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Although the *Standard Oil* case did not deal with copyrights, the statements made by the Court as to intangibles are certainly applicable to copyrights. Based upon the *Standard Oil* rationale and the fact that state courts are competent tribunals for the determination of assignments and titles to copyrights,[106] it appears logically consistent that state courts are the proper forums for copyright mortgage foreclosure.

Conclusion

The copyright has until recently been predominantly used by those in the entertainment industry. However, today other commercial enterprises are realizing the value of copyrighting. The toy industry, the game industry, and any of the many industries which utilize designs, such as the clothing or container industries are beginning to take advantage of the copyright laws. These businesses, especially the smaller ones, might find it very desirable to offer a copyright as collateral. However, if a creditor is going to accept the copyright as security, then the copyright must be readily marketable and the security interest in the copyright must be capable of adequate perfection.

If the lack of decisional law is a forecast of the impracticality of mortgaging the copyright, it is due to the ambiguity in the law and not to any inadequacy of the copyright as personalty.

THE SECURITIES ACTS AMENDMENTS OF 1964: EFFECT ON THE OVER-THE-COUNTER MARKET

The diversity and lack of organization of the over-the-counter markets have continuously perplexed those seeking to regulate them. The framers of the Securities Exchange Act stated that both the exchange and the over-the-counter markets were "affected with a national public interest."[1] However, the Act of 1934, while subjecting the exchange markets to detailed regulation, did not provide like provisions for the over-the-counter markets. Rather, it granted to the Securities and Exchange Commission broad rule-making power in relation to the over-the-counter market, without, however, providing any guidelines for the exercise of

[106] See cases cited note 100 *supra*.

[1] Securities Exchange Act of 1934, § 2, 48 Stat. 881, 15 U.S.C. § 78b (1958).

that power.[2] During the following years, both the Commission and the National Association of Securities Dealers, which utilized the principle of self-regulation established by the Maloney Act,[3] made significant advances in regulating the over-the-counter markets and raising the business standards of its participants.[4] Despite these advances, there has been a persistent effort to extend to unlisted securities the disclosure and other safeguards applicable to listed securities.[5] Generally, the problems involved in effecting such extended coverage have been: (1) the precise scope and standards of coverage, and (2) the impact of the insider-trading provisions on broker-dealers who are also corporate insiders.[6]

The resolution of these problems finds expression in the Securities Acts Amendments of 1964,[7] which effect a sweeping extension of the authority of the SEC in the field of federal securities regulation. The purpose of this note is to discuss the scope of those provisions of the new law which extend federal regulation to the over-the-counter markets, and to examine the problems both solved and created by these amendments.

The Need for Adequate Protection

The same basic principles of "public interest" and "investor protection" which compelled Congress to establish the disclosure provisions for investors in listed securities are applicable to the over-the-counter markets.[8] Investors in exchange-listed securities or in the over-the-counter markets have the same need for accurate information as a basis for investment decisions and as a protection against fraud and manipulation. Also, the danger of misuse by insiders of confidential corporate information is as great in one market as in the other. The need for full disclosure is perhaps even more urgent in the over-the-counter markets, since these

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[2] Securities Exchange Act of 1934, § 15, 48 Stat. 895, as amended, 49 Stat. 1377 (1936), 15 U.S.C. § 78o (1958) (amended by 72 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2804-05 (1964)).

[3] Securities Exchange Act of 1934, § 15A, as added, 52 Stat. 1070 (1938), 15 U.S.C. § 78o-3 (1958) (amended by 78 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2810-15 (1964)).

[4] The Commission and the National Association of Securities Dealers established broker-dealer inspection programs, adopted further rules prohibiting fraudulent and unethical practices, and developed higher standards through administrative and disciplinary proceedings and litigation. *E.g.*, 17 C.F.R. § 240.15cl-9 (1964); NASD MANUAL, *Markup Policy* G-5 (1960).

[5] See Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 220 (1958).

[6] See 2 LOSS, SECURITIES REGULATION 1149-64 (2d ed. 1961).

[7] 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2798-2817 (1964)).

[8] See Securities Exchange Act of 1934, § 2, 48 Stat. 881, 15 U.S.C. § 78b (1958).

markets include some relatively unknown, unsubstantial, and unseasoned issues.[9]

The practices of over-the-counter issues, in respect to reports, proxy solicitation, and insider-trading, present a striking contrast to the practices of issuers subject to the regulations of the SEC in these areas. Although the non-regulated companies were not required to file financial reports with the Commission, many have voluntarily provided financial data to the financial manuals and to their shareholders. However, other companies in this category either make no reports to shareholders at all or their reports are meager and inadequate. Deficiencies in financial data reporting include failure to classify inventories, failure to state the method of valuing inventories, failure to include explanatory notes, and lack of certification.[10]

In addition, the proxy-solicitation practices of both groups present striking divergencies. One study of the proxy-solicitation practices of issuers of unlisted shares revealed the following major deficiencies: (1) a failure to state the names of nominees in solicitations for the election of directors; (2) a failure to provide a place for a "yes" or "no" vote relating to major proposals; (3) a failure of proxies relating to bonus, profit-sharing, and management-remuneration plans to state the cost of such plans; and (4) a failure of proxies relating to mergers, consolidations, acquisitions, and similar matters to state the effect of the proposed transaction on present security holders.[11]

A third area in which investors in over-the-counter securities need protection involves insider-trading abuses. Abuses in this area are great because of the concurrence of a lack of reliable and current information and because many over-the-counter issuers are insider controlled.[12] In the absence of the same deterrents that are currently imposed on insiders who trade in exchange-listed securities, the insiders in the over-the-counter market enjoy unparalleled opportunities for short-swing profits.

The Registration Requirement

Issuers to be Included

It was necessary for the framers of the new statute to achieve a balance of practical considerations in determining to

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[9] For a detailed analysis of the heterogeneity of the over-the-counter market, see SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 2, at 546-53 (1963) (hereinafter cited as SPECIAL STUDY).

[10] An analysis of the reporting practices of the over-the-counter issuers, as determined by an examination of the annual reports of a selected group of such issuers, may be found in SPECIAL STUDY pt. 3, at 10-12.

[11] The results of one survey in this area are found in SPECIAL STUDY pt. 3, at 12-14.

[12] See SPECIAL STUDY pt. 3, at 14.

which issuers on the over-the-counter market the requirements of the disclosure provisions of the Exchange Act should be extended. Complete protection would have been afforded if the requirement of disclosure extended to all companies in which there were outside shareholders, no matter how few. However, practicality calls for a standard of coverage which is both reasonably reliable and easily enforceable. Such a standard would include only those issuers which are substantial enough in terms of public interest to warrant both the burden of compliance imposed on the issuer, and the high cost of regulation imposed on the government.

In the 1964 amendments, Congress attempted to achieve this delicate balance by employing a phased program of registration in order to ease the burden of compliance. Two tests were established to determine the registration status of issuers: the shareholder test and the asset test. Issuers with assets in excess of one million dollars will be required to register each class of equity security held of record by at least 750 persons.[13] However, issuers of securities held of record by more than 500 but less than 750 persons will be given a two-year postponement for registration.[14] In addition, registration is required only if the issuer is engaged in interstate commerce or if its securities are traded by use of the mails or the instrumentalities of interstate commerce.[15] The purpose of the mail and instrumentalities provisions is, of course, to clearly furnish a constitutional basis for federal regulation.

The shareholder test has long been recognized as probably "the single most workable and most meaningful criterion" of public-investor interest.[16] However, in order to arrive at the stockholder number which would accurately reflect public interest, the framers of the amendments had to consider certain other factors. The first relationship considered was that between the number of shareholders and the number of transfers of record, since such transfers help to distinguish actively traded securities from inactive ones. Furthermore, each transaction may increase the number of investors to whom statutory protection will be available. The results of a questionnaire addressed to a representative sample of issuers[17] revealed that a comparison of the number of record shareholders with the number of record transfers indicated a general correspondence between the two. For example, where there were between 25 and 299 shareholders the proportion of issuers showing

[13] Securities Exchange Act of 1934 § 12(g)(1)(A), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2800 (1964)).

[14] Securities Exchange Act of 1934, § 12(g)(1)(B), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2800-01 (1964)).

[15] Securities Exchange Act of 1934 § 12(g)(1), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2800-01 (1964)).

[16] SPECIAL STUDY pt. 3, at 18.

[17] A discussion of the method used in selecting the issuers as well as a listing of the principal data requested in questionnaire OTC-4 may be found in SPECIAL STUDY pt. 3, at 18-19.

25 or more transfers ranged from a negligible 7.9 per cent to a clear majority of 61.1 per cent. However, beginning at the 300 shareholder level a majority of companies showed at least 100 transfers, a clear shift from a preponderance of less active to more active stocks.[18] Therefore, the relationship between shareholders and transfers was clear evidence and a vivid illustration of how a number-of-shareholders criterion could be used to evaluate the public interest in an issue which would be sufficient to warrant regulation.

The second relationship considered involved a comparison between the number of shareholders and the concentration of holdings. Concentration of holdings is pertinent in two respects: (1) in appraising the significance of mere numbers of shareholders at any given time, and (2) in weighing the significance of proxy and insider-trading provisions. Data obtained in a recent study indicates that below the 1000 shareholder level, over half of the companies are more than 50 per cent owned by the ten largest holders. Where there were between 500 and 749 shareholders, the determinative category under the new law, the number of companies owned by the ten largest holders is just under one-half of the total.[19] The figures are an overstatement, however, because only record holdings were considered since the number of beneficial owners could not be determined.[20] Nevertheless, the correlation between the number of shareholders and the concentration of holdings again indicates how the number-of-shareholders criterion could be employed not only to measure the size of the group most immediately to be protected, but also to indicate the level at which the need for protection is substantially increased by a significant increase in the number of holders.

The third relationship, that between the number of shareholders and dealers' trading interest, is important in two respects: (1) in distinguishing actively traded from other securities, and (2) in relation to insider-trading protection where the dealer is also an insider. Comparisons of the number of broker-dealers entering wholesale quotations in the "sheets" of the National Quotation Bureau [21] with the number of shareholders indicate that from the 300 shareholder level upward the indices reveal an increase in public interest and trading activity. Thus, more than 60 per cent of the companies having from 300 to 749 shareholders

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[18] The correspondence is indicated by SPECIAL STUDY pt. 3, at 21.

[19] These comparisons are indicated by SPECIAL STUDY pt. 3, table IX-d. at 30.

[20] SPECIAL STUDY pt. 3, at 30 n.48.

[21] The "sheets" published by the National Quotation Bureau, Inc. are of crucial importance to the over-the-counter markets since they are the primary medium for the dissemination of wholesale or "inside" quotations among professionals. They are used to find and communicate buying or selling interests in securities and to judge activity. A detailed study of the "Bureau" is found in SPECIAL STUDY pt. 2, at 595-609.

have one or more quotations. A roughly corresponding increase in activity and broker-dealer interest is evident as one continues to move up the shareholder levels.[22] It is important to note, however, that the significance to be attached to the comparisons is subject to the important qualification that a numerical count of quotations necessarily ignores the large qualitative differences between them. A single appearance of a large New York City wholesale market-maker presumably indicates a greater likelihood of active trading than does a similar appearance of a more obscure broker-dealer. Nevertheless, the comparisons indicate the probable size of the group most directly affected by statutory protections as well as the shareholder level at which the need for protection is substantially increased.

The data set forth above indicate that at and above the 300 shareholder level, trading activity, as measured by transfers and dealer interest, becomes significant for a majority of issuers. It is clear also that under any definition of "public" for purposes of the protections afforded by the securities laws, a company with 300 or more shareholders of record is deemed to be public.[23] Even at the level of 300 shareholders, however, the data tend to indicate such a large number of companies covered that the Commission would be unable to shoulder the administrative burden involved.[24]

In the interest of feasibility, therefore, a second criterion, the asset test, was established to determine which issuers should be affected by the extended regulations. The amount of assets would seem to be no more than a secondary criterion, at best, since there is an absence of a clear or necessary relationship between total assets and the equity interest of investors to be protected.[25] In its Special Study, the Securities and Exchange Commission Committee thought that such an asset limit could, in theory, be justified only if expressed in a very modest amount.[26] Nevertheless, the practical effect of including the asset test in conjunction with the shareholder test is a significant reduction in the number of companies affected by the regulations. One study of a selected group of issuers indicated that a one million dollar asset limit in the new law would remove about 22 per cent of all companies at the 300 or more shareholder level, 17 per cent at the 500 or more shareholder level, and 13 per cent at the 750 or more shareholder level.[27] By including the asset test in the amendments as passed, it is probable that Congress recognized the significant

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[22] See SPECIAL STUDY pt. 3, table IX-b, at 22, chart IX-c, at 22.
[23] SPECIAL STUDY pt. 3, at 34.
[24] See SPECIAL STUDY pt. 3, at 34.
[25] See SPECIAL STUDY pt. 3, table IX-c, at 27, chart IX-d, at 29.
[26] SPECIAL STUDY pt. 3, at 32-33.
[27] See SPECIAL STUDY pt. 3, at 33.

role such a test would play in keeping the number of issuers affected at a practical level for administrative regulation.

In establishing a two-phased program and in setting the appropriate standard of coverage at the 500 shareholder level, Congress did not follow the recommendation of the Special Study which provided for a third phase covering issuers at the 300 shareholder level, the level thought to be the appropriate permanent standard.[28] Rather, Congress recognized the fact that administrative needs required a shareholder test which was both consistent with the limits imposed by the asset test and indicative of the level at which public interest became clearly marked. A study of pertinent data showed that both requirements are fulfilled at the 500 shareholder level.[29]

Termination of Registration

The significance of the 300 shareholder level is, however, recognized in the termination provision of the new law.[30] A registration will terminate when the number of shareholders is reduced to less than 300 and proper application and certification of such fact is made by the issuer. The registration will terminate 90 days after such certification, unless the SEC decides to terminate it earlier. Termination may be denied, however, if there is a question as to the truth of the certification.

Effective Date of Registration

Issuers required to register under the new law must do so within 120 days after the last day of the fiscal year on which they first meet the conditions requiring registration.[31] Thus, if a corporation has a fiscal year ending August 31, and if on August 31, 1964, it had assets of one million dollars and a class of equity security held by at least 750 persons, it must file a registration statement for that security within 120 days. However, the SEC has the authority to grant extensions of time for any issuer or class of issuers.[32] The effective date of a registration statement is 60 days after filing, but it may become effective within a shorter

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[28] See SPECIAL STUDY pt. 3, at 34. The committee made its proposal in light of the fact that the deficiencies in reporting and proxy solicitation are prevalent in substantially the same degree in the case of those companies having at least 300 shareholders.

[29] See SPECIAL STUDY pt. 3, table IX-5, at 107.

[30] Securities Exchange Act of 1934 § 12(g)(3), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2802 (1964)).

[31] Securities Exchange Act of 1934, § 12(g), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2800-02 (1964)).

[32] *Id.* at 2800-01. Corporations with between 500-749 stockholders are required to wait two years before they are allowed to register.

period by direction of the SEC.[33] The importance of the date of effectiveness lies in the fact that any false or misleading statements which the registration may contain will not render the issuer liable, under the civil liability sanctions of Section 18 of the Securities Exchange Act,[34] to a person who has purchased or sold a security in reliance on such statements until the registration becomes effective.

Information Required

In addition to the information already required in the registration statements of exchange-listed issuers,[35] the new law adds a further category of information which must be disclosed by issuers in both the exchange and over-the-counter markets seeking to register public issues. Information in registration statements must now include all "material contracts" made by the issuer within the two years preceding such registration or which are to be executed, in whole or in part, at or after the registration.[36] The statute defines a "material contract" as one "not made in the ordinary course of business." [37] The only contracts *expressly* deemed to be in this category by the statute are "every material patent or contract for a material patent right." [38] Committee Reports indicated that the contracts included in this category will be similar to those about which such information was required in registering an initial issue of securties under the Securities Act of 1933.[39] Contracts deemed to be "material" for purposes of regulation under that act included any management contract or contract providing for special bonuses or profit-sharing arrangements, and every contract in which a public utility company, or its affiliate, agreed to give or receive technical or financial advice or service for which the annual charge to any party was in excess of 2,500 dollars.[40] In addition to these specific examples, any contract about which a reasonably prudent investor ought to have been informed before purchasing a registered security was deemed to be a "material contract." [41] In the absence of a clear statutory definition, it is anticipated that the Commission will administer these requirements "in such a manner as not to be unduly burden-

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[33] *Ibid.*
[34] *Ibid.*
[35] See Securities Exchange Act of 1934, § 12(b)(1), 48 Stat. 892, 15 U.S.C. § 781(b)(1) (1958) (amended by 78 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2799 (1964)).
[36] Securities Exchange Act of 1934, § 12(b)(1)(I), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2799 (1964)).
[37] *Ibid.*
[38] *Ibid.*
[39] S. REP. No. 379, 88th Cong., 1st Sess. 58 (1963).
[40] Securities Act of 1933, schedule A, item 24, 48 Stat. 88, 90, 15 U.S.C. § 77aa (1958).
[41] In the Matter of Winnebago Distilling Co., 6 S.E.C. 926 (1940).

some to business."[42] However, full disclosure for the protection of the public will remain the primary consideration, and, in light of this fact, the provision should be subject to an interpretation favoring investors. The statute does not indicate what information is to be included, but it is likely that the Commission will require the type of information required under the similar provision of the Securities Act. Such information must include dates of and parties to such "material contracts," as well as a concise statement of the general effect of such a contract.[43]

Liability for Failure to Register

In contrast to the mechanics of the requirement for exchange-traded securities, the registration requirement for over-the-counter securities is directed at the issuer and not at brokers and dealers.[44] Under the provisions of the 1934 Act, liability for a transaction in an unregistered security on an exchange falls upon the broker-dealer effecting such transaction.[45] However, since the new law does not make it unlawful for a broker or dealer to effect over-the-counter transactions in unregistered securities which are subject to the registration requirement of the new law, a broker or dealer doing so will not be subject to civil liabilities or criminal penalties. Rather, enforcement of the new registration requirement for over-the-counter securities is aimed directly at the issuer, since it is the issuer, rather than the broker-dealer, who will be in possession of the facts determinative of the registration status of an over-the-counter issue. Under the new law, the SEC has the express power, upon the failure of any issuer to register, and after a hearing to determine whether there has been a violation of the act, to issue an order demanding compliance with the registration requirement.[46] Should an issuer fail to obey a compliance order, the SEC may apply to a federal district court for enforcement of the order.[47] The SEC may also suspend trading of the issue for a ten-day period,[48] and in appropriate cases, invoke criminal sanctions.[49]

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[42] 13 U.S. CODE CONG. & AD. NEWS 3080 (1964).

[43] Securities Act of 1933, schedule A, item 24, 48 Stat. 88, 90, 15 U.S.C. § 77aa (1958).

[44] Securities Exchange Act of 1934, § 12(g), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2800-02 (1964)).

[45] Securities Exchange Act of 1934, § 12(a), 48 Stat. 892, 15 U.S.C. § 78l(a) (1958).

[46] Securities Exchange Act of 1934, § 15(c)(4), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2809 (1964)).

[47] Securities Exchange Act of 1934, § 21(f), 48 Stat. 899, 901, as amended, 49 Stat. 1379 (1936), 15 U.S.C. § 78u(f) (1958).

[48] Securities Exchange Act of 1934, § 15(c)(5), as added, 78 Stat. 565 (1964) (U.S. CODE CONG. & AD. NEWS 2809 (1964)).

[49] Securities Exchange Act of 1934, § 32, 48 Stat. 904, as amended, 49 Stat. 1380 (1936), 15 U.S.C. § 78ff (1958).

Banks and Insurance Companies

Under the new law, banks and insurance companies are given special consideration. Banks, whose deposits are insured by the Federal Deposit Insurance Corporation and who meet the general registration conditions outlined previously, do not register their issues with the SEC. Rather, they are required to register their securities in accordance with the procedures established by the appropriate federal bank regulatory agency.[50] Some disclosure provisions, such as periodic reporting, proxy, and insider-trading, of the 1934 Act will apply to bank securities[51] and will be administered by the same agency.[52] By including banks among the issuers subject to the new requirement, Congress recognized the fact that the registration provisions of the new act are essential to protect investors in bank securities. Congress obviously felt that the existing regulation of banks was designed primarily to protect depositors and was not adequate for investment purposes.[53]

Insurance companies, on the other hand, are exempted from the new registration requirement on the condition that they are subject to state regulations which, comparable to that offered under the new federal law, will furnish protection to investors.[54] Existing state regulation, however, is not designed primarily to protect investors, but is intended for the benefit of policyholders.[55] In order that an insurance company meet the conditions for exemption, therefore, state regulation, which has been described as "less and less meaningful" when matched against the "more and more relevant" disclosure policy of the securities acts,[56] must become more concerned with investor-oriented protections in the areas of disclosure, proxy-solicitation, and insider-trading. The requirement that there be insider-trading regulation is postponed for two years to enable state legislatures to adopt necessary regulatory statutes.[57] Regulation of proxy solicitations, consents, and authorizations is effected through state administrative action.[58]

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[50] Securities Exchange Act of 1934, § 12(i), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2803 (1964)).

[51] *Ibid.*

[52] *Ibid.*

[53] For an analysis of the protection afforded investors in bank securities by federal and state regulation, see SPECIAL STUDY pt. 3, at 35-39.

[54] Securities Exchange Act of 1934, § 12(g)(2)(G), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2802 (1964)).

[55] An analysis of the investor protection afforded by state regulation of insurance companies is set forth in SPECIAL STUDY pt. 3, at 40-42.

[56] SEC v. Variable Annuity Co., 359 U.S. 65, 85 (1959) (Brennan, J., concurring).

[57] Securities Exchange Act of 1934, § 12(g)(2)(G)(iii), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2802 (1964)).

[58] Securities Exchange Act of 1934, § 12(g)(2)(G)(i), (ii), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2802 (1964)).

Regulation of Proxy Solicitation

Pursuant to the broad powers given by the 1934 Act to prescribe rules relating to the solicitation of proxies,[59] the SEC has adopted a variety of rules prescribing the information which must be furnished by management when proxies are solicited from holders of exchange-listed stocks.[60] The new law broadens the authority of the SEC by extending it to proxies solicited from holders of over-the-counter securities which are registered pursuant to the new provisions.[61]

In the past, corporate recognition of the record owner limited the distribution of solicitation material to such person, thereby denying the beneficial owner the opportunity to decide whether and to whom a proxy should be given.[62] While the 1934 Act provided that proxies could be given by exchange members in accordance with rules prescribed by the SEC,[63] the SEC did not in fact promulgate proxy rules to protect the beneficial owners of the stock. The reason for this inaction was the lack of power possessed by the SEC to compel the broker or dealer who was the record owner of the stock to give proxies at all when requested by the beneficial owner. However, some stock exchanges have adequately protected the beneficial owners of stock by adopting rules regulating proxy solicitation.[64] No such rules were adopted by the over-the-counter markets. In an attempt to remedy this deficiency the new law provides that no exchange member or registered broker or dealer can give or refrain from giving a proxy in contravention of rules prescribed by the SEC, if the stock is registered on an exchange or under the new provisions.[65] By extending the rule-making power of the SEC to proxies for stock traded only over-the-counter, investor protection comparable to that afforded investors in exchange-listed stocks is provided. Protection for the beneficial owner, in both markets, is provided by the power given the SEC to affirmatively require a broker or dealer to give proxies.[66]

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[59] Securities Exchange Act of 1934, § 14, 48 Stat. 895, 15 U.S.C. § 78n (1958) (amended by 78 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2804 (1964)).

[60] See 17 C.F.R. 240.14 (1964).

[61] Securities Exchange Act of 1934, § 14, 48 Stat. 895, as amended, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2804 (1964)).

[62] CCH, SECURITIES ACTS AMENDMENTS OF 1964 16 (1964).

[63] Securities Exchange Act of 1934, § 14(b), 48 Stat. 895, 15 U.S.C. § 78n(b) (1958) (amended by 78 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2804 (1964)).

[64] The New York Stock Exchange and some other exchanges have adopted rules which regulate the giving of proxies by members. See NEW YORK STOCK EXCHANGE GUIDE 450-55.

[65] Securities Exchange Act of 1934, § 14(b), 48 Stat. 895, as amended, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2804 (1964)).

[66] *Ibid.*

While the proxy rules which have been adopted by the SEC serve other purposes, the basic philosophy underlying these rules is to disclose information to stockholders. When corporate management fails to solicit proxies, it avoids such disclosure. While companies on the New York Stock Exchange and the American Stock Exchange agree to solicit proxies for all meetings of shareholders,[67] unlisted companies and companies listed on some exchanges are subject to no similar requirement.[68] In order to insure disclosure to stockholders when proxies are not solicited, the new law requires that, prior to any stockholders' meeting, management file with the SEC and furnish to stockholders information equivalent to that which would be required if proxies were solicited.[69]

Regulation of Insider-Trading

The insider-trading provisions of the 1934 Act,[70] formerly applicable only to directors, officers, and qualifying stockholders (those who own more than ten per cent of the stock) of companies with equity securities listed on a national securities exchange, have been extended to the same insiders of over-the-counter issuers with registered securities.[71] The three means adopted by Congress to control insider-trading consist of a disclosure provision,[72] an automatic-recovery provision,[73] and a provision against short sales.[74] There is no difference in the terms of the provisions as now applied to insiders in both markets. However, the new law specifically exempts from the short-swing profit and short-sale provisions those broker-dealers who make markets for the stocks of certain issuers while serving as directors of the issuing company.[75]

This exemption will undoubtedly give rise to much controversy and discussion, especially in light of the Special Study's conclusion that a general and broad exemption for such market-making transactions would not be warranted.[76] However, if the automatic-re-

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[67] NEW YORK STOCK EXCHANGE GUIDE, listing agreement, pt. III, item 5; AMERICAN STOCK EXCHANGE GUIDE, listing form L, item 5, 8955.

[68] CCH, SECURITIES ACTS AMENDMENTS 17 (1964).

[69] Securities Exchange Act of 1934, § 14(c), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2804 (1964)).

[70] Securities Exchange Act of 1934, § 16, 48 Stat. 896, 15 U.S.C. § 78p (amended by 78 Stat. 565 (1964), 13 U.S. CODE CONG. & AD. NEWS 2815 (1964)).

[71] Securities Exchange Act of 1934, § 16(a), 48 Stat. 896, as amended, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2815 (1964)).

[72] *Ibid.*

[73] Securities Exchange Act of 1934, § 16(b), 48 Stat. 896, 15 U.S.C. § 78p(b) (1958).

[74] Securities Exchange Act of 1934, § 16(c), 48 Stat. 896, 15 U.S.C. § 78p(c) (1958).

[75] Securities Exchange Act of 1934, § 16(d), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2816 (1964)).

[76] SPECIAL STUDY pt. 3, at 54.

covery provision were applied to the director-market-maker, any short-swing profits realized in the trading of the corporation's stock would be recoverable by the corporation. Because of this loss of profit, it may be presumed that the director-market-maker would be forced either to resign or to terminate his trading. The forcing of such a choice was not desirable in order to obtain the protection of this section. The importance of this problem is emphasized by the fact that many underwriters of new issues of securities place representatives on the issuer's board of directors as a common practice.[77]

The resolution of the problem is found in that section of the new law which provides that the short-swing and "sale against the box"[78] provisions will *not* apply to any purchase or sale

> of an equity security not then or theretofore held by him [director-market-maker] in an investment account, by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market . . . for such security.[79]

The SEC is given the authority to define the terms of the exemption,[80] which does not, of course, sanction misuse of inside information. It is probable that Congress granted this exemption in recognition of several facts: the frequent occurrence of such situations,[81] the proper flow of information which is likely to result from the seeking or acceptance of directorships by broker-dealers,[82] and the correlation between effective market-making and the benefit of board representation.[83]

It has been indicated that SEC rules and regulations under the new exemption will consider a broker or dealer to be "making a market" if at the time of a particular sale or purchase he was willing to buy and sell the securities on a regular basis for his own account at fair market prices.[84] Whether a dealer will be regarded as making a "primary" or a "secondary" market will depend on the extent and the nature of the trading in which he engages. If he is regarded as the principal source or market by brokers and dealers having orders to buy the particular security, the broker or dealer will be considered to be making a "primary" market. If regular

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[77] See SPECIAL STUDY pt. 1, at 428-29.

[78] CCH, SECURITIES ACTS AMENDMENTS OF 1964 19 (1964). According to the "sale against the box" provision the officer, director or qualifying stockholder may not sell stock of the issuer unless: (1) he delivers it within a twenty-day period after the sale, or (2) he places it in an authorized means of transportation within five days after the sale.

[79] Securities Exchange Act of 1934, § 16(d), as added, 78 Stat. 565 (1964) (13 U.S. CODE CONG. & AD. NEWS 2816 (1964)).

[80] *Ibid.*

[81] See SPECIAL STUDY pt. 1, at 428-29.

[82] See SPECIAL STUDY pt. 1, at 429-32.

[83] See SPECIAL STUDY pt. 3, at 47.

[84] S. REP. No. 379, 88th Cong., 1st Sess. 70 (1963).

trading of a security is on a more limited basis, the broker or dealer will be regarded as making a "secondary" market.[85] If two or more dealers are "making a market" in a security at the same time, all such market-making transactions will be exempt. However, a transaction by a dealer made as an incident to a market established or maintained by another dealer would not be exempt.[86] Securities held by the broker or dealer, either in his trading account or in his investment account, will be taken into consideration for purposes of the ten per cent test used in determining whether or not a stockholder is subject to the short-swing and short-sale provisions of the 1934 Act.[87]

The Special Study of the Securities Markets drew a distinction between a mere "market-maker" and a "sponsor" in its consideration of the advisability of an exemption for market-makers.[88] The Special Study defines the term "make a market" as to "enter a listing in the daily 'sheets' of the National Quotation Bureau and/or to stand ready to buy or sell stock in a limited quantity."[89] The term "sponsorship," on the other hand, means the making of "a continuous market in the securities of a particular issuer regularly executing orders to buy or sell coming from other investors or other dealers."[90] If the short-swing and "sale against the box" provisions were made applicable to sponsors who are also directors, thereby forcing them to make a choice between the two positions, some broker-dealers might elect to retain their directorships and withdraw as a sponsor. By such loss of a sponsor, an issuer would be deprived of its most reliable market, the one which remains available during periods of market inactivity or instability when investors' needs are most urgent. While SEC Chairman Cary has said that the new exemption is designed to "take care of the so-called sponsorship problem,"[91] no distinction is made between "sponsors" and other "market-makers." It is possible that such a distinction will be made in regulations to be issued, but the Committee Reports make no positive indication that it is forthcoming.

Conclusion

In the past the absence of financial reporting and the other investor protections provided for listed securities has created special burdens and difficulties for broker-dealers and their customers in

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[85] *Ibid.*
[86] *Ibid.*
[87] *Ibid.*
[88] See SPECIAL STUDY pt. 3, at 49.
[89] SPECIAL STUDY pt. 3, at 45 n.90.
[90] *Ibid.*
[91] *Hearings on H. 6793 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 88th Cong., 1st & 2d Sess. 96 (1963).

dealing with over-the-counter securities. Because of the difficulty in assessing the investment worth of securties of a non-reporting company and because of the lack of statutory protections, many investors drew a fairly sharp line between listed and unlisted markets, so that many over-the-counter securities failed to attract the degree of interest which they might have enjoyed if protections were available.

Providing the protections of disclosure for investors in the over-the-counter market will have a twofold effect: (1) it will encourage a development of that market, and (2) it will eliminate the inherent inequities in the double standard of regulation. Securities should gravitate to the market which is best suited for them without the arbitrary influence of regulations affecting issuers. The allocation of capital resources can be significantly affected by disclosure or the lack of it since adequate disclosure will tend to inspire confidence in investors and, therefore, will ensure that sound companies will be the ones that receive their funds. Full disclosure, therefore, is an essential element of fair competition and makes it possible for investors to make their decisions on the basis of the actual merits of securities offered, and for the price to be fairly determined by the laws of supply and demand. That the principle is unassailable and that the need is clear have been recognized. What remains is the implementation of this principle by the means provided in the new law.