts to grant such relief has been judicially recognized.[3] The Commission has often requested the court to appoint a receiver for a broker-dealer or other business where investors were likely to be harmed by continuance of the existing management. It has also requested, among other things, court orders restricting future activities of the defendants, requiring that rescission be offered to securities purchasers, or requiring disgorgement of the defendants' ill-gotten gains.

The SEC's primary function is to protect the public from fraudulent and other unlawful practices and not to obtain damages for injured individuals. Thus, a request that disgorgement be required is predicated on the need to deprive defendants of profits derived from their unlawful conduct and to protect the public by deterring such conduct by others.

If the terms of any injunctive decree are violated, the Commission may file criminal contempt proceedings, as a result of which the violator may be fined or imprisoned.

The Federal securities acts also authorize the Commission to impose remedial administrative sanctions. Most commonly, administrative enforcement proceedings involve alleged violations of the securities acts or regulations by firms or persons engaged in the securities business, although the Commission's jurisdiction extends to all persons. Generally speaking, if the Commission finds that a respondent willfully violated a provision of or rule under the securities acts, failed reasonably to supervise another person who committed a violation, or has been convicted for or enjoined from certain types of misconduct, and that a sanction is in the public interest, it may revoke

or suspend the registration of a broker-dealer or investment adviser, bar or suspend any person from the securities business or from association with an investment company, or censure a firm or individual. Proceedings may also cover adequacy of disclosure in a registration statement or in reports filed with the Commission. Such cases may lead to an order suspending the effectiveness of a registration statement or directing compliance with reporting requirements. The Commission also has the power to suspend trading in a security summarily when the public interest requires.

Proceedings are frequently completed without hearings where respondents waive their right to a hearing and submit settlement offers consenting to remedial action which the Commission accepts as an appropriate disposition of the proceedings. The Commission tries to gear its sanctions in both contested and settlement cases to the circumstances of the case. For example, it may limit the sanction to a particular branch office of a broker-dealer rather than sanction the entire firm, prohibit only certain kinds of activity by the broker-dealer during a period of suspension or only prohibit an individual from engaging in supervisory activities.

ADMINISTRATIVE PROCEEDINGS

Summarized below are some of the many administrative proceedings pending or disposed of in fiscal 1973.

Disciplinary Proceedings

Continental Investment Corporation. – During the fiscal year, proceedings were instituted against Continental, two broker-dealer subsidiaries, Waddell & Reed Inc. and Kansas City Securities Corporation (KCSC), and The First National Bank of Boston. Waddell & Reed is investment adviser and principal underwriter for the United Funds complex, a group of registered investment companies with net assets in excess of $2.5 billion.

The Continental respondents were charged by the Commission's staff with abuse of their fiduciary duty in that they effected Fund portfolio transactions principally for their own benefit, rather than for the benefit of the Funds and their shareholders. Among other things, it was alleged that portfolio transactions were effected through KCSC although its services were not needed, and that Continental and Waddell, together with First National, improperly used Fund custodian accounts and the balances therein to provide compensating balances for a loan to Continental. The loan, originally for about $82.5 million, was used by Continental to purchase Waddell. As part of this course of conduct, the respondents were charged with causing United Science Fund to enter into a custodian contract with First National on a basis less favorable than that enjoyed by the bank's other custodial clients.

On June 13, 1973, the Commission issued an order censuring First National pursuant to an offer of settlement.[4] First National renegotiated its fee structure with United Science Fund and recomputed its fees, thereby effecting a repayment of approximately $117,000 to the fund.

Butcher and Sherrerd.[5] – This firm, a broker-dealer and investment adviser, and six partners submitted a settlement offer consenting to certain findings without admitting staff allegations against them. The Commission found, pursuant to the offer, that the respondents violated anti-fraud provisions of the securities laws in connection with their activities and transactions with respect to the common stock of Penn Central Company. For a 10-year period, the firm induced customers to purchase Penn Central stock on the basis of the firm's investment judgment. Then the firm changed its recommendation so as to advise sale of the stock instead of purchase, but the change was communicated only on a selected basis to certain preferred customers, and not to others who still held shares of the stock which they had purchased on the firm's recommendation. Pursuant to the offer, the Commission suspended the retail sales department of the firm for 10 business days and suspended the firm's partners for varying periods from association with any broker-dealer, investment adviser or investment company. In addition, the firm established a

$350,000 escrow fund for customers in order to ameliorate their losses on Penn Central transactions.

During the past fiscal year, the Commission stepped up its enforcement activities with respect to the improper use of inside information. During that time, seven proceedings were instituted against approximately 50 tippers and tippees. As the Commission noted in the Faberge case, discussed below, "few practices,

short of manipulation, have as deleterious an effect on the investing public's confidence in corporate institutions and the securities markets as the selective disclosure of and misuse of inside information."[6]

In connection with trading in Faberge stock, the Commission ordered administrative proceedings against three broker-dealers and a bank based on staff charges that the broker-dealers conveyed adverse inside information concerning the sales and earnings of Faberge, Inc., for its third quarter ended September 30, 1970, to certain select customers, and recommended the sale of Faberge securities while in possession of such information. The brokers, according to the charges, received the information from a Faberge vice president,[7] and the bank, from a broker-dealer. The Commission announced at the same time that it had accepted waivers of the formal institution of administrative proceedings, and consents to certain findings and conclusions, from two other broker-dealers and three firms operating as investment advisers of investment companies, in connection with misuse of the same inside information. Based on the waivers and consents, the Commission found that the conduct of the five firms violated antifraud provisions of the Exchange Act and was censurable.

In its opinion accepting the waivers and consents,[8] the Commission stated that proper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group. To hold otherwise, the Commission asserted, would

be to sanction competition for tips in which the ordinary individual investor would inevitably be at a serious disadvantage.

The Commission emphasized the importance and necessity of broker-dealers, investment advisers, and institutional investors, as well as issuers, instituting and implementing effective procedures calculated to deter and detect the misuse of inside information. The opinion included a discussion of some elements of an effective compliance program, including the training and education of employees and an ongoing review of trading to spot trading concentrations by employees.

Disqualification of Accountants and Attorneys

Laventhol, Krekstein, Horwath & Horwath[9]– The Commission accepted an offer of settlement from the accounting firm of Laventhol, Krekstein, Horwath & Horwath in an administrative proceeding instituted pursuant to Rule 2 (e) of the Commission's Rules of Practice with respect to Laventhol's qualifications to appear and practice before it. A permanent injunction against the firm had been entered, with its consent and without its admitting or denying the allegations of the complaint, in a Commission action which alleged that Laventhol was involved in the preparation and dissemination of false and misleading certified financial statements and other financial information of Takara Partners, a limited partnership engaged in investment activities. The complaint in that action further alleged that Laventhol was not independent or qualified to certify Takara's financial statements because partners or employees of the branch office working on the Takara audit received approximately $17,000 in payments from the general partners of Takara in the guise of profits from participating in the purchase and sale of "hot issues." Pursuant to its offer, Laventhol was ordered to permit an investigation, within a specified period, to ascertain whether its professional practice is being conducted in compliance with the standards and procedures which the injunctive decree required it to adopt and maintain. The Commission's order also placed restrictions, for specified periods, on mergers and acquisitions by the firm and on its acceptance of certain new professional engagements.

Stuart Schiffman.[10] – Stuart Schiffman, a lawyer, was permanently suspended from practice before the Commission under Rule 2 (e) (3) of the Commission's Rules of Practice. The order of suspension was based upon an injunction against violations of the registration and anti-fraud provisions of the securities acts that had been entered against Schiffman in December 1972,[11] and upon findings by the Commission in an administrative proceeding that Schiffman willfully violated and willfully aided and abetted violations of antifraud, net capital, record-keeping and reporting provisions of those acts.[12] In the Rule 2 (e) proceeding, Schiffman did not petition the Commission to lift the temporary suspension it had ordered, and the suspension therefore became permanent by operation of Rule

Emanuel Fields.[18] – The Commission entered an order pursuant to Rule 2 (e) (3) of the Commission's Rules of Practice summarily suspending Fields, a lawyer, from appearing or practicing before it. The order was based upon the entry of a judgment in *SEC v. Emanuel Fields, et al.*,[14] permanently enjoining Fields from violating the registration and antifraud provisions of the Federal securities laws. Pursuant to Rule 2 (e) (3), Fields petitioned the Commission to lift the temporary suspension. The Commission denied the petition and, as required by the rule, set the matter down for hearing to determine what ultimate sanction, if .any, should be imposed. Fields then waived an evidentiary hearing, and, after briefing and oral argument, the Commission issued an order permanently disqualifying him from appearing or practicing before it. The Commission rejected Fields' contention that his summary suspension violated due process. It stated that summary action was appropriate when predicated on previous findings of serious misconduct.[15]

Reports

Great Southwest Corporation.[16] – In a detailed opinion, the Commission directed Great Southwest to file amended financial statements on Form 10-K for the years 1968 and 1969 in order to exclude profits on certain transactions and eliminate related sales and cost of sales. The company's annual reports, filed pursuant to

Exchange Act requirements, treated certain real estate transactions, involving amusement parks in Texas and Georgia and raw land in California, as sales, and recorded profits.

The Commission found that although the transactions may have met the formal legal requirements for a sale, the corporation retained control over management of the properties and substantially all risk of loss and opportunity for gain. Accordingly, the Commission concluded that the method of accounting employed by the corporation did not reflect the economic realities of the transactions at issue.

Trading Suspensions

The Securities Exchange Act authorizes the Commission summarily to suspend trading in a security traded on either a national securities exchange or in the over-the-counter market for a period of up to 10 days if, in the Commission's opinion, it is required in the public interest.

During fiscal 1973, the Commission suspended trading in the securities of 174 companies, an increase of about 270 percent over the 47 securities suspended in fiscal 1972. In most instances, this action was taken either because of substantial questions as to the adequacy, accuracy or availability of public information concerning the companies' financial condition or business operations or because of transactions in the companies' securities suggesting possible manipulation or other violations. Although trading suspensions are frequently a prelude to other enforcement action, the Commission during 1973 began temporarily suspending trading in the securities of issuers who were delinquent in filing required reports with the Commission.[17] This was done in order to alert the public to the lack of adequate, accurate and current information concerning such issuers. Of the 174 suspensions initiated by the Commission this year, 95 were instituted for that reason. For example, trading in Met Sports Centers, Inc. was suspended in February 1973 for failure to file 10-K Annual Reports for 1970, 1971, and 1972, 10-Q quarterly reports for 1971 and 1972, and a 9-K report for the 6 months ending March

1970.18 The following examples illustrate circumstances under which the Commission may suspend trading.

On March 28, 1973, the Commission suspended exchange and over-the-counter trading in all securities of Equity Funding Corporation of America, listed on the New York Stock Exchange, because rumors concerning the financial condition and operations of the company were circulating in the investment community.[19] The suspension was also ordered because of an increased volume of trading and a dramatic decline in the prices of Equity's securities.

In April 1973, at the request of Giant Stores Corp., the Commission suspended trading in the company's securities, listed on the American Stock Exchange, because of the unavailability of adequate and accurate financial information concerning the company and indications of possible record-keeping irregularities in connection with the preparation of its financial statements.[20] Subsequently, several members of the company's management resigned, and the company's independent auditors withdrew their opinion on company financial statements because of certain irregularities in connection with the accounts of the company and its subsidiaries.

Trading in the securities of Marcon Electronics Corporation was suspended in January 1973, at a time when five broker-dealers were making a market in the stock of the company, because it had been adjudicated bankrupt in 1969 and had no stockholder equity remaining, its assets having been sold and the proceeds distributed to creditors.[21] Additionally, the company had no offices, no transfer agent, and the Secretary of State of New Jersey had declared it a "voided corporation" because of its failure to pay taxes.

On Decembers, 1972, the Commission suspended trading in the securities of U.S. Financial, Inc., listed on the New York Stock Exchange.[22] The suspension was initiated because of the lack of accurate and reliable information concerning the company's financial condition. The company's independent auditor had withdrawn its certification of the company's 1971 annual report, and the company had announced that it intended to re-audit its 1971 financial

statements and conduct a special audit with respect to financial reports contained in 1972 filings.

On June 5, 1973, the Commission suspended trading in the securities of Coastal States Gas Corp., listed on the New York Stock Exchange, because of rumors concerning the company's gas reserves and its ability to meet contractual commitments, and the impact of such rumors on the market for Coastal securities.[23]

CIVIL PROCEEDINGS

During fiscal 1973, the Commission instituted a total of 178 injunctive actions. Some of the more noteworthy of these injunctive proceedings and significant developments in actions instituted in earlier years are reported below.

Coordination between self-regulatory bodies and the Division of Enforcement resulted in several enforcement actions, as well as investigations. Among the more important actions was an injunctive suit, *S.E.C. v. Eisenberger, et al.*[24] resulting from a joint effort by the Commission and the American Stock Exchange. Eisenberger, an unregistered investment adviser, had purchased stock of Vetco Offshore Industries, Inc. and call options on the stock for his own account, for a limited partnership of which he was the general partner, and for accounts maintained with a European investment adviser which had given him discretionary authority to invest funds in the accounts. Through such purchases of stock and call options, control was acquired over approximately 27 percent of Vetco's outstanding stock. The Commission charged that Eisenberger, the limited partnership, and the foreign investment adviser constituted a "group" within the meaning of Section 13 (d) (3) of the Exchange Act (The Williams Act) and had failed to file the required Schedule 13D with the Commission disclosing ownership interests and other information. Consent injunctions were obtained from Eisenberger and the limited partnership, as well as from the European investment adviser which had not been named a party to the litigation. Pursuant thereto, a statement on Schedule 13D was filed with the Commission

reflecting the dates and amounts of purchases and sales of the Vetco shares and options, the manner in which certain of the option transactions were effected, and the effect such transactions may have had on transactions in underlying Vetco common stock on the American Stock Exchange.

As a further result of cooperation with self-regulatory bodies, an investigation was begun into the improper disclosure of inside information concerning the earnings decline of Liggett & Myers, Inc. in the second quarter of 1972. The Commission charged, in a complaint filed on June 25, 1973, that Liggett & Myers and an assistant vice president of the company violated antifraud provisions by disseminating undisclosed material inside information concerning the earnings decline to certain preferred individuals.[25] The case is still pending.

SEC v. Shapiro.[26] – In this injunctive action, the district court permanently enjoined two partners of a firm specializing in corporate mergers and acquisitions from further violations of Rule 10b-5 under the Exchange Act, and ordered them to disgorge to a court-appointed trustee the profits derived from their unlawful purchases of stock of Harvey's Stores, Inc., a publicly held corporation listed on the American Stock Exchange. The court held that these defendants had violated the rule by purchasing stock without disclosing to the sellers material nonpublic information concerning a proposed merger which they had acquired as a result of their positions as finders and through friendship with corporate officials of the prospective merger partners. The court further held that the defendants were also subject to liability for "tipping" inside information concerning the proposed merger to others in order that the "tippees" might benefit Prior to the court's decision all other defendants in the action, including tippees of parties privy to the merger negotiations, consented to the entry of final judgments of permanent injunction and orders of disgorgement.

In rejecting the defendants' contention that they did not have to make disclosure since the possibility of merger was remote and the information was therefore not material, the court found that at the time of the defendants' first purchases the proposed merger was a

"viable possibility" which became "even more distinct" during the period encompassing their subsequent purchases. Following the standard for materiality enunciated in *S.E.C. v. Texas Gulf Sulphur Co.*,[27] the court considered the defendants' own trading activities as the most convincing factor illustrating the materiality of the information, noting that there existed "very significant juxtapositions between the timing of the defendants' purchases and critical events in the negotiations" and that "the pace and quantity of defendants' purchases increased as developments grew more promising for an eventual merger." The court also held that injunctive relief was particularly appropriate in view of the fact that the defendants' repeated and persistent violations arose out of their activities as corporate "marriage brokers" and there was no indication that they planned to change professions or cease their business activities. At fiscal year-end, appeals taken by these defendants were pending.

S.E.C. v. Bausch & Lomb, Inc., et al.[28] – In another action alleging the improper disclosure and use of inside information, the Commission filed an injunctive complaint against Bausch & Lomb, its chief executive officer, and nine other defendants. The information in question related to the company's disappointing sales and earnings from its soft contact lens. The complaint alleges, among other things, that one of the tippees, a brokerage firm securities analyst, withdrew his "buy" recommendation shortly after receiving the adverse inside information during the course of an interview with Bausch & Lomb's chief executive officer, and that, after receipt of the information, the head securities trader at the brokerage firm sold 2,300 shares of Bausch & Lomb common stock held in his and 13 family-related accounts. It is further alleged that an investment adviser and an investment manager caused the sale of 72,000 and 3,000 shares, respectively, of Bausch & Lomb stock after receipt of the information.

S.E.C. v. Lum's, Inc. et al.[29] – Investors Diversified Services, Inc. (IDS), a defendant in another Commission suit involving inside information, consented, without admitting or denying the allegations of the complaint, to a permanent injunction which among other things, required the firm to implement the Statement of Policy described below.[30] The Commission's complaint had alleged the improper use

of adverse inside information in connection with the sale of IDS's position of 83,000 shares of Lum's common stock. The Statement of Policy requires an IDS employee who receives "material information about a company which he knows or has reason to believe is directly or indirectly attributable to such company (or its insiders), [to] determine that the information is public" before utilizing it. If the employee has any doubt at all as to whether the information has been made public, he must consult with IDS' in-house counsel.

S.E.C. v. J. C. Bradford & Company, et al.[31] – On November 10, 1972, the Commission, in another action in this area, filed an injunctive complaint against J. C. Bradford & Co., a New York Stock Exchange member firm, two of its' officers, and two Bradford subsidiaries including Life Stock Research Corporation, a registered investment adviser. The action sought an injunction for alleged violations of antifraud provisions, and disgorgement of defendants' profits for allegedly trading in securities of The Old Line Life Insurance Company of America while in possession of material non-public information. That information concerned another corporation's interest in acquiring Old Line by offering a share for share exchange of stock that would have nearly doubled the value of Old Line shares. The defendants, without admitting or denying the allegations of the complaint, consented to entry of an injunction and agreed to set up a fund of more than $100,000 to provide for payment of claims arising out of their trading in Old Line stock. As part of the settlement, the defendants also consented to the imposition of administrative sanctions.[32]

S.E.C. v. Bangor Punta Corporation. – This was an appeal from a district court order denying injunctive relief in a Commission action alleging violations of the antifraud provisions of the Securities Act and the Exchange Act in connection with a contest between Bangor Punta Corporation and Chris-Craft Industries, Inc. for control of Piper Aircraft Corporation. On May 29, 1969, Bangor filed with the Commission a registration statement and prospectus for an offering of its securities in exchange for Piper stock, in which it was not disclosed that the Bangor and Aroostook Railroad, owned by Bangor and carried on its books at $18,400,000, was being negotiated for

sale at between $5 and $7 million.[33] The district court found that the sale of the railroad was not delayed, as the Commission had charged, to avoid an adverse effect on the tender offer, but that the registration statement was misleading in omitting to disclose the negotiations to sell the railroad at a greatly reduced value. The district court directed Bangor to make a restricted offer of rescission to Piper shareholders who had accepted the Bangor exchange offer, but denied injunctive relief sought by the Commission to restrain Bangor from future violations of the securities laws.[34] On appeal, a divided panel of the Court of Appeals for the Second Circuit affirmed (2 to 1) the district court's denial of injunctive relief. The court of appeals, however, found that the failure to disclose "clearly was unreasonable" and demonstrated "reckless disregard" so that the refusal of the district court to award damages in the related private action was erroneous.[35] In addition, the court of appeals affirmed the order requiring Bangor to offer rescission, and, as urged by the Commission, concluded that a condition imposed on the offer by the district court was inappropriate. On May 8, 1973, the court of appeals denied the Commission's motion for rehearing and suggestion for rehearing en bane, three judges dissenting. On August 15, 1973, the Commission filed a petition with the United States Supreme Court for a writ of certiorari to overturn the court of appeals affirmance of the denial of injunctive relief.

The Court of Appeals for the Ninth Circuit in *Securities and Exchange Commission v. United Financial Group, Inc.*,[36] affirmed the district court's conclusion that it had jurisdiction under the Securities Act and the Exchange Act over the activities of the defendant offshore mutual funds, although there had been only a few sales by those funds to American investors. The court stated that the proper focus should be upon the activities of the defendants in this country and the impact of those activities on American investors, that the Federal securities laws should be broadly construed to promote their remedial purposes and, that the "jurisdictional hook need not be large to fish for securities laws violations."

The court also construed Section 30 (b) of the Exchange Act which provides that the Act does not apply to any person "insofar as he

transacts a business in securities without the jurisdiction of the United States," unless in contravention of Commission rules adopted to prevent evasion of the Act. The court held the section inapplicable, stating that the "jurisdiction of the United States" does not mean territorial limits. Moreover, offers and sales were made by defendants to United States citizens, and defendants carried on substantial activities in the United States in order to facilitate the sale of securities abroad.

In *S.E.C. v. Computer Statistics, Inc.*,[37] the United States Court of Appeals for the District of Columbia Circuit affirmed, in a per curiam order, the district court's entry of summary judgment in the Commission's favor requiring the defendant to file timely and proper periodic reports.[38] It also affirmed the lower court's denial of defendant's motion to dismiss for improper venue or, in the alternative, to transfer venue to the Northern District of Texas where the defendant had its principal place of business. The court of appeals rejected the contention that summary judgment should not have been granted because there was an issue of fact as to whether a reasonable likelihood of future violations existed in light of the defendant's assertion that it would attempt to comply with reporting requirements in the future.

S.E.C. v. Allegheny Beverage Corporation.[39] – In May 1973, the Commission instituted an injunctive action against Allegheny and 24 other defendants alleging violations of reporting, antifraud, and registration provisions of the securities acts. In addition to Allegheny, the defendants include Value Vend Credit Corporation (VVCC) (an Allegheny subsidiary), four Allegheny officers, the company's auditors, the underwriter of a VVCC public offering, counsel for the underwriter, counsel for VVCC, and the escrow agent for the public offering, Suburban Trust Company.

The complaint alleges that various Allegheny financial reports disseminated to the public and filed with the Commission in 1971 and 1972 were materially false and misleading. The reports allegedly included income from improperly reported sales and materially understated certain expenses. Another portion of the complaint

relates to a 1971 public offering of $25 million of VVCC debentures. The prospectus stated that $10 million of such debentures had to be sold and paid for within a specified period or all money received from subscribers, to be maintained in a special account at Suburban, would be returned. It is alleged that VVCC was able to sell only $500,000 of the debentures but entered into fraudulent arrangements, aided by certain of the defendants, to make it appear that $10 million had been sold.

S.E.C. v. Frigitemp Corp.[40] – In March 1973, the Commission filed an injunctive complaint against Frigitemp and four other defendants alleging violations of the registration and antifraud provisions of the Federal securities laws. Thereafter, the defendants, without admitting or denying the allegations, consented to entry of a permanent injunction and certain ancillary relief sought by the Commission.

The Commission had alleged that the defendants filed false and misleading registration statements, offered and sold unregistered Frigitemp securities, manipulated the market for Frigitemp stock, and engaged in a fraudulent scheme involving cash payments to induce the awarding of contracts to Frigitemp. As requested by the Commission, the four individual defendants agreed to pay the company $185,000, approximating the monies paid by Frigitemp to induce the awarding of contracts. The defendants also agreed to implement a plan under which independent directors would supervise Frigitemp's operations for a specified period.

S.E.C. v. General Host Corporation, et al.[41] – In connection with its surveillance of corporate takeover attempts, the Commission filed an injunctive action against General Host and nine other defendants charging a fraudulent scheme to acquire control of Armour and Company. In addition, the suit alleged violations in connection with General Host's efforts to dispose of its Armour holdings to Greyhound Corporation and further violations in connection with General Host's acquisition, through merger, of Li'l General Stores, Inc. The Commission obtained a consent injunction against Kleiner, Bell & Co., Inc., one of the dealer-managers of General Host's exchange

offer for Armour.[42] The case is still pending with respect to the remaining defendants.

In *S.E.C. v. M. A. Lundy Associates*[43] the United States District Court for the District of Rhode Island preliminarily enjoined further violations of the registration and antifraud provisions of the securities laws in connection with the offer and sale of scotch whiskey warehouse receipts and certificates of beneficial interest in certain trusts. It held, in accordance with the Commission's views, that the warehouse receipts offered by some of the defendants were securities, noting that "the success of most, if not all, of the investors in said scotch whiskey warehouse receipts is dependent on the advice of the brokers thereof." The district court also rejected the defendants' contention that the certificates of beneficial interest in the trusts were exempt from the registration requirements of the Securities Act by virtue of Section 3 (a) (3)[44] which relates to various forms of short term commercial paper, holding that the certificates could not be considered to be within the class of prime quality negotiable commercial paper not normally available for purchase by the general public which Congress intended to be covered by the exemption.[45]

During the past fiscal year, the Commission sought injunctive relief against three so-called pyramid promotion schemes. In all three cases, the promoters purported to offer franchises for the retail sale of goods or services. In *S.E.C. v. Glenn W. Turner Enterprises, Inc*.[46] the defendants purported to offer "distributorships" for the sale of tape recorded self-improvement courses through Dare to Be Great, Inc., a subsidiary of Turner Enterprises. The overwhelming emphasis of defendants' promotion, however, was upon the financial rewards that an investor might obtain by sharing with the promoters in the profits to be derived from the recruitment of other investors into the scheme. The new recruits could, in turn, obtain a similar profit from the recruitment of still other investors. The United States District Court for the District of Oregon found, as the Commission urged, that the scheme depended for its success upon high-pressure, deceptive sales tactics featuring emotionally charged gatherings of investors and prospective investors orchestrated by defendants. As requested by the Commission, the court held that the interests offered and sold

were securities within the Securities Act's descriptive terms "investment contract," "certificate of interest or participation in any profit-sharing agreement," and "any interest or instrument commonly known as a 'security.'" The district court observed that "the subjection of the investor's money to the risk of an enterprise over which he exercises no managerial control is the basic economic reality of a securities transaction."[47] It preliminarily enjoined defendants from offering or selling such securities absent compliance with the registration provisions of the Securities Act and all other applicable provisions of the federal securities laws.

The United States Court of Appeals for the Ninth Circuit affirmed, holding the interests sold to be "investment contracts" and hence "securities." It applied the test for an "investment contract" contained in *S.E.C. v. W. J. Howey Co.*,[48] – "an investment of money in a common enterprise with profits to come solely from the efforts of others." Although it was necessary for investors to perform some recruitment functions, the court of appeals concluded that the "efforts" which Howey requires to be made by persons other than the investor are "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[49] Defendants have petitioned the Supreme Court for a writ of certiorari to which the Commission has filed a memorandum in opposition.

In *S.E.C. v. Koscot Interplanetary, Inc.*,[50] the Commission sought to enjoin the fraudulent offer and sale of unregistered interests in a substantially identical pyramid promotion scheme run by Koscot Interplanetary, Inc., another subsidiary of Turner Enterprises. Contrary to the conclusion reached by the Court of Appeals for the Ninth Circuit in Turner Enterprises, however, the United States District Court for the Northern District of Georgia held that the interests offered and sold by Koscot were not securities within the statutory definitions. Accordingly, the court granted defendants' motion to dismiss for failure to state a claim upon which relief could be granted. The Commission's appeal of this decision is now pending before the United States Court of Appeals for the Fifth Circuit.[51]

The third pyramid case, *S.E.C. v. Holiday Magic, Inc. et al*.[52] involves a substantially similar but unrelated promotion. The action is now pending in the United States District Court for the Northern District of California where the Commission has requested an injunction against future violations of the registration and antifraud provisions, as well as an accounting and disgorgement of profits and the appointment of a receiver for the assets of the company.

S.E.C. v. Datronics Engineers, Inc.[53] – The United States Court of Appeals for the Fourth Circuit held, contrary to the decision of the district court, that spin-off distributions by Datronics to its shareholders of stock of nine non-public companies involved the "sale" of unregistered securities and therefore violated the registration provisions of the Securities Act. Agreeing with the decision in *S.E.C. v. Harwyn Industries Corp.*,[54] the court concluded that the spin-off distributions – which were effected solely to create trading markets in the spun-off stocks – were "dispositions of a security ... for value" and thus "sales" within the meaning of Section 2 (3) of the Act. The court found that "value" accrued to Datronics and to its officers and agents in that the creation of trading markets gave added value both to the spun-off stock retained by Datronics and to the stock received by its officers and agents as compensation for legal and other services rendered to the spin-off companies.

The court further ruled that the spin-offs were not exempt as transactions by a person other than an issuer, underwriter or dealer under Section 4 (1) of the Securities Act, since Datronics was "actually an issuer, or at least a co-issuer." Datronics was also found by the court to be an underwriter within the meaning of Section 2 (11) of the Act in that it purchased stock from the spin-off companies with a view to the distribution of the stock to Datronics shareholders.

Having determined that the spin-off distributions were sales, the court further held that the defendants violated the anti-fraud provisions of the Exchange Act by disseminating false and misleading information in connection with the spin-offs. The court also found that the nature and extent of the violations, including the number and magnitude of the unregistered distributions, warranted the grant of an injunction to

prevent recurrences, and accordingly directed that a preliminary injunction be entered.

In two enforcement actions, *S.E.C. v. Continental Commodities Corporation, et al*.[55] and *S.E.C. v. Goldstein, Samuelson, Inc., et al*.[56] the Commission urged that schemes which in form purported to involve the offer and sale of options on commodity futures involved, in substance, the offer and sale of "securities" within the meaning of the Federal securities laws. In both cases the promoters undertook to pay a sum of money to investors contingent upon favorable market price movements of certain unregulated commodities. The Commission alleged in each case, however, that neither the "option" acquired nor the payment made by an investor had any necessary relationship to any commodities futures or actual commodities to be bought, sold, accepted or delivered by the defendants. Accordingly, the contributed capital of all investors, which was subjected to the risks of the promoters' corporate enterprise, could be devoted to any purpose unrelated to commodities that the promoters might choose; and whether the promised payment could be made to investors depended upon the success of the promoters' management of the enterprise to which the investors' funds had been committed. Consistent with these facts it was alleged that the interests offered and sold were "investment contract[s]," "evidence[s] of indebtedness" and interests or instruments "commonly known as a security."

On March 21, 1973, the district court in the *Continental* case appointed a temporary receiver for the company's assets at the request of the Commission. Thereafter, however, the court denied the Commission's motion for a preliminary injunction on the ground that neither the interests sold in the form of purported commodity options nor the promissory notes that were issued to investors in lieu of payments due them were securities within the statutory definitions. The Commission has appealed the ruling on the promissory notes to the United States Court of Appeals for the Fifth Circuit. The temporary receivership remains in effect pending appeal.

The *Goldstein* case is still pending in the district court.

S.E.C. v. Geo Tek Resources Fund, Inc.[57] – In May 1973, the Commission brought suit seeking the appointment of a receiver for Geo Tek and an injunction restraining the company and 25 other defendants from violating registration, antifraud and reporting provisions of the securities acts. According to the complaint, from January, 1964 through January, 1972, the defendants obtained about $30 million in violation of the securities acts from more than 2,000 public investors in various oil and gas programs. The Commission alleged that the defendants (1) sold unregistered securities and certain of them misappropriated the proceeds, (2) disseminated to investors and prospective investors materially false and misleading prospectuses, reports and offering circulars; and (3) filed with the Commission materially false and misleading information as to (a) the financial condition and business operations of various oil and gas programs, and (b) transactions involving certain officers, directors, employees and affiliates of the programs.

S.E.C. v. Florida East Coast Railway Company.[58] – In January 1973, the Commission instituted an injunctive proceeding against the railroad and three other defendants alleging violations of the reporting, proxy and antifraud provisions of the securities acts.

The Commission charged that the railroad filed a false and misleading proxy statement with the Commission in February, 1972 pertaining to a proposed increase in its authorized capital stock and an exchange of that stock for its outstanding First Mortgage Bonds. The complaint also charged the Alfred I. duPont Testamentary Trust, one of the defendants, with purchasing the bonds while in possession of material non-public information concerning the proposed exchange offer, and the railroad, with purchasing its Second Mortgage Bonds in the open market while in possession of material non-public information concerning their retirement. The Commission sought a permanent injunction and certain ancillary relief.

In May 1973, the railroad disseminated to stockholders new proxy soliciting material in connection with obtaining a new shareholder vote on the exchange offer. The Commission filed a motion for a preliminary injunction and a temporary restraining order to prevent

the holding of a scheduled stockholders' meeting and a vote on the matters raised in the proxy materials, which the Commission alleged were materially false and misleading. The court denied the motion for a temporary restraining order and consolidated for trial the motion for a preliminary injunction and the action seeking a permanent injunction.

In October 1972, the Commission filed two complaints in the United States District Court for the Western District of Tennessee seeking to enjoin a total of 7 municipal bond dealers, not registered with the Commission, and 23 individual defendants from violations of antifraud provisions of the Federal securities laws. In one case, *S.E.C. v. Investors Associates of America, Inc., et al.*,[59] all of the defendants consented to preliminary injunctions, with the exception of one dealer and one individual who consented to permanent injunctions.[60] The defendants were charged with having engaged in a scheme to sell municipal bonds by means of high pressure, "boiler-room" sales techniques. It was alleged that, in furtherance of the scheme, they employed a campaign of intensive long distance telephone solicitation of customers in order to induce the purchase of low quality municipal bonds by means of fraudulent representations concerning among other things, the source, quality and market price of the bonds. In the second case, *S.E.C. v. Charles A. Morris & Associates, Inc.*,[61] the Commission alleged that similar misconduct had occurred. Following a hearing, the court granted the Commission's motion for a preliminary injunction against all of the defendants, with the exception of three who consented to a permanent injunction.

In *S.E.C. v. American Agronomics Corporation et al.*[62] the Commission obtained consent decrees of permanent injunction against 14 defendants alleged to have violated the registration and antifraud provisions of the Federal securities laws in connection with the sale of orange grove investment contracts. In addition to consenting to permanent injunctions, Agronomics, its wholly owned subsidiary, and two principal owners and officers agreed to a court ordered undertaking whereby rescission will be offered to all orange grove investors for whom the investment is determined to be unsuitable by a special counsel appointed by the court. Additionally,

the two owners and officers agreed to deposit with the corporation 60,000 shares of their personal Agronomics stock to defray any expense incurred by the corporation as a result of the Commission's action and the conduct alleged in its complaint. The settlement also requires the corporation to take steps to assure the proper allocation of investors' orange grove maintenance fees and the proper intercompany transfer of funds, and to keep grove owners informed as to the condition and care of their individual groves.

SEC v. Westgate-California Corporation, et al.[63] is an injunctive action instituted by the Commission in May 1973 against Westgate and others alleging violations of registration, antifraud, re-porting and proxy provisions of the securities acts. The defendants include C. Arnholt Smith, (chairman, chief executive and former president of Westgate), Philip Toft (president and director of Westgate), and several privately-held companies allegedly owned and controlled by Smith or M. J. Coen, another defendant.

The complaint alleges that Smith and Toft assisted Westgate in perpetrating a fraudulent course of business by lending its assets on an interest-free basis to corporations controlled by Smith. These companies would allegedly pledge the "lent assets" as collateral for millions of dollars worth of loans from the United States National Bank of San Diego, owned in part and controlled by Smith. In order to avoid detection, the lent assets would allegedly be returned to Westgate apparently Unencumbered, just prior to examination of its accounts by independent auditors.

This complaint also alleges a second fraudulent course of business. The object of this second scheme was allegedly to manufacture earnings for Westgate in order to present a false appearance of profitability. It is alleged that in order to generate bogus earnings, Smith and Toft arranged for the sale of Westgate assets for cash, and for Smith to loan the purchasers the funds necessary to complete the transactions, funds Smith allegedly borrowed from the bank. The complaint further alleges that the purchasers in these arranged sales were insulated from any losses or costs. According to the complaint, in many instances the purchasers were assured a profit resulting from

an option arranged by Smith whereby the purchaser obtained the right to resell the asset at a gain. It is alleged that, as a result of this course of conduct, Westgate recorded many millions of dollars in profits over the last 4 years from sales which were not arms-length, were totally devoid of economic substance, and which resulted in a distorted and misleading presentation of the company's profitability.

The complaint seeks, among other things, a permanent injunction against further violations by the defendants, the appointment of a receiver to conduct the operations of Westgate, an injunction prohibiting Smith and Toft from serving as an officer or director of any public company without sufficient assurance that they will not engage in similar misconduct, and an agreement from Smith and Toft to indemnify Westgate against any losses incurred as a result of their actions.

At a hearing on July 23, 1973, the court entered an interim order placing restrictions on certain sales of Westgate assets and ordering Westgate to place an additional director on its board who will also be a member of its executive committee. The director will submit reports on Westgate's activities to the court as requested.[64]

In December 1972, after an extensive investigation, the Commission filed an action, *SEC v. Biozymes International Ltd., et al.*[65] against five individuals and two corporations, including Joseph "Bayonne Joe" Zicarelli, Guido Orlandi and Andrew R. L. McNaughton, seeking to enjoin them from further violations of the registration and antifraud provisions of the Federal securities laws in connection with the sale of Biozymes stock. The Commission's complaint charged that Biozymes, a Canadian corporation that claims to own an alleged cancer cure drug known as "Laetrile," sold millions of its unregistered shares to investors in the United States and other countries by means of fraudulent statements including the representation that Biozymes' stock would be traded on a stock exchange by a specific date. The Food and Drug Administration has banned the manufacture, sale and administering of Laetrile in the United States. On March 21, 1973, consent injunctions were entered against Zicarelli, Orlandi, and McNaughton. On April 27, 1973, Biozymes was permanently enjoined

on the basis of its default. The case is still pending against other defendants.

In April 1973, the Commission filed an injunctive action, *S.E.C. v. Accurate Calculator Corp*., et al.,[66] against the corporate defendant and six individual defendants, including Anthony Salerno and Irwin "Steve" Schwartz, to prevent further violations of registration and anti-fraud provisions of the securities acts in connection with transactions in Accurate securities. The New York Times of May 31, 1973 stated that Salerno was "reported to be one of the most powerful Mafia figures in the metropolitan area." The complaint charged a scheme involving a distribution of unregistered shares, the dissemination of false and misleading statements regarding the corporation and the misappropriation of a substantial portion of the proceeds of the offering. Administrative proceedings were instituted against several United States and Canadian broker-dealers with respect to the unlawful sales.

SEC v. Normandie Trust Company, et al.[67] – The Commission in this case obtained injunctions against Normandie Trust Company ("Normandie") and ten individuals. Normandie was an off-shore company incorporated in Panama for the purpose of defrauding U.S. citizens through the sale of letters of credit. The defendants prepared a fraudulent balance sheet which showed Normandie as having more than $170,000,000 in assets, when in fact it had little if any. The defendants informed purchasers that Normandie's letters of credit could be utilized to obtain loans from banks, and purchasers were required to pay into escrow in advance anywhere from 1 percent to 4 percent of the face value of the letter of credit to show their "good faith." The money was then paid out of escrow to the defendants upon the issuance of a letter of credit to the purchaser. In this manner, defendants obtained approximately $150,000 in exchange for letters of credit having a face value of more than $25,000,000.

In *S.E.C. v. First American Bank & Trust Company*,[68] the court of appeals reversed a district court order that had denied, except in one respect, the Commission's request for an injunction restraining the defendants from violating anti-fraud provisions. The Commission had

alleged that a sales brochure distributed by the defendants describing certain securities issued by the bank contained various materially false and misleading statements. The only statement that the district court enjoined was the representation that the bank, which was not subject to Federal or State deposit insurance, was "bonded and insured for the protection of depositors." The court of appeals affirmed this aspect of the order. The district court also found misleading the brochure's statement that the bank paid "guaranteed" interest on deposits, but the court ruled that the misstatement was not material because there was no evidence that any investor had relied on the statement. The court of appeals disagreed with this position stating, as the Commission had argued, that the question of reliance has no part in the consideration of whether the materiality standard has been met. In addition, the court of appeals indicated dissatisfaction with the district court's finding that certain other statements in the brochure were not misleading because they were recognizable as mere "puffing."

Securities and Exchange Commission v. Radio Hill Mines Co., Ltd.[69] – The court of appeals held in this case that a Federal district court has power to include within an injunctive decree, prohibiting further violations of the registration and anti-fraud provisions of the Federal securities laws, a requirement that the defendant file with the Commission an initial and periodic reports of his securities holdings and transactions, where such ancillary relief is necessary to aid enforcement of the injunction. The Commission's showing that the defendant had made a practice of concealing his illegal transactions necessitated the reporting requirement. The court of appeals further held, citing *California v. Byers*,[70] that the Fifth Amendment privilege against self-incrimination may not be invoked as a basis for non-compliance with the reporting requirement, since "securities regulation is an essentially 'non-criminal and regulatory area of inquiry' ", the ownership of securities "is generally a completely 'lawful activity' ", and "disclosure of such ownership is not an admission of an 'inherently suspect' activity."

S.E.C. v. Spectrum, Ltd.[71] – The district court refused to enter a preliminary injunction against a lawyer who .wrote an opinion letter

stating that the common stock of Spectrum, Ltd., held by some 58 persons, could be sold without registration under the Securities Act. In fact, as the court found, the 58 persons included a number of nominees for a statutory underwriter of the shares in question, and the letter had been sought as part of a scheme to sell the shares illegally. The court stated that the lawyer could be an aider and abettor of the Section 5 violations only if he had knowledge of the improper scheme and, with the purpose of furthering it, had performed an act necessary to its execution. The court concluded that while the lawyer may have been negligent in preparing the opinion letter, there was insufficient evidence that he was guilty of more serious misconduct. The Commission appealed, arguing (1) that the district judge erred in declining to hold an evidentiary hearing even though he found various facts concerning the lawyer's knowledge of the scheme to be in dispute, and (2) that the Commission may obtain injunctive relief against an attorney who issues an opinion that securities may be sold without registration where a reasonable investigation would have disclosed that such was not the case.

S.E.C. v. Ezrine[72] – The Commission brought an enforcement action to enjoin Ezrine, an attorney, from continuing to appear and practice before it in violation of Rule 2 (e) of the Commission's Rules of Practice and orders issued by the Commission pursuant thereto. The Commission charged that after Ezrine had been temporarily and then permanently suspended from practice before the Commission, he continued to appear and practice by representing certain respondents in an administrative proceeding conducted before an administrative law judge of the Commission and by continuing to serve as house counsel to a broker-dealer, advising the broker-dealer with respect to its responsibilities under the Federal securities laws. Ezrine's temporary suspension was predicated on his misconduct involving a public offering of securities of Manor Nursing Centers, Inc. for which he had been permanently enjoined in an earlier Commission enforcement action from further violations of the registration and antifraud provisions of the Federal securities laws.[73] He was thereafter permanently disqualified from appearing and practicing before the Commission by operation of Rule 2 (e) (2) as a result of

his being convicted of conspiracy to violate Federal Reserve Board Regulation T, a felony.[74]

In addition to seeking injunctive relief, the Commission requested the district court to direct Ezrine to disclose to all persons who seek to retain his services in connection with any matters relating to the Federal securities laws, the fact that he has been permanently disqualified from appearing and practicing before the Commission. The Commission further requested that Ezrine be restrained from obtaining any legal fees or other consideration for services he may render involving matters before or within the jurisdiction of the Commission, and that he be ordered to disgorge all legal fees obtained for services rendered during the period of his disqualification.

The United States District Court for the Southern District of New York, on the Commission's motion for temporary relief, preliminarily enjoined Ezrine from continuing to appear and practice before the Commission. For purposes of the injunction, the term "appearing and practicing" was determined to include, (1) participating in a representative capacity in an administrative proceeding or investigation instituted by the Commission; (2) participating in a representative capacity in any formal or informal conference with the Commission or its staff; (3) representing or advising any entity or person in connection with the preparation or filing of documents with the Commission; and (4) representing, in connection with any matters arising under the Federal securities laws, any broker-dealer, investment company or investment adviser registered or required to be registered with the Commission. The court further ordered that, pending disposition of the Commission's request for permanent relief, Ezrine advise all present and prospective clients, who have retained or seek to retain his legal services in connection with matters involving the Federal securities laws, that he cannot and will not practice before the Commission. The court also restrained Ezrine from receiving or retaining legal fees or other compensation which he may receive or claim for services rendered subsequent to the date of the order and in contravention thereof.

S.E.C. v. Everest Management Corp.[75] – The court of appeals affirmed the district court's denial of a motion by an investment company and its adviser to intervene as plaintiffs in a Commission enforcement action for the purpose of seeking damages from certain of the 44 defendants named in the suit. The Commission had charged the defendants with violations of antifraud provisions of the Investment Company Act designed to prevent self-dealing and gross abuse of trust. In holding that the district court did not abuse its discretion in denying the request for intervention, the court of appeals agreed with the Commission's argument that the action would become unduly confused and complex since intervention would add new issues and interfere with the expeditious conduct of the action and the possibility of negotiating consent decrees with some of the defendants. The court noted that, while under unusual circumstances it might be appropriate for a district court to allow a private party to intervene in a Commission enforcement action, the propriety of the district court's denial of intervention was clearly supported where the complicating effect of the additional issues and additional parties outweighed any advantage of a single disposition of the common issues.

S.E.C. v. National Student Marketing Corporation ("NSMC")[76] – The Commission brought suit to enjoin 20 defendants, including NSMC and a number of its officers and directors, its outside auditors, its outside legal counsel, various officers and directors of, and outside counsel to Interstate National Corporation ("Interstate"), a company acquired by NSMC, and a lawyer representing the purchasers of a company sold by NSMC, from further violations of the antifraud, proxy and reporting provisions of the Federal securities laws. The law firm that had been outside counsel to NSMC and one of the firm's partners filed a motion to dismiss based on improper venue in the District of Columbia and an alternative motion to sever the claims against them and transfer them to the Southern District of New York. The district court denied both motions. On the venue claim, the court held that, since the Commission had alleged a common scheme among the defendants to violate the securities laws and since some of the transactions alleged to have been made in furtherance of the scheme had concededly occurred in the District of Columbia, venue

was proper there as to all of the defendants, whether or not a particular defendant had himself performed a violative transaction in the District of Columbia. In addition, the court held that venue once established under either the Securities Act or the Exchange Act is sufficient for both acts. The court denied the alternative motion for severance and transfer on the grounds that while such a severance might be convenient to the moving defendants, it would be inconvenient to other parties and witnesses who, as a result of the transfer, would have to undergo two separate trials.

The court also denied motions for summary judgment and, in the alternative, to dismiss, which were filed by the president of Interstate and its counsel. The allegations against these defendants concern the closing of a merger between NSMC and Interstate and a contemporaneous sale of NSMC stock by certain Interstate insiders after these defendants had received a draft "comfort letter" from NSMC's auditors stating that the financial statements of NSMC that had been presented to the shareholders of both companies in seeking their approval of the merger required certain significant adjustments. In denying the motions, the court observed that receipt of the draft comfort letter "would provide the basis for an inference of an awareness that previously received financial information was false and misleading, and, consequently, that the acts performed by the movants were done knowingly and wilfully." The court granted summary judgment in favor of three other Interstate directors who had been present at the closing and had sold NSMC stock on that day on the theory that, assuming these defendants had knowingly and wilfully violated the securities laws, there was no reasonable likelihood of a future violation by them, since they had either retired or were approaching retirement.

The Commission moved to have dismissed from the action cross-claims filed by various of the defendants against their co-defendants. The court dismissed them, observing in its opinion that "[w]here suit is brought by the government to enforce the law, public policy militates against the pendency of private claims and the concomitant delay, confusion and complexity they introduce."

However, over the Commission's opposition, the Judicial Panel on Multidistrict Litigation, pursuant to 28 U.S.C. § 1407, ordered the action consolidated for pre-trial proceedings with seven private actions seeking monetary damages, pending in other judicial districts.[77] Although conceding that its action shared common questions of fact with the private suits, the Commission urged that its action be excluded from Section 1407 on the ground that such pre-trial proceedings would delay and complicate resolution of the action and frustrate its purpose of securing prompt injunctive relief to protect the public from further violations of the Federal securities laws. The Commission emphasized that the importance to the public of securing injunctive relief as quickly as possible and the danger that a request for injunctive relief would be delayed by those seeking recompense for injury already suffered were the very considerations which prompted Congress to enact in Section 1407 (g) an exemption from pre-trial consolidation for government antitrust injunctive suits. The Panel ruled, however, that 28 U.S.C. § 1407 could not be construed to provide an exception for Commission injunctive actions. It based this determination on the ground that, apart from the express antitrust suit exemption, Section 1407 did not limit the civil actions within its purview. Accordingly, the Panel concluded that to exclude the Commission's action would be "violative of the basic statutory purpose" to secure the just and efficient conduct of multidistrict litigation. A Commission petition for a writ of mandamus to seek review of the Panel's decision was dismissed by the court of appeals.

Prior to the Panel's decision in this case, government enforcement actions had not been subjected to Section 1407 pre-trial consolidation, and on two earlier occasions, the Panel had specifically declined to consolidate Commission actions with private damage suits. But in these instances,[78] it refused only because the Commission's litigation was either ready for trial or was on appeal from the grant of preliminary relief requested by the Commission. The precedent established in this case has since resulted in a pre-trial consolidation of *S.E.C. v. Lum's, Inc., et al*.[79] with a number of private damage suits involved in *In re Caesar's Palace Securities Litigation*.[80] In view of the substantial adverse effect of the Panel's decision on the Commission's enforcement activities, the Commission has prepared

and transmitted to the Congress a draft bill to amend Section 1407 to exempt Commission enforcement actions from that statute's coverage.

Participation as *Amicus Curiae*

The Commission frequently participates as *amicus curiae* in litigation between private parties under the securities laws where it considers it important to present its views regarding the interpretation of the provisions involved. For the most part, such participation is in the appellate courts.

Safeway Portland Employees' Federal Credit Union v. C. H. Wagner & Co., Inc.[81] – This is a private action brought under Section 12 (1) of the Securities Act by a purchaser of brokered certificates of deposit. The Commission has argued in its *amicus curiae* brief in the court of appeals that such certificates must be registered under the Securities Act and do not fall within the "bank-issued-securities" exemption of Section 3 (a) (2) of that Act. A brokered certificate of deposit is a bank certificate combined with a broker's promise to pay bonus interest over and above the interest payable by the bank. The interest to be paid by the broker comes from a person who wishes to borrow money from the bank but lacks sufficient funds to satisfy the bank's compensating balance requirement. The prospective borrower approaches a broker who undertakes to find an investor to purchase a certificate of deposit in the bank in lieu of the compensating balance, and the broker charges a fee to the borrower, part of which fee the broker uses to pay the bonus interest to the investor. The Commission has taken the position that the brokered certificate is an investment contract issued by the broker since the broker offers an investment involving a different economic inducement and a different degree of risk from those associated with a bank certificate of deposit.

In a suit against C. H. Wagner & Co., Inc. and various corporations and individuals affiliated with it, the Commission obtained a permanent injunction against the defendants' sale of "brokered" certificates of deposits.[82] No appeal was taken.

Lanza v. Drexel & Co.[83] – In this case, the court of appeals, sitting en bane, held that a director of a corporation engaged in selling its securities is not liable for damages to a purchaser of those securities under Exchange Act Rule 10b-5, even though the purchaser acquired the securities on the basis of materially false and misleading statements by the corporation. The court based its decision on a district court opinion, rendered after trial, which concluded that the director in question did not know that any of the information supplied to the purchaser was false or misleading and, under the circumstances, did not have any reason to believe that it was. At the request of the court, the Commission participated *amicus curiae* in this case. In its brief, the Commission asserted that it could not be determined from the district court's opinion whether the director had reason to believe that other corporate officers had engaged in improper conduct. The Commission urged that if the district court on remand were to find the circumstances such as to put a reasonable director on notice of improper conduct, then the director's failure to discover the false statements was actionable.

The court of appeals, with four judges dissenting, rejected the Commission's position on the ground that a corporate director owes no "duty of diligence to prospective purchasers to insure that all material adverse information is conveyed to such purchasers. . . ." After reviewing the evidence and finding that the director was not negligent, the court held that directors are not insurers. It concluded that "proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."

In *Travis v. Anthes Imperial Limited*,[84] the United States Court of Appeals for the Eighth Circuit held, as the Commission had urged, that the district court erred in dismissing a suit by Missouri residents who alleged that, in the course of telephone calls they placed from Missouri to Canada, Canadian defendants had fraudulently induced them to refrain from selling certain securities, in violation of Section 10 (b) of the Exchange Act and Rule 10b-5 thereunder. The court accepted the Commission's position that the Exchange Act was applicable even though the plaintiffs initiated the telephone calls and

even though the securities in question were neither issued by an American corporation nor traded on an American exchange. The court stated that the "real question is whether the mails or instrumentalities of interstate commerce were used to mislead the plaintiffs."

In its brief the Commission had also urged the court to abandon the doctrine established by *Birnbaum v. Newport Steel Corp.*,[85] that permits only a purchaser or seller of securities to recover monetary damages in a private action under Rule 10b-5. While the court found it unnecessary to reach this issue – holding that the plaintiffs were in fact sellers of securities since they eventually sold the securities they had allegedly been fraudulently induced to hold – it did express some doubt as to the doctrine's validity.

In *Blakely v. Lisac*,[86] a private action for damages under Section 10 (b) of the Securities Exchange Act and Rule 10b-5, the Commission filed a memorandum as *amicus curiae* expressing its views concerning the showing of reliance and causation required to support recovery. Some of the plaintiffs had purchased shares of a company based upon a fraudulent prospectus during the initial public offering; other purchases had been made in the after-market when materially misleading company reports were being released. The Commission argued, in accord with *Mills v. Electric Auto-Lite Co*.[87] and *Affiliated Ute Citizens v. United States*,[88] that causation would be adequately established by proof that material omissions had been made in the prospectus or reports. Accordingly, there would be no need for individual proof of causation whether through reliance or otherwise. As to affirmative misrepresentations, the Commission argued that, at least where injury is alleged to result from the adverse impact of fraudulent statements upon the market price of a security, causation would be adequately demonstrated by a showing of materiality, and no individual proof should be required from individual members of the class.

In *Naftalin & Co., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[89] the United

States Court of Appeals for the Eighth Circuit, while remanding for further proceedings, expressed general agreement with the previously reported decision of the district court[90] in a proceeding brought by six broker-dealers to have Naftalin & Co., Inc., also a broker-dealer, adjudicated an involuntary bankrupt. The district court had found that Naftalin purported to sell securities it did not own through special cash accounts it maintained with each of the six broker-dealers, and that the broker-dealers failed to liquidate those accounts until long after the dates on which Naftalin agreed to make delivery of the securities. The district court disallowed the broker-dealers' claims to the extent they arose out of unlawful extensions of credit to Naftalin in violation of the provisions of the Federal Reserve Board's Regulation T.[91] In accord with views expressed by the Commission as *amicus curiae*, the court of appeals generally agreed with the district court that the broker-dealer appellants had violated Regulation T if they had not timely bought in securities to cover Naftalin's sales when Naftalin failed to make prompt delivery of the securities, but disagreed with that court that (by analogy to the seven-day liquidation period applicable to purchase transactions)[92] delivery was required on or before the seventh day after sale. The court of appeals recognized, as the Commission had argued, that the good faith of a broker-dealer in expecting prompt delivery is determinative; that at some point in time inquiry is required, and that only reliance upon a credible explanation for further delay would prevent a violation from occurring. The court of appeals further held that a broker-dealer's Regulation T violation limited its claim against Naftalin, notwithstanding Naftalin's perpetration of a fraud, to the difference between the sales price of the securities sold for Naftalin and the price at which the broker-dealer should have bought in the securities when Naftalin failed to deliver.

In *Herbst v. Able*,[93] a private action arising out of the sale of debentures by Douglas Aircraft Company, Douglas, its underwriters and its accountants were charged with filing a false and misleading registration statement and prospectus and with violations of the antifraud provisions of the securities laws. The defendants attempted to introduce evidence of "approval" of certain statements in the prospectus by Commission staff members at pre-filing conferences.

Plaintiffs moved to exclude this evidence. The Commission filed a memorandum as *amicus curiae* in support of the motion, arguing that responsibility for the accuracy of a registration statement is upon those who participate in its preparation and file it; and that responsibility cannot be shifted to the Commission, which does not have authority to "approve" registration statements. In any event, the Commission noted, views expressed by members of the Commission's staff do not necessarily reflect the views of the Commission. The court held that evidence of the conferences was inadmissible as to whether the statements in the prospectus were accurate, and also inadmissible to prove the "due diligence" defense of all defendants except the accountants.

CRIMINAL PROCEEDINGS

As a result of investigations conducted by its staff, the Commission during the past fiscal year referred 49 cases to the Department of Justice for criminal prosecution. This represents a very substantial increase over the 38 cases referred during the preceding fiscal year. As a result of these references, 40 indictments naming 178 defendants were returned, as compared to 28 indictments against a total of 67 defendants during the previous year. In addition, during the past fiscal year, the Commission authorized its staff to file five criminal contempt actions and convictions were obtained against eight defendants.

Members of the staff of the Commission who have investigated a case and are familiar with the facts involved and the applicable statutory provisions and legal principles, are usually requested by the Department of Justice to participate and assist in the trial of a criminal case referred to the Department, and to participate and assist in any subsequent appeal from a conviction. During the past fiscal year, 83 defendants were convicted in the 26 criminal cases that were tried. Convictions were affirmed in four cases that had been appealed, and appeals were still pending in nine other cases at the close of the period.

The criminal cases that were handled during the fiscal year demonstrated the great variety of fraudulent practices that have been devised and employed against members of the investing public.

U.S. v. Richard Mackay and Chester Brewer[94] was a case that involved a fraudulent scheme in which Mackay, a Dallas attorney, aided and abetted by Brewer, a Dallas banker, purchased a controlling stock interest (93.3 percent) in Federated Security Insurance Corporations, and 19.5 percent of the stock of Transwestern Life Insurance Co., and misappropriated Federated's entire securities portfolio with a book value of approximately $5,500,000 in order to pay for the stock purchased in both companies. Mackay and Brewer intended to use the companies to acquire other insurance companies which they could strip of their liquid assets and then merge with or exchange for still other companies at a profit to themselves.

Following a jury trial, both defendants were found guilty of all 15 counts of the indictment. They were each sentenced in March 1973 to serve 1 year on each of the 15 counts, to be served consecutively, and fined $27,000. Both defendants were released on bond pending appeal.

In the case of *U.S. v. Seymour Vigman*,[95] the defendant, who was the president of a Miami broker-dealer, was indicted for a scheme to defraud public investors. The broker-dealer was underwriter for 250 Aero Systems, Inc. warrants each giving the purchaser the right to buy 100 shares of Aero common stock. The indictment alleged that Vigman withheld 113 warrants from sale by placing them with friends and relatives, and sold them more than a year later for a profit of $750,000. Vigman pleaded guilty to ten counts of the indictment and was fined $100,000.

In the case of *United States v. Jack L. Clark, et al.*,[96] Clark, former president of Four Seasons Nursing Centers of America, Inc., pleaded guilty to one count of conspiracy to violate the antifraud and false filing provisions of the securities acts and mail fraud. Clark was charged in the conspiracy count with falsifying the financial

statements of Four Seasons, whose stock was traded on the American Stock Exchange at a price of over $100 per share prior to its eventual bankruptcy. He was further charged with obtaining in excess of 6 million dollars from the public through the use of a prospectus which contained false financial statements.

As a result of the Commission's referral of the files in the *Everest Management Corporation* case,[97] nine criminal actions were brought charging 19 persons with violations of the securities laws. Among those cited, John Peter Galanis and Akiyoshi Yamada were charged with looting the securities and cash of domestic and offshore mutual funds.[98] Galanis was also charged, along with Robert Hagopian, Stephen Sanders and Ramon D'Onofrio, with engaging in a scheme to defraud domestic and foreign mutual funds.[99] Galanis, Yamada, Hagopian and Sanders were sentenced to prison[100], and D'Onofrio is awaiting sentencing.

Organized Crime Program

The prosecution of securities cases is often based on circumstantial evidence requiring extensive investigation by highly trained personnel. The difficulties in such investigations and prosecutions are compounded when elements of organized crime are involved. Witnesses are usually reluctant to cooperate because of threats or fear of physical harm. Books, records, and other documentary evidence essential to the investigations and to a successful prosecution may be destroyed or nonexistent. The organized crime element is adept at disguising its participation in transactions through the use of aliases and nominee accounts, operating across international boundaries, and taking advantage of foreign bank secrecy laws. It frequently operates through "fronts" and infiltrates legitimate business concerns. Organized crime has an extensive network of affiliates throughout this country in all walks of life, and in many foreign nations. Despite these difficulties, the Commission, working in cooperation with other enforcement agencies, has been able to make major contributions to the fight against organized crime.

As a result of an intensive Commission investigation, and a subsequent criminal trial in the Southern District of New York in the case of *U.S. vs. Dioguardi, et al.*,[101] seven individuals, including John Dioguardi, also known as Johnny Dio, and Anthony Soldano, were convicted of securities fraud, mail fraud and conspiracy in connection with transactions in the securities of Belmont Franchising Corporation ("Belmont"). Three other defendants in the case pleaded guilty prior to trial. The scheme involved the manipulation of the price of Belmont's stock from approximately $5 per share in February 1970 to approximately $42 per share in May 1970. On April 12, 1973, Dioguardi was sentenced to 9 years imprisonment and fined $30,000. Soldano was later sentenced to 2 years imprisonment. The defendants have filed notices of appeal.

In another significant case, *U.S. vs. Aloi, et al.*[102] a Federal grand jury in the Southern District of New York indicted 12 individuals, including Vincent Aloi, Sebastian Aloi, and John Dioguardi, on charges of violating the antifraud provisions of the Federal securities laws and conspiracy to violate these statutes. The indictment charged a scheme involving the defendants' fraudulent acquisition of control of At-Your-Service Leasing Corp. in order to misappropriate corporate funds.

Cooperation with Other Enforcement Agencies

In recent years the Commission has given increased emphasis to cooperation and coordination of its own activities with the various other enforcement agencies, including the self-regulatory organizations, enforcement agencies at the State and local level, and certain foreign agencies. Its programs in this area cover a broad range. For example, the Commission believes that certain cases are more appropriately enforced at the local rather than the Federal level where the violations, while involving the Federal securities laws, are of a local nature. In these instances, the Commission authorizes the referral of the case to the appropriate State or local agency, and members of the staff familiar with it are made available for assistance to that agency in its enforcement action.

The Commission has also fostered programs designed to provide a comprehensive exchange of information concerning mutual enforcement problems and possible securities violations. During the fiscal year, it continued its program of annual regional enforcement conferences. These conferences are attended by personnel from State securities agencies, the U.S. Postal Service, Federal, State and local prosecutors' offices and local offices of self-regulatory associations such as the NASD. They provide a forum for the exchange of information on current enforcement problems and new methods of enforcement cooperation. One result of these conferences has been the establishment of programs for joint investigations. Although the conferences were initially hosted by the Commission's regional offices, many State agencies are now serving as sponsors or co-sponsors.

The Commission is constantly seeking ways to improve these conferences. One approach that was tried in some regions was to open one session to the brokerage community and to private practitioners in the securities field. The resulting exchange of views has proven to be very beneficial to all concerned, and the use of this approach has been expanded.

The Commission's Proceedings and Litigation Records Branch provides one of the means for cooperation on a continuing basis with other agencies having enforcement responsibilities. The Branch acts as a clearinghouse for information regarding enforcement actions in securities matters that have been taken by State and Canadian authorities, other governmental and self-regulatory agencies, and the Commission itself. It answers requests for specific information and in addition publishes a periodic bulletin which is sent to contributing agencies and to other enforcement and regulatory bodies. During fiscal 1973, the branch received 3,710 letters either providing or requesting information, and sent out 3,099 communications to cooperating agencies. Records maintained by the Branch reflect a steady increase in recent years in the number of enforcement actions taken by State and Canadian authorities. The data in the SV (Securities Violation) Files, which is computerized and is useful in screening issuers and applicants for registration as securities or

commodities brokers or dealers or investment advisers, as well as applicants for loans from such agencies as the Small Business Administration.

FOREIGN RESTRICTED LIST

The Commission maintains and publicizes a Foreign Restricted List designed to alert broker-dealers, financial institutions, investors and others to possible unlawful distributions of foreign securities. The list consists of names of foreign companies whose securities the Commission has reason to believe have recently been, or are currently being, offered for public sale in the United States in violation of registration requirements. Most broker-dealers refuse to effect transactions in securities issued by companies on the list. This does not necessarily prevent promoters from illegally offering such securities directly to United States investors. During the past fiscal year 14 corporations were added to the Foreign Restricted List, bringing the total number of corporations on the list to 75. The following companies were added during the year:

Rodney Gold Mines Limited.[103] – This is a Canadian corporation that was inactive from 1946 until November 1971. Its only known asset is a mining claim in Ontario. In December 1971 it registered 633,214 shares with the Ontario Securities Commission including a secondary offering of 383,214 shares acquired that same month for less than 1/5 of a cent per share. The shares in the secondary offering were sold at prices ranging from 35 cents to 48 cents per share. On February 2, 1972, the Ontario Securities Commission suspended trading in this security due to the apparently unjustified sharp increase in its market price.

Antel International Corporation. Ltd., Canterra Development Corporation, Ltd., Cardwell Oil Corporation, Ltd.[104] – These three interrelated Canadian corporations were placed on the list at the same time. Antel was the successor to American Mobile Telephone & Tape Company Ltd., already on the list, which had sold unregistered shares fraudulently, whose investors had never received their shares,

and whose officers had pleaded *nolo contendere* to the felony of selling shares not qualified under California securities laws. Antel was to merge with Canterra in a purported effort to give defrauded investors some measure of restitution, until the California Department of Corporations determined that Canterra was not a viable entity since it had no income from business operations. The proposed reorganization contemplated issuance of unregistered shares of Cardwell, which appeared to be the true assignee of the telephone device purportedly transferred from American Mobile to Antel.

Tam O'Shanter, Ltd.,[105] and *Warden Walker Worldwide Investment Company*.[106] These two corporations, the former Swiss and the latter British, were engaged in selling by mail to investors in the United States warehouse receipts or other documents evidencing ownership of Scotch whiskey in storage and ageing in Scotland. The circumstances were such that investors ordinarily looked to the corporation to manage their investments. Under the circumstances, investors were really being offered a security.

S. A. Valles & Co. Inc.[107] – This is a Philippine corporation whose president came to the United States and sold investors unregistered shares of stock and evidences of indebtedness by means of fraudulent representations. Although the corporation's ostensible purpose was to purchase and own real estate in the Philippines, it never engaged in any business. Investors were falsely told that a Philippine bank had approved a loan commitment of 50 million pesos to the corporation for a low cost housing project near Manila, and that the company's securities would be listed on the New York and Manila Stock Exchanges.

Claravella Corporation.[108] This Costa Rican corporation solicited investors in the United States by mail to reserve shares of its stock at $2.00 per share in any amount from 100 to 5,000 shares with a view to financing a possible diamond drilling program in Costa Rica and pre-production development work.

Caye Chapel Club, Ltd.[109] This corporation was organized in 1967 in British Honduras to build a resort hotel on Caye Chapel Island off the

coast of British Honduras. The company had obtained a mortgage loan from a bank with the island and hotel properties as security. The bank had instituted foreclosure proceedings and the receiver that had been appointed had advertised the properties for sale without receiving a bid in sufficient amount to discharge the indebtedness on the mortgage. The corporation and its president had also obtained another loan of $145,000 from another bank which had instituted legal proceedings because no payments had been made on its loan.

Societe Anonyme de Refinancement (now known as Northern Trust Company, S.A.).[110] This is believed to be a joint stock company, incorporated in Switzerland. Certificates of deposit purportedly issued by this company were distributed in the United States and attempts were made to pledge these certificates with banks as collateral on loans. However, the company refused to honor its certificates of deposit. In addition, a number of individuals attempted to purchase securities through United States broker-dealers using this company as a credit reference. Although the company's Director and Administrator indicated that these individuals had substantial accounts with the company, in a number of cases the individuals never paid for the securities purchased through the broker-dealers.

Western International Explorations, Ltd.[111] This is a Bahamian corporation. Solicitations to United States investors were mailed from Toronto, Canada, urging them to send money for investment to Inter-State Investments, Limited of Kingston, Jamaica. The Assistant Commissioner of Police of the Jamaican constabulary reported that Inter-State's office was never open for business but was merely used to receive mail, including checks from investors, which promoters came to Jamaica at intervals to collect. The United States Postal Service had previously issued a number of Foreign Postal Fund Fraud Orders against Inter-State for the purpose of having postal officials intercept and return to the senders mail addressed to this company.

NOTES FOR PART 4

[1] 480 F. 2d 1047 (C.A. 2, 1973).

[2] 422 F. 2d 1371, *certiorari* denied, 398 U.S. 958 (1970).

[3] See e.g. the decision in *S.E.C. v. Texas Gulf Sulphur Company*, 446 F. 2d 1301 (C.A. 2, 1971).

[4] Investment Company Act Release No. 7859, 1 SEC Docket No. 20, p. 22.

[5] Securities Exchange Act Release No. 9894 (December 11, 1972).

[6] Securities Exchange Act Release No. 10174 (May 25, 1973), 1 SEC Docket No. 18, at p. 23.

[7] The United States District Court for the Southern District of New York has, with their consent, permanently enjoined Faberge and two of its officers from further violations of the antifraud provisions. (See Litigation Release No. 5548, September 28, 1972.)

[8] Faberge, Inc., Securities Act Release No. 10174 (May 25, 1973), 1 SEC Docket No. 18, p. 21.

[9] Securities Exchange Act Release No. 10172 (May 23, 1973, 1 SEC Docket No. 17, p. 11.

[10] Administrative Proceeding File No. 3-4193.

[11] *Securities and Exchange Commission v. Ramon D'Onofrio, et al.*, S.D.N.Y. No. 72 Civ. 3507.

[12] Stuart Schiffman, Securities Exchange Act Release No. 9885 (Dec. 4, 1972). Schiffman, who was president of a broker-dealer, was barred from association with any broker or dealer.

[13] Securities Act Release No. 5404 (June 18, 1973), 2 SEC Docket 1.

[14] S.D.N.Y., 71 Civ. 5416 (December 13, 1971).

[15] A petition by Fields for review of the order of permanent disqualification is pending in the Court of Appeals for the District of Columbia Circuit (No. 73-1722).

[16] Securities Exchange Act Release No. 9934 (January 15, 1973).

[17] Securities Exchange Act Release No. 10214 (June 11, 1973), 1 SEC Docket No. 20, p. 4.

[18] Securities Exchange Act Release No. 9980 (February 1, 1973).

[19] Securities Exchange Act Release No. 10064, 1 SEC Docket No. 9, p. 4.

[20] Securities Exchange Act Release No. 10131, 1 SEC Docket No. 14, p. 1.

[21] Securities Exchange Act Release No. 9962 (January 23, 1973).

[22] Securities Exchange Act Release No. 9896.

[23] Securities Exchange Act Release No. 10202, 1 SEC Docket No. 19, p. 6.

[24] See Litigation Release No. 5765 (March 1, 1973), 1 SEC Docket No. 5, p. 25.

[25] See Litigation Release No. 5943, 2 SEC Docket 61.

[26] 349 F. Supp. 46 (S.D.N.Y., 1972), appeal pending, C.A. 2, No. 72-1927.

[27] 401 F. 2d 833 (C.A. 2. 1968), cert, denied, 394 U.S. 976 (1969).

[28] 73 Civil Action No. 2458 (S.D.N.Y.).

[29] 70 Civ. 5280 (S.D.N.Y.).

[30] CCH Fed. Sec. L. Rep. If 93,659 (November 9, 1972).

[31] 72 Civ. 4776 (S.D.N.Y.).

[32] See Litigation Release No. 5917 (June 1, 1973), 1 SEC Docket No. 18, p. 54.

[33] The railroad was sold for $5 million, less than three months after the registration statement became effective.

[34] *SEC v. Bangor Punta Corporation*, 331 F. Supp. 1154 (S.D.N.Y., 1971).

[35] The Commission's appeal was decided together with two related private actions. Chris-Craft Industries, Inc. v. Piper Aircraft Corporation, 480 F. 2d 341 (1973).

[36] 474 F. 2d 354. See 38th Annual Report, p. 77.

[37] 72-1230 (C.A. D.C., 1973).

[38] See Securities and Exchange Commission, 38th Annual Report, 80 (1972).

[39] Civil Action No. 932-73 (D.D.C.).

[40] Civil Action No. 596-73 (D.D.C.).

[41] See Litigation Release No. 5699 (January 17, 1973).

[42] See Litigation Release No. 5973 (July 13, 1973), 2 SEC Docket 156.

[43] Civil Action No. 4999 (D.R.I.).

[44] 15 U.S.C. 78c (a) (3).

[45] Another decision concluding that whiskey warehouse receipts are securities within the meaning of the Securities Act was subsequently handed down. *SEC v. Haffenden-Rimar International, Inc.*, Civil Action No. 108/73A (E.D. Va. August 8, 1973). The Commission has instituted administrative proceedings based on staff allegations of registration and antifraud violations in connection with the offer and sale of such receipts. *McGivney and Company, Inc., et al.*, Administrative Proceeding File No. 3 – 4336 (July 24, 1973).

[46] 348 F. Supp. 766 (D. Oreg., 1972), affirmed, 474 F. 2d 476 (C.A. 9, 1973), petition for certiorari filed, 41 U.S.L.W. 3609 (May 1, 1973) (No. 72-1480).

[47] 348 F. Supp. at 773.

[48] 328 U.S. 293, 301 (1946).

[49] On June 22, 1973, the district court entered an order of permanent injunction.

[50] [Current] CCH Fed. Sec. L. Rep. 1193,960 (N.D. Ga., April 19, 1973).

[51] No. 73-2339.

[52] N.D. Cal., No. C 73-1095.

[53] CCH Fed. Sec. L. Rep. H 94,082 (C.A. 4. 1973).

[54] 326 F. Supp. 943 (S.D.N.Y., 1971).

[55] N.D. Texas, No. CA-3-6976-D; C.A. 5, No. 73-2429.

[56] C.D. Cal., No. 73-472.

[57] Civil Action No. 73-0819 SW (N.D. Calif.).

[58] Civil Action No. 152-73 (D.D.C.).

[59] See Litigation Release No. 5583 (October 26, 1972).

[60] See Litigation Release (February 28, 1973), 1 SEC 5. p. 24.

[61] See Litigation Release (October 26, 1972).

[62] N.D. Ohio, No. C72-331

[63] S.D. Cal., 73 Civ. 217N.

[64] See Litigation Release No. 5995 (July 26, 1973), 2 SEC Docket 212.

[65] N.D. Calif., C72-2217-SW.

[66] S.D.N.Y., 73 Civ. 1557.

[67] S.D. Fla., Civil No. 72-1531.

[68] Nos. 72-1306 and 72-1313 (cross appeals) (C.A. 8).

[69] CCH Fed. Sec. L. Rep. [Current Binder] 94,016, Nos. 72-1615 and 72-1746 (C.A. 2, 1973).

[70] 402 U.S. 424 (1971).

[71] C.A. 2, Docket No. 72-2369.

[72] S.D.N.Y., No. 72 Civ. 3161 (CBM).

[73] *Securities and Exchange Commission v. Manor Nursing Centers, Inc.*, 340 F. Supp. 913 (S.D.N.Y., 1971), affirmed, 458 F. 2d 1082 (C.A. 2, 1972).

[74] *U.S. v. Ezrine*, S.D.N.Y., No. 70 Crim. 1118.

[75] 475 F. 2d 1236 (C.A. 2, 1972).

[76] D.D.C., Civil Action No. 225-72.

[77] CCH Fed. Sec. L. Rep. ¶ 93,694 (J.P.M.L, December 1, 1972) and U 93,-743 (J.P.M.L., January 29, 1973), *petition for writ of mandamus dismissed*, C.A.D.C. No. 73-1199 (1973).

[78] *In Re Glenn W. Turner Enterprises Litigation*, J.P.M.L. Docket No. 109 (December 18, 1972 and January 30, 1973), involving *SEC v. Glenn W. Turner Enterprises, Inc., et al.*, D. Oreg., Civ. No. 72-390, and *In Re King Resources Securities Litigation*, 342 F. Supp. 1179 (J.P.M.L, 1972), involving *S.E.C. v. Crofters, Inc., et al.*, S.D. Ohio, Civil Action No. 70-351.

[79] S.D.N.Y., 72 Civ. 1145.

[80] J.P.M.L. Docket No. 110 (December 10, 1972).

[81] C.A. 9, No. 72-1429.

[82] *S.E.C. v. C. H. Wagner & Co., Inc., et al.*, D. Oreg., Civil Action No. 71-386.

[83] CCH Fed. Sec. L. Rep. [Current Binder] if 93,959 (C.A. 2, 1973).

[84] See Litigation Release No. 5831 (April 5, 1973), 1 SEC Docket No. 10, p. 22.

[85] C.A. 8, No. 71-1587, reported previously in 38th Annual Report, pp. 84-85.

[86] 193 F. 2d 461 (C.A. 2, 1952), *cert. denied*, 343 U.S. 956 (1952).

[87] D. Oregon, No. 70-377.

[88] 396 U.S. 375 (1970).

[89] 406 U.S. 128 (1972).

[90] 469 F. 2d 1166 (C.A. 8, 1972).

[91] 336 F. Supp. 136 (D. Minn. 1971), 38th Annual Report, p. 83.

[92] 12 CFR 220.1 et seq.

[93] Section 4 (c) of Regulation T, 12 CFR 220.4 (c).

[94] S.D.N.Y., 66 Civ. 3216-CBM.

[95] S.D. Fla. No. 72-151-CR.

[96] S.D.N.Y., 72 CR 1356.

[97] See the 38th Annual Report, p. 81.

[98] S.D.N.Y., Nos. 72 CR 520 and 528.

[99] S.D.N.Y., No. 72 CR 884.

[100] See Litigation Release No. 5753 (February 22, 1973), 1 SEC Docket No. 4, p. 19; Nos. 5772 and 5773 (March 5, 1973), 1 SEC Docket No. 6, pp. 28-29; and No. 5992 (July 24, 1973), 2 SEC Docket 211.

[101] S.D.N.Y., 72 Cr. 96.

[102] S.D.N.Y., 73 Cr. 362.

[103] Securities Act Release No. 5285 (July 24, 1972).

[104] Securities Act Release No. 5329 (November 13, 1972).

[105] Securities Act Release No. 5339 (November 21, 1972).

[106] Securities Act Release No. 5339 (December 11, 1972).

[107] Securities Act Release No. 5381.

[108] Securities Act Release No. 5392.

[109] Securities Act Release No. 5390.

[110] Securities Act Release Nos. 5291 and 5375.

[111] Securities Act Release No. 5317.

PART 5
INVESTMENT COMPANIES AND ADVISERS

Under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, the Commission is charged with extensive regulatory and supervisory responsibilities over investment companies and investment advisers. Unlike the other Federal securities laws which emphasize disclosure, the Investment Company Act provides a regulatory framework within which investment companies must operate. Among other things the Act: (1) prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval; (2) protects against management self-dealing, embezzlement or abuse of trust; (3) provides specific controls to eliminate or mitigate inequitable capital structures; (4) requires that an investment company disclose its financial condition and investment policies; (5) provides that management contracts be submitted to shareholders for approval, and that provision be made for the safekeeping of assets; and (6) sets controls to protect against unfair transactions between an investment company and its affiliates.

Persons advising others on their securities transactions for compensation must register with the Commission under the Investment Advisers Act. This requirement was extended by the Investment Company Amendments Act of 1970 to include advisers to

registered investment companies. The Advisers Act, among other things, prohibits performance fee contracts which do not meet certain requirements; fraudulent, deceptive or manipulative practices; and advertising which does not comply with certain restrictions.

The August 1972 reorganization of the Commission for the first time placed responsibility for both investment companies and investment advisers in one Division – the Division of Investment Company Regulation. In January 1973, to reflect its responsibilities more accurately, the Division's name was changed to the Division of Investment Management Regulation.

PROPOSED LEGISLATION

Investment companies provide an important vehicle for the pooling of the collective resources of individuals for investment in the nation's capital markets. Investor confidence is vital to their success in attracting the savings of individuals, and the safeguards provided by the Investment Company Act contribute to sustaining such confidence. As discussed in Part 1 of this report, the Commission has submitted proposed legislation to the Congress designed to bolster foreign investor confidence in offshore funds investing in American securities by creating a new type of mutual fund, organized in the United States and registered with the Commission but directing its sales efforts at foreigners.

Proposed Oil and Gas Investment Act

Another business area where the Commission deems further regulation necessary for investor protection is that of oil and gas drilling funds and programs. In June, 1972, the Commission submitted to the Congress legislation which would provide such protection by requiring registration of oil programs and by subjecting them to comprehensive regulation. It would provide controls designed to prevent conflicts of interest and unfair transactions between oil programs and their managers, and to insure financial responsibility of program managers; prohibit changes in fundamental policies of an oil

program without approval of the participants; and require that a person acting as a program manager do so under a written contract which contains certain provisions. Some provisions of the proposed statute would be administered primarily by the National Association of Securities Dealers with Commission oversight. These relate to sales charges, sales literature, suitability of an investment and a classification system for the various forms of management compensation.

The legislation was introduced in both houses of the 92d Congress, but was not acted upon. It was reintroduced in the 93d Congress in 1973.[1]

Sale of Investment Adviser

In 1972, the Commission also proposed legislation[2] to modify those sections of the Investment Company Act that were affected by the decision of the Court of Appeals for the Second Circuit in *Rosenfeld v. Black*.[3] In that case, the court held that the general principle in equity that a fiduciary cannot sell his office for personal gain is impliedly incorporated into Section 15 (a) of the Act requiring shareholder approval of any new investment advisory contract. Consequently, a retiring investment adviser of an investment company violates the Act by receiving compensation which reflects either (1) a payment contingent upon the use of influence to secure approval of a new adviser or (2) an assurance of profits for the successor adviser under a new advisory contract and renewals.

In submitting the proposed legislation, the Commission expressed its view that the principles of equity were appropriately applied to the facts of the above case, which involved an outright sale by an investment adviser of its advisory contract with a registered investment company. While the *Rosenfeld* case did not involve the sale of an outgoing investment adviser's assets, the sweep of the Court's language nevertheless cast doubt on whether an investment adviser could profit when it sold its business in that manner.

In its statement accompanying the legislation, the Commission suggested that it would be in the public interest to remove the uncertainty in the mutual fund industry generated by the *Rosenfeld* decision. Thus, the proposed amendments are intended to permit an investment adviser, or an affiliated person of an adviser, to obtain a profit in connection with a transaction which results in an assignment of the advisory contract if certain conditions are met. These conditions are designed to prevent a retiring investment adviser or an affiliate, in connection with the sale of the adviser's business, from receiving any payment or other benefit which includes any amount reflecting its assurance that the investment advisory contract will be continued.

The proposed bill was not enacted in the 92d Congress. During the past year it was reintroduced in modified form and passed by the Senate.[4]

Municipal Bond Rating Services

In March 1973, a bill was introduced in the House of Representatives which would amend the Investment Advisers Act to provide substantive regulation of persons rating municipal bonds and qualitative assessment of municipal bond ratings.[5] Under the bill, the Commission would be required to prescribe substantive standards governing municipal bond ratings and impose requirements which would assure that rating procedures used by municipal bond rating agencies were fair to issuers and guarantors of municipal bonds. Finally, the bill would allow any person "aggrieved or adversely affected" by any action of a municipal bond rating agency to file a complaint with the Commission, which could order any remedial action to be taken that it determined to be in the public interest. By the end of the fiscal year, the Commission had not commented on the proposed legislation.

Institutional Disclosure

In the Letter of Transmittal of the Institutional Investor Study Report, the Commission stated that "gaps (exist) in the information about the

purchase, sale and holdings of securities by major classes of institutional investors," and recommended that such gaps be eliminated by amending the securities laws "to provide the Commission with general authority to require reports and disclosures of such holdings and transactions from all types of institutional investors."[6] Since then, the Commission's position has received widespread support.

On April 25, 1973, it was announced that the Commission would draft and sponsor institutional disclosure legislation which would require all institutional investors to report all of their securities holdings and their institution-sized trades. Such institutional disclosure would permit Commission study of the effects of institutional trading and holdings on the securities markets, and the characteristics of institutional investors, for the purpose of developing possible further disclosure requirements and, if needed, further regulatory controls on institutional investors. After the end of the fiscal year, Senator Harrison A. Williams, Jr., Chairman of the Senate Subcommittee on Securities, introduced legislation in the Senate along these conceptual lines,[7] with the Commission's support as to the objectives of the bill.

MUTUAL FUND DISTRIBUTION

As in prior years, the Commission's concern over the cost to investors of participating in mutual funds, and with regulatory problems associated with the distribution system, was manifested in a number of areas.

As discussed in Part 1 of this report, extensive hearings were held by the Commission on these matters during the fiscal year. In addition, certain specific proposals were made. The Commission, on December 21, 1972, proposed an amendment of Rule 22d-1 under the Investment Company Act to permit quantity discounts for group purchases of open-end investment company securities under certain limited circumstances. Section 22 (d) of the Act, in effect, prohibits registered investment companies from selling redeemable securities

to any person other than a dealer or principal underwriter at a price less than that at which the securities are sold to the public, but provides that the Commission may permit exceptions to this retail price maintenance provision by rule. Rule 22d-1 adopted under Section 22 (d), presently permits quantity discounts to individual purchasers, their spouses and children under 21, and to trustees of single fiduciary accounts, including qualified pension and profit-sharing plans, but not to groups of purchasers.

The proposal would, in effect, give each issuer a choice between (a) giving quantity discounts to the persons now specified in Rule 22d-1 and not to groups or (b) offering quantity discounts to certain "bona fide" groups as well as to purchasers to whom they are presently available. Eligible groups would be defined to exclude any groups not in existence for at least six months or which have no other purpose than to purchase mutual fund shares at a discount. In addition to written comments, the Commission solicited comments on the rule proposal from those appearing at the mutual fund distribution hearings held in February 1973.

The need to develop new markets for fund shares is a product of increased competition for investors' savings. One means adopted by certain funds to attract investors has been to reduce or eliminate the sales load previously imposed on sales of their shares. As a result of the Commission's opinion in *United Funds, Inc.*,[8] which granted certain open-end investment companies an exemption from Section 22 (d) to permit their shareholders to use redemption proceeds to repurchase shares without the payment of a sales load within 15 days after requesting redemption, numerous applications were received from open-end companies for similar exemptions. During the fiscal year, the Commission published for comment proposed Rule 22d-2.[9] The proposed rule is designed to codify the exemptive relief afforded United Funds, Inc. and to extend the permissible period between redemption and reinvestment from 15 to 30 days. No final action has yet been taken on the proposal.

During the fiscal year, the Commission continued to seek liberalization of its mutual fund advertising rules,[10] which may also

have an impact on the distribution process. On January 18, 1973, the Commission published for comment a proposed amendment to Rule 134 which would permit greater flexibility in investment company advertisements by further expanding the categories of information which could be included.[11] The proposals were published prior to commencement of the mutual fund distribution hearings in February in order to provide a concrete basis for the discussion of advertising problems.

Under the proposed amendment an investment company with an effective registration statement could include in its advertisements a description of its own special features, method of operation and services; name its principal officers and directors and describe its key advisory personnel: state its date of incorporation and total net asset value; and use any design or illustration contained in the prospectus not involving performance figures. The use of such material would require inclusion of a statement of certain fees and charges and a coupon to request a prospectus. Proposed Rule 425B would require that the prospectus sent in response to a coupon request from such an advertisement contain a statement stressing the importance of reading the prospectus before making an investment decision.

Litigation initiated during the fiscal year may also affect the distribution of mutual funds. On February 22, 1973, the Antitrust Division of the Department of Justice instituted an action in the District of Columbia Federal District Court against the National Association of Securities Dealers ("NASD"), certain mutual fund underwriters and various retail broker-dealer firms.[12] The Antitrust Division's complaint generally alleges that the contractual agreements between certain mutual fund underwriters and retail broker-dealer firms prevent or inhibit the development of a secondary dealer or brokerage market in the shares of those mutual funds. Specifically, the contractual agreements allegedly (1) prohibit a broker-dealer firm from selling mutual fund shares as a broker, (2) prohibit sales to non-contract broker-dealers by broker-dealers under contract at less than the current public offering price, which includes a sales load, and (3) require that all shares tendered to the contract broker-dealer be returned for redemption to the fund underwriter. The

following relief was requested by the Antitrust Division: (1) a permanent injunction against the use of these contractual restrictions; (2) disclosure in mutual fund prospectuses of the potential existence of brokerage or secondary dealer markets; (3) disclosure in NASD publications that NASD members are free to act as brokers with respect to mutual fund transactions; and (4) disclosure by broker-dealers to their prospective customers of the potential existence of a brokerage market and its potential cost savings. By the end of the fiscal year, proceedings in the Justice Department suit and related class actions filed by private investors had not developed beyond preliminary stages.

ADVISORY COMMITTEE ON INVESTMENT MANAGEMENT SERVICES

On January 23, 1973, the Commission released the report of the Commission's Advisory Committee on Investment Management Services for Individual Investors. This industry committee was appointed by the Commission in October to study problems in the development of investment management services for direct investors with relatively small amounts to invest. A major problem for those wishing to develop such services is the uncertainty as to when such services can be deemed to involve the sale of a security or the operation of an investment company and thus be subject to the various registration provisions.

The Advisory Committee's report contains the results of a survey on practices in the selection and use of brokers, custodial and record-keeping services, the designation of investment objectives, the use of model accounts and approved lists, and other ingredients of the investment management process.

Among the Committee's principal recommendations: (1) Investment management services for small accounts should not be treated as investment companies for purposes of the Investment Company Act, whether or not they furnish individualized service, as long as there is no pooling of clients' accounts; (2) These services should not be

treated as involving the public offering of a security for purposes of the Securities Act if they furnish clients individualized service or make recommendations only and have no discretion in the execution of portfolio transactions; (3) The Commission should adopt guidelines, as suggested by the Committee, for persons offering these services to determine what constitutes "individualized service;" (4) Firms offering these services should be required to give prospective clients a written disclosure statement to aid them in deciding whether to retain the services of a particular firm; (5) The Commission should adopt rules or publish interpretations to provide necessary protection for clients of small account services against certain conflicts of interest, such as those that can arise from fee-sharing promotional arrangements, broker affiliations, and the use of inside information; (6) The Commission should take appropriate action to promulgate standards governing the professional qualifications and financial responsibility of investment advisers and a system of self-regulation for investment advisers.

The Commission is studying the Committee's recommendations and considering staff proposals for action based on the recommendations.

INVESTMENT ADVISER REGULATION

During the latter part of the fiscal year, the Commission directed the Division of Investment Management Regulation to develop for Commission consideration a comprehensive program to tighten regulation of investment advisers. The program may include new rules regarding disclosure, reporting and other matters concerning advisory operations, a staff inquiry into existing industry practices, and, where such inquiry reveals substantial deficiencies, the proposal of additional new rules or legislation. Particular consideration will be given to the necessity of minimum qualifications for advisory employees, financial responsibility of investment advisers, and problems of potential conflicts of interest.

LIAISON PROCEDURES WITH SMALL BUSINESS ADMINISTRATION

During the fiscal year, the Divisions of Corporation Finance and Investment Management Regulation designated staff members as a joint committee to coordinate SEC-SBA activities affecting Small Business Investment Companies ("SBICs"). Informal discussions were held concerning more effective liaison in such matters as the integration of statistical information for SBICs with closed-end investment companies; significant changes affecting the status of licensed companies which require reporting or other action pursuant to the Federal securities laws or the Small Business Investment Act; SEC examination, investigation and proceedings against registered SBICs; and proposed SEC and SBA rules and regulations affecting SBICs. Formal lines of communication have not yet been completely established.

NUMBER OF REGISTRANTS

As of June 30, 1973, there were 1,361 investment companies registered under the Act, with assets having an aggregate market value of over $73 billion. Compared with corresponding totals at June 30, 1972, those figures represent an increase of 28 in the number of registered companies but a decrease of nearly $8 billion in the market value of assets. Further data is presented in the statistical section of the report.

On June 18, 1973, the Commission determined that more than 750 investment advisers were no longer in existence or were not engaged in business as investment advisers and issued an order canceling their registrations.[13] The Commission had previously issued a notice of intention to cancel the registrations of more than 800 registered investment advisers,[14] principally based on the fact that, despite prior communications that annual assessments for 1971 and/or 1972 were due and payable, payments had not been made. Fourteen of those investment advisers withdrew from registration, and the Commission received payment of 1971 and/or 1972 annual assessments, totaling

approximately $8,300, from about 59 registrants. At June 30, 1973, 2,892 investment advisers were registered with the Commission, representing a decrease of 919 from a year before.

During the fiscal year, the staff of the Commission conducted 170 investment company examinations and 272 investment adviser examinations, representing increases of 60 percent and 84 percent, respectively, over the prior fiscal year.

During the same period, approximately $815,628 was recovered by investment companies and their shareholders as a result of the Commission's various compliance and enforcement activities.

APPLICATIONS

One of the Commission's principal activities in its regulation of investment companies and investment advisers is the consideration of applications for exemptions from various provisions of the Investment Company and Investment Advisers Acts or for certain other relief under those Acts. Applications may also seek determinations of the status of persons or companies. During the fiscal year, 347 applications were filed under both Acts, and final action was taken on 326 applications. As of the end of the year, 158 applications were pending under both Acts.[15] Of the totals described, the predominant number were applications under the Investment Company Act. With respect to the Advisers Act, 3 applications were filed, final action was taken on 1, and 2 were pending at year end.

Under the Investment Company Act, affiliates of a registered investment company cannot participate in a joint arrangement with the registered company or purchase from or sell securities to the registered company unless they first obtain the Commission's approval. Life Insurance Investors, Inc., a registered open-end investment company which owned 8.06 percent of the stock of Old Line Life Insurance Company, certain affiliates of Life Insurance Investors who also owned stock of Old Line, and Old Line, filed an application for an order permitting them to vote their holdings of Old

Line stock to merge Old Line with a wholly-owned subsidiary of USLIFE Corporation and to receive common stock of USLIFE through the conversion of all the outstanding common stock of Old Line into common stock of USLIFE. As originally contemplated, the merger terms called for the payment of a $650,000 fee to an affiliate of Life Insurance Investors for arranging the merger. After the staff pointed out that payment of such a fee might raise problems under the standards of Section 17 of the Act, the applicants eliminated provision for this fee and improved, by a comparable amount in the aggregate, the terms offered all Old Line shareholders. During the pendency of this application, it became apparent that, in previously acquiring stock of Old Line, certain affiliates of Life Insurance Investors might have violated provisions of the securities laws. The Commission commenced a legal action in a Federal court charging such violations against these persons, seeking a preliminary and permanent injunction and an order directing the defendants to disgorge all profits.[16] Council for defendants then represented that certain defendants would (and they subsequently did) deposit certain sums in an escrow account, subject to determination in such action as to how the account should be distributed. In ruling on the application, the Commission noted that separate action to achieve accountability for any violations arising from previous acquisitions of Old Line stock was available to the Commission and other interested persons, and concluded that, under those circumstances and in view of the total stockholder interests affected by the proposed merger, an order granting the application was appropriate.[17]

In *Chase Investors Management Corporation New York*,[18] the applicant requested that the Commission issue an order declaring that it was not an investment adviser as defined in Section 202 (a)(11) of the Advisers Act. The applicant was a subsidiary formed by Chase Manhattan Corporation, the bank holding company which also owns Chase Manhattan Bank, to take over and expand the advisory services conducted by the bank. The subsidiary indicated its intent to offer investment research, advisory and management services to the bank, to the public, and to institutional investors such as employee benefit funds and, possibly, investment companies. The applicant argued that its status as a bank holding company subsidiary

subjected it to the same regulation as a bank or bank holding company, thereby qualifying it for the "bank" exclusion from the Advisers Act. A hearing was ordered by the Commission on the application. Prior to commencement, the hearing was canceled when the applicant withdrew its application and registered under the Advisers Act. Subsequently, a number of other non-bank investment advisory subsidiaries of bank holding companies have registered with the Commission under the Advisers Act.

In order to market its shares effectively in foreign countries, a registered mutual fund may find it necessary to conform to selling practices prevailing abroad. Those practices, however, may in some instances conflict with the requirements of the Investment Company Act, and the utilization of different practices in diverse locations may itself be impermissible under that Act. For example, a practice in Japan pursuant to which shares of mutual funds are sold to the public in block offerings at prices based on net asset values previously determined rather than at prices determined after the sale, as required by the Act, could not be followed by a registered fund without an order of exemption. Similarly, a registered fund may not, without another exemption, sell its shares to the public in Japan at prices, including sales loads, which differ from those applicable in the United States. The Commission granted exemptions to The Dreyfus Fund, Incorporated to permit its shares to be sold in Japan at prices and with sales loads which are determined in conformity with the usual and customary Japanese practice with respect to the sale of mutual fund shares.[19]

Under the Investment Company Act, an affiliated company of a registered investment company cannot sell any security to or participate in any joint arrangement with the investment company absent an order of the Commission. Christiana Securities Company, a closed-end investment company with assets valued at market in excess of $2.2 billion and which owns 28 percent of the common stock of E. I. duPont de Nemours and Company, filed a joint application with duPont for an order permitting Christiana and duPont to merge. DuPont common stock held by Christiana represents 98.7 percent of the value of Christiana's assets. Pursuant to the merger

terms, duPont common stock would be issued to the Christiana common shareholders, whose Christiana shares would be retired, and duPont would be the surviving corporation. For purposes of the merger, the Christiana common shares were valued at approximately 97.5 percent of their net asset value. The Commission held hearings in response to requests from several shareholders who alleged the merger terms were unfair.[20] After the close of the fiscal year, the Commission heard oral argument in the matter and took it under advisement.

In September 1971, Pacific Scholarship Trust Sponsored by the Pacific Scholarship Fund filed an application requesting exemptions from certain sections of .the Investment Company Act to permit the sale of scholarship plans. The plans would require investors to deposit sums in bank savings accounts, from which earnings would be periodically transferred to a trust fund and invested to provide funds for the eventual college education of designated child beneficiaries. A portion of the payouts to students who did attend college would be derived from amounts forfeited by other investors in the plans. A forfeiture would result if the designated child failed to enter college or to complete the first year successfully, or if the investor failed to maintain his savings account or to make required periodic payments. In order to offer plans which include such a forfeiture feature, the trust required exemptions from several sections of the Act, including an exemption from Section 27 (c) (l), which prohibits the sale of non-redeemable periodic payment plan certificates. On May 24, 1972, the Commission ordered hearings on the application to determine whether the granting of the requested exemptions would be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.[21] Hearings were conducted from June 17 through June 21, 1972. An initial decision by the administrative law judge was waived, and the Commission heard oral argument on March 9, 1973. No decision had been reached by the end of the fiscal year.

Section 22 (d) of the Investment Company Act prohibits a registered investment company from selling its redeemable securities at a price

other than the current public offering price described in the prospectus. Putnam Investors Fund, Inc., a registered open-end investment company, filed an application for exemption from Section 22 (d) so that its shares could be issued in exchange for the assets of Refractory Service, Inc., a personal holding company.[22] As the application was originally filed, only 23.5 percent of the assets of Refractory were securities which would be retained in Putnam's portfolio. Following staff comment with regard to the brokerage costs to Putnam shareholders for resulting portfolio adjustments, Refractory's portfolio was adjusted prior to the transaction at its expense so that securities to be retained would amount to a minimum of 60 percent.

RULES AND GUIDELINES

Continued implementation of the Investment Company Amendments Act of 1970 as well as the normal continuing review of rules in light of changing conditions and administrative experience resulted in the revision of various rules under the Investment Company and Investment Advisers Acts during the fiscal year.

Codes of Ethics

In 1963, the Commission's Report of Special Study of Securities Markets,[23] after examining the nature and extent of trading in the portfolio securities of an investment company by persons with access to the company's investment information, concluded that securities transactions by such persons often placed them in a conflict of interest position. It recommended clarification of the nature and extent of obligations in this area. Subsequently, after further examination in its report, Public Policy Implications of Investment Company Growth,[24] the Commission recommended that the Investment Company Act be amended to empower the Commission to adopt rules for the protection of investors in connection with purchases or sales of securities by persons with access to the investment company's decision-making process ("access persons").

In response to this recommendation Section 17 (j) was added by the Investment Company Amendments Act of 1970.

On December 26, 1972, the Commission proposed for public comment Rule 17J-1 to implement the provisions of Section 17 (j).[25] As proposed, the rule would provide a general antifraud provision, similar to those contained in Rules 10b-5 and 15c-2 under the Exchange Act and Section 206 of the Advisers Act, in the context of the purchase or sale by an access person of a security which is held or to be acquired by the investment company with which he is affiliated. Further, it would contain a specific antifraud provision prohibiting any access person from purchasing or selling a security for his own account when he knows the investment company is purchasing or selling it or the investment adviser is recommending or is considering recommending that the investment company purchase or sell that security. This prohibition would apply to situations where consideration of a recommendation has reached an advanced stage. To enforce the general and specific anti-fraud provisions, proposed Rule 17J-1 includes a reporting requirement for access persons which is patterned after Rule 204-2 (a) (12) under the Advisers Act. Finally, the rule proposal would require investment companies, their investment advisers and principal underwriters to adopt Codes of Ethics establishing, as a minimum, such standards as may be reasonably necessary to prevent access persons from engaging in any activity which violates the specific antifraud provisions. To provide greater certainty and protection for access persons, Rule 17j-1 would permit Codes of Ethics to allow "prior clearance" procedures under which access persons could receive pre-trans-action guidance as to the applicability of the specific antifraud provisions. During the comment period, the Commission received 105 letters concerning various provisions of proposed Rule 17J-1. As a result of these comments, it is expected that the Commission will revise the rule and re-circulate it for public comment.

Performance Fees

Section 205 of the Advisers Act was amended by the Investment Company Amendments Act of 1970 to deal with the problem of unfair

compensation arrangements between investment advisers and their clients. Many performance fees did not decrease when performance was poor, or, if they did, the decrease was disproportionate to the increase for good performance. The 1970 amendment was designed to align, as nearly as possible, the interests of the investment adviser and its clients by prohibiting incentive fee arrangements where the compensation does not increase or decrease proportionately with investment performance over a specified period in comparison with the investment record of an appropriate index of securities prices. The "fulcrum" point from which increases and decreases must be measured is the fee which is earned or paid when the investment performance of the advisory account is equivalent to that of the index. Section 205, as amended, allows such incentive fee arrangements only with respect to persons (except collectively-invested employee benefit funds) with managed assets in excess of $1 million and registered investment companies.

During the fiscal year, the Commission adopted Rule 205-1 under the Advisers Act.[26] The rule is designed to assure that "investment performance" of an investment company is computed on the same basis as the "investment record" of an index, so as to make the two comparable. The Commission also adopted Rule 205-2 which requires that the performance portion of the advisory fee be more closely based upon the assets upon which performance was achieved and not be influenced unduly by the amount of assets added or subtracted from the advisory account.[27]

Recordkeeping Requirements

During the fiscal year, Rule 31a-2 under the Investment Company Act was amended to allow microfilm records to be maintained by investment companies in lieu of hard copy records.[28] The amended rule requires, however, that equipment and facilities for reading and making hard copies from microfilm be available, and contains certain other safeguards, such as requiring the maintenance of duplicate copies at other locations in case of fire or other loss.

NOTES FOR PART 5

[1] H.R. 6821, S. 1050 (93d Cong., 1st Sess.).

[2] S. 3681, H.R. 15304 (92d Cong., 2d Sess.).

[3] 445 F. 2d 1337 (C.A. 2, 1971).

[4] S. 470 (93d Cong., 1st Sess.).

[5] H.R. 5532 (93d Cong., 1st Sess.).

[6] SEC, Institutional Investor Study Report, H.R. Doc. 64, 92d Cong., 1st Sess., Vol. 1 at X, XI (March 10, 1971).

[7] S. 2234 (93d Cong., 1st Session.).

[8] Investment Company Act Release No. 7189 (May 25, 1972).

[9] Investment Company Act Release No. 7555 (December 8, 1972).

[10] See 38th Annual Report, pp. 97-98.

[11] Securities Act Release No. 5357.

[12] *U.S. v. N.A.S.D., Inc.*, Civil Action No. 338-73 (D.D.C. 1973).

[13] Investment Advisers Act Release No. 384 (June 18, 1973), 2 SEC Docket 21.

[14] Investment Advisers Act Release No. 367 (March 19, 1973), 1 SEC Docket No. 8, p. 16.

[15] These figures represent only those applications processed in the Division of Investment Management Regulation and exclude applications filed pursuant to Section 9 of the Investment Company Act which are processed by the Commission's Division of Enforcement.

[16] *S.E.C. v. J. C. Bradford & Co., et al.*, 72 Civ. 4776 (S.D.N.Y.). For a further discussion of this action see Part 4.

[17] Life Insurance Investors, Inc., Investment Company Act Release No. 7523 (November 22, 1972).

[18] Investment Advisers Act Release No. 333 (August 21, 1972).

[19] Investment Company Act Release No. 7631 (January 18, 1973).

[20] Investment Company Act Release No. 7563 (December 13, 1972).

[21] Investment Company Act Release No. 7196 (May 24, 1972).

[22] Investment Company Act Release No. 7913 (July 31, 1973), 2 SEC Docket 242.

[23] SEC, *Report of Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 at 235-255 (1963).

[24] SEC, *Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess., at 195-200 (Dec. 2, 1966).

[25] Investment Company Act Release No. 7581 (Dec. 26, 1972).

[26] Investment Advisers Act Release No. 327 (August 8, 1972).

[27] Investment Advisers Act Release No. 347 (November 10, 1972).

[28] Investment Company Act Release No. 7724 (March 16, 1973), 1 SEC Docket No, 7, p. 15.

PART 6
PUBLIC UTILITIES HOLDING COMPANIES

Under the Public Utility Holding Company Act of 1935, the Commission regulates interstate public-utility holding-company systems engaged in the electric utility business and/or retail distribution of gas. The Commission's jurisdiction also covers natural gas pipeline companies and other non-utility companies which are subsidiary companies of registered holding companies. There are three principal areas of regulation under the Act: (1) the physical integration of public-utility companies and functionally related properties of holding-company systems, and the simplification of intercorporate relationships and financial structures of such systems; (2) the financing operations of registered holding companies and their subsidiary companies, the acquisition and disposition of securities and properties and certain accounting practices, servicing arrangements, and intercompany transactions; (3) exemptive provisions relating to the status under the Act of persons and companies, and provisions regulating the right of persons affiliated with a public-utility company to become affiliated with another such company through acquisition of securities.

COMPOSITION

At fiscal year-end, there were 23 holding companies registered under the Act. Twenty were included in the 17 "active" registered holding-company systems.[1]

The remaining three registered holding companies, which are relatively small, are not considered part of "active" systems.[2] In the 17 active systems, there were 84 electric and/or gas utility subsidiaries, 62 non-utility subsidiaries, and 16 inactive companies, or a total, including the parent holding companies and the subholding companies, of 182 system companies..

PROCEEDINGS

Cities of Lafayette and Plaquemine, Louisiana v. SEC[3] — The Court of Appeals for the District of Columbia Circuit affirmed the Commission's denial of a motion filed by the cities of Lafayette and Plaquemine, Louisiana ("Cities"),[4] seeking reopening of the record, closed 14 months prior to the filing of the motion, and affirmed the Commission's approval of the acquisition of the common and preferred stock of Arkansas-Missouri Power Company by Middle South Utilities, Inc., a registered holding company.[5] The Cities had alleged that certain activities of Louisiana Power & Light Company, a subsidiary of Middle South, violated Federal antitrust laws. The court observed that where the administrative process is far advanced in a particular case, a party seeking to present new evidence must at least demonstrate the probability that consideration of such evidence would alter the agency's decision, a showing the court found wanting. In essence, the court found that since the Cities' objection was untimely and their allegations bore only a dubious nexus to the transaction at issue, their motion was properly denied.

American Electric Power Company, Inc.[6] — Shortly after the close of the fiscal year, an administrative law judge issued an initial decision denying the application of American Electric, a registered holding company, to acquire, by a tender offer, the common stock of Columbus and Southern Ohio Electric Company, a non-associate electric utility company. The administrative law judge found, as urged by the Division of Corporate Regulation and the Department of Justice, that the proposed acquisition would have anticompetitive effects warranting disapproval under Section 10 (b) (l) of the Act and would not produce sufficiently significant economies to justify approval under Section 10 (c) (2). The Commission has granted petitions for review filed by American Electric, Columbus and Southern, and others.

Delmarva Power & Light Company.[7] — The Commission instituted a proceeding under Section 11 (b) (l) of the Act with respect to Delmarva which operates both electric and retail gas distribution systems in Delaware and has electric utility subsidiary companies operating in two other states. Delmarva has asserted that its principal integrated public-utility system is its electric system and that the gas

properties are retainable under the standards of Section 11 (b) (l). Delmarva also filed an application for exemption from the Act pursuant to Section 3 (a) (2). Both proceedings have been consolidated for hearing and disposition.[8] The Delaware Public Service Commission intervened as a party in support of Delmarva. The hearing has been completed and briefs are to be filed with the administrative law judge.

New England Electric System.[9] — The Commission ordered a hearing on a plan of divestiture filed by New England Electric proposing to sell three of its gas utility subsidiaries to Eastern Gas & Fuel Associates, an exempt holding company. The Antitrust Division of the Department of Justice intervened in the proceeding. Petitions for intervention in opposition to the proposed sale were filed by Massachusetts Congressman Michael J. Harrington, the Association of Massachusetts Consumers, the towns of Wakefield, Pea-body and Gloucester, Massachusetts, and an individual prospective bidder. After the close of the fiscal year, the opposing intervenors entered into settlement with Eastern. An initial decision was waived and the matter was taken under advisement by the Commission.

Union Electric Company.[10] — During the fiscal year, the administrative law judge issued an initial decision on an application by Union Electric, an exempt holding company and an operating electric and gas utility company, for permission to acquire, by tender offer, the outstanding common stock of Missouri Utilities Company, an electric and gas company. The initial decision concluded that the application should be granted, but only on condition that the gas, water and certain electric properties of Missouri Utilities and the gas properties of Union Electric and its present subsidiary companies be divested. At year-end, the case was pending for decision by the Commission on review of the initial decision.

In two companion cases, *Pacific Lighting Corporation* and *National Utilities & Industries Corporation*,[11] the Commission, which was then one Commissioner short of full strength, was evenly divided on the question of the extent to which an exempt holding company could engage in businesses unrelated to its utility operations.[12] All

Commissioners agreed that exempt holding companies were not subject to the absolute prohibition against functionally unrelated activities to which registered holding companies are held. Two Commissioners were of the view that prudent and limited diversification was not likely to present undue risks to investors or consumers and could serve a beneficial purpose. They proposed the adoption of certain restrictions and guidelines for diversification and found that Pacific and National conformed substantially to the proposed limitations. The other Commissioners considered that an exempt holding company should be permitted to engage only in such non-utility activities as are related or complementary in a significant way to its utility business. Other non-utility activities, they said, would dilute the predominant utility orientation and tend to impair the stability associated by investors with public-utility operations.

The result of the even division of the Commission was not the same in the two cases. In *Pacific*, the issue was whether a 1936 exemption order should be revoked or modified; the even division left the exemption in effect. In National, the question was whether the company's application for exemption should be granted; the division left the application pending. In the meantime, National has the benefit of an interim exemption provided by the Act for a company which files an exemption application in good faith.

In three opinions,[13] the Commission granted exceptions from the competitive bidding requirements of Rule 50 under the Act for the sale of common stock of gas utility companies to be divested by electric utility systems. Objections were filed in two of the cases by municipalities professing an interest in the purchase of a segment of the gas company's properties, and preferred stockholders objected in the third case.

The municipalities, in essence, contended that their proposed bids might not receive serious consideration. The Commission noted, in rejecting their contentions, that merely granting the exceptions did not constitute a decision as to the method or conduct of negotiations, or determine the successful bidder. After a sale agreement is concluded the company must apply for authorization to conclude the sale, and

appropriate inquiry could then be made with respect to the maintenance of competitive conditions as required by Section 12 (d) of the Act.

In the third case the gas properties subject to divestiture were owned by a subsidiary which was also engaged in the electric utility business; the gas properties were to be transferred to a newly organized company in exchange for its stock; and-divestment was to be accomplished either by a sale of the stock or physical assets. The preferred stockholders of the subsidiary urged that, without their prior consent or payment of the voluntary redemption price, which the company declined to pay, the gas properties could not be transferred or divested. The Commission observed that the grant of the exception would not prejudice their interests. The questions of when and how much they would be paid was deferred pending an application for authorization to sell.

FINANCING

Volume

During fiscal 1973, a total of 14 active registered holding-company systems issued and sold 55 issues of long-term debt and capital stock for cash aggregating $2.71 billion[14] pursuant to authorizations by the Commission under Sections 6 and 7 of the Act. All but 3 of these issues were sold at competitive bidding to raise new capital. The public utility financing table in the statistical section presents the amount and types of securities issued and sold by these holding company systems.

The volume of external financing during 1973 decreased by 3 percent from the record amount issued and sold during fiscal 1972. Bonds, debentures and preferred stock issued and sold decreased by 3 percent, 15 percent and 46 percent, respectively, while the amount of common stock issued and sold increased by 53 percent from fiscal 1972.

The lower volume of financing was accompanied by a slight increase in the earnings coverages of interest and preferred dividends reversing a long-term downward trend. For the calendar year 1972, the earnings (after taxes) of the 17 active registered holding company systems represented an average of 2.10 times their interest and preferred dividend requirements as compared to 2.04 times in 1971.

Leasing

In recent years, the use of leases to finance significant additions to utility facilities has developed. Such transactions are involved in only a small portion of the massive expansion the utility industry has experienced in this period, but are far from negligible in absolute amount. The title retained by the lessor, usually a financial institution, under such a lease makes it the owner of a utility facility. As such, it would be defined as an electric or a gas utility company by Sections 2 (a) (3) and 2 (a) (4) of the Act and subject to various obligations thereunder. Lessors sought relief by applications for exemption under those sections.

While these sections do contain ex-emptive authority, they were designed for other purposes and it became clear with experience that grant of such exemptions was not an appropriate source of relief. During the fiscal year therefore, the Commission promulgated Rule 7 (d) under the Act which declares that the lessor's title retained under leases meeting its conditions shall not constitute ownership of a utility facility within the meaning of Sections 2 (a) (3) or 2 (a) (4).

The conditions are drawn to insure that the excluded lease does, in fact, vest effective control over the facility in an operating public utility company, leaving the lessor with only the passive title on which the exclusion is premised.

The terms of the lease must also have been expressly approved by a regulatory authority having jurisdiction over the rates and services of the lessee, to make certain that the excluded transaction is examined by an appropriate public agency responsible for the protection of investors and consumers.

The exclusion becomes effective on the filing with the Commission of a simple certificate, Form U 7D, identifying the lease. The Commission also amended Rule 106 under the Act, to reduce the fee for filing such certificate from $2,000 to $200. As of July 31, 1973, 21 certificates had been filed.

Allowance for Funds Used During Construction

"Allowance for Funds Used During Construction" (AFC) is an amount generally permitted by rate-regulatory agencies to be included in the cost of construction and subsequently recovered after commencement of commercial operation through rates charged consumers over the life of the related assets. AFC represents the net cost, during the period of construction, of funds borrowed for construction purposes plus a reasonable rate for other funds when so used. During the period of construction, (i.e., before the asset is placed in service) AFC is reflected in the income statements of the utility as an item of "Other Income."

When the item of AFC was relatively small, its inclusion in utilities' income statements received little attention. In recent years, however, the electric industry's continuous huge construction programs, coupled with sharply higher financing costs, has caused a rapid increase in the AFC item – both in an absolute sense and relative to reported net income. Thus, in the past fiscal year, the amount of AFC reflected in income statements of subsidiaries of registered holding companies has ranged as high as 43 percent of reported net income; and generally the same has been true for the electric utility industry as a whole.

With the constant growth of the AFC item and its often substantial impact on reported net income, considerable controversy has arisen in the accounting and investment communities regarding the nature of AFC and the traditional treatment of this non-cash amount as an item of "Other Income" in the income statement. Recognizing the importance of this subject, the Commission has in the past fiscal year required fuller disclosure of AFC for all utility companies (including

subsidiaries of registered holding companies) in the registration of security offerings. The expanded requirements include a clear definition of AFC; the rate applied to construction work in progress in computing the amount of AFC; a separation of AFC into its two components of (a) interest paid on borrowed funds used for construction, and (b) the imputed cost of other funds when so used; and the ratio that such imputed cost of "other funds" bears to net income reported as available for common stock. Fuller disclosure requirements should help to develop uniformity in the accounting for AFC and its presentation in the income statement.

Joint Ventures

Traditionally, the retail gas utility industry has obtained the bulk of its natural gas requirements through contractual purchase arrangements with large interstate pipe line companies. However, the steady shrinkage of natural gas reserves, coupled with steadily increasing demands, has in recent years forced the gas holding company systems to intensify their efforts to develop additional sources of supply through exploration and development programs of their own. The many complex problems, technical and financial, inherent in such programs have led increasingly to joint ventures with non-associated oil and gas interests. Individual joint agreements vary in detail, but in general the objective of the gas company participants is to obtain direct entitlement to, or first call on, gas reserves developed through the joint ventures. Where these ventures involve participation by registered holding companies or subsidiary companies thereof the Commission must pass upon the financing of their participations and related matters under applicable provisions of the Act. Prior to fiscal 1973, the Commission approved several such joint-venture participations by registered gas utility holding companies or their subsidiaries.[15]

In fiscal 1973, the Commission approved participation by the Columbia Gas System in a joint venture with two non-affiliated oil and gas interests, Energy Ventures, Inc. and Forest Oil Corporation, to bid for offshore oil and gas leases offered by the U.S. Department of the Interior. The total initial capital requirements were estimated at

$200 million, about half of which would be Columbia's obligation.[16] In American Natural Gas Company, the Commission authorized financing of up to $50 million for participation by the company's production subsidiary in a group bidding jointly for offshore Texas tracts offered in June 1973, by the Interior Department.[17]

The exploration and development activities of gas utility systems are generally conducted through non-utility subsidiaries. In the early phases of exploration and development projects, these subsidiaries often incur substantial net tax losses which are included in the system's consolidated tax returns, thus reducing the consolidated tax liability. Rule 45 (b) (6) promulgated under the Act some years ago requires in effect that, unless the Commission otherwise permits, the benefit of tax savings arising from the tax losses of the exploration subsidiaries be distributed among the other subsidiaries having taxable income.[18] In light of the substantial amounts of capital required in exploration and development activities and the risks involved, the gas holding company systems have requested permission to deviate from Rule 45 (b) (6) so as initially to give the cash equivalent of the tax savings to the exploration subsidiaries and thereby aid their programs for the development of new gas reserves. In recognition of the vital need for these programs in the context of the nationwide energy shortage, the Commission, during fiscal 1973, authorized deviations from the rule in response to declarations filed by the three largest gas utility holding company systems, Consolidated Natural Gas Company,[19] American Natural Gas Company,[20] and the Columbia Gas System.[21]

NOTES FOR PART 6

[1] Three of the 20 were subholding utility companies in these systems. They are The Potomac Edison Company and Monongahela Power Company, public-utility subsidiaries of Allegheny Power System, Inc., and Southwestern Electric Power Company, a public-utility subsidiary of Central and South West Corporation.

[2] These holding companies are British American Utilities Corporation; Kinzua Oil & Gas Corporation and its subsidiary company, Northwestern Pennsylvania Gas Corporation; and Standard Gas & Electric Company, which has been dissolved and its assets distributed.

[3] C.A.D.C., No. 71-1337 (June 29, 1973).

[4] Holding Company Act Release No. 17081 (March 30, 1971).

[5] Holding Company Act Release No. 17116 (May 5, 1971).

[6] Previously reported in 38th Annual Report, p. 108; 37th Annual Report, p. 170; 36th Annual Report, p. 160; 35th Annual Report, p. 149; 34th Annual Report, p. 138.

[7] See 38th Annual Report, p. 108.

[8] Holding Company Act Release No. 17748 (November 2, 1972).

[9] Holding Company Act Release No. 17908 (March 14, 1973), 1 SEC Docket No. 7, p. 8.

[10] Previously reported in 38th Annual Report, p. 109; 37th Annual Report, pp. 172-73.

[11] Previously reported, 38th Annual Report, page 109.

[12] Pacific Lighting Corporation, Holding Company Act Release No. 17855 (January 11, 1973); National Utilities & Industries Corporation, Holding Company Act Release No. 17857 (January 11, 1973).

[13] Connecticut Light & Power Co., Holding Company Act Release No. 17905 (March 5, 1973), 1 SEC Docket No. 6, p. 13; Middle South Utilities, Inc., Holding Company Act Release No. 17944 (April 25, 1973), 1 SEC Docket No. 13, p. 14; American Electric Power Co., Inc., Holding Company Act Release No. 18007 (June 19, 1973), 2 SEC Docket 12.

[14] Debt securities are computed at their price to company, preferred stock at the offering price, and common stock at the offering or subscription price.

[15] See, for example, The Columbia Gas System, Inc., (i) Holding Company Act Release No. 17213 (August 2, 1971), joint venture with BP Oil Corp. – SOHIO for development of oil and gas reserves at Prudhoe Bay, Alaska, at an estimated cost of $800-900 million of which Columbia's share is about $200 million; and (ii) Holding Company Act Release No. 17290 (September 27, 1971), joint venture with Dome Petroleum, Ltd., for gas exploration in the Canadian Arctic Islands, in which Columbia has a 50 percent interest at an estimated cost of $30 million. See also Consolidated Natural Gas Company, Holding Company Act Release No. 17559 (May 1, 1972), covering participations in three ventures for explorations of gas acreage in Canada.

[16] Holding Company Act Release No. 17809 (December 14, 1972).

[17] Holding Company Act Release No. 17984 (June 5, 1973), 1 SEC Docket No. 19, p. 16.

[18] The rule was designed to conform with the method of allocating consolidated taxes prescribed by Section 1552 (a) (l) of the Internal Revenue Code of 1954. Like the rule, the Code affords procedures for deviations from the prescribed method.

[19] Holding Company Act Release No. 17875 (February 6, 1973), 1 SEC Docket No. 2, p. 12.

[20] Holding Company Act Release No. 17984 (June 5, 1973), 1 SEC Docket No. 19, p. 16.

[21] Holding Company Act Release No. 18000 (June 12, 1973), 1 SEC Docket No. 20, p. 14.

PART 7
CORPORATE REORGANIZATIONS

The Commission's role under Chapter X of the Bankruptcy Act, which provides a procedure for reorganizing corporations in the United States district courts, differs from that under the various other statutes which it administers. The Commission does not initiate Chapter X proceedings or hold its own hearings, and it has no authority to determine any of the issues in such proceedings. The Commission participates in proceedings under Chapter X to provide independent, expert assistance to the courts, participants, and investors in a highly complex area of corporate law and finance. It pays special attention to the interests of public security holders who may not otherwise be represented effectively.

Where the scheduled indebtedness of a debtor corporation exceeds $3 million, Section 172 of Chapter X requires the judge, before approving any plan of reorganization, to submit it to the Commission for its examination and report. If the indebtedness does not exceed $3 million, the judge may, if he deems it advisable to do so, submit the plan to the Commission before deciding whether to approve it. When the Commission files a report, copies or summaries must be sent to all security holders and creditors when they are asked to vote on the plan. The Commission has no authority to veto a plan of reorganization or to require its adoption.

The Commission has not considered it necessary or appropriate to participate in every Chapter X case. Apart from the excessive administrative burden, many of the cases involve only trade or bank creditors and few public investors. The Commission seeks to participate principally in those proceedings in which a substantial public investor interest is involved. However, the Commission may also participate because an unfair plan has been or is about to be proposed, public security holders are not represented adequately, the reorganization proceedings are being conducted in violation of important provisions of the act, the facts indicate that the Commission

can perform a useful service, or the judge requests the Commission's participation.

The Commission in its Chapter X activities has divided the country into five geographical areas. The New York, Chicago, Los Angeles and Seattle regional offices of the Commission each have responsibility for one of these areas. Supervision and review of the regional offices' Chapter X work is the responsibility of the Division of Corporate Regulation of the Commission, which, through its Branch of Reorganization, also serves as a field office for the southeastern area of the United States.

PROPOSED CHAPTER X RULES

The Advisory Committee of the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States has proposed new Chapter X rules. In response to a general invitation for comment, the Commission's staff submitted a comprehensive report, dated July 5, 1973, generally critical of many aspects of the proposed rules. Subsequently, the Commission adopted the staff report as its official position, contending that the draft rules repeatedly abolish, without comment, carefully devised Congressional safeguards for public investors. In the Commission's view, the rules would also make it more difficult to perform the responsibilities imposed upon the Commission by Congress with respect to Chapter X proceedings, and do not adequately reflect the differences between procedures needed to bring about the reorganization of an enterprise under Chapter X in order that it may continue as a going concern, and procedures necessary to accomplish liquidation in ordinary bankruptcy proceedings.

SUMMARY OF ACTIVITIES

In fiscal 1973, the Commission entered 18 new Chapter X proceedings involving companies with aggregate stated assets of

approximately $750 million and aggregate indebtedness of approximately $664 million.

Including the new proceedings, the Commission was a party in a total of 117 reorganization proceedings during the year.[1] The stated assets of the companies involved in these proceedings totaled approximately $2.2 billion, and their indebtedness about $1.8 billion.

During the year, 8 proceedings were closed, leaving 109 in which the Commission was a party at fiscal year-end.

ADMINISTRATIVE MATTERS

In Chapter X proceedings, the Commission seeks to have the courts apply the procedural and substantive safeguards to which all parties are entitled. The Commission also attempts to secure judicial uniformity in the construction of Chapter X and the procedures thereunder.

King Resources Co.[2] – The Court of Appeals, as urged by the Commission, affirmed without opinion the order of the lower court in transferring this Chapter X proceeding from Texas to Denver, Colorado.[3]

Petitioning creditors had argued on appeal that the judge did not afford them an opportunity to file exceptions to the special master's recommendation pursuant to Rule 53 of the Federal Rules of Civil Procedure. The Commission pointed out that the order conformed to the standard practice in the Texas district court, that it did not prejudice appellants' appeal, and that the departure from Rule 53 was permitted by General Order 37.

Congaree Iron & Steel Company, Inc.[4] – A lawyer who had actively represented creditors in the filing of an involuntary Chapter X petition was later appointed general counsel to the Chapter X trustee. The debtor's answer to the involuntary petition questioned the validity of the claim of one of the petitioning creditors, thereby creating a

situation where the general counsel to the trustee would have to inquire into the validity of a former client's claim.

Though not participating in the case, the Commission urged the court that counsel was not disinterested as required by Sections 157 and 158 of Chapter X, even though he had ceased to represent the petitioning creditors on his appointment as general counsel to the trustee. The matter is still pending before the district court.

Tilco, Inc.[5] – A lawyer, associated with the law firm which acted as counsel for the debtor within 2 years preceding the filing of the Chapter X petition, was appointed by the court as general counsel to the Chapter X trustee. The law firm as well as an individual partner were named as defendants in three class actions brought against the debtor corporation and its principals. The Commission advised the lawyer that he was not disinterested as required by Sections 157 and 158 of Chanter X, and he resigned.

The debtor, Tilco, is a publicly-held holding company with a number of wholly-owned subsidiaries engaged in the business of producing oil and gas. One of the debtor's subsidiaries, Natural Resources Fund, Inc. (NRF), is the general partner in six limited partnerships formed for the purpose of exploring, drilling, and operating oil and gas properties. About 5,500 investors contributed in excess of $27 million for interests in the six limited partnerships.[6]

The debtor's Chapter X petition purported to include all wholly-owned subsidiaries. NRF's only source of income was its fees and charges as general partner in the various limited partnerships. Although it had approximately $1 million in cash on hand, this represented earnings of the respective limited partnerships. The Commission took the position that these funds, as well as the properties which generated them, belonged to the publicly-owned limited partnerships and could not be appropriated for Tilco's Chapter X proceeding. The Commission supported NRF's management in obtaining an order authorizing the distribution of approximately $750,000 of the limited partnerships' accumulated earnings to the limited partners.

Subsequently, a voluntary Chapter X petition by NRF was approved. This brought all of the partnership properties into the Chapter X court. However, the order of approval, as urged by the Commission, prohibited consolidation of NRF's partnership assets with those of Tilco and its other subsidiaries, but authorized their joint administration.

Imperial-American Resources Fund, Inc.[7] – The debtor was the general partner in 13 limited partnerships with a total investment of over $100 million contributed by more than 16,000 investors.

An individual sought to form a protective committee for the limited partners and began soliciting funds from them as well as authority to represent them in the Chapter X proceeding. The Commission objected to the individual's activities, claiming that he had not complied with the applicable provisions of Chapter X or the Commission's proxy rules.[8] Upon the application of the Commission, the district court ordered the individual to make no further solicitations and to submit an accounting for all funds received and disbursements thereof.

The Commission subsequently filed objections to the accounting and requested disallowance of substantially all expenses, including attorneys' fees incurred by the individual in defending against the Commission's action. The referee declined to exercise jurisdiction on the question of the propriety of these expenses, holding that restitution was a matter between those who made the contributions and the individual. The Commission has petitioned the district court for review of the referee's decision.

TMT Trailer Ferry, Inc.[9] – The Committee which has represented common stockholders since 1957 appealed from an order directing it to file new authorizations from stockholders and requiring that each shareholder granting such authorization disclose detailed information as to the acquisition of his stock. The committee had fully complied with Section 211 on entering its appearance,[10] had reiterated the facts as to its composition from time to time and supplied such

information as was available without a general solicitation of stockholders.

The Commission supported the committee's appeal. Although the Commission acknowledged that the Chapter X court has broad power to regulate committees and to require full disclosure, it argued that the type of information sought from individual shareholders was not relevant to the Committee's standing.[11] The requirement that new authorizations be solicited seemed inconsistent with a previous order of the court of appeals,[12] and was not based on any new development.

The court of appeals reversed and vacated the order of the lower court, finding it to be "another episode in the continuing pattern of harassment of the committee".[13] The court of appeals indicated that it was unwilling to allow the role of the committee to be downgraded or impeded, particularly in view of the important services which it has rendered during the reorganization.

Traders Compress Co.[14] – The debtor is a small publicly-owned corporation engaged primarily in the sale and distribution of liquefied petroleum gas ("LPG") to over 8,500 rural customers in Oklahoma. A major supplier sought to discontinue sales of LPG to the debtor, asserting a shortage in supply. The supplier made no attempt to ration LPG to its customers, but proposed to solve the shortage by eliminating the debtor's allocation completely.

Since other sources of supply were unavailable, the trustee sought an injunction to restrain the supplier from terminating the supply of LPG. The trustee urged that termination of the contract to supply the debtor would jeopardize any hope for a successful reorganization and would leave many of the debtor's customers without a source of supply. He contended that the laws of Oklahoma prohibited such discrimination. The Commission argued that the Chapter X court had jurisdiction to enter an injunction to preserve the going-concern value of the debtor for the benefit of its creditors and shareholders if the governing local law prohibited the attempted termination. The district court found that it had jurisdiction, and permanently enjoined the supplier from

terminating its agreement to supply the debtor, finding that the action of the supplier was discriminatory and violative of the Oklahoma public utility and antitrust laws. The injunctive order has been appealed to the court of appeals, where the matter is now pending.[15]

Sales of major assets under authority of Section 116 (3) of Chapter X rather than pursuant to plans of reorganization were involved in four cases in this fiscal year. The Commission objected to only one.

The Commission is satisfied that any proposed sale of all or a critical portion of a debtor's assets under the summary procedure of Section 116 (3) involves a conflict with the policy of Chapter X. Such a sale terminates the effort to reorganize and frustrates the purposes of the proceeding.[16] While Section 216 (10), dealing with plans of reorganization, expressly permits a plan to provide for the sale of any or all of the debtor's property, that power is not committed to the court's sole discretion, but is dependent upon compliance with the safeguards with which Congress has surrounded adoption of a plan of reorganization. In particular, it requires the consent of the statutory majority of the creditors and stockholders who are beneficial owners of the property being dealt with. Resort to Section 116 (3) as a substitute for Section 216 (10) effectively disenfranchises the creditors and shareholders and normally reduces the plan of reorganization to ratification of a fait accompli. In short, there must be a strong presumption against the propriety of such a transaction. However, the presumption is not conclusive. There are situations in which use of the powers granted by Section 116 (3) may be justified. The case of a warehouse full of deteriorating produce is not the only, or even the most important, example." The emphasis on the "wasting asset" concept[18] is an unfortunate and misleading turn taken by the law in this field. The trustee should not be required to cry "spoiled fish" in order to justify a sale.

With the increasing complexities of corporate business, and particularly the indiscriminate diversification which may precede corporate failures, the need to prune a debtor's business into reorganizable shape has become an almost routine aspect of Chapter X administration. Chapter X does not require that the debtor

be frozen in the unsatisfactory position which caused its insolvency. Sound business judgment may require rather substantial sales independent of a plan of reorganization.

The Commission does not insist that Section 216 (10) be complied with regardless of consequences. In given circumstances, where an adequate price is offered, it may not be feasible to embody the sale in a plan. In that event, Section 116 (3) is an effective procedure, provided ample notice is afforded creditors and stockholders. But it cannot be emphasized too strongly that a real, as distinguished from a self-created, need must be present to justify such elimination of the right of creditors and stockholders to decide affirmatively whether or not their property should be sold.

Bubble Up Delaware, Inc., et al.[19] – After competitive bidding and negotiations, the trustees presented to the court two offers to purchase substantially all of the debtors' operating assets. They relied on Section 116 (3) of Chapter X as authority for the sale.

Although sales and profits of the debtors had increased during the Chapter X proceeding, one of the trustees testified that in his opinion the business had reached its peak; that operating difficulties could set in as a result of an adverse court decision in an antitrust suit; and that controversies as to the relative rights of the creditors and stockholders of the several corporations involved might take time to litigate, thus precluding a sale pursuant to a plan of reorganization. After an extensive evidentiary hearing, the judge found that an emergency situation confronted the trustees and approved the sale to the party he found had made the highest offer. An appeal by the unsuccessful bidder was withdrawn and the sale was consummated.

Bermec Corporation.[20] – The trustee sought authority to sell most of the debtor's operating assets to certain competitors for approximately $8.1 million, having concluded after a thorough analysis that the business could not survive. The Commission did not dispute the trustee's decision to sell, but opposed acceptance of the initial offer on the ground that there was no showing that the price was adequate and reasonable. The court ordered an auction to be held, setting $8.1

million as the minimum upset price. The operating assets were ultimately sold for $9.4 million, and additional assets were sold for about $1.4 million.

Beck Industries, Inc.[21] – The Commission objected to the sale of a large furniture retailing subsidiary to its former owners citing inadequate consideration and the circumstance that the proposed sale appeared to be another step in the liquidation of the debtor outside of a plan of reorganization. The purchasers increased their offer, which the district judge approved.[22]

TRUSTEE'S INVESTIGATION

A complete accounting for the stewardship of corporate affairs by prior management is a requisite under Chapter X. One of the primary duties of the trustee is to make a thorough study of the debtor to assure the discovery and collection of all assets of the estate, including claims against officers, directors, or controlling persons who may have mismanaged the debtor's affairs. The staff of the Commission often aids the trustee in his investigation.

King Resources Company.[23] – The trustee resolved several primary problems regarding the estate during the past year. For one, he was successful in negotiating a compromise settlement with some 83 lien creditors and other parties asserting conflicting claims to 25 domestic oil or gas leases. Under the terms of this settlement, each of the lien creditors agreed to release his lien, and forego contractual interest and attorney's fees, in return for a cash payment of 75 percent from accumulated production and allowance of the 25 percent balance as an unsecured claim. As part of the settlement, the balance on production payments due to various parties was reduced by $519,000. These production payment holders will receive their agreed share of the oil and gas produced, thereby reducing the burden of interest payments on the estate.

The trustee also settled for $2.5 million a plenary suit he had brought against the surety under a fidelity bond of the debtor. The suit was

based on misappropriation of the debtor's funds in connection with former management's attempt to take control of Investors Overseas Service. The settlement as approved by the court amounted to 50 percent of the bond. The trustee used these funds to reduce the balance of his outstanding certificates.

The trustee rejected two pre-Chapter X agreements by the debtor to sell fractional interests in Canadian oil and gas exploration permits to John M. King and his private corporation, the Colorado Corporation. The rejection of the contracts was approved by the district court and upheld on appeal.[24]

Dolly Madison Industries, Inc.[25] – Two shareholders filed a class action against the debtor, certain of its former officers and directors, and its former accountants, alleging violations of the antifraud provisions of the Federal securities laws in that certain financial statements of the debtor were false and misleading. The plaintiffs also filed a class proof of claim in the reorganization proceeding to enforce the same liability against the debtor. The class actions sought about $10 million for the loss sustained by shareholders who had purchased the debtor's stock during the period from November 8, 1969, when the financial statements were made public, to February 18, 1970, when they were corrected.

After 11 weeks of trial, a settlement was reached under which the class claimants were allowed a $1.5 million unsecured claim against the debtor in the reorganization proceeding and approximately $1,950,000 in cash and securities from the other defendants in the class action. The settlement of the civil action also provided for an enlargement of the class to include purchasers and sellers up to June 26, 1970, the date of suspension of trading following the Chanter X petition. Under Rule 23 of the Federal Rules of Civil Procedure, class members were entitled to prove their claims against the settlement fund subsequent to the settlement. However, an order had been entered in the Chapter X case barring class members who had failed to file individual proofs of claim from participating in any recovery against the debtor.

The Commission did not object to the amount of the settlement, but urged, unsuccessfully, that the court should reopen the time for filing claims under Section 119 in order to permit individual proofs of claim to be filed in the Chapter X proceeding.

One shareholder, who failed to file a timely claim in the reorganization proceeding, appealed from the order approving the settlement. After the close of the fiscal year, the shareholder entered into a stipulation with the debtor, which the court approved, providing for withdrawal of the appeal and permitting a late filing at 75 percent of the claim. The Commission opposed the approval of the stipulation on the ground that, since the appellant had asserted rights common to the entire class of excluded shareholders, it was improper to terminate the appeal by a settlement limited to his claim.[26]

TMT Trailer Ferry, Inc. – In 1968, the Supreme Court reversed confirmation of a plan of reorganization for TMT.[27] The Court held that the district court had erred in finding the debtor insolvent and excluding shareholders from participation through the use of improper valuation standards, and in accepting the trustee's decision to allow two major contested claims since the record was insufficient to permit an informed, independent judgment as to the fairness and equity of the trustee's acceptance of the claims. The Supreme Court remanded for further proceedings, since the record did not permit conclusions as to whether or not the debtor was solvent or whether the disputed claims should be allowed.

In the last fiscal year, both these major claims were dealt with, after an investigation by the new trustee. An agreement to settle the claim of Merrill-Stevens, Inc. for $525,000, post bankruptcy interest being waived, was heard and approved. The claim had previously been allowed for $1.6 million principal, which would be equivalent to about $3.2 million with interest. A settlement of the "Caplan mortgage" claim was affirmed by the court of appeals.[28] Although the major part of this claim was held to be valid, certain participants in the loan were excluded from the settlement on equitable grounds, and their claims have since been adjusted or denied on the merits.

The new trustee's operation of TMT has been far more profitable than was forecast in the erroneous valuation findings. A cash offer more than sufficient to pay all creditors in full, with interest, has been received and is being weighed against other reorganization prospects.

REPORTS

Generally, the Commission files a formal advisory report only in a case which involves substantial public investor interest and presents significant problems. When no such formal report is filed the Commission may state its views briefly by letter, or authorize its counsel to make an oral or written presentation. During the fiscal year the Commission published no formal advisory report, but its views on five plans of reorganization were presented to the courts either orally or by written memoranda.[29]

American Loan & Finance Company.[30] – This equity receivership, which originated in an injunctive action by the Commission,[31] was superseded by a Chapter X proceeding after the receiver had determined that a sale of the debtor as a going-concern could best be effected by a Chapter X plan of reorganization. The debtor was insolvent, but provision was made for participation by the publicly-held 7 percent preferred stock. The holders of this stock, as urged by the Commission, were accorded creditor status under the plan, since the stock was sold to them in violation of the Securities Act.[32] The proceeds of the sale were distributed, pro rata, to these stockholders and to the public investment certificate holders at the rate of about 75 percent of their claims.

Four Seasons Nursing Centers of America, Inc.[33] – The court of appeals affirmed the Chapter X court's order approving the plan of reorganization which included a settlement of claims asserted against the debtor by persons who had allegedly been fraudulently induced to purchase its stock in violation of Federal securities laws.[34] Pursuant to the compromises embodied in the plan, the defrauded stockholders, whose claims exceeded $100 million, received one-

third of the equity of the reorganized company valued at $11.4 million.[35] Holders of unsecured claims against the debtor, totaling about $27 million, received the remaining equity valued at $22.8 million. Since, as a consequence of the settlement, the debtor was insolvent, the plan made no provision for stockholders who had purchased their stock after the filing of the Chapter X petition and disclosure of the alleged fraud.

A nonparticipating stockholder appealed. He urged that he should be included among the stockholders in the settlement or, in the alternative, the claim of fraud should be litigated and decided on the merits rather than compromised.

The court of appeals agreed with the trustee and the Commission[36] that the lower court had properly found that there was a strong probability that violations of the Federal securities laws had occurred for which the debtor would be liable; that a compromise of claims based on such violations was fair; and that there were no countervailing equities favoring inclusion of post-Chapter X stock purchasers in the reorganization plan. The court pointed out that the class of shareholders represented by appellant had full knowledge of the hazards involved and such purchases were motivated by "opportunism."

Farrington Manufacturing Co., et al.[37] – After determining that the debtor could not be reorganized, the trustee obtained court approval to sell its assets pursuant to Section 116 (3). As a result, the domestic estates' assets were basically reduced to cash and receivables, about $3.5 million. After the close of the fiscal year, the court approved the trustee's plan to distribute the cash to creditors only, including certain "creditor-stockholders" as discussed below, since the debtor was insolvent.

Pursuant to his extensive Section 167 investigation, the trustee had reported that certain of Farrington's shareholders might have causes of action against the company for violations of the Federal securities laws because of the publication of false and misleading information. Such claims were estimated at more than $30 million. If allowed in

full, they would have represented more than 40 percent of total liabilities. After negotiation and compromise between the trustee and various interests, a class of "creditor-stockholders" was recognized under the plan in order to avoid litigating these complex issues.

The settlement reached allots to Farrington's "creditor-stockholders" 17 percent and other creditors 83 percent of the domestic estates. The costs of counsel who represented the class will be deducted from the allotment to the "creditor-stockholders" which will also bear its share of administration expenses. The Commission advised the court that the plan was fair and equitable.

San Francisco & Oakland Helicopter Airlines, Inc.[38] – As urged by the Commission, the trustee operated the debtor's business for an additional year. Improvement in helicopter operations enabled him to propose another internal plan. It provided that the reorganized company would assume a portion of the secured debt and would issue stock to its unsecured creditors. Since the debtor was insolvent, shareholders were accorded no participation under the plan. The court, as recommended by the Commission, found the plan fair, equitable and feasible.

The Commission objected to a provision in the plan allowing the trustee to select the directors of the reorganized company. Such provision was amended to comply with Section 221 (5) which requires that the judge find that the appointment of directors "is equitable, compatible with the interests of creditors and stockholders and . . . consistent with public policy."

After confirmation of the plan, the necessary authorizations for consummation were obtained from the Civil Aeronautics Board. The plan was substantially consummated after the close of the fiscal year.

Federal Coal Company.[39] – The trustee, as directed by the court,[40] conducted a thorough investigation into the debtor's affairs, discovering numerous potential causes of action against the family group which had controlled the debtor. As a result, a settlement was reached in the form of a plan of reorganization. The plan provides for

the acquisition of full ownership of the debtor by the family group which had controlled it, by payment in cash of 112 percent of the principal amount of the debt to all bondholders, except the bonds owned by the purchasing group. The cash payment, which may be contrasted with the 30 percent originally offered in a Chapter XI plan of arrangement, would take the form of an additional payment of approximately 37 percent to those bondholders who already received 75 percent by accepting an unregistered tender offer made during the proceeding, and a full 112 percent to those who had declined to sell their bonds. Provision was made for efforts to locate missing bondholders, and for payment, in addition, of the costs .of the proceeding.

No provision is made for participation by Federal's shareholders since the debtor is hopelessly insolvent. However, the exclusion of stockholders will have little adverse effect on public investors since there is a substantial identity between stockholders and debenture holders. The Commission, in its memorandum, advised the court that the plan was fair, equitable and feasible. The memorandum pointed out that, when measured against the trustee's valuation of the debtor, the public bondholders would be entitled to receive only about 63 percent of the face amount of their bonds if the bonds held by the purchasing group were to share equally. The settlement provided for a payment of almost twice that sum. Shortly after the close of the fiscal year, the plan was substantially consummated.

Imperial '400' National, Inc.[41] – Four plans of reorganization for this debtor, which replaced the three which the Commission's original advisory report concluded should not be approved, were referred to the Commission. After the end of the fiscal year a supplemental advisory report was filed, concluding that each of the new plans had defects, but could be amended to be fair, equitable and feasible.[42]

The district court, before referring the plans to the Commission, entered an order finding the value of the debtor to be about $18.9 million, rather than $20.5 million which the Commission had adopted in its original advisory report.[43] An appeal was filed by a stockholder, who had proposed one of the four plans and had presented testimony

valuing the debtor at about $22.5 million.[44] The Commission sought to stay the appeal on the ground that the finding of value should not be reviewed except in the context of approval or rejection of a plan. The court of appeals denied the Commission's motion for a stay and granted the trustee's motion for an expedited hearing.

Landmark Inns of Durham, Inc.[45] – The issue of the ground lease forfeiture having been disposed of in favor of the trustee,[46] he was able to turn his attention to reorganizing this debtor whose operations became profitable during his administration. A plan, based on an offer by four individuals to purchase for cash all of the stock of the reorganized corporation, was duly confirmed and has been substantially consummated. The plan provided for the payment in full of all debts, including publicly-held debentures, with post-petition interest, and the issuance of 7-year promissory notes at the rate of $1 per share to the debtor's original shareholders.

ALLOWANCES

Every reorganization case ultimately presents the difficult problem of determining the compensation to be paid to the various parties for services rendered and for expenses incurred in the proceeding. The Commission, which under Section 242 of the Bankruptcy Act may not receive any allowance for the services it renders, has sought to assist the courts in assuring economy of administration and in allocating compensation equitably on the basis of the claimants' contributions to the administration of estates and the formulation of plans. During the fiscal year, 319 applications for compensation totaling about $14 million were reviewed.

Cybern Education, Inc.[47] – The court of appeals, as urged by the Internal Revenue Service and the Commission, reversed the order of the lower court which awarded the trustee and his counsel fees that equaled the remaining cash left in the debtor's estate after liquidation of all of its assets.[48]

The court vacated the order allowing the fees, and directed that the case be reassigned to another district judge, stating:

"The notice was clearly in violation of the mandatory requirements of Section 247 even as the petition violated Section 249 and Rule X-18. But our concern here runs deeper than the statutory derelictions. It goes to the applicants' paramount interest in their own fees and to the court's purporting to permit the entire estate to be wiped out by the fees in a Chapter X proceeding which was improvidently commenced and should have been quickly terminated with little or no expense. The fact that it was not does not tend to reflect favorably upon the fee applicants nor upon the court's supervision of them."

It directed that notices of future fee applications be served on all persons specified by Section 247, and that:

"Notices of presentment of petitions shall in particular be served upon the Secretary of the Treasury and the Securities and Exchange Commission sufficiently in advance of hearing to permit their staffs to formulate recommendations to their superiors and to obtain authorization for positions to be taken upon such petitions in the district court."

Four Seasons Nursing Centers of America, Inc.[49] – The indenture trustee of the debtor's European debenture issue filed an application for a final allowance of $362,653, of which $123,653 was for its own services and $239,000 for reimbursement of payments made to its local and New York counsel.

The Commission noted that a large portion of the time of the indenture trustee and its counsel was devoted to reviewing papers filed by others in the proceeding. It pointed out that a creditor cannot be compensated as an auxiliary trustee, and that there was a duplication of effort of major proportions by counsel and the indenture trustee. The fact that the indenture trustee had already paid its counsel did not entitle it to recover such payments from the estate since the allowance of fees is within the exclusive jurisdiction of the

court which cannot be negated by a private arrangement between a client and his attorney.

The Commission recognized that the indenture trustee's responsibilities were large, and that it dealt with novel and important issues of law. The fact that its legitimate concern for the interests of debenture holders conflicted at times with the objectives of the trustee should not affect its right to compensation. Accordingly, the Commission recommended allowances of $190,368 for the services of the indenture trustee and its counsel, and reimbursement of expenses. The district court awarded $158,012.

Counsel for shareholders, who had filed and negotiated the settlement of the fraud claim described above under "Reports," requested a final allowance of $200,000. The Commission acknowledged that counsel were experienced in stockholder class actions and that their services were very beneficial to the estate. However, the Commission noted that fee standards in such actions are quite different from those prevailing in Chapter X. It also pointed out that the charges against the debtor, which applicants were asserting in the Chapter X proceeding, were also involved in a class action against third parties, and that counsel would share in the fee awarded in that action which had been settled.

Accordingly, the Commission recommended an allowance of about $95,000 including expenses. The court awarded applicants $47,000. Applicants sought review but the court of appeals denied leave to appeal.

Jade Oil & Gas Co., et al.[50] – Twenty applicants sought final allowances and reimbursement of expenses in the total amount of about $720,000, and the Commission recommended payment of $382,000. The court awarded fees and expenses aggregating about $530,000.

Since the estate did not have sufficient funds, the Commission suggested that, to the extent funds were not available, payments

should be made on a deferred basis and not in stock of the reorganized company.

The issuance of stock to claimants for administrative expenses does not fall within the exemption from registration under Section 5 of the Securities Act provided by Section 264a (2) of Chapter X. In the absence of registration, securities issued for such expenses cannot be resold unless some other exemption under the Securities Act is available.

The court, however, ordered that applicants allowed more than $10,000 be paid 75 percent in cash and 25 percent in newly issued common stock valued at 25 percent below the current market price to compensate for its restricted status. One applicant agreed to accept stock only, and applicants allowed less than $10,000 received full payment in cash.

INTERVENTION IN CHAPTER XI

Chapter XI of the Bankruptcy Act provides a procedure by which debtors can effect arrangements with respect to their unsecured debts under court supervision. Where a proceeding is brought under that chapter but the facts indicate that it should have been brought under Chapter X, Section 328 of Chapter XI authorizes the Commission or any other party in interest to make application to the court to dismiss the Chapter XI proceeding unless the debtor's petition is amended to comply with the requirements of Chapter X, or a creditors' petition under Chapter X is filed.

Attempts are sometimes made to misuse Chapter XI so as to deprive investors of the protections which the Securities Act and the Exchange Act are designed to provide.[51] In such cases the Commission's staff normally attempts to resolve the problem by informal negotiations. If this proves fruitless, the Commission intervenes in the Chapter XI proceeding to develop an adequate record and to direct the court's attention to the applicable provisions of the Federal securities laws and their bearing on the particular case.

Alco Universal.[52] – The company, a wholly-owned subsidiary of VTR, Inc.,[53] had not been in operation for over 2 years and had virtually no assets. A plan of arrangement called for the issuance of over one million shares of the debtor's stock to more than 300 of its unsecured creditors in reliance upon the Section 393a (2) exemption of Chapter XI. The Commission intervened and filed a brief suggesting that the issue of these securities appeared to be motivated by stock market considerations rather than by any serious desire to rehabilitate a business, and that a plan so conceived lacked the "good faith" required by Section 366 (4) of Chapter XI. The debtor was subsequently adjudicated a bankrupt.

Meister Brau, Inc.[54] – A Section 328 motion was filed by shareholders to have the proceeding transferred to Chapter X. The Commission after making a preliminary investigation took no position because of its doubt that the debtor, a large regional brewer, could be reorganized. The lower court denied the shareholders' motion. The court requested that the Commission continue its investigation into the debtor's affairs as an aid to the court. Subsequently, the staff filed an extensive factual report on the financial history of the debtor. The report was prepared entirely from the debtor's records and other public information and stressed the primary reason for the debtor's financial problems – a series of improvident attempts at diversification on borrowed money in the face of an increasingly difficult competitive situation. It also pointed out that the debtor had sold its established brands just prior to its filing, and had little hope of re-establishing a viable brewery operation. Efforts to revive the debtor were fruitless and it was adjudicated a bankrupt.

DCA Development Corporation.[55] – The debtor, a tile-making and housing development concern, attempted to effect a Chapter XI arrangement with its unsecured creditors, including public debenture holders. The proceeding aborted when the debtor was not able to raise the necessary capital to fund its proposed arrangement. It thereupon filed a Chapter X petition.

At the request of the Commission, the court held an evidentiary hearing on the "good faith" of that petition, which was being contested by some creditors. Since the tile business was not in operation and the housing business was not viable, the court held "that it is unreasonable to expect that a plan of reorganization can be effected." Accordingly, it dismissed debtor's Chapter X petition pursuant to Section 146 (3). The proceeding then reverted to Chapter XI. Shortly thereafter, the debtor, being unable to effect a new arrangement, was adjudicated a bankrupt.

NOTES TO PART 7

[1] A table listing all reorganization proceedings in which the Commission was a party during the year is contained in Part 9.

[2] D. Colo., No. 71-B-2921. Previously reported in 38th Annual Report, pp. 114, 116-117.

[3] In re King Resources Co., 467 F. 2d 944 (C.A. 5, 1972).

[4] D. S.C., No. 72-72.

[5] D. Kansas, No. 23662.

[6] Originally there were 12 limited partnerships in which the public invested more than $40 million. The initial six partnerships were dissolved with the limited partnership interests being exchanged for stock in the parent corporation, Tilco, Inc. This exchange transaction and the related proxy solicitations were the subject of a Commission enforcement action. See Litigation Release Nos. 5107 and 5190 (July 29 and October 19, 1971).

[7] D. Colo., No. 72-B-556.

[8] Cf. *Halsted v. Securities and Exchange Commission*, 182 F. 2d 660, 663-64 (C.A. D.C.), cert. den., 340 U.S. 834 (1950). Unreported

decisions are compiled in the 38th Annual Report, pp. 117-18; 31st Annual Report, p. 98; and 30th Annual Report, p. 100.

[9] S.D. Fla., No. 3659-M-Bk-WM. Previously reported in 38th Annual Report, pp. 124-125; 37th Annual Report, pp. 191-193; 36th Annual Report, pp. 179-180, 190, 191; 35th Annual Report, pp. 160, 168; 34th Annual Report, p. 153; 33d Annual Report, p. 135; 32d Annual Report, pp. 92-93; 31st Annual Report, p. 100; 30th Annual Report, p. 105; 29th Annual Report, pp. 91-92; 28th Annual Report, p. 100; 27th Annual Report, pp. 132, 134; and 26th Annual Report, pp. 155, 158, 160.

[10] Section 211 requires every person or committee representing more than 12 creditors or stockholders to file with the court a statement under oath, which must include information regarding the formation of the committee and the holdings of the creditors or stockholders represented.

[11] Section 211 (4): See In re Pittsburgh Railways, 159 F. 2d 630 (C.A. 3, 1946), cert. den., 331 U.S. 819 (1947).

[12] *Protective Committee v. Mehrtens*, 457 F. 2d 104, 106 (C.A. 5), cert. den., 409 U.S. 849 (1972).

[13] Protective Committee v. Kirk/and, 481 F. 2d 606 (C.A. 5, 1973).

[14] W.D. Okla., No. Bk-72-644.

[15] C.A. 10, No. 73-1524.

[18] *In re Solar Mfg. Corp.*, 176 F. 2d 493 (C.A. 3, 1949). Cf. *In the Matter of Penn Central Transportation Company*, – F. 2d – (C.A. 3, 1973), and *In re Pure Penn Petroleum Co., Inc.*, 188 F. 2d 851 (C.A. 2, 1951), construing parallel provisions of Section 77 and Chapter XI, respectively.

[17] See *Frank v. Drinc-o-matic, Inc.*, 136 F. 2d 906 (C.A. 2, 1943); *In re Marathon Foundry and Machine Company*, 228 F. 2d 594 (C.A. 7,

1955), cert. den., 350 U.S. 1014 (1956); *In re Air and Space Manufacturing, Inc*., 394 F. 2d 900 (C.A. 7), cert. den., 393 U.S. 801 (1968); *In re The Dania Corporation*, 400 F. 2d 833, 836 (C.A. 5, 1968), cert. den., 393 U.S. 1118 (1969); and see also *In re Wonder-bowl, Inc*., 424 F. 2d 178, 180 (C.A. 9, 1970); *In re Northern Illinois Development Corporation*, 324 F. 2d 104 (C.A. 7, 1963), cert. den., 376 U.S. 938 (1964) (Chapter XI).

[18] See *In re Loewer's Gambrinus Brewery Co., Inc*., 141 F. 2d 747 (C.A. 2, 1944) and its sequel, *Patent Cereal v. Flynn*, 149 F. 2d 711 (C.A. 2, 1945). Only in *In re Sire Plan, Inc*., 332 F. 2d 497 (C.A. 2), cert den., 379 U.S. 909 (1964), has possible physical deterioration been a significant factor.

[19] C. D. Calif., Nos. 78641-FW, 78950-FW, 79596-FW, and 80470-FW. Previously reported in 38th Annual Report, pp. 115-116.

[20] S.D. N.Y., No. 71-B-291. Previously reported in 38th Annual Report, pp. 125-126; 37th Annual Report, p. 179.

[21] S.D. N.Y., No. 71-B-523. Previously reported in 38th Annual Report, p. 116.

[22] For the fourth case involving Section 116 (3), see Farrington Manufacturing Company, infra.

[23] D. Colo., No. 71-B-2921.

[24] King v. Baer, 482 F. 2d 552 (C.A. 10, 1973).

[25] E.D. Pa., No. 70-354.

[26] Cf. *Young v. Higbee*, 324 U.S. 204, 212-213 (1945).

[27] *Protective Committee v. Anderson*, 390 U.S. 414 (1968).

[28] *Protective Committee v. Kirkland*, 471 F. 2d 10 (C.A. 5, 1972).

[29] *In re American Loan & Finance Co.*, E.D. Va., No. 508-72-N; *In re Cochise College Park, Inc.*, D. Ariz., No. 13-72-760-Phx.; *In re Farrington Manufacturing Co., et al.*, E.D. Va., Nos. 17-71-A, 256-71-A, and 257-71-A; *In re Federal Coal Co.*, S.D. W.Va., No. 69-270; *In re San Francisco & Oakland Helicopter Airlines, Inc.*, N.D. Calif., No. B-70-5175.

[30] E.D. Va., No. 508-72-N.

[31] See *Securities and Exchange Commission v. F. Wallace Bowler,* 427 F. 2d 190 (C.A. 4, 1970).

[32] Id. at 193-194.

[33] W.D. Okla., No. Bk-70-1008. Previously reported in 38th Annual Report, pp. 118, 120-121; 37th Annual Report, pp. 180-181.

[34] *In re Four Seasons Nursing Centers of America, Inc.*, 472 F. 2d 747 (C.A. 10, 1973).

[35] The defrauded shareholders also received about $7 million in cash from defendants other than the estate in settlement of related class actions.

[36] The position urged by the Commission was in accord with its advisory report on the plan of reorganization, Corporate Reorganization Release No. 310 (March 16, 1972). See also 38th Annual Report, pp. 120-121.

[37] E.D. Va., Nos. 17-71-A, 256-71-A and 257-71 – A. Previously reported in 38th Annual Report, p. 118.

[38] N.D. Calif., No, B-70-5175. Previously reported in 38th Annual Report, pp. 122-123.

[39] S.D. W. Va., No. 69-270. Previously reported in 38th Annual Report, pp. 118-119; 37th Annual Report, p. 196; and 36th Annual Report, pp. 194-195.

[40] *In re Federal Coal Company*, 335 F. Supp. 1183 (S.D. W.Va. 1971); see also 38th Annual Report, pp. 118-119.

[41] D.C. N.J., No. 656-65. Previously reported in 38th Annual Report, pp. 117, 122, 125; 36th Annual Report, pp. 176-177, 190; 35th Annual Report, p. 161; 33rd Annual Report, pp. 132, 137; 32nd Annual Report, p. 94.

[42] *Imperial '400' National, Inc.*, Corporate Reorganization Release No. 313, (August 29, 1973), 2 SEC Docket 377.

[43] These are gross values and include about $8.2 million of undefaulted mortgages.

[44] C.A. 3, No. 73-8116.

[45] M.D.N.C., No. B-198-69. Previously reported in 38th Annual Report, p. 115; 37th Annual Report, p. 181; 36th Annual Report, p. 179.

[46] *Weaver v. Hutson*, 459 F. 2d 741 (C.A. 4), cert. den., 409 U.S. 957 (1972).

[47] N.D. Ill., No. 70-B-5299. Previously reported in 38th Annual Report, p. 125.

[48] *In re Cybern Education, Inc.*, – F. 2d – (C.A. 7, 1973).

[49] W.D. Okla., No. Bk 70-1008.

[50] C.D. Calif., Nos. 17312-F and 17313-F. Previously reported in 36th Annual Report, pp. 181-183.

[51] See 38th Annual Report, p. 126; 37th Annual Report, p. 198; 36th Annual Report, p. 197.

[52] W.D. Mich., No. 370-72-B5.

[53] This publicly-held company has had a history of securities law problems. See Litigation Release Nos. 3311, 3314, 3335, 3356, 3370, 3985, 4142, 4265, 4287, 4490, 4787, 5001, 5131, 5717 and 5864; Securities Exchange Act Release Nos. 7692,7894, 9980 and 10078.

[54] N.D. Ill., No. 72-B-3965.

[55] D. Mass., No. 73-152.

PART 8
SEC MANAGEMENT OPERATIONS

Major changes occurred in fiscal 1973 affecting the Commission's organization, the management of its two critical resources, people and money, and its information handling.

ORGANIZATIONAL CHANGES

Creation of Major Divisions

In August 1972, the first major reorganization of the Commission in 30 years occurred, changing the Commission's structure from one based on the various Federal securities statutes to one based on the Commission's three primary functions – regulation, disclosure and enforcement.

Three divisions were created to carry out the basic regulatory responsibilities for the diverse areas of Commission jurisdiction. Market Regulation was given responsibility for securities markets, broker-dealers and the self-regulatory agencies; Investment Management Regulation was made responsible for investment companies, investment advisers, and other money managers; and Corporate Regulation was given jurisdiction over public utility holding

companies as well as bankruptcy and reorganization matters. All disclosure activity was concentrated in the Division of Corporation Finance. Finally, responsibility for all investigative and enforcement matters was consolidated in the new Division of Enforcement. Experience to date has demonstrated that the new structure has effectively focused Commission resources on its major responsibilities and facilitated the vigorous and efficient carrying out of staff duties.

Office of Policy Planning

In October 1972, an Office of Policy Planning was established to improve the Commission's ability to anticipate and plan for, rather then react to, possible future capital market and investor needs. Creation of such an office was recommended by, among others, Congressman John Moss of California, Chairman of the House Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, and the SEC's 1972 Advisory Committee on Enforcement Policies and Practices (the Wells Committee).

The office is responsible for identifying new trends in the financial markets, such as the increasing impact of institutional investors, and then assisting the Commission in developing appropriate public policy. The office also works with other offices and divisions to suggest improvements in the Commission's rules and procedures and in those of the securities industry's self-regulatory organizations, and to develop proposals for changes in the statutory framework. The office also provides Commission representation on various bodies concerned with international finance, assists the Commission and its staff in interpreting important legislative developments, and provides liaison with members of Congressional committees and their staffs.

New Staff Units

Three new staff units were created to improve the Commission's service to the public and internal efficiency. The Office of Registrations and Reports, which merged 8 separate units with about

100 employees, was created to centralize the receipt, initial examination and distribution of the more than 150,000 filings and reports the Commission receives annually. The office has full responsibility for receiving filings, issuing receipts, checking for rules compliance, extracting data for computer input, calculating fees, writing deficiency letters, and assigning material to the appropriate branch for review, as well as performing substantive examination of those forms which do not need professional review. Among the benefits stemming from this consolidation of functions was the introduction of a central filing facility to which members of the public can both submit filings and raise questions as to the status of their filings. A further description of the office is contained in Part 1.

The Office of Records was established to improve the Commission's control over its records and to make such records more readily available to the public and the Commission's staff. The wealth of information submitted to the Commission over the past 40 years provides a unique and valuable data base for professionals. The bulk of the information sometimes makes it difficult to produce desired records efficiently. The new office is charged with improving the quality of recordkeeping in the short run, and, in the long run, with investigating fundamentally new approaches to record retention.

The Office of Administrative Services was established to deal with the housekeeping, staff transportation and staff support problems generated by a rapidly growing staff dispersed between two Washington locations. The office provides space management, transportation, and communication services, and directs the print shop and supply operations.

PERSONNEL MANAGEMENT

As shown by the table below, the permanent personnel strength of the Commission totaled 1,556 employees on June 30, 1973.

Commissioners: 3
Staff—

Headquarters Office: 978
Regional Offices: 575
Total Staff: 1,553
Grand Total: 1,556

Since the ability and motivation of the staff is the major determinant of the quality of the Commission's performance, every effort was made to attract, motivate and employ effectively a high quality staff in fiscal 1973. Normal recruiting patterns were interrupted midway through the year, first by a government-wide hiring freeze and then by budgetary limitations within the agency. The combined effects of attrition and the freeze posed a potential workload problem at times, but the Commission was able to avoid a serious disruption. An aggressive catch-up effort resulted in the hiring of 315 new employees, as compared with 319 terminations.

The deployment of the staff was significantly affected by the reorganization. More than 600 employees were transferred, had their job classifications reviewed, or were given new functions to perform. A major new career ladder was created by development of a new Securities Compliance Examiner series of jobs, a title which encompasses certain examiners, investigators and accountants in grades 5 through 13.

Efforts to recognize and reward outstanding performance continued. Distinguished Service Medals were awarded to three staff members; five employees received awards for 35 years of SEC service; and nine others were honored for 30 years of service. Within-grade salary increases or cash awards in recognition of high quality or special service were also granted to 150 employees. In the course of the year, 445 staff members earned promotions to higher grades.

Finally, two exciting new programs were developed to help attract talented professionals to the SEC. The Attorney Fellow and the Accounting Fellow Programs provide for two-year appointments of outstanding professionals from the private sector. The agency is expected to benefit from the infusion of new ideas and perspectives, while the professionals gain the opportunity of working with top SEC

staff members on significant legal and accounting problems. The first Accounting Fellow entered on duty in June 1973.

FINANCIAL MANAGEMENT

In fiscal 1973, the Commission greatly accelerated its efforts to minimize the cost of Commission operations to the general public through (a) rigorous review and improved control of the utilization of Commission resources, and (b) the recovery of a fair but significant proportion of Commission costs through user fees.

As part of the planning for the fiscal 1974 budget, the Commission's 29 operating divisions, regional offices and support units were required to analyze thoroughly the current use of their resources and the proposed use of any additional resources requested. Precise estimates were made of workload, current productivity, and the benefits, timetables, and costs of special projects. The result was the establishment of a data base on Commission operations which will facilitate ongoing management information and cost control in the future.

During fiscal 1973, the Commission collected fees for the (1) registration of securities issues; (2) qualification of trust indentures; (3) registration of exchanges; (4) registration of brokers and dealers who are not members of a registered national securities association; and (5) certification of documents filed with the Commission, based on a fee schedule which became effective March 1, 1972. The fees collected, which are immediately deposited into the Treasury of the United States as miscellaneous receipts, amounted to $22.2 million. This represented 73 percent of the agency's Congressional appropriation of $30.3 million. Thus, the net cost of SEC operations to the taxpayer was $8.1 million.

INFORMATION HANDLING

The handling of information is one of the SEC's most fundamental tasks. Steps were taken in 1973 to improve both the supply of information to the public and its internal processing.

To further its primary goal of timely disclosure, the Commission awarded a two-year contract at no cost to the government for the dissemination of non-confidential data filed with the SEC. Building on earlier microfiche and copying services, the new contract incorporates (1) a new comprehensive master indexing service for corporate filings, both by issuer and subject, (2) paper copy reproductions of SEC documents in public reference rooms at lower cost to the public, (3) a new program aimed at increasing dissemination of SEC information through libraries open to the public, and (4) a discount for college and university users of SEC microfiche packages to offset charges for the new document indexing service.

The Commission also held two informal briefings to acquaint members of the professional communications community with SEC activities and responsibilities. It is the Commission's hope that these briefings will stimulate a greater understanding by the public of the SEC's role.

Finally, the Commission increased its efforts to apply electronic data processing (EDP) to the internal collection and analysis of important information.

Information derived from Form 144, the "Notice of Proposed Sale of Securities Pursuant to Rule 144 under the Securities Act of 1933" was computerized and tied to other EDP systems to provide the Commission with an up-to-date cross analysis of securities traded under Rule 144.

Broker-dealer complaint information received and processed by the regional offices was also computerized and added to the operational Complaint Processing System. This system and a centralized data file containing statistical information on broker-dealer examinations conducted by the various regulatory bodies will be part of an

automated "Broker-Dealer Informational Early Warning System" planned by the Commission.

A computer file of data collected through the Registered Investment Adviser Examination Statement was created, which assisted the staff in its development of the proposed Institutional Disclosure Act. Another system developed in fiscal 1973 will replace the Commission's present addressograph mailing process with a computerized mailing list. Many additional EDP projects are planned for the future.