37th Annual Report
of the
SECURITIES AND EXCHANGE COMMISSION

For the Fiscal Year Ended June 30th, 1971

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

COMMISSIONERS

WILLIAM J. CASEY, Chairman
HUGH F. OWENS
JAMES J. NEEDHAM
A. SYDNEY HERLONG, JR.
PHILIP A. LOOMIS, JR.

RONALD F. HUNT, 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-Seventh Annual Report of the Commission covering the fiscal year July 1, 1970 to June 30, 1971, 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,

WILLIAM J. CASEY,
Chairman

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

in

COMMISSIONERS AND PRINCIPAL STAFF OFFICERS
(As of December 1, 1971)

Commissioners

WILLIAM J. CASEY of New York, Chairman -- Term expires June 5, 1974
HUGH F. OWENS of Oklahoma -- Term expires June 5, 1975
JAMES J. NEEDHAM of New York -- Term expires June 5, 1973
A. SYDNEY HERLONG, JR. of Florida -- Term expires June 5, 1976
PHILIP A. LOOMIS, JR. of California -- Term expires June 5, 1972

Secretary: RONALD F. HUNT
Executive Assistant to the Chairman: CHARLES S. WHITMAN, III

Principal Staff Officers

A. JONES YORKE, Executive Director

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

SOLOMON FREEDMAN, Director, Division of Corporate Regulation
AARON LEVY, Associate Director
ALLAN S. MOSTOFF, Associate Director

IRVING M. POLLACK, Director, Division of Trading- and Markets
SHELDON RAPPAPORT, Associate Director
STANLEY SPORKIN, Associate Director

G. BRADFORD COOK, JR., General Counsel
DAVID FERBER, Solicitor
WALTER P. NORTH, Associate General Counsel

ANDREW BARR, Chief Accountant
A. CLARENCE SAMPSON, JR., Associate Chief Accountant

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

LEONARD HELFENSTEIN, Director, Office of Opinions and Review
W. VICTOR RODIN, Associate Director
ALFRED LETZLER, Associate Director

WARREN E. BLAIR, Chief Hearing Examiner

WILLIAM E. BECKER, Chief Management Analyst

FRANK J. DONATY, Comptroller

ERNEST L. DESSECKER, Records and Service Officer

HARRY POLLACK, Director of Personnel

RALPH L. BELL, EDP Manager

REGIONAL AND BRANCH OFFICES

Regional Offices and Regional Administrators

Region 1. New York, New Jersey. -- Kevin Thomas Duffy, 26 Federal Plaza, New York, New York 10007.

Region 2. Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, Maine. -- Floyd H. Gilbert, Suite 2203, John F. Kennedy Federal Bldg., Government Center, Boston, Mass. 02203.

Region 3. Tennessee, Virgin Islands, Puerto Rico, North Carolina, South Carolina, Georgia, Alabama, Mississippi, Florida, that part of Louisiana lying east of the Atchafalaya River. -- Jule B. Greene, Suite 138, 1371 Peachtree Street, 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 South Dearborn Street, Chicago, Illinois 60604.

Region 5. Oklahoma, Arkansas, Texas, that part of Louisiana lying west of the Atchafalaya River, and Kansas (except Kansas City). -- Gerald E. Boltz, 503 U.S. Court House, 10th & Lamar Streets, Fort Worth, Texas 76102.

Region 6. Wyoming, Colorado, New Mexico, Nebraska, North Dakota, South Dakota, Utah. -- Donald J. Stocking, 7224 Federal Bldg., 1961 Stout Street, Denver, Colorado 80202.

Region 7. California, Nevada, Arizona, Hawaii, Guam. -- Arthur E. Pennekamp, 450 Golden Gate Avenue, Box 36042, San Francisco,

California 94102. Region 8. Washington, Oregon, Idaho, Montana, Alaska. -- James E. Newton, 900 Hoge Bldg., Seattle, Washington 98104.

Region 9. Pennsylvania, Maryland, Virginia, West Virginia, Delaware, District of Columbia. -- Alexander J. Brown, Jr., Room 300, Ballston Center Tower #3, 4015 Wilson Boulevard, 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 2606 Federal Office & Courts Bldg., 515 Rusk Ave.

Los Angeles, California 90012. -- Room 1043, U.S. Courthouse, 312 North Spring Street.

Miami, Florida 33130. -- Room 1504, Federal Office Bldg., 51 S.W., First Ave.

St. Louis, Missouri 63101. -- Room 1452, 210 North Twelfth Street.

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

COMMISSIONERS

William J. Casey, Chairman

Chairman Casey was born in Elmhurst, New York, on March 13, 1913. He received a B.A. degree from Fordham University in 1934 and an LL.B. degree from St. John's University in 1937. At the time of his appointment to the Commission, he was a partner in the New York law firm of Hall, Casey, Dickler & Howley and the Washington law firm of Scribner, Hall, Casey, Thornburg & Thompson. Mr. Casey has authored and edited a broad spectrum of publications on legal, tax, financial and economic subjects, and has served as Chairman of the Board of Editors of the Research Institute of America and Chairman of the Board of Editors of the Institute for Business Planning, a subsidiary of Prentice-Hall. During World War II, he served as Chief of the Secretariat at the European headquarters of the Office of Strategic Services and, subsequently, Chief of O.S.S. intelligence operations in the European Theatre. In 1948, he served on the legal staff of the

European headquarters of the Marshall Plan. Subsequently, he served as special tax counsel for the Senate Small Business Committee. He has served as a member of the General Advisory Committee on Arms Control and as a member of the Presidential Task Force on International Development. He has also been President of the International Rescue Committee and of the Long Island Association. He has served as Trustee of Fordham University, of Good Counsel College and of Catholic Charities in the Long Island. Diocese. Mr. Casey was sworn in as Chairman of the Securities and Exchange Commission on April 14, 1971.

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 LL.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 on 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.

James J. Needham

Commissioner Needham was born in Woodhaven, New York, on August 18, 1926. He received a B.B.A. in 1951 from St. John's University. During 1944-46, he was in the Naval V-5 Program at Cornell University. At the time of his appointment to the Commission, Commissioner Needham, a Certified Public Accountant, was associated with A. M. Pullen & Company, based in Greensboro, North Carolina, serving as partner in charge of its New York office, and as a member of the firm's Executive Committee. Previously, he was associated with Raymond T. Hyer & Company and with Price, Waterhouse & Co. Commissioner Needham has been active in professional and business organizations, including the American Institute of Certified Public Accountants (as a member of Council) ; the New York State Society of Certified Public Accountants (including service as Treasurer and as a member of its Board of Directors and Executive Committee) ; the New York Chamber of Commerce; and the Accountants Club of America, Inc. He also has participated actively in many community organizations. Prior to assuming office on July 10, 1969, for the term expiring June 5, 1973, he resided in Plainview, New York.

A. Sydney Herlong, Jr.

Commissioner Herlong was born in Manistee, Alabama, on February 14, 1909, and in 1912 moved to Sumter County, Florida, and later to Lake County, Florida, where he attended public schools. He received an LL.B. degree from the University of Florida, Gainesville, Florida, in 1930, and commenced practicing law in his home town of Leesburg, Florida. Commissioner Herlong continued practicing law until 1937 when he was elected County Judge of Lake County, Florida. He continued serving as County Judge until 1948 when he was elected to the U.S. House of Representatives, in which body he served until January 1969, when he voluntarily retired. While serving in Congress, Mr. Herlong was a member of the Post Office and Civil Service Committee, the Agriculture Committee, and, for the last seven terms, the Ways and Means Committee. Upon retirement from Congress, he became a consultant to the Association of Southeastern Railroads. He is a past president of the Florida County Judges Association, the University of Florida Alumni Association and the Florida State Baseball League. Mr. Herlong received the Good Government Award from the Florida Junior Chamber of Commerce and the Distinguished Alumni Award from the University of Florida. He took office as a member of the Securities and Exchange Commission on October 29, 1969, for the term of office expiring June 5, 1971, and was reappointed for the term expiring June 5, 1976.

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 LL.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, 1972.

TABLE OF CONTENTS

Periodic reports

New rules relating to companies reporting pursuant to Section 15 (d)

Proposed amendments of reporting forms

Timely disclosure of material corporate developments

Proceedings to obtain compliance with Exchange Act registration or reporting requirements

Administrative actions

Civil actions

Proxy solicitations

Scope and nature of proxy regulation

Statistics relating to proxy and information statements

Stockholders' proposals

Proxy contests

Litigation relating to proxy rules

Disclosure in connection with takeover bids and other large acquisitions

Insiders' security holdings and transactions

Ownership reports

Recovery of short-swing trading profits

Investigations with respect to reporting and proxy provisions

Summary suspension of trading

Accounting and auditing matters

Relations with the accounting profession and the public

The work of the Accounting Principles Board and committees of the AICPA

Other current developments

Exemptions for securities of international banks

International Bank for Reconstruction and Development

Inter-American Development Bank

Asian Development Bank

Trust Indenture Act of 1939

PART III
REGULATION OF SECURITIES MARKETS

Regulation of exchanges

Registration and exemption of exchanges

Review of exchange rules and procedures

Litigation relating to review of exchange rules

Inspections of exchanges

Delisting of securities from exchanges

Litigation relating to delisting

Statistics relating to securities traded on exchanges

Number of issuers and securities

Market value of securities available for trading

Volume of securities traded

Foreign stocks on exchanges

Comparative exchange statistics

Block distributions reported by exchanges

Unlisted trading privileges on exchanges

Supervision of activities of National Association of Securities Dealers, Inc.

Review of NASD rules and policies

NASD rule abrogation proceeding '

Inspections of the NASD

Over-the-counter trading in common stocks listed on the New York Stock Exchange

Regulation of broker-dealers and investment advisers

Registration

Financial reports of broker-dealers

Broker-dealer income and expense reports

Regulation of broker-dealers who are not members of a registered securities association

Statistical studies

Issues registered under the Securities Act of 1933

New securities offerings

Private noninsured pension funds

Stock transactions of financial institutions

Financial position of corporations

Plant and equipment expenditures

Directory of registered companies

Stock market data

PART IV
CONTROL OF IMPROPER PRACTICES

Detection of improper practices

Public complaints and inquiries

Inspections

Market surveillance

Investigations

Enforcement of investigative subpoenas

Enforcement and remedial action

Administrative proceedings

Judicial review of administrative decisions

Civil proceedings

Participation as *amicus curiae*

Criminal proceedings

Organized crime program

Proposed Swiss treaty

Disciplinary action by self-regulatory organizations

Exchanges

NASD

Commission review of NASD disciplinary action

Commission review of NASD action on membership

Cooperation with other enforcement agencies

Section of Securities Violations

Enforcement problems with respect to foreign securities

Disqualification from practice before Commission

PART V
REGULATION OF INVESTMENT COMPANIES

Companies registered under the Act

Investment company assets

Investment company filings, other than applications

Developments with respect to particular types of investment companies

Investment company sponsored by a public accounting firm

Financing of active registered public-utility holding companies and their subsidiaries

PART VII
PARTICIPATION IN CORPORATE REORGANIZATIONS

Summary of activities

Jurisdictional, procedural, and administrative matters

Trustee's investigation

Reports on plans of reorganization

Activities with regard to allowances

Intervention in Chapter XI proceedings

PART VIII
SUPPORTING ACTIVITIES

Public information services

Dissemination of information

Publications

Availability of information for public inspection

Litigation involving public information provisions of the Administrative Procedure Act

Electronic Data Processing

Extension of application of automation techniques

Assistance to state and federal agencies

Sharing of EDP facilities

EDP training

Personnel and financial management

Personnel program

Personnel strength; financial management

PART I
IMPORTANT RECENT DEVELOPMENTS

INVESTOR PROTECTION; MARKET STRUCTURE

Major efforts were launched in 1971 to provide additional investor protection and to review on a comprehensive basis the structure and functioning of our securities markets. Among other things, the Commission adopted or proposed new rules designed to strengthen the financial and operational responsibility of brokerage firms, and it commenced broad-based public hearings to examine the structure and functioning of the markets. The re-examination which is in progress was occasioned in large part by the substantial operational and financial problems that the securities industry experienced during the period from 1968 through 1970.

Large, unanticipated increases in trading volume occurred in the exchange and over-the-counter markets during the middle 1960's. Existing systems for processing securities transactions proved inadequate at individual brokerage firms and at the industry-wide level. Many firms were unable to maintain record-keeping control and lost physical control over stock certificates. In the resulting confusion, a significant number of securities were either lost or stolen. Errors and delays in executing and settling trades were widespread, and customers frequently found it difficult to obtain delivery of securities they had paid for.

Although a decrease in trading volume in 1969 eased the operational problems somewhat, it brought with it lower income for the industry. A financial squeeze ensued, and the industry's overall capital base shrank under the impact of operating losses and a significant drop in market value of trading and investment accounts.

As a result, a number of firms, including some of the industry's largest, were forced into liquidation, and many others were merged out of existence. Hundreds of thousands of customers were saved from major loss by having their accounts transferred to stronger firms or through the injection of stock exchange trust fund monies. In all, the industry expended about $130 million in its rescue efforts.

In order to restore public confidence in the safety of the markets, Congress passed the Securities Investor Protection Act of 1970. This legislation, the most important in the securities field in 30 years, established the Securities Investor Protection Corporation to provide insurance for customer accounts. Customers are now insured up to $50,000 per account (of which no more than $20,000 can be in cash). To minimize the exposure of the SIPC fund, which is backed by a billion dollars in taxpayers' monies, Congress ordered the Commission to study and report on the unsafe and unsound practices of brokerage firms, and on the need for additional legislation to correct such practices.

Some of the operational problem areas scheduled to be examined in the Commission's study of brokerage practices were: physical facilities for effecting and processing securities transactions; automation and record-keeping systems; order entry and execution systems; trade comparisons and settlements; transfer and custody of securities; relationships of banks to brokers; internal controls maintained at brokerage firms; customer accounts; and needed expansion programs. In the financial area the major problem areas to be covered are: permanence and adequacy of the industry's capitalization; reliance upon customers' funds and securities; lack of internal controls over financial condition; faulty handling of customer accounts; and stock record differences.

The experiences of recent years, the various Congressional hearings of 1970 and 1971, and the SIPC Study all point up the need for additional investor protection measures. Of those already implemented or under consideration, the most significant are those dealing with the establishment of reserves against customer free credit balances and the segregation of customers' securities. Authority to pass rules in these areas was explicitly granted to the Commission by the Securities Investor Protection Act.

Following consideration of various proposals, the Commission on November 8, 1971 issued proposed new Rules 15c3-3 and 15c3-4 and proposed amended Rules 8c-1 and 15c2-1 under the Securities Exchange Act of 1934.2 Proposed Rule 15c3-3 requires the complete separation of customer funds from firm funds and provides for reserves designed to protect customer funds held by broker-dealers. Proposed Rule 15c3-4, concerned with customer protection in the area of custody and use of customers' securities, requires that the broker-dealer promptly obtain physical possession or control of customer securities and contains provisions for reserves against securities of customers which should be but are not in the physical possession or control of a broker-dealer. Supplementing proposed Rule 15c3-4 are proposed amendments to Rules 8c-1 and 15c2-1 (the hypothecation rules) which would, as regards securities carried for the accounts of customers which are loaned or borrowed by a broker-dealer, provide the same protections as are currently provided for by rules of the self-regulatory organizations with regard to the lending of securities as well as by the hypothecation rules with regard to rehypothecated securities.

In addition to acting to protect customers' funds and securities on deposit with brokers, the Commission has taken steps to improve procedures for detecting and monitoring financial and operational problems at firms. On September 15, 1971, Rule 17a-11 under the Securities Exchange Act went into effect. It requires the giving of immediate notice by a broker-dealer who is in violation of a net capital rule or whose books and records are not being maintained in a current manner. Where a firm's financial condition is deteriorating, although it is not in violation of a net capital rule, it must file detailed financial and operational information on a monthly basis. Reports under the rule are to be sent both to the Commission and to all self-regulatory organizations of which the troubled firm is a member, so as to permit early consideration of problems and assistance to the firm on a coordinated basis.

Another rule recently promulgated by the Commission under the Securities Exchange Act, Rule 17a-13, requires firms to count their "box" at least once each calendar quarter. During the 1968-1970 period when some firms lost control of their back offices, sizeable differences sprang up between records reflecting stock ownership and the inventory of securities actually on hand (or at identifiable outside locations, such as transfer agents). Some firms had substantial amounts of securities on hand whose ownership they could not identify and were missing large amounts of other securities which their records reflected as being owned by customers. Because these differences were in many cases not discovered, researched and resolved promptly, customers whose securities were in "street name" were at considerable risk. The "box count rule" will focus the attention of firms and their auditors on this problem area as a routine practice, thereby lessening the chance that operational errors will cause serious financial exposure to the firms and their customers.

Rule 15c3-1 under the Exchange Act, commonly known as the Commission's "net capital rule", imposes minimum net capital requirements on brokers and dealers and limits the amount of indebtedness which may be incurred by a broker-dealer by providing that a broker-dealer's "aggregate indebtedness" (as defined in the rule) may not exceed 20 times the amount of its "net capital" (as computed under the rule). As such, the rule provides safeguards for the protection of customers of broker-dealers by requiring that at all times broker-dealers have sufficient liquid assets available to meet their current obligations.

The Commission recently took action to raise the standards for entry into the broker-dealer business, through proposed amendments to Rule 15c3-1.[5] Under these, a firm would be required to have net capital of at least $25,000, instead of $5,000 as at present, and during the first year of its existence, a firm would be required to maintain an aggregate indebtedness to net capital ratio not exceeding 8:1, rather than the 20:1 ratio otherwise acceptable for firms subject to the Commission's net capital rule.

During the past 2 years the Commission has conducted inspections of the administration and interpretation of the New York Stock Exchange's net capital rule, the primary test of financial responsibility for member firms, and a series of conferences has been held between the two organizations. As a result the Exchange moved in August 1971 to strengthen the rule. It dropped the maximum permissible ratio of aggregate indebtedness to net capital from 20:1 to 15:1, and it made mandatory a charge against capital for short stock record differences 45 days after their discovery. Among the other amendments was one requiring the contraction or liquidation of a firm when its net capital ratio exceeds 12:1. Various parts of the revision are already in effect, and by August 1972, the new capital rule will be largely in force.

At the same time that the Commission was proposing and implementing measures for investor protection, it was engaged in studying the basic structure and functioning of the markets. Public hearings began on October 12, 1971 to help determine what changes are needed in the rules under which stock exchanges and other market institutions operate. In a statement accompanying the announcement of the hearings, Chairman Casey noted that there had been a tendency for some of the most critical questions to be resolved, not as a duly deliberated matter of broad public policy, but as an expedient to effect short-run savings or to settle or avoid private law suits. Mr. Casey said the Commission would determine what the public interest requires in the way of rules governing the operations of various markets, the relationship between these markets, and the disclosure of quotations, prices and trading volume in these markets.

In a related area, the Commission held a conference with industry spokesmen in June 1971 on the subject of the stock certificate. Discussion centered on methods of improving the efficiency of securities handling systems. Presentations were made by proponents of different programs for evolving a satisfactory standardized, nationwide method of handling securities, including a presentation favoring the elimination of stock certificates altogether. Chairman Casey pointed out the need to develop a sound industry-wide operational system satisfying the need for the prompt consummation of securities transactions and resolving the diverse settlement practices of the various securities markets. Participants were requested to submit additional ideas for consideration by the Commission in its role of coordinating and furthering industry attempts to implement operational systems able to handle existing and foreseeable levels of trading.

STRUCTURE AND LEVEL OF COMMISSION RATES

As discussed in last year's report, the New York Stock Exchange submitted a new commission rate schedule to the Commission on June 30, 1970. Following extended' public hearings, the Commission announced on October 22, 1970 that with certain modifications the new schedule would not be objected to. On February 11, 1971, the Commission announced that it would not object to the Exchange's commencing competitive rates on portions of orders above a level not higher than $500,000. These competitive rates became effective on most exchanges on April 5, 1971. Intra-member rates for floor brokerage and clearance on portions of orders above $500,000 also became subject to negotiation at the same time.

The Commission also requested the Exchange to present on or before June 30, 1971, a new rate structure based on a percentage scale of the money involved in an order, a proposed revision of the intra-member charges for floor brokerage and clearance, and a proposal for reasonable non-member access.

On June 28, 1971, the Exchange presented a new commission rate structure, a proposed revision of intra-member rates for floor brokerage and clearance, and a proposal for a 30 percent discount from the public commission rate for certain broker-dealers who are not Exchange members. In accordance with the Commission's announcement on August 31, 1970, a temporary commission rate surcharge was continued until such time as circumstances warranted its termination.

On September 24, 1971, the Commission informed the New York Stock Exchange that it would not object to implementation of the Exchange's proposed new minimum commission rate schedule subject to a number of conditions, including compliance with the President's restrictions on price increases. Other conditions included: the elimination of the commission surcharge; an increase to 40 percent in the discount for broker-dealers who are not Exchange members; a requirement of continued unrestricted service to small investors in the case of firms which traditionally have served such investors; the development of uniform reporting by member firms of income and expenses; the adoption of rules permitting member firms to enter into cooperative executing and clearing arrangements; re-examination by the Exchange of the necessity for fixed intra-member commission rates; and an adjustment of the rate schedule to eliminate a pricing anomaly that would have required investors to pay more for execution of odd-lot purchases than for the next higher round-lot purchase.

PUBLIC OWNERSHIP OF BROKER-DEALERS

In March 1970, the New York Stock Exchange amended its rules to permit the public ownership of member firms provided the member and any parent are primarily engaged in business as brokers or dealers in securities. Since then, the National Association of Securities Dealers, Inc., after reviewing the recommendations of a specially formed subcommittee on self-underwritings, abandoned its position that members could not participate in distributions of their own securities and published proposed regulations and procedures to govern such distributions. Pending the adoption of these regulations, the Association determined to review, on a case by case basis, proposals by its members to participate in distributions of their own or an affiliate's securities. These actions by the Exchange and the NASD cleared the way for Merrill Lynch, Pierce, Fenner & Smith to register with the Commission and distribute primarily to its customers a $112,000,000 offering of its securities. Subsequently, several other NYSE members filed registration statements with the Commission, which became effective, covering public offerings of their equity securities.

Generally, under the NASD proposals, which were submitted to the Commission in September 1971, an Association member would be permitted to "go public" if: (1) specified financial statements were submitted with the registration statement; (2) no more than 25 percent of the equity interest of the owners of the member was offered as a part of the issue; (3) the amount of the offering did not exceed three times the member's net worth; and (4) the member's aggregate indebtedness to net capital ratio, as computed under Rule 15c3-1, would not exceed 10:1 at the termination of the offering. Additionally, a member would be prohibited from making a subsequent public offering for at least one year and would be required to send to each of its shareholders a quarterly statement of its operations and an annual independently audited and certified financial statement. Finally, in addition to the above requirements, if the member participated in the distribution of its own securities or those of an affiliate, it would have to obtain two independent underwriters with at least 5 years experience in the underwriting business, three of which were profitable, to certify to the fairness of the offering price. These seasoning and profitability requirements would apply to the member-issuer as well. If the member recommended the securities to a customer it would have to have reasonable grounds to believe that the recommendation was suitable and would also have to maintain a record in its files showing the basis upon which it reached its suitability determination. As of the end of October, the Commission had these proposals under consideration,

SECURITIES QUOTATIONS WITHOUT SPECIFIED INFORMATION

The Commission has always been concerned with the problem of brokers and dealers publishing quotations for a security when there is no current information available to them or to the public concerning the issuer of the security. The publication of quotations for such securities subjects the investing public to a situation having a great potential for fraud and manipulation. In order to protect public investors, the Commission adopted Rule 15c2-11 under the Exchange Act.

With certain exceptions, the rule prohibits brokers or dealers from submitting or publishing quotations respecting a security in the absence of publicly available information concerning the issuer and the security. In general, the rule prohibits a broker or dealer from submitting any quotation for a security to a quotation medium unless (1) there had been a recent public offering pursuant to a registration statement or a notification under the Regulation A exemption from registration, or (2) the issuer is subject to certain reporting requirements of the securities laws and the broker or dealer has no reason to believe that such reporting requirements are not being complied with, or (3) the broker or dealer has specified information concerning the issuer reasonably believed to be correct and reliable, which must be made available to any person interested in a transaction in the security with the broker or dealer. The rule does not prohibit quotations for a security which had been the subject of quotations at least twelve days within the previous thirty calendar days, or for a security which is listed on an exchange and has been traded on the same day or on the day before the submission of the quotation.

NASD AUTOMATED OVER-THE-COUNTER QUOTATIONS SYSTEM (NASDAQ)

On February 8, 1971, the National Association of Securities Dealers, Inc. (NASD) formally commenced public operations of the NASDAQ automated quotations system with approximately 2300 over-the-counter securities. The system, which is operated by Bunker-Ramo Corporation for the NASD, has three levels of operating service. Level I service provides a current representative inter-dealer bid and ask quotation for any security registered in the system for the information of registered representatives and customers of retail firms. Level II is designed to supply upon request of trading rooms a list of market makers and their respective current bid and ask quotations for any such security. Finally, Level III service is similar to Level II but also has input facilities allowing authorized NASDAQ market makers to enter, change or update their bid and ask quotations.

By the end of the fiscal year the number of securities quoted on the system had reached approximately 2700 with a total market value of over $110 billion, and there were about 475 registered NASDAQ market makers. The NASD began developing a "stock watch" surveillance program for the new system and has been cooperating with the Commission's surveillance staff in looking into unusual market activity in NASDAQ securities.

During the fiscal year the Association also began a special test plan with respect to quoting securities which are traded both over the counter and on one or more national exchanges. The plan, which began on April 5, 1971, included 32 securities of which 29 were listed on the New York Stock Exchange, 2 on the American Stock Exchange and 1 on the Midwest Stock Exchange. On September 21, 1971, the NASD announced its intention to continue the test plan for an additional 3 months and to expand it to include all listed securities which meet the qualification standards for quotation on the system. During the year the NASD also began to compile price indices for NASDAQ securities and to release them to the news media for public information. To assist the Association in compiling these indices the Commission adopted Rules 13a-17 and 15d-17 under the Securities Exchange Act and a new reporting Form 10-C to require the submission of certain information to the Commission and to the NASD by issuers of securities quoted on NASDAQ with respect to any aggregate net change of 5 percent or greater in a class of securities quoted on the system.

During the fiscal year the Commission reviewed and made effective a NASDAQ rule change which provides access to Level II quotations to nonmembers of the Association. Under this change nonmembers, for an additional charge, would be able to obtain on a real-time basis quotations of over-the-counter market makers for securities quoted on the system. Shortly after the end of the fiscal year, the Association announced its plans to expand the system so as to allow subscribing brokerage firms to report the details of each securities trade to the NASDAQ central computer. The proposed trade reporting system, which will probably take about two years to put into effect, would make it possible for traders to verify each trade within seconds of its execution and to detect immediately any errors. It is expected that such a reporting system will provide more information to investors and will speed up the clearing and settling of over-the-counter transactions.

INSTITUTIONAL INVESTOR STUDY

On March 10, 1971, the Commission transmitted to the Congress the Institutional Investor Study Report, together with its initial conclusions and recommendations. The Report consists of 15 chapters organized into four major parts. Part One, in addition to introductory material, contains a summary of the Background Report on Institutional Investors and Corporate Stock prepared for the Study by the National Bureau of Economic Research, a pioneer in the development of flow of funds statistics and the system of national accounts. The substantive analyses in Part One were designed to place in historical perspective detailed studies in Part Two of the recent behavior of financial institutions as equity investors. Part Three was designed to assess the impact of institutional investing upon the stability of prices in the secondary equity markets, upon the structure of those markets and upon the securities industry that services the markets. Part Four analyzes certain aspects of the impact of institutional investors on portfolio companies: institutional participation in primary equity financing and institutional economic power and influence over companies whose equity securities are held by institutions or held for the benefit of persons whose investments are managed by institutions.

Among the Commission's initial conclusions and recommendations were the following:

1. Although institutions have increased their share of outstanding equity securities (relative to non-institutional holders), the increase has been relatively slow-paced over time. Institutions have tended to concentrate their purchases and holdings in the more stable securities of larger corporations while individual investors have sought and obtained higher returns on more risky securities. Thus, the status of institutions as net purchasers of corporate stock from individuals over most of the post-World War II period has not resulted in a perceptible increase in their share of the value of all equity securities during the last decade. Since the past and likely future growth of institutional investors in the equity markets makes essential the collection and analysis of timely information about institutional holdings and activity in securities, the Commission recommended amendment of the Securities Exchange Act of 1934 to provide the Commission with general authority to require reports and disclosures of institutional securities holdings and transactions. Such authorization would permit the Commission to obtain continuing data for public disclosure and for the production of statistical data or aggregates. In order to utilize fully the

data so collected, the Commission recommended that its economic research capability be expanded through additional budgetary and personnel resources and that appropriate steps be taken to make such data available to persons outside the Commission for analytical purposes.

2. Competitive pressures on institutional portfolio managers for improved investment performance have led to the rapid growth of relatively exotic, aggressively managed investment vehicles -- such as certain types of registered investment companies, hedge funds and offshore funds -- and to increased willingness on the part of many institutions to adopt more aggressive investment strategies and trading practices. Since these pressures have encouraged investment managers to assume higher levels of investment risk, the Commission concluded that improved disclosure of investment returns, portfolio volatility and short-term trading is needed from the managers of most types of professionally managed portfolios. In addition, the Commission suggested that where incentive or performance fees are utilized, penalties should be structured for sub-standard investment performance, as is currently the case for registered investment companies.

The Commission made specific recommendations for dealing with hedge funds and offshore funds that would subject those institutions to needed regulation while preserving their tax advantages.

3. Noting the accelerating trend during the last half of the 1960's toward the integration or diversification of institutions into multi-purpose financial service organizations, the Commission discussed several possible solutions to problems of conflicts of interest, competition and economic power that are generated by such structures: unbundling of certain services currently provided in combination with others at fixed rates; lower cost distribution systems for the mutual fund industry; and institutional membership on stock exchanges. Although no definitive conclusions were reached as to these matters, the Commission emphasized the importance of its prior determination that fixed commission rates on portions of orders in excess of $500,000 executed on securities exchanges could not be justified.

4. The Study's data indicated that institutional trading was associated with relatively few of the large price changes that occur in the securities markets. Thus, the Study did not discover any basis in terms of price stability for imposing generalized limitations on the volume of institutional trading or on the size of institutional transactions. At the same time, rapid and "significant changes in the securities markets suggest the need for restructuring those markets. Although the Commission stated that it was neither feasible nor desirable for any government agency to predetermine and require a particular market structure, certain goals and principles were set forth. Its objective, the Commission stated, was "to see a strong central market created to which all investors have access, in which all qualified broker-dealers and existing market institutions may participate in accordance with their respective capabilities, and which is controlled not only by appropriate regulation but also by forces of competition. "We propose, in consultation with all interested persons, to seek the furtherance of these general objectives as we perform our reviewing function over proposed changes in market structure."

5. Institutional purchases of equity securities from issuers, including restricted securities required to be registered under the Securities Act of 1933 upon subsequent resale, provide companies with additional capital and are thus of particular economic significance. In order to alleviate some of the problems that are associated with restricted securities, the Commission stated its view that the principles for valuing such securities at their current fair value, as set forth in releases under the Investment Company Act of 1940, should be observed by all types of institutions and persons managing securities portfolios. The Commission also noted that proposed rules relating to the resale of restricted securities it might, if adopted, result in a reduction in the cost to issuers of obtaining financing through the sale of restricted securities since the price of such securities when privately placed is usually substantially lower than the market price of similar securities that are freely tradeable.

6. Although it appears that limited numbers of institutions, particularly banks, have the potential economic power, were they to act together, to exercise control or influence over a number of portfolio companies, the Study found that except in the case of transfers of corporate control

(that is, takeover situations), where the expectation of benefits to institutions or their managers is relatively clear, institutions generally report that they do not participate in corporate decision-making. However, institutional influence, when exercised -- as in the case of transfers of control -- can be of decisive importance. The Commission concluded that additional disclosures should be required from all types of institutions, both as to the size and types of securities they hold and manage and as to matters bearing on their involvement in corporate affairs: voting authority, policies towards corporate management, participation in transfers of corporate control and policies regarding business relationships, personnel relationships and informal consultation with management. In the takeover area, the Commission recognized the need to consider additional rules to deal with the misuse of undisclosed information concerning transfers of control.

* * * * *

The Commission has been considering various means of implementing its initial recommendations and of developing further conclusions that may lead to additional proposals for legislative or administrative action.

REFORM OF THE INVESTMENT COMPANY ACT

Efforts to obtain much-needed reform of the Investment Company Act of 1940 were finally brought to a successful conclusion on December 14, 1970 when the Investment Company Amendments Act of 1970 (1970 Act) became law. As described in previous annual reports, antecedents of this legislation, representing proposals of the Commission, were first introduced in May 1967. The principal Commission proposals involved the reduction of sales loads imposed on the acquisition of mutual fund shares, the elimination of the so-called "front-end load," and establishment of a means to test the fairness of management fees. The proposals also dealt with a number of other areas which in the Commission's opinion required legislative action.

In proposing mutual fund legislation in 1967, the Commission recognized that most of the specific abuses aimed at in the Investment

Company Act had been substantially eliminated. However, the dramatic growth of the industry and accompanying changes created new situations which were not anticipated in 1940. While the industry accepted or even welcomed many of the changes proposed by the Commission, it took exception to the principal recommendations of the Commission, and as a result these were modified in the legislation passed by Congress. The most significant aspects of that legislation, which also included certain amendments of the Investment Advisers Act of 1940, are described below.

INVESTMENT ADVISORY FEES

The 1970 Act amends the Investment Company Act by adding a new Section 36 (b) (effective June 14, 1972) which specifies that the investment adviser of a registered investment company has a fiduciary duty with respect to the receipt of compensation for services or payments of a material nature paid by such company or its shareholders to the adviser or an affiliate of the adviser. An action for breach of this duty may be brought in a Federal court by the Commission or by a shareholder on behalf of the company. It may be brought only against the recipient of the compensation or payments, and damages are limited to the actual damages resulting from the breach of fiduciary duty and may not exceed the amount of compensation or payments received. Section 36 (b) further provides that the court is to give such consideration as it deems appropriate to approval of the compensation or payments in question by the board of directors and to approval or ratification by the shareholders.

An earlier House bill would have imposed on the plaintiff in a Section 36 (b) action the burden of proving a breach of fiduciary duty by "clear and convincing evidence." The House and Senate conferees rejected this standard of proof, which the Commission urged was inappropriate in a civil action, in favor of the approach taken by the Senate and finally adopted, which specifies merely that the plaintiff has the burden of proving such breach. The Report of the Senate Committee on Banking and Currency indicates that the normal standard of proof, under which a plaintiff must establish his case by a preponderance of the evidence, is to apply.

While the Commission had originally recommended adoption of a standard of "reasonable" management compensation, it considered the fiduciary standard finally agreed upon and adopted as equivalent in substance. Clearly, the new provision represents a significant improvement over the prior standards of "corporate waste" and "gross abuse of trust" applicable under state and federal law, respectively.

SALES CHARGES

In the area of sales charges imposed on investors in mutual fund shares, the 1970 Act amended Section 22 (b) of the Investment Company Act to provide that the National Association of Securities Dealers, Inc. (NASD) may by rule prohibit its members from offering such shares at a price which includes an "excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors." Previously, the NASD was authorized only to prohibit an "unconscionable or grossly excessive sales load." The 1970 Act also provides that at any time after 18 months from the date of its enactment, or after the NASD has adopted rules under amended Section 22 (b), the Commission may alter or supplement the rules of the NASD. The NASD is presently engaged in a study of sales loads to provide a basis for the adoption of appropriate rules.

THE FRONT-END LOAD ON CONTRACTUAL PLANS

Other significant amendments of the 1940 Act relate to the so-called "front-end load" on periodic payment plan certificates (i.e., certificates issued in connection with contractual plans for the accumulation of fund shares on an installment basis). Formerly, there was no right to a refund for an investor who did not want or was unable to continue payments to the end of the plan under which as much as 50 percent of the payments made during the first year could be deducted for sales charges. Thus, plan-holders who did not complete their payments were disadvantaged in terms of the portion of their payments actually invested in shares.

The 1970 Act, through amendment of Section 27 of the 1940 Act, provides a desirable improvement in investor protection in this area. Under the new provisions, sales charges on contractual plans may be imposed under either of two alternative methods. Under the so-called "spread load" alternative (which must be elected by written notice to the Commission), the sales load is restricted to not more than 20 percent of any payment and not more than an average of 16 percent over the first 4 years of the plan. Under the other alternative, periodic payment plan certificates may still be sold with a 50 percent front-end load, but plan sponsors must refund, to any investor surrendering his certificate within the first 18 months of the plan, that portion of the sales charges which exceeds 15 percent of the gross payments made, as well as paying him the value of his account. The 1970 Act further provides that, regardless of the alternative followed, an investor is entitled to a full refund of the value of his account plus all sales charges if he cancels his plan within 45 days from the mailing by the custodian bank of notice of the charges to be deducted and of his cancellation right. Such a notice must be mailed within 60 days after issuance of his certificate. The Commission is authorized to make rules requiring contractual plan sponsors to maintain specified reserves to meet refund obligations and specifying the notice to be given to investors regarding their refund rights.

FUND HOLDING COMPANIES

Provisions of the Investment Company Act relating to fund holding companies (i.e., investment companies whose portfolios consist either entirely or largely of the securities of other investment companies) were also amended, so as to limit the creation of new fund holding companies and the further enlargement of existing companies. Concern with such companies has centered on the fact that they result in "layering" of sales charges and administrative and other expenses to investors and may have a disruptive effect on the funds whose securities are held in their portfolios. Section 12 (d) (1) of the 1940 Act formerly prohibited a registered investment company, subject to certain exceptions, from purchasing more than 3 percent of the outstanding voting stock of another investment company unless it already owned at least 25 percent. This limitation was inadequate, since it applied only to purchases by registered investment companies. Hence, a foreign-based fund holding company not subject to registration under the Act could make unlimited investments in registered investment companies.

Under the 1970 amendments, no investment company may have more than 10 percent of the value of its assets invested in securities of other investment companies. However, that limitation is made inapplicable to a registered investment company if certain conditions are met, principally that: (1) not more than 3 percent of the outstanding stock of any one investment company is owned by the holding company, and (2) the sales load of the holding company cannot exceed 1½ percent. In addition, the portfolio fund is not obligated to redeem its securities held by the holding company in an amount exceeding one percent of its outstanding securities in any period of less than 30 days.

PERFORMANCE FEE ADVISORY CONTRACTS

The 1970 Act, in accordance with the Commission's recommendation, amended the Investment Advisers Act by deleting the exemption from the coverage of its provisions formerly provided for an investment adviser whose only clients are registered investment companies. The Advisers Act was further amended so as to prohibit an investment adviser from performing or entering into an advisory contract with a registered investment company providing for certain types of "performance fees," i.e., compensation based on the realized or unrealized appreciation of the investment company's portfolio.

The Commission had originally recommended a flat prohibition of performance fee arrangements between investment advisers and registered investment companies. It considered that such arrangements give advisers incentives to take undue risks and noted that many fee arrangements were unfair or so complex that it was virtually impossible to understand them. However, after discussion with industry representatives, the Commission agreed to an exception for certain limited types of performance fees. The amendments as adopted exempt from the prohibition against performance fee compensation an arrangement based on a percentage of a registered investment company's net asset value averaged over a specified period, which provides for proportionate increases and decreases in compensation on the basis of investment performance of the company as measured against an appropriate index of securities prices or such other measure of investment performance as the Commission may specify.

EXPANDED COMMISSION ENFORCEMENT AUTHORITY

The 1970 Act added a new subsection (b) to Section 9 of the Investment Company Act to provide additional grounds for disqualification of persons from affiliation with an investment company. Formerly only persons subject to certain convictions or injunctions were so disqualified. The new provision parallels comparable provisions in the Securities Exchange and Investment Advisers Acts providing for remedial action through administrative proceedings. It empowers the Commission, after notice and opportunity for hearing, to prohibit any person, either permanently or for such time as may be appropriate, from serving a registered investment company in the capacities of employee, officer, director, member of an advisory board, investment adviser, depositor or principal underwriter or as an affiliated person of its investment adviser, depositor, or principal underwriter. The Commission may take such action if it finds (1) that such person has willfully violated, or willfully aided and abetted violations by another, of any provision of the Securities Act, Securities Exchange Act, Investment Company Act, or Investment Advisers Act, or any rule or regulation thereunder, or has willfully made or caused to be made a materially false or misleading statement in any registration statement, application or report filed under the Investment Company Act, and (2) that such action is in the public interest.

BANKS AND INSURANCE COMPANIES

While the amendments of the 1940 Act were under consideration by the Congress, the question of whether banking laws permitted banks to operate so-called commingled managing agency accounts was pending before the Supreme Court, in Investment Company Institute v. Camp. A Senate bill would have expressly permitted banks and savings and loan associations to operate such accounts (which are investment companies), subject to specified restrictions, and would have made it clear that no other provision of law shall be deemed to prohibit such activities. A House bill would have provided that if no other provision of state or federal law prohibited operation by a bank or savings and loan association of an investment company, such investment company could be operated, subject to substantially the same restrictions specified in the Senate bill.

The 1970 Act, as finally adopted, does not contain either of these provisions. Subsequent to its enactment, the Supreme Court issued its decision in the Camp case, holding that the national banking laws do not permit banks to operate commingled managing agency accounts.

In another area the 1970 Act clarifies the status of certain bank collective funds and insurance company separate accounts under the Investment Company Act and the other federal securities laws. These amendments codify certain administrative interpretations by the Commission with respect to bank collective trust funds which are used as funding media for pension and profit sharing plans qualified for favorable treatment under the Internal Revenue Code. The amendments also provide treatment more equal to that of bank trusts for separate accounts maintained by insurance companies as funding vehicles for such plans.

OIL AND GAS FUNDS

In the area of oil and gas funds, the Senate bill would have deleted the existing exclusion from the Investment Company Act of such funds if they issued redeemable securities or periodic payment plan certificates, but would have left the exclusion intact for those oil and gas funds in which investors make only a single investment. The House version would not have altered the existing exclusion of oil and gas funds.

The Commission recommended adoption of the House approach. In the course of the hearings on the mutual fund legislation, the oil and gas industry had argued that regulation under the Investment Company

Act would involve difficulty in accommodating the structure contemplated by the Act with the structure adopted by the industry in order to secure favorable tax treatment for oil and gas investors. The Commission took the position that a satisfactory solution could be achieved by enactment of a regulatory statute which would provide safeguards paralleling those provided by the Investment Company Act, but which would be specifically tailored to the practices, problems and operating methods of the oil and gas funds.

The House and Senate conferees determined to retain the exclusion, with the same understanding. They directed the Commission to submit a legislative proposal in this area, hopefully to be worked out in cooperation with the oil and gas industry, within eighteen months of enactment of the 1970 Act.

IMPLEMENTATION OF INVESTMENT COMPANY ACT AMENDMENTS

Following passage of the 1970 Act, the Commission took steps to adopt rules implementing the new provisions, rescind existing rules which had become obsolete because of the legislation, and issue explanatory releases.

EXPLANATORY RELEASES

Beginning in February 1971, the Commission published a series of explanatory and interpretive releases dealing with the changes effected in the Investment Company and Investment Advisers Acts by the 1970 Act. The releases explained the effects of various of these changes, called the attention of registered investment companies and their counsel to actions which needed to be taken in order to comply with the new provisions, and rescinded certain rules and a form superseded by the amendments.

ADOPTION OF RULES UNDER AMENDED SECTION 27

As described above, the 1970 Act added to Section 27 of the Investment Company Act certain rights of withdrawal and refund in connection with the sale of periodic payment plan certificates. Shortly after these amendments became effective on June 14, 1971, the Commission adopted a series of rules and related forms to implement them. Among other things, the rules require principal underwriters and depositors to establish and maintain funds in a segregated trust account in order to assure their ability to meet refund obligations and specify the method, form and contents of the notices required to inform certificate holders of their refund rights.

REVISION OF ANNUAL REPORT FORM

In May 1971, the Commission published notice of a proposal to revise Form N-1R, the annual report form for most management investment companies, and in October 1971 it adopted the proposal, with certain modifications. The revision effected changes in the items of the form consistent with the 1970 amendments. In addition, since annual reports for the fiscal year which includes December 14, 1971, will involve the reporting, in certain items, of information relating to requirements of the Investment Company Act both before and after the effective date of amendments, the form was also revised to provide a means of reporting information for the fiscal year within which the amendments become effective.

STUDY OF THE POTENTIAL ECONOMIC IMPACT OF THE REPEAL OF SECTION 22 (d) OF THE INVESTMENT COMPANY ACT

The Committee on Banking and Currency of the United States Senate requested in its Report Accompanying the Investment Company Amendments Act of 1969 that the Commission review the potential consequences to the investing public and to the mutual fund sales organizations of a repeal of the "retail price maintenance" provision of Section 22 (d) of the Investment Company Act and report its findings to the Committee. Section 22 (d) precludes the sale to public investors of redeemable investment company securities which are being currently offered to the public by or through an underwriter except at a current public offering price described in the prospectus.

In the spring of 1971, approximately 600 selected broker-dealers, investment companies and their principal underwriters were surveyed through questionnaires developed to elicit the information necessary to analyze the potential impact of the repeal of Section 22 (d). The completed analysis will cover the potential impact on the funds themselves, principal underwriters, retail sales organizations and their salesmen, the investing public and the stock market.

PROPOSED RULES REGARDING RESALES OF RESTRICTED SECURITIES

The Commission has taken further steps in its efforts to bring greater clarity and certainty into one of the most difficult areas of securities law: the application of the registration provisions of the Securities Act of 1933 to the resale of securities acquired from issuers in transactions not involving public offerings ("restricted securities") and securities held by persons in a control relationship with an issuer.

As discussed in the last annual report, the Commission published a proposed Rule 144 dealing with those matters in September 1970. A large number of comments were received in response to this proposal and a still earlier one. In light of the comments and a further re-examination by the Commission of its interpretations in this area, the Commission, in September 1971, published a revised draft of proposed Rule 144 for comment as part of a package of proposed rules.

The proposed rule is designed to implement the disclosure objective of the Securities Act and would also operate to inhibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public. In essence, the rule would permit holders of restricted securities and persons in a control relationship with the issuer to sell, after a two-year holding period designed to assure that the seller has held the securities at risk, limited amounts of securities through brokers without registration, provided adequate public information about the issuer is available. Sellers of the securities will benefit from the greater certainty of clear-cut objective standards -- a 2-year holding period and the availability of public information -- which will replace the subjective "state of mind" and "change in circumstances" tests presently in effect. The adequate information condition is deemed to be met if the issuer is subject to the reporting requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934 and has filed all reports due within the past 90 days. Under a companion proposal to amend the annual and quarterly report forms, issuers filing such reports would be required to state whether all required filings within the preceding 90 days had been made, so that sellers will know whether Rule 144 is available for their use. If an issuer is not subject to these reporting requirements, there must be publicly available specified information concerning the issuer.

In order to prevent substantial blocks from coming into the market at one time which may result in wide swings in the market price, the revised rule would permit the sale of a maximum of 1 percent of the outstanding stock of an issuer in any six-month period. The securities must be sold in "brokers' transactions" within the meaning of Section 4 (4) of the Securities Act. There can be no solicitation of buy orders by the broker or the seller of the securities, and the broker can receive only the usual and customary broker's commission.

When the securities to be sold will exceed 500 shares or other units or the aggregate sale price will exceed $10,000, a notice of the proposed sale must be filed with the Commission at least 10 days prior to the sale. If the securities are not sold within 90 days after the notice is filed, an amended notice must be filed before any further sales are made.

In a related action, the Commission invited comment on a proposed new Rule 237 providing certain exemptions from registration under the Securities Act. The proposal reflects the Commission's recognition that noncontrolling persons owning restricted securities of issuers which do not satisfy all of the conditions of proposed Rule 144 might have difficulty in selling those securities due to circumstances beyond their control. Rule 237 is designed to avoid unduly restricting the liquidity of such investments.

Under the proposed rule any person satisfying the conditions of the rule would be permitted to offer securities up to one percent of the amount of the class outstanding or $50,000, whichever is less, during any twelve-month period, reduced by the amount of any other sales pursuant to an exemption under Section 3 (b) of the Act or Rule 144 during the period. The conditions would include the following: The seller has owned and fully paid for the securities for at least five years; the issuer is a domestic organization which has been actively engaged in business as a going concern for at least 5 years; the securities are sold in negotiated transactions otherwise than through a broker or dealer; and the seller must file a notice of intention to sell securities under the rule.

Another related proposal is to amend Regulation A so as to allow noncontrolling shareholders to sell limited amounts under that Regulation without having such offerings counted against the $500,000 maximum available to the issuer.

DISCLOSURE BY DEFENSE CONTRACTORS

In May 1970, the Commission received from its staff a report of an extensive private investigation authorized to determine if Lockheed Aircraft Corp. and certain of its officers and directors had made inadequate disclosures and engaged in illegal insider trading in connection with the cost history of Lockheed's C-5A contract. Based on this report and other evidence which the staff presented to the Commission, it was decided that enforcement action would not be taken against Lockheed. The Commission instead determined that a broader inquiry should be made into the entire area of defense contracting so that specific industry-wide financial disclosure standards might be established. Accordingly, on June 4, 1970, the Commission ordered a public inquiry, pursuant to Section 21 (a) of the Securities Exchange Act of 1934, into the disclosure practices of defense contractors.

As a part of this public investigation of disclosure practices, 50 of the nation's largest defense contractors received a written questionnaire directed to their current accounting and financial reporting practices.

The staff also took on the record testimony from representatives of certain companies and their independent auditors.

It is anticipated that the facts adduced in this inquiry will provide a basis for improving disclosure by defense contractors, through the issuance of specific guidelines to registration under the Securities Act or a requirement of new items or additional instructions to existing items to be reported pursuant to the regular reporting requirements of the Securities Exchange Act.

OFFERING OF SECURITIES AS SUBSTITUTE OR SUPPLEMENT FOR SAVINGS ACCOUNT DEPOSITS AND CERTIFICATES OF DEPOSIT

During the fiscal year the Commission issued a release announcing its concern regarding recent proposals for public offerings of a novel type of security with characteristics which appear to invite unwarranted comparisons with bank savings accounts, savings and loan association accounts, and bank time deposit certificates. Such securities may be presented to the public as a satisfactory investment medium to .serve as a supplement, or even a preferable alternative, to such savings accounts and certificates of deposit.

The security in question is customarily an unsecured debt security bearing interest at a rate lower than those prevailing for long term corporate debt, but somewhat higher than the prevailing rates for savings accounts and certificates of deposit. When the security does not have a relatively short maturity, it usually has a so-called redemption, presentment, tender or repurchase feature respecting principal and accrued interest which may lead the investor to believe that his security would have liquidity comparable with that of conventional savings accounts and bank certificates of deposit.

The Commission's release noted that investors in such securities would not have the safeguards resulting from state and federal supervision of financial institutions or the benefits of federally created insurance protections. It also pointed out that the so-called redemption or similar feature of these securities may be illusory because the issuers of the securities are in general not subject to any regulation or law with respect to the maintenance of reserves. Accordingly, the Commission cautioned members of the public to examine carefully the risk factors associated with securities they are invited to purchase and reminded persons engaged in the offering and sale of the securities described in the release of their obligations under antifraud provisions of the federal securities laws to consider and disclose the risk and other pertinent factors.

PROPOSED FEE SCHEDULE

Over the past few years, Congress has expressed concern that the Federal Government is not receiving sufficient returns for the services it renders, and it has been suggested that agencies review their schedules of fees and charges with a view to making increases or adjustments to offset the increasing needs for direct appropriations for agency operating costs.

Consistent with this suggestion, the Commission, in September 1971, published for comment a proposed fee schedule covering fees for certain filings and services under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Advisers Act of 1940 and the Investment Company Act of 1940.

Under the proposed schedule, fees would be charged for certain filings and services under these acts where no charges have previously been made and there would be no refund of any fees paid. Consistent with that approach, the Commission also proposed to amend Rule 457 under the Securities Act, which now provides for partial refunds of Securities Act registration fees under certain circumstances, so as to provide that no refund will be made once a registration statement has been filed.

The authorization to establish fees is found in Title V of the Independent Office Appropriations Act of 1952 which is applicable to all Federal independent agencies.

ENFORCEMENT ACTION CHARGING MISUSE OF PENSION FUNDS

In S.E.C. v. Victor Posner, et al., the Commission for the first time brought enforcement proceedings involving the alleged misuse of corporate pension funds in connection with the purchase or sale of securities. In May 1971, an injunctive action was instituted against six defendants, who after a takeover of Sharon Steel Corporation allegedly engaged in a fraudulent scheme to use the assets of Sharon's two pension funds to assist in takeovers and consolidation efforts." According to the complaint, the defendants accomplished the scheme by, among other things, causing the pension funds to liquidate a portion of their security holdings and to reinvest the proceeds in securities issued by certain of the defendant companies and other companies, all of them controlled by Posner.

PART II
FULL DISCLOSURE OF INFORMATION ABOUT THE ISSUERS OF SECURITIES

A basic purpose of the Federal securities laws administered by the Commission, in particular the Securities Act of 1933 and the Securities Exchange Act of 1934, is to provide disclosure of material financial and other information about companies seeking to raise capital through the public offering of their securities and those companies whose securities are already publicly held, so as to enable investors to evaluate the securities of these companies on an informed and realistic basis.

To this end, the Securities Act, generally speaking, requires that before securities may be offered to the public by an issuing company or a person in a control relationship to such company, a registration statement must be filed with the Commission disclosing prescribed categories of financial and other information, and that in connection with the sale of the securities investors be furnished a prospectus containing the most significant of that information.

The Securities Exchange Act, which deals in large part with securities already outstanding, requires the registration of securities listed on a national securities exchange and over-the-counter securities in which there is a substantial public interest. Issuers of registered securities must file annual and other periodic reports which are 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 connection with the solicitation of proxies for the election of directors or the approval of corporate action at a stockholders' meeting, and in connection with attempts to acquire control of a company through a tender offer or other planned stock acquisition, and it provides that "insiders" of companies whose equity securities are registered must report their holdings of and transactions in all equity securities of the company with which they are affiliated.

DISCLOSURE IN CONNECTION WITH PUBLIC OFFERINGS

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 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.

TYPE OF INFORMATION INCLUDED IN REGISTRATION STATEMENT

While the Securities Act enumerates the categories of information to be included in a registration statement, the Commission has the authority to prescribe appropriate forms, and to increase, or in certain instances vary or diminish, 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 Form S-7, which do not require disclosure of matters covered in reports and proxy material filed or distributed under provisions of the Securities Exchange Act.

In general, the registration statement of an issuer other than a foreign government must disclose such matters as the names of persons who participate in the management or control of the issuer's business; the security holdings and remuneration of such persons; the general character of the business, its capital structure, past history and earnings; underwriters' commissions; payments to promoters made within 2 years or intended to be made; the interest of directors, officers and principal stockholders in material transactions with the issuer; pending legal proceedings; and the purposes to which the proceeds of the offering are to be applied, and it must include financial statements certified by an independent public accountant. The registration statement of a foreign government must contain information concerning the purposes for which the proceeds of the offering are to be used, the natural and industrial resources of the issuer, its revenues, obligations and expenses, the underwriting and distribution of the securities being registered, and other material matters, but need not contain certified financial statements.

NEW REGISTRATION GUIDES

From time to time in recent years, the Commission has authorized the publication of guides reflecting policies of the Division of Corporation Finance regarding disclosure and other matters relating to the registration of securities.

During the fiscal year the Commission authorized the publication of a guide relating to disclosure of the interests of counsel named in a prospectus as having passed on the legality of the securities being registered or on other legal matters in connection with the registration or offering of the securities. The guide calls for disclosure of any interest in the issuer presently held or to be acquired by named counsel in connection with the registration or offering of the securities. The theory underlying the requirement is that potential investors should be told of any interests which such counsel may have in the issuer or the offering to enable them to judge for themselves counsel's independence and objectivity.

Another guide which was published requires disclosure in the prospectus of the registrant's business address and telephone number. Complaints had been received from time to time that investors and state regulatory agencies had been unable to communicate conveniently with registrants because that information had not been given.

In August 1970, a proposed guide to the preparation of registration statements relating to so-called "equity funding" programs was published for comment. The accompanying release pointed out that in recent months numerous registration statements had been filed for such programs which involve the offering of securities, usually mutual fund shares, and the use of such shares as collateral for a loan the proceeds of which are then used to pay a premium on a life insurance policy sold to the customer at or about the same time. The Commission has taken the position that such a program involves an investment contract which is a security under the Securities Act. Among other things, the proposed guide indicates the manner in which the risk factors involved in an equity funding program should be disclosed.

ADOPTION OF NEW OR REVISED REGISTRATION FORMS

During the year the Commission adopted Form S-16, a new short form for registration statements, for use in connection with certain types of offerings. The form may be used by any issuer which at the time of filing the registration statement would be entitled to use Form S-7, i.e., a company which has an established record of earnings and stability of management and business and has complied with reporting and proxy requirements of the Securities Exchange Act for at least 3 years. Form S-16 may be used for registering securities to be sold in the following types of offerings: Securities offered by persons other than the registrant in the regular way on a national securities exchange if securities of the same class are registered on the same or another such exchange; securities to be offered by an issuer to holders of convertible securities of an affiliate of the issuer which are convertible into securities of the issuer, where no commission or other remuneration is paid or payable by anyone for soliciting such conversion; and securities to be issued upon the exercise of outstanding publicly-held warrants where no commission or other remuneration is paid for soliciting the exercise of the warrants.

The Form S-16 prospectus consists in large part of the latest annual and other report and proxy or information statement filed by the issuer which are incorporated in the prospectus by reference. The prospectus must disclose where the documents incorporated by reference may be inspected or copies obtained. Any material adverse changes in the registrant's affairs subsequent to the date of the latest certified financial statements must also be disclosed. Like Forms S-7, S-8 and S-9 which also take into consideration information otherwise filed with the Commission, Form S-16 is in the nature of an experiment. The Commission intends to observe its operation in conjunction with the recently revised registration and reporting requirements under the 1934 Act to determine whether the omission of information from the prospectus is consistent with the objectives of the 1933 Act.

The Commission also adopted certain amendments to Forms S-1, S-9 and S-11. Form S-1, the general form for registration of securities, was amended to require a source and application of funds statement for each fiscal year or other period for which a profit and loss statement is required. This amendment conforms the requirements of Form S-1 to those of revised Forms 10 and 10-K under the Securities Exchange Act.

The amendments to Form S-9, an optional form for registration of non-convertible, fixed interest, debt securities, and Form S-11, which is used for registration of securities of certain real estate companies, also relate to the nature of the financial information to be furnished.

IMPROVING THE READABILITY OF PROSPECTUSES

Over the years the Commission has taken various measures to make prospectuses and other documents filed with it and furnished to the investing public more understandable to the average investor. Nevertheless, many prospectuses are still lengthy and complex. While they may be accurate and complete and useful for financial analysts and sophisticated investors, they may be unintelligible to the average investor and thus fail to achieve their statutory purpose of providing full and fair disclosure to investors. Accordingly, the Commission during the fiscal year invited comments and suggestions from interested persons with respect to reasonable measures which might be taken to improve the readability and informativeness of prospectuses and other documents the purpose of which is to inform investors or security holders. Many helpful responses were received, and shortly after the end of the fiscal year the Commission invited comments on certain specific proposals designed as the first in a series of steps to be taken toward this objective. Among the proposed measures is the required use in prospectuses of "pie-charts" to show the intended use of the proceeds of the offering and the dilution of the investor's equity in the enterprise.

In a related action, the Commission amended certain rules under the Securities Act and the Securities Exchange Act so as to require that notes to financial statements and other tabular data in prospectuses, proxy statements and other documents filed with the Commission or sent to security holders be set forth in a larger size type than was previously required. These notes often contain information of material importance to investors not found elsewhere in the documents.

DISPOSITION OF ABANDONED REGISTRATION STATEMENTS

During the fiscal year the Commission adopted a new Rule 479 which provides a procedure whereby the Commission may determine whether a registration statement or post-effective amendment to such a statement, which has not become effective, has been abandoned and remove such statement or amendment from consideration as a pending matter. The rule provides that when a statement or amendment has become out of date by the passage of 9 months from the filing date, or the filing of the latest substantive amendment, and the registrant has not furnished a satisfactory explanation as to why it has not amended or withdrawn the registration statement, the Commission may, in its discretion, give notice to the registrant and if the registration statement or amendment is not thereafter amended or withdrawn declare the statement or amendment abandoned. The rule also provides that the abandoned statement or amendment shall be suitably marked and remain in the files of the Commission.

NEW RULES RELATING TO PUBLICATION OF INFORMATION AND DELIVERY OF PROSPECTUS BY BROKER-DEALERS PRIOR TO OR AFTER THE FILING OF A REGISTRATION STATEMENT

During the year the Commission adopted rules designed to establish standards for determining circumstances under which broker-dealers may publish certain information about an issuer which proposes to or has registered securities under the Securities Act and to clarify a dealer's obligation to deliver prospectuses under Section 4 (3) of that Act and the anti-fraud provisions of the Securities Exchange Act. Information, opinions or recommendations by a broker-dealer about securities of an issuer proposing to register securities under the Securities Act for a public offering or having securities so registered may constitute an offer to sell such securities within the meaning of that Act, particularly when the broker-dealer is participating in the distribution as an underwriter or selling group member. Publishing such information may result in a violation of Section 5 of the Act. The purpose of the rules is to provide guidance to broker-dealers and to alleviate such requirements where it appears that the purposes and policies of the Act will not be prejudiced, while assuring that persons engaged in a distribution of a registered offering and their customers will be supplied with the disclosure afforded by the statutory prospectus.

STAFF EXAMINATION OF REGISTRATION STATEMENTS

Registration statements filed with the Commission are examined by its staff for compliance with the standards of adequate and accurate disclosure. This examination is primarily the responsibility of the Division of Corporation Finance. Generally speaking, if it appears that a statement fails to conform, in material respects, with the applicable requirements, the issuing company is notified by a letter of comment and is afforded an opportunity to file correcting or clarifying amendments. The Commission also has the power, after notice and opportunity for hearing, to issue a "stop-order" suspending the effectiveness of a registration statement if it finds that material representations are misleading, inaccurate or incomplete. In certain instances, such as where the deficiencies in a registration statement appear to stem from careless disregard of applicable requirements or from a deliberate attempt to conceal or mislead, a letter of comment is not sent and the Commission either conducts an investigation to determine whether "stop-order" proceedings should be instituted or immediately institutes such proceedings. The exercise of the "stop-order" power during fiscal year 1971 is discussed on pages 40-42.

TIME REQUIRED TO COMPLETE REGISTRATION

The Commission's staff endeavors to complete its examination of registration statements in as short a time as possible. The 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 thereto). Since most registration statements require one or more amendments, they usually do not become effective until some time after the original 20-day period. The period between filing and effective date is intended to afford 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 so as to shorten the 20-day waiting period, taking into account, among other things, the adequacy of the information respecting the issuer theretofore available to the public and the facility with which the facts about the offering can be understood.

During the fiscal year, 2,985 registration statements became effective. Of these, 226 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. With respect to the remaining 2,759 statements, the median number of calendar days which elapsed from the date of the original filing to the effective date was 52, representing a substantial reduction over the comparable figures for the two preceding years. As a matter of fact, during the last few months of the fiscal year the processing time was substantially below the figure for the year as a whole.

The following table shows by months during the 1971 fiscal year the number of registration statements which became effective, and the number of calendar days elapsed during the registration process for the median registration statement.

[table omitted]

STATISTICS REGARDING REGISTRATION STATEMENTS FILED

During the 1971 fiscal year, 3,404 registration statements were filed for offerings of securities aggregating $70.0 billion, as compared with 4,314 registration statements filed during the 1970 fiscal year for offerings amounting to $66.9 billion. This represents a decrease of 21.0 percent in the number of statements filed and an increase of 4.6 percent in the dollar amount involved.

Of the 3,404 registration statements filed in the 1971 fiscal year, 997, or 29 percent, were filed by companies that had not previously filed registration statements under the Securities Act. Comparable figures for the 1970 and 1969 fiscal years were 2,071, or 48 percent, and 2,350, or 50 percent, respectively.

Particulars regarding the disposition of all registration statements filed from the effective date of the Act to June 30, 1971, are summarized in the following table:

[table omitted]

The reasons assigned by registrants for requesting withdrawal of the 869 registration statements withdrawn during the 1971 fiscal year are shown in the following table:

[table omitted]

STATISTICS REGARDING SECURITIES REGISTERED

During the fiscal year ended June 30, 1971, a total of 2,989 registrations of securities in the amount of $69.6 billion became effective under the Securities Act Although the number of statements declined, the dollar amount effectively registered increased 18 percent from fiscal year 1970, reflecting a sharp rise in the volume of large security issues registered. The chart on page 36 shows the number and dollar amounts of effective registrations for the period 1935 to 1971.

[chart omitted]

The figures for 1971 cover all effective registrations including secondary distributions and securities registered for other than cash sale, such as issues exchanged for other securities and securities reserved for conversion. Of the dollar amount of securities registered in 1971, 84 percent was for the account of the issuer for cash sale, 10 percent for the account of the issuer for other than cash sale, and 6 percent for the account of others, as shown in the table below.

[table omitted]

The amount of securities offered for cash sale for the account of issuer in 1971 amounted to a record $58.5 billion, an increase of $10.3 billion over the preceding fiscal year and $6.4 billion more than the previous record established in fiscal year 1969. This increase was primarily due to the large volume of debt securities issued; $27.6 billion of bonds, debentures and notes were registered for the account of the issuer for cash sale as compared to $18.4 billion and $11.7 billion in fiscal years 1970 and 1969, respectively. Securities registered for the account of the issuer for other than cash sale declined slightly in 1971, with the volume of securities registered for purposes of exchange amounting to $1.5 billion compared to $2.0 billion during fiscal year 1970. Registrations of secondary offerings (for account of other than issuer) aggregated $4.1 billion, $500 million more than in the preceding fiscal year.

As shown in the table below, corporate issues effectively registered for immediate cash sale totaled a record $38.2 billion in 1971, an increase of $12.2 billion or 47 percent over the preceding year. New corporate bonds, notes and debentures were up sharply, aggregating $27.1 billion compared to the previous high of $17.8 billion registered in fiscal year 1970. New common stock flotations totaled $7.7 billion and showed a moderate increase from 1970 levels. New issues of preferred stock amounted to $3.3 billion, a record high for this type of securities financing. Almost one-half of these senior equities were offered to securities holders through subscription rights whereas virtually all of the preferred stock registered in 1970 and 1969 was issued to the general public.

[table omitted]

The following chart shows the amounts of debt issues, common and preferred stock offered for immediate cash sale in each of the past ten fiscal years. It points up the precipitous growth in the demand for capital funds during that period. Thus, the security financing total in 1971 represented a six-fold increase from the $6.3 billion registered in 1962.

[chart omitted]

The following table shows the volume of issues registered to be offered continuously over an extended period. Most of these issues were common stock offerings, including investment company issues, employee stock purchase plans and stock reserved for warrants and options. Registrations of extended offerings amounted to $18.7 billion in fiscal year 1971, a decline of $3.0 billion from 1970 and down sharply from the $34.0 billion registered in 1969.

[table omitted]

The chart below shows dollar amounts of registrations of issues offered over an extended period for the fiscal years 1962-1971. It also reflects the close parallel that has existed between the total volume of such registrations and investment company issues.

[chart omitted]

REPORTS OF SALES AND USE OF PROCEEDS

The Commission adopted a new rule and form requiring issuers registering securities under the Securities Act for the first time to file reports of sales of such securities and the application of the proceeds from such sales. The first report must be filed 3 months after the effective date of the registration statement and subsequent reports at 6-month intervals during the period of the offering and until the proceeds have been applied by the registrant. A final report is required upon completion of the offering and application of the proceeds. Information as to the progress of an offering of registered securities will enable the Commission to know whether the registrant is required to file and use an updated prospectus and whether dealers effecting transactions in the securities must furnish a copy of the prospectus to purchasers. Information concerning the actual use of the proceeds will indicate whether the statements in the prospectus with respect to such use are borne out by the registrant's subsequent actions.

EXAMINATIONS AND INVESTIGATIONS

The Commission is authorized by Section 8 (e) of the Securities Act to make an examination in order to determine whether a stop order proceeding should be instituted under Section 8 (d) and in connection therewith is empowered to examine witnesses and require the production of pertinent documents. Failure of the issuer or underwriter to cooperate in or obstruction of an examination constitutes grounds for issuance of a stop order. In addition, investigations into the adequacy and accuracy of registration statements may be conducted pursuant to Section 20 (a) of the Act which authorizes the Commission to conduct an investigation to determine whether any provision of the Act or any rule or regulation prescribed thereunder has been or is about to be violated. The following tabulation shows the number of examinations and investigations relating to registration statements which were in progress during the year:

[table omitted]

STOP ORDER PROCEEDINGS

Section 8 (d) of the Securities Act gives the Commission the power, after notice and opportunity for hearing, to issue a stop order "suspending" the effectiveness of a registration statement which includes an untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading. The effect of a stop order, which may be issued even after the sale of securities has begun, is to bar distribution of the securities so long as the order remains in effect. Although the order does not have the effect of restoring losses which may already have been suffered by investors, the Commission's decision and the evidence on which it is based may serve to put them on notice of their rights and aid in their private recovery suits. As provided by the Act, a stop order is lifted when the registration statement has been amended to correct the deficiencies.

At the beginning of the fiscal year two stop order proceedings were pending and during the year two additional proceedings were instituted. Two of the proceedings were terminated through the issuance of stop orders, and the others were pending as of the end of the year. One of these was terminated through issuance of a stop order shortly after the end of the fiscal year.

In Blimpie Corporation of America, the Commission had authorized an examination and investigation to determine whether a registration statement filed by Blimpie contained false or misleading statements concerning the identity of persons in control of the company, the background of its board of directors and transactions by and between its officers and directors. However, the persons listed in the registration statement as officers, directors and stockholders refused to testify when subpoenaed by the staff. The Commission held that such refusal constituted a failure by Blimpie to cooperate in the examination, which, pursuant to Section 8 (e), constituted a ground for issuance of a stop order.

In Augion-Unipolar Corporation, decided shortly after the close of the fiscal year, the Commission found that the registration statement filed by the issuer, a newly organized research and development corporation, was materially deficient in describing the intended use of the proceeds of the offering and certain inventions on which the issuer's business was dependent and in failing to disclose the possibility of adverse claims to those inventions and that the issuer's licensee did not have the financial capacity to honor potential multi-million dollar contractual commitments described in the registration statement. The Commission also found that the issuer had failed to cooperate in an examination conducted by its staff pursuant to Section 8 (e) of the Securities Act, in that the issuer's president, claiming- his privilege against self-incrimination, had refused to answer a staff member's question, and the issuer had failed to respond to a subpoena duces tecum calling for the production of corporate books and records. The Commission rejected contentions that no examination could be conducted pursuant to Section 8 (e) prior to the formal institution of stop-order proceedings under Section 8 (d), and that the president's claim of the privilege excused the issuer's failure to cooperate.

In view of the material deficiencies in the registration statement and the issuer's failure to cooperate, the Commission determined that a stop order suspending the effectiveness of the registration statement should issue. It rejected the argument that Section 8 (c) of the Securities Act required it to declare the issuer's post-effective amendments effective and to dismiss the proceedings. The Commission noted that its consideration of such amendments after the institution of stop-order proceedings was discretionary. It pointed out that even if the post-effective amendments were fully curative of the deficiencies which it had found in the registration statement, the information which the issuer and its officers had refused to furnish during the staff's examination might have disclosed further material deficiencies, and that consideration of the post-effective amendments would therefore be inconsistent with the public interest and the protection of investors.

EXEMPTION FROM REGISTRATION OF SMALL ISSUES

The Commission is authorized under Section 3 (b) of the Securities Act to exempt, by its rules and regulations and subject to such terms and conditions as it may prescribe therein, any class of securities from registration under the Act, if it finds that the enforcement of the registration provisions of the Act with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering. The statute imposes a maximum limitation of $500,000 upon the size of the issues which may be exempted by the Commission in the exercise of this power.

Acting under this authority, 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 $100,000.

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

Rules 234-236: Exemptions, up to limited amounts, 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 exempt securities issued by a small business investment company subject to the Small Business Investment Act. Acting pursuant to this authority the Commission has adopted Regulation E, which exempts such securities up to a maximum offering price of $500,000.

Exemption from registration under Section 3 (b) or 3 (c) of the Act does not carry any exemption from the provisions of the Act prohibiting fraudulent conduct in the offer or sale of securities and imposing civil liability or criminal responsibility for such conduct.

EXEMPT OFFERINGS UNDER 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. These include the filing of a notification supplying basic information about the company with the appropriate Regional Office of the Commission, and the filing, and use in the offering, of an offering circular. However, an offering circular need not be filed or used in connection with an offering not in excess of $50,000 by a company with earnings in one of the last 2 years.

During the 1971 fiscal year, 836 notifications were filed under Regulation A, covering proposed offerings of $254,220,725, compared with 1104 notifications covering proposed offerings of $293,666,784 in the 1970 fiscal year. The table below sets forth various features of the Regulation A offerings during the past 3 fiscal years:

[table omitted]

Reports of Sales. -- Regulation A requires the filing of periodic sales reports during the pendency of the offering and a final report upon its completion or termination. During the fiscal year 1971, 1036 reports of sales were filed reporting aggregate sales of $67,629,044.

Suspension of Exemption. -- The Commission may suspend an exemption under Regulation A where, in general, the exemption is sought for securities for which the regulation provides no exemption or where the offering is not made in accordance with the terms and conditions of the regulation or in compliance with the prescribed disclosure standards. Following the issuance of a temporary suspension order by the Commission, the respondents may request a hearing to determine whether the temporary suspension should be vacated or made permanent. If no hearing is requested within 30 days after the entry of the temporary suspension order and none is ordered by the Commission on its own motion, the temporary suspension order becomes permanent.

During the 1971 fiscal year, temporary suspension orders were issued in 23 cases. Added to the 19 cases pending at the beginning of the fiscal year, this resulted in a total of 42 cases for disposition. Of these, the temporary suspension order was vacated in 1 case and became permanent in 28 cases: in 14 by lapse of time, in 8 by withdrawal of the request for hearing, and in 6 by final determination by the Commission (including 5 based on offers of settlement). Thirteen cases were pending at the end of the fiscal year.

EXEMPT OFFERINGS UNDER REGULATION B

During the fiscal year ended June 30, 1971, 941 offering sheets and 917 amendments thereto were filed pursuant to Regulation B and were examined by the Oil and Gas Section of the Commission's Division of Corporation Finance. During the 1970 and 1969 fiscal years, 749 and 613 offering sheets, respectively, were filed. The following table indicates the nature and number of Commission orders issued in connection with such filings during the fiscal years 1969-71. The balance of the offering sheets filed became effective without order.

[table omitted]

Reports of Sales. -- The following table shows the number of sales reports filed under Regulation B during the past 3 fiscal years and the aggregate dollar amount of sales during each such year.

[table omitted]

EXEMPT OFFERINGS UNDER REGULATION F

Regulation F provides an exemption for assessments levied upon assessable stock and for delinquent assessment sales in amounts not exceeding $300,000 in any one year. It requires the filing of a simple notification giving brief information with respect to the issuer, its management, principal security holders, recent and proposed assessments and other security issues. The regulation requires a company to send to its stockholders, or otherwise publish, a statement of the purposes for which the proceeds of the assessment are proposed to be used. Copies of any other sales literature used in connection with the assessment must be filed. Like Regulation A, Regulation F provides for the suspension of an exemption thereunder where the regulation provides no exemption or where the offering is not made in accordance with the terms and conditions of the regulation or in accordance with the prescribed disclosure standards.

During the 1971 fiscal year, 19 notifications were filed under Regulation F, covering assessments of $407,719, compared with 19 notifications covering assessments of $498,220 in the prior year.

CONTINUING DISCLOSURE REQUIREMENTS

The Securities Exchange Act of 1934, as amended, contains a number of significant disclosure provisions with respect to securities traded in the securities markets. These provisions, applicable in general to issuers of securities listed on exchanges and issuers of securities traded over the counter which meet minimum asset and number of stockholder tests, include requirements for the registration of securities with the Commission and for periodic reports, as well as for appropriate disclosure in connection with the exercise of stockholders' voting rights, takeover bids and insiders' securities transactions.

REGISTRATION OF SECURITIES ON EXCHANGES

Unless a security is registered on a national securities exchange under Section 12 (b) of the Exchange Act or is exempt from registration, it is unlawful for a member of such exchange or any broker or dealer to effect any transaction in the security on the exchange. In general, the Act exempts from registration obligations issued or guaranteed by a State or the Federal Government or by certain subdivisions or agencies thereof and authorizes the Commission to adopt rules and regulations exempting such other securities as the Commission may find necessary or appropriate to exempt in the public interest or for the protection of investors. Under this authority the Commission has exempted securities of certain banks, certain securities secured by property or leasehold interests, certain warrants and, on a temporary basis, certain securities issued in substitution for or in addition to listed securities.

Pursuant to Section 12 (b) of the Exchange Act, an issuer may, if it meets the requirements of the exchange, register a class of securities on an exchange by filing with the Commission and the exchange an application which discloses pertinent information concerning the issuer and its affairs. Information must be furnished regarding the issuer's business, its capital structure, the terms of its securities, the persons who manage or control its affairs, the remuneration paid to its officers and directors, and the allotment of options, bonuses and profit-sharing plans. Financial statements certified by an independent accountant must be filed as part of the application.

Form 10 is the form used for registration by most commercial and industrial companies. There are specialized forms for certain types of securities, such as voting trust certificates, certificates of deposit and securities of foreign governments.

REGISTRATION OF OVER-THE-COUNTER SECURITIES

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). The same Form 10 referred to above is the general form for registration pursuant to Section 12 (g).

During the fiscal year, 714 registration statements were filed under Section 12 (g). This makes a total, from the enactment of Section 12 (g) in 1964, through June 30, 1971, of 5,690 registration statements filed. Eleven of these statements were withdrawn before they had become effective upon determination that they were not required to be filed under the Act.

Of the 714 registration statements filed under Section 12 (g) in fiscal year 1971, 420 were filed by issuers already subject to the reporting requirements of Section 13 or 15 (d) of the Act. The latter figure includes 19 registration statements filed by issuers with another security registered on a national securities exchange, and 401 filed by issuers subject to the reporting requirements of Section 15 (d) because they had registered securities under the Securities Act. These latter companies, however, had not been subject to the proxy solicitation and other disclosure and insider trading provisions of Sections 14 and 16 of the Exchange Act. The remaining 294 issuers which filed registration statements had not been subject to any of the disclosure or insider trading provisions and became subject to them through registration.

New Rule Regarding Registration by Successor Issuers. -- It has been the Commission's position that an issuer which succeeds by merger, consolidation, exchange of securities or acquisition of assets, to another issuer which had securities registered pursuant to Section 12 (g), or securities which would have been required to be registered but for the succession, assumes the duty to provide for such security holders a continuation of the benefits provided, or which would have been provided, by registration of the predecessor, unless upon consummation of the succession the securities are exempt from registration or all securities of the class are held of record by less than 300 persons. A new Rule 12g-3 adopted by the Commission, designed to avoid a hiatus in registration and reporting, provides that where an issuer which has no securities registered pursuant to Section 12 of the Act has issued equity securities to holders of equity securities of a predecessor which were registered under Section 12 (g) and there are at least 300 holders of the class so issued, such class shall be deemed registered pursuant to that section. It further provides that where the predecessor was required to register securities pursuant to that section but had not yet done so, the successor shall file a registration statement within the period of time the predecessor would have been required to file one, or within such extended period as the Commission may authorize.

Exemptions From Registration. -- Section 12 (h) of the Act authorizes the Commission, either by rules and regulations or by order upon application of an interested person, to grant a complete or partial exemption from the provisions of Sections 12 (g), 13, 14, 15 (d), or 16 if the Commission finds that because of the number of public investors, the amount of trading interest in the securities, the nature and extent of the activities of the issuer, the income or assets of the issuer, or otherwise, the exemption is not inconsistent with the public interest or the protection of investors. At the beginning of the fiscal year 9 applications for exemption orders were pending and 6 applications were filed during the year. Of these 15 applications, 3 were withdrawn and 3 were granted, and the remaining 9 applications were pending at the end of the fiscal year.

PERIODIC REPORTS

Section 13 of the Exchange Act requires issuers of securities registered pursuant to Section 12 (b) or 12 (g) to file periodic reports keeping current the information contained in the registration statement. During the fiscal year the content and nature of the reports to be filed were substantially revised. Thus, Form 10-K, the principal annual report form, was revised so as to provide on an annual basis information which, together with that contained in the proxy or information statement sent to security holders, will give a reasonably complete and up-to-date statement of the registrant's business and operations. The semiannual report on Form 9-K was replaced by a new quarterly report on Form 10-Q calling for summarized financial information. As heretofore, current reports on Form 8-K were required to be filed for each month in which any of certain specified events of immediate interest to investors occurred. A report on this form deals with matters such as changes in control of the registrant, important acquisitions or dispositions of assets, the institution or termination of important legal proceedings and important changes in the issuer's securities. Certain real estate companies are required to file quarterly reports on Form 7-Q, which replaced Form 7-K. Section 15 (d) of the Exchange Act, generally speaking, requires issuers which have registered securities under the Securities Act of 1933 and which have no securities registered under Section 12 to file the reports described above.

The following table shows the number of reports filed during the fiscal year pursuant to Sections 13 and 15 (d) of the Exchange Act. As of June 30, 1971, 3,130 issuers had securities listed on a national securities exchange and registered under Section 12 (b) of the Act, 4,797 issuers had securities registered under Section 12 (g), and 2,482 additional issuers were subject to the reporting requirements of Section 15 (d) of the Act.

[table omitted]

NEW RULES RELATING TO COMPANIES REPORTING PURSUANT TO SECTION 15 (d)

A new Rule 15d-5 provides that where an issuer which is not required to file reports pursuant to Section 15 (d) of the Act succeeds to an issuer which is required to file such reports, the successor is deemed to have assumed the duty to file such reports, and shall file the reports required by that section and the rules and regulations thereunder, unless it is exempt therefrom or the duty to file reports is suspended under the provisions of that section.

Under Section 15 (d), if the number of record holders of securities of each class registered is reduced to less than 300 persons at the beginning of any fiscal year, the duty to file reports is suspended for that year. To enable the Commission to know whether an issuer's failure to file reports is due to delinquency or to a suspension of the duty to file, the Commission adopted a new Rule 15d-6 which requires notice to the Commission whenever the duty to file has been suspended.

PROPOSED AMENDMENTS OF REPORTING FORMS

The Commission gave notice of a proposal to amend Forms 10-K and 10-Q to require information regarding recent transactions by the issuer in all unregistered securities. This information will be of material assistance in the administration of the so-called private offering exemption contained in Section 4 (2) of the Securities Act and in the administration of the securities laws by the staff and the Commission.

Certain amendments to Form 8-K relating to accounting matters are discussed in the accounting section below.

TIMELY DISCLOSURE OF MATERIAL CORPORATE DEVELOPMENTS

In a release issued during the year, the Commission reiterated the need for publicly held companies to make prompt and accurate disclosure of material developments, both favorable and unfavorable, to security holders and the investing public, so that investor confidence can be maintained in an orderly and effective securities market. It reminded companies subject to the reporting requirements of the Exchange Act of their obligation to file reports on time. The Commission further pointed out that even though a company complies with the reporting requirements, it still has an obligation to make full and prompt announcements of material facts regarding its financial condition.

PROCEEDINGS TO OBTAIN COMPLIANCE WITH EXCHANGE ACT REGISTRATION OR REPORTING REQUIREMENTS

Administrative Actions. -- Section 15 (c) (4) of the Exchange Act empowers the Commission to find, after notice and opportunity for hearing, that any person subject to the provisions of Section 12, 13 or 15 (d) of the Act or the rules thereunder has failed in any material respect to comply with any of those provisions. It thus provides an administrative procedure for apprising investors of materially misleading filings and for the resolution of accounting and other complex and technical questions involving the disclosure provisions of the Act. Under Section 15 (c) (4) the Commission can publish its findings and issue an order requiring compliance and, when the circumstances of a particular case so warrant, apply to a U.S. district court for enforcement of its order.

At the beginning of the fiscal year, one proceeding pursuant to Section 15 (c) (4) was pending, and during the year three additional proceedings were instituted. The Commission issued decisions in two of the proceedings during the year, and the other two were pending at the end of the year.

Major Realty Corporation involved the adequacy of disclosures contained in annual reports filed by Major for its 1968 and 1969 fiscal years in connection with an agreement for the sale of a parcel of land. Major entered into a contract to sell the parcel of land which provided, among other terms, that Major had the right to rescind the contract, subsequent to closing, under certain conditions, and no interest or principal payments were to be made until after the right to rescind was no longer extant. Major received a down payment of $25,000 representing less than 1 percent of the purchase price and a non-recourse note for the remainder of $3,475,000 from a subsidiary of the buyer which had assumed the buyer's obligation and only had nominal assets. Major reflected $3,152,170 as income derived from this, transaction and the note of $3,475,000 as an asset in its 1968 annual report on Form 10-K.

The Commission found that Major improperly treated the land transaction as a reportable sale and thereby overstated its net income and understated its deficit in retained earnings on its 1968 Form 10-K and continued the understatement of its deficit in retained earnings on its 1969 Form 10-K. The Commission concluded that the proper accounting treatment, following the substance rather than the form of the transaction, should have recognized that Major obtained nothing more than a small deposit in exchange for an option to purchase. Pursuant to Major's offer of settlement in which it consented to findings that the annual reports were deficient, the Commission ordered Major to file correcting amendments and to send copies of the Commission's Findings, Opinion and Order to all of its stockholders.

Civil Actions. -- The Exchange Act empowers the Commission to bring civil actions in Federal district courts to enjoin violations of the provisions of Sections 12, 13 or 15 (d) of that Act or to compel affirmative compliance with those provisions. During the fiscal year 12 actions to compel such compliance were instituted. In one case a default judgment was entered against the issuer, and the others were pending as of the end of the year.

PROXY SOLICITATIONS

Scope and Nature of Proxy Regulation. -- Regulation 14A under the Exchange Act, implementing Section 14 (a) of that Act, governs the manner in which proxies or other authorizations may be solicited from the holders of securities registered under Section 12 of that Act, whether for the election of directors, approval of other corporate action, or some other purpose. It requires that in any such solicitation, whether by the management or minority groups, disclosure must be made of all material facts concerning the matters on which security holders are asked to vote, and they must be afforded an opportunity to vote "yes" or "no" on each matter other than elections. The regulation also provides, among other things, that where the management is soliciting proxies, a security holder desiring to communicate with other security holders may require the management to furnish him with a list of all security holders or to mail his communication to security holders for him. A security holder may also, subject to certain limitations, require the management to include in its proxy material any appropriate proposal which he wants to submit to a vote of security holders. Any security holder or group of security holders may at any time make an independent proxy solicitation upon compliance with the proxy rules, whether or not the management is making a solicitation. Certain additional provisions of the regulation apply where a contest for control of the management of an issuer or representation on the board is involved.

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.

Under Section 14 (c) of the Act, issuers of securities registered under Section 12 must, in accordance with rules and regulations prescribed by the Commission, transmit information comparable to proxy material to security holders from whom proxies are not solicited with respect to a stockholders' meeting. Regulation 14C implements this provision by setting forth the requirements for "information statements."

Statistics Relating to Proxy and Information Statements. -- During the 1971 fiscal year, 6,152 proxy statements in definitive form were filed, 6,132 by management and 20 by nonmanagement groups or individual stockholders. In addition, 126 information statements were filed. The proxy and information statements related to 5,942 companies, some 316 of which had a second solicitation during the year, generally for a special meeting not involving the election of directors.

There were 5,864 solicitations of proxies for the election of directors, 383 for special meetings not involving the election of directors, and 25 for assents and authorizations.

The votes of security holders were solicited with respect to the following types of matters, other than the election of directors:

[table omitted]

Stockholders' Proposals. -- During the 1971 fiscal year, 489 proposals submitted by 46 stockholders were included in the proxy statements of 204 companies under Rule 14a-8 of Regulation 14A.

Typical of such stockholder proposals submitted to a vote of security holders were resolutions relating to 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 113 additional proposals submitted by 28 stockholders were omitted from the proxy statements of 48 companies in accordance with Rule 14a-8. The principal reasons for such omissions and the number of times each such reason was involved (counting only one reason for omission for each proposal even though it may have been omitted under more than one provision of Rule 14a-8) were as follows:

[table omitted]

Proxy Contests. -- During the 1971 fiscal year, 31 companies were involved in proxy contests for the election of directors. A total of 720 persons, both management and non-management, filed detailed statements as participants under the requirements of Rule 14a-11. Proxy statements in 22 cases involved contests for control of the board of directors and those in 9 cases involved contests for representation on the board.

Management retained control in 13 of the 22 contests for control of the board of directors, five were settled by negotiation, non-management persons won two, and two were pending as of June 30, 1971. Of the nine cases where representation on the board of directors was involved, management retained all places on the board in four contests, opposition won places on the board in three cases, one was settled by negotiation and one was pending as of June 30, 1971.

Litigation Relating to Proxy Rules. -- In *Medical Committee for Human Rights v. S.E.C.*, as previously reported, the Commission petitioned the Supreme Court for a writ of certiorari to review a decision of the Court of Appeals for the District of Columbia Circuit which had held that a refusal of the Commission to advise a company that the Commission was of the view that a stockholder proposal should be included in the company's proxy soliciting material was reviewable. The Dow Chemical Company had refused to include in its proxy statement for the company's annual meeting a proposal submitted to it by one of its shareholders, the Medical Committee for Human Rights. The Commission, in indicating that it would not institute an enforcement action against Dow, had not expressed any view with respect to the reasons given by Dow for its refusal to include the proposal.

The petition was granted on March 22, 1971. In its brief on the merits in the Supreme Court the Commission urged that its determination not to take enforcement action against Dow was not an "order" within the meaning of the relevant jurisdictional statute, Section 25 (a) of the Securities Exchange Act, and that its "no-action" determination was without legal effect or impact.

DISCLOSURE IN CONNECTION WITH TAKEOVER BIDS AND OTHER LARGE ACQUISITIONS

Sections 13 (d) and (e) and 14 (d), (e) and (f) of the Securities Exchange Act, which were enacted in July 1968, as implemented by rules and regulations adopted by the Commission, provide among other things for appropriate disclosure in connection with cash tender offers and other large stock acquisitions. 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. In December 1970 the statutory provisions were amended, so as to improve their effectiveness in light of the Commission's experience gained in administering them. The most significant of the amendments requires the filing of information with respect to acquisitions of securities by persons who own more than 5 percent of the class, or the making of tender offers or requests for tenders of equity securities if after consummation thereof the persons making the tender offer or solicitation would be the beneficial owner of more than 5 percent of the class. Previously the percentages were 10 percent in both cases. The amendments also extended the coverage of Sections 13 (d) and 14 (d) to insurance companies and made the provisions of Section 14 (d) applicable to tender offers made by means of a registration statement under the Securities Act. To implement the amendments, the Commission adopted a new rule under the Securities Act and amended its rules and regulations under Sections 13 (d) and 14 (d).

Rule 13d-1 under the Act now requires the filing with the Commission of a Schedule 13D report by a person or group which acquires any of a class of equity securities registered pursuant to Section 12 of the Act, or issued by an insurance company which would have been required to be so registered except for the exemptions contained in Section 12 (g) of the Act, or issued by a closed-end investment company registered under the Investment Company Act of 1940, if such acquisition results in the ownership by such person or group of more than five percent of such class of securities, and the acquisitions by such person or group in the past twelve months exceed 2 percent of such class. During the 1971 fiscal year 514 Schedule 13D acquisition reports were filed. Rule 14d-1 requires the filing of a Schedule 13D report by a person or group making a tender offer, including an exchange offer pursuant to a registration statement under the Securities Act, which, if successful, would result in such person or group owning more than 5 percent of any class of equity securities subject to Section 14 (d). Forty-three Schedule 13D tender offer notices were filed during the fiscal year.

In addition, 21 Schedule 14D reports were filed pursuant to Rule 14d-4 involving solicitations or recommendations in connection with a tender offer by a person other than the maker of the offer, and 15 statements were filed pursuant to Rule 14f-1. The latter relate to the replacement of a majority of the board of directors (otherwise than by stockholder vote) pursuant to an arrangement or understanding with the person or persons acquiring securities in a transaction subject to Section 13 (d) or 14 (d) of the Act. One statement was filed pursuant to Rule 13e-1 relating to corporate reacquisitions of securities while the issuer is the target of a cash tender offer.

INSIDERS' SECURITY HOLDINGS AND TRANSACTIONS

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 as to insiders' securities transactions and holdings, and to prevent the unfair use of confidential information by insiders to profit from short-term trading in a company's securities.

Ownership Reports. -- 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 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 Act and Investment Company Act.

During the fiscal year, 94,961 ownership reports (20,666 initial statements of ownership on Form 3 and 74,295 statements of changes in ownership on Form 4) were filed with the Commission. By comparison, during fiscal year 1970, 95,952 such reports were filed (21,337 initial statements and 74,615 statements of changes).

All ownership reports are made available for public inspection as soon as they are 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 10,000 subscribers.

Recovery of Short-Swing Trading Profits. -- In order to prevent insiders from making unfair use of information which they may have obtained by reason of their relationship with a company, Section 16 (b) of the Exchange Act and corresponding provisions in the Holding Company Act and Investment Company Act provide for the recovery by or on behalf of the issuer of any profit realized by insiders (in the categories listed above) from certain purchases and sales, or sales and purchases, of securities of the company within any period of less than 6 months. The Commission at times participates as *amicus curiae* in actions to recover such profits when it deems it important to present its views regarding the interpretation of the statutory provisions or of the exemptive rules adopted by the Commission thereunder.

INVESTIGATIONS WITH RESPECT TO REPORTING AND PROXY PROVISIONS

Section 21 (a) of the Exchange Act authorizes the Commission to make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of the Act or any rule or regulation thereunder. The following investigations were undertaken pursuant to Section 21 (a) in connection with the enforcement of the provisions of Sections 12, 13, 14 and 15 (d) of the

Act and the rules thereunder, particularly those provisions relating to the filing of annual and other periodic reports and proxy material:

[table omitted]

SUMMARY SUSPENSION OF TRADING

Section 19 (a) (4) of the Exchange Act authorizes the Commission summarily to suspend trading in a security listed on a national securities exchange for up to 10 days if in its opinion the public interest so requires. Under Section 15 (c) (5) of that Act the Commission may summarily suspend over-the-counter trading in any non-exempt security for up to 10 days if it believes that such action is required in the public interest and for the protection of investors.

During the 1971 fiscal year, the Commission temporarily suspended trading in 26 securities, compared to 55 in fiscal 1970 and 33 in fiscal 1969. In four instances exchange-traded securities were involved and the Commission acted under both Section 19 (a) (4) and Section 15 (c) (5).41 In each of these cases, the exchange on which the securities were listed had previously halted or suspended trading.

In most instances the Commission ordered suspension of trading because adequate information concerning the company was not available or the Commission learned of information not generally known to the securities community and investors which indicated the existence of substantial questions concerning the financial condition or business operations of the company or the purchase or sale of its securities.

The suspensions involved a wide variety of factual circumstances, as illustrated by the cases described below. In the case of Rolls-Royce, Ltd., trading in the company's common stock and American Depositary Receipts (ADRs) had been halted by the American Stock Exchange about a month previously, pending the release of additional information relating to the company's financial condition and plans, and the company had announced that it was going into receivership. Thereafter an active over-the-counter market had developed in Rolls-Royce

ADRs. The suspension was ordered after it appeared that the English transfer registrar and the American depositary for ADRs would close their books. Once the books were closed, American citizens would be unable to transfer ADR certificates and to convert ADRs into common stock or common stock into ADRs.

In the case of Canadian Javelin Limited, the suspension was ordered because of the unavailability of adequate and accurate information concerning the extent, quality and commercial feasibility of possible mineral deposits within a mining concession in Panama owned by a company in which Canadian Javelin owned an interest and had options to acquire the remaining interest. Widespread rumors had circulated concerning the concession, and the prices of Canadian Javelin's securities had increased on a comparatively high trading volume.

The temporary suspension of trading in the securities of Ecological Science Corporation was ordered because facts coming to the attention of the Commission indicated that information then public concerning the company and its financial condition may have been inaccurate. Thereafter, as a result of an action brought by the Commission, the company, pursuant to court order, filed a restated annual report for 1969 which indicated substantially lower earnings than previously reported.

Commission releases announcing the terminations of trading suspensions frequently carry a warning to investors to exercise care in transactions involving the securities in question, and remind brokers and dealers of their responsibility under the Federal securities laws for full disclosure of material facts in connection with the solicitation of purchases.

ACCOUNTING AND AUDITING MATTERS

The several Acts administered by the Commission reflect a recognition by Congress that dependable financial statements of a company are indispensable to an informed investment decision regarding its securities. The value of such statements is directly dependent on the soundness of the judgment exercised in applying accounting principles and practices in their preparation, and on the adequacy and reliability of the work done by public accountants who certify the statements. 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 certifying accountants. The primary responsibility for this program rests with the Chief Accountant of the Commission.

Pursuant to the Commission's broad rulemaking power regarding the preparation and presentation of financial information, 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 statutes administered by the Commission. The Commission has also formulated rules with respect to accounting for and auditing of brokers and dealers and has 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 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 certificate 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 is designed to secure for the benefit of public investors the detached objectivity of a knowledgeable professional person not connected with the management.

The accounting staff examines 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, the formation of new types of business, the large number of combinations of old businesses, the use of more sophisticated securities, and other innovations, create accounting problems which require a constant reappraisal of the procedures.

RELATIONS WITH THE ACCOUNTING PROFESSION AND THE PUBLIC

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 staff and outside accountants regarding appropriate accounting and auditing policies, procedures and practices for the protection of investors, the staff maintains continuing contact with individual accountants, other government agencies, and various professional organizations. These include the American Accounting Association, the American Institute of Certified Public Accountants (AICPA), the American Petroleum Institute, the Financial Analysts Federation, the Financial Executives Institute, the National Association of Accountants, and the National Association of Railroad and Utilities Commissioners. Since the AICPA is one of the principal professional organizations involved in the development and improvement of accounting and auditing standards and practices, regular liaison is maintained with it through its Committee on Relations with Securities and Exchange Commission and Stock Exchanges. Conferences are held with this committee from time to time at which problems of mutual interest are discussed and the staff is briefed on the work being done by the Institute's Committees on Ethics and Auditing Procedures and by its Accounting Principles Board. The Commission's accounting staff also meets with the Committee on Corporate Reporting of the Financial Executives Institute to discuss possible improvements of accounting standards and practices.

As part of the Commission's effort to maintain a continuing exchange of views with the accounting profession, members of the Commission and accounting staff members from time to time address, or participate in panel discussions at, professional society meetings. In this way the Commission can indicate problem areas in accounting where it believes the profession can aid in developing solutions. The Chief Accountant also accepts engagements to discuss the work of the Commission as it relates to accounting at colleges and universities throughout the country.

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 corresponds with foreign accountants, meets with many who visit this country, and, on occasion, participates in foreign accounting conferences or writes for foreign professional journals. For example, in September 1970 he presented a paper at the First Annual Conference of the British Accounting and Finance Association in Edinburgh, Scotland.

THE WORK OF THE ACCOUNTING PRINCIPLES BOARD AND COMMITTEES OF THE AICPA

The Accounting Principles Board sponsors research studies of problem areas in accounting and formulates formal opinions and advisory statements for the improvement of accounting standards and practices. The Board submits drafts of these studies, opinions and statements to the Chief Accountant for review and comment prior to their publication, and representatives of the Board confer with him on projects in progress or under consideration. Standing committees of the AICPA develop statements on auditing standards and procedures for the guidance of the profession in much the same manner that Board opinions are developed.

In connection with the development of opinions in major problem areas in accounting, the Board conducts symposiums or formal hearings in order to obtain the views of representatives of professional groups and governmental organizations, including the SEC, and other persons concerned with the particular accounting problems. The Board also maintains liaison with other important professional associations for coordination of their efforts with respect to its projects.

Early in the fiscal year the Board published opinions on "Business Combinations" and "Intangible Assets" which deal with difficult and long-standing problems relating to the accounting for business combinations and for the intangible assets that are created in many acquisitions. The Chairman and the Chief Accountant had urged the profession to restudy the principles applicable to these areas of accounting in order to develop criteria which would curb abuses that had arisen because of inadequate restrictions on the choice between the alternatives of purchase or pooling-of-interests accounting to be accorded business combinations and assure an adequate program of amortization of the intangible assets or "goodwill" resulting from some of these transactions.

The Board issued two other opinions during the fiscal year and two additional opinions under consideration during the year were issued in August 1971. One opinion extends the application of the equity method of accounting for investments in common stocks to situations in which the investor's interest in the investee may in general be as low as 20 percent instead of the prior minimum of 50 percent. Another opinion provides detailed rules for accounting for changes in accounting principles, accounting estimates and reporting entities, and specifies that an entity should demonstrate that changes which are made in accounting principles will provide more useful financial information than the prior method of accounting.

The third opinion, on "Interest on Receivables and Payables," provides needed guides for the determination of the effective rates of interest and the amounts of discount or premium involved when notes of certain types which are received or issued do not bear interest or bear an interest rate differing materially from the prevailing interest rates for comparable notes.

The fourth opinion establishes a requirement for the presentation, as a basic financial statement to be covered in the independent auditor's opinion, of a statement summarizing changes in financial position when balance sheets and statements of income and retained earnings are presented, and provides guides for preparation of the statement. Comparable requirements were also adopted by the Commission during the year by an amendment to Regulation S-X, to include a section which specifies the content of a statement of source and application of funds, and by amendments to registration and annual report forms under the securities acts to require the inclusion of such statements.

The Board has plans to develop and issue ten more opinions by June 30, 1972 on the following subjects: marketable equity securities, leases, tax allocation on unremitted earnings of subsidiaries, stock compensation plans, repurchase of debt instruments at large discounts, noncash transactions, diversified companies, extraordinary items, components of a business enterprise, and accounting policies. Other topics on which the Board or its subcommittees are working with a view to issuing opinions are the following: interim financial statements, common stock equivalents, accounting for land development companies, public utilities, and extractive industries.

Accounting research studies are in progress on the subjects of intercorporate investments, research and development, foreign operations, stockholders' equity, concept of materiality, inventory pricing, depreciation methods, working capital, asset and liability valuation, and worldwide financial reporting.

A Statement of the Board on "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," published in October 1970, is intended to provide a basis for enhanced understanding of the broad fundamentals of financial accounting and for guiding its future development.

The AICPA Committee on Auditing Procedure issued during the fiscal year Statements on Auditing Procedure on "Confirmation of Receivables and Observation of Inventories" (a revision of an earlier statement) and "Reports Following a Pooling of Interests," and in July 1971 issued Statements on "Piecemeal Opinions" and "Using the Work and Reports of Other Auditors." This committee is also developing

Statements relating to the short-form report, internal control, comfort letters, and subsequent event procedures, and reporting on Article 5A companies, i.e., commercial, industrial and mining companies in the promotional, exploratory or development stage that present financial statements included in filings with the SEC in conformity with Article 5A of Regulation S-X. The committee is also considering Statements on the subjects of negative assurance, degrees of qualification, reporting on price-level financial information, transactions with affiliates, reporting on forecasts, and reliance upon experts.

Committees of the AICPA are also developing or revising Audit Guides for the following types of organizations whose financial statements may be filed with the SEC: stock brokers and dealers, finance companies, life insurance companies and savings and loan associations.

OTHER CURRENT DEVELOPMENTS

During the fiscal year the Commission issued three Accounting Series Releases. One of these, as noted above, added a new section to Regulation S-X governing the content of statements of source and application of funds. Funds statements are now required to be included in registration and reporting forms under the Securities Act and Securities Exchange Act.

Another release provided an interpretation regarding the computation of the ratio of earnings to fixed charges which is required to be shown in certain registration forms under the Securities Act and is permitted to be shown in certain registration and report forms under the Securities Exchange Act. An additional interpretation on the subject was issued in August 1971.

The third release dealt with the accounting for investment securities by registered investment companies. This and another release issued shortly after the end of the fiscal year which amended annual report Form N-1R for management investment companies are discussed in greater detail in Part V of this report.

In May 1971 the Commission invited public comment on a proposal to amend certain registration and reporting forms and Regulation S-X to remove the exemption from certification of financial statements of banks filed under the Securities Act and the Securities Exchange Act and statements of life insurance companies filed under the Securities Exchange Act. After consideration of the comments received, the Commission, shortly after the end of the year, adopted amendments which removed the exemption from certification of financial statements of banks for fiscal periods ending after November 30, 1971. However, the Commission determined to retain at this time the exemption with respect to life insurance companies. This will permit the accounting profession in collaboration with the life insurance industry to complete work now underway to develop and promulgate accounting guidelines for life insurance companies which will enable the financial statements of such companies to be certified in accordance with generally accepted accounting principles.

In May 1971 the Commission also issued for comment a proposal to amend certain reporting forms to require registrants to furnish additional information regarding any unusual material charges or credits to income; to report a change in the certifying accountants and the reasons for the change and to request the replaced accountant to furnish a letter to the Commission discussing the reasons; and to report changes in accounting principles and practices materially affecting the financial statements together with a letter from the independent accountants regarding the changes. With some modifications, the proposed amendments were adopted by the Commission in September 1971.

In August 1971 the Commission issued for public comment a proposal to revise Articles 1, 2, 3, 4, 5, 9 and 11 and Rules 12-01 to 16 (exclusive of 12-06A), and to omit Rules 12-17 and 12-32, of Regulation S-X. These proposed general revisions, the first since 1950, represent changes, additions and deletions that have become necessary as a result of changing conditions over the years. Committees of the AICPA and Financial Executives Institute submitted many helpful suggestions for the proposed revisions. The Commission's Disclosure Study Group had also recommended certain revisions, particularly with respect to the schedules required under Rule

12. In connection with Article 9, which pertains to bank holding companies and banks, representatives of the Federal bank regulatory agencies also submitted suggestions for revisions.

EXEMPTIONS FOR SECURITIES OF INTERNATIONAL BANKS

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Section 15 of the Bretton Woods Agreement Act, as amended, exempts from registration under both the Securities Act and the Securities Exchange Act 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 with respect to such securities as the Commission determines to be appropriate in view of the special character of the Bank and its operations, and necessary in the public interest or for the protection of investors. Pursuant to this authority, the Commission has adopted rules requiring the Bank to file quarterly reports and also to file copies of each annual report of the Bank to its Board of Governors. The Bank is also required to file reports with the Commission in advance 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 at any time as to any or all securities issued or guaranteed by the Bank during the period of such suspension. The following summary of the Bank's activities reflects information obtained from the Bank.

During the year the Bank made 78 loans totaling $1,896 million in 41 countries, compared with a total of $1,680 million the previous year.

Net income for the year was $212 million, virtually unchanged from the previous year. The Bank's Executive Directors recommended to the Board of Governors and the Board has subsequently approved that $110 million be transferred as a grant to its affiliate, the International Development Association. The remaining portion of the year's net earnings, amounting to approximately $102 million, will be transferred to the Bank's Supplemental Reserve, increasing it to $1,254 million. Total reserves of the Bank, including the Special Reserve, will amount to $1,546 million.

Gross income for fiscal 1971 aggregated $578 million including $187 million income from investments, $384 million income from loans and $7 million income from other sources. Income from investments was $38 million higher than in the prior year as a result of both a higher level of investments and a continuing high level of yields. Income from loans was $39 million higher primarily due to expansion of the Bank's loan portfolio. The interest charged on new loans increased during the fiscal year from 7 percent to 7¼ percent.

Expenses in fiscal 1971 totaled $366 million compared with $291 million the previous year. Interest on the Bank's own bonds and other financial costs amounted to $309 million, an increase of $63 million over fiscal 1970 reflecting both increased borrowings and higher interest rates. Administrative expenses were $11 million higher at a total of $56 million, after deduction of $20.1 million in management fees charged to the International Development Association, and of $1.7 million of "Service and Support Fees" charged to the affiliated International Finance Corporation.

The Bank increased its investments in liquid securities during the year by $483 million to an aggregate of $2,203 million at June 30, 1971. Other liquid investments held in the Bank's Special Reserve, on the same date, amounted to $292 million, bringing its liquid securities to a total of $2,495 million. This compares with a total of $2,012 million in similar holdings at June 30, 1970.

Repayments of principal on loans received by the Bank during the year amounted to $319 million, and a further $146 million was repaid to purchasers of parts of loans. Total principal repayments to the Bank through June 30, 1971, aggregated $4,227 million, including $2,445 million repaid to the Bank and $1,782 million repaid to purchasers of borrowers' obligations sold by the Bank.

Outstanding funded debt of the Bank was $5,424 million on June 30, 1971. During the year the Bank borrowed $400 million in the United

States market; $375 million through the issuance of 2-year U.S. dollar bonds to Central Banks and other governmental agencies in some 70 countries; DM 1,078 million (U.S. $294.5 million) in Germany; 79 billion yen (U.S. $291 million) from the Bank of Japan; f120 million (U.S. $33.2 million) in the Netherlands; L10 million (U.S. $28 million) in Libya, the Bank's first borrowing in that country; and SwF 75 million (U.S. $17.5 million) in Switzerland. The Bank also issued $43.5 million of bonds that had been sold in a previous year under delayed delivery contracts.

These borrowings, in part, refunded maturing issues amounting to the equivalent of $490 million. After retirement of U.S. $58 million equivalent of obligations retired through sinking fund and purchase fund operations, the Bank's outstanding funded debt showed an increase of $856 million from the previous year.

During the fiscal year the Bank's authorized capital was increased by $3,000 million to $27,000 million to enable the Bank to accept special increases in capital stock totaling up to $2,222 million by 75 member countries. To June 30, 1971, nine members had taken up their special increases in subscriptions and a further 13 were taking the necessary steps to do so. On June 30, 1971, aggregate subscribed capital of the Bank was $23,871 million of which $2,387.1 million had been paid in to the Bank and the remaining $21,483.9 million was subject to call only to meet the obligations of the Bank.

INTER-AMERICAN DEVELOPMENT BANK

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 information, documents and reports as are required from the International Bank for Reconstruction and Development. The following summary of the Bank's activities reflects information submitted by the Bank to the Commission.

During the year ended June 30, 1971, the Bank made 19 loans totaling the equivalent of $230,510,000 from its Ordinary Capital resources, bringing the net total of loan commitments outstanding, after cancellations, to 212, aggregating $1,566,546,787. During the year, the Bank sold or agreed to sell $2,280,875 in participations in the aforesaid loans, all such participations being without the guarantee of the Bank. The loans from the Bank's Ordinary Capital resources were made in Argentina, Brazil, Colombia, Ecuador, Jamaica, Mexico, Peru, Uruguay and Venezuela.

During the year the Bank also made 37 loans totaling the equivalent of $415,830,000 from its Fund for Special Operations, bringing the gross total of loan commitments outstanding to 292, aggregating $2,206,758,846. The Bank made no loans during the year from the Social Progress Trust Fund, which it administers under an agreement with the United States, leaving the gross total of loan commitments outstanding from that Fund at 116, aggregating $494, 191,039.

On June 30, 1971, the outstanding funded debt of the Ordinary Capital resources of the Bank was the equivalent of $948,641,000, reflecting a net increase in the past year of the equivalent of $174,079,000. During the year the funded debt was increased through public bond issues in Austria, France, Germany, Netherlands, Switzerland and the United States totaling the equivalent of $175,053,000 as well as private placements in Japan, Latin America, Norway, Sweden and the United Kingdom totaling the equivalent of $69,263,000. The revaluation of the Swiss franc and Austrian schilling in May 1971 resulted in an increase in the funded debt in the equivalent of $3,323,000. The funded debt was decreased through the retirement of $43,350,000 of short-term dollar bonds, SF 50,000,000 ($11,434,000) representing a short-term loan in Switzerland and $18,776,000 through sinking fund purchases and scheduled debt retirement.

The subscribed ordinary capital of the Bank on June 30, 1971 was the equivalent of $2,763,020,000 of which $2,374,540,000 represented callable capital.

ASIAN DEVELOPMENT BANK

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 information, documents and reports as are required from these banks. The Bank has 36 members, including 22 countries in the region and 14 nonregional developed countries with subscriptions totaling $1,005 million. Of the $502.7 million of paid-up shares subscribed, $490.3 million had matured by June 30, 1971.

As of June 30, 1971, Australia, Belgium, Canada, Denmark, Germany, Italy, Japan, the Netherlands, and the United Kingdom had contributed or pledged a total of $174,645,944 to the Bank's Special Funds. In addition to the $14.575 million set aside from Ordinary Capital in 1969 by the Board of Governors for Special Funds purposes, another $9.935 million were set aside in April 1971, making a total of $24.510 million set aside. In addition, the United States Congress is considering a proposal for a $100 million U.S. contribution to the Bank's Special Funds and there have been indications from other countries of additional contributions in 1971 and thereafter.

In November 1970, the Bank sold in Japan 6 billion yen ($16,667 million) 7.4 percent bonds. In April 1971, the Bank sold $20 million U.S. bonds to regional central banks at 5.5 percent, sold in Switzerland 40 million francs ($9.147 million U.S.) 7 percent bonds, and sold $25 million notes in the United States at 6½ percent and $25 million bonds in the United States at 7¼ percent.

As of June 30, 1971, the Bank had made 45 loans from Ordinary Capital resources totaling $341.035 million, and had approved 21 loans totaling $71.208 million from its Special Funds resources. As of June

30, 1971, a number of technical assistance grants, totaling $7,422,546, had been made or pledged to the Bank, by Australia, Belgium, Canada, Ceylon, China, Denmark, Finland, Germany, India, Japan, Korea, Netherlands, New Zealand, Pakistan, Switzerland, United Kingdom and the United States, including $1 million for the Southeast Asia Regional Transport Survey. Norway has also indicated its intent to contribute. The Bank has provided technical assistance to 15 countries through 53 projects amounting to over $7 million, as well as contributing to important regional projects.

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 their trusts. It requires that the indenture trustee be free of conflicting interests which might interfere with the faithful exercise of its duties in behalf of the purchasers of the securities. It requires also that the trustee be a corporation with a minimum combined capital and surplus; imposes high standards of conduct and responsibility on the trustee; precludes preferential collection of certain claims owing to the trustee by the issuer in the event of default; provides for the issuer's supplying evidence to the trustee of compliance with indenture terms and conditions such as those relating to the release or substitution of mortgaged property, issuance of new securities or satisfaction of the indenture; and provides for reports and notices by the trustee to security holders. Other provisions of the Act prohibit impairment of the security holders' right to sue individually for principal and interest except under certain circumstances, and require the maintenance of a list of security holders which may be used by them to communicate with each other regarding their rights.

[table omitted]

PART III
REGULATION OF SECURITIES MARKETS

In addition to the disclosure provisions discussed in Part II of this report, the Securities Exchange Act of 1934 gives the Commission significant responsibilities with respect to the securities markets and persons engaged in the securities business. Among other things, it requires securities exchanges to register with the Commission and provides for Commission supervision of the self-regulatory responsibilities conferred on registered exchanges. The Act also provides for the registration and regulation of brokers and dealers doing business in the over-the-counter markets, and grants to registered associations of brokers or dealers self-regulatory functions under the Commission's supervision. In addition, it contains provisions designed to prevent fraudulent, deceptive, and manipulative acts and practices on the exchanges and in the over-the-counter markets.

This and the next part of the report deal with developments and actions taken in these areas during the 1971 fiscal year. Statistical information concerning the securities markets is presented in this part. Certain recent developments of particular significance are discussed in Part I.

REGULATION OF EXCHANGES REGISTRATION AND EXEMPTION OF EXCHANGES

The Securities Exchange Act requires an exchange to be registered with the Commission as a national securities exchange unless the Commission exempts it from registration because of the limited volume of transactions effected. As of June 30, 1971, the following 12 stock exchanges were registered:

American Stock Exchange
Boston Stock Exchange
Chicago Board of Trade
Cincinnati Stock Exchange
Detroit Stock Exchange
Midwest Stock Exchange
National Stock Exchange
New York Stock Exchange
Pacific Coast Stock Exchange
Philadelphia-Baltimore-Washington Stock Exchange
Salt Lake Stock Exchange
Spokane Stock Exchange

The Honolulu Stock Exchange and the Richmond Stock Exchange were exempt from registration during the fiscal year.

REVIEW OF EXCHANGE RULES AND PROCEDURES

A major aspect of the Commission's supervisory function with respect to national securities exchanges is the continuous review by its Division of Trading and Markets of the existing rules, regulations, procedures, forms, and practices of all exchanges. Such review is necessary in order to: (1) ascertain the effectiveness of the application and enforcement by the exchanges of their rules; (2) determine the adequacy of exchange rules and of related statutory provisions and rules administered by the Commission in light of changing market conditions; and (3) anticipate and define problem areas so that members of the Commission's staff can meet with exchange representatives in an effort to work out salutary procedures within the framework of cooperative regulation. In addition, Rule 17a-8 under the Exchange Act provides that each national securities exchange must file with the Commission a report of any proposed amendment or repeal of, or addition to, its rules and practices not less than 3 weeks (or such shorter period as the Commission may authorize) before taking any action to effectuate the change. These proposals are submitted for review and comment to the Branch of Regulation and Inspections of the Division of Trading and Markets.

During the 1971 fiscal year, 163 changes in exchange rules and practices were submitted to the Commission pursuant to Rule 17a-8. Among the more significant were:

1. A significant revision by the New York Stock Exchange (NYSE) of its net capital rule. The new provisions are to be implemented in phases over a period of a year. The revision represents a strengthening of the financial responsibility required of the Exchange's members.

2. An amendment to the Pacific Coast Stock Exchange's net capital rule to reduce the allowable ratio of aggregate indebtedness to net capital from 20:1 to 15:1.

3. An amendment to the constitution of the Boston Stock Exchange to increase the number of Governors of the Exchange from sixteen to seventeen and provide that one Governor be an officer or director of a company which has a class of stock listed on the Exchange.

4. Revocation by the American Stock Exchange of its Special Trust Fund. The Trustees of the Fund authorized payment of the approximately $3,000,000 in the Fund to the Securities Investor Protection Corporation for its initial financing.

5. Amendments to the rules of the Detroit and Philadelphia-Baltimore-Washington Stock Exchanges to facilitate the membership of broker-dealer firms which are market-makers in the "third market."

The New York Stock Exchange incorporated in February 1971. The Commission subsequently indicated to the Exchange that to the extent that the chief purpose of incorporation was to end the unlimited liability each member of the Exchange had for acts and omissions of the Exchange, there is now a greater burden on the Exchange to provide adequate resources for satisfying its responsibilities under the Exchange Act.

Litigation Relating to Review of Exchange Rules. -- In *Thill v. The New York Stock Exchange*, the Court of Appeals for the Seventh Circuit held that New York Stock Exchange rules are not immune from challenge under the federal antitrust laws by reason of the Commission's power to review such rules pursuant to Section 19 (b) of the Securities Exchange Act. The court ruled that the Exchange must demonstrate that any rule having anticompetitive effects is necessary to the operation and effectiveness of the Act. The case was remanded to the district court where it is now pending. The Commission has intervened in the case, pursuant to an order of the district court entered November 16, 1971.

In *Independent Broker-Dealers' Trade Association v. S.E.C.*, a trade association of broker-dealers, none of which are members of the New York Stock Exchange, filed suit against the Commission seeking declaratory and injunctive relief against what they characterized as a Commission "direction or order" to the Exchange which resulted in the elimination of customer-directed give-ups, a practice of splitting brokerage commissions that in some cases benefited members of the Association. In May 1968, as part of its review of various aspects of the commission rate structures of national securities exchanges, the Commission made a request, pursuant to Section 19 (b) of the Securities Exchange Act, that the Exchange adopt an interim rate structure incorporating a volume discount or, in the alternative, that it eliminate fixed rates of commission for certain large transactions. The Exchange in reply to this request made a counter-proposal which included the abolition of customer-directed give-ups. The Commission regarded this counter-proposal as acceptable, and the proposals were adopted by the Exchange effective December 5, 1968.

The Association challenged the Commission's authority allegedly to have ordered the Exchange to abolish give-ups. The district court dismissed the complaint for lack of jurisdiction, holding that the Commission had entered no "order," but the Court of Appeals for the District of Columbia Circuit reversed in part, stating that the Commission had exerted "pressure" on the Exchange to prohibit give-ups and that such pressure constituted reviewable "agency action." On the merits, however, the court rejected the Association's contention that the Commission had acted improperly and remanded the case to the district court with directions to enter summary judgment in favor of the Commission.

INSPECTIONS OF EXCHANGES

Another aspect of the Commission's supervision of exchange self-regulation is the program of regular inspections of various phases of exchange activity conducted by the Branch of Regulation and Inspections in the Division of Trading and Markets. These inspections enable the Commission to recommend, where appropriate, improvements designed to increase the effectiveness of self-regulation. In cases where it appears that revisions in internal policies are desirable, the Commission's staff communicates its views to the particular exchange and discusses the matters with exchange personnel in an effort to arrive at appropriate solutions.

In the 36th Annual Report, mention was made of an inspection of the New York Stock Exchange relating to the enforcement and interpretation of its net capital rule, and of inspections of the New York and American Stock Exchanges relating to the activities of specialists including performance, capital and financing arrangements. Follow-up conferences and correspondence continued into fiscal 1971. In the specialist area, the staff sent recommendations for improvement to the NYSE. The inspection of the American Stock Exchange resulted in general commendation although some recommendations for improvement were made by the staff.

As a result of two major inspections relating to the enforcement and interpretation of the NYSE net capital rule, numerous meetings and a lengthy exchange of correspondence between the staff of the Commission and the staff of the NYSE, the Exchange, as noted above, adopted a more stringent net capital rule, which is expected to enhance the financial strength of its members.

In fiscal 1971, the Branch of Regulation and Inspections conducted nine formal inspections. These included general inspections of the Boston, Midwest, Cincinnati, Detroit and Pacific Coast Exchanges, and inspections of the New York and American Stock Exchanges limited to exchange activities in specific areas.

Recent inspections of the New York Stock Exchange centered upon a comprehensive review of its surveillance and enforcement programs. The staff inspected two divisions of the NYSE which exercise disciplinary control over members and member firms, the Conduct Division and the Advertising Department. The Conduct Division conducts investigations into alleged rule violations, but does not exercise any surveillance over member firms. It investigates and develops disciplinary cases only when information is disclosed or discovered by other sources. The Advertising Department reviews all member firm advertising prior to publication for compliance with Exchange standards. Several of the recommendations based on the inspections, relating primarily to enforcement activities, were adopted by the Exchange.

An inspection was also made of the disciplinary programs of the American Stock Exchange, which are focused on the approximately forty members who are not also members of the NYSE. Generally speaking, the inspection team found an effective disciplinary program. Staff recommendations for certain improvements have been accepted.

DELISTING OF SECURITIES FROM EXCHANGES

Under Section 12 (d) of the Securities Exchange Act and the Commission's Rule 12d2-2 thereunder, securities may be stricken from listing and registration upon application 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.

During the fiscal year ended June 30, 1971, the Commission granted applications by exchanges for the removal of 62 stock issues, representing 56 issuers, and 58 bond issues from listing and registration. The distribution of these removals among exchanges was as follows:

[table omitted]

Delisting applications by exchanges are generally based on the ground that continued listing is no longer appropriate because of a reduced number of shares of the issue in public hands or an insufficient number of shareholders (sometimes resulting from acquisitions or mergers) ; the low market value of outstanding shares; insufficient trading volume on the exchange; failure to meet the exchange's requirements as to earnings or financial condition ; failure to file required reports with the exchange; cessation of operations by the issuer; or a combination of these factors.

Seven applications by issuers to withdraw securities from listing and registration were granted during the year, resulting in the removal of two securities each from the National and Philadelphia-Baltimore-Washington Stock Exchanges, and three securities from the Salt Lake Stock Exchange.

Litigation Relating to Delisting. -- In *Winkleman v. New York Stock Exchange*, suit was brought by Scientific Resources Corporation and one of its shareholders to enjoin the New York Stock Exchange from continuing to suspend trading of the company's stock and from initiating steps to delist the stock. The district court denied plaintiffs' motion for preliminary injunction and dismissed the complaint, concluding that the Commission had exclusive jurisdiction over delisting procedures. On appeal to the Court of Appeals for the Third Circuit plaintiffs argued that the Exchange's delisting rules were applied arbitrarily and without opportunity for fair hearing, constituting a violation of the federal antitrust laws. In a brief *amicus curiae* in support of the lower court's action, the Commission urged that its procedures on an application by an exchange for delisting are sufficient to guarantee the company and its shareholders due process and a forum for the consideration of any allegations of unfairness or arbitrariness.

The court of appeals affirmed the denial of preliminary relief, but remanded the case to the district court in order to afford plaintiffs an adequate opportunity to be heard on the Exchange's motion to dismiss.

STATISTICS RELATING TO SECURITIES TRADED ON EXCHANGES NUMBER OF ISSUERS AND SECURITIES

As of June 30, 1971, 5781 stock and bond issues, representing 3220 issuers, were admitted to trading on securities exchanges in the United States. Of these, 5650 securities issues (3623 stock issues and 2027 bond issues), representing 3130 issuers, were listed and registered on national securities exchanges, the balance consisting primarily of securities admitted to unlisted trading privileges and securities listed on exempted exchanges. The listed and registered issues included 1915 stock issues (52.8 percent of the total) and 1827 bond issues (90 percent), representing 1652 issuers (52.8 percent), which were listed and registered on the New York Stock Exchange. Table 4 in the Appendix to this report contains comprehensive statistics as to the number of securities issues admitted to exchange trading and the number of issuers involved.

During the 1971 fiscal year, 284 issuers listed and registered securities on a national securities exchange for the first time, while the registrations of all securities of 132 issuers were terminated. A total of 742 applications for registration of securities on exchanges was filed.

MARKET VALUE OF SECURITIES AVAILABLE FOR TRADING

As of December 31, 1970, the market value of stocks and bonds admitted to trading on U.S. stock exchanges was approximately $796 billion. The tables below show various components of this figure.

With reference to the tables, it should be noted that issues traded on either the New York or American Stock Exchange are not traded on the other of those two exchanges. Many of these issues are, however, also traded on the so-called regional exchanges. The figures below for "other exchanges" show only the number of issues traded solely on the regional exchanges. The figures in the tables exclude issues suspended from trading and a few inactively traded issues for which quotations were not available.

[table omitted]

The New York Stock Exchange has reported aggregate market value of all stocks listed thereon monthly since December 31, 1924, when the figure was $27.1 billion. The American Stock Exchange has reported totals as of December 31 annually since 1936. Aggregates for stocks exclusively on the remaining exchanges have been compiled as of December 31 annually since 1948. The available data since 1936 appear in Table 5 in the Appendix of this Annual Report. It should be noted that changes in aggregate market value over the years reflect not only changes in prices of stocks but also such factors as new listings, mergers into listed companies, removals from listing and issuance of additional shares of a listed security.

VOLUME OF SECURITIES TRADED

The number of shares traded on all exchanges in calendar 1970 (including stocks, rights and warrants) was over 4.8 billion, compared to 5.1 billion shares traded in 1969. Dollar value of shares traded was $132 billion in 1970, or 25 percent less than trading in 1969. Bonds with a principal amount of $6.3 billion were traded in 1970.

During the first half of calendar 1971 trading accelerated markedly -- total dollar value of all exchange trading was over $105 billion, considerably higher than during the same 1970 trading period.

The figures below show the volume and market value of securities traded on all registered and exempt stock exchanges during calendar 1970 as well as the first six months of 1971. Refer to Tables 6 and 7 of the Appendix for more comprehensive trading statistics classified by exchanges.

[table omitted]

FOREIGN STOCKS ON EXCHANGES

The estimated market value on December 31, 1970 of all shares and certificates representing foreign stocks on U.S. stock exchanges was $20.5 billion, of which $16.3 billion represented Canadian and $4.2 billion represented other foreign stocks.

[table omitted]

The total of 105 stock issues represents a decline of one issue over the number a year earlier. There has been a steady decline since 1960 when 173 foreign issues were being traded.

Trading in foreign stocks on the American Stock Exchange fell from 10.70 percent of aggregate share volume on that exchange in 1969 to 9.11 percent in 1970. Similarly, on the New York Stock Exchange trading in foreign stocks in relation to aggregate share volume declined from 3.4 percent in 1969 to 2.9 percent in 1970.

COMPARATIVE EXCHANGE STATISTICS

The number of stocks listed on exchanges increased by four percent during fiscal 1971 to total 3,740 issues. The number of stocks on both the New York and American Stock Exchanges increased, but stocks listed exclusively on other exchanges decreased. Refer to Appendix Table 4 for more detail on exchange listings.

[table omitted]

The aggregate market value of shares listed on exchanges was $680.7 billion at the end of calendar 1970. Of this amount, over 93 percent was the value of shares listed on the New York Stock Exchange. While the value of NYSE listed stock as a proportion of total listed stock increased in 1970, the percentages attributed to AMEX listings and to stocks traded exclusively on other exchanges decreased. Appendix Table 5 carries historical data on value of stocks on exchanges.

[table omitted]

The total volume of all exchange transactions in stocks, rights and warrants is broken down by exchanges in the following tables. In 1970, share volume on the New York Stock Exchange amounted to 3.4 billion shares, up moderately from the 3.2 billion of the previous year. In terms of dollar value, 1970 New York Stock Exchange transactions amounted to $103.3 billion, or 20 percent less than 1969 dollar value. During the first six months of 1971, however, both share and dollar value on the NYSE were up considerably over the first half of 1970.

On the American Stock Exchange 1970 share volume was 920 million shares or 35 percent below the previous year; AMEX dollar volume was $14.6 billion, less than half that of the previous year. In the first half of 1971, American Stock Exchange volume -- both dollar and share volume -- advanced from the first half statistics of 1970. However, the increase was not as strong as that on the NYSE.

[table omitted]

The NYSE's percent of total exchange volume jumped appreciably in 1970 to 71 percent of share volume and 78 percent of dollar volume. The gain was at the expense of AMEX volume which dropped from 28 percent of all exchange share volume in 1969 to 19 percent in 1970 and from 18 to 11 percent of dollar volume. Other exchange volume increased both as a percent of share and dollar volume. Percentage data for the first six months of 1971 are basically similar to the relationships tabulated for calendar year 1970. See Appendix Table 7 for further detail.

[table omitted]

BLOCK DISTRIBUTIONS REPORTED BY EXCHANGES

Special distribution methods are utilized when blocks are considered too large for the regular auction market on the floor of the exchanges.

The most important of these methods is the secondary distribution which typically is utilized for larger blocks than other block distribution methods. A secondary distribution takes place off the floor of the exchange, usually after trading hours. The block is offered by an exchange firm or a selling group of firms formed for the distribution and at a price usually below the last transaction. In 1970, there were 72 secondary distributions involving stock valued at $505 million, representing a considerable reduction from 1969 levels. As the table below shows, the number and value of secondary distributions rose dramatically in the first half of 1971, totaling more than double the dollar value of such distributions for the entire year 1970. This large jump in secondary distributions came at the same time as the introduction of negotiated commission rates on large transactions.

Under another method, the exchange distribution, a group of member firms solicits buy orders sufficient to cross with the block sell order. The transaction is then made on the floor and announced on the tape. There were 35 exchange distributions in 1970, as against 32 in the previous year. The dollar value of shares sold under exchange distributions was $48 million, compared to $52 million in 1969.

A third method of block distribution, special offerings, has not been used in several years. In a special offering, a large block is sold at a fixed price via an announcement on the tape seeking bids.

[table omitted]

UNLISTED TRADING PRIVILEGES ON EXCHANGES

The number of stocks with unlisted trading privileges which are not listed and registered on other exchanges further declined during the fiscal year from 62 to 61. During the calendar year 1970, the reported volume of trading on the exchanges in stocks with only unlisted trading privileges decreased to about 20,649,003 shares, or about 0.46 percent of the total share volume on all exchanges, from about 47,958,150 shares, or about 0.97 percent of the share volume during calendar year 1969. About 98 percent of the 1970 volume was on the American Stock Exchange, while two other exchanges contributed the remaining 2 percent. The share volume in these stocks on the American Stock Exchange represented 2.3 percent of total share volume on that exchange.

Unlisted trading privileges on exchanges in stocks listed and registered on other exchanges numbered 2,397 as of June 30, 1971. The volume of trading in these stocks for the calendar year 1970 was reported at about 190,057,913 shares. About 98.5 percent of this volume was on regional exchanges in stocks listed on the New York or American Stock Exchanges. The remaining 1.5 percent represented unlisted trading on the American Stock Exchange in issues listed on regional exchanges. While the 190,057,913 shares amounted to only 4.2 percent of the total share volume on all exchanges, it represented a substantial portion of the share volume of most regional exchanges, as reflected in the following approximate percentages: Cincinnati 87.8 percent; Boston 73.7 percent; Detroit 48.5 percent; Philadelphia-Baltimore-Washington 88.1 percent; Midwest 36.7 percent; and Pacific Coast 27.0 percent.

Applications by exchanges for unlisted trading privileges in stocks listed on other exchanges, filed pursuant to Rule 12f-1 under Section 12 (f) (1) (B) of the Securities Exchange Act, were granted by the Commission during the fiscal year ended June 30, 1971, as follows:

[table omitted]

SUPERVISION OF ACTIVITIES OF NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Section ISA of the Exchange Act provides for registration with the Commission of national securities associations and establishes standards and requirements for such associations. The National Association of Securities Dealers, Inc. (NASD) is the only association registered under the Act. The Act contemplates that such associations will serve as a medium for self-regulation by over-the-counter brokers and dealers. Their rules must be designed to protect investors and the public interest, to promote just and equitable principles of trade, and to meet other statutory requirements. They are to operate under the general supervision of the Commission, which is authorized to review disciplinary actions taken by them, to disapprove changes in their rules, and to alter or supplement their rules relating to specified matters. Review of NASD rules is carried out for similar purposes as the review of exchange rules described at page 74.

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 a member from dealing with a nonmember broker or dealer except on the same terms and conditions as the member affords the general public. The NASD has adopted such rules. As a result, membership is necessary to 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 4,390 members, reflecting a net loss of 92 members during the year. This loss was the net result of 439 admissions to and 531 terminations of membership. At the end of the year NASD member firms had 7,028 branch offices, reflecting a net loss of 347 offices during the year. This loss was the net result of the opening of 1,468 new offices and the closing of 1,815 offices. During the year the number of registered representatives and principals, which categories include all partners, officers, traders, salesmen and other persons employed by or affiliated with member firms in capacities which require registration, increased by 6,547 to stand at 199,917 as of June 30, 1971. This increase was the net result of 26,100 initial registrations, 33,087 re-registrations and 52,640 terminations of registrations during the year.

During this period the NASD administered 59,025 qualification examinations of which approximately 37,028 were for NASD qualification and the balance for other agencies, including major exchanges, the Commission and various States.

REVIEW OF NASD RULES AND POLICIES

Under Section 15A (j) of the Exchange Act, the NASD must file for Commission review, 30 days in advance of their effectiveness, copies of any proposed rules or rule amendments. These may be disapproved by the Commission if not consistent with the requirements of the Act. In practice, 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 pursuant to these procedures. Among the significant matters covered in such submissions were:

1. Amendments to Schedule "D" of the NASD by-laws revising: (1) the minimum price criteria for securities included in the Association's NASDAQ quotation system; and (2) the system's eligibility standards for foreign securities, ADR's, rights and warrants.

2. A revised interpretation of the Board of Governors concerning "Free-Riding- and Withholding" which is designed to eliminate unfair and manipulative practices in underwritings of securities that sell in the "aftermarket" at a premium over the initial public offering price.

3. Amendments of the Association's Uniform Practice Code relating to:

(1) the delivery of mutilated securities;

(2) the reclamation of securities which have been the subject of an over-delivery, or other similar errors in delivery; and

(3) the closing out of open contracts with an Association member where the member can not meet its obligations as they become due.

4. An amendment to the Association's Code of Procedure for Handling Trade Practice Complaints to provide specified procedures for settlement of Association disciplinary actions.

5. Amendment to Schedule "C" of the NASD by-laws to provide for the establishment of a new qualification examination for principals of NASD member firms.

In *Harwell v. Growth Programs, Inc.*, reported previously, the United States District Court for the Western District of Texas, agreeing with positions urged by the Commission in its *amicus curiae* brief filed with that court, upheld an "interpretation" promulgated by the Board of Governors of the NASD in 1966 that the speculative use of the withdrawal-and-reinstatement privilege contained in certain contractual plans for the accumulation of mutual fund shares was contrary to the public interest and inconsistent with Article III, Section 1, of the NASD's Rules of Fair Practice. That rule requires NASD members to conduct their business in accordance with "high standards of commercial honor and just and equitable principles of trade."

Plaintiffs, who were purchasers of single payment contractual plans containing this "in-and-out" privilege, sued the mutual fund's sponsor and its underwriter, as well as the NASD, seeking, among other things, actual and exemplary damages (including treble damages from all of the defendants for an alleged conspiracy in violation of the antitrust laws) and resumption of the right to unlimited exercise of the in-and-out privilege.

Under the terms of the investment programs in question, the investor had the right to liquidate into cash at any time, and as often as he wished, up to 90 percent of his shares in the mutual fund. He could later repurchase these shares with the proceeds of his prior withdrawal, at the then market value, without the payment of any additional brokerage commission. Both the NASD and the Commission decided that this speculative activity was detrimental to the interest of nonspeculating shareholders in the underlying funds, since it diluted their shares, and to the funds themselves, since it imposed liquidity problems arising out of the necessity to maintain relatively large cash positions to meet requests for redemptions. The district court granted the defendants' motions for summary judgment, and the plaintiffs appealed to the Court of Appeals for the Fifth Circuit. The Commission filed a brief with the court of appeals, *amicus curiae*, in which it urged that the district court properly determined that the NASD interpretation was clearly within the power granted the NASD under the Exchange Act; that the promulgation of such interpretation did not violate due process of law; and that, since the interpretation was promulgated under close supervision of the Commission, it did not constitute a violation of the antitrust laws. The appeal was pending at the close of the fiscal year.

NASD RULE ABROGATION PROCEEDING

In April 1970 the Commission instituted a proceeding, pursuant to Section 15A (k) of the Exchange Act, to determine whether, as alleged by the Commission staff, the NASD had in specific situations improperly construed or applied the authority granted to it under Section 15A (i) of the Exchange Act and Article III, Section 25 of its Rules of Fair Practice. Section 15A (i) authorizes the NASD to provide in its rules that no member may deal with a nonmember broker-dealer except at the same prices and on the same terms as it accords to the general public. Section 25 of the NASD rules provides in pertinent part that NASD members may not (1) grant to nonmember broker-dealers any selling concession, discount or other allowance not accorded to the general public, or (2) join with any nonmember broker-dealer in the distribution of an issue of securities to the public.

The principal issue in the proceeding relates to whether the latter provision and the statute permit the Association to prohibit its members from joining in a distribution of securities with a nonmember broker-dealer where the concession or other special price discount flows from the nonmember to the member. A petition filed by Aetna Life and Casualty Company and its subsidiaries, Aetna Financial Services, Inc. and Participating Annuity Life Insurance Company, had raised similar issues with respect to the NASD's authority to restrict its members' dealings with nonmember broker-dealers, and the Aetna companies were admitted as parties to the proceeding.

During fiscal year 1971 an evidentiary hearing was held before a hearing examiner. The examiner rendered an initial decision in May 1971. Thereafter the Commission granted petitions for review of the initial decision filed by the NASD, the Commission staff and the Aetna companies, and at the end of the fiscal year the matter was pending before the Commission.

INSPECTIONS OF THE NASD

Under the regulatory scheme of the Exchange Act the Commission, as noted, is charged with general oversight of national securities associations in the performance of their self-regulatory activities. With a view to insuring that the NASD is meeting its responsibilities, the Commission's staff conducts periodic inspections of various phases of NASD activity. During the past fiscal year, the staff inspected the overall operations of the Association's district office in Boston, and reviewed the New York district office's programs and procedures with respect to the monitoring of the financial and operating conditions of NASD member firms.

OVER-THE-COUNTER TRADING IN COMMON STOCKS LISTED ON THE NEW YORK STOCK EXCHANGE

During the calendar year 1970, total over-the-counter sales of common stocks listed on the New York Stock Exchange (the so-called "third market") continued to increase both in share and dollar volume as they have in every year since 1965, when reports to the Commission regarding such transactions were first required. Third market sales in 1970 amounted to 210 million shares, valued at $8,021 million. The increase in dollar volume of third market sales contrasts with a decrease in dollar volume on the NYSE in 1970. As a result, the value of trading over the counter in NYSE common stocks in relation to the value of all stock trading on the Exchange reached a new high ratio of 7.8 percent. In the first half of 1971, third market volume and NYSE volume both increased sharply. Third market volume, in terms of dollars, grew at a faster rate, however, reaching the equivalent of 8.1 percent of NYSE dollar volume.

REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS REGISTRATION

The Securities Exchange Act requires brokers and dealers who use the mails or the means of interstate commerce in the conduct of an over-the-counter securities business to register with the Commission. Investment advisers must register under the Investment Advisers Act of 1940, which establishes a pattern-of regulation comparable to that established by the Exchange Act with respect to brokers and dealers. Applicants for registration which are subject to a statutory disqualification may be denied registration, and misconduct following registration may result in suspension or revocation of the registration.

As of June 30, 1971, 4,940 broker-dealers and 3,485 investment advisers were registered. The number of broker-dealers represented a decrease of 284 from the total a year earlier, attributable principally to the withdrawal of a large number of registrations. However, the number of investment advisers increased by 425 over that at the end of fiscal year 1970.

The following tabulation reflects various data with respect to registrations of brokers and dealers and investment advisers during the 1971 fiscal year:

[table omitted]

FINANCIAL REPORTS OF BROKER-DEALERS

Rule 17a-5 under the Exchange Act requires registered broker-dealers to file annual reports of financial condition with the Commission. These reports must be certified by a certified public accountant or public accountant who is in fact independent, with certain limited exemptions applicable to situations where certification does not appear necessary for customer protection. During the fiscal year 4,481 reports were filed with the Commission.

These reports enable the Commission and the public to determine the financial position of broker-dealers. They provide one means by which the staff of the Commission can determine whether a broker-dealer is in compliance with the net capital rule. Failure to file required reports may result in the institution of administrative proceedings to determine whether the public interest requires remedial action against the registrant, as well as possible injunctive or criminal action.

BROKER-DEALER INCOME AND EXPENSE REPORTS

In order to obtain improved financial information concerning the securities industry, the Commission, in June 1968, adopted Rule 17a-10 under the Securities Exchange Act, effective January 1, 1969. This 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 National Association of Securities Dealers, Inc. (NASD)] which has qualified a plan pursuant to the rule. The self-regulatory organization is to transmit copies of such reports to the Commission. All reports are submitted to the Commission on a confidential basis.

The Commission has approved the plans of the NASD, and the American, Midwest, and Philadelphia-Baltimore-Washington Stock Exchanges. In summary, these plans provide that the self-regulatory organization will (1) adopt and implement appropriate internal procedures for review of the reports submitted by members, (2) review all reports filed for reasonableness and accuracy, (3) transmit edited reports to the Commission (excluding the names and addresses of the respective firms), and (4) undertake certain other obligations.

The reports covering calendar year 1970 of SECO broker-dealers 16 and non-NASD members of those exchanges which have not qualified a plan have been received and reviewed by the Commission. The 1970 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. The Commission will analyze the reports, and it anticipates that it will publish aggregate information based on them for the calendar years 1969 and 1970.

REGULATION OF BROKER-DEALERS WHO ARE NOT MEMBERS OF A REGISTERED SECURITIES ASSOCIATION

Under the Exchange Act, as amended in 1964, the Commission has the responsibility for establishing and administering rules relating to qualification standards and business conduct of broker-dealers who are not members of the NASD 17 and persons associated with them, so as to provide regulation for these SECO broker-dealers comparable to that provided by the NASD for its members.

During the fiscal year, the number of nonmember broker-dealers decreased from 336 to 301 and the number of associated persons of such firms (which includes principally partners, officers, directors, and employees not engaged in merely clerical or ministerial functions) decreased from 19,504 to 16,060.

[table omitted]

Various rules have been adopted by the Commission since 1964 in the development of its regulatory program for nonmember broker-dealers. One of the requirements imposed by these rules is that each associated person engaged in specified securities activities successfully complete the Commission's General Securities Examination or an examination deemed by the Commission to be a satisfactory alternative. Alternative examinations include those given by the NASD, by certain of the national securities exchanges and by many states. During the fiscal year the examination requirements of the various states were surveyed by the Commission. The results of this survey are being studied to determine whether the list of acceptable alternative examining jurisdictions and examinations should be further revised.

Rule 15b9-2 under the Act provides for an annual assessment to be paid by nonmember broker-dealers to defray the cost of regulation. It includes a base fee, a charge for each office, and a charge for each associated person. The rule also provides that the maximum amount payable by any one SECO member is set each year on the assessment form which must be filed by each firm. The maximum for fiscal year 1971 was raised from $25,000 to $50,000.

Pursuant to the inspection program for nonmember broker-dealers, 66 inspections were conducted during 'the fiscal year. These inspections were designed to determine compliance with applicable Commission rules and to obtain information which will prove helpful in the further development of the SECO program.

STATISTICAL STUDIES

The regular statistical activities of the Commission and its participation in the overall Government statistical program under the direction of the Office of Statistical Standards, Office of Management and Budget, were continued during fiscal 1971 in the Commission's Office of Policy Research. The statistical series described below are published in the Commission's monthly Statistical Bulletin. In addition, current figures and analyses of data are published quarterly on new securities offerings, stock transactions of financial institutions, the financial position of corporations, and plant and equipment expenditures.

ISSUES REGISTERED UNDER THE SECURITIES ACT OF 1933

Monthly statistics are compiled on the number and volume of registered securities. Summary statistics for the years 1935-1971 are given in Appendix Table 1 and detailed statistics for the fiscal year 1971 appear in Appendix Table 2.

NEW SECURITIES OFFERINGS

Monthly and quarterly data are compiled covering all new corporate and noncorporate issues offered for cash sale in the United States. The series includes not only issues publicly offered but also issues privately placed, as well as other issues exempt from registration under the Securities Act, such as intrastate offerings and offerings of railroad securities. The offerings series include only securities actually offered for cash sale, and only issues offered for the account of issuers.

Estimates of the net cash flow through securities transactions are prepared quarterly and are derived by deducting, from the amount of estimated gross proceeds received by corporations through the sale of securities, the amount of estimated gross payments by corporations to investors for securities retired. Data on gross issues, retirements and net change in securities outstanding are presented for all corporations and for the principal industry groups.

PRIVATE NONINSURED PENSION FUNDS

An annual survey is published of private pension funds other than those administered by insurance companies, showing the flow of money into these funds, the types of assets in which the funds are invested and the principal items of income and expenditures. Quarterly data on assets of these funds are published in the Statistical Bulletin.

STOCK TRANSACTIONS OF FINANCIAL INSTITUTIONS

A statistical series containing data on stock trading of four principal types of financial institutions is published quarterly. Information on purchases and sales of common stock by private noninsured pension funds and nonlife insurance companies has been collected on a quarterly basis by the Commission since 1964. These data are combined with similar statistics prepared for mutual funds by the Investment Company Institute and for life insurance companies by the Institute of Life Insurance.

FINANCIAL POSITION OF CORPORATIONS

The series on the working capital position of all U.S. corporations, excluding banks, insurance companies, investment companies and savings and loan associations, shows the principal components of current assets and liabilities, and also contains an abbreviated analysis of the sources and uses of corporate funds.

During fiscal year 1971 the responsibility for compiling the quarterly financial report of all U.S. manufacturing corporations, previously shared by the Commission and the Federal Trade Commission, was assigned to the latter agency. This report gives complete balance sheet data and an abbreviated income account, data being classified by industry and size of company. The Commission's staff has been working with the FTC staff to assure an orderly transfer of this data collection responsibility, which is to be completed by the end of calendar year 1971.

PLANT AND EQUIPMENT EXPENDITURES

The Commission, together with the Department of Commerce, conducts quarterly and annual surveys of actual and anticipated plant and equipment expenditures of all U.S. business, exclusive of agriculture. After the close of each quarter, data are released on actual capital expenditures of that quarter and anticipated expenditures for the next two quarters. In addition, a survey is made at the beginning of each year of the plans for business expansion during that year.

DIRECTORY OF REGISTERED COMPANIES

The Commission annually publishes a list of companies required to file annual reports under the Securities Exchange Act of 1934. In addition to an alphabetical listing, there is a listing of companies by industry group classified according to The Standard Industrial Classification Manual.

STOCK MARKET DATA

The Commission regularly compiles statistics on the market value and volume of sales on registered and exempted securities exchanges, round-lot stock transactions on the New York and American Stock Exchanges for account of members and non-members, odd-lot transactions in 100 selected stocks on the New York Stock Exchange and block distributions of exchange stocks. Since January 1965, the Commission has been compiling statistics on volume of over-the-counter trading in common stocks listed on national securities exchanges (the so-called "third market") based on reports filed under the Securities Exchange Act.

Data on round-lot and odd-lot trading on the New York and American Stock Exchanges are released weekly. The other stock market data mentioned above, as well as these weekly series, are published regularly in the Commission's Statistical Bulletin.

PART IV
CONTROL OF IMPROPER PRACTICES

One of the major areas of the Commission's work is its enforcement activities, which encompass the detection and investigation of possible violations of the Federal securities laws and the taking of appropriate action to curtail fraudulent and other unlawful activities. The Commission's enforcement program is designed to achieve a broad regulatory impact within the framework of its limited resources. In addition to direct action by the Commission, the various self-regulatory organizations have a responsibility (subject to Commission oversight) to uncover and take appropriate action with respect to improper practices by their respective members. Moreover, there is a significant degree of coordination between the enforcement activities of the Commission, the self-regulatory agencies, the various states, and certain foreign securities agencies.

This part of the report deals with some of the more significant aspects of these enforcement activities conducted during the fiscal year and with developments in litigation arising out of prior enforcement actions. It also summarizes certain noteworthy cases involving private litigation under the Federal securities laws in which the Commission participated as *amicus curiae*.

DETECTION OF IMPROPER PRACTICES

PUBLIC COMPLAINTS AND INQUIRIES

The Commission receives many communications from the public, consisting predominantly of complaints against members of the securities industry and requests for information about issuers. These complaints and inquiries are given careful attention in connection with the Commission's responsibility to enforce the Federal securities laws. Within the scope of its authority, the Commission endeavors to assist investors in obtaining the desired information or resolving their complaints. Where violations of the Federal securities laws are indicated, the matters are referred to the enforcement officials of the Commission for appropriate action. The Commission may also refer matters to the stock exchanges or the National Association of Securities Dealers, Inc. (NASD). Analysis of complaints and inquiries helps the Commission to recognize problems being experienced by a particular firm or by the industry in general.

Indicated below are the approximate number of written and telephoned complaints and inquiries relating specifically to broker-dealers which the Commission received from the public during the last 4 fiscal years.

[table omitted]

Approximately 80 percent of the complaints against broker-dealers involve back-office problems, such as the failure of firms to deliver securities or funds promptly and the alleged improper handling of accounts.

As a result of the inquiries the Commission makes of brokerage firms upon receipt of complaints, thousands of investor complaints have been resolved. The Commission's authority, however, does not extend to arbitrating private disputes or controversies between brokerage firms and investors or to assisting investors in the assertion of their private rights. The Commission generally does not reveal the existence, progress, or results of any investigation it may undertake as a result of a particular complaint unless and until these are made a matter of public record in proceedings brought before the Commission or in the courts.

Other sources of information regarding possible securities law violations include stock exchanges, the NASD, brokerage firms, State and Canadian securities authorities, better business bureaus, and various law enforcement agencies.

INSPECTIONS

The program of surprise inspections of broker-dealers and investment advisers by the Commission's staff is another important device for the detection of unlawful practices. During fiscal 1971, the staff conducted 772 broker-dealer inspections (as compared with 707 the previous year) and 121 inspections of investment advisers (as compared to 96 during the previous year).

The table below shows the types of infractions indicated by the inspections conducted during the fiscal year:

[table omitted]

MARKET SURVEILLANCE

In order to enable the Commission to meet its responsibilities for the surveillance of the securities markets, the market surveillance staff has devised a number of procedures to identify possible manipulative activities. These include a program of staff surveillance over listed securities, which is coordinated with the stock watching operations of the New York, American and regional stock exchanges. The staff reviews the daily and periodic stock watch reports prepared by these exchanges and, on the basis of its analysis of the information developed by the exchanges and other sources, determines matters of interest, possible violations of applicable law, and the appropriate action to be taken.

In addition, the market surveillance staff maintains a continuous ticker tape watch of transactions on the New York and American Stock Exchanges, and monitors the sales and quotation sheets of regional exchanges in order to detect any unusual or unexplained price variations or market activity. The financial news ticker, leading newspapers and various financial publications and statistical services are also closely followed.

If any of these sources reveals possible violations, the market surveillance staff conducts a preliminary inquiry into the matter. These inquiries, some of which are conducted with the cooperation of the exchange concerned, generally begin with the identification of the brokerage firms which were active in the security. The staff may communicate with principals or registered representatives of these firms, with customers, or with officials of the issuer involved to determine the reasons for the activity or price change in the securities in question and whether violations may have occurred.

The Commission has also developed an over-the-counter surveillance program involving the use of automated equipment to provide more efficient and comprehensive surveillance of stock quotations distributed by the National Quotation Bureau and the NASD's automated NASDAQ service. That equipment 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 automated system prints out current and historic market information concerning it. This data, combined with other available information, is collated and analyzed to select those securities whose activity indicates the need for further inquiry or referral to the Commission's enforcement staff.

INVESTIGATIONS

Each of the Acts administered by the Commission specifically authorizes it to conduct investigations to determine whether violations of the Federal securities laws have occurred.

The nine regional offices of the Commission are chiefly responsible for the conduct of investigations. In addition, the Office of Enforcement of the Division of Trading and Markets at the Commission's headquarters office conducts investigations dealing with matters of particular interest or urgency, either independently or with the assistance of the regional offices. The Office of Enforcement exercises general supervision over and coordinates the investigative activities of the regional offices and recommends appropriate action to the Commission. Investigations are also conducted by the Divisions of Corporation Finance and Corporate Regulation in the areas under their respective jurisdictions.

It is the Commission's general policy to conduct its investigations on a confidential basis. Such a policy is necessary to effective law enforcement and to protect persons against whom unfounded or unconfirmed charges might be made. The Commission investigates many complaints where no violation is ultimately found to have occurred. To conduct such investigations publicly would ordinarily result in hardship or embarrassment to many interested persons and might affect the market for the securities involved, resulting in injury to investors with no countervailing public benefits. Moreover, members of the public would tend to be reluctant to furnish information concerning violations if they thought their personal affairs would be made public. Accordingly, the Commission does not generally divulge the existence or findings of a nonpublic investigation unless they are made a matter of public record in proceedings brought before the Commission or in the courts.

When it appears from a preliminary investigation that a serious violation of the Federal securities laws has occurred or is occurring, a full investigation is conducted. Under certain circumstances the Commission may issue a formal order of investigation which designates members of its staff as officers authorized to issue subpoenas, take testimony under oath, and require the production of documents.

The following tables reflect in summarized form the Commission's investigative activities during fiscal year 1971:

[table omitted]

ENFORCEMENT OF INVESTIGATIVE SUBPOENAS

In **Vesco and International Controls Corp. v. S.E.C.**, plaintiffs sought to enjoin the Commission from requiring compliance with investigative subpoenas. The Commission counterclaimed for enforcement of the subpoenas. The United States District Court for the District of New

Jersey granted the relief requested by the Commission and dismissed plaintiffs' claims. The court rejected the asserted bases for noncompliance -- that disclosure of certain information pursuant to the Commission's investigative order would subject plaintiffs to criminal sanctions under Swiss laws relating to secrecy in banking and commercial affairs, that the Commission had access to the information sought in its investigation from sources other than plaintiffs, and that the Commission's principal investigating officer was "non-objective." The Court of Appeals for the Third Circuit and the Supreme Court (by Mr. Justice Marshall) denied plaintiffs' request for a stay of the district court order pending appeal.

ENFORCEMENT AND REMEDIAL ACTION

When the Commission determines, based upon staff investigation, that enforcement action appears appropriate, it may authorize the staff to institute civil court proceedings for injunctive relief or, in particularly serious cases, it may refer the matter to the Justice Department with a recommendation for criminal prosecution. The Commission may also, on the basis of staff allegations, initiate administrative proceedings which can result in a Commission order imposing remedial sanctions on the persons involved. In appropriate cases, the Commission may refer matters to state or local enforcement agencies or to industry self-regulatory organizations.

ADMINISTRATIVE PROCEEDINGS

Under the Securities Exchange Act, as amended in 1964, the Commission has available to it a wide range of administrative sanctions which it may impose against brokers, dealers and other persons. The Commission may deny a broker-dealer's application for registration. With respect to a broker-dealer already registered, it may impose sanctions ranging from censure to suspension or revocation of registration and may suspend or terminate a broker-dealer's membership in a stock exchange or the NASD. In addition, it may suspend or bar any person from association with a broker-dealer, or censure him. Comparable sanctions may be imposed under the Investment Advisers Act, as amended in 1970.

Generally speaking, the Commission may impose a sanction only if, after notice and opportunity for hearing, it finds (1) that the respondent willfully violated, or aided and abetted violations of any provision of the securities acts or the rules thereunder; failed reasonably to supervise another person who committed such violations; or is subject to certain disqualifications, such as a conviction or injunction relating to specified types of law violations; and (2) that a particular sanction is in the public interest.

Broker-dealer and investment adviser proceedings are frequently disposed of without hearings where respondents waive their right to a hearing and submit offers of settlement consenting to the imposition of certain sanctions, which the Commission accepts as an appropriate disposition of the proceedings. In those instances where hearings are held, the hearing officer who presides renders an initial decision, including an appropriate order, unless such decision is waived by the parties. If Commission review is not sought, and if the case is not called up for review on the Commission's own initiative, the initial decision becomes the final decision of the Commission, and the examiner's order becomes effective.

In those instances where it prepares its own decision upon review or waiver of an initial decision, the Commission is generally assisted by the Office of Opinions and Review. This Office is directly responsible to the Commission and is completely independent of the operating divisions of the Commission, consistent with the principle of separation of functions embodied in the Administrative Procedure Act. Where the parties to a proceeding waive their right to such separation, the operating division which participated in the proceeding may assist in the drafting of the Commission's decision. The Commission's opinions are publicly released and are distributed to the press and to persons on the Commission's mailing list.

Set forth below are statistics regarding administrative proceedings with respect to brokers and dealers and investment advisers pending during fiscal 1971.

[table omitted]

Certain of the more noteworthy administrative proceedings pending during the fiscal year and significant decisions rendered by the Commission during the year or shortly thereafter are described below:

In a decision of particular significance, *Investors Management Co., Inc.* (the so-called Douglas Aircraft -- Merrill Lynch case), the Commission addressed itself to the responsibility of "tippees", i.e., persons other than corporate insiders who receive non-public corporate information, under the antifraud provisions of the Federal securities laws. Following the issuance of the hearing examiner's initial decision, from which no appeal was taken to the Commission by any of the parties, the Commission, sua sponte, decided to review the legal issues and express its views on them because of their significant implications for the securities industry and the investing public.

The essential facts as found by the hearing examiner were that from June 21 through June 23, 1966, institutional salesmen for Merrill Lynch, Pierce, Fenner & Smith, Inc. conveyed to the respondents (investment companies, investment advisers and hedge funds) material non-public information, which Merrill Lynch had received from Douglas Aircraft Co., in its capacity as managing underwriter of a proposed offering of Douglas securities, concerning substantially reduced earnings for the first six months of 1966 and lowered earnings projections for 1966 and 1967. The respondents thereupon sold virtually their entire holdings in Douglas stock (133,400 shares) and sold short 21,100 shares prior to the public release of the information on June 24, for an aggregate price of more than $13.3 million. The examiner held that 12 of the respondents had willfully violated the anti-fraud provisions of the Federal securities laws and should be censured. [Footnote: The examiner dismissed the proceedings against one respondent who had made no use of the information obtained from Merrill Lynch, and he discontinued the proceedings against two respondents who merely were in control relationships to some of the violators, holding that no sanction was warranted as to them.]

In its decision the Commission held that the antifraud proscriptions against the use of inside information apply not only to those persons who occupy a special relationship to an issuer but also to others who receive inside information. The recipient of material non-public corporate information violates the antifraud provisions when such information is a factor in his decision to effect a securities transaction and he knows or has reason to know that such information is non-public and "had been obtained improperly by selective revelation or otherwise." The Commission noted that its formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like, and observed that there could be potential responsibility where persons who innocently come into possession of information which they have reason to know is intended to be confidential use that information.

In holding that the Douglas Aircraft adverse earnings information was material, the Commission indicated that it considered the following factors: the degree of specificity of the information; the extent to which it differed from publicly available information; and its reliability in view of its nature, source and the circumstances under which it was received. The Commission further indicated that this information was of such an extraordinary nature that its significance was immediately clear, and that it was not merely one link in a chain of analytical information. In determining that the earnings information was non-public, the Commission, relying upon the test set forth in the Second Circuit's decision in *S.E.C. v. Texas Gulf Sulphur Co*., held that "information is non-public when it has not been disseminated in a manner making it available to investors generally". Here the earnings information did not become available to the investing public until after the issuance of a press release by Douglas on June 24.

In discussing the tippees' awareness of the fact that the information they obtained from Merrill Lynch was non-public, the Commission noted that respondents knew that Merrill Lynch was the prospective underwriter of an imminent Douglas Aircraft debenture offering, and also knew that underwriters customarily receive non-public information from issuers during the course of the preparation of public offerings.

The Commission stated that it appreciated concerns which had been expressed for the free flow of corporate information throughout the financial community and the need to provide public investors and their financial advisers with the most accurate and complete factual basis upon which to make investment decisions. "In some cases, however, there may be valid corporate reasons for the nondisclosure of material information." The Commission indicated that where such reasons exist, it would not ordinarily consider it to be an antifraud violation for an issuer to refrain from making public disclosure, but that it was necessary to ensure that there be no improper use of such undisclosed information for non-corporate purposes.

In determining whether the information received was a factor in respondents' investment decisions, the Commission stated that where a securities transaction of the kind consistent with the nature of the information (e.g., the sales and short sales by the respondents after receiving the adverse information concerning Douglas Aircraft's earnings) is effected by the recipient of inside information prior to its public dissemination, an inference arises that the information was a factor, and that in this case respondents did not overcome that inference by countervailing evidence.

The Commission rejected respondents' argument that they had a fiduciary duty to their clients to sell their Douglas stock upon learning of the poor Douglas earnings, holding that the obligations of a fiduciary do not include performing an illegal act.

The Commission affirmed the examiner's decision that each of the respondents should be censured.

In a concurring opinion, former Commissioner Smith placed emphasis upon the respondents' awareness of Merrill Lynch's special relationship with Douglas Aircraft, and stated that he would hold that tippees are liable when they know or have reason to know that the inside information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes. Commissioner Smith would have also required proof that the information substantially contributed to the recipient's decision to buy or sell.

In another significant decision, the Commission addressed itself to the responsibilities of banks in connection with the distribution of unregistered securities. In *Southern California First National Bank of San Diego*, the Commission for the first time instituted administrative proceedings against a bank. The bank, without admitting or denying the charges, consented to findings of violations of the Securities Act registration provisions as alleged in the order for proceedings, and to an order censuring it.

The Commission found that the bank had participated in an unlawful distribution of unregistered securities in 1968, by selling 20,000 shares of common stock of Mastercraft Electronics Corp. through an account which it maintained with a brokerage firm. The shares were sold purportedly for an employee of Mastercraft, although he was apparently used as a nominee by persons engaged in a large-scale distribution of unregistered Mastercraft stock. Two sell orders for the employee's account, each covering 10,000 shares, were placed with the bank by a customer of the bank by telephone from New York. Although the customer gave no information concerning the employee to the bank official handling the transaction, who did not know the employee, the official failed to inquire whether the employee was connected with Mastercraft or into the circumstances of the transaction. The customer directed the bank to make its checks for the proceeds of sales payable to the employee, but to send them in part to an individual with the same last name as the customer and in part to c/o an individual who was an officer and director of Mastercraft and its house counsel.

The Commission noted that it appeared that the use of bank brokerage accounts for transactions by bank customers or other persons was widespread and that often the banks did not disclose the seller's name to executing brokers, and it pointed out that such practice may provide essentially unregulated channels of distribution for securities. It stated that if banks wish to maintain brokerage accounts for the convenience of their customers or others, it is incumbent upon them to take precautions to avoid the use of such accounts in connection with unlawful distributions of unregistered securities. The Commission held that while the nature of the inquiry to be undertaken by a bank varies with the circumstances of particular cases,

"Generally speaking, it would seem that the bank would be expected to follow procedures substantially equivalent to those which we have required broker-dealers to establish and maintain . . . We would consider that, alternatively, a bank could meet its responsibilities by requesting the broker-dealer with which it maintains its account to conduct the necessary investigation of the circumstances surrounding a proposed securities transaction, of course with the full cooperation of the bank."

The Commission noted that in this case not even the most elementary safeguards were observed, despite the presence of many "red flags."

In *Haight & Co., Inc.*, the Commission revoked the respondent firm's broker-dealer registration and barred nine of the ten individual respondents from being associated with any broker or dealer for violations of the antifraud and other provisions of the Federal securities laws.

The Commission found, among other things, that the respondents had engaged in a scheme to defraud customers by holding themselves out as financial planners who would exercise their talents to make the best choices for their clients from all available securities, when in fact the firm had no research staff and the respondents' efforts were directed at liquidating clients' portfolios and utilizing the proceeds and their clients' other assets to purchase securities which would yield respondents the greatest profits, in some instances in complete disregard of the clients' stated investment objectives. This scheme was implemented by, among other things, the firm's advertising and its training program for salesmen.

The firm created sales quotas and other inducements designed to spur its salesmen to generate a greater volume of transactions that would earn a high return for the firm. The sales staff was taught by principals of the firm to utilize a variety of high pressure and fraudulent tactics to obtain financial planning clients and then induce them to convert their assets into securities yielding respondents high profits. For example, salesmen were told to appeal to the prospect's fears and greed, to give clients only such facts as were necessary to support a sales presentation, and to dominate the interview, dramatize the facts, appeal to the client's sense of prestige and create a sense of urgency. The salesmen were told that, in selling, emotion was more important than logic, and that "an ounce of enthusiasm at the proper time is worth a pound of knowledge."

In *Quinn & Co., Inc.*, the Commission held that a brokerage firm cannot avail itself of certain exemptions for brokers and dealers from the securities registration provisions of the Securities Act of 1933 where it is aware of circumstances indicating that a selling customer is engaged in a distribution of unregistered securities.

Based on stipulated facts, the Commission found that in 1968 the firm effected sales of 25,000 shares of unregistered stock of Mountain States Development Co. for the account of a customer who had received the stock in exchange for properties sold by him to the issuer. The Commission stated that it was clear that the customer intended to resell the shares on the open market as soon as possible in order to obtain cash for the properties he had sold. Thus, his acceptance of the stock and immediate resale for cash did not differ in essence from an arrangement whereby the issuer sold the stock to the public for cash and used the cash so raised to buy the properties, an arrangement which clearly would have required registration. Under the circumstances, the customer was an "underwriter," regardless of whether, as claimed, he was deceived by the issuer as to the saleability of the stock without registration, and no exemption was available to the respondent broker-dealer which was aware of the pertinent facts.

The Commission stated that respondent was not entitled to rely on the absence of any restrictive or cautionary legends on the Mountain certificates. While such a legend or instructions to transfer offices may serve as useful devices by issuers to alert buyers to the restricted character of unregistered securities and to prevent violations of the registration requirements, the failure of an issuer to take such measures cannot relieve a broker-dealer from his duty as a professional in the securities business to make a reasonable inquiry into facts known to him indicating that he is participating in an illegal sale of unregistered securities.

In view of certain mitigating factors, the Commission suspended the firm from NASD membership for 15 days and suspended a principal of the firm who had handled the transactions from association with any broker or dealer for 20 days.

In a case involving "interpositioning," the Commission barred *Edward Sinclair*, who was an order clerk in the over-the-counter department of Filor, Bullard and Smyth, from association with any broker-dealer. It also barred two individuals who held similar positions with another firm.

According to the Commission's decision, Sinclair, in order to increase business for Filor on which he would receive commissions, entered into a reciprocal arrangement with Hoit, Rose & Co., then a registered broker-dealer, under which Hoit directed listed business to Filor, and Sinclair directed over-the-counter business to Hoit. When he directed a transaction to Hoit, Sinclair first would obtain quotations from at least three market-makers in the stock, and, contrary to Filor's instructions, offer to deal with Hoit at the best quotation obtained even though Hoit did not make a market in the stock. The Commission found that in 1965 Hoit was interposed between Filor's customers and the best available market in 189 transactions, at a profit to itself which generally ranged from ¼ to ½ and reached a high of 5½, for a total profit of about $8,500. The Commission further found that in 90 percent of these transactions, Hoit executed the trade simultaneously or within 10 minutes with a market-maker, in many instances one from whom Sinclair had obtained a quotation.

Stressing that it "cannot sanction any erosion of the broker's obligation to secure the best execution for his customers," the Commission held that "the short amount of time needed by Hoit to better the so-called 'best price' obtained by Sinclair would seem to indicate that the quotations recorded on the order tickets by Sinclair were false, or that he did not negotiate with the dealers from whom he obtained quotations, or that he did not negotiate in good faith to ascertain the best price obtainable."

According to the decision, Sinclair, in order to conceal the interpositioning from his supervisor, falsely listed on the order ticket as the executing dealer a market-maker (usually one he called for a quotation), while entering Hoit's name on the copy of the ticket from which accounting entries were made and confirmations sent.

The two other respondents were found to have interposed Hoit in 1,456 transactions between October 1963 and February 1966 pursuant to a secret arrangement under which Hoit paid them 25 percent of its gross profits on such business, or about $12,000 to each of them, and to have violated the Commission's record-keeping requirements.

In a number of cases pending during the fiscal year, the alleged misconduct included serious manipulations and other improper activities inconsistent with the maintenance of fair and honest securities markets. Among these cases were the following proceedings, all of which were disposed of during or shortly after the fiscal year on the basis of settlement offers and consents.

In proceedings with respect to *Nadel & Co.*, four other broker-dealer firms and 24 individuals, the Commission's order included staff allegations charging the respondents variously with violations of the registration and/or antifraud provisions of the securities laws in the distribution of and manipulation of the market for securities of Computer Counseling, Inc.

Computer Counseling made a purported public offering of 100,000 shares of its common stock in reliance on the Regulation A exemption from the registration provisions of the Securities Act. In its offering circular, it represented that these shares would be offered to the public without the use of an underwriter. However, according to the Commission's decisions, certain of the respondents underwrote at least 55,000 of the shares, and a substantial portion of those shares was withheld and purchased at the offering price by them or persons affiliated with them. Thereafter, most of the withheld shares were sold at far higher prices without disclosure of the profits realized. Certain respondents manipulated the market in Computer stock and made misrepresentations in connection with transactions in such stock.

The sanctions imposed by the Commission ranged from partial suspension of operations for 5 days to revocation of registration for the broker-dealer respondents and from censure to bar from broker-dealer association for the individual respondents.

In *Brand, Grumet & Seigel, Inc.*, the firm, two of its officers and a registered representative were charged, among other things, with manipulation of the market for the securities of L'Aiglon Apparel, Inc. which were listed and traded on the American Stock Exchange. The order charged that as part of the manipulative scheme, respondents effected transactions in L'Aiglon stock which involved no change in beneficial ownership and which raised the price of the stock and entered purchase and sale orders for such stock with the knowledge that orders of substantially the same size, at substantially the same time and price, for the sale and purchase of that stock had been or would be entered. It was alleged that respondents effected these and other transactions for the purpose of creating a false and misleading appearance of active trading in L'Aiglon stock and for the purpose of inducing others to purchase such stock. Pursuant to respondents' offer of settlement, in which they consented to findings of violations as charged without admitting or denying the allegations, the Commission revoked the firm's registration, suspended the individual respondents for periods of from 2 to 12 months and imposed additional restrictions on those respondents.

The proceedings respecting *J. H. Rapp Co*. and its two principals involved among other things violations of registration and antifraud provisions of the Federal securities laws arising out of transactions in common stock of LesStuds Corporation (now Trans-Southern Holding Corp.). According to the Commission's decision, shortly after LesStuds' incorporation in June 1969, one of the respondents discussed with its president a method of making LesStuds a publicly-held corporation by having its shares transferred to a publicly-held company which would then "spin-off" those shares to its stockholders. Thereafter, 75,000 LesStuds shares were exchanged for shares of a wholly-owned subsidiary of Atomic Fuel Extraction Corp., to which the respondent had referred the president of LesStuds. The subsidiary was formed for the sole purpose of effecting this exchange. The LesStuds shares were then distributed to the Atomic stockholders, and active trading in the shares began with no information on LesStuds being available to the investing public. As part of its trading in such shares, the Rapp firm purchased from officers of Atomic over 16,000 LesStuds shares received by them in the "spin-off", and resold such shares to customers and other broker-dealers.

Beginning in July 1969, the Rapp firm entered quotations for LesStuds stock in the pink sheets published by the National Quotation Bureau, Inc. at arbitrary prices which bore no reasonable relationship to the actual value of the stock. Respondents purchased LesStuds stock from persons engaged in its illegal distribution at prices far below those which respondents artificially maintained in the sheets, sold such stock and other shares of such stock to customers of the firm and others at such inflated levels, and used fictitious and nominee accounts to conceal the identity of buyers and sellers. In addition, respondents made materially false and misleading statements.

The Commission revoked the registration of the firm and barred its principals from association with any broker or dealer.

Judicial Review of Administrative Decisions. -- In *Jaffee & Co. and Wilton L. Jaffee, Jr. v. S.E.C.*, the Court of Appeals for the Second Circuit affirmed that part of the Commission's order which imposed sanctions on Mr. Jaffee for violations of Rule 10b-6 under the Securities Exchange Act. The court rejected Jaffee's contention that his purchases of Solitron Devices, Inc. stock in the course of a registered secondary offering of such stock held by him and other stockholders were not proscribed because he had no present intent to sell his registered shares immediately and so had not engaged in a "distribution" within the meaning of Rule 10b-6. The court held that Jaffee's "registration of shares owned by him implied an intention to sell or distribute. . . ." The court also rejected his argument that no violation of the rule had been established because manipulative intent or fraudulent conduct had not been shown. It stated (446 F.2d at 391 :

"The Commission need not have shown that Jaffee actually intended to defraud the marketplace through his purchases. The rule proscribes and clearly defines a practice. . . . Where the rule applies, its prohibition is absolute."

Reversing that part of the Commission's order which imposed sanctions on Jaffee & Co., a registered broker-dealer in which Jaffee's interest exceeded 90 percent but which had not been in existence at the time of his violations, the court held that the order instituting the Commission's proceedings had not afforded Jaffee & Co. adequate notice that a sanction might be imposed against the firm solely on the basis of Jaffee's conduct.

In *Sinclair v. S.E.C.*, the Court of Appeals for the Second Circuit affirmed an order of the Commission barring Edward Sinclair, who was an order clerk in the over-the-counter trading department of a registered broker-dealer, from further association with any broker or dealer. The court held that substantial evidence in the record supported the Commission's findings that Sinclair had violated the antifraud provisions of the federal securities laws when he interposed another broker-dealer between his firm's customers and the executing dealers, or market-makers, in certain over-the-counter securities, thereby causing customers to pay higher prices for securities purchased or to receive lower prices for securities sold than had he dealt directly with those dealers. The court also agreed with the Commission's holding that Sinclair's falsification of the names of executing dealers on order tickets was a violation of the recordkeeping requirements of the Securities Exchange Act. The court found no merit in Sinclair's contention that a commissioner had prejudged Sinclair's case by participating in an earlier Commission decision to accept an offer of settlement submitted by another respondent in the same administrative proceeding. The court noted that the settlement was based upon facts "stipulated by the parties solely for the particular settlement, just as is the practice in the negotiation of consent decrees" and that the Commission's decision accepting the offer of settlement stated that it was not binding on the other respondents.

In *Levine v. S.E.C.*, the Court of Appeals for the Second Circuit affirmed the Commission's holding that a broker-dealer firm, two of its officers and a salesman had violated antifraud provisions of the securities laws as a result of the sale of certain securities by material false representations including many contained in a brochure prepared by the issuer and distributed by the broker-dealer to its customers. The court rejected petitioners' argument that they had a right to rely on statements made by the management of the company concerning its business affairs, noting that one of the principals of the broker-dealer had personal knowledge of the company's financial affairs and indicating that certain of the matters discussed in the brochure could have been checked with others. The court also held that the hearing examiner had properly refused to allow petitioners to introduce the testimony of numerous investors that certain misrepresentations had not been made to them, stating that their testimony would not have negated the testimony of other investors who had testified that misrepresentations had been made to them. The court rejected a claim that the petitioners had been deprived of due process because their books and records had been subpoenaed by the New York State Attorney General and had been made available to the Commission's staff but not to the petitioners. It noted that the records were never in the possession of or under the control of the Commission and that the petitioners failed to show that they could not have examined the records at the Attorney General's Office.

In *Stead v. S.E.C.*, the Court of Appeals for the Tenth Circuit affirmed an order of the Commission imposing sanctions upon Stead, a securities salesman. The court sustained the Commission's finding that Stead had violated the registration provisions of the Securities Act by selling unregistered securities for an account controlled by the issuer. The fact that Stead called the transfer agent and was advised that the securities were freely tradeable was held to be "obviously not a sufficient inquiry." The court also sustained the Commission's finding that Stead willfully aided and abetted his firm's violations of the recordkeeping provisions of the Securities Exchange Act in connection with errors in Stead's trading account with the firm, of which he was aware.

CIVIL PROCEEDINGS

Each of the several statutes administered by the Commission authorizes the Commission to seek injunctions in the Federal district courts against continuing or threatened violations of those statutes or the Commission's rules thereunder. During the past fiscal year the

Commission instituted a total of 140 injunctive actions. A substantial number of these actions were designed to restrain further violations of the registration or antifraud provisions of the Securities Act and Securities Exchange Act; others sought injunctions against operation of broker-dealers in violation of net capital or other investor protection requirements. In appropriate cases the Commission also sought ancillary relief, including the appointment of a receiver, or court orders requiring that rescission be offered to securities purchasers or that profits unlawfully obtained be disgorged.

The nature of some of the more noteworthy of these actions, developments in actions instituted in prior years, and certain appellate decisions in injunctive proceedings, are summarized below.

In *S.E.C. v. Parvin Dohrmann Company*, earlier aspects of which were discussed in the last annual report, the United States District Court for the Southern District of New York entered a final judgment in December 1970 against eight of the defendants, upon their consent, providing essentially all of the broad relief sought in the Commission's complaint. That complaint had alleged, among other things, that those defendants who were part of a group with Delbert W. Coleman that controlled Parvin Dohrmann, were to receive a cash premium for their shares of the company's stock while the uninformed shareholders of the company were to receive shares of Denny's Restaurants, Inc. stock, worth substantially less.

The judgment required these defendants to disgorge virtually all of the company's shares they had purchased through Coleman, (and, as to defendant Edward Torres, who had not acquired his shares through Coleman, to disgorge approximately Vs of his shares -- roughly corresponding to the premium he was to have received for the sale of his shares), such shares to be turned over to a court-appointed trustee for ultimate distribution to those beneficial shareholders of the company as of July 10, 1969 (the date of the alleged unlawful preference) who had no connection with Coleman, the other defendants, or any of the unlawful schemes alleged in the Commission's complaint. These defendants were permitted to keep an installment of the sale price they had received from defendant Butler that was roughly equivalent to the cost to them of their shares plus interest. The court's order further required these defendants to divest themselves, within 1 year, of their remaining holdings of the company's shares; to refrain from any future purchase or acquisition of the stock of the company, its assigns, successors or subsidiaries; to refrain from holding any position or office in the company, its assigns, subsidiaries and successors; and to relinquish any and all claims of any nature that they had against the company. The decree also enjoined the defendants from any future violations of those provisions of the federal securities laws which they had allegedly violated, with respect to any securities.

Consent judgments of permanent injunction were also entered against four other defendants, providing essentially all the relief demanded in the complaint as to them. Nathan Voloshen, one of the non-consenting defendants, has died, and the case remains open as to only one defendant, Albert Parvin.

In *S.E.C. v. Texas Gulf Sulphur Company*, the Court of Appeals for the Second Circuit affirmed (except as to one defendant) the decision of the United States District Court for the Southern District of New York, which had found Texas Gulf to have violated Section 10 (b) of the Securities Exchange Act and Rule 10b-5 thereunder in the release of a false and misleading press release on April 12, 1964. The court also affirmed the district court's order that certain officers and employees of the company who had violated the antifraud provisions be required to disgorge the profits they made from the purchase of Texas Gulf stock and calls on such stock on the basis of material, non-public information about the company. The court of appeals emphasized:

"It would severely defeat the purposes of the Act if a violator of Rule 10b-5 were allowed to retain the profits from his violation."

A defendant who had given tips to others as well as purchasing stock for himself was required to disgorge both his own profits and those of his tippees. The court stated that,

"without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given."

With respect to a defendant who had accepted a stock option while in the possession of inside information, the court of appeals, confessing error as to its previous determination that the option should be cancelled, remanded the matter to the district court for a hearing on the question of appropriate remedy.

After a trustee had been appointed, as previously reported, in *S.E.C. v. Golconda Mining Co.*, he attempted to locate all persons who had traded with the defendants during the period of the alleged antifraud violations in order to pay such persons a share of the fund provided by defendants and consisting of profits which the Commission alleged resulted from the use of inside information in violation of Rule 10b-5 under the Securities Exchange Act. On May 27, 1971, the district court ruled that to the extent persons entitled to share in the fund could not be found, any remaining moneys should be deposited in the registry of the court and ultimately paid over to the Treasury of the United States to be held pursuant to 28 U.S.C. §§ 2041 and 2042 for the benefit of those persons. The court refused to permit the return of any part of the fund to defendants, on the ground that this would impair the deterrent impact of the court's judgment, even though the judgment had been entered upon defendants' consent.

In *S.E.C. v. Harwyn Industries, Inc.*, the Commission alleged that, in violation of the registration provisions of the Securities Act, Harwyn had spun-off shares of stock of four subsidiary companies to its shareholders in consummation of arrangements pursuant to which certain persons received controlling blocks of stock in the spun-off companies in exchange for assets given to these companies. Although the district court denied the Commission's motion for preliminary relief, it held that these transactions violated Section 5 of the Securities Act since the unregistered spin-offs were "sales" within the meaning of the Act. The court found that the effect of each spin-off .was to convert a Harwyn subsidiary into a publicly-held company whose shares were then actively traded in the over-the-counter market. The transactions were sales or dispositions of a security for value, the defendants realizing benefits in the form of a contribution of assets to each subsidiary and the creation of a public market in the subsidiary's shares. Harwyn, as the controlling company of each subsidiary, was held to be an "underwriter" within the meaning of the Act and the other defendants were found to have participated in the violations.

In *S.E.C. v. Liberty Equities Corporation*, the Commission filed a complaint against 12 defendants to enjoin further violations of the antifraud, proxy, reporting and registration provisions of the federal securities laws. The defendants included four officers and directors of Liberty Equities; Peat, Marwick, Mitchell & Co., a national accounting firm; National Savings & Trust Co., a national bank; and four broker-dealers. The Commission alleged, *inter alia*, that certain of the company's financial statements certified by Peat, Marwick showed as current assets non-negotiable, non-interest bearing certificates of deposit which were purchased from National Savings with the proceeds of a 14-month 6 percent loan in the amount of the certificates, obtained on the same day. The certificates of deposit in fact were pledged as collateral for the loan, but the pledge was not disclosed in the certified statements. The complaint alleged that the entire transaction was a sham, entered into only to lend the appearance of bolstering the company's financial position. All of the defendants except one -- against whom the case is still pending -- have consented to the entry of final judgments of permanent injunction against further violations of the provisions involved. In addition, Peat, Marwick withdrew its certification of the company's financial statements challenged by the Commission.

In *S.E.C. v. Bangor Punta Corp.*, the United States District Court for the Southern District of New York on August 25, 1971 entered judgment after trial ordering Bangor Punta to make an offer of rescission to shareholders of the Piper Aircraft Co. who had exchanged their shares for a package of Bangor Punta securities pursuant to a registered exchange offer in July 1969. The court found that Bangor Punta's registration statement and prospectus covering the exchange offer were materially false and misleading, in that the $18.4 million carrying value which Bangor Punta had assigned in its financial statements, included in the prospectus, to its investment in the Bangor and Aroostook Railroad (based on an appraisal of 1965 fair market value) had become "obsolete to the point of being misleading." The circumstances surrounding Bangor Punta's negotiations in May and

June 1969 for disposition of the railroad had indicated that the only willing buyer would pay no more than $5 million. Concluding, however, that this deficiency was not purposeful, the court denied the Commission's request for injunctive relief.

In *S.E.C. v. Home-Stake 1970 Program Operating Corporation*, the Commission sought, and by consent obtained, injunctions against violations of the registration requirements of the Securities Act and antifraud provisions of the Securities Exchange Act in the offer and sale of units of participation in a program of oil and gas drilling projects. The defendants admitted that, in violation of Section 5 of the Securities Act, promotional sales literature was disseminated and sales of units of participation were made before a registration statement had become effective. No violation of the antifraud provisions was admitted. The defendants did admit, however, that estimates of future recoverable oil reserves contained in the promotional sales literature, other than reserves actually proven, were extremely uncertain and speculative.

In accordance with the final judgment, the defendant corporation offered rescission to all persons who had purchased a participation in its "1970 Program," providing each purchaser a prospectus that purported fully and accurately to describe the oil and gas recovery projects that were to be included in the Program. Thereafter, an order was entered directing that the participants who elected to rescind be repaid an aggregate of $5,609,000, including interest.

In *S.E.C. v. Barraco & Co.*, the Court of Appeals for the Tenth Circuit reversed the judgment of the district court which had dismissed the Commission's complaint for an injunction against officers of a registered broker-dealer for aiding and abetting the latter's violations of the Securities Exchange Act. The court sustained the Commission's authority, pursuant to Section 21 (e) of the Act, to obtain injunctions against those who participate in or aid and abet violations of the securities laws. The case was remanded to the district court for trial on the merits.

In *S.E.C. v. Jan-Dal Oil & Gas, Inc.*, a corporation and its president had consented to the entry of a decree permanently enjoining them from selling or offering to sell fractional undivided interests in oil, gas, and other mineral rights in violation of the registration provisions of the Securities Act of 1933. About 8 months later, the defendants brought an action to dissolve the consent decree, stating that they had complied with the securities law and that the injunction was a continuing- embarrassment to them and might adversely affect the proposed sale of oil and gas interests pursuant to a registration statement that they contemplated filing with the Commission. The district court set aside the injunction. On appeal by the Commission, the Court of Appeals for the Tenth Circuit remanded the case to the district court with directions to vacate its order and to reinstate the injunction to full force and effect. Reaffirming well-established judicial guidelines, the court pointed out that where modification or dissolution of an injunctive decree is sought a strong showing is required that there are no longer any substantial dangers and that the moving party is exposed to severe hardships of extreme and unexpected nature. The court stated that short-term compliance with the law and a continuing embarrassment in present business relationships because of an earlier dereliction were not enough.

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. During fiscal 1971, the Commission filed *amicus curiae* briefs in six cases.

In *Chasins v. Smith, Barney & Co., Inc.*, the Court of Appeals for the Second Circuit held that the failure of a broker-dealer to disclose its market-making activity in securities it recommended in writing to a customer upon his request constituted a violation of Section 10 (b) of the Securities Exchange Act and Rule 10b-5 thereunder. On defendant's petition for rehearing, the Commission, as *amicus curiae*, noted its agreement with the result reached by the court under the facts of the case, which established an investment advisory relationship where the customer was relying upon the broker's recommendations and hence should have been advised of the broker's economic interest in the sale of securities in which it was making a market. At the same time, the Commission expressed concern that the court's holding might be construed broadly to hold a broker-dealer liable for its customers' losses due to market declines solely because the broker had failed to disclose that it was making a market in particular securities the customers had purchased. The court of appeals denied the petition for rehearing, but modified its initial opinion so as to limit its holding to the facts in the case.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, the complaint had alleged that the named defendants had engaged in a scheme whereby Manhattan Casualty Company, a New York insurance company, was induced to sell nearly $5 million worth of its portfolio Treasury Bonds upon the misrepresentation that the proceeds of the sale would be invested for the company in certificates of deposit. Instead, the complaint alleged, the defendants intended to and in fact did misappropriate the proceeds from the sale of these government bonds without disclosing this fact to Manhattan. The court of appeals, relying upon its prior decision in *Birnbaum v. Newport Steel Corp.*, held that "Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than, 'fraudulent mismanagement of corporate affairs.' " The court of appeals further held that, although the creditors of Manhattan might have been defrauded by the alleged scheme, the creditors would have to look to state law, rather than Federal law, to ascertain whether any remedy was available to them as a result of the alleged fraud. In its brief *amicus curiae* in the Supreme Court, the Commission took the position that the antifraud provisions of the Federal securities laws were intended to cover all manipulative and deceptive devices of whatever type if they were in connection with the purchase or sale of securities and that the Superintendent of Insurance, successor to all the rights of Manhattan, could maintain a suit under the Federal securities laws on behalf of the company's creditors.

In *Levine v. Seilon*, a former preferred shareholder of Seilon, Inc. alleged that the company had violated Sections 10 (b) and 14 (e) of the Securities Exchange Act and Rule 10b-5 thereunder by fraudulently inducing preferred shareholders to refrain from selling their stock. Although allegedly leading such shareholders to believe that Seilon would not redeem the preferred shares but would instead make an offer to exchange the shares for common stock, the company redeemed the preferred shares without making any exchange offer. On appeal from dismissal of the complaint, the Commission as *amicus curiae* expressed the view that plaintiff had stated a claim of fraud "in connection with" the sale of securities under Section 10 (b) and Rule 10b-5 because Seilon's redemption resulted in a "forced sale" by the preferred shareholders and it had been alleged that the company's misrepresentations had affected plaintiff's investment judgment whether to sell or hold the company's securities. The Commission also took the position that a claim had been stated under Section 14 (e), governing tender offers, on the ground that this provision was not limited in application to consummated tender offers but also included fraudulent announcements of intent to make a tender offer, such as the alleged representation in this case that Seilon would exchange its preferred shares for common stock.

The court of appeals, finding it unnecessary to consider either of the Commission's positions, affirmed the dismissal of the complaint. It held that dismissal was proper because the complaint did not assert any causal relation between the alleged fraud and the raising of funds needed for redemption and because the complaint failed to allege recoverable damages in that it did not state that the preferred shares had any investment value in excess of their redemption price.

CRIMINAL PROCEEDINGS

The statutes administered by the Commission provide that the Commission may transmit evidence of violations of any provisions of these statutes to the Attorney General, who in turn may institute criminal proceedings. Where an investigation by the Commission's staff indicates that criminal prosecution is warranted, a detailed report is prepared. After careful review by the Office of Criminal Reference and Special Proceedings and the General Counsel's Office, the report and the General Counsel's recommendations are considered by the Commission. If the Commission believes criminal proceedings are warranted, the case is referred to the Attorney General, who in turn refers the case to the appropriate U.S. Attorney. Commission employees familiar with the case generally assist the U.S. Attorney in the presentation of the facts to the grand jury, the preparation of legal memoranda for use in the trial, the conduct of the trial, and the preparation of briefs on appeal.

During the past fiscal year 22 cases were referred to the Department of Justice for prosecution. As a result of these and prior referrals, 16 indictments were returned against 83 defendants during the year. Convictions were obtained against 89 defendants in 32 cases. Convictions were affirmed in 5 cases, and appeals were still pending in 9 other criminal cases at the close of the year.

During the fiscal year, the Court of Appeals for the Seventh Circuit, in *U.S. v. Amick*, affirmed among others the convictions of Van C. Vollmer, former editor of an Indiana financial newspaper, and the Indiana Investor and Business News, Inc., its publisher, for violating Section 17 (b) of the Securities Act by publishing an article describing stock of Air and Space Underwriters, Inc. for consideration received from the issuer without disclosing the receipt and amount of such consideration. The court rejected the defendants' argument that Section 17 (b) abridged the freedom of the press, contrary to the First Amendment, stating that, "The substantial interest of the investing public in knowing whether an apparently objective statement in the press concerning a security is motivated by promise of payment is obvious. We see no significant abridgement of freedom of the press in requiring disclosure of a promise of payment if there has been one."

In another appellate decision, the Court of Appeals for the Eighth Circuit affirmed the convictions of and sentences of 35 and 25 years, respectively, imposed on Donald P. Smallwood and Roy E. Lay. The defendants had been found guilty of violations of the antifraud and registration provisions of the Securities Act of 1933 and the Mail Fraud Statute, in connection with the sale of promissory notes of Diversified Brokers Company. In affirming the sentences, the court stated:

"We recognize that the sentences . . . are severe. But we are also mindful, as was the district court, that the hardship and suffering endured by thousands of unsuspecting individuals, including many elderly persons, as the result of the nefarious operations of Smallwood and Lay, was also severe."

As reported in last year's annual report, Harry A. Lowther, Jr. and three others were indicted for alleged violations of the Securities Act and the Securities Exchange Act in connection with the offer and sale of common stock of Elkton Company, a corporate shell which Lowther revived by causing it to acquire assets of questionable value. During the fiscal year, Lowther, Wendell Everett Lowry and Lowry Investments, Inc., a Colorado corporation, were convicted. These three convictions are presently on appeal.

In a prosecution arising out of transactions in the securities of Mooney Corporation, Hal Frances Rachal, an attorney, and Edward B. Hunnicutt, an accountant, were convicted on each of 13 counts of an indictment charging violations and conspiracy to violate the antifraud and registration provisions of the Securities Act and the Mail Fraud Statute. Rachal sold stock of Mooney Corporation by making false statements to the effect that the issuer, a shell corporation, manufactured airplanes and was to be listed on a stock exchange. Under the direction of Rachal and Hunnicutt a false and misleading Form 10 and unaudited financial statements were filed with the Commission. Rachal was sentenced to five years in prison and fined $10,000, Hunnicutt to three years imprisonment and fined $5,000. Each was also assessed costs of approximately $10,000.

Lengthy prison sentences were also meted out in a criminal case involving the offer and sale of certificates of beneficial interest in two Indiana real estate investment trusts, American National Trust and Republic National Trust. Four defendants were convicted of violation of the Securities Act and the Mail Fraud Statute. Calvin R. Mummert, who pled guilty to certain counts during the course of the trial, received a ten-year suspended sentence. Defendants Jack Aldridge, Samuel P. Good and James J. Perrault were convicted by a jury and received prison sentences of 40, 65 and 65 years, respectively. Kenneth A. Erickson and Gordon William Schuetz were indicted during the fiscal year for violations of the registration and antifraud provisions of the Securities Act and the antifraud provisions of the Securities Exchange Act in connection with the offer and sale of unregistered undivided fractional interests in oil and gas leases held by Arch Creek Development Company. The indictment charges that the sales promotion of these interests engaged in by Erickson, a gospel singer, and Schuetz, a traveling evangelist, was surrounded by an aura of religion and was accomplished by means of fraudulent misrepresentations. The Department of Justice is presently seeking the extradition of Erickson who is a resident of Canada.

The Commission has continued its efforts designed to assure that injunctions which have been obtained by it are obeyed and to have those who violate such injunctions held in contempt. During the fiscal year, 11 persons were convicted of criminal contempt for violating injunctions. Contempt proceedings with respect to 12 others were pending at the end of the year. In one case, a criminal contempt proceeding was filed during the fiscal year against Albert Silver, Vernon Brown and Turf Enterprises, alleging violations of provisions of a permanent injunction entered in August 1969. It was alleged that subsequent to the injunction, Silver and Brown continued to sell stock in Turf Enterprises, using the proceeds to place wagers on horses at various tracks in the United States and Canada. The court accepted a *nolo contendere* plea from Silver; the proceedings as to Brown were pending as the year ended.

Organized Crime Program. -- The Commission gives priority to the investigation of cases where there is an indication that organized crime may be involved. Pursuant to Executive Order 11534, the Chairman of the Commission was designated in June 1970 to be a member of the National Council on Organized Crime. In that capacity, the Chairman and his designees have met with other government officials to formulate a national strategy for the elimination of organized crime. In this connection, members of the staff have assisted in the development of plans regarding better accounting and auditing procedures for gambling operations in the State of Nevada.

In fiscal 1970 the Commission's efforts with respect to organized crime were intensified by the establishment of an organized crime unit in its headquarters office to focus on the involvement of organized crime in the securities markets. This unit acts as a "back-up" unit to the various Justice Department "strike forces" against organized crime and as an enforcement unit investigating securities violations in which persons with organized crime associations are believed to be involved.

The Commission maintains close liaison with the organized crime and racketeering section of the Department of Justice and submits quarterly reports relating to organized crime investigations. During the 1971 fiscal year, the Commission had four enforcement staff members assigned to the New York Strike Force against organized crime and one enforcement staff member assigned to Strike Force Number 18. Commission staff members, including those assigned to the strike forces, played significant roles in many cases involving persons reported to be associated with organized crime.

Proposed Swiss Treaty. -- Since approximately January 1969, a representative of the Commission has participated with the State Department and other agencies of the United States Government in discussions looking toward a possible Treaty of Mutual Assistance in Criminal Matters between the United States and Switzerland. It is believed that such a Treaty would be of assistance to the Commission in dealing with problems presented by the use of Swiss financial institutions in connection with securities transactions taking place in the United States.

The Commission's representative participated in a series of informal discussions between U.S. and Swiss officials in Washington, D.C. and in Bern, Switzerland, which resulted in an informal agreement by the working groups on an English text of a draft treaty. Substantial further progress was made during the 1971 fiscal year. An additional round of informal discussions, looking toward resolution of the remaining problems between the two working groups, was scheduled for the fall of 1971.

DISCIPLINARY ACTION BY SELF-REGULATORY ORGANIZATIONS EXCHANGES

Although the Exchange Act does not provide for Commission review of disciplinary action by exchanges, each national securities exchange reports to the Commission actions taken against members and member firms and their associated persons for violations of any rule of the exchange or of the Exchange Act or of any rule or regulation under that Act.

During the fiscal year, seven exchanges reported 135 separate actions, including impositions of fines in 90 cases ranging from $10 to $50,000, with total fines aggregating $502,465; the revocation of 1 member firm and expulsion of 3 individuals; the suspension from membership of 7 member firms and 49 individuals; and censure of 26 member firms. These exchanges also reported the imposition of various other sanctions against 95 registered representatives and other employees of member firms.

NASD

The Commission receives from the NASD copies of its decisions in all disciplinary actions against members and registered representatives. In general, such actions are based on allegations that the respondents violated specified provisions of the NASD's Rules of Fair Practice. Where violations are found, the NASD may impose one or more sanctions upon a member, including expulsion, suspension, fine, or censure. If the violator is an individual, his registration as a representative 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. Under Section 15A (b) (4) of the Exchange Act and the NASD's by-laws, no broker-dealer may be admitted to or continued in NASD membership without Commission approval if he has been suspended or expelled from membership in the NASD or a national securities exchange; he is barred or suspended from association with a broker or dealer, members of the NASD, or an exchange; his registration as a broker-dealer has been denied, suspended, or revoked; he has been found to be a cause of certain sanctions imposed upon a broker-dealer by the Commission, the NASD, or an exchange; or he has associated with him any person subject to one of the above disqualifications.

During the past fiscal year the NASD reported to the Commission its final disposition of disciplinary complaints against 291 member firms and 206 individuals associated with member firms. With respect to 24 members and 22 associated persons, complaints were dismissed where the NASD determined that the alleged violations had not been established. In the remaining cases, violations were found and penalties were imposed on 267 members and 184 registered representatives or other individuals. The maximum penalty of expulsion from membership was imposed against 16 members, and 26 members were suspended from membership for periods ranging from 1 day to 5 years. In many of these cases, substantial fines were also imposed. In another 209 cases, members were fined amounts ranging from $100 to $35,000. In 16 cases, the only sanction imposed was censure, although censure was usually a secondary penalty where a more severe penalty was also imposed.

A variety of penalties were also imposed on associated individuals found to have violated NASD rules. Seventeen individuals were barred from association with any NASD member. The registrations of 27 registered representatives were revoked, and 48 representatives had their registrations suspended for periods ranging from 5 days to 2 years. Fines in various amounts were also imposed against many revoked or suspended representatives. In addition, 92 other representatives were censured and/or fined amounts ranging from $100 to $10,000.

The number of final disciplinary actions reported to the Commission during the past fiscal year increased by approximately 37 percent over fiscal 1970. This increase is attributable in part to the severe operational and financial conditions prevailing in the securities industry during the past 2 years.

Commission Review of NASD Disciplinary Action. -- Section 15A (g) of the Exchange Act provides that disciplinary actions by the NASD are subject to review by the Commission on its own motion or on the timely application of any aggrieved person. This section also provides that upon application for or institution of review by the Commission the 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. Section 15A (h) of the Act defines the scope of the Commission's review. If the Commission finds that the disciplined person committed the acts found by the NASD and thereby violated the rules specified in the determination and that such conduct was inconsistent with just and equitable principles of trade, the Commission must sustain the NASD's action unless it finds that the penalties imposed are excessive or oppressive, in which case it must cancel or reduce them.

At the start of the fiscal year eight proceedings to review NASD disciplinary decisions were pending before the Commission. During the year seven additional cases were brought up for review. Seven cases were disposed of by the Commission. In one of these cases the Commission sustained in full the disciplinary action taken by the NASD. It dismissed the review proceedings in two cases as having been abandoned, and permitted the withdrawal of three applications for review. With respect to the remaining case, the Commission sustained most of the NASD's findings of violations but reduced the penalty as to one of the applicants. Eight cases were pending at the end of the year.

One of the review cases, *May & Co., Inc*., involved the NASD's interpretation respecting the fairness of underwriting compensation. The NASD found that May & Co. had violated the Association's rules of fair practice by entering into underwriting arrangements with respect to an offering of common stock of Fibers, Inc. which were unfair and unreasonable, and failing promptly to file with the Association required documents in connection with such offering.

According to the Commission's decision, May & Co. acted as managing underwriter in an offering of 147,500 shares of Fibers common stock at $2 per share pursuant to Regulation A under the Securities Act. Two months before the offering, Fibers had sold 40,000 unregistered shares at $0.50 per share to an officer of May & Co., and issued 5,000 shares for no cash consideration to another person who was a director and promoter of Fibers and had served as a consultant to May & Co.

In its opinion, the Commission observed:

"The NASD very properly has been concerned with the arrangements between issuers and underwriters in connection with the public offering of securities of unseasoned companies. Its interpretation that it is a violation of ... its Rules of Fair Practice for a member to act as an underwriter in a public offering in which the underwriting arrangements are unfair or unreasonable is consistent with the Rule and beneficial in the exercise of its function of self-regulation in the securities business.

Thus it is important in the application of this Interpretation that there be a strict standard which avoids even the appearance of overreaching."

The NASD treated the stock issued to the two individuals as stock issued to related parties of May & Co. in connection with the offering for the purpose of computing the overall underwriting compensation. The Commission sustained the NASD's finding that the stock issued to the officer was a part of the underwriting compensation, particularly since the officer had signed the underwriting agreement and acquired his shares when it was known that a public offering was contemplated in which his firm would be managing underwriter. The Commission did not agree with the NASD, however, that the evidence was sufficient to show that the stock acquired by the promoter-consultant was issued in connection with the offering, but concluded that even with the exclusion of these shares the total underwriting compensation, including the direct underwriting commission and the anticipated profit on the officer's shares, equaled 28.8 percent of the aggregate offering price and was unfair and unreasonable. The Commission also sustained the NASD's finding of a violation based on the late filing, and it affirmed the sanctions imposed, consisting of a 2-day suspension from membership and a $2,000 fine.

Commission Review of NASD Action on Membership. -- As previously noted, Section 15A (b) (4) of the Act and the bylaws of the NASD provide that, except where the Commission finds it appropriate in the public interest to approve or direct to the contrary, no broker or dealer may be admitted to or continued in membership if he, or any person associated with him, is under any of the several disabilities specified in the statute or the NASD by-laws. A Commission order approving or directing admission to or continuance in Association membership, notwithstanding a disqualification under Section 15A (b) (4) of the Act or under an effective Association rule adopted under that Section or Section 15A (b) (3), is generally entered only after the matter has been submitted initially to the Association by the member or applicant for membership. The Association in its discretion may then file an application with the Commission on behalf of the petitioner. If the Association refuses to sponsor such an application, the broker or dealer may apply directly to the Commission for an order directing the Association to admit or continue him in membership. At the beginning of the fiscal year, 5 applications for approval of admission to or continuance in membership were pending. During the year, 12 additional applications were filed, and 8 were approved, leaving 9 applications pending at the year's end.

COOPERATION WITH OTHER ENFORCEMENT AGENCIES

In recent years the Commission has given increased emphasis to the coordination of its enforcement activities with those of the various state and local authorities, the self-regulatory agencies, and foreign securities agencies. This program encompasses the referral to state or local authorities for investigation and prosecution or other action of those cases where it appears that the activities were confined largely to one state or local area and that the matter will be dealt with promptly and effectively. The Commission frequently provides manpower assistance to these authorities in the development of such cases. In addition, the Commission's regional offices have taken steps to improve the coordination of inspections and other activities with state securities administrators and with the NASD in those areas where their respective jurisdictions overlap. Staff members of the Commission and of certain state authorities have conducted joint inspections which have made the entire inspection program more effective.

In a case referred during the fiscal year to local enforcement authorities, Phyllis C. Dempster was indicted by a citizens grand jury in Detroit, Michigan for violation of the Michigan Uniform Securities Law in connection with the offer and sale of high interest promissory notes of Dempster Investment Co. Evidence compiled by the Commission's staff during its investigation of this matter was turned over to local authorities because almost all of the allegedly defrauded investors were residents of Michigan.

During the fiscal year, the Commission continued its program of cooperative regional enforcement conferences at each of its regional offices. These conferences, during which Commission personnel meet with personnel from state securities agencies, post office inspectors, Federal, state, and local prosecutors and local representatives of self-regulatory agencies such as the NASD, are designed to promote the exchange of information concerning regional enforcement problems, the development of methods of increasing cooperation and communication, and the elimination of needless effort and waste of manpower and other resources in the regulation of the securities markets. Although the Commission served as the primary agency in establishing these cooperative enforcement conferences, they have progressed to the point where state securities agencies frequently serve as hosts of the programs. During the previous 4 years the Commission each year held enforcement training sessions at its headquarters office in Washington, D.C., to which it invited staff members of state and foreign securities agencies and other law enforcement agencies working in the securities area in addition to its own personnel. A shortage of funds in 1971 and an accompanying reduction in new employees resulted in a determination not to conduct a training program in the past year.

SECTION OF SECURITIES VIOLATIONS

The Commission's Section of Securities Violations provides one of the means for cooperation on a continuing basis with other agencies having enforcement responsibilities. This Section acts as a clearing house for information regarding enforcement actions in securities matters taken by state and Canadian authorities, by other governmental and self-regulatory agencies, and by the Commission. In addition to handling requests for specific information, the Section publishes a periodic Bulletin which is sent to contributing agencies and to other enforcement and regulatory organizations. The Bulletin contains current information which is a matter of public record regarding the institution and disposition of remedial and enforcement proceedings.

Among other things, the data in the SV files (which are maintained in a computer) constitute a valuable tool for screening applicants for registration as securities or commodities brokers or dealers as well as applicants for loans from such agencies as the Small Business Administration and the Economic Development Administration of the Department of Commerce.

During the fiscal year, the Section received 4,704 letters either providing or requesting information and sent out 3,051 communications to cooperating agencies. State and Canadian securities administrators reported 142 criminal actions, 11 injunctive actions, 255 actions in the nature of cease and desist orders, and 169 other administrative orders, such as denials, suspensions, and revocations of issuers, broker-dealer, and salesmen.

ENFORCEMENT PROBLEMS WITH RESPECT TO FOREIGN SECURITIES

The past fiscal year was again marked by extensive efforts by various promoters and others to distribute foreign securities in the United States without complying with the registration and disclosure provisions of the Securities Act of 1933, and generally in violation of the antifraud provisions of the federal securities laws. In some instances companies which were represented as having issued the securities were in fact non-existent. Known securities laws violators, as well as individuals associated with organized crime, appear to be connected with some of the more flagrantly fraudulent offerings of foreign securities.

To alert brokers and dealers, financial institutions, investors, and others to possible unlawful distributions of foreign securities, the Commission maintains and publicizes a Foreign Restricted List. That list is comprised of the names of foreign companies whose securities the Commission has reason to believe recently have been, or currently are being, offered for public sale in the United States in violation of the registration requirements of the Securities Act. The number of companies on the list increased from 46 on June 30, 1970 to 54 at the end of the 1971 fiscal year. Most brokers and dealers refuse to effect transactions in securities issued by companies on the list; however, this does not necessarily prevent promoters from illegally offering such securities directly to investors in the United States, either in person or by mail.

The following companies were added to the list during the year:

1. Allied Fund for Capital Appreciation, S.A., also known as AFCA, S.A., purportedly a Panamanian company. AFCA claimed to have $37 million in assets in the custody of its depository, Midwest National Banking Corporation, in Panama City, Panama. As a result of investigations by Panamanian and Canadian authorities, it was reported that no such assets could be located at the premises of Midwest, which consisted of one office with no regular employees. Despite the apparent absence of assets, loans have been made in the United States on the basis of shares of AFCA used as collateral. Attempts to redeem the shares upon default in payment of the loans were reported to have been unsuccessful.

2. J. P. Morgan & Company, Ltd. of London, England (not to be confused with J. P. Morgan & Co., Incorporated, New York) ; Swiss Caribbean Development & Finance Corporation, Zurich, Switzerland; and Trust Company of Jamaica, Ltd. Spurious "bank money orders" bearing the J. P. Morgan name and exceeding $375,000 in amount were mailed to 31 savings and loan associations in California, as well as a bank in Minnesota, ostensibly for the purpose of opening new accounts against which cash withdrawals were attempted. In addition, instruments labeled "Negotiable Certificate of Deposit" of "J. P. Morgan & Company, Ltd." of London were distributed in the United States. With respect to the other two companies, advertisements were placed in U. S. newspapers offering joint venture interests and certificates of deposit, respectively. The same individual is believed to have been behind all 3 offerings.

3. Unitrust Limited, of Dublin, Ireland. Through newspaper advertisements in the United States, Unitrust offered securities representing interests in Irish real estate properties.

4. Northern Survey of Montreal, Canada. This company, through mail solicitation and advertisements in a magazine widely distributed in the United States, offered three-year mineral leases on designated locations in Canada for amounts ranging from $100 for 10 acres to $650 for 160 acres. Upon expiration of a lease, the purchaser would be entitled to renew it for another three years by payment of the same amount. These offers were accompanied by representations that the purchaser would profit in the event that a rich strike of minerals were

made near his lease by another company, because in that event other large corporations would seek to acquire his lease at a substantial profit to him. In addition, Northern Survey held itself out as willing to advise and assist the investor in negotiating a profitable sale of his lease. The cover page of the brochure used to solicit persons to purchase these leases contained the following representations:

"DO NO MINING -- YOU DO NO WORK PAY NO TAXES -- IMPROVE NO LAND
YOU MAY REALIZE A PROFIT ON YOUR LEASE WITHOUT EVER LEAVING HOME"

The Commission's staff determined that what was being offered was an investment contract and as such a "security" as defined in the Securities Act. Moreover, Canadian authorities had received numerous complaints from investors in the United States that they had transmitted funds to purchase leases offered and in return each had received a document which Canadian officials charged with the duty of recording transfers of land titles had refused to accept and record because it was so poorly drawn that the land described could not be located and because it was not notarized.

5. Hebilla Mining Corporation and Cia. Rio Banano, S. A. Unregistered shares of these companies were offered to investors in the United States by mail from Costa Rica. Information available to the Commission indicated that a Robert Colucci was an officer of both companies. One Robert Colucci had been indicted in 1969 by a federal grand jury in Peoria, Illinois in a 61-count indictment charging him and five others with conspiring to violate and violating the Federal securities laws and the Mail Fraud Statute by fraudulently selling unregistered securities. The individual defendants have been fugitives from justice since that time.

On June 30, 1971, the following companies were on the Foreign Restricted List:

[table omitted]

DISQUALIFICATION FROM PRACTICE BEFORE COMMISSION

In *Murray A. Kivitz*, the Commission suspended an attorney from practice before it for a period of two years, pursuant to Rule 2 (e) of the Commission's Rules of Practice. The Commission found that Kivitz had allowed a layman, Harold G. Quase, to control and exploit Kivitz's privilege to practice before the Commission. Kivitz permitted Quase to represent to a prospective corporate issuer that Quase had an "organization" which could, through the use of political influence, obtain Commission clearance of a registration statement to be filed pursuant to the Securities Act; that part of the fee paid by the issuer would be used to purchase such influence; and that accountants who would "stretch a point" could be found to prepare the financial information required for the prospectus. The Commission held that it had jurisdiction to discipline Kivitz under Rule 2 (e) for his participation as an attorney in such a scheme, even though the prospective client did not accept Kivitz's proposed retainer agreement and Kivitz never made any filings in its behalf.

Recognizing the need for expeditious disqualification procedures in appropriate cases, the Commission further amended Rule 2 (e) of its Rules of Practice to provide for the suspension from appearing or practicing before it of any attorney, accountant or other expert who by name (1) has been permanently enjoined by any court of competent jurisdiction by reason of his misconduct in an action brought by the Commission from violating or aiding and abetting the violation of any provision of the federal securities laws, or (2) has been found by any court in an action brought by the Commission to which he is a party, or by the Commission in any administrative proceeding to which such person is a party, to have violated or to have aided and abetted the violation of any provision of the federal securities laws, unless the violation was expressly found not to have been willful. Under the amendment, such a person may be temporarily suspended by the Commission, the suspension becoming permanent after thirty days unless a petition for hearing is filed within that time. Upon petition, the Commission may lift the suspension or, after prompt opportunity for hearing, may censure or discipline the practitioner. In any hearing, after the Commission's staff has demonstrated that an injunction has been entered or that findings of violation have been made, the burden will be upon the practitioner to show why he should not be disciplined, and he will not be permitted to litigate factual questions that he litigated or, but for any consent to injunction or findings, might have litigated in the earlier proceeding upon which the disqualification proceeding is based.

PART V
REGULATION OF INVESTMENT COMPANIES

In broad terms, an investment company is any arrangement by which a group of persons invests funds in an entity that is itself engaged in investing in securities. Investment companies are important vehicles for public participation in the securities markets. They enable small as well as large investors to participate in a professionally managed and diversified portfolio of securities.

The Investment Company Act of 1940 imposes various obligations and restrictions on investment companies and persons affiliated with them and sets forth the Commission's responsibilities in protecting investors in such companies. It provides a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or in its investment policies without shareholder approval, contains prohibitions against theft or conversion of assets or breaches of fiduciary duty, and provides specific controls to eliminate or mitigate inequitable capital structures. The Act also requires that an investment company disclose its financial condition and investment policies; requires that management contracts be submitted to shareholders for approval; prohibits underwriters, investment bankers, or brokers from constituting more than a minority of an investment company's board of directors; regulates the custody of investment company assets; and provides specific controls designed to protect against unfair transactions between investment companies and their affiliates.

In addition to complying with the requirements of the Investment Company Act, an investment company must comply with the Securities Act of 1933 when offering its securities, and it is subject to certain provisions of the Securities Exchange Act of 1934, including those relating to proxy and tender offer solicitations and insider trading and reporting.

1 For a discussion of the Investment Company Amendments Act of 1970, enacted during the fiscal year, which amended the 1940 Act in various significant respects, see Part I of this report.

COMPANIES REGISTERED UNDER THE ACT

As of June 30, 1971, there were 1,351 investment companies registered under the Act, with assets having an aggregate market value of approximately $78 billion. Compared with corresponding totals at June 30, 1970, these figures represent an increase of 23, or only 1.7 percent, in the number of registered companies, but an increase of approximately $22 billion, or about 39 percent, in the market value of assets. The $78 billion represents the highest market value of assets of active companies as of the end of any fiscal year since the Act was passed.

The following table shows the numbers and categories of registered companies and the approximate market value of the assets in each category as of June 30, 1971.

[table omitted]

The approximately $9.5 billion of assets of the registered unit investment trusts includes approximately $8.1 billion of assets of unit investment trusts which invest in securities of other registered investment companies, substantially all of them mutual funds.

The graph below shows the number of registered investment companies, broken down into the various categories, over a 5-year period.

[table omitted]

The following table on page 144 shows the number of investment companies which became registered during the fiscal year and the number of registrations terminated.

[table omitted]

As the table shows, 12, or approximately 10 percent, of the newly registered companies were variable annuity separate accounts of insurance companies. [Footnote: Typically, a variable annuity contract provides payments for life commencing on a selected date with the amounts of the payments varying with the investment performance of equity securities which are set apart by the insurance company in a separate account which is registered with the Commission as an investment company. The separate accounts now registered are either open-end management companies or unit investment trusts.] Including these companies, there were 78 active variable annuity separate accounts registered at June 30, 1971, consisting of 31 unit investment trusts and 47 management open-end investment companies. A significant part of the Commission's regulatory effort with respect to variable annuities has involved the application of the requirements of the Investment Company Act to the patterns and procedures which have grown up in the insurance industry.

INVESTMENT COMPANY ASSETS

The table on the preceding page sets forth the number of investment companies registered under the Investment Company Act and their estimated aggregate assets, in round amounts, at the end of each fiscal year, 1941 through 1971.

INVESTMENT COMPANY FILINGS, OTHER THAN APPLICATIONS

As previously noted, investment companies offering their shares for sale to the public must register them under the Securities Act of 1933. Registration statements filed by such companies are reviewed for compliance with that Act as well as with the Investment Company Act. Proxy soliciting material filed by investment companies is reviewed for compliance with the Commission's proxy rules. The number of registration statements and proxy soliciting materials filed or processed during the fiscal year was as follows:

[table omitted]

Investment companies also filed 902 annual reports, 3,051 quarterly reports, 2,249 periodic reports to shareholders containing financial statements and 1,939 copies of sales literature.

DEVELOPMENTS WITH RESPECT TO PARTICULAR TYPES OF INVESTMENT COMPANIES

During the fiscal year, a variety of novel investment companies began operations and certain developments of particular interest occurred with respect to operating investment companies.

INVESTMENT COMPANY SPONSORED BY A PUBLIC ACCOUNTING FIRM

Arthur Andersen & Co., a large international accounting firm, established and registered the Fund A Partnership as a non-diversified, open-end, no-load investment company. The Fund, participation in which is limited to partners and persons holding equivalent positions, is designed to provide a vehicle for investment by such persons in a manner consistent with the firm's interests. Thus, the Fund cannot invest in clients of the firm or make investments of a type which the firm's partners are not permitted to make as a matter of firm policy or which the Fund's management committee or the firm determines to be adverse to the independence, reputation or business of the firm. The committee, consisting of partners, may employ others to supply investment advisory or management services.

The Fund's structure is unique in several respects. To permit operation of the Fund in a manner consistent with its intended objectives, the Commission granted certain requested exemptions from various provisions of the Investment Company Act, designed principally to permit the firm to maintain control over the Fund to insure that it will operate without conflicting with the independence and reputation of the firm.

MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES

On February 26, 1971, *Southern California Minority Capital Corporation*, a closed-end, non-diversified management investment company, offered its shares to the public. The company proposes to provide equity funds, long-term loans and management assistance to small business concerns owned by socially and economically disadvantaged persons. As a minority enterprise small business investment company (MESBIC), the company has applied for a license to operate under the Small Business Investment Act of 1958.

The company proposed to raise an initial $500,000 through the sale of 5,000 shares to be purchased for investment and not with a view to distribution. If the shares were not sold and the license granted by July 31, 1971, the offering would terminate and all funds paid for shares would be returned without interest. As of July 20, 1971, the $500,000 had not been obtained, and the company was making tentative plans to extend the offering until December 31, 1971.

Minority Investments, Inc., a registered closed-end, non-diversified investment company, which has applied for a license to operate as a MESBIC, filed an application for exemption from Sections 16 (a) and 18 (i) so that two classes of voting securities could be issued and holders of less than one-half of the outstanding stock could elect more than one-half of the directors. Class A stock, offered primarily to members of the minority community, is entitled to elect 60 percent of the company's board of directors. Class B stock, entitled to elect 40 percent of Minority's board of directors, will be offered only to business corporations with gross assets of at least $750,000, trade associations, banks, trust companies, insurance companies, and tax-exempt organizations. The requested exemptions were granted upon condition that if a majority of Class A shares are no longer held by members of minority groups, the differing voting rights will be eliminated and the shares made identical.

MUTUAL FUND FOR LABOR UNION MEMBERS AND PENSION FUNDS

American Union Investment Fund, Inc., a no-1oad, diversified, open-end investment company, began selling its shares in December 1970. Shares of the Fund are being offered only to members of labor unions, jointly administered pension and welfare funds, and other funds held for the benefit of labor union members. Each member of the board of directors must be a current or former labor union officer or a person who has served as trustee or in some other capacity with respect to pension or welfare funds of labor unions or for the benefit of labor union members. In addition the Fund, as a fundamental policy, will not invest in the security of any company which is involved in a major labor dispute. The Fund claims that it was established in response to the generally limited investment opportunities for rank and file labor union members resulting from unfamiliarity with existing funds and other investment matters.

SHAREHOLDERS' PROPOSALS IN INVESTMENT COMPANY PROXY MATERIAL

Relying on the provisions of Rule 14a-8 under the Securities Exchange Act concerning the inclusion of shareholder proposals in proxy material, two shareholders of *Fidelity Trend Fund, Inc*. submitted to the management of the Fund two proposals which were included in the Fund's proxy material for the 1971 annual meeting of shareholders.

The first proposal recommended that management consider adoption of an investment policy requiring management to consider as part of its security analysis the activities of potential and existing portfolio companies in regard to pollution, minority hiring, and the conduct of business in certain foreign nations. If analysis of these activities revealed certain specified information regarding the potential or present portfolio companies, such as existence of a lawsuit brought by any governmental body for noncompliance with anti-pollution standards, the recommended investment policy required the Fund either not to invest or retain its investment in such companies, or, if an investment were made or retained in such companies, to seek to change those activities by taking certain actions as a shareholder. Such actions could include exercise of its voting rights, making shareholder proposals designed to improve deficient performance in the areas of concern, or consulting with management of the portfolio companies with respect to adoption of policies designed to improve such performance. The proposal also specified that the Fund's annual report should include descriptions of all instances in which the Fund had acted to further the "corporate responsibility" of portfolio companies and that the proposed policy, if adopted, be disclosed in the Fund's prospectus.

The second proposal recommended that the board of directors justify the merits of the management fee payable to the Fund's investment adviser in its next annual report, and include comparisons of the adviser's net income, Fund-related expenses, the Fund's total net assets and the net asset value of shares held by Fund shareholders.

Management included in the proxy statement its statement in opposition to the proposals, in accordance with Rule 14a-8. Shareholders of the Fund voted at their annual meeting not to adopt either of the proposals.

SELECTION OF A NEW INVESTMENT ADVISER BY AN INVESTMENT COMPANY

During the last year, the three funds managed by a subsidiary of Hayden, Stone, Inc. -- *American DualVest, Tudor Hedge Fund and Tudor Capital Fund* -- terminated their advisory contracts with their investment adviser and invited other investment advisers to indicate upon what terms they would be willing to enter into an advisory agreement. Among the offers received, and the one accepted, was that of Weiss, Peck & Greer, a member firm of the NYSE, which offered approximately $1,000,000 directly to the three funds if it were selected as investment adviser. Weiss' decision to negotiate directly with the three funds resulted in the funds dividing the payment according to their respective net asset values.

REVISIONS OF RULES AND FORMS; POLICY STATEMENTS

In the course of fiscal year 1971, the Commission adopted or revised various rules and forms under the Investment Company Act and issued policy statements as to certain matters.

ADOPTION OF RULE 18f-1 AND FORM N-18F-1

During the fiscal year the Commission adopted Rule 18f-1 which permits any registered open-end investment company to waive partially the right to redeem in kind. The definition of "redeemable security" in the Investment Company Act has traditionally been interpreted as giving the issuer the option of redeeming its securities in cash or in kind. The securities administrators of several states and some foreign countries now require or are considering requiring, as a condition to doing business in their respective jurisdictions, that open-end companies which have the right to redeem in kind file an undertaking that redemptions by residents of such jurisdictions will be effected in cash only or that redemptions in kind will not be effected unless specific approval is first obtained from the securities administrator. Such requirements involve priorities as to distribution of assets and thus create senior securities within the meaning of Section 18 of the Act, which are prohibited by that section.

Although redemptions in kind are extremely rare, the Commission believes that it is desirable for open-end companies to retain the flexibility afforded by the opportunity to make such redemptions, and it determined to adopt the rule in order to avoid needless conflicts with state and foreign regulatory authorities.

Under the rule, any registered open-end investment company which has the right to redeem in kind may file with the Commission, on new Form N-18F-1, a notification of election committing itself to pay in cash all redemptions by any shareholder of record, limited in amount during any 90-day period to the lesser of $250,000 or 1 percent of the net asset value of the fund at the beginning of the 90-day period. Should redemptions by one shareholder during any 90-day period exceed this limit, the fund would have the option of redeeming the excess in cash or in kind.

AMENDMENT OF RULE 22d-1

During the fiscal year, the Commission amended paragraph (h) of Rule 22d-1 under the Act to restrict the categories of persons to whom mutual fund shares may be sold with a lower sales load than that charged to the general public.

Section 22 (d) of the Act prohibits a registered investment company, its principal underwriter or a dealer in its redeemable securities from selling such securities to "any person" except "at a current public offering price described in the prospectus." Many exemptions from these price maintenance provisions were granted by the Commission to meet special circumstances and in 1958 the Commission codified its administrative interpretations by adopting Rule 22d-1.

Paragraph (h) of that rule, in essence, permitted sales of shares at a reduced sales load or none at all to directors, officers or partners of the investment company, its investment adviser or principal underwriter, and to full-time employees or sales representatives of any of the foregoing who had acted as such for not less than 90 days.

Under the terms of that provision, many individuals who provided no services to the investment company could be favored. For example, a life insurance company having possibly thousands of employees, which was investment adviser or principal underwriter for an investment company, could offer shares of that company to employees at a reduced sales load even though their activities were completely unrelated to the advisory or underwriting functions. The Commission therefore determined that the paragraph should be revised to limit the exemption to persons associated directly with the investment company, and to those associated with the adviser or underwriter only if more than half their working time involved rendering investment advisory services to the investment company, selling its shares, or supervising persons engaged in such activities.

REVISION OF ANNUAL REPORT FORM N-1R

Shortly after the end of the fiscal year, the Commission adopted certain revisions of the Annual Report Form for Registered Management Investment Companies (Form N-1R) to focus more attention on the "back office" problems of investment companies, and to place greater reliance upon the review and opinion of the independent accountants in detecting and reporting such problems. The revisions of Form N-1R require more explicit information with respect to the registration of investment company shares; the processing of orders for sales, redemptions and repurchases of such shares; and investment company portfolio transactions generally and in "restricted securities." Information relating to the status of shareholder accounts and processing of shareholder inquiries is also required. The opinion of the independent public accountant filed with the annual report on Form N-1R is required to include comments upon any material inadequacies in the accounting system and the system of internal accounting control of the investment company and any corrective action taken or proposed.

VALUATION OF SECURITIES

The Commission published its views on some of the more important questions concerning the accounting for investment securities by registered investment companies. The Commission set forth some of the general factors which the directors should consider in determining a valuation method for an individual issue of securities if a market quotation is not readily available. These include the fundamental analytical data relating to the investment, the nature and duration of restrictions on disposition of the securities and the forces which influence the market in which the securities are purchased and sold.

As reported in the 36th Annual Report, during fiscal 1970 the Commission issued a policy statement and a supplemental release dealing with problems arising from the acquisition and holding of "restricted" securities by registered investment companies. During the last fiscal year, the Commission issued another release dealing with valuation of such securities. It called attention to an interpretive position taken by its staff concerning a possible "shelf" registration by the issuer of the securities. It was the staff's view that maintenance of an effective Securities Act registration statement for a specified period of time (a "shelf" registration) was a factor which could properly be taken into consideration by an investment company's board of directors in valuing restricted securities, but that automatic valuation at the market price on the basis of the shelf registration alone, without considering all of the business and financial changes which might occur with respect to the issuer after the filing of the registration statement, would be improper.

POSITION WITH RESPECT TO DILUTION OF NET ASSET VALUE AND INAPPROPRIATE EXTENSIONS OF CREDIT ON SALES, REDEMPTIONS AND REPURCHASES OF FUND SHARES

On March 5, 1971, the Commission published a release in which it observed that a number of open-end investment companies were not making prompt and diligent efforts to protect their shareholders against the dilution of net asset value which usually results when orders for the sale, repurchase or redemption of fund shares are not honored by investors and the investment companies merely cancel or reverse the transactions on their records. The Commission noted that when, under these circumstances, investment companies fail to require prompt settlement of the transactions in fund shares they are, in effect, extending non-interest bearing loans at their own risk.

As to purchases of fund shares, the Commission stated its view that where a principal underwriter is involved it should be responsible for completing the transaction with the fund whether or not the offsetting transactions with the customers are honored. Where a fund distributes directly to investors rather than through a principal underwriter and dealers, the fund should consider refusing to accept orders for fund shares unless accompanied by payment, except when a responsible person has indemnified the fund against losses resulting from failure of investors to make payment.

APPLICATIONS FOR COMMISSION ACTION

Under Section 6 (c) of the Act, the Commission, by rules and regulations upon its own motion or by order upon application, may exempt any person, security, or transaction from any provision of the Act if and to the extent such exemption is 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. Other sections, such as 6 (d), 9 (b), 10 (f), 17 (b), 17 (d), and 23 (c), contain specific provisions and standards pursuant to which the Commission may grant exemptions from particular sections of the Act or may approve certain types of transactions. Also, under certain provisions of Sections 2, 3, and 8, the Commission may determine the status of persons and companies under the Act. One of the principal activities of the Commission in its regulation of investment companies is the consideration of applications for orders under these sections.

During the fiscal year, 275 applications were filed under these and other sections of the Act, and final action was taken on 361 applications. As of the end of the year, 221 applications were pending. The table below contains a more detailed presentation of these statistics.

[table omitted]

Among the applications disposed of during the fiscal year, the following were of particular interest:

The National Association of Small Business Investment Companies, an association of small business investment companies (SBICs) licensed by the Small Business Administration (SBA) pursuant to the Small Business Investment Act of 1958 (SBI Act), had applied during fiscal 1969 for exemption of all SBICs subject to registration under the Investment Company Act from certain provisions of that Act.

In May 1971, the Commission, with two Commissioners dissenting, granted limited exemptions from the statutory prohibitions with respect to the issuance of stock options and, with two other Commissioners dissenting, denied exemptions from provisions of the Act requiring Commission approval of transactions between investment companies and affiliated persons and prohibiting the issuance of convertible securities.

The SBI Act's prime purpose is to establish a program to stimulate and supplement the flow of private equity capital and long term loan funds to small business concerns. For this purpose, the SBA is authorized to license and lend money to SBICs which in turn can provide the loans and equity type fundings to small business concerns.

The Commission pointed out that it is not an inadvertent result that SBICs may be subject to regulation under both the Investment Company Act and the SBI Act. Congress was aware of this situation at the time of the passage of the SBI Act in 1958 when it concluded that SBICs with a public investor interest should not be exempted from the basic provisions of the Investment Company Act, and as recently as 1967 it again recognized that SBICs were subject to regulation both by the SBA and the Commission.

With particular reference to the requested exemption from Section 17 of the Investment Company Act, sometimes referred to as the "self-dealing" section, the Commission stated that that section is intended, in general, to prevent abuses and unfair transactions by insiders of investment companies and, as such, is a keystone in the statutory scheme enacted to protect investors. SBA regulations against conflicts of interest have a coverage narrower than that under the Investment Company Act. While compliance with that Act entails some increased costs and inconvenience, such consequence, the Commission observed, is a necessary incident to regulatory oversight and is not itself a justification for a blanket exemption from any section of the Act for an entire industry. The Commission further pointed out that it had by rule granted to SBICs specific exemptions from Section 17 in recognition of particular problems incident to SBIC activities. With reference to stock options, the Commission concluded that the issuance of "qualified" stock options under the Internal Revenue Code, subject to the adoption of SBA regulations satisfactory to the Commission imposing appropriate limitations on employee stock option plans, would not offend the policies and purposes of the Act. The

Commission noted that the adverse factors which have been stated as resulting from the issuance of options are not persuasive in the case of SBICs, and that restrictions placed on "qualified" options under the Internal Revenue Code contain a number of safeguards.

The hearing examiner's conclusion that no showing had been made that it was necessary or appropriate in the public interest that an exemption be granted from the restrictions on the issuance of convertible securities was upheld by the Commission.

In *Ivy Fund, Inc.*, the Commission denied the application of the Fund and its investment adviser for an order exempting from the prohibition of Section 17 (a) of the Act the proposed grant by the Fund to the adviser of a license to use the word "Ivy" in a proposed new name for the adviser and in the names of other investment companies advised by it, in consideration of a payment of $2,000 by the adviser to the Fund. The denial was based on the Commission's finding that the applicants had failed to prove that the consideration proposed to be paid was reasonable and fair.

The Commission noted that while the Fund's board of directors had discussed various relevant factors, it acted without the benefit of independent expert assistance and had not made any effort to place dollar values on any of such factors. The Commission stated that although there was no specific precedent available to the board which could serve as a basis for comparison, it seemed likely that guidance could have been obtained from a consideration of analogous situations. Moreover, the Commission held, "without such guidance the various uncertainties as to the use which Adviser would make of the license, particularly the extent to which it could make use of the Ivy name in connection with other investment companies, precluded a reasonable determination by the board of directors of an appropriate consideration for all such uses. Such uncertainties could have been narrowed by appropriate limitations in the licensing agreement or a formula provision for additional payments."

In an application filed pursuant to Section 6 (c), Small Business Investment Company of New York, Inc. (SBICNY), a closed-end, non-diversified investment company, sought exemption from Section 12 (d)

(3) to permit it to invest in Daniels & Bell, Inc., a proposed broker-dealer firm that was to be the first black-controlled member firm of the New York Stock Exchange. Section 12 (d) (3) prohibits a registered investment company from investing in a broker-dealer unless the investment company or a group of registered investment companies will wholly-own the broker-dealer. The exemption requested was granted subject, however, to conditions designed to reduce SBICNY's risk and to prevent any conflicts of interest.

First American-Australian Investors Limited, an investment company chartered under the laws of the Commonwealth of Australia, applied for an order under Section 7 (d) of the Investment Company Act to permit the company to register as an investment company under the Act and make a public offering of its securities in the United States. That section prohibits a foreign investment company from selling its securities to the public through the mails or any means or instrumentalities of interstate commerce unless the Commission, upon application, issues an order permitting the company to register and make a public offering.

The company was organized for the purpose of engaging in business as a closed-end diversified management investment company investing principally in the securities of Australian companies. The Commission found that, in light of the company's charter and by-law provisions and certain undertakings and agreements contained in its application, it was both legally and practically feasible to enforce effectively the provisions of the Act against the company and that it was consistent with the public interest and protection of investors to issue the requested order.

In *N.A.S.D. v. S.E.C.*, the Supreme Court vacated the Commission's order granting First National City Bank of New York exemptions from certain provisions of the Investment Company Act with respect to a Commingled Investment Account which the Bank established and registered under the Act, because of the Court's holding, in a companion case, that the establishment of an investment company such as that created by First National City Bank involves the bank in the underwriting, issuing, selling and distributing of securities in violation of the Glass-Steagall Act. The Commission had taken no position on the applicability of the Glass-Steagall Act or any other provision of federal banking laws; however, the Court's determination that operation of the investment company would violate those laws required that the Commission's exemptive order be vacated. Although the Court did not decide whether the Commission's order was properly granted, the two dissenting members of the Court (Justices Harlan and Blackmun) stated that the Commission had not abused its discretion in granting the exemptions.

CONTROL OF IMPROPER PRACTICES

INSPECTION AND INVESTIGATION PROGRAM

During the fiscal year, the Commission's staff conducted 95 investment company inspections. Many of these disclosed violations of the Investment Company Act and of other statutes administered by the Commission. Among the violations were failure to obtain best execution on portfolio securities transactions resulting in unnecessary costs to investment companies, improper use of investment company portfolio brokerage, inadequate disclosures concerning the activities of a company, participation by investment companies in joint ventures with affiliated persons, and various accounting and bookkeeping problems.

A number of situations were noted where investment advisers of investment companies became insolvent and were unable to discharge their obligations to the companies, with resultant losses to them.

In most cases, deficiencies noted during inspections were pointed out to the companies concerned, and corrective action was immediately taken. Largely as an outgrowth of information obtained during inspections, a substantial number of private investigations were commenced during the fiscal year to develop facts concerning what appeared to be serious violations. As a result of the Commission's inspection and investigation program, more than $3,600,000 was returned to investors either directly or indirectly during the year. This brings to more than $11,700,000 the total amount returned to investors since the inception of the inspection program in 1963.

CIVIL AND ADMINISTRATIVE PROCEEDINGS

During the fiscal year, the Commission instituted a number of civil and administrative proceedings involving investment companies, and various pending proceedings continued to progress or were concluded.

The Commission brought an injunctive action in October 1970 in the United States District Court for the Central District of California against All American Fund, Inc., its investment adviser and its principal underwriter, and the president of the Fund and the adviser.-- The complaint alleged that as of June 30, 1970, the adviser was insolvent and was therefore unable to reimburse the Fund for certain of the Fund's excess expenses, as it was obligated to do by the terms of its investment advisory contract with the Fund. The complaint further alleged that the adviser had received unauthorized reimbursements from the Fund to cover the salaries of certain employees of the adviser and had failed to account to the Fund for rebates received from a broker who executed portfolio transactions. In addition, the complaint alleged that the Fund's shares were overvalued to the extent that its net assets included the amounts due from the insolvent adviser, that its directors had not made a good faith valuation of such receivables as required by the Investment Company Act, and that its shares were being sold by means of a false and misleading prospectus which failed to disclose the above matters. The defendants, without admitting the allegations of the Commission's complaint, consented to the entry by the court of a final judgment permanently enjoining them from engaging in such violations of the Investment Company Act and applicable antifraud provisions of the securities laws.

In December 1970 the Commission instituted an injunctive action in the U. S. District Court for the Northern District of California against *Investment/Indicators Fund* and its investment adviser. The complaint alleged, among other things, that as of October 20, 1970, the adviser was insolvent and unable to account to and reimburse the Fund for certain expenses in accordance with the terms of its advisory agreement with the Fund; that it had converted to its own use moneys belonging to the Fund by continuing to accept advisory fees from the Fund while insolvent and indebted to the Fund; and that the Fund and the adviser had sold Fund shares without complying with applicable state securities laws with the result that substantial contingent liabilities had accrued arising from the rights of investors to rescind their investments. The complaint also alleged that Fund shares had been overvalued to the extent that its net assets included amounts due from the insolvent adviser and that its directors had not made a good faith effort to value such receivables. Finally, the complaint alleged that Fund shares were being sold through the use of a materially false and misleading prospectus which did not disclose any of the above matters.

In July 1971 the U. S. District Court for the Northern District of California preliminarily enjoined *Golden Gate Fund, Inc.*, the adviser to the Fund, and John B. Licata, president of the adviser, from engaging in acts and practices in violation of the antifraud provisions of the federal securities laws. The court also appointed an interim investment adviser for the Fund pending determination by the Fund's board of directors as to proposals, if any, to be submitted to shareholders concerning future management of the Fund. The court found that the adviser was insolvent and unable to meet its accruing obligation to reimburse excess expenses of the Fund, as required by the terms of its advisory agreement with the Fund, and that Licata had guaranteed the adviser's indebtedness to the Fund, but was insolvent and unable to fulfill his guarantee. The court further found that, in view of the adviser's insolvency, the Fund's net assets had been overvalued by inclusion of the adviser's indebtedness as an asset of the Fund, so that Fund shares had been redeemed at an inflated value to the detriment of the Fund's shareholders, and that the Fund's prospectus was materially false and misleading.

In administrative proceedings respecting *Sierega & Co., Inc*., a registered broker-dealer and investment adviser which had acted as principal underwriter for Olympus Fund, Inc., its subsidiary which acted as the Fund's investment adviser, and two principal officers of the corporate respondents, the Commission's staff alleged that Sierega & Co. engaged in business while it was insolvent and unable to meet its current obligations, that respondents induced the Fund to engage in transactions which were excessive in size and frequency for their own benefit and not in the interest of the Fund, and that the Fund paid expenses which the adviser was obligated to but did not repay to the Fund. Among the issues raised in these proceedings is whether, pursuant to new Section 9 (b) of the Investment Company Act, the respondents should be prohibited from affiliation with an investment company in any of the various capacities enumerated in that section.

In December 1970, an action by the Commission against *American General Insurance Company* and three affiliated investment companies was settled. In its complaint the Commission had alleged that the defendants had published a series of nine advertisements in *The Wall Street Journal* in September and October 1969, offering securities of the investment companies in violation of the prospectus requirements of Section 5 (b) (1) of the Securities Act and the sales literature filing provisions of Section 24 (b) of the Investment Company Act.

Under the terms of the settlement, American General, without admitting the violations charged, entered into an undertaking to comply with the above statutory provisions. The undertaking was incorporated in a court order, thus making American General subject to the sanction of contempt in the event of future violations. As part of the settlement, the case was dismissed as to the remaining defendants.

In August 1969 the Commission had instituted administrative proceedings against *Value Line Securities, Inc.*, a broker-dealer which is principal underwriter for three investment companies, its president, and the controlling shareholder of its parent company which is investment adviser to those companies. The proceedings were based on staff allegations that, among other things, respondents offered and sold shares of the investment companies by means of misleading prospectuses which failed to disclose a lack of personnel and facilities necessary to service shareholders' accounts properly. During the past fiscal year, respondents, without admitting the allegations, agreed not to contest certain findings of violations of antifraud and record-keeping provisions of the Securities Exchange Act and a finding of failure of supervision. They also consented to suspensions ranging from 15 to 40 days and agreed that for nine months Value Line would submit monthly reports on various aspects of its business.

In *S.E.C. v. Enterprise Fund, Inc*., the district court, in February 1970, had entered, upon consent, a final judgment of permanent injunction against Enterprise Fund, Inc. and an order approving a stipulation and undertaking by Shareholders Management Company ("Management"), the fund's investment adviser and principal underwriter. The injunction and order had prohibited the offer and sale of Enterprise shares until further court order and had directed Enterprise and Management to take steps necessary to make and keep current and accurate the records of Enterprise in compliance with the requirements of the Investment Company Act. Subsequently, in October 1970, an order was entered by the court, with the Commission's approval, permitting the resumption of sales of Enterprise shares and also approving an agreement between Enterprise and Management which provided for the payment of approximately $1.8 million to Enterprise by Management and State Street Bank and Trust Company, Enterprise's transfer agent. Enterprise's application for authorization to resume sales of its shares followed compliance with certain provisions of the court's initial order, pursuant to which Management filed with the Commission and the court a report by an independent certified public accounting firm retained by Management and an analysis prepared by Management of costs and expenses incurred by Enterprise and Management in connection with the maintenance of Enterprise's records. That analysis formed the basis for the $1.8 million payment referred to above. That payment, as well as more than $970,000 which Enterprise and its shareholders had already received from State Street Bank and Bank of America, the former transfer agent, are part of a total of over $5 million which Management and the two banks have expended to bring Enterprise's records into compliance.

A permanent injunction was entered by the U. S. District Court for the Southern District of New York against *Arnold Bernhard & Co., Inc.*, a registered investment adviser, and certain affiliated firms and individuals. Bernhard & Co. publishes investment advisory publications under the name "Value Line" and acts as investment adviser for several investment companies. The Commission's complaint alleged, among other things, that securities analysts who did research for the publications and investment companies failed to disclose their activities as finders of mergers, acquisitions, and financing for companies they were reviewing, and that certain of the defendants had accepted compensation for the placement of investment company portfolio transactions. The defendants consented to the injunction without admitting or denying the allegations in the Commission's complaint.

Administrative proceedings were instituted under the Exchange Act and the Investment Advisers Act with respect to *Maxwell Ohlman* and several firms controlled by him, based on allegations of the Commission's staff that respondents induced the investment advisers and/or principal underwriters of several investment companies to direct allocations of brokerage and "give-ups" by their affiliated investment companies to the Ohlman firms and certain other persons, in exchange for undisclosed payments by the respondents to the advisers and/or underwriters of direct and indirect pecuniary benefits and other compensation. The staff further alleged that respondents failed to deal fairly with the investment companies involved in that, having undertaken to act in connection with the portfolio transactions of those companies, they engaged in the acts and practices described above without disclosing them to the investment companies or their shareholders.

On the basis of an offer of settlement submitted by the respondents, the Commission suspended, for 30 and 15 calendar days,, respectively, the broker-dealer and investment adviser registrations of *Financial Programs, Inc.*, principal underwriter for and adviser to three investment companies, and suspended *Thomas J. Herbert*, former president of Programs and of the investment companies, from association with any broker-dealer, investment adviser or investment company for 30 business days. The Commission found, among other things, that during the years 1961-68 Programs caused the three funds to allocate brokerage and "give-ups" to another broker-dealer or his designees, pursuant to an arrangement whereby companies affiliated with such broker-dealer in return paid certain expenses of Programs related to its distribution of the shares of the funds. The Commission held that these and related activities by Programs, including the failure to make proper disclosures thereof in the funds' prospectuses and in other filings with the Commission, were violative of antifraud and other provisions of the federal securities laws, and that Herbert aided and abetted the violations and failed to exercise reasonable supervision of employees to prevent the violations. The respondents consented to these findings and the sanctions without admitting any violations.

The Commission filed a complaint in U. S. District Court for the Central District of California, in June 1971, seeking to enjoin Incentive Fund, Inc., its investment adviser, and the president and director of both the Fund and the adviser. The complaint alleges that defendants violated antifraud and other provisions of the federal securities acts by causing the Fund to make excessive purchases and sales of its portfolio securities and by failing to adhere to the Fund's investment policies as set forth in its prospectus. On October 13, 1971, the court issued an injunction against the investment adviser and the president-director. However, it declined to enjoin the Fund, partly because of a change of management subsequent to institution of the proceedings.

The U. S. District Court for the Eastern District of Kentucky entered a preliminary injunction on October 20, 1970 enjoining *Albert B. Chandler, Sr., J. Daniel Chandler* and others from violating various sections of the Investment Company Act, and enjoining J. Daniel Chandler from violating Section 10 (b) of the Securities Exchange Act and Rule 10b-5 thereunder. This action was taken pursuant to a complaint filed by the Commission alleging, among other things, that defendants, officers of Commonwealth Security Investors, Inc., a registered investment company, had engaged in prohibited joint transactions with that company and, acting as agents, had received compensation for the purchase or sale of property to or for that company, in connection with a plan of reorganization under which the assets of Commonwealth were exchanged for stock of Daniel Boone Fried Chicken, Inc.

Toward the end of the fiscal year, the Commission instituted administrative proceedings involving Charles W. Steadman and various companies bearing his name. Among the issues raised was whether action should be taken against the respondents pursuant to new Section 9 (b) of the Investment Company Act. All respondents are alleged to be affiliates of a group of registered investment companies (Funds) managed and advised by Steadman Security Corporation (SSC), one of the respondents, or its subsidiaries. The staff alleged, among other things, that Steadman and SSC and others caused transfers of securities between Ameri-Fund, an "off-shore" fund controlled by Steadman, and certain of the registered companies in violation of certain provisions of the Investment Company Act; that

Steadman and SSC engaged in prohibited joint arrangements with certain of the Funds by using the assets of the Funds to obtain a loan for SSC; that SSC and another respondent failed promptly to reimburse certain of the Funds managed by SSC for excess expenses as they were required to do by agreement with the Funds and with each other and thereby effected a prohibited "borrowing" from the Funds; and that respondents caused reports, proxy soliciting materials and prospectuses to be filed with the Commission and transmitted to shareholders which were false and misleading concerning the above practices and transactions.

In *S.E.C. v. Fifth Avenue Coach Lines, Inc.*, the Court of Appeals for the Second Circuit affirmed the judgment of the district court, previously reported, which appointed a trustee-receiver for Fifth Avenue Coach Lines, Inc. and enjoined certain of the individual defendants from violating, with respect to transactions involving Fifth Avenue, Section 10 (b) of the Securities Exchange Act and Rule 10b-5 thereunder, and various provisions of the Investment Company Act. The court of appeals sustained the district court's finding that Fifth Avenue was an investment company required to register as such with the Commission, ruling that "there is nothing surprising about considering Fifth to be an investment company," since the "transformation of an industrial company into an investment company, which occurred with Fifth, was anticipated by events preceding the enactment of the 1940 Act." In affirming the injunction that had been issued against future violations of the Investment Company Act by the individual defendants, the court adopted the view that an injunction may be entered upon evidence of "a propensity to violate the Act in the future."

The court further held that the lower court was justified in granting an injunction for violations of Rule 10b-5 in connection with the sale by Fifth Avenue of its stock in Gateway National Bank to Gray Line Corp., another of the complex of companies formerly controlled by the individual defendants. The court agreed with the Commission's contention that the sale of Gateway stock constituted a fraud upon Fifth Avenue, in that the defendants, as "controlling persons [of Fifth], without full disclosure to the entire board of directors, caused their corporation to sell valuable stock owned by it to another corporation known by the controlling persons to be incapable of paying for the stock." In this connection the court rejected the argument that the appointment of a receiver for the company precluded the issuance of an injunction under the securities laws.

During the fiscal year the Commission also prosecuted a related injunctive action, *S.E.C. v. Gray Line Corp.*, to compel Gray Line to register as an investment company. In July 1970, Gray Line consented to the entry of a permanent injunction and order which, among other things, directed the company to file required reports with the Commission under the Investment Company Act and to conduct a shareholders meeting for the election of directors and to vote upon whether Gray Line should be liquidated.

Thereafter, the court, upon the Commission's application, entered an order appointing a trustee-receiver for Gray Line. In January 1971, the Court of Appeals for the Second Circuit summarily affirmed the appointment of a receiver for Gray Line.

At fiscal year end the respective receivers of Fifth Avenue and Gray Line had negotiated in principle a settlement, subject to court approval, of litigation brought on behalf of Fifth Avenue against Gray Line to recover an alleged indebtedness to Fifth of about $3 million. The proposed settlement provides for the elimination of the cross-ownership existing between the two investment companies, which had previously enabled the individual defendants in the Commission's action against Fifth Avenue to maintain control of both these companies.

PART VI
REGULATION OF PUBLIC-UTILITY 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 in the retail distribution of gas. The Commission's jurisdiction also extends to natural gas pipeline companies and other nonutility companies which are subsidiary companies of registered holding companies. There are three principal areas of regulation under the Act. The first includes those provisions of the Act which require 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. The second covers 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. The third area of regulation includes the exemptive provisions of the Act, 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 a second such company through the acquisition of securities.

COMPOSITION OF REGISTERED HOLDING-COMPANY SYSTEMS

At the close of the 1971 fiscal year, there were 23 holding companies registered under the Act. Of these, 20 are included in the 17 "active" registered holding-company systems, 3 of the 20 being subholding utility operating companies in these systems. [Footnote: The three subholding companies are The Potomac Edison Company and Monongahela Power Company, public-utility subsidiary companies of Allegheny Power System, Inc., and Southwestern Electric Power Company, a public-utility subsidiary company of Central and South West Corporation.] The remaining 3 registered holding companies, which are relatively small, are not considered part of "active" systems. [Footnote: These holding companies are British American Utilities Corporation; Kinzua Oil & Gas Corporation and its subholding company, Northwestern Pennsylvania Gas Corporation; and Standard Gas & Electric Company, which is in the process of dissolution.] In the 17 active systems, there are 95 electric and/or gas utility subsidiaries, 49 nonutility subsidiaries, and 17 inactive companies, or a total, including the parent holding companies and the subholding companies, of 181 system companies. The table on page 169 shows the number of active holding companies and the number of subsidiaries (classified as utility, nonutility, and inactive) in each of the active systems as of June 30, 1971, and the aggregate assets of these systems, less valuation reserves, as of December 31, 1970.

SECTION 11 MATTERS IN REGISTERED HOLDING -- COMPANY SYSTEMS

Washington Gas Light Company, which, pursuant to Section 3 (a) (2), had been granted an exemption from the Act except Sections 11 (b) (2), 11 (d), and 11 (e), filed a plan under Section 11 (e) proposing the elimination of the 0.7 percent publicly-held minority interest in the common stock of its gas utility subsidiary company, Shenandoah Gas Company. After a hearing on the plan, the Commission approved the plan, and, on application of the Commission, the United States District Court ordered the plan enforced.

As reported previously, the Commission approved an amended plan filed by *Pennzoil United, Inc*. for the divestiture of its interest in its gas utility subsidiary company, United Gas Corporation, pursuant to Section 11 (e) of the Act. The divestments were completed during this fiscal year.

PROCEEDINGS WITH RESPECT TO ACQUISITIONS, SALES, AND OTHER MATTERS

In *American Electric Power Company, Inc.* (AEP), discussed previously, the reopened hearings continued during the fiscal year with respect to AEP's proposal to acquire, in exchange for its stock, the common stock of Columbus and Southern Ohio Electric Company, a nonassociate electric utility company.

In *New England Electric System*, reported previously, hearings were concluded during the fiscal year on the proposal for an affiliation, through the creation of a new holding company to be known as Eastern Electric Energy System, of New England Electric System and Eastern Utilities Associates, both registered holding companies, and Boston Edison Company, a nonaffiliated electric utility company. The Division of Corporate Regulation opposes approval on the grounds that (a) the anti-competitive effects of the acquisition would be contrary to the standards of Section 10 (b) (1) and (b) it was not shown that, as required by Section 10 (c) (2), significant economies would result from the proposed affiliation. The United States Department of Justice and 39 Massachusetts Municipal electric systems also oppose the proposed affiliation.

American Electric Power Company, Inc., filed an application seeking authorization for the issue and sale of $100 million principal amount of debentures. A hearing was ordered to determine whether the proposal meets the standards of Section 7 of the Act.

In two separate orders, the Commission authorized *Louisiana Power & Light Company* (LP&L), an electric utility subsidiary company of Middle South Utilities, Inc., a registered holding company, to issue and sell first mortgage bonds and preferred stock at competitive bidding and short-term notes to banks and to dealers in commercial paper. The Cities of Lafayette and Plaquemine, Louisiana (Cities) sought to intervene as parties and requested a hearing unless LP&L consented to the imposition of conditions requiring cessation of activities alleged to be in violation of Federal antitrust laws. The Commission determined that the facts alleged by the Cities did not present issues relevant to Section 7 of the Act and that Section 7 (f) does not authorize the Commission to impose terms and conditions to resolve collateral and unrelated controversies in which a declarant may be engaged with other parties. The Cities filed petitions for review from both orders, oral argument was heard by the Court of Appeals, and, at the end of the fiscal year, the matter was under advisement.

In *Middle South Utilities, Inc.*, the Commission rejected the above Cities' intervention and request for reopening the hearing, filed 15 months after the hearing, with respect to the proposal by Middle South to acquire, in exchange for its common stock, the outstanding common and preferred stocks of Arkansas-Missouri Power Company, an unaffiliated company. The Cities' petition reasserted the alleged violations of the Federal antitrust laws charged in the proceedings relating to the proposed financing of Louisiana Power & Light Company. The Commission concluded that the rule permitting intervention by interested municipalities "cannot be deemed to grant, nor does an orderly administration of proceedings permit, an extension of the privilege for such a long period of time beyond the time fixed in the public notice of hearing for interested persons to request participation." Subsequently, the Commission approved the proposed acquisition, without ordering the hearing requested by the Cities. The Cities have filed petitions for review with respect to both orders.

In *Michigan Consolidated Gas Co. v. S.E.C*., the Court of Appeals for the District of Columbia Circuit affirmed an order of the Commission denying an application by Michigan Consolidated and its subsidiary company for permission to provide financing to the subsidiary company which, pursuant to the National Housing Act, proposed to construct in its service area two housing projects for low and moderate income families. The court agreed with the Commission's construction of the "other business" clauses of Section 11 (b) (1) which govern the retain-ability of nonutility businesses.

Under that construction, the court pointed out, "the holding company or its subsidiary must clear two hurdles. First, the company must show that its 'other business' is 'reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system.' . . . Once a company has cleared this hurdle, the Commission then looks to see whether the second sentence of Section 11 (b) (l) is adhered to, i.e., whether the retention of the 'other business' is 'necessary or appropriate in the public interest.'" The court agreed that the operation of a low-rent housing project did not meet the functional relationship test and that it was therefore not necessary for the Commission to reach the "public interest" question. [Footnote: The court also affirmed orders of the Commission which had denied motions for an "interim order" and "limited relief" filed subsequent to the issuance of its order denying the main application. These motions sought authorization to complete construction and financing of the projects during the period required to implement the divestiture order. The court noted that there had been no showing that denial of this relief would render any substantial harm to Michigan Consolidated, its investors, or any of its customers.]

Legislation has been introduced in the 92nd Congress (H.R. 6711 and S. 1991) to provide an exemption from the Act to permit registered holding companies to participate in low and moderate income housing programs. The bills are identical to those introduced in the 91st Congress.

In *National Utilities & Industries Corporatio*n, a hearing has been held on an application by National for an exemption as a holding company under Section 3 (a) (1) of the Act. National, which was organized in 1969, acquired all of the outstanding common stock of Elizabethtown Gas Company in an exchange of National stock for stock of Elizabethtown. National also has non-utility subsidiary companies which are engaged in such activities as data processing and computer services, exploration for gas, leasing an aircraft, and a travel agency business. The principal question is whether under the "unless and except" clause of Section 3 (a) the exemption should be denied in light of the fact that National has become engaged in activities unrelated to the retail gas utility business. At the conclusion of the hearing, the Division announced that it would oppose granting of an exemption to National. National and the Division waived an initial decision by the hearing examiner, and, subsequent to the close of the fiscal year, briefs were filed with the Commission.

Union Electric Company, an exempt holding company and an electric and gas utility company, filed an application relating to a proposal to acquire, through an invitation for tenders, the outstanding shares of common stock of Missouri Utilities Company, a nonassociate electric and gas utility company. A hearing commenced during the fiscal year to determine whether the proposed acquisition meets the standards of Section 10 of the Act and whether Union Electric should be granted an exemption pursuant to Section 3 (a) (2) thereof.

In *Columbia Gas System, Inc.*, a hearing was held on an application relating to the acquisition of the common stock of National Gas & Oil Corporation by Columbia. At the conclusion of the hearing, Columbia filed a brief in support of the acquisition. Thereafter, National terminated the agreement with Columbia, and Columbia's request to withdraw its application was granted.

FINANCING OF ACTIVE REGISTERED PUBLIC-UTILITY HOLDING COMPANIES AND THEIR SUBSIDIARIES

During fiscal 1971, 16 active registered holding-company systems issued and sold for cash a total of 72 issues of long-term debt and capital stock, aggregating $2,496 million, pursuant to authorizations granted by the Commission under Sections 6 and 7 of the Act. All of these issues were sold for the purpose of raising new capital. The table on page 174 presents the amounts and types of securities issued and sold by these holding-company systems.

The financing highlight of fiscal 1971 was the record volume of external financing by registered holding companies and their subsidiary companies. The total of $2,473 5 million of new securities publicly issued and sold for cash by these companies, as shown in the preceding table, represents the greatest volume of external financing by companies subject to the Act for any year since passage of the Act and is almost 1.5 times the volume of securities issued and sold the previous year. The amount of preferred stock issued in 1971 was 2.7 times the amount issued in 1970.

All of the senior securities were sold at competitive bidding except a $58,000,000 debenture issue of GPU, with an interest rate of 10¼ percent, which was sold pursuant to a rights offering to its common stockholders at principal amount. All of the common stock was issued and sold at competitive bidding except for 597,909 shares issued by Delmarva Power & Light Company, 3,800,000 shares issued by The Southern Company, and 3,000,000 shares issued by GPU. These shares were sold pursuant to rights offerings to common stockholders with the compensation to standby underwriters determined by competitive bidding except for GPU whose rights offering was not underwritten.

This unprecedented volume of financing was accompanied by continuing high interest and preferred dividend rates and the deterioration of ratios of earnings coverages for interest and preferred dividends. For the calendar year 1970, the 17 registered electric and gas holding-company systems earned their income deductions plus preferred dividend requirements an average 2.19 times (after taxes) as compared to 2.93 times in 1966 and 3.07 times in 1955.

PART VII
PARTICIPATION IN 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 in order to provide independent, expert assistance to the courts, the 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 a summary 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.

For purposes of carrying out its functions under Chapter X, the Commission has divided the country into five geographic areas. The New York, Chicago, San Francisco 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 fifth area.

SUMMARY OF ACTIVITIES

In the fiscal year 1971, the Commission entered its appearance in 19 new proceedings involving companies with aggregate stated assets of approximately $373.4 million and aggregate indebtedness of approximately $267.4 million. The corporations involved in these proceedings were engaged in a variety of businesses, including, among others, those manufacturing such diverse items as ice cream, furniture, education devices, soft drinks, data processing equipment and shoes, as well as such businesses as producing oil and gas, renting uniforms, refining beet sugar, providing computer services, leasing trucks, operating an insurance holding company, a school, nursing homes, automobile race tracks and helicopter and commercial airlines, and engaging in commercial finance and real estate development.

Including the new proceedings, the Commission was a party in a total of 114 reorganization proceedings during the year. The stated assets of the companies involved in these proceedings totaled approximately $1.4 billion and their indebtedness totaled approximately $1.1 billion. The proceedings were scattered among district courts in 36 states and the District of Columbia as follows: 12 in California; 11 in New York; 9 in Arizona; 7 in Pennsylvania; 6 in Texas; 5 each in Florida, Illinois, Indiana, and New Jersey; 4 each in Louisiana and North Carolina; 3 in Oklahoma; 2 each in Arkansas, Colorado, Hawaii, Kansas, Michigan, Nevada, Ohio, South Dakota, and Utah; 1 each in Connecticut, District of Columbia, Georgia, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Montana, Missouri, North Dakota, Tennessee, Virginia, West Virginia and Wisconsin.

During the year, 13 proceedings were closed. As of the end of the fiscal year the Commission was a party in 101 reorganization proceedings.

JURISDICTIONAL, PROCEDURAL, AND ADMINISTRATIVE MATTERS

In Chapter X proceedings in which it participates, 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.

In *Bermec Corporation*, the district court approved the debtor's petition over the opposition of several major creditors holding claims secured by liens on the debtor's motor vehicles. These creditors contended that the petition had not been filed in good faith, principally on the ground that it was unreasonable to expect that a plan of reorganization could be effected. The court of appeals, in accordance with the view urged by the Commission, affirmed, stating: "In sum, we cannot find the prospect so hopeless as to require setting aside the order below . . . the expressed intention of certain secured creditors to reject any plan that does not provide full payment ... is not enough to defeat the petition. Creditors have been known to change their minds when a plan is actually put on the table."

In *Maine Sugar Industries, Inc.*, an involuntary Chapter X petition was filed against the debtor and one of its wholly-owned subsidiaries by three unsecured creditors. As a result of a settlement with them, these creditors filed a motion to dismiss the petition. The court granted the motion over the Commission's objection that the motion papers failed to disclose adequately the terms of the settlement.

In *Federal Shopping Way, Inc.*, previously reported, the court of appeals affirmed the decision of the district court that debenture holders were not disqualified from joining in a creditor's petition for reorganization merely because they also held common stock of the debtor. The court also agreed that the appointment of a receiver *pendente lite* in an injunctive action filed by the Commission constituted the appointment of a receiver "in a pending equity proceeding," within the meaning of Section 131 (2) of Chapter X, and that one of the alternative requirements for an involuntary petition had therefore been met.

In *Kelly Development Company* a case in which the Commission was not participating, a lawyer who was an officer and stockholder of creditors of the debtor was appointed as general counsel to the Chapter X trustee. The Commission advised the attorney that he was not disinterested as required by Sections 157 and 158, and he resigned.

Four Seasons Nursing Centers of America, Inc., et al., includes a group of associated companies jointly engaged in the construction and operation of nursing centers. At the time they entered Chapter X, 45 centers were in operation and an equal number were in various stages of construction. Ownership of the centers was divided among a bewildering maze of partnerships and corporations, although their management was centralized in the principal debtor.

The reorganization trustee for the parent corporation caused a voluntary Chapter X petition to be filed in the same court for *Four Seasons Overseas, N.V.*, a wholly-owned subsidiary, which had been organized abroad with $3 million of capital provided by its parent. The subsidiary had issued and sold to European investors $15 million of debentures guaranteed by its parent, lent the $15 million proceeds to its parent and had $1,700,000 on deposit in American banks. Over objections raised by Finimtrust, S. A., a Luxembourg corporation (the indenture trustee under the trust indenture pursuant to which the debentures were sold), the reorganization court, as urged by the Commission, retained jurisdiction over the proceeding for the subsidiary, approved its petition for reorganization as filed in good faith and appointed the Chapter X trustee for the parent as trustee for the subsidiary. Finimtrust appealed from these rulings, and the

Commission filed a brief urging affirmance. After the close of the fiscal year the matter was settled and the appeals dismissed.

In the same proceeding a bank attempted to set off funds deposited by a subsidiary company in reorganization against the unpaid balance on a loan owed to the bank by the parent corporation. The district court, on petition of the reorganization trustee, ruled against the bank, which appealed. The Commission urged that the district court was correct in refusing to disregard the separate corporate entities of the parent and the subsidiary and in determining that it had summary jurisdiction to order the bank to turn over to the trustee the amount the bank sought to offset. The matter was settled by the parties prior to decision by the court of appeals, and the appeal was dismissed by stipulation. In this proceeding a number of disputes have arisen as to the status of property titled in a partnership in which a debtor was a general partner and operator but had outside partners. The court ruled that a partnership interest is property of the debtor within the meaning of Chapter X. In all cases but one, satisfactory settlements have been made with the other partners.

Serious charges of fraud have been made against debtors in various transactions and numerous class actions on behalf of shareholders are pending against debtors and their officers, accountants and underwriters. Several claims under the Securities Act, including one for $100 million, have been filed on behalf of the shareholders, but have not been resolved.

In *Landmark Inns of Durham, Inc.*, previously reported, the Commission opposed the petition of landlords asking the Chapter X court to declare a forfeiture of a lease of real property on which the debtor had constructed a motel, its principal asset. The Commission, citing *In re Fleetwood Motel Corp.*, had argued that it would be inequitable to permit the landlords to obtain the debtor's principal asset as a result of breaches of the lease which had been remedied by the Chapter X trustee.

The referee in bankruptcy denied the landlords' petition. The landlords filed a petition for review with the district judge who upheld the referee's decision. The landlords have appealed, and the Commission filed a brief supporting the district court's order. The matter is pending on appeal.

In *Los Angeles Land and Investments, Ltd.*, previously reported, after the close of the fiscal year the court of appeals, as urged by the Commission, affirmed the decision of the district court that, when an officer of the debtor filed proofs of interest and claims, the reorganization court had summary jurisdiction to allow a counterclaim filed by the reorganization trustee for breach of fiduciary obligation and for violation of a permanent injunction entered on consent in a prior action by the Commission. It held that summary jurisdiction exists even where the counterclaim did not arise in a strict sense from the same transaction, although it found that the officer's claims were sufficiently related to the trustee's counterclaim. The court of appeals stated that it was unable to distinguish the present case from Alexander v. Hillman, 296 U.S. 222 (1935), an equity receivership proceeding.

In *Manufacturers' Credit Corporatio*n, previously reported, the debtors, consisting of the parent and 25 affiliated and subsidiary companies, were engaged primarily in the business of operating bus lines in New Jersey and vicinity. Certain secured creditors made a motion for an order to allow them to reclaim the buses securing their claims. At the hearing before the referee these creditors argued that the debtor could not be reorganized within a reasonable time and that their security was being impaired in the meantime. The Commission urged that such drastic action was premature and that the trustee should be granted more time to explore various alternatives which might lead to some form of reorganization.

The referee recommended in his report that (1) the secured creditors be restrained from reclaiming their buses for at least four months from the date of the court's order on the referee's report, during which time they should be paid the sums set forth in a previous order of the court; and (2) if a plan of reorganization could not be proposed within this time, the trustee be directed to undertake thereafter the liquidation of the assets of the various debtor corporations. The district court has scheduled a hearing on the referee's report.

In *Canandaigua Enterprises Corporation*, previously reported, the Commission objected to the trustee becoming president of the reorganized company on the ground that under Section 158 a trustee must be disinterested not only at the outset but also during the proceeding and that to allow the trustee to assume the presidency of the reorganized company gives him an interest in the outcome of the reorganization not consistent with the policy of Section 158. The district court overruled the Commission's objections.

TRUSTEE'S INVESTIGATION

A complete accounting for the stewardship of corporate affairs by the 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.

In *R. Hoe & Co., Inc.*, the trustee, after conducting an extensive investigation into the affairs of the debtor, instituted suits against former principals of the debtor and the debtor's former independent public auditor alleging, among other things, mismanagement on the part of the principals, and negligent execution of professional duties on the part of the accountants, leading to the debtor's financial collapse. The trustee is seeking at least $40 million in damages from each of the defendants. The trustee also instituted suit to set aside security interests granted a factor, two banks, and two insurance companies, and to recover approximately $10 million transferred to them and a major supplier, alleging that such conveyances were fraudulent and constituted voidable preferences.

In *Webb & Knapp, Inc.*, previously reported, the court of appeals en bane held that, because no property of the debtor or "res" was involved, a Chapter X trustee does not have standing to assert a class claim on behalf of public debenture holders of the debtor against the indenture trustee for alleged misconduct or gross negligence, either in the reorganization proceeding or in a plenary action. The Chapter X trustee filed a petition for a writ of *certiorari*, which the Commission is supporting.

REPORTS ON PLANS OF REORGANIZATION

Generally, the Commission files a formal advisory report only in a case which involves a 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 reports. However, its views on twelve plans of reorganization were transmitted to the court either orally or by written memorandum.

In *Sunset International Petroleum Corporation*, the debtor had interests in some 5,000 producing oil and gas wells recorded on its books at a net of $40 million but valued for purposes of reorganization at about $18 million. Liabilities exceeded $59 million, including over $25 million of debt due its parent, Commonwealth United Corporation, consisting of about $14.8 million on an open account and about $10.8 million in debentures.

The Commission supported the trustee's plan of sale, under which the open account was disallowed for lack of proof. The Commission also supported the subordination of the Commonwealth debenture claims to the claims of other creditors, including debenture holders. Commonwealth had acquired control of Sunset when it was insolvent and, as the Commission noted, did very little during the three years after acquisition to relieve Sunset from its excessive indebtedness. The Sunset acquisition was used by Commonwealth for its own promotional ends, while keeping Sunset just "two jumps ahead of the wolf".

The Commission stated that the subordination of Commonwealth should not extend to notes of Sunset held by several banks. These banks originally held unsecured notes of Sunset. To obtain an extension of time, Commonwealth caused Sunset to convert the banks to a secured position. Subsequently the banks made substantial loans to Commonwealth, which, in turn, used part of the proceeds of the loans to acquire the Sunset notes from the banks. These notes, along with other assets, were then pledged to the banks as security for the Commonwealth loans. The banks thus became exclusively creditors of Commonwealth. As pledgees the banks asserted claims against Sunset on the notes. In the Commission's opinion, the banks, in seeking to realize on the pledge in the Sunset proceeding, were not entitled to the additional benefit they would receive by subordinating Commonwealth's other claims against Sunset to its claims as pledgor of the notes. The banks' share of the estate should be determined without regard to the Commonwealth subordination.

The plan was amended in this and other respects in accordance with the views of the Commission. As so amended, the plan was approved and confirmed by the court.

In *Riker Delaware Corporation*, previously reported, the Commission reported on three plans of reorganization, filed respectively by the trustees, the debtors, and stockholders. The Commission found the trustees' plan neither fair and equitable nor feasible. It urged that the other two plans would meet the statutory standards if amended in certain respects, and both plans were amended accordingly. The Commission advised the court that Sections 174 and 175 of Chapter X do allow the approval of more than one plan, and permit security holders to decide by a vote which plan they favor. The court approved and confirmed only the debtors' plan, as amended.

Under this plan, unsecured creditors would receive $250,000 in cash and 5 percent convertible debentures in the principal amount of $2.25 million, representing the value of their interest in the assets of the debtors. A secured creditor, the plan proponent, would supply $500,000 in cash for 1,440,000 shares of capital stock of the reorganized company. Preferred and common stockholders would receive 360,000 shares of new common stock, or 20 percent of the total to be outstanding, although creditors were not receiving full compensation for their claims.

The Commission stated that such stockholder participation in an insolvent debtor was fair and equitable. The proponent was entitled to all the common stock equity for the contribution of fresh capital, and the allotment, presumably for tax reasons, of 20 percent of the common stock to the old stockholders was a "gratuity" the proponent was free to grant since it was not at the expense of the creditors.

In *Arlington Discount Company* the debtor owned a large quantity of heavily mortgaged marginal real estate. Cash flow was about equal to the mortgage payments, plus a small amount for overhead. It appeared that an appreciable equity above the mortgage liabilities would be left if the properties were liquidated over a period of time. The plan of reorganization, as originally proposed, was based on an orderly liquidation by a reorganized company, a waiver of past mortgage defaults, and issuance of income debentures and common stock for the publicly held unsecured notes. The Commission objected to the plan because the terms of the debentures were so contingent as to make them illusory and deceptive. The plan was amended to provide for issuance of common stock only, and as amended it was confirmed and consummated.

In *Bankers Trust, et al.*, previously reported, a plan of reorganization which has been consummated provided for consolidating eight affiliated debtors and many subsidiaries into a new reorganized company, the payment of all debts except certain mortgage obligations assumed by the new company, and distribution of shares of the new company and surplus cash to the public certificate holders. The plan set aside assets sufficient to pay some $2 million in disputed secured claims, and discharged the asserted liens of the claimants on other assets considered surplus collateral. One creditor appealed, contending that he had an absolute right to retain all collateral until his claim was adjudicated. On the eve of oral argument, this creditor's claim was settled and paid, and the appeal became moot.

In *Peoples Loan and Investment Company*, a plan of reorganization, supported by the Commission, was approved and confirmed by the court. The plan incorporated a settlement of several causes of action on terms favorable to the estate. These included a claim against a bonding company based on dishonesty and mismanagement by former officers and directors which was settled for $90,000, and a claim for legal malpractice against a former attorney for the debtor which was settled for $75,000. The Chapter X proceeding resulted in a recovery of 57 percent to 60 percent for the 3,000 depositors whose claims constituted substantially all of the debtor's liabilities. According to the trustee's testimony, in a bankruptcy liquidation the depositors would have realized only about 5 percent of their claims.

In *Maryvale Community Hospital*, the court first approved a sale of the debtor's property for cash and thereafter approved a plan under which the bondholders of the debtor, the only remaining creditors, would receive the total net proceeds of the sale pursuant to the terms of the indenture, including principal, interest, interest on interest and a prepayment premium. The State of Arizona and the Health Facilities Planning Counsel of Arizona objected to the plan of distribution insofar as it provided for the payment of interest on interest and a call premium. The Commission expressed the view that the plan was fair and equitable except for the allowance of the call premium. On appeal the Commission filed a brief in support of its position below. The appeal was pending at the end of the fiscal year.

In *Los Angeles Land & Investments, Ltd.*, previously reported, the trustee's plan offered the public creditors a choice of selecting specific lots of California land owned by the debtor or receiving both debt and equity securities of the liquidating company. The old common stock, held by the principal promoter, was declared worthless.

The Commission urged in its report that since this was a liquidation, the court should not approve the issuance of any negotiable securities to the creditors but provide for the issuance of transferable, non-negotiable liquidating certificates. The trustee amended the plan to conform with the suggestions of the Commission, and the court approved and confirmed the plan as thus amended.

John Rich Enterprises, Inc., et al. involved debtor companies organized by their promoter for the purpose of developing and exploiting two novel devices. One of these was an automobile bumper that cushions the shock by means of a water release device. The other was a unit consisting of a chair, to which is affixed a small television set and a coin box. The unit was designed for installation in airports, railroad stations, bus terminals, etc. The financing came from the public which had been induced to invest over $5 million in these ventures.

Prior to the Chapter X proceeding the Commission had brought an injunctive action seeking to restrain violations of the registration and antifraud provisions of the Federal securities statutes by the debtors and by their controlling persons and the appointment of a receiver to conserve the debtors' assets. Without admitting or denying the allegations against them, the defendants had consented to the entry of injunctive decrees, which provided that the debtors would file Chapter X petitions.

Sometime before the Chapter X proceedings the debtors' managers converted the debtors into investment companies by transferring substantially all of their assets to two unaffiliated corporations in exchange for non-controlling stock interests in those corporations. Concluding that it would be unwise to attempt to rescind these conveyances, the trustee has endeavored to reorganize the debtors on the basis of their common stock interests in those companies.

The trustee proposed a plan for the television chair operations. It called for the merger of the company that was actually operating this business into one of the debtors, and for the issuance of half of the stock in the reorganized company to the investors who had entrusted their savings to the debtor. Since the company would be in dire need of capital, the plan proposed to raise fresh money by means of an offering of new stock to the old investors. This offering was to be made without registration under the Securities Act in reliance on Section 264a (2) of Chapter X, which exempts "any transaction in any securities issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property" from the Securities Act's registration and prospectus-delivery provisions (emphasis added).

The Commission found this plan unfeasible. Its memorandum pointed out that "the reorganized company will not only be engaging in a novel and an untested business, but will do so while it staggers under a mountain of debt". Noting that the reorganized company's capital structure was to consist of nine-tenths debt and one-tenth equity, the

Commission concluded that seldom, if ever, could such a capital structure be squared with Chapter X standards and that "this kind of finance is especially objectionable where, as here, the business that is to pay the debt has no earnings history at all and confronts a most uncertain future."

On the question of exemption from registration the Commission's memorandum stated:

"We do not suggest that the provisions of the Securities Act and of the Bankruptcy Act which permit companies in Chapter X to raise new money from old stockholders and old creditors pursuant to plans of reorganization are available only for securities of triple-A quality. Debtors who resort to Chapter X are usually in poor health: That is why they are there. It would be unreasonable to read Section 3 (a) (10) of the Securities Act and Section 264a (2) of the Bankruptcy Act as requiring a showing of top investment quality. But a showing of fairness and some credible evidence of intrinsic investment value is essential."

Indeed, the Commission pointed out, the very exemption from registration imposed upon the reorganization court a special responsibility to scrutinize the soundness of securities to be issued under a plan. It was particularly essential to do so in the present case in which the new stock was to be supported by an almost nominal book equity in an enterprise with no earnings history.

The Commission also took issue with the fairness of the plan. Fairness was questionable, the Commission thought, because a half-interest in the reorganized chair business was to go to a company that had never paid anything -- and that the plan did not obligate to pay anything -- for that interest. This company's right to that interest was founded on a pre-Chapter X contract between it and the debtors by which it had undertaken to obtain financing from others for the television chair venture. Since the trustee had at first questioned the validity of this contract, the Commission thought an evidentiary record was required to ascertain the reasons for his decision to abandon his objections to the contract. In this connection the Commission directed the attention of the parties and the court to the Supreme Court's holding in *Protective Committee v. Anderson*, 390 U.S. 414, 424-425 (1968) that "The requirements ... of Chapter X ... that plans of reorganization be both 'fair and equitable' apply to compromises just as to other aspects of reorganization."

Since the television chair business was still embryonic, the Commission considered any attempt to reorganize it now as premature, suggesting that another year of operation would permit a better-informed assessment of the situation. It observed that the trustee could well use this breathing spell to explore simpler plans than the rather involved merger scheme on which his present plan rested.

The trustee advised the court that he agreed with the tenor of the Commission's comments and that he deemed it best to defer a disposition of the debtors' interest in the television chair.

In *Standard Airways, Inc*., a non-participating case, the debtor's scheduled liabilities exceeded $3 million. Hence the plan of reorganization was referred to the Commission as required by Section 172 of the Bankruptcy Act. The proponent of the plan, a substantial creditor, proposed to exchange its claim against the debtor and additional cash and property for 80 percent of the reorganized company's stock. The balance of the stock would be distributed to several hundred trade creditors. The Commission's sole concern with the plan was the status under the Securities Act of the proponent's controlling stock interest in the reorganized company.

It was obvious that the proponent, a corporation, would control the reorganized company and that it would therefore be subject to the inhibitions that the Securities Act imposes on those who control issuers. The Commission observed that the exemption from registration in Section 264a (2) applied only to the immediate transaction between the debtor and the proponent, but not to any transaction thereafter. Hence, if the proponent was taking the stock directly from the issuer with a view to distribution, it was clearly an underwriter, and thus would be unable to dispose of any securities of the reorganized company, unless some exemption from registration were available at the time. If the proponent were taking for investment and not with a view to distribution, then the initial distribution should be treated as a private offering to the proponent, which but for Section 264a (2) would not be exempt under Section 4 (2) of the Securities Act because of the simultaneous distribution to the trade creditors. The Commission concluded that in either event a restrictive legend on the securities to be issued to the proponent would be appropriate.

The proponent agreed to the imposition of the restrictive legend. Thereafter the plan was approved, confirmed and consummated.

In *Hudson & Manhattan Railroad Company*, the Commission supported, and the court approved, a petition for authority to make an initial liquidating distribution of about $41 million to the debtor's Class A and Class B stockholders in accordance with the plan of reorganization, which had been consummated years ago. A total distribution of approximately $56 million will be made pursuant to the plan of reorganization, representing the proceeds of various condemnation awards and the interest thereon.

Some security holders objected to the distribution, contending that the debtor should be given the opportunity to depart from the reorganization plan for the purpose of exploring possible mergers. The Commission took the position, with which the court agreed, that since the plan had been substantially consummated, the liquidating dividend should be made as contemplated by the plan.

ACTIVITIES WITH REGARD TO 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 223 applications for compensation totaling about $7 million were reviewed.

In *TMT Trailer Ferry, Inc.*, previously reported, the Commission supported appeals by the Protective Committee for Independent Stockholders and its counsel from orders of the district court (1) awarding Committee counsel $10,000 in interim compensation and $5,000 interim reimbursement of expenses for services rendered over an 11-year period and (2) denying motions by the Committee and counsel (a) for a protective order against certain depositions which the Chapter X trustee's general counsel proposed to take of the individual members of the Committee and their counsel and (b) for instructions as to the future role of the Committee and its counsel in the Chapter X proceeding. The court of appeals reversed the orders of the district court.

It held, as urged by the Commission, that the amounts allowed by the district court were "grossly inadequate," and adopted the recommendation of the Commission made in the district court for $60,000 as interim compensation and an interim amount of $10,000 for expenses. In order to prevent unduly burdensome conditions which might prevent the Committee from utilizing the allowance, the court of appeals also adopted the Commission's suggestion that the amount allowed not be subject to vacation, setting aside, reduction or modification except upon proof that Committee counsel were legally disqualified to receive any allowance.

The court of appeals also held that the district court should have issued a protective order in order to prevent "undue harassment" and that "in the future the District Court should, in the firmest and most emphatic manner possible, state to the trustee and its counsel the absolute need of cooperation and harmony with the Protective Committee and its counsel to insure a proper determination and final wind-up of this reorganization." The court stated that "the Committee is entitled to participate fully in these proceedings. . . ."

After the trustee's petition for writ of certiorari was denied, the district court, upon remand, entered an order authorizing further discovery proceedings directed against the Committee and its counsel on grounds substantially identical to those which trustee's counsel had raised on appeal. After the close of the fiscal year, the Committee and its counsel petitioned the court of appeals for a writ of mandamus and prohibition directed to the district judge to require compliance with the previous decision of the court of appeals. The Commission supported this petition.

The district court awarded counsel for TMT's trustee compensation at a rate of $60 per hour for service rendered during the first half of 1970. The court of appeals granted the Protective Committee leave to appeal from that award. While this appeal was pending, the district court awarded interim compensation to the trustee's general counsel for services rendered during the last six months of 1970 and also granted interim compensation to the trustee's special counsel, each at a rate of $60 an hour. By leave of court, the Protective Committee appealed, and the two appeals were consolidated.

In its briefs the Commission pointed out that since the appointment of trustee's present general counsel in January of 1969 there had been almost no progress in the reorganization proceeding. The Commission noted that despite this lack of progress the district court had awarded such counsel approximately $150,000 in interim compensation for services rendered during the two-year period and urged that these awards were overly generous and tended to encourage procrastination. The Commission recommended that counsel be allowed interim compensation at a rate not to exceed $35,000 per year and that this amount be allowed only upon demonstration of substantial progress towards the reorganization of the debtor. The Commission further recommended that the special counsel receive interim compensation at a rate not to exceed $40 per hour. The appeals were pending at the close of the fiscal year.

The district court also entered an order *ex parte*, establishing a procedure for valuation of the debtor's estate, and providing that, in certain circumstances, compensation for services rendered by creditors and stockholders, or their representatives, would be precluded regardless of any benefits which such services might provide to the estate. The Commission urged deletion of this provision, stating that it was contrary to the purposes of Chapter X which provides for allowance of compensation to those who render beneficial services as an incentive to active and useful participation by all parties in the proceeding.

Another order issued ex parte authorized the trustee to bring certain admiralty suits, appointed the trustee's general counsel as special counsel to prosecute these suits, and fixed an hourly rate of compensation he was to receive as additional compensation should his efforts prove successful. The Commission pointed out that one of the reasons for counsel's appointment as general counsel was his expertise in admiralty law and that it was his duty to make that expertise available to the estate under his general appointment. The Commission also urged that a judicial commitment in advance to an hourly rate of compensation was not in accordance with the fee provisions of Chapter X which contemplate an allowance of compensation after services are rendered and then only on application and hearing upon proper notice.

The district court amended both orders as requested by the Commission.

In *Webb & Knapp, Inc.*, previously reported, counsel for the trustee and the trustee applied for fourth interim allowances of $200,000 and $25,000, respectively, for services rendered during a 22-month period. The Commission urged deferral of the requests, pointing to the substantial prior interim awards which had been allowed and the uncertainty as to the fate of the proceeds from the estate's virtual liquidation because of a disputed $35 million claim asserted by the Internal Revenue Service. The Commission also urged that, if the court decided to make any award to trustee's counsel, it should not exceed $75,000, and that no further interim award should be made to the trustee who had not rendered such substantial services as to warrant an interim award to alleviate economic hardship. The court allowed $20,000 to the trustee and $125,000 to counsel, noting that there was no reason to believe that any further interim allowances would be necessary.

In *Riker Delaware Corporation*, previously reported, the two trustees and their two attorneys sought second interim awards aggregating $40,000 and $50,000, respectively, for services rendered over a 3-year period. The Commission urged that, having received prior interim allowances for the earlier portion of the 3-year period, the applicants could not receive additional interim compensation for the same period, and that the pending applications should be considered as requests for compensation only for the last 15 months of the period. The Commission recommended that both trustees and one of their attorneys be denied interim awards since the time spent in the latter period was insubstantial. It recommended an interim award of $20,000 to the second attorney who had spent about 40 percent of his time on the estate. The district court granted interim awards to all applicants, including a total of $17,500 to the two trustees, and $2,500 to one attorney. The second attorney, who had sought $30,000, was allowed $15,000.

In *R. Hoe & Co., Inc.*, the trustee and his counsel sought "interim" compensation of $146,000 and $706,000, respectively, for services rendered over a one-year period. The Commission urged that the requests were excessive, because they reflected rates charged private clients, and that applicants were really seeking payment in full for services rendered during this period. The Commission further urged that the trustee, although an attorney, was not appointed to render legal services and any interim allowances to him should reflect services he rendered in his capacity as chief executive officer of the estate. The Commission recommended interim allowances of $40,000 and $185,000, respectively.

An application for compensation in the amount of about $235,000 was also filed by the accounting firm retained by the trustee. Although rates of compensation for the accountant are normally fixed in the order of retention, no rates were set in this case. The Commission opposed the request since it appeared that the average rate was far above that at which the same firm was being paid for services in other large Chapter X proceedings in the jurisdiction of this district court. The Commission recommended about $142,000 as a final allowance, or payment in full, for the period covered by the application.

The district court awarded the following interim allowances to the three applicants: $50,000 to the trustee; $350,000 to his counsel; and $150,000 to the accountants.

In *Canandaigua Enterprises Corporation*, previously reported, the trustee requested a final allowance of $750,000, including prior interim awards, for services rendered by himself and his law firm over a period of almost six years. The Commission contended that the request was excessive and urged that the application be viewed as separate requests for final allowances by the trustee and his law firm, since the services rendered were by separate persons and distinguishable. It recommended final allowances of $180,000 and $60,000 to the trustee and his law firm, respectively, but the court granted a single award of $310,000, including $200,000 previously awarded as interim compensation.

INTERVENTION IN CHAPTER XI PROCEEDINGS

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.

In *Viatron Computer Systems Corporation*, the debtor was engaged in the business of developing, manufacturing and selling data processing and computer systems. It had outstanding nearly $15 million in principal amount of convertible debentures held by over 1,200 persons, and over 3.5 million shares of common stock held by more than 7,500 persons. For its first three years of operations ended October 31, 1970, the debtor sustained operating losses of approximately $40 million on gross sales of about $3.2 million. At the time of the filing of the petition, the debtor had a net asset deficit of about $23 million and no working capital.

After a default in interest payments, creditors filed a bankruptcy petition. The debtor filed a Chapter XI petition, which stayed the bankruptcy proceeding. The proposed Chapter XI arrangement provided that all the outstanding unsecured debt of approximately $25 million, including the publicly-held debentures, would be converted into common stock at a prescribed ratio.

The Commission made a motion pursuant to Section 328, urging that the financial condition of the debtor called for more than a simple composition of unsecured debt, and that fairness to public creditors, and the need for a disinterested investigation to account, among other things, for the dissipation of approximately $35 million in public funds over a period of 14 years, required the broader scope and protections of Chapter X.

The debtor, the trade creditors' committee, and the debenture holders' protective committee opposed the motion, but it was granted by the district court. Creditors thereupon filed an involuntary Chapter X petition, which the debtor opposed and the Commission supported. The court approved the petition and appointed a trustee.

In *Federal Coal Company*, previously reported, the debtor's appeal from the district court's order granting the Commission's Section 328 motion was withdrawn, and a voluntary Chapter X petition was filed. After the close of the fiscal year, the debtor's controlling persons moved for the dismissal of the Chapter X proceeding on the ground that during the course of the proceeding they had acquired virtually all of the claims against the company. The Commission and the trustee opposed that motion, which is pending.

In *Fotochrome, Inc.*, the debtor had outstanding 3,463,036 shares of common stock and $2,450,000 of debentures held by approximately 11,000 and 500 members of the public, respectively. The debtor proposed a Chapter XI arrangement which provided for payment in full over a period of 7 years of the approximately $2.5 million owed to trade creditors. The debenture holders were offered common stock of the debtor for 50 percent of their claims at a price of $3.33 per share. The remaining 50 percent would be paid at the end of a ten-year period without interest, with a right to convert into additional common stock at specified rates ranging from $3.33 to $5.00 per share. The Commission moved for dismissal pursuant to Section 328, urging that Chapter XI did not permit such a radical adjustment of the rights of public debenture holders.

The debtor amended the proposed arrangement so as to provide, among other things, that the debtor would pay debenture holders past due principal and interest upon confirmation of the arrangement and make all future payments when due. The Commission thereupon withdrew its motion on condition that the amended arrangement be confirmed by the court.

In *Super Stores, Inc.*, the Chapter XI debtor operated a chain of small variety stores along the Gulf Coast from Alabama to Louisiana. It had about $4 million in liabilities, including some $1 million of publicly-held 6½ percent debentures, due in 1981, which were subordinated to all other unsecured debts. The debtor's common stock was also publicly-held.

The proposed plan of arrangement provided that the non-public unsecured creditors would receive 55 percent of their claims payable in installments over a period of five years from confirmation. The claims of the debenture holders would also be reduced to 55 percent of principal amount, but such reduced amount would mature in 1981, with sinking fund obligations to commence five years after confirmation. Interest on the debentures was to be waived for five years and then to be payable at 3½ percent on the original principal sum.

Since the debtor proposed to effect a drastic revision in the rights of its public creditors, the Commission, together with an individual debenture holder, moved under Section 328 to dismiss the debtor's Chapter XI petition unless the proceedings were transferred to Chapter X. The motions were opposed by the debtor and various creditors. After an evidentiary hearing and oral argument, the district judge denied the motions and a motion for rehearing, and the debenture holder appealed.

While the appeal was pending the arrangement was amended to provide that the claims of debenture holders would only be reduced to 75 percent of the principal amount. In addition, the debenture holders would receive, immediately upon confirmation, 725 shares of common stock for each $1,000 principal amount of debentures presently outstanding, thereby giving the debenture holders a substantial amount of the common stock to be outstanding. Payment to other unsecured creditors was to remain at 55 percent as originally proposed.

The Commission, although somewhat doubtful about the feasibility of the arrangement, decided not to object to confirmation of the amended arrangement, and the debenture holder withdrew his appeal. The arrangement, as amended, was confirmed.

In *Nationwide Investment Corporation*, the Chapter XI debtor had been in the securities business but left it after having been enjoined from further violations of the Federal securities statutes. Its principal creditors were the public investors with whom it had dealt while in the securities business. The debtor's proposed plan of arrangement called for the liquidation of its estate and for the distribution of the proceeds to its creditors -- except for the sum of $100,000 which was to be returned to the debtor's managers for "investment" in whatever fashion they saw fit. The scheme rested on the hope that these unspecified investments would prove productive enough to permit all creditors to be paid in full, leaving a residue that would inure to the benefit of the debtor's stockholders. When the bankruptcy court asked for the Commission's views, the Commission pointed out that nothing in Chapter XI sanctioned a proposal of this character and that because of its vagueness the plan did not meet that chapter's feasibility requirements, and it stated that in its view the debtor's public creditors would be better off if the estate were liquidated *in toto* in ordinary bankruptcy. The court refused to confirm the plan and adjudicated the debtor a bankrupt.

As was noted in last year's annual report, attempts are sometimes made to misuse Chapter XI so as to deprive investors of the protections which the Securities Act and the Securities Exchange Act are designed to provide. When such cases come to the attention of the Commission's staff, it normally attempts to resolve the problem by informal negotiations with the debtor's counsel. When negotiations prove fruitless or there appears to be a deliberate effort to evade these statutes, the Commission, in order to discharge its statutory responsibilities for protection of investors, intervenes in the Chapter XI proceeding to assist in the development of 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.

In *Transystems, Inc*., a publicly-held company caused one of its wholly-owned subsidiaries to file a Chapter XI petition. The proposed plan of arrangement called for the distribution, without registration under the Securities Act, of the parent's stock to the debtor-subsidiary's creditors, none of whom were public investors. One of these creditors moved to dismiss the Chapter XI proceeding under Section 328. That same creditor also objected to the plan of arrangement on various grounds, one of which was that the unregistered distribution of the parent's stock called for by the plan violated the Securities Act because the exemption under Section 393 a (2) of Chapter XI did not apply. That section exempts from registration, among other things, "any transaction in any security issued pursuant to an arrangement in exchange for claims against the debtor." The Commission did not intervene, but, at the request of the referee, commented as a friend of the court on some of the issues presented.

Read literally, the exemption seems not to be limited to securities issued by the debtor. The Commission urged, however, that the provision must be interpreted in the light of the statutory policy, and that the exemption does not necessarily extend to securities issued by a corporation other than the debtor, since Chapter XI was designed primarily for simple compositions under which securities of the debtor are issued in exchange for claims against it.

The Commission pointed out that it was not necessary for the bankruptcy court to resolve definitively all questions raised in a Chapter XI proceeding regarding the application of the Securities Act. It stated:

"When a close question regarding the registration requirements of the Securities Act is presented in a particular Chapter XI proceeding, it is sufficient if the Commission assures the court that on the facts before it the Commission will not seek to upset the contemplated transactions by invoking the Securities Act."

The Commission said that in this case it would raise no objection regarding the claimed exemption and that

"We believe this advisory determination sufficient to free the court from any further concern with the impact of Section 5 of the Securities Act on the debtor's proposal, which may thus be appraised solely on its merits in terms of the Chapter XI requirements for confirmation."

The Commission took the position that the proposed arrangement was objectionable on three grounds: (1) the materials used in soliciting the trade creditors' assent were misleading and inadequate; (2) the parent's stock on which the bankruptcy court was being asked to place its stamp of approval was of a speculative character; and (3) the president of the debtor, who was also a creditor, was to be accorded different treatment in that he was to receive common stock of the debtor rather than of its parent.

The referee refused to confirm the arrangement. He rejected the debtor's contention that approval was required because its parent's stock was selling on the market for "something", and held that:

"While the bankruptcy court ordinarily does not directly supervise or review the soliciting of acceptances in Chapter XI cases, this is true primarily because the ordinary simple composition of debts involved in such cases, for cash consideration, requires very little in the way of additional disclosure beyond that given by the Court in the statutory notice. However, when corporate stock is being distributed under the plan, particularly when the stock is not that of the debtor itself, the question of adequate disclosure of relevant information becomes more pertinent. . . Accordingly, the bankruptcy court has a duty ... to prevent issuance of unsound or deceptive securities as a result of a judicial proceeding. . . . One way to facilitate meaningful scrutiny by the Court is to require adequate disclosure of relevant facts to the parties in interest -- thereby assuring effective adversary hearings when appropriate. . . .

"While a Chapter XI solicitation letter involving a stock distribution need not give the extensive detail that an SEC registration would, it should give basic financial data concerning the corporation whose stock is being issued under the plan -- in order that the creditors may make an informed judgment as to accepting or rejecting the plan, or objecting to confirmation thereof."

In *Greater Western Home Manufacturers*, the debtor had during the course of the Chapter XI proceeding acquired a substantial quantity of the stock of another corporation directly from the issuer in a transaction that was not registered under the Securities Act of 1933. At the time of the acquisition the debtor represented that it was taking these shares for investment, and the issuer and its counsel accordingly viewed the transaction as one "not involving a public offering" and therefore exempt from the Securities Act's registration requirements under Section 4 (2) of that statute. Some months thereafter the debtor obtained an order from the bankruptcy court authorizing it to sell the securities to the public through a broker. In that order the referee found that there was no "practical need" for registration since the security in question was listed on several exchanges and abundant information with respect to it was available to the public.

The Commission intervened in the Chapter XI proceeding for the limited purpose of preventing the violation of the Securities Act that the referee had purported to authorize. It pointed out that the debtor was an "underwriter" of the securities that it proposed to sell, within the meaning of the Securities Act, and that public sales by it would require registration, and it urged that there was no legal basis for the referee's "practical need" rationale. The debtor thereupon arranged for a private sale, and the referee vacated the order to which the Commission had objected.

In *Gibson Products Company of Lodi, California, Inc*., and in *Cable Car Burgers, Inc*., Chapter XI plans of arrangement were proposed calling for issuance to creditors, without registration under the Securities Act, of large quantities of the stock of a corporation (the proponent of the plans) that wished to acquire both debtors. The debtors and the proponent considered that these transactions would be exempt from the registration requirements by reason of Section 393a (2).

Because the cases presented questions of moment under both the registration and the antifraud provisions of the Federal securities statutes, the Commission intervened in both proceedings. The

Commission pointed out that since the stock which the creditors would receive was to be issued by an entity other than the debtors, the availability of the claimed exemption was highly doubtful, and that it might therefore well be that both plans would run afoul of the Securities Act. However, the Commission did not choose to press this point. Instead, it stressed the character of the proponent's history and the deceptive nature of the materials that had been used to solicit creditors' consents.

In *Cable Car Burgers* the bankruptcy court refused to confirm the proposed plan and adjudicated the debtor a bankrupt. In *Gibson Products* the plan was amended to provide for the issuance of the debtor's own shares to its creditors. To that amended plan the Commission raised no objection.

In *Sveden House of Texas, Inc.*, the court confirmed a Chapter XI arrangement, its order reciting that the Sveden stock to be issued thereunder was to be issued pursuant to the Section 393a (2) exemption. Pursuant to the arrangement, stock was issued to creditors but one block of stock was sold for cash to a purchaser who was not a creditor.

Subsequently, the debtor and that purchaser sought to enjoin the Commission from interfering with any resale by him without registration. The court agreed with the Commission that the Commission was not bound by the order confirming the arrangement and declined to take jurisdiction to restrain the Commission since, notwithstanding the recitals in the order, it appeared that the exemption did not extend to the issue and sale of securities to persons who were not creditors.

Meter Maid Industries, Inc. and *Language Laboratories, Inc.*, involved publicly-held debtors that had dissipated almost all of their assets and had ceased doing business in any real sense. In each case a plan of arrangement was proposed calling for the issuance of large quantities of new stock to the creditors in reliance upon the Section 393a (2) exemption.

The Commission suggested that the proposed securities would be spurious and that their issuance without registration under the

Securities Act was precluded by the standards implicit in Chapters X and XI of the Bankruptcy Act. Both debtors were adjudicated bankrupt.

Studio Creative Crafts, Inc. and *Universal Topics, Inc.*, involved small, closely-held debtors. In the Studio case, the debtor's assets consisted of an unsuccessful retail ceramic shop. In the other the debtor had been formed for the purpose of publishing one book which never saw the light of day.

In both cases the proposed plan of arrangement called for the issuance of massive quantities of stock in each of several as yet unformed corporations to the creditors and to the private "investment groups" which had undertaken to supply the modest amounts of cash needed to pay off the priority creditors. These private investors were to pay a small fraction of a cent per share for their stock.

The Commission pointed out that after the consummation of these plans of arrangement the debtors would be multilevel corporate shells, with public investors at all levels, and little in the way of assets and business. It suggested that plans of arrangement of this type, motivated primarily by stock market considerations rather than by any serious desires to rehabilitate a business, lacked the "good faith" required by Section 366 (4) of Chapter XL Neither plan was confirmed, and both debtors were adjudicated bankrupt.

84 The Commission pointed out that it was doubtful that the exemption found in Section 393a (2) of Chapter XI applied to such an offering. See the discussion of Transystems, Inc. at pp. 199-200, supra.

PART VIII
SUPPORTING ACTIVITIES

PUBLIC INFORMATION SERVICES DISSEMINATION OF INFORMATION

As the discussion in prior sections of this Report indicates, most large corporations in which there is a substantial public investor interest have filed registration statements or registration applications under the Securities Act or the Securities Exchange Act with the Commission and are required to file annual and other periodic reports. Widespread public dissemination of the financial and other data included in these documents is essential if public investors generally are to benefit by the disclosure requirements of the securities laws. This is accomplished in part by distribution of the prospectus or offering circular in connection with new offerings. Much of the data reflected therein and in the annual and other periodic reports is also reprinted and receives general circulation through the medium of securities manuals and other financial publications, thus becoming available to broker-dealer and investment adviser firms, trust departments and other financial institutions and, through them, to public investors generally. The documents mentioned above are also available for public inspection both at the offices of the Commission and at the exchanges on which particular securities may be listed.

Various activities of the Commission also facilitate public dissemination of information filed as well as other information. Among these is the issuance of a daily "News Digest" which contains (1) a resume of each proposal for the public offering of securities for which a Securities Act registration statement is filed; (2) a list of issuers of securities traded over the counter which have filed registration statements under the Securities Exchange Act; (3) a list of companies which have filed periodic reports disclosing significant corporate developments; (4) a summary of all notices of filings of applications and declarations, and of all orders, decisions, rules and rule proposals issued by the Commission; (5) announcements of the Commission's participation in corporate reorganization proceedings under Chapter X of the Bankruptcy Act and of the filing of advisory reports of the Commission on the fairness and feasibility of reorganization plans; (6) a brief report regarding actions of courts in litigation resulting from the Commission's law enforcement program; and (7) a brief reference to each statistical report issued by the Commission.

The News Digest is made immediately available to the press, and it is also reprinted and distributed by the Government Printing Office, on a subscription basis, to some 5,000 investors, securities firms, practicing lawyers and others. In addition, the Commission maintains mailing lists for the distribution of the full text of its orders, decisions, rules and rule proposals.

These informational activities are supplemented by public discussions from time to time of legal, accounting and other problems arising in the administration of the Federal securities laws. During the year, members of the Commission and various staff officers made speeches before a number of professional, business and other groups interested in the Federal securities laws and their administration and participated in panel discussions of like nature. Participation in these discussions not only serves to keep attorneys, accountants, corporate executives and others abreast of developments in the administration of those laws, but it also is of considerable value to the Commission in learning about the problems experienced by those who seek to comply with those laws. In order to facilitate such compliance, the Commission also issues, from time to time, general interpretive releases and policy statements explaining the operation of particular provisions of the Federal securities laws and outlining policies and practices of the Commission.

Publications. -- In addition to the daily News Digest, and releases concerning Commission action under the Acts administered by it and litigation involving securities violations, the Commission issues a number of other publications, including the following:

Weekly:

Weekly trading data on New York Exchanges: Round-lot and odd-lot transactions effected on the New York and American Stock Exchanges (information is also included in the Statistical Bulletin).

Monthly:

Statistical Bulletin.

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

Quarterly:

Financial Report, U.S. Manufacturing Corporations (jointly with the Federal Trade Commission). (Statistical Series Release summarizing this report is available from the Publications Supply Unit.)

Plant and Equipment Expenditures of U.S. Corporations (jointly with the Department of Commerce).

New Securities Offerings.

Working Capital of U.S. Corporations.

Stock Transactions of Financial Institutions.

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.

Private Noninsured Pension Funds (assets available quarterly in the Statistical Bulletin).

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.)

Securities and Exchange Commission -- The Work of the Securities and Exchange Commission.

Commission Report on Public Policy Implications of Investment Company Growth

Cost of Flotation of Registered Equity Issues, 1963-1965.

Report of SEC Special Study of Securities Markets. (Out of print, available only for reference purposes in SEC Washington, D. C. and Regional Offices.)

Institutional Investor Study Report of the Securities and Exchange Commission (1971) -- Eight Parts, H. Doc. No. 64 (92nd Cong.)

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.

AVAILABILITY OF INFORMATION FOR PUBLIC INSPECTION

The many thousands of registration statements, applications, declarations, and annual and periodic reports filed with the Commission each year are available for public inspection and copying at the Commission's public reference room in its principal offices in Washington, D.C. Also available at that location are other documents contained in Commission files and indexes of Commission decisions.

The categories of materials which are available for public inspection and copying are specified in the Commission's rule concerning records and information, 17 CFR 200.80, as revised t implement the provisions of the Public Information Amendment to Section 3 of the Administrative Procedure Act which became effective July 4, 1967. The rule also establishes a procedure t be followed in requesting records or copies thereof, provides ; method of administrative appeal from the denial of access to an; record, and provides for the imposition of fees when more than one-half man-hour of work is performed by members of the Commission's staff to locate and make available records requested.

The Commission has special public reference facilities in the New York and Chicago 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 pursuant to the Securities Exchange Act by companies having their principal office in the region, recent annual reports and quarterly reports filed pursuant to 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 indexes of Commission decisions Additional material is available in the New York and Chicago regional offices.

Members of the public may make arrangements through the Public Reference Section at the Commission's principal offices 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 8 ½" 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 a public reports filed on Forms 10-K, 10-Q, 8-K, N-1Q and N-17 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 whose securities are listed on the New York Stock Exchange, the American Stock Exchange, or regional stock exchanges or traded over the counter and standard industry classifications (S.I.C.). Arrangements also may be made to subscribe to reports of companies of one's own selection. Over one hundred million pages (microimagery frames) annually are being distributed to the user community. The subscription services system may be extended to further groups of filings in the future if demand warrants. The company also will supply, at reasonable prices, 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 public reference areas in the Commission's headquarters office and New York Regional Office, and sets of the microfiche are available for inspection there.

Visitors to the public reference rooms of the Commission's Washington, D.C., New York and Chicago offices also may make immediate reproductions of material in those offices on coin-operated copying machines at a cost of 25 cents per 8½" x 14" 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 service and copies may be obtained from the Public Reference Section of the Commission.

Each year, many thousands of requests for copies of and information from the public files of the Commission are received by the Public Reference Section in Washington, D.C. During the 1971 fiscal year, 12,435 persons examined material on file in Washington and several thousand others examined files in New York, Chicago, and other regional offices. More than 28,628 searches were made for information requested by individuals, and approximately 3,667 letters were written with respect to information requested.

LITIGATION INVOLVING PUBLIC INFORMATION PROVISIONS OF THE ADMINISTRATIVE PROCEDURE ACT

The public information provisions of the Administrative Procedure Act, among other things, require agencies, including the Commission, to make records maintained by them available to members of the public. The Act contains various exemptions from the general disclosure requirements, the meaning of certain of which was the subject of litigation involving the Commission during the fiscal year. In *M. A.*

Schapiro & Co., Inc. v. S.E.C. plaintiff asked that the Commission be required to make public a staff study on Rule 394 of the New York Stock Exchange and transcripts of testimony and other records obtained in the course of an investigation of the rule. The Commission has taken the position that these documents are exempt from disclosure under various exemptive provisions, including those for "investigatory files compiled for law enforcement purposes," matters that are "contained in or related to examination, operating, or condition reports prepared . . . for the use of an agency responsible for the regulation or supervision of financial institutions," information "specifically exempted from disclosure by statute" and "commercial or financial information [which is] privileged or confidential." In addition the Commission has urged that the staff study is an intra-agency memorandum exempt from disclosure under the Act. As of the end of the fiscal year, the plaintiff's motion for a preliminary injunction was pending in the district court.

In *Frankel v. S.E.C.*, plaintiffs seek access to the contents of an investigatory file which was the basis of a civil enforcement action resulting in injunctions against future violation of the securities laws. The Commission has asserted that the documents requested are exempt from the disclosure requirements of the Act as investigatory files compiled for law enforcement purposes, matters that are specifically exempted from disclosure by statute, and commercial or financial information which is privileged and confidential. Preliminary motions were pending before the court at the end of the fiscal year.

In *Commercial Envelope Mfg. Co., Inc. v. S.E.C.*, a petition was filed in the Court of Appeals for the Second Circuit to review the Commission's refusal to make public a document obtained from an informant relating to the completeness and accuracy of a registration statement filed under the Securities Act. The Commission's motion to dismiss the petition for lack of jurisdiction was denied without prejudice to renewal at the time of briefing on the merits. The Commission contends that the document is exempt from disclosure as commercial or financial information which is privileged and confidential and as part of an investigatory file compiled for law enforcement purposes. It further contends that the district courts have exclusive jurisdiction over public information cases.

ELECTRONIC DATA PROCESSING EXTENSION OF APPLICATION OF AUTOMATION TECHNIQUES

During the 1971 fiscal year the Commission continued the improvement of existing EDP systems and progressed in the development of planned systems described in previous annual reports.

In a further extension of the use of automation for analysis of data related to the financial structure of business and the economics and practices of the securities industry, several new EDP systems have been developed. One of these is a system for assessing developments in corporate liquidity by analyzing liquid asset holdings of approximately 850 large non-financial corporations registered with the Commission. Another new system related to a survey of factors influencing 1970 and 1971 business investment. It provided statistical data on developments in the years 1969-70 which may have resulted in changes in selected companies' actual investment in 1970 and expected investment in 1971.

The Commission also implemented a system involving statistical data on issues registered under the Securities Act of 1933, private placements, and issues of Federal, State and local governments and other securities exempt from registration under the Securities Act. This system produces data for the Commission's Statistical Series releases and for special studies concerning the cost of flotation of new issues, the yield structure of corporate debt placed privately, the maturity distribution of debt securities, and the selling arrangements for new issues.

In addition, detailed systems design and computer programming work was begun on an automated system which will provide data for a study of the potential impact on the mutual fund industry of the repeal of Section 22 (d) of the Investment Company Act. This project is being conducted in conjunction with a related study being undertaken by the National Association of Securities Dealers.

EDP applications currently under development include a system for processing reports of security holdings and transactions of corporate insiders and the automated preparation of the "Official Summary" of insiders' transactions and holdings published by the Commission.

As time and other resources permit, the use of EDP will be extended to other areas of Commission activities.

ASSISTANCE TO STATE AND FEDERAL AGENCIES

The Commission continued during the past year to provide certain information from its computer files to State authorities, self-regulatory institutions and Federal agencies as described in previous annual reports.

SHARING OF EDP FACILITIES

During the past fiscal year the Commission entered into sharing arrangements with the General Accounting Office and the National Weather Service. Under these arrangements the Commission provides a total of approximately 300 hours of computer time per year at a significant savings to the Government as compared with the prevailing rates of commercial facilities.

EDP TRAINING

During the year the Commission continued its training programs geared to the specific needs of its computer specialists and operators. The program is designed to enable the Commission's EDP staff to utilize more advanced hardware and software in the development and implementation of new and revised computer systems.

PERSONNEL AND FINANCIAL MANAGEMENT

PERSONNEL PROGRAM

In fiscal 1971 the Commission experienced a sharp decline in its turnover rate, as a consequence of which recruiting activity had to be halted or drastically reduced throughout most of the year. However, in the face of this general curtailment of job opportunities, the SEC continued its efforts to implement its various special hiring programs, notably in the areas of equal employment opportunity, and in utilizing the special authority for making "Veterans Readjustment Appointments." The Com mission was successful in attracting to its staff a number of qualified minority individuals and women. In some instances these were first-time appointments of such persons for the positions involved. Many of the Commission's clerical jobs were filled by the appointment of veterans recently discharged after military service in Vietnam.

With the cooperation of the law schools involved, the Office of Personnel arranged for the assignment of law students to the SEC as uncompensated Student Observers, with a view to giving them an opportunity to study first-hand the Commission's operations and activities. Under this program, the students spend 10 to 15 hours a week at the SEC. Some of them receive academic credit for this activity as part of their law school education. During the fiscal year, three of the law students who had served as Student Observers were hired as permanent members of our legal staff.

The Office of Personnel conducted an in-depth evaluation of the Commission's EEO Action Plan which was designed to assess past results and develop affirmative action for the future. Each office and division was asked for short and long-range objectives in this area, and the Office of Personnel aided the operating officials in establishing realistic and meaningful goals for equal employment opportunities for present staff members and for future recruitment needs and goals. A revised EEO Action Plan has been prepared incorporating additional means for furthering the aims of the EEO Program.

As a result of a special election, the Commission granted the AFGE Local 2497 exclusive bargaining rights for all non-supervisory general schedule and wage grade employees in the Headquarters Office. The only other union local with exclusive recognition in the Commission is located in the New York Regional Office.

The Commission's Sixteenth Annual Service and Merit Awards Ceremony was held in November 1970. Distinguished Service Medals were awarded by the Commission to Nellye Thorsen, Assistant Secretary of the Commission; Alexander J. Brown, Jr., Regional Administrator of the Washington Regional Office; and Aaron Levy, Associate Director of the Division of Corporate Regulation. Ten employees were given 35-year pins for SEC service and eight employees received pins for 30-year SEC service; within-grade salary increases in recognition of high quality performance were granted to 24 employees; and cash awards totaling $8,875 were presented to 37 employees for superior performance, special service or adopted suggestions.

The Commission is singularly proud of the special recognition accorded Philip A. Loomis, Jr., General Counsel of the Commission (subsequently appointed Commissioner), by the District of Columbia Chapter of the Federal Bar Association when it presented him with its Annual Justice Tom C. Clark Award. That award is presented to one lawyer in Government service in recognition of superior and exceptional professional performance in the career service. The award, which was signed by Chief Justice Warren E. Burger, Attorney General John N. Mitchell, and other members of the selection committee, stated in part:

"Your expert abilities in the highly specialized field of federal securities law have been an invaluable assistance to the Securities and Exchange Commission, where you are presently the General Counsel, in its important service to the public. Your distinguished accomplishments have contributed to the preservation of confidence by the individual investor in the integrity of the capital markets of the nation and have advanced the cause of investor protection."

PERSONNEL STRENGTH; FINANCIAL MANAGEMENT

The following comparative table shows the personnel strength of the Commission as of June 30, 1970 and 1971.

[table omitted]

The table on page 216 shows the status of the Commission's budget estimate for the fiscal years 1967 to 1972, from the initial submission to the Congress to final enactment of the annual appropriation.

The following table shows the Commission's appropriation, total fees collected, percentage of fees collected to total appropriation, and the net cost to the taxpayers of Commission operations for the fiscal years 1969, 1970 and 1971.

[table omitted]

The Commission is required by law to collect fees for (1) registration of securities issued; (2) qualification of trust indentures; (3) registration of exchanges; (4) brokers and dealers who are registered with the Commission but who are not members of a registered national securities association (the National Association of Securities Dealers (NASD) is the only such organization) ; and (5) certification of documents filed with the Commission.