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A REVIEW OF THE SECURITIES ACT OF 1933.*

In his message to Congress on March 29, 1933, recommending the passage of a Federal law regulating the sale of securities, President Roosevelt said, in part.

"I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

"In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

"Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

"There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."

As a result of the President's recommendation, Congress enacted the Securities Act of 1933, which was signed by the President May 27, 1933, certain sections thereof becoming effective immediately and others becoming effective July 27th. The principal features of the Act are herein briefly reviewed.¹

Except in the case of securities exempt from the provisions of the Act (which will be discussed later), the Act (Section 5) makes it unlawful to use the instrumentalities of interstate commerce or of the mails to sell or offer to buy a security or to transport a security for the purpose of sale or delivery after sale unless a reg-

¹Two important distinctions between the Federal Act and the State Blue Sky Law (Remington's Revised Statutes, Section 5853-1 to 5853-25) should be noted. Under the State Blue Sky Law the Director of Licenses is authorized to permit the sale of a particular security only if he finds that the proposed plan of business of the issuer is "fair, just and equitable." Under the Federal Act the Federal Trade Commission has no authority to determine whether a particular security is or is not proper to be sold to the public. Under the Federal Act a company incorporated to raise lemons at the North Pole can sell its stock, provided its registration statement truthfully reflects the character of the business to be conducted by the company (77 Cong. Rec. 2951, May 5, 1933)

The second distinction lies in the fact that under the State Blue Sky Law no person can engage in the business of selling securities until he has been granted a certificate by the Director of Licenses upon satisfying that official that he is of good character and trustworthiness. The Federal Act requires no licensing of underwriters, brokers or dealers and the Federal Trade Commission has no direct control over persons engaged in the sale of securities. In attempting to regulate the sale of securities it is as important to regulate the persons engaged in the business as it is to regulate the character of the securities which they sell.

For the benefit of those interested in Blue Sky legislation, reference is made to Substitute House Bill No. 421, which was passed by the Legislature of the State of Washington at its 1933 Session and was vetoed by the Governor.

*Read before the Washington State Bar Association at its meeting at Spokane, August 11, 1933.

istration statement is in effect. It is also made unlawful to use such instrumentalities to transmit a prospectus relating to any registered security unless the prospectus meets the requirements of Section 10, or to transport a security for the purpose of sale or delivery after sale unless accompanied or preceded by such prospectus.

It is provided, however, that this restriction as to the use of the mails shall not apply to the sale of a security where the entire issue is sold only to persons resident in a single state and where the issuer is a person resident and doing business within the state or a corporation incorporated by and doing business within the state.

The contents of the registration statement are set forth in Schedule A, which specifies 32 items of information (Section 7). The preparation of such a registration statement involves considerable time and expense. Schedule A involves the inclusion of many matters which are of but casual interest to the average investor.

The registration statement must be filed with the Federal Trade Commission in triplicate (Section 6). It must be signed by the issuer, its principal executive, financial and accounting officers, and by a majority of its partners or board of directors. The filing fee is 1/100th of 1% of the maximum selling price of the securities, with a minimum fee of \$25. The statement automatically becomes effective twenty days after its filing,² unless it appears to the Commission that the statement is incomplete or inaccurate in any material respect, in which case the Commission can issue an order not later than ten days after the filing refusing to permit the registration statement to become effective until amended in compliance with the order. (Section 8.)

The registration statement is subject to public inspection and copies thereof are furnished to applicants upon the payment of 20c per page for photostatic copies and 25c per page for typewritten copies (Article 9 of Rules and Regulations).

The prospectus, as prescribed by Section 10, must contain substantially the same statements as those embraced in the registration statement, except that the Commission may authorize the omission of any statements that it deems unnecessary for the protection of investors. In its regulations, the Commission has authorized the omission of a statement as to the amount of commission or profit which the underwriter is receiving in connection with the sale of the securities (Article 16 of Rules and Regulations). Therefore, the ordinary investor can only obtain this information by an inspection of the registration statement in the office of the Commis-

A similar waiting period prescribed by the Michigan Blue Sky Act was held invalid as being an arbitrary interference with the right to contract in *Alabama, etc., Co. v. Doyle*, 210 Fed. 173 (D. C. Michigan) 1914.

sion or by paying for a copy of the registration statement.

For a period of one year after the last date on which an issue of securities has been offered to the public, no sale or offer to purchase such securities can be made through interstate commerce or the mails except while a registration statement is in effect, and then only when a prospectus meeting the requirements of Section 10 is used. After the expiration of such year, the dealing in registered securities constitutes a transaction exempt from the provisions of Section 5 of the Act (which requires registration with the Commission). Other transactions exempted by Section 4 are:

- (1) transactions by a person other than an issuer, underwriter or dealer,
- (2) transactions by an issuer not with or through an underwriter and not involving any public offering;³
- (3) brokers' transactions executed on customers' orders upon any exchange or in the open or counter market, but not the solicitation of such orders,
- (4) the issuance of new securities to existing security holders exclusively, in exchange for their securities, where no commission or other remuneration is paid,
- (5) the issuance of securities to existing security holders or other existing creditors of a corporation in the process of a *bona fide* reorganization under the supervision of any court.

Under Section 3 the following securities are exempt from all of the provisions of the Act, except the provisions of Sections 12 and 17 (relating to civil and criminal liability for misrepresentation)

1. any security which has been sold by the issuer or *bona fide* offered to the public prior to July 27, 1933,
2. any security issued or guaranteed by the United States or any state, or political subdivision⁴ thereof, territory or municipality or public instrumentality, or by any bank (Section 12 does not apply to these securities),
3. commercial paper maturing within nine months, the proceeds of which are used for current transactions,
4. any security issued by a corporation organized exclusively for religious, educational, charitable and similar purposes,
5. any security issued by a building and loan association or a farmers' cooperative association,
6. any security issued by a common carrier which is subject to the provisions of Section 20(a) of the Interstate Commerce Act,
7. receivers' certificates issued with the approval of the court,
8. insurance endowment policies and annuity contracts.

³ See H. R. Rep. No. 85, 73rd Cong. 1st Sess.

⁴ For definition of "political subdivision," see H. R. Rep. No. 85, 73rd Cong. 1st Sess.

In addition to these, the Commission is authorized to exempt other securities where the issue does not exceed \$100,000. Under regulations promulgated November 1, 1933 (superseding regulations promulgated July 27, 1933, relating to obligations secured by real estate mortgages), the commission has exempted three classes of securities upon certain conditions.⁵

The most important sections of the Act from the lawyer's standpoint are Sections 11 and 12. These provide for civil liability to a purchaser of securities. Section 11 deals with liabilities arising on account of failure of the registration statement to accurately describe the securities.⁶ If the registration statement contains either an untrue statement of a material fact or omits to state a material fact "required to be stated therein or necessary to make the statements therein not misleading," any person acquiring such security (unless he knew of such untruth or omission) may sue

- (1) every person who signed the registration statement,
- (2) every director or partner of the issuer at the time of registration,
- (3) every person named with his consent as a prospective director or partner,
- (4) every accountant, engineer, appraiser, or other person whose profession gives authority to a statement made by him, if named with his consent as having prepared any portion of the registration statement (this probably includes lawyers, although they are not specifically named),
- (5) every underwriter (this section does not apply to dealers)

Under this section the above-named persons are jointly and severally liable to all persons purchasing the securities. Such purchaser need not prove that he relied on the registration statement and the liability exists in respect to sales within the state even though the mails are not used. The purchaser may either sue to recover the consideration paid for the security, less any income received by him, upon tendering back the security, or for damages if he no longer owns it, but no recovery may be had in excess of the offering price.

Release No. 66 of the Federal Trade Commission dated November 1, 1933, exempts three classes of securities: (1) obligations comprising an issue not exceeding \$15,000, secured by a first mortgage on the issuer's home; (2) securities of any character comprising an issue not exceeding \$100,000, upon compliance with six prescribed conditions therein stated; (3) securities comprising issues which are exchanged for other outstanding securities, including extensions or renewals of outstanding obligations where the par value thereof does not exceed \$100,000, provided that a prospectus be furnished to each person to whom securities are sought to be exchanged for a new security

An excellent analysis of the serious risks which are assumed by the various parties under Section 11 is found in an article by Arthur H. Dean of the firm of Sullivan & Cromwell, published in the August number of "Fortune" magazine, pp. 100-102.

This section places the burden of proof upon the defendant who may escape liability only if he can satisfy a court or jury by a clear preponderance of the evidence as follows.

- (1) that before the effective date of the registration statement he had resigned and had notified the commission and the issuer that he would not be responsible for the registration statement, or
- (2) that, if such registration statement became effective without his knowledge, he forthwith advised the Commission upon learning such fact and give reasonable public notice thereof, or
- (3) (a) that, except as to expert opinions, he had, after reasonable investigation, reasonable ground to believe and did believe that the statements contained in the registration statement were true and that there was no omission of a material fact, and
(b) that, as to his own expert opinions, if any, he had, after reasonable investigation, reasonable ground to believe and did believe that the statements therein contained were true and that there was no omission to state a material fact, or that such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy or extract from his report, and
(c) that, as to expert opinions of others, he had reasonable ground to believe and did believe that the statements therein were true and that there was no omission of a material fact, and that such part of the registration statement fairly represented the statement of the experts, and
(d) that, as to portions of official public reports and documents, he had reasonable ground to believe and did believe the statements therein were true, and that there was no omission of a material fact and that such part of the registration statement fairly represented the official document or report.

As to what constitutes a reasonable investigation and a reasonable ground for belief in this connection, this section provides that the standard of reasonableness shall be that required of a person occupying a fiduciary relationship.⁷

Section 12 covers the liability of a seller of securities to a purchaser. By that section, any person who sells a security in violation of Section 5 of the Act, or who sells any security (whether or not exempt under Section 3) except Government, state, municipal or bank securities, through the instrumentalities of interstate commerce or of the mails by means of a prospectus or oral com-

⁷ See Sec. 169, Restatement of Law of Trusts, Tentative Draft No. 2 (Am. Law Institute), Cf. *Easter v. Henry*, 139 Wash., 416, 421, 247 Pac. 469 (1926) holding that no fiduciary relation exists between a dealer and a purchaser of securities.

munication which includes an untrue statement of a material fact or omits to state a material fact "necessary in order to make the statements in the light of the circumstances under which they were made not misleading," is liable to a purchaser (not knowing of such untruth or omission), unless he shall sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of such untruth or omission. The measure of damages is similar to that provided in Section 11, the purchaser being permitted to recover the full purchase price paid for the security, less any income received thereon, by tendering the security to the seller, or for damages if he no longer owns the security.⁸ A question which arises under Section 12 is to what extent a dealer acting in good faith may rely either upon the prospectus furnished him by an underwriter or upon the registration statement. If he is under an obligation to make an independent investigation to verify the accuracy of the statements contained therein, a dealer in Seattle or Spokane, for example, would hesitate to sell a new issue of stock in the U. S. Steel Corporation. This is but one of the many questions which will have to be determined by courts.

It is to be noted that this section has been in force since May 27th and applies to all securities except Government, state, municipal and bank securities.

No person can maintain an action, either under Section 11 or Section 12, unless the action is brought within two years after the discovery of the untrue statement or omission, or within two years after it should have been discovered by the exercise of reasonable diligence. In no event can any action be maintained more than ten years after the security was offered to the public.

It is at once apparent that the rule of *caveat emptor* has been by these two sections reversed to read "*caveat venditor*" At common law, the burden of proof in such case was upon the purchaser to show that the seller had made a false statement of a material fact which he knew to be false, that the plaintiff relied on such statement and was damaged as a result of such reliance.⁹ The measure of his recovery was limited to such damages as naturally resulted from such reliance.¹⁰ Under Sections 11 and 12 the

⁸ It is to be noted that in actions brought against officers and directors of the issuer and other persons liable under Section 11, the amount of the recovery is limited to the price at which the security was offered to the public. However, in actions brought against dealers under Section 12, the purchaser can recover the full consideration which he paid for the security less any income received thereon. This amount may be greatly in excess of the original offering price.

⁹ 12 R. C. L. 424-426, and cases cited. See also *Carter v. Walker* 151 Wash. 356, 275 Pac. 730 (1929).

¹⁰ 12 R. C. L. 451-453 and cases cited.

burden of proof is transferred from the purchaser to the seller and the former is permitted, upon tendering the security, to recover its full purchase price,¹¹ less income received, even though at the time of the trial the security, on account of economic or other conditions over which the seller had no control, may have become valueless. The effects of this radical change in the obligations resting upon the seller of securities cannot be definitely determined at this time, but it is obvious that these two sections will be a serious deterrent to raising capital for established businesses as well as for highly speculative enterprises.¹²

One or two other sections of the Act deserve particular notice.

Under Section 9 any person aggrieved by an order of the Commission may within sixty days petition the Circuit Court of Appeals (for the Circuit in which he resides or has his principal place of business) for a review of such order. However, the order remains effective during the appeal, unless otherwise ordered by the court. Consequently, in most cases, by the time a decision is obtained the opportune time for selling the particular securities will have passed. The public interest in various types of securities changes rapidly and a decision after a delay of several months is of little practical value.

By Section 17 it is made unlawful to use the instrumentalities of interstate commerce or of the mails to employ any device or scheme to defraud or to obtain money or property by means of any untrue statement of a material fact or omission to state a material fact, or to engage in any transaction, practice or course of business which operates as a fraud upon the purchaser. The same section also makes it unlawful to use such instrumentalities to publish or circulate any circular, advertisement or other similar communication which, though not purporting to offer a security for sale, describes such security for a consideration, without disclosing the receipt, whether past or prospective, of such consideration and the amount thereof. This provision is aimed at newspaper articles

¹¹ But the recovery cannot exceed the offering price in case of suit under Section 11. See footnote 8 (*supra*).

¹² In regard to the civil liabilities under the Securities Act, Chairman March of the Federal Trade Commission is quoted in the United States News of August 26, 1933, as saying: "Under the common law, before the Securities Act was passed, corporation officials were liable for fraud and deception. Now the liability is in print and it appears more formidable."

In the United States News of October 28, 1933, Dr. James M. Landis, newly appointed member of the Federal Trade Commission, who played an active part in writing the Securities Act, is credited with a statement to the effect that the liability under the common law "approaches" that imposed by the Securities Act in its severity.

A comparison of the liability of sellers of securities under the common law with the liability imposed by Sections 11 and 12 does not, in the opinion of the writer, sustain the views expressed by these two members of the Federal Trade Commission.

and other similar written statements which, while purporting to give unbiased advice regarding securities, in reality are bought and paid for by some one having an interest in the sale of the securities described in the articles. Section 17 has been effective since May 27th and none of the exemptions provided in Section 3 of the Act are applicable to the provisions of Section 17

Civil actions may be brought in either a state court or a United States District Court, and if instituted in the former are not removable to the latter (Section 22) Section 24 provides for a penalty for wilful violation of the Act, this being a fine of not more than \$5,000 or imprisonment for not more than five years, or both.

In his article above referred to,¹³ Mr. Arthur D Dean makes the following prophecies as to the effect of the Securities Act of 1933

"(a) The Act is drastically deflationary in nature and may seriously retard economic recovery. Many short-term loans now in the commercial banks, the liquidation of which depends on improvement in the bond market, may be frozen. Commercial banks may either be forced to grant additional loans which cannot be liquidated or they may refuse to grant additional credits for construction or other purposes on the ground that corporations cannot liquidate them by seeking long term credit in the bond market.

"(b) It may result in unemployment because corporations may be forced to make drastic economies and to suspend the payment of dividends in order to obtain necessary working capital.

"(c) It may result in a disintegration of the larger units into smaller units in order to meet the requirements of the registration statement and to make financing possible under the Act.

"(d) It will be difficult to obtain money for new and speculative enterprises and medium-sized corporations may have difficulty in obtaining long-term capital. In the opinion of competent observers this has been one of the effects of the English Companies Act and this bill is far more restrictive than that Act.

"(e) The cost of raising money to all borrowers will be greatly increased both on account of the additional investigation and because those made liable on the registration statement will demand greater compensation.

"(f) Defaults may result in the case of impending maturities because of the inability of issuers and underwriters to prepare the information, meet the time schedules required by the Act, and organize the necessary distribution groups at a time when the market is receptive to the particular issue.

"(g) Firm commitments by underwriting houses to borrowing corporations will in all probability be ended. Corporations issuing additional stock to their stockholders may have difficulty in finding underwriters because of the small compensation usually given for this type of underwriting and because of the drastic liability placed on underwriters under the Act.

"(h) Since firm commitments will be eliminated, the necessity for intermediary underwriting syndicates will be eliminated and the smaller houses will only take commitments as members of selling groups. Corporations such as fixed trusts accustomed to marketing their securities direct through dealers may experience difficulty because small dealers may not wish to become underwriters under the Act. The Act in effect chases itself around in a circle in this connection because if there is no underwriter as such, a dealer cannot limit his liability and if a corporation cannot find an underwriter, it may not be able to market its securities through dealers.

¹³ See footnote 6 (*supra*).

"(i) Only the largest houses which have competent statistical staffs capable of making the investigation required by the Act can afford to be underwriters.

"(j) It places majority stockholders, or several stockholders together controlling a corporation, and possibly voting trustees in a very unenviable position.

"(k) Independent directors will be chary about sitting on boards of directors and exposing themselves to the liability imposed by the Act. It is doubtful if this is in the social interest as boards composed of officers are usually under the domination of the president who needs the objective scrutiny of independent directors.

"(l) It will tend to prevent foreign governments and foreign corporations borrowing in the American markets. This may be the purpose of the Act, but it would have been better to have placed such loans under the jurisdiction of the Federal Reserve Board or Secretary of the Treasury. As a practical matter today, foreign loans cannot be floated in England without the consent of the Bank of England.

"(m) It may force American corporations to go abroad for capital.

"(n) Since, as a practical matter, few reorganizations are carried out without the organization of a new corporation and since, again, as a practical matter, it is impossible to get all of the security holders to exchange their old securities for the new securities unless banking houses throughout the country are paid for their services in effecting the exchanges, many voluntary reorganizations may be forced into the expense and delay of judicial receiverships in order to avoid registration.

"(o) The number of 'strike suits, that is, suits brought for the purpose of legal blackmail, will be greatly increased.

"(p) The financial advertising of securities unless satisfactory regulations on this point are issued will probably be ended because to publish the prospectus in the form required by the Act will be so expensive that such ads will probably be reduced simply to a statement of the name of the issue, a statement as to where a prospectus meeting the requirements of the Act may be obtained, and the name of the house which will execute the orders.

"It is sincerely to be hoped that none of these prophecies will come true. With the purpose of the Act, i. e., the protection of the public against fraudulent securities, the writer is in full sympathy, but it seems hardly necessary to burn down the house to exterminate vermin."

As pointed out by Mr. Dean, the problems presented by the Securities Act are numerous and complex. The novelty of its provisions and the lack of precedents make interpretation difficult. Some questions will be settled by regulations of the Commission and others (including constitutional questions) will be decided by the courts in the course of time. Experience in the administration of the Act will probably demonstrate the necessity for the enactment of amendments by Congress.

However, in the judgment of the writer, ultimately a practical law will result which will permit the raising of capital for legitimate enterprises through the medium of honest security dealers and at the same time protect the public against the sale of worthless securities by irresponsible and unscrupulous vendors.

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