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# THE FEDERAL SECURITIES ACT OF 1933

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As Berle has said, the Securities Act,[1] though probably one of the most spectacular types of legislation, is of secondary importance in a comprehensive program of social control over finance.[2] Some, however, have believed, apparently in all sincerity, that the great drop in security values in the last five years was the result of failure to tell the "truth about securities."[3] And others have thought that with the Securities Act it would be possible to prevent a recurrence of the scandals which have brought many financiers into disrepute in recent years. As a matter of fact there are but few of the transactions investigated by the Senate Committee on Banking and Currency which the Securities Act would have controlled. There is nothing in the Act which would control the speculative craze of the American public, or which would eliminate wholly unsound capital structures. There is nothing in the Act which would prevent a tyrannical management from playing wide and loose with scattered minorities, or which would prevent a new pyramiding of holding companies violative of the public interest and all canons of sound finance. All the Act pretends to do is to require the "truth about securities" at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.

But even the whole truth cannot be told in such simple and direct

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1. P. L. No. 22, 73d Cong., 1st Sess. (1933), hereinafter called "the Act." For current discussions see Mead, *Amend the Securities Act* (1933) 1 ECON. FORUM 425; Legis. (1933) 33 COL. L. REV. 1220; *The Securities Act—An Interim Report* (1933) 8(6) FORTUNE 34.

2. Berle, *High Finance: Master or Servant* (1933) 23 YALE REV. 20, 42.

3. See, e.g., 73d Cong., 1st Sess., H. R. REP. 85 (1933) at 2.

terms as to make investors discriminating. A slow educational process must precede that. Those who need investment guidance will receive small comfort from the balance sheets, statistics, contracts, and details which the prospectus reveals. Thus the effects of such an Act, though important, are secondary and chiefly of two kinds: (1) prevention of excesses and fraudulent transactions, which will be hampered and deterred merely by the requirement that their details be revealed;[4] and (2) placing in the market during the early stages of the life of a security a body of facts which, operating indirectly through investment services and expert investors, will tend to produce more accurate appraisal of the worth of the security if it commands a broad enough market.

At the present time one could not expect more far reaching effects. The economy under which we live is not static. Industry is not stabilized and under our present methods never can be. Competition and the progress of invention make it inevitable that many enterprises will fail. The toll of technology over a period of years is enormous. And the downward turn of the business cycle may eliminate more than just the marginal enterprise. Other factors of management, not related to cupidity and fraud, contribute to the same end. As a result, a substantial percentage of industrial investment will in any event be lost. To speak then of underwriting the values which are based on such unstable foundations is sheer nonsense. And to expect that the judgment of investors as respects these imponderable factors will improve perceptibly in this generation is baseless optimism.

This is reason enough why the state should not pronounce investments sound or unsound.[5] To the business community it seems likewise sufficient reason for tempering and moderating the liabilities of those responsible for the issue. For, it is said that when security values shrink as they have in the last few years it is but natural to find blame laid at the door of those who got the money, who were identified with the flotation, or who were connected with the management. In that connection it is also urged that risks should not be placed so high as to deter substantial and honest men from engaging in legitimate business. On the other hand, it is insisted, as legislative history has shown, that the mere requirement that the truth about securities be told is ineffective unless the penalties are so severe as to make it improvident not to tell it. Like most questions of law the problem reduces itself to one of degree. It is around this mat-

4. See Frankfurter, *The Federal Securities Act: II* (1933) 8(2) FORTUNE 53, 55.

5. See Section 23 of the Act, making it unlawful to represent to any prospective purchaser that the fact that the registration statement is filed or is in effect or that a stop order is not in effect is a finding by the Federal Trade Commission that the registration statement is true and accurate or that the Commission has in any way passed upon the merits of the issue or given approval to it. And see H. R. REP. 85, *op. cit. supra* note 3, at 4; Frankfurter, *supra* note 4, at 108.

ter of giving maximum protection to investors with minimum interference to business that the present battle on the Act is being waged.

It is not the purpose of this article to prove or disprove that the Act is serving as an unhealthy deterrent to legitimate business. Rather an attempt will be made to give a picture of the impact of the Act on various parties and the functions they perform. Secondly, it will be shown how the Act promises to defeat in part its purpose by virtue of its uncertainties. This is of primary importance in two ways. In the first place it increases many fold the hazards which business feels. A decade from now when courts have completed the task of interpreting the Act many of those fears will have been proved to be unreal. Nevertheless, in terms of attitudes, they are at present real and one man's guess as to what courts will do will not be sufficient to offset another's fear of what they might do. The problem thus resolves itself into one of going as far as possible in making the Act clear and unequivocal both in principle and in detail. In the second place the presence of so many uncertainties serves to detract attention from the fundamental purpose of the Act—protection of investors. Nevertheless, in spite of the varied issues raised by the present battle over the Act, it cannot be denied that the principles embodied in the Act have become a permanent and integral part of our legal system. The present problem is not their abolition or retention but the discovery of ways and means of accomplishing expeditiously and efficiently their avowed purposes.

## II

### Civil and Criminal Liability

The civil liabilities imposed by the Act[6] are not only compensatory in nature but also *in terrorem*.[7] They have been set high to guarantee that the risk of their invocation will be effective in assuring that the "truth about securities" will be told. There are two types of situations to which civil liability attaches. One is the sale of securities which must be registered. The other is the sale of any security, registered or not, except for a few hereafter discussed. Liability on the registration statement is imposed by Section 11;[8] liability on sales generally, by Section 12.

6. None of these civil liabilities supplants any common-law or other remedy by purchasers of securities against any of the parties named or others. See § 16. The liabilities imposed arise solely out of this federal legislation. For its bases see Isaacs, *The Securities Act and the Constitution* (1933) 43 Yale L. J. 218.

7. See Shulman, *Civil Liability and the Securities Act* (1933) 43 Yale L. J. 227, 251; H. R. Rep. 85, *op. cit. supra* note 3, at 2, 3; Landis, Address before the New York State Society of Certified Public Accountants, Wall St. Journal, Nov. 1, 1933, at 10.

8. The classes of persons to which Section 11 applies and their various defenses are discussed at p. 190, *infra*.

*Materiality, Causation and Damages*

Actions for rescission or damages may be maintained under Section 11 by any purchaser in case "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[9] It would not be profitable to discuss here the philosophical and pragmatic distinctions[10] between "fact" and "opinion." It is worthy of note, however, that the use of the word "material" has introduced certain innovations somewhat foreign to the common law. In the first place materiality is to be judged as of one point of time—the date when that particular part of the registration statement became effective. The purchaser may have purchased shortly after that date or several years subsequently. Yet he is not required to prove that an untrue statement or omission was material at the time of his purchase. Thus contentions that the Act uses materiality in reference to facts material to the investment are not strictly true. The market may have wholly discounted the misstatement at the time of plaintiff's purchase. Nevertheless proof of that by the defense would not warrant dismissal of the complaint. This is a strict interpretation of the Act but it seems to be in conformity with the design with which it was drawn.[11] In the second place the Act requires no proof of reliance by plaintiff on the untruth or omission. Neither the plaintiff nor anyone else need have known of it. In this connection there is, however, the defense that plaintiff knew of the untruth or omission.

These two factors materially improve the position of investors. By some it is feared that the road of the blackmailer is made too easy, and that every suit brought must be settled because of the impregnable position in which the plaintiff is placed. Nevertheless it is true that the section gives to investors additional protection long needed. Satisfaction of the common-law requirements of fraud raised almost insurmountable barriers to recovery. The road of investors has not been an easy one owing to the common-law insistence on scienter, reliance, and causation.[12]

When the Act provides for damages it likewise introduces distinct innovations. Materiality is referred neither to plaintiff's investment nor to his damages. For example, a security is offered to the public at $100.

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9. § 11(a).

10. See Shulman, *supra* note 7, at 236 *et seq.*

11. If the Act were interpreted to mean that a particular untruth or omission must be related to the date when plaintiff purchased the security, there would have to be read into the section a provision which is not there, namely, that the untruth or omission was "material" not only at the effective date of the registration but also at subsequent times. This would seem counter to the intent of Congress of lightening the burden of proof on purchasers. See H. R. REP. 85, *op. cit. supra* note 3, at 9, 10.

12. See Shulman, *supra* note 7, at 229 *et seq.*

At the end of a year plaintiff buys at $50. Thereafter the market drops to $25 at which price plaintiff sells. Facts wholly foreign to the registration statement have sent the price from $50 to $25. Yet plaintiff can recover $25 provided the registration statement contained a material untruth or omission and provided the defense does not prove that plaintiff knew of such untruth or omission at the time of purchase.[13] This is merely one example of what is meant when it is said that the action for damages is derivative from the action of rescission.[14]

But the point is carried farther—farther, it is submitted, than the Act warrants. It is provided that "In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."[15] If the purchaser still owns the security he may on tendering it back to any of the parties under Section 11 recover what he paid for it,[16] provided he paid less than the public offer price. In case he paid more than the public offer price he would be entitled to receive only an amount equal to that price. If he bought at $125, the public offering price being $100, and the price dropped to $50 he might elect to rescind and recover $100. But if he sold at $50 he might recover damages of $75. Now it has been asserted that in such a case the damages recoverable would be $50—the difference between the public offering price and the price at which plaintiff sold.[17] In other words it is claimed that the subsection quoted means what would have been meant if it had provided "In no case shall the amount recoverable as damages under this section exceed the amount by which the price at which the security was offered to the public is in excess of the price at which plaintiff sold the security." Section 11 (g), however, does not use such a measure. If courts thus restrict the measure of damages, they may or may not be conforming to the intent of Congress. But they certainly would be reading into the Act words that are not there.

Admittedly certain trading losses are recoverable.[18] And if the Act is interpreted in light of the ordinary meaning of the language employed, any trading losses are recoverable as damages—provided they do not exceed in amount the public offering price and provided, of course, that the registration statement contains a material untruth or omission. Thus a security never falls in price below the public offering price of $100.

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13. See Landis, *supra* note 7, at 10.

14. See *ibid;* Frankfurter, *supra* note 4, at 108.

15. § 11(g).

16. ". . . with interest thereon, less the amount of any income received thereon." § 11(e).

17. Landis, *supra* note 7, at 10. A case is put where the offering price of a bond is $100. A buys it on the market at $75. B at $125. It is said, ". . . assume that A and B have disposed of their bonds on the market at $60. A, who had paid $75 for his bond, could recover $15, whereas B who paid $125 for his bond recovers not $65 but $40."

18. See discussion pp. 174-175, *supra,* and Landis, *supra* note 7.

But owing to factors in no way associated with the untruth or omission in the registration statement the price rises to $200, at which plaintiff buys, and then falls to $100 at which plaintiff sells. It is by no means clear that plaintiff could not recover $100.[19] If he can, so can subsequent purchasers where there are similar oscillations in the market price. It is for reasons like the foregoing that damages are said to be apparently illimitable under Section 11.

Congress may not have intended to include in rescission or damages cases where damage suffered bore no relation to misrepresentations made nor cases where the price of the security never fell below the public offering price. Yet the courts which are to interpret these provisions are many and it will take years before authoritative decision is had.[20] Meanwhile reasonable men will continue to interpret the section differently, and the resulting uncertainty will force into prominence the *in terrorem* aspects of the section.

As stated above the protection given to investors by Section 11 fills a long felt need in so far as it shifts the burden of proof. This is particularly desirable during the early life of the security. At that time the registration statement will be an important conditioner of the market. Plaintiff may be wholly ignorant of anything in the statement. But if he buys in the open market at the time he may be as much affected by the concealed untruths or the omissions as if he had read and understood the registration statement. So it seems wholly desirable to create a presumption in favor of the investor in this regard. If carried out logically, however, some time limitation might be placed upon this presumption, for in most cases after a year or so the statements made in the registration would have become outmoded and wholly discounted by a host of other factors. In other words, the present provision for reliance provides an excellent rule of thumb during the early life of the security. It has less justification the longer the security is outstanding.

The irrelevancy of the relation between plaintiff's purchase or plaintiff's damages and the untruths or omissions avoids a complicated procedural matter which the average investor has no competence to handle.[21] The result of it, however, is in many cases to hand purchasers nothing but windfalls. It is at least arguable that the Act would accomplish all that is needful if it merely made the defense prove the absence of materiality of the untruths or omissions either as respects investment or damages. Whatever scope is ultimately given to the section the policy it

19. The position has been taken by Baldwin B. Bane, Chief, Securities Division, Federal Trade Commission, that such trading losses are not recoverable. See Washington Release, Sept. 22, 1933, N. Y. Times, Sept. 23, 1933, at 21.

20. In this connection it should be noted that the Commission has no jurisdiction to interpret such matters. See p. 213, *infra*.

21. *Cf.* Frankfurter, *supra* note 4; Shulman, *supra* note 7.

contains should be made clear and the formulae it adopts made unequivocal. It must be remembered that this section contains the major *in terrorem* effects. It should be made sufficiently explicit so as to permit reasonable prediction of risks.

In this connection it should be noted that Section 11 applies to all registrations. But it has been drawn largely with reference to one type of case—where a corporation makes a *public* offering of securities. Yet it also applies to private offerings.[22] Section 11(g) needs, therefore, to make provision for the measure of damages in such cases. This is likewise true of the issue of certificates of deposit by committees.[23] How are damages measured or measurable under Section 11? Any one of several methods could be employed. Special and adequate provision must also be made for this type of case.

The foregoing observations apply only to Section 11. Under Section 12 the results are quite different. Section 11 gives civil rights to all purchasers (from whomsoever they purchase) against those liable on the registration statement. Section 12, however, limits suits to those by buyers against their immediate sellers. There are two such types of suits permitted. If a security is sold in violation of Section 5, the purchaser may sue the seller in rescission or damages.[24] To maintain his suit he need only show violation of Section 5. Causation, reliance, misrepresentation, damages are all irrelevant. In rescission he would recover what he had paid (with interest, less income received). In damages the measure of recovery is uncertain but probably is the difference between what he had paid and the price at which he had sold.[25] This remedy is strictly and wholly punitive.

The remedy under Section 12 (2), however, is probably compensatory. If any one "sells" (by use of any agency of interstate commerce or of the mails) any security,[26] whether or not registered, by means of a "prospectuses or oral communication" which includes an "untrue statement of a material fact or omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading," he is liable to the "person purchasing such security from him" either in rescission or "damages," as follows. The purchaser apparently must prove that he did not know of such untruth or omission. Defendant must sustain the burden of proof that he did not know and

22. See pp. 184 *et seq., infra.*

23. See pp. 185 *et seq., infra.*

24. § 12(1).

25. But the section does not state whether if it adopts as the measure the difference between the purchase price and market value, or the difference between the value as represented and the market value at the time of purchase. See Shulman, *supra* note 7, at 244, 249.

26. Except those exempt by Section 3(a) (2) which in general are United States bonds, state and municipal bonds, and securities of national and certain state banks.

in the exercise of reasonable care could not have known of such untruth or omission. There is no point of time to which materiality is related. It therefore is perhaps an open question whether such facts or omissions must be material as of the time of statement or of purchase. The more reasonable view would be that of the Companies Act, making materiality refer to the latter.[27] The measure of damages here as under Section 11 is probably the difference between the purchase price and the price at which the security was disposed of. Such a construction is not, however, a necessary one. In any event it will require judicial construction to determine with finality both the measure of damages and the extent to which the section preserves the common-law elements of causation. In the latter connection it seems not unlikely that for practical purposes the effect of the section is to eliminate it as a separate inquiry. It is clear, however, that it makes radical changes in the common-law action of fraud and deceit by eliminating all inquiry as to scienter and perhaps as to reliance.[28]

### *Contribution*

Section 11(f) permitting contribution "as in cases of contract" between persons liable on the registration statement was taken almost bodily from the Companies Act.[29] Criticism frequently has been made of its vagueness and of the impossibility of its application. Section 11(f) is to be construed against the background of the common law and the few decisions arising under the Companies Act.[30] From these it is probable,

27. *Cf.* Cackett v. Keswick, 85 L. T. R. 14 (1901). In contrast to the Act, the Companies Act provides for an action of damages as follows: ". . . to all persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement therein . . ." 19 & 20 GEO. V, c. 23, § 37(1) (d) (1929).

28. As to damages see note 25, *supra*. It is arguable that reliance is still necessary by virtue of the language "by means of a prospectus or oral communication." *cf.* § 2 (10).

29. *Supra* note 27, § 37(g).

30. Thus under the Act the contract right to contribution avoids application of the tort doctrine—actio personalis moritur cum persona—and therefore permits contribution from the executors of a co-contractor. This was the common-law rule in contract cases, WILLISTON, CONTRACTS (1920) § 1286; Batard v. Hawes, 2 El. & Bl. 285 (1852); Durfee v. Kelly, 228 Mass. 571, 117 N. E. 907 (1917), and is the rule under the Companies Act. Shepheard v. Bray, [1906] 2 Ch. 235. But see same case on appeal, [1907] 2 Ch. 571. Likewise the ordinary rule that there can be no contribution between joint tort feasors becomes inapplicable, aside from the specific exemption in the statute. Gerson v. Simpson, [1903] 2 K. B. 197. And see WILLISTON, *op. cit. supra*, § 345; Note (1926) 74 U. OF PA. L. REV. 319. Furthermore, under the Act where some of the co-contractors are insolvent or out of the jurisdiction those solvent and in the jurisdiction must contribute equally. This is true under the Companies Act, Shepheard v. Bray, *supra*, and was true of the common law, where only pro rata contribution was allowed. Williams v. Riehl, 127 Cal. 365, 59 Pac. 762 (1899); Browne v. Lee, 6 H. & C. 689 (1827). *Contra:* Liddell v. Wiswell, 59 Vt. 365, 8 Atl. 680 (1887); Wetmore & Morse Granite Co. v. Ryle, 93 Vt. 245, 107 Atl. 109 (1919).

though not certain, that the parties liable on the registration statement may by contract allocate inter se their liability. There is no doubt but that such contracts were enforceable at common law.[31] One exception to this under the Act is the case where the party suing was guilty of fraudulent misrepresentations while the party sued was not. Another is the fact that the right to contribution of those liable under Section 15 does not seem to be covered by Section 11(f).

If the courts adopt the view that all parties, including those liable under Section 15, may dispose of the problem by express contract, that should take care of most of the cases. But even so, there would remain a residual group presenting complicated situations. These will inevitably arise, first because uncertainty in the Act will result in persons being held to be afoul of Section 5 who did not suspect that they were; and secondly because those brought into the flotation will at times not obtain an express contract either because of ignorance or inferior bargaining position. The only workable rule to apply to this residual group is the one of pro rata contribution according to the rules of law and equity already mentioned. On the whole, judged by administrative expediency, this is probably as simple and satisfactory a way to handle the matter

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But in equity the shares of the solvent ones would be increased proportionately. Gross v. Davis, 87 Tenn. 226, 11 S. W. 92 (1888). Likewise co-contractors absent from the jurisdiction were generally eliminated from the calculation. Security Insurance Co. v. St. Paul Fire & Maine Insurance Co., 50 Conn. 233 (1882); Whitman v. Porter, 107 Mass. 522 (1871); United States Fidelity & Guaranty Co. v. Naylor, 237 Fed. 314 (C. C. A. 8th, 1916); Jones v. Blanton, 41 N. C. 115 (1849). In addition, the action for contribution in contract is limited to the amount for which the co-contractor was initially liable. WILLISTON, *op. cit. supra,* § 1279. Thus under the Companies Act it has been held that neither the costs of a settlement which were not included in the amount of damages nor costs recoverable under that Act are recoverable in an action of contribution. Shepheard v. Bray, *supra; cf.* Boardman v. Paige, 11 N. H. 431 (1840) WILLISTON, *op. cit. supra,* § 1284.

31. In Batard v. Hawes, *supra* note 30, Lord Campbell said, at 296, "If the original arrangement was inconsistent with the fact that each was to pay his share, no action for such contribution could be maintained. Thus if, by arrangement between themselves, one of the joint contractors, though liable to the creditor, was not to be liable to pay any portion of the debt, it is clear that no action could be maintained against him." And see United States Fidelity & Guaranty Co. v. Naylor; Jones v. Blanton, both *supra* note 30; Loring v. Bacon, 57 Mass 465 (1849); Reed v. Rogers, 134 Ark. 528, 204 S. W. 973 (1918); Lehigh Valley Trust Co. v. Strauss, 258 Pa. 382, 101 Atl. 1047 (1917); Cambria Title, Savings & Trust Co. v. Barron, 223 Pa. 116, 141 Atl. 845 (1928). See also WILLISTON, *op. cit. supra* note 30, §§ 345, 1279, 1282. "When one of two sureties becomes such at the request of his co-surety and upon his promise that he would be put to no loss, he may recover the whole of what he may have been compelled to pay of his co-surety, and such promise may be shown by parol." Hayden v. Thrasher, 18 Fla. 795, 805 (1881). Accord: Reed v. Rogers, *supra;* Hoyt v. Griggs, 164 Iowa 672, 146 N. W. 745 (1914); Blake v. Cole, 39 Mass. 97 (1839).

as any. To resort to fault,[32] compensation,[33] or extent of participation[34] would be even more confusing.

Nevertheless, even though the substantive rule is reduced to simple terms, the procedural difficulties are exceedingly complex. Under Section 22 federal and state courts have concurrent jurisdiction over such suits. Furthermore, each defendant has the defense that if he were to be sued separately by a purchaser he would not be liable. His defense might or might not be the same as plaintiff's defense to a purchaser's action.[35] But even though the defenses were the same, defendant's liability to purchasers would have to be tried. The court which would try that issue might not (and probably would not) be the court which previously had tried plaintiff's liability to purchasers, or which subsequently would try any suits by purchasers against defendant. The decision by the court as to defendant's duty to contribute would not end the matter, unless all parties liable under Section 11 had been joined by plaintiff or interpleaded by defendant and all were solvent. But it would be unusual to find this situation. The normal result would be that those before the court would proceed to other courts to sue other parties liable under Section 11. In those new suits the identical defenses previously tried might have to be tried again. It can readily be seen how complicated and repetitious the situation could become when it is remembered that

32. As in cases like Lowell v. Boston and Lowell Rr. Corp., 40 Mass. 24 (1839); Kiffer v. Bienstock, 128 Misc. 451, 218 N. Y. Supp. 526 (Mun. Ct. 1926); Hoggan v. Cahoon, 26 Utah 444, 73 Pac. 512 (1903).

33. It seems doubtful if the difference in compensation received by the various parties would control their pro rata shares. One analogy is the case of a compensated surety and accommodation surety at common law. It was there held that the mere fact that one cosurety was compensated for his suretyship and the other became surety merely for accommodation was immaterial in an action for contribution by the former against the latter. United States Fidelity & Guaranty Co. v. Naylor, *supra* note 30; United States Fidelity & Guaranty Co. v. McGinnis' Administrator, 147 Ky. 781, 145 S. W. 1112 (1912); Leach v. Commercial Savings Bank, 205 Iowa 975, 213 N. W. 612 (1927). See WILLISTON, *op. cit. supra* note 30, § 1280.

34. Regarding, however, the parties liable on the registration statement as quasi-joint adventurers, the old partnership rule of contribution (in absence of contract to the contrary) according to their respective participation in the profits is suggested. UNIFORM PARTNERSHIP ACT § 18(a). This might be applicable in suits between underwriters but obviously would have no application to suits by issuer against directors, officers against experts, underwriters against officers, etc. Likewise the common-law analogy of the restriction of liability of sureties to the amount of their respective bonds might be useful in limiting the inter se liability under the Act to the amount of the participation by the various parties. See WILLISTON, *op. cit. supra* note 30, § 1279. But the only groups to which this would apply would be issuers and underwriters. To the others it obviously has no application.

35. If they were both directors, the defense would be the same. If one was an expert and the other a director; or if one was an issuer and the other was a director; or if one was an underwriter and the other was an expert, the defenses available under Section 11 would be different. See discussion under III, *infra*.

under the normal issue there would be at least many dozen and often several hundred people prospectively liable under Section 11. Still further, under Section 11(f) there probably would be several suits for contribution arising successively over a period of years each time one party paid a new claim. The spectacle is unseemly, inefficient and expensive at the very best. No one can possibly benefit from it except those who prosper on litigation. It seems clear that enforcement of the contribution provisions should be by one tribunal.[36]

The right to contribution certainly is an ameliorating factor to be considered in evaluating the severity of the penalties imposed under Section 11. If the section means that all liability inter se may be governed by contract, theoretically it becomes possible for a person apparently illimitably liable to be free from liability. Actually, however, this is not true, not only because that construction of the section is unnecessary but also for the reasons which follow. Under the Act as drawn its uncertainties make it possible for unwary persons to be held. This is nowhere more clear than under section 15, which is discussed hereafter. Furthermore, those specified in Section 11 are not of equal bargaining position. Even if they are, they run the risk of insolvency of their promissor. And the risks are so uncertain that it is unlikely that surety bonds can be readily obtained to cover them. In any event men who act reasonably and in good faith balk at the opportunities which the Act offers to become engaged in extensive litigation to vindicate their reputation and to mature their claims against other parties.

### *Criminal Penalties*

Certain phases of the criminal provisions of the Act have been considered in an accompanying article.[37] In addition thereto only a few points need be mentioned here. Section 17 makes[38] unlawful all schemes to defraud.[39] Likewise it makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts.[40] The section applies to all securities whether or not they are exempt from registration.[41] No penalties are stated nor any civil rights expressly given. Section 17 probably does

36. See p. 215, infra.

37. MacIntyre, *Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes* (1933) 43 YALE L. J. 254.

38. It is of course in relation to the sale of any security "by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails . . ." § 17(a).

39. Section 17(a) (1) relates to the employment of "any device, scheme, or artifice to defraud . . ."; Section 17(a) (3) to engagement "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

40. § 17(a) (2).

41. § 17(c). Thus even federal government bonds are included.

not enlarge civil remedies of purchasers.[42] This seems clear by negative implication, since Sections 11 and 12 expressly state the remedies which are available. It is clear, however, that a willful violation of Section 17 would give rise to the criminal penalties of Section 24. Furthermore Section 20 gives the Commission power to investigate any violation of the Act and to obtain injuctive relief against such violations.[43] So it is evident that a violation of Section 17 even though innocent would be grounds for such investigation or injunction. And, as noted, it is sufficiently broad to be applicable to government bonds and insurance policies as well as to any other security whether long outstanding, presently issued or in the process of issuance. Wisely used this injunctive power and the criminal penalties can go further in real protection of the investor than mere piling up of civil penalties. But as is made clear in the accompanying article on criminal provisions,[44] we had, so far as criminal law goes, a fair "arsenal of weapons"[45] to employ against subversive practices during the last decade. Yet little attempt was made to use them, and the failure can hardly be blamed solely upon limited state jurisdiction. Essentially it is a problem of law administration which no amount of additional legislation can assure.

Section 17 contains an additional provision controlling tipster sheets and certain practices of those who purvey financial news and render investment counsel. Its general purpose is to require disclosure of any consideration and the amount thereof received or to be received, directly or indirectly, from an issuer, underwriter or dealer. Its willful violation entails criminal liability, and it likewise is subject to injunctive control.[46]

## III

### Securities and Transactions Affected

The Act defines a "security" in very broad terms.[47] Many sorts of contracts, such as those of insurance,[48] not usually considered to be

42. Query, whether the making of an act unlawful by the Act gives to purchasers an action of rescission on the grounds of illegality. It should be noted that Section 16 preserves all existing remedies at law or equity.

43. See pp. 212, 213, *infra*.

44. MacIntyre, *supra* note 37.

45. See p. 211, *infra*.

46. This subsection will serve a useful purpose and should have an effective deterrent influence. But it needs clarification to differentiate between cases where a security is offered for sale and where it is not. Other difficulties are raised by the subsection but space does not permit their elaboration.

47. See § 2(1).

48. The definition in Section 2(1) is broad enough to include them, and their specific exemption under Section 3(8) from the registration and other requirements of Section 5 supports this inference. If it is correct, transactions in them are subject to restrictions upon sales of other "securities."

securities are included. The sweeping character of the definition was presumably dictated by a desire to prevent the use of allied forms for purposes of evasion. While the Act gives little direct recognition to the differing characteristics of these various securities,[49] the Commission may in most instances by authorized rules and regulations fix requirements suited to particular circumstances.[50]

Directly and by implication the Act provides for or recognizes several classes of exemptions. Some apply to the nature of the transaction, others to the kind of security involved, and still others to the circumstances of the issue. In the first place security issues, and any subsequent transactions therein, over which Congress clearly lacks jurisdiction (since consummated from solicitation to delivery without the use of agencies of interstate commerce or the mails) are subject to none of the provisions of the Act.[51]

Where the Act does apply, distinction is made between securities (and transactions therein) subject to the registration and prospectus requirements of Secton 5 and those subject only to such other provisions as Sections 12(2) and 17. No securities or transactions are exempt from Section 17.[52] Only securities of the United States government and its political subdivisions and certain instrumentalites thereof and of certain banks, and transactions therein, are exempt from Section 12 (2).[53] The requirement of registration and effective registration, invoking risks of penalties under Sections 11, 12(1), and 24, do not remove risks under Sections 12(2) and 17.

Exemptions from Section 5 include several kinds of securities.[54] The

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49. Such, for example, as making a protective committee an "issuer," requiring its "principal accounting officer" to sign the registration statement, and giving its members no defenses of good faith or diligence.

50. See the discussion on pp. 213 *et. seq.*

51. Civil liability under Section 12 would probably follow even though only part of the entire transaction was consummated in interstate commerce or through the mails. Thus solicitation of the sale through the mails or by interstate commerce followed by delivery of the security in a wholly intrastate transaction without use of the mails would probably be sufficient, and vice versa. *Cf.* § 2(7) defining "interstate commerce." See Dean, *The Federal Securities Act: I* (1933) 8(2) FORTUNE 50. The same result follows under Section 11. See H. R. REP., *op. cit. supra* note 3, at 22. But in connection with Section 11 a person is entitled to rely on the registration and need not prove he relied on it, even though this particular transaction was an intrastate sale not involving the use of the mails. *Cf.*, however, § 5(c).

52. Including securities of the United States Government.

53. §§ 12(2) and 3(a) (2). Constitutional problems and political expediency may have dictated the exemption of securities issued by states and their political subdivisions and certain instrumentalities thereof.

54. § 3(a), except paragraph (1). In addition Section 3(b) gives the Commission discretion to exempt other classes of securities under certain conditions, but no issue of any such class is exempt "where the aggregate amount at which such issue is offered to the public

only uncertainty which will arise here will be whether a given security falls within or without the rule. Bonds of the United States[55] or the stock of a common carrier subject to the provisions of Section 20(a) of the Interstate Commerce Act, as amended,[56] are clearly exempt. On the other hand, a security issued by a State bank whose business is supervised by a State bank commissioner is exempt only if its business "is substantially confined to banking."[57]

Other exemptions from Section 5 are based on the time and circumstances of the issue. Any security "sold or disposed of by the issuer or bona fide offered to the public" prior to July 27, 1933, is exempt.[58] But this exemption does not apply to "any new offering of any such security by an issuer or underwriter" subsequent to July 26, 1933.[59]

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exceeds $100,000." The Commission pursuant to this power has already exempted some securities. Ruling, Nov. 1, 1933. By negative implication such securities, no matter the amount involved, may be made exempt by the Commission, if the securities are *privately* offered.

55. § 3(a) (2).

56. § 3(a) (6).

57. § 3(a) (2). "Banking" may be a "trade term" subject to definition by the Commission. See discussion p. 213, *infra.*

58. § 3(a) (1). Question has arisen as to whether securities pledged by an issuer prior to July 27, 1933, may be considered to have been "sold or disposed of by the issuer." Perhaps "disposed of" is sufficiently broad for the purpose. *Cf.* § 2(3). If that term is not applicable and if a pledge is not a sale within Section 2(3), the value to the pledgee is seriously affected, for he frequently could not force the pledgor-issuer to register.

59. § 3(a) (1). Question has been raised as to whether "new offering" contemplates only public or both public and private offerings. Dean, *supra* note 51, at 52. Consonant with the other registration provisions of the Act, it would appear that the word "public" had been omitted by design. Thus, under Section 4(1) providing exemption for "transactions by an issuer not with or through an underwriter and not involving any public offering," new private offerings by issuers without "underwriting" are exempt. Registration is invoked for the issuer either by a "public offering" or by "underwriting."

With the presence of "underwriting," however, several problems are raised. Any security holder who may be held to have been in control of, or controlled by, or under common control with, the "issuer," as defined in Section 2(4), and who sells to any person who may have a view to "distribution" or has any person "sell" for him with such a view, becomes an "issuer" for the purposes of Section 2(11); and the person purchasing from or selling for him becomes an "underwriter." § 2(11). Such a person who becomes an "issuer" under Section 2(11) probably is not required to sign the registration statement if he can get the actual issuer to register. So he would not be liable if he were a controlled person, though by Section 15 he would be if he controlled the actual issuer. Unless he did control, however, he probably could not get the actual issuer to register, and even then his control would have to be dominant in order to induce other persons involved, who would be made liable, to accept the risk. If he sold to the "underwriter" without a registration statement being in effect, his part of the transaction would be exempt under Section 4(1), since the term "issuer" in that section refers only to an "issuer" as defined in Section 2(4), while the "underwriter's" part might be subject to Section 24 if the purchase were held to involve an "offer to buy" under Section 5(a) (1). The "underwriter" would be liable for his sales under both Sections 12(1) and 24.

If the new offerings referred to in Section 3(1) are registered, the problem will arise of distinguishing registered from unregistered securities. This problem will also arise in cases

Other securities are exempt from registration according to the circumstances of the original offering, but since only that offering, rather than the securities themselves, is exempt from Section 5, subsequent transactions in them probably are not exempt.[60] There are four such exemptions. If agencies of interstate commerce are not employed, if the issuer is a resident of, or, if a corporation, incorporated by, and doing business within a single state or territory, and if the security is "sold" only to persons resident within that state or territory, the "sale" is not subject to Section 5 even though the mails are used.[61] If an issue involves neither "underwriting" nor "a public offering," it is exempt.[62] If an issue is ex-

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where several registrations are filed for the same security over a period of years. Although all issues of a security may have similar shares in management, earnings and assets, the rights possessed by their holders to sue on registration statements would differ. Dealers would have to observe the distinction if they were to gain the exemption provided for them in Section 4(1). If they were differentiated, there might be a variation in price, determined somewhat by the difference in rights under the Act but chiefly by the breadth of the market for each and the costs of shifting investments, since there could be no arbitrage. It appears improbable that they will be differentiated, unless the Commission has the power to and does require it. If they are not differentiated, a person suing would have to prove that he had acquired the particular security under that registration statement which involved the alleged untruth or omission. If they are required to be differentiated, issuers may try to register or reregister all securities of the sort then being offered, but such registration is not provided for in the Act and may not be effective. See § 6(a) or practical impediments in distribution may well "kill" the market.

60. With the result that a "dealer" who acquired such a security may not in its sale employ agencies of interstate commerce or the mails "within one year after the last date upon which the security was bona fide offered to the public by the issuer," etc. § 4 (1). An "An underwriter" could never sell it by means of such agencies, with the indirect result that "underwriting" is thus made impossible for such issues in reorganizations under court supervision as are exempt under Section 4(3). In other words Section 3(a) does not provide that those securities are exempt where transactions in them are exempt by Section 4. It has been stated, however, by an officer of the Commission that securities, transactions in which are exempt under Section 4(3), are likewise exempt from Section 5. See letter of Baldwin B. Bane, Sept. 6, 1933.

61. This exemption may have been considered safe because of state jurisdiction over the offering. It might be an encouragement to local incorporation where capital needs and supply are equalized within state lines. If this exemption from Section 5 is used, however, the transactions even within the State become subject to Sections 12(2) and 17.

62. § 4(1). If any person purchases from the issuer who may be held to have had a view to "distribution," then "underwriting" is present. "Distribution" is not defined, but presumably may be defined by the Commission, under its power to define "trade terms." See p. 213, *infra*.

A "public offering" is likewise not defined. If a protective committee is held to be an "issuer" [*cf.* note 104, *infra*], but no *other* persons solicit deposits for it, so that "underwriting" cannot be said to be present, it may be plausible to insist that such a committee need not register the certificates of deposit, because such solicitation as it made would not amount to a "public offering." Is an offer to existing security holders of a corporation and to them alone a private or a public offering? English courts have indicated that an offer is public even though it is to a "defined class of the public." Nash v. Lynde, [1929] A. C. 158, 171; see also *In re* South of England Natural Gas & Petroleum Co., Ltd., [1911] 1 Ch. 573. Any number from "two to infinity may serve." Nash v. Lynde, *supra*, at 169.

changed by the issuer "with its existing security holders exclusively, where no commission or other remuneration is paid or given directly or indirectly in connection with such exchange," such issuance is exempt.[63] If a corporation is "in the process of a bona fide reorganization. . . under the supervision of any court,"[64] the issuance of securities "to the existing security holders or other existing creditors" of such corporation "either in exchange for the securities of such security holders or claims of such creditors or partly for cash and partly in exchange for the securities or claims of such security holders or creditors," is exempt.[65] The uncertain-

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Under state "Blue Sky" laws an offer of subscription to stock in a farmers' cooperative made to a group of interested citizens in one town or vicinity has been held not to constitute a public offering. Cannon v. Farmers' Union Grain Agency, 103 Ore. 26, 202 Pac. 725 (1921); Kirk v. Farmers' Union Grain Agency, 103 Ore. 43, 202 Pac. 731 (1921). So with one isolated sale through personal contact. Gillespie v. Long, 212 Ala. 34, 101 So. 651 (1924). If offerings to existing security holders of corporations were held not to constitute public offerings, then an investment trust, say, might avoid the registration requirement by offering to exchange its securities in one corporation for those of another. Such obviously was not the intent of Congress. Furthermore, the Commission's recognition of the registration requirement for certificates issued by or for protective committees [*cf.* Form D-1] has considerable weight in the determination of the question. Perhaps the Commission has the power to define "public offering" as being a "trade term." See § 19(a) and p. 213, *infra*.

63. It is by no means clear that a simple refunding operation is exempt, for the exemption in Section 4(3) applies only "where no commission or other remuneration is paid or given directly or indirectly in connection with such exchange . . ." If the exchange offer is accompanied by the payment of fees for soliciting or guaranteeing exchanges the transaction is clearly not exempt. This was probably the sole interest of Congress, but the wording is not so restricted. The phrase may be held to include fees to transfer agents and others. If so, the "issue" would have to be registered. The transfer agents and others might then be held as "underwriters" because of their "participation." *Cf.* § 2(11). It would be an unusual refunding operation in which no remuneration was paid directly or indirectly. Even though Congress may have meant to include only fees for certain services, the actual uncertainty has brought some refunding operations to a standstill, for fear of the severe penalties imposed upon violators of the section. The statement has been made, however, by an officer of the Commission that only fees for certain services are included and not expenses. See III Commerce Clearing House Stocks and Bonds Law Service ¶ 7544.

It is clear that this part of Section 4(3) does not cover the issuance of securities by a committee to be exchanged for securities of another "issuer." The language is, "issuance of a security *of a person* exchanged by *it* with *its* existing security holders exclusively."

64. The rule stated presents great administrative difficulties. It is impossible to predict what "supervision" will be held to mean. If it means cases where the court is merely ordering a foreclosure pursuant to or following a reorganization, it will have fairly wide application. If, however, the "supervision" required is of the plan, fewer cases will be included. If it requires "supervision" of the kind specified under Section 77 of the Bankruptcy Act, only occasional cases will fall within it. What "bona fide" adds is likewise uncertain. In view of the vagueness of the test, prudence would dictate registration in most cases.

65. Whether securities "issued" by committees come under this exemption is not altogether clear. This will depend upon whether any of the wording in the preceding clause [*cf.* note 63, *supra*] is interpreted as modifying this one. They probably are not exempt, but in many cases this would be an academic question, for protective committees

ties, however, as to what constitute a "public offer," "a bona fide reorganization under the supervision of any court," or "remuneration" paid directly or indirectly in connection with an exchange, and as to when "underwriting" may be held to have been involved, probably make these exemptions of limited application for the immediate future.[66]

The remaining exemptions from the provisions of Section 5 relate to neither securities nor their issuance but to subsequent transactions therein. Transactions by "any person other than an issuer, underwriter, or dealer" are exempt.[67] Transactions by an "issuer not with or through an underwriter and not involving any public offering" are also exempt.[68] "Dealers' " transactions are exempt: (1) if they occur a year or more[69] "after the last date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter" and do not involve securities constituting "the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter";[70] (2) if the securities involved were never "bona fide offered to the public by the issuer or by or through an underwriter"[71] and do not constitute the whole or part of such an unsold allotment to the dealer; and (3) if they are purely brokerage transactions "executed upon customers' orders on any exchange or in the open or counter market," although "the solicitation of such orders" is not exempt.[72]

### *Registration Statements and Prospectuses*

The circumstances under which registration statements must be in effect have been discussed in the preceding section. In transactions not exempted by Section 4[73] involving securities not exempt under Section 3 a person may not deliver securities for or after sale (by agencies of interstate commerce or the mails) unless a prospectus meeting the re-

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usually have to take action before the reorganization can, under any theory, be deemed to be under court supervision. Securities issued entirely for cash are not exempt under this part of Section 4(3).

66. The question even arises as to whether committees may *gratuitously* solicit deposits or exchanges of securities not registered because exempt under Section 4(3). They might well fall within the definition of "underwriter" [*cf.* § 2(11)] and in soliciting deposits would be violating Section 5 and would accordingly be liable under Sections 12(1) and 24.

67. § 4(1).

68. § 4(1). This provision exempts both the original issue and subsequent transactions by an issuer.

69. "(excluding in the computation of such year any time during which a stop order issued under Section 8 is in effect as to the security)." *Ibid.*

70. § 4(1). See the discussion on pp. 207 *et seq.*, *infra*, and notes 209 and 211.

71. By negative implication from § 4(1).

72. § 4(2). See the discussion pp. 206 *et seq.*

73. Or by § 5(c) if agencies of interstate commerce are not used.

quirements of Section 10 accompanies or precedes them.[74] Nor may he make use of any such agencies to transmit a prospectus relating to such securities unless it meets those requirements.[75] Such a prospectus duplicates the registration statement, except for a few documents inclusion of which is optional.[76] The definition of "prospectus" is very broad, including any letters, advertisements, or circulars offering a security for sale.[77] The Commission may classify prospectuses, however, "according to the nature and circumstances of their use" and prescribe appropriate forms and contents.[78]

Inasmuch as the Commission is empowered to change the informational requirements for registration statements[79] and prospectuses,[80] and presumably will employ this power to make the requirements reasonable[81] for the many classes of issuers and securities involved,[82] detailed consideration of present requirements or of the Schedules in the Act is inappropriate here.

In general it may be said that much material information has been required to be stated[83] and that the way has been opened for greater clarity in accounting expression. What is required may, as some think,[84] be unbalanced in the stress laid upon ownership, underwriters' interests, fees, and commissions. But this impression comes rather from the number of items in the Schedules than from its relative bulk in the whole registration statement or from its availability to the investors.[85] Obviously the present requirements do not provide disclosure of all facts

74. § 5(b) (2).

75. § 5(b) (1). See, however, exceptions (a) and (b) of § 2(10).

76. § 10(a).

77. *Cf.* § 2(10).

78. § 10(b) (4). *Cf.* § 19(a).

79. § 7. Note that exclusions may only be made by "class of issuers or securities," while additional information may be required in particular cases. *Cf.* also § 19(a).

80. § 10(b) (2) and (3).

81. Though, of course, appropriate to the protection of investors.

82. In its Forms C-1 (for investment trusts), D-1 (for certificates of deposit), and D-2 (for issues pursuant to a plan of reorganization), the Commission has made a start toward recognition of requirements peculiar to certain classes of securities. The evolution and refinement of such requirements may be expected as the Commission gains experience and conditions change. The task confronting the Commission is important and difficult. Without its aid many almost insoluble problems present in the schedules would raise hopeless confusion and litigation.

83. In any particular instance more information is probably called for than would be "material." This has the virtue of including such facts when they are material, but the disadvantage of leaving the sorting process entirely to the investor. Issuers and investment bankers will not assume the risk under the Act of doing it for them.

84. See the address delivered by A. H. Dean before the Financial Advertisers Association Convention, New York.

85. Such information would not otherwise be available to investors as might other facts about a company or general information as to an industry or economic conditions.

necessary to a sound investment judgment. They never can be pushed that far. In any event they cannot go much further without falling hopelessly within the realm of opinion rather than fact. It is the preponderance of unknowns as contrasted to knowns which makes of investment not only an inexact science but an imperfect art and which makes investment losses inevitable and unavoidable.

On at least one point in connection with prospectuses required to conform to the provisions of Section 10 there is considerable uncertainty, which the Commission by indirection may or may not be able to resolve.[86] That is whether the new information required by Section 10(b)(1) necessitates a new registration or an amendment involving a fresh set of liabilities. If it does, it will work hardship on dealers who may have no means of compelling such registration.[87] It is possible, however, that such information, if it could be obtained otherwise,[88] would not necessitate registration, and civil liability on such parts of the prospectus would be confined to Section 12(2).[89]

As to "prospectuses" on which liability may be invoked under Section 12(2) there are several uncertainties.[90] Such prospectuses include every written communication or advertisement offering a security for sale.[91] Only when the security was newly registered and prospectuses meeting the requirements of Section 10 were available would the exceptions in Section 2(10) apply. As a result a letter which merely identified a security, named its price, and offered to sell would be a "prospectus." Perhaps only under exceptional conditions could such a prospectus lead to liability under Section 12(2).[92] Any further statements, however, might

86. Through the exercise of its power under Section 10(b) to change informational requirements for prospectuses. But see note 89, *infra.*

87. The period during which "dealers" are required to use a Section 10 prospectus may extend far beyond the 13 months under which the original prospectus would serve. Presumably "underwriters" could contract with the issuer for a new registration, but it is not clear that "dealers" who were not "underwriters" would have rights under that contract.

88. Not only would they have to obtain new financial statements, but also material contracts made (not in the ordinary course of business) during the preceding year, remuneration paid to certain officers, securities held by certain persons, and similar information. This they would be unable to acquire in many cases, though it might be given to them in some.

89. But Section 10(a), which Section 10(b) (1) modifies, specifically provides that the prospectus shall contain "the same statements made in the registration statement," not the information specified in the Schedules. Thus it would appear that legally as well as practically the information required by Section 10(b) (1) must be based on a new registration.

90. Prospectuses meeting the requirements of Section 10, as well as other prospectuses, are subject to Section 12(2).

91. *Cf.* § 2(10). It is not clear, but apparently the Commission has no power to rule on prospectuses other than those specified in Section 5. *Cf.* § 19(a).

92. Dependent upon the interpretation of the phrase, "in the light of the circumstances under which they were made," referring to omissions. A casual seller who neglected to state that a stop order issued by the Commission was in effect might be held, for example. A vendor who was known by the purchaser to be well informed on the condition of a com-

be extremely hazardous. Here the disclosure presumably is not limited by the informational requirements for registration statements. The phrase, "in the light of the circumstances under which they were made," (relating in Section 12(2) to misleading omissions of material facts) may be used as a two-edged sword which at times will permit omissions and at others will require the inclusion of material facts. While the burden of proof to be sustained by a person sued under Section 12(2)[93] is a safeguard for the honest and diligent in case a statement is untrue, it will afford less protection in the event of omissions. Some vendors could fill several volumes with what they knew or could reasonably ascertain. The question of omission would be dictated by their judgment of what was material and what was misleading. But the risk of juries deciding otherwise with the benefit of hindsight is present.

## IV

## PARTIES LIABLE

### *Issuers*

Issuers and dealers would appear to bear the major risks of liability under Section 12(1).[94] As discussed above their liability is absolute,[95] but runs only to persons "purchasing" from them.[96] For violation of Section 11 the issuer has only two defenses:[97] that the person suing knew of the untruth or omission at the time of acquiring the security; or that the time limitation within which suits or actions might be brought had run.[98] All defenses of good faith, reasonable care, and reasonable investigation are of no avail to issuers. And the measure of damages is not governed by losses sustained by reason of the untruth or omission.[99]

Some may hold that this duty is not particularly severe, because the

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pany might be held to have represented the security to be "worth" the price asked. Persons who sold at a "market price" which they manipulated or knew was manipulated might be held for failure to disclose that fact.

93. "that he did not know and in the exercise of reasonable care could not have known, of such untruth or omission." The shift in burden of proof is discussed p. 177, *supra*. The additional observation should be made that knowledge of these material facts is not peculiarly that of the vendor in all cases.

94. Because their acts would be more likely to result in violations of Section 5. If directors were held to "control" corporations under Section 15, however, their liability would likewise be invoked.

95. If suit is brought within two years after violation, § 13. *Cf.* last sentence of § 13.

96. § 12.

97. For *alleged* violation, of course, the issuer might prove that there was no such untruth or omission, or that the untruths or omissions did not involve *material* facts or involved opinion rather than facts.

98. Ten years after the public offering is the maximum, § 13.

99. See the discussion pp. 174 *et seq.*

issuer receives the proceeds of the issue, and because for corporate issuers the liability is limited and impersonal. All made liable as issuers, however, are not corporations. In the first place, Section 15 in sweeping language makes jointly and severally liable with and to the same extent as any person (including the issuer) liable under Sections 11 and 12, "every person who, by or through stock ownership, agency, or otherwise," or by agreement or understanding with others, "controls" such person. This assuredly makes a majority stockholder liable, whether corporate or not. Its further extension is uncertain. A dominant stockholder who may hold but a small percentage of the stock may be held liable. Those whose proxies are obtained by a dominant group may be liable.[100] No one knows what "controls" will be held to mean. Considering the number of courts having jurisdiction[101] uniform holdings will not soon be forthcoming. Some courts might hold it to mean that type of control[102] which now renders stockholders liable for corporate debts. But this would be an emasculation of Section 15. If that section is interpreted in light of its apparent scope, stockholders in a corporation may be in a more hazardous position than directors and other persons made liable under the Act, and the legislative sanction of limited liability will be cast to the winds. Until all doubt is resolved a conservative management will hesitate to guarantee the adequacy as well as accuracy of a registration statement where that guarantee is to be backed by the entire financial resources of the group without benefit of limited liability.

In the second place the actual issuer may not be a corporation.[103] Of such instances none is more to the fore at the moment than that of so-called protective committees. Protective committees have served a high purpose (sometimes well and sometimes miserably) in the process of financial rehabilitation or readjustment. Under the Act they become absolute guarantors of the registration statement if they are held as issuers.[104] Committees represent one type of issuer which does not re-

100. Presumably all stockholders are not made liable by virtue of the "control" they possess. Query, whether several stockholders whose aggregate holdings comprise a majority of the stock and who without express agreement support the management, would be liable. And see note 59, *supra.*

101. All state as well as federal courts. § 22(a).

102. Douglas and Shanks, *Insulation From Liability Through Subsidiary Corporations* (1929) 39 YALE L. J. 193.

103. *Cf.* § 2(4) and (2).

104. With respect to certificates of deposit "the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued." § 2(4). A few committees might be able to avoid this category of "depositor or manager," but if they solicited deposits they would run the risk of being held as "underwriters." But if the committee *is* an issuer and no *other* persons solicit deposits for it (so that "underwriting" cannot be held to be present), then it may be plausible to insist that such committee need not register its certificates, because such solicitation as it made would not amount

ceive the proceeds of the issue. But they have no defenses which other issuers do not have. Provision is made for registration of certificates of deposit,[105] and recent rules and regulations of the Commission specify requirements for such registration.[106]

The cumulative effects of the absolute liability of the issuer, the undefined liability of stockholders,[107] the liability of directors irrespective of the nature of their appointments,[108] the liability of underwriters, and the increasing difficulty on the part of issuers to obtain that underwriting,[109] make it more and more apparent that, whether rightly or wrongly, justifiably or otherwise, the Act will prevent a great amount of financing by many companies with well established businesses and will continue to deter refunding operations and reorganizations.[110]

### *Directors and Other Officers*

Certain officers of the issuer are required to sign the registration statement[111] and as signers are subject to liability for the entire issue.[112]

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to a "public offering" under Section 4(1). This appears to be extremely doubtful. See the discussion note 62, *supra.*

105. § 2(4). If there is no registration statement in effect before deposits are solicited, Section 5 is violated, since "sell" is so defined as to include solicitation of that kind. § 2(3). Such violation, if willful, entails criminal liability. § 24. Those who had exchanged securities for the certificates would have an action for rescission or damages against the committee, even though the committee had made no untrue or misleading statements and even though there was no causal connection between what was said or done and what happened to the certificates. § 12(1). Any solicitation of deposits would have to involve a prospectus satisfying the requirements of Section 10, or Section 5 would be violated and criminal and civil penalties would be incurred, as above. In case the solicitation of deposits was based upon a specific plan of reorganization, then the registration statement (and prospectus) must contain additional information prescribed by the Commission. Form D-1, Part II. More commonly, however, the plan would be devised subsequent to deposit. In that event, a new registration is involved and redeposit must be solicited with a new prospectus if Section 5 is not to be violated. One more registration would be necessary when the reorganized company issued the new securities, unless that issue were exempt [see the discussion note 62, *supra,* but in that case the committee would not be the issuer, though it might well be subject to the same liability through the control it exercised over the issuer [§ 15] as a result of its dominant position in the reorganization. In any event it runs the risk of being held as "underwriter" in soliciting exchanges. See note 104, *supra.*

106. Form D-1, Parts I and II. The extent to which these regulations decrease the liability of committees is discussed pp. 213-214, *infra.*

107. Because of the obscurity of Section 15. Since the term "control" may have been used in a loose, non-legal sense, the Commission may assert its power under Section 19(a) to define it as a "trade term." See p. 213, *infra.*

108. See the discussion on pp. 192 *et seq., infra.*

109. See the discussion on pp. 198 *et seq., infra.*

110. See the discussion pp. 185 *et seq., supra;* Mead, *supra* note 1, at 433; Dulles, *The Securities Act and Foreign Lending* (1933) 12 FOREIGN AFFAIRS 33.

111. § 6(a).

112. § 11(a) (1) and (e).

Others are made similarly liable even though they do not sign.[113] This liability (as well as the liability of others hereafter considered) is expressly made to rest upon a "fiduciary relationship"[114] to the investor. As to parts of the registration statement not purporting to be made on the authority of an expert and not purporting to be a copy of or extract from a report or valuation of an expert or public document, such person must have had, after reasonable investigation, reasonable ground to believe and belief that the statement was true and involved no material omissions.[115] As to any part purporting to be made on the authority of an expert (other than himself) or purporting to be a statement of an official person or a copy of a public document, he must have had reasonable ground to believe and did believe that the statements contained no such untruths or omissions.[116] And for statements made by such persons as experts, they must have made a reasonable investigation and have had reasonable grounds for believing and did believe the statements to be true and to contain no material omissions.[117] Criticism is frequently made that the standard is too high. Objection to it, however, cannot be made in the abstract but only in its particular applications.

To a very limited extent the doctrine is no innovation to the common law. Courts have on many occasions described directors as occupying a fiduciary relationship to stockholders,[118] and the doctrine has made genuine advance in recent years following its effective and persuasive promotion by Berle.[119] To all classes of persons liable under Section 11 it is, however, for all practical purposes new.[120] Yet it is not so far in advance of the common law nor so inconsistent with liberal thought as to be deemed revolutionary. More particularly, however, it is frequently said that the test given injects into the Act a vague and uncertain formula. This is true. Many states have differing statutes regulating certain activities of trustees.[121] In addition each state has its common law. If these factors are pertinent to an interpretation of the Act, there will be at least verbal—and perhaps substantial—differences among the various courts.[122] In essence, however, the Act is setting a high standard

113. Directors, or persons performing similar functions, or partners [§11(a) (2)], and those named with their consent "as being or about to become" directors, or persons performing similar functions, or partners [§ 11(a) (3)].

114. § 11(c).

115. § 11(b) (3) (A).

116. § 11(b) (3) (C) and (D).

117. § 11(b) (3) (B). See p. 197, *infra.*

118. *E.g.,* Strong v. Repide, 213 U. S. 419 (1909); Sisk v. Jordan Co., 94 Conn. 384, 101 Atl. 181 (1920).

119. Berle, *Corporate Powers as Powers in Trust* (1931) 44 HARV. L. REV. 1049.

120. Of course, even as respects directors the common law has never gone so far as to hold them vicariously liable to investors on such a basis.

121. Collected in Bogert, *The Trustee's Duty With Regard to Conversion of Investments* (1933) 1 U. OF CHICAGO L. REV. 28.

122. See *ibid.*

—an immeasurable difference in degree. It could go farther than it does and resolve those verbal differences,[123] and that seems desirable.

Under Section 6(a) the issuer's "principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer" must sign. Presumably the Commission, under its power to define "trade terms,"[124] will resolve doubts as to the extensiveness of the category of principal executive officers.[125] Since the Commission technically lacks the power to exempt from signing any person named,[126] the question arises as to whether a statement can be made effective for an issuer lacking any such officers. In most cases persons could be named to such offices for the particular purpose, but this would appear a strange fiction, say, for a protective committee. Of all persons made liable under the Act, with the possible exception of "experts," the principal executive officers seem to be in the most favored position to sustain the burden of proof imposed.[127] While relatively at an advantage, they assume risks which mount with the size or degree of complexity of the enterprise. Since, for the most part, it is the large enterprise which seeks capital from the public and since most large enterprises, especially in the industrial field, are fairly complex, the penalty imposed on these employees (who, after all, do not receive the proceeds of the issue) may well deter some of them from assuming the risk if they are persons of financial substance. The financial and accounting officers seem to have been included as the experts responsible for certain phases of the enterprise vital to the registration statement, but unlike the other "experts"[128] contemplated by the Act their liability is not confined to the

123. For example, by codifying the rule as stated in the Restatement of the Law of Trusts, Draft T. No. 2 (Am. L. Inst. 1931) § 169: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill as he has."

124. §19(a).

125. If the Commission should have failed to rule in a particular case and one person who might later be held to be one of the "principal executive officers" should have failed to sign, the question might arise as to whether the registration statement ever became effective. If it were held not to have become effective on this account, all who "sold" the security might be absolutely liable under Section 12(1), while the directors, other officers, and some underwriters might not be unless they were held to "control" the issuer or others who "sold" [§ 15]. See note 100, *supra,* and note 140, *infra.* As to the applicability of the doctrine of estoppel to such a situation see p. 214, *infra.* Perhaps courts would avoid this switching of liability from Section 11 to Section 12(1) by interpreting "principal executive officer *or* officers" to mean that only one is *required* to sign.

126. See pp. 213, 214, *infra.*

127. In a great many cases the executive officers, other than those responsible merely for particular phases of an enterprise, would be expected to maintain fairly intimate contact with detailed operations and to be in a position to make the *investigation* which might prove their only defense in case suit were brought.

128. *Cf.* § 11(a) (4); and see the discussion on p. 197, *infra.*

portions of the statement which their positions would qualify them to pass upon.[129]

Although only a majority of the board of directors[130] is required to sign,[131] all directors[132] are made liable[133] as well as "every person who, with his consent,[134] is named in the registration statement as being or about to become a director."[135] As with the other persons made liable on the registration statement, the risks to directors increase with the size or complexity of the issuer's operations.[136] Furthermore, though there may be some or many directors who do not "direct" (in the sense that they merely draw prestige and fees from the position) there are a great many, particularly of the larger and more complicated enterprises, who do and yet are not personally familiar with all details of operation. Nor could their services be obtained in most cases if they were required to investigate details of the enterprise.[137] The experience and judgment of men of affairs is of great value to most of our more important corporations. To deprive enterprises of this asset would seem uneconomic in view of the slight gains which may be expected.[138] It is

129. *Cf.* § 11(a) (1).

130. ". . . or persons performing similar functions (or, if there is no board of directors or persons performing similar functions, by the majority of the persons or board having the power of management of the issuer)." § 6(a).

131. *Ibid.*

132. Or " . . . person performing similar functions, or partner." § 11(a) (2), and (3). In view of the difference in the description here and in Section 6(a) [note 130, *supra*], the question arises as to whether there is any liability imposed upon the minority of "the persons or board having the power of management of the issuer" in the absence of a board of directors "or persons performing similar functions" and if such persons are not partners.

133. Directors and other persons (except the issuer) subject to suit under Section 11(a) are not held liable if they sustain the burden of proof that before the effective date of the registration they had resigned from and ceased to act in the capacity described in the registration and had notified the Commission to this effect and that they would not be responsible. § 11(b) (1). Presumably only directors who did not sign (and possibly "underwriters") could avoid liability by sustaining the burden of proof that if the part of the registration statement with respect to which their liability was asserted became effective without their knowledge they, upon becoming aware of such fact, "forthwith acted and advised the Commission, in accordance with paragraph (1)" of Section 11(b), "acted" thus presumably meaning that he had resigned and ceased to act in the described capacity, "and, in addition, gave reasonable public notice that such part of the registration statement had become effective without" their knowledge. § 11(b) (2).

134. The Act does not specifically require the filing of this consent in writing, as it does in the case of "experts." *Cf.* § 7.

135. Or " . . . person performing similar functions, or partner." § 11(a) (3).

136. See the discussion on p. 194, supra.

137. Here, as at many other points in the Act, it is tolerably clear that Congress intended to accomplish certain ends wholly ancillary to the avowed purpose of the Act of requiring the truth about securities to be given investors "with the least possible interference to honest business."

138. It is not to be denied that cases where directors have used their position merely as a social badge or as an advantageous trading position have been far too numerous in

possible to safeguard the accuracy and completeness of the registration statement without subjecting every director to the burden of proof that after reasonable investigation he had reasonable ground for believing and did believe the registration statement to be free from actionable untruths or omissions.

One cannot foretell with certainty whether principal executive officers and directors, as such, may be subject, as those who "control" the issuer, to liability under Section 15 as well as under Section 11. They certainly are in a position to exercise the highest degree of immediate "control," though if this type of "control" is contemplated in Section 15 many of the provisions of Section 11 respecting such persons become meaningless.[139] If on the authority of Section 15 they are joined with an issuer in a suit brought under Section 11, they are deprived of all defenses specified in Section 11(b).[140] By virtue of Section 15, however, the so-called "dummy" director is cast aside and those are held liable who tell him how to act and what to do.

Another, though perhaps a relatively minor, effect upon directors (and, more particularly, upon other officers and employees) is the risk they may incur in selling securities which they own and which were originally issued[141] by the corporation or other "person" by whom they are employed. If any person who purchased from or sold for them is held to have so purchased or sold with a view to "distribution," such person would become an "underwriter" if the officers or employees may be said to have been directly or indirectly "controlled" by the issuer.[142] Unless the security were registered Section 5 would be violated.

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the past. It is also not to be denied that adequate regulatory legislation is needed for the protection of the corporation and the minorities in such cases. It is doubtful, however, if that end has any dominant place in a securities act. Legislation could be more effectively designed to accomplish the other purpose if considered separately. In that way it is believed that a more effective control over the many different malpractices would be realized.

139. Section 15 obviously is drawn with little reference to the many different situations in which it may apply. Until courts round out its meaning by an accretion of decisions, the risks must remain uncertain.

140. The wording of Section 15 is not sufficiently clear to permit one to state whether a "controlling" person may be sued independently of, and prior to a judgment against, the person "controlled." Although the "controlling" person is made "jointly and severally" liable, it is "with and to the same extent as" the person controlled. Doubt also exists as to whether a person made liable only under Section 15 would have a right of contribution under Section 11(f) against other persons made liable, since Section 11(f) refers specifically to persons made liable under that section.

141. The issue may have been "sold or disposed of by the issuer" [§ 3(a) (1)] long before July 27, 1933, but the sale by or for the employee might be held to be a "new offering" [§ 3(a) (1)] not exempt from Section 5 by Section 4(1) because of the presence of "underwriting" [§ 2(11)], even though the "offering" were not "public."

142. *Cf.* § 2(11).

*Experts*

Specific provision is made for certification of parts of the registration statement by experts such as accountants, engineers and appraisers whose professions give authority to their statements.[143] The written consent of experts named as having prepared or certified such parts is required to be filed with the registration statement.[144] This results in making such an expert liable for the whole issue[145] if untruths or omissions creating liability under Section 11 occur in the part of the statement which he is named as preparing or certifying.[146] Experts named as having prepared or certified "any report or valuation" which is "used in connection with the registration statement" also are made similarly liable if they are so named with their consent.[147] As to such experts, however, the Commission is empowered to waive the filing of their written consent;[148] and if their written consent is not so filed, they are not made liable unless the person suing can prove that such consent was in fact given, though it was not so filed.[149]

Of all those made liable on the registration statement the "expert" is in the least vulnerable position. He is not made liable unless the part of the statement which he prepares or certifies contains a material untruth or omission.[150] Furthermore the reports of experts in practically all

143. § 7. The Commission probably has power under Section 19(a) to define which professions give such authority. Upon such rulings may depend the ability of issuers to have every material fact in the registration statement prepared by an "expert." See note 168, *infra*.

144. § 7.

145. § 11(a) (4) and (e). Experts are given a right of contribution under Section 11(f), but it would probably only be enforceable against the issuer, and any person controlling the issuer [§ 15], unless the experts could controvert the proof advanced by others that they had *reasonable ground* to believe his statements to be true and complete. See p. 180, *supra* If the untruths or omissions are willful, they become subject to criminal liability under Sections 17(a) and 24.

146. If such untruths or omissions occur only in a part so prepared or certified, any person made liable under Section 11, other than the issuer, those controlling the issuer, and the expert involved, is relieved from sustaining the burden of proof that his reasonable ground for belief and his belief in the truth and adequacy of the statements was based upon an investigation which would be reasonable for a person in a fiduciary capacity. He must, however, sustain the burden of proof that he had reasonable ground for believing and belief "that such part of the registration statement fairly represented the statement of the expert or was a fair copy of or extract from the report or valuation of the expert"; and that the statement contained no such untruths or omissions. *Cf.* § 11(b) (3) (A) and (C).

147. §§ 7 and 11(a) (4).

148. If it is "impracticable" or involves "undue hardship on the person filing the registration statement." § 7.

149. § 11(a) (4). Suit in such cases would be highly improbable in view of the difficulty of sustaining such proof.

150. If that part does contain such an untruth or omission, the expert must sustain the burden of proof that "he had, after reasonable investigation, reasonable ground to believe

cases are based on some form of investigation, and the standard of care probably would equal, though not exceed, that for their profession. Nevertheless the Act may make it impossible for accountants to obtain protection from their statements under the cloak of a limited certification.[151] To say the least the Act goes as far in protection of purchasers of securities as plaintiff in *Ultramares Corp. v. Touche*[152] unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor.[153] The change which that court thought so "revolutionary" as to be "wrought by legislation"[154] has been made. And the duty placed on experts such as accountants has not been measured by the expert's relation to his employer but by his service to investors.[155]

The hesitancy of reputable and substantial persons to be named as "experts" could result only from fear of the heavy penalties which might attend an error or which might be imposed by an unintended construction of their statements by a jury. Nevertheless it may be expected that the reputable firms will be more chary than ever of becoming experts for any but the more substantial issuers. And it may be predicted that the fees of these experts will measurably increase, at least until greater experience has been gained from litigation under the section, since many uncertainties remain—some necessarily so. May an accountant rely upon an appraiser's certificate, where it does or where it does not contain qualifications? May he rely upon an officer's certificate of inventory? In a financial statement, what falls within the realm of fact, what within the realm of opinion?

### *Underwriters*

Where the Companies Act holds responsible in addition to directors and certain promoters only such persons as "authorised the issue of the prospectus,"[156] the Securities Act imposes liability upon all "underwriters."[157] The introduction into the Act of the business term "un-

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and did believe" the statements to be true and complete, or that "such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation . . ." § 11(b) (3) (B).

151. Section 11(c) provides that in determining what constitutes "reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship." See the discussion on p. 193, *supra*. If a limited certification should be held to protect an expert, it seems that those other than experts who are made liable would not be relieved of sustaining the burden of proof that they had made a reasonable investigation of the statements not so certified by the expert.

152. 255 N. Y. 170, 174 N. E. 441 (1931).

153. In view of the standard of a fiduciary imposed by Section 11(c) it goes further.

154. *Supra* note 152, at 187, 174 N. E. at 447.

155. See *id.* at 188-189, 174 N. E. at 448. By virtue of Section 16, however, there still remains the expert's liability for fraud.

156. *Supra* note 27, § 37.

157. § 11(a) (5).

derwriter" necessitated definition, and the definition employed[158] includes many more persons than have hitherto been comprehended in that term.[159] Those persons actually play a variety of rôles whose differences are quite marked in business. For example, the underwriter who originates the issue and typically manages its distribution occupies an essentially different position with respect to the security, the prospectus, and the issuer than do those other persons who may be considered as underwriters or who are so considered under the Act.[160]

With reference to the Act this difference is founded upon ability to make the "reasonable investigation" required of a fiduciary.[161] In originating security issues honest and competent houses make such investi-

158. § 2(11).

159. Underwriting has been defined as "an agreement entered into before the shares are brought before the public, that in the event of the public not taking up the whole of them, or the number mentioned in the agreement, the underwriter will, for an agreed commission, take an allotment of such part of the shares as the public has not applied for." *In re* Licensed Victuallers' Mutual Trading Association, 42 Ch. D. 1 (1889). The Standard Dictionary follows this definition; Webster's extends it to include agreements for outright purchase. Berle explains this extension as the adoption of the definition of "American financial slang." See New York Times, June 4, 1933, VIII-1. Like other slang its definitions are not fixed and invariable. As sometimes used the term is confined to "originating houses" or again to "principal underwriters" or members of an "original purchase group." At its furthest extension it has included all "selling syndicate" members, but in so far as is known it has not been applied to members of "selling groups," though at times their practical commitments are scarcely to be differentiated. But even its broadest usage does not encompass all those included under the Act—such, for example, as the small retail dealer who solicits and confirms orders in a security for an issuer at a small commission without taking any commitment in the security. That explanation may cover the inclusion of any person who "has purchased" from an issuer rather than a restriction to persons who technically underwrite, but it does not make clear how any person that "sells for an issuer" is included.

160. For a more extended discussion of the various functions of "underwriters," see Douglas and Bates, *Some Effects of the Securities Act Upon Investment Banking* (1933) 1 U. OF CHICAGO L. REV. 283. As a practical matter a prospective issuer of securities usually deals with but one investment banker, except as the issuer may technically contract with a greater number at the instance of that banker. It is the function of such a banker, known as the "originating house" with respect to the security involved, to investigate the issuer and the market to determine whether the proposed or some lesser credit or capital investment is warranted and what form it should take. Realistically, there is great variation in the weight given the factors entering into such a judgment, but the important point here is that the originating house is in a peculiarly strategic position to investigate and weigh them. Furthermore, in the course of subsequent negotiations, the originating house has the opportunity to influence decision as to the precise form the security will take, the protective provisions with which it will be hedged, and the time, price, and conditions in respect of its offering, including the form of prospectus employed therein. If the size or nature of the issue and the relative capital or distributing capacity of the originating house necessitate, or factors affecting the issuer or banker make it desirable, other houses may be called upon to participate in the underwriting and/or distribution of the security. Typically the originating house acts as manager of such groups or syndicates as are thus formed, and if there are co-managers acts as agent for such managers for purposes of centralized administration.

161. § 11(a) (5), (b) (3) (A), and (c).

gations and are compensated therefor. They normally assist in the preparation of the prospectus and lend their names to the issue. Under the Act they are assigned no special responsibility, however, which would differentiate them from a host of other persons far removed from the origination of the issue.[162] It is not strange that originating houses should be held to the standard of responsibility imposed by the Act. It is, however, anomalous to find that many other persons are held to as high a standard, even though they are in no position to duplicate the investigatory function of the originator or to participate in his activities. In one particular, however, the originating house is set apart from others who may become "underwriters," inasmuch as "preliminary negotiations or agreements between an issuer and any underwriter" are exempt.[163] The failure to provide similar exemption for negotiations and agreements among underwriters[164] will hamper the orig-

162. It has been suggested [see Douglas and Bates, *supra* note 160, at 284-86] that in the performance of his functions of origination the originator, as such, incurs no liability under the Act. This is a highly theoretical point, for in practically all cases the originating house would subsequently share in the purchase or underwriting of the security originated and, in any event, might be held under the sweeping provision of Section 2 (11) which includes as an "underwriter" any person who "participates or has a direct or indirect participation in any such undertaking," depending upon the interpretation of the term "participation." But it is as an "underwriter," not as an originator, that the originating house comes within the purview of the Act. In addition, of course, he may be liable where his name is used as giving authority to any statements made in the registration statement [§ 11(a) (4) and (b) (3) (B) (I) and (II)] or where he controls the issuer, its officers, or experts. §§ 11(a) (2), 15.

163. § 2(3). This exemption only applies to the definition of "sale." It may mean, however, that preliminary negotiations between issuers and "underwriters" are exempt only if the issuer approaches the "underwriters." No such exemption is made with respect to an "offer to buy." Still such offer is expressly made unlawful under Section 5(a) if a registration statement is not in effect. Violation of that section would entail civil liability under Section 12(1) if such offer were included in the definition of "sale" and possible criminal liability under Sections 17 and 24 whether or not it were so included. See Douglas and Bates, *supra* note 160, at 288 *et seq.* But mere solicitation of business by an issuer would not be considered the making of an offer to buy unless the undefined "buy" were interpreted in the same way and as broadly as its correlative "sell." If it should be so interpreted, the same exemption might be carried over to such an instance.

164. The requirement that the names of, and certain facts with respect to, underwriters be given in the registration statement [Sch. A (5), (7), (16), (17), and (28) and Sch. B (6), (10), and (13)] would mean that only such underwriters could be included as had dealt directly with the issuer, and that sub-underwriters could not be approached prior to the effective date of the registration statement. Their acceptance of participations would require amendment to the registration statement and possibly further delay before the statement again became effective as amended. Considerable delay might also occur between the offering and acceptance of such sub-underwritings. *Cf.* Section 12 (d) of the Senate Amendment to H. R. 5480 exempting "Any preliminary negotiations between the issuers, underwriters, or other persons necessary to preparing an issue of securities for registration under this Act or for sale to the public after registration." It is unfortunate that some similar provision was not included in the bill as passed. The word "preliminary" should have

inating house in forming groups to underwrite a commitment for the issue.[165]

One other possible function of the originating house is also affected. Since it is most prominently identified with and sponsors the issue, it usually accepts some measure of responsibility for keeping watch over the security and the affairs of the issuer with a view to representing the interests of security holders in the event of difficulties, impending or actual. The liabilities and deterrents imposed by the Act on those performing this function provide a real impediment, whether they be originators or wholly independent groups.[166]

As has been noted, numerous persons other than originators are made liable on the registration statement as "underwriters" to the same extent as the originating house. A few of them, sometimes denominated as the "principal underwriters," may be in nearly as strategic a position to investigate and to dictate the form of the registration statement as the originators. Most others who might fall within the category of "underwriter" would have no such opportunity.[167] Thus with respect to security distribution all members of purchase and banking groups and selling syndicates are so made liable. Few of the fifty to several hundred widely scattered members of syndicates underwriting large issues would have sufficiently large participations to justify making the investigation required.[168] Sound underwriting requires that the risk be so

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prevented the evasion of federal jurisdiction evidently feared by the draftsmen of the present Act if other provisions therein are not adequate to the purpose.

165. See Douglas and Bates, *supra* note 160, at 288 *et seq.* There would seem to be a possibility, however, that the originating house might be employed as the agent of the issuer in approaching potential "underwriters."

166. See discussion p. 191, *infra.*

167. For an elaboration of this point see Douglas and Bates, *supra* note 160, at 290 *et seq.*

168. The possibility of all who might become "underwriters" jointly employing an agent to investigate, thus preserving in such formal way the existing division of functions as between originating houses and participants, is probably precluded by the failure of the Act to exempt preliminary negotiations among underwriters. If means or instruments of the mails or of transportation or communication in interstate commerce were used, Section 5 would be violated. If the violation were willful a criminal penalty would be risked, but of greater practical importance is the fact that if the negotiations resulted in participation by such other "underwriters," the person (other than the issuer) approaching them with respect to the security would be liable to suit under Section 12(1) any time within two years thereafter [§ 13] for damages or rescission, and the action would need show no causation between what the person violating Section 5 (whether willfully or not) said or did and what happened to the security. *Cf.*, however, the discussion of damages at p. 177, *supra.*

A method of obviating this technical difficulty by making the originating house the agent of the issuer has been mentioned. See note 165, *supra.* Another method of meeting the difficulty would be for the issuer to employ "experts" to verify *every* fact in the registration statement, so that the entire statement would be purely a compilation of signed reports. But the "underwriters" would still be required to prove, not only belief in the truth and adequacy of the statements, but "reasonable ground" for so believing. Presumably

spread that all who participate will be able to bear it conservatively. Since such ability of individual underwriters is not unlimited many small participations are implicit, especially for large issues. Economy is achieved by delegating to the originating house the function of investigation, not of the exercise of judgment upon the facts investigated. If it was the design of Congress to assure accuracy and completeness in the registration statement by multiplying the number of investigations, it lost sight not only of this but of other costs entailed.[169]

Specifically excluded from the definition of "underwriter" are those "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."[170] This exemption is ambiguous. Perhaps it applies only to regularly employed commission salesmen or those acting in a similar capacity with no greater interest in the transaction.[171] But it probably applies also to dealers who without commitment merely confirm sales for an "underwriter or dealer."[172] The moot question[173] is whether this exemption includes dealers who do not underwrite in the technical sense

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this would call for investigation and knowledge of the integrity and competence of the experts and even for some verification of the experts' reports, especially where the experts were not passing upon routine legal, accounting, or engineering facts. Otherwise such copious use of experts would be too obvious a dodge.

169. A person of financial substance would scarcely assume the risk of civil liability involved in becoming an "underwriter" without making the sort of investigation which would be his only certain defense. If his participation were no more than $10,000 to $100,000 with a gross spread of from $300 to $4,000, out of which he would have to cover his overhead, pay direct expenses and commissions, set aside a reserve for unsuccessful underwritings, derive a profit, and in addition finance an investigation similar to that which might be undertaken by the originating house, it is obvious that he would not participate. To increase the gross profit of all participants sufficiently so that such investigation might be made would make the cost of financing prohibitive. One result might be that security distribution would fall into the hands of financially irresponsible houses. This would not only be directly inimical to the interests of investors, but would place all the real burden of underwriting back upon the issuer. Another possibility would be that only small or moderate issues of issuers close to financial centers would be underwritten.

170. § 2(11).

171. If so, it is curious that similar exemption was not extended to salesmen who might be employed on a commission basis by an issuer. Perhaps it was the intent of Congress that if the issuer used the customary methods and channels of security distribution an "underwriter" should be interposed to provide an independent check on the issue. The breadth of the definition of "underwriter" would defeat the essence of such a purpose, however, for any person who "sells for an issuer" is as much an "underwriter" as a person of independent financial substance.

172. This is the interpretation being acted upon in some cases. The failure to provide similar exemption for persons so distributing for issuers, however, has led to the device of setting up an "underwriter" in the nature of a strawman between the issuer and such dealers. See note 171, *supra*.

173. It is hardly possible that "distributors" would be interpreted as being synonymous with "underwriters," otherwise the impact of Section 11 would be only upon "underwriters" who received more than a normal commission.

but who subscribe for securities in advance of firm orders from customers.[174] Strict interpretation would hold them to be "underwriters."[175] Dealer discounts from the public offering price usually are (and certainly, in view of this possible exemption, would be) denominated "commissions," however, and the reference in Section 4(1) to the "unsold allotment to or subscription by" a "dealer" may sometime be relied upon as evidence that Congress intended their exemption.[176] In any event, few of them would be in a position to sustain the burden of proof required of "underwriters," though their opportunity would probably be as great as for most such "underwriters."

In fact it is curious to find in the Act an exemption for those who will actually represent the security to investors when others who may merely guarantee its sale are made liable. Although a person who "purchased" with no view to "distribution"[177] is not directly included as an "underwriter," he is if he "participates or has a direct or indirect participation in any such undertaking," with the result that, if any other "purchaser" should have, or should be held to have had, such a motive, he is made liable on the registration statement.

"Participation" is not defined. If "participants" are held to be only the signers of a joint agreement, the attempt of strict underwriters (not having a view to distribution) to escape liability by signing agreements distinct from those made by persons having a view to distribution would be unavailing, because of the further inclusion of any person who "par-

174. *Cf.* Douglas and Bates, *supra* note 160, at 297, 302.

175. This view would be strengthened if the intent of Congress in including "underwriters" among those made liable on the registration statement were assumed to be for the purpose of placing responsibility upon those having strong incentives to sell, and if it were assumed that the presence of an inventory or a commitment (confirmed subscription) entailing risk of loss as well as opportunity for profit was such an incentive while the mere opportunity for a "normal" profit was not. Strict adherence to such a theory would lead courts to hold as "underwriters" those dealers who, though not members of selling groups, purchase at the small "dealers' concession" from selling group members in advance of customer orders. Courts might discriminate, however, between members and nonmembers of selling groups, or between those who did and did not agree to sell on such terms. But as to the actual intent of Congress, see H. R. REP. 85, *op. cit. supra* note 3, at 13-14.

176. The use of the term "dealer" at that point in Section 4 (1) is unfortunate. If the intent of Congress was to except from the exemption there provided only transactions by an underwriter, whether or not any longer acting as such with respect to the security involved, it would have been much clearer to have so stated, rather than to use the term "such dealer" which in its context includes both a "dealer" and an "underwriter no longer acting as an underwriter." That this might have been the intent may be inferred from the inclusion in that clause of the term "issuer." Presumably an allotment by an issuer to a dealer would make the latter an "underwriter," as Section 2 (11) provides no exemption in such a case. See note 172, *supra*.

177. § 2(11). "Distribution" is not defined. Presumably it might apply to either private or public "sales" in lots smaller than the bulk purchase, or even to a bulk sale made within a short time after the purchase.

ticipates or has a participation in the direct or indirect underwriting of any such undertaking." It is possible, however, that such a holding would permit an investor to make an outright purchase from an issuer of a portion of an issue being "underwritten" without himself becoming an "underwriter." There is no certainty as to such a holding, however, and unwary persons who never contemplated such a rôle may find themselves held as "underwriters."[178]

Other persons who are not commonly considered as underwriters or security dealers likewise may become "underwriters" under the Act. Those who, in connection with a reorganization[179] or some other plan of a protective committee, solicit, even gratuitously, the deposits of securities in exchange for certificates of deposit may become "underwriters."[180] There would normally be no other "underwriters" for whom they might act, so that the exception in Section 2(11) would not apply, even if they were not acting gratuitously. They would be "selling" for an issuer under Section 2(11) in view of the broad definition of "sale" in Section 2(3).[181]

Two additional factors will seriously affect orthodox underwriting. The "waiting period" of twenty or more days prior to the effective date of a registration statement[182] will probably result in such underwriting

178. Under § 11. Query, under Section 2 (11), whether an investor buying from an issuer securities neither publicly offered nor otherwise underwritten, and so not registered, might not, if agencies of interstate commerce or the mails were used and the transaction did not come within Section 5(c), be held to be an "underwriter" if some other buyer should be held to have had a view to distribution in making the purchase. Note that transactions by him as an "underwriter" would not be exempt under Section 4(1). The two-year risk of such decisions to the issuer and its officers under Section 12 (1) may deter even private offerings except those of a purely intrastate character.

179. Section 4 (3) does not exempt securities issued in a reorganization if the reorganization is not "bona fide" or if it is not under court "supervision." Furthermore, even in cases of such "supervision," deposit usually occurs prior to such reorganization or supervision, and, in any event, the exemption probably applies only to securities issued by the corporation being reorganized, not to certificates of deposit issued by others. This is the interpretation accepted by the Federal Trade Commission in preparation of its forms Nos. D-1 and D-2.

180. At least, they run the risk of such an interpretation.

181. See the discussion p. 207, *infra*.

182. § 8(a). "The effective date of a registration statement shall be the twentieth day after the filing thereof." But this may be delayed through amendments or stop orders. § 8(b), (c) and (d). Statements on certain foreign securities may become effective in seven days. § 8(a). In the Statement of the Manager on the part of the House, the twenty-day period was explained as providing time sufficient for public scrutiny, while the Commission is expected during this period to make only a "preliminary check-up." See H. R. REP. 85, *op. cit. supra* note 3, at 20. Undoubtedly this provision will be useful administratively in permitting the Commission to prevent some patent violations.

The "waiting period" was also included for other than administrative reasons. H. R. REP. 85, *op. cit. supra* note 3, at 7-8, states, "It contemplates a change from methods of distribution lately in vogue which attempted complete sale of an issue sometimes within

being postponed until some time after that date. Such "underwriting" as may be necessary to bring the "underwriters" into the registration statement will probably be so hedged that the issuer will bear the risk of sale prior to the effective date of the statement, or commissions paid underwriters will be considerably increased to cover their added risks.[183] The value of such a provision may prove to make its cost in correlative effects too high.[184]

The other factor is the "stop order" which may be issued by the Commission suspending the effectiveness of a registration statement.[185] Presumably all "underwriter" and dealer commitments will provide for repurchase by the issuer in the event a stop order should issue, for otherwise they might be left for a period with unsaleable inventory, and might even have no other recourse against the issuer.[186] Limited capital rela-

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one day or at most a few days. Such methods practically compelled minor distributors, dealers, and even salesmen, as the price of participation in future issues of the underwriting house involved, to make commitments blindly." If "participation in future issues" is valuable and is to be obtained in no other way, commitments will still be made, though perhaps not so "blindly." Other factors, such as liabilities imposed, may induce caution or fear of commitments. On the other hand the provision may prevent certain commitments which are predicated upon little more than the lure of the unknown. But even this is highly questionable. In periods of rising security prices and consequent opportunity for speculative profit there probably will be oversubscription based on unknowns which the registration statement will not dispel. More than twenty days of falling prices are usually required to dispel such hopes. Security dealers, like other merchants, can seldom successfully resist the tide of popular demand or lure for profit.

As for the investor, furthermore, there is little likelihood that issuers or "underwriters" who did not consider that their securities would pass the test of a twenty-day scrutiny would make the prospectus available to prospective buyers much in advance of actual solicitation. In fact, there may be considerable risk in any issuer or "underwriter" so doing [under Sections 12 (1) and 24, because of violation of Section 5 when read in connection with Section 2 (3)], though an official of the Commission has ruled otherwise. Release No. 70, Nov. 6, 1933, quoting H. R. REP. 85, *op. cit. supra* note 3, at 12-13. In practice few investors of the type supposedly most needing protection would undertake the initiative and expense of obtaining transcripts of registration statements. As to cost see Regulations, Art. 9. Perhaps better for the immediate protection of investors than the waiting period is the power granted to the Commission to require the filing with it of prospectuses used in connection with the sale of registered securities. § 10(d). Scrutiny of such prospectuses reinforced by the grant of injunctive relief [§ 20] may be of real value in protecting investors.

183. *Cf.* note 164, *supra,* for a further difficulty in connection with the waiting period introduced by the failure to exempt preliminary negotiations among underwriters. The bringing in of sub-underwriters will require amendment of the registration statement and indeterminate delay beyond the original twenty days. § 8(c). Some question arises as to whether a change in the public offering price necessitates an "amendment" under Section 8(a) or (c). It is probably not required, judging from the wording of Schedules A (16) and B (9) and from Art. 17(a) of the Rules and Regulations of the Commission published July 6, 1933.

184. *Cf.* note 182, *supra.*

185. § 8(b), (d), and (e). See discussion p. 212, *infra.*

186. A stop order might issue under Section 8(e) because of the refusal of the issuer

tive to the size of repeated underwriting requirements and the greater profit in turnover than in investment should lead security merchants, as other merchants, to minimize the risks of frozen inventory, except as they may obtain adequate compensation for assuming them.

### *Dealers*

Dealers are subject to regulation under the Act and incur new risks, apart from their intentional[187] or unwitting participation[188] in security issues as "underwriters." The definition of "dealer" is so broad, furthermore, that in the absence of a fairly uniform "rule of reason" many investors and investing institutions may be included.[189]

Brokers are specifically included as "dealers."[190] In one instance, however, they are distinguished from other "dealers."[191] Their transactions executed in the market upon customers' orders without solicitation are exempt from Section 5, so that any security involved need not be registered nor need the prospectus requirement be met. If a broker solicits orders[192] or buys or sells for his "own" account,[193] he is not differentiated from other "dealers." Whether in a strictly brokerage transaction he is subject to liability under Section 12(2) is uncertain. That section applies to "any person who sells a security."[194] Under the com-

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or some underwriter to permit an examination by the Commission, but it would not be sufficient ground for rescission. Presumably, however, the Commission would follow its stop order in such a case with an application for a writ of mandamus under Section 20(c), so that the stop order would eventually be lifted or the issuer and possibly others would be made liable under Section 11. But in the meantime the capital of the wholly innocent "underwriters" and dealers in the security would be frozen.

187. See p. 202, *supra.*

188. See p. 203, *supra.*

189. § 2 (12). The definition includes "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." Except in the light of other definitions of the term it might be difficult to extricate from this classification many management investment trusts, insurance companies and some individual investors, as well as most speculators. Persons who solicit business for insurance companies are possibly included, since the definition of "security" is sufficiently broad to include them. § 2 (1). This inference is supported by the exemption of such contracts from registration. § 3 (8).

190. § 2(12).

191. § 4(2).

192. The Act does not define "solicitation." Probably the line between mere acceptance of orders and solicitation must always be vague. Brokers should have little difficulty in avoiding this borderline, however, and they may further minimize their risks of suit by more careful selection of those with whom they do business.

193. *Cf.* Bates and Douglas, *Secondary Distribution of Securities—Some Problems Suggested by Kinney v. Glenny* (1932) 41 YALE L. J. 949; Douglas and Bates, *Stock "Brokers" as Agents and Dealers* (1933) 43 YALE L. J. 46.

194. Other than those securities exempt under Section 3(a) (2).

mon law a broker was held not to "sell,"[195] but in the Act "sell" is defined so broadly[196] as to include certain activities of brokers. Subject to the exceptions listed below it would seem unlikely that a broker would be liable under Section 12(2) for statements made to a customer where he acts as agent for the customer in buying or selling the security. In such instances the broker probably does not "sell" the security to the customer.[197] The risk is heightened if he makes a "solicitation of an offer to buy," for that falls within the definition of "sell." And if the broker acts for both seller and purchaser in the same transaction the provisions of Section 12(2) will probably apply to any statement made to the purchasers, since it seems likely that he will be deemed to make them as broker for the seller. And if the broker acts for a seller and makes statements to the purchaser or to the broker of the purchaser, Section 12(2) probably applies. In any event the answers depend upon the meaning of the words "person purchasing such security." Purchase may or may not be held to be used as a correlative of "sell" as defined in the Act.

The question has been raised whether a dealer may do more than confirm orders for "underwriters" without himself becoming an "underwriter."[198] If a dealer, even though not held to be an "underwriter" by so participating, acquires an allotment of securities "as a participant in the distribution of such securities by the issuer or by or through an underwriter,"[199] it is unlawful for him to "sell" or deliver such securities (if not exempt under Section 3) by means of interstate commerce or of the mails unless a registration statement is in effect and unless the delivery of such securities by such means is preceded or accompanied by a prospectus meeting the requirements of Section 10.[200] If the effectiveness of a registration statement should be suspended while the dealer has unsold inventory, he may have recourse under Section 11 against the issuer or others made liable on the registration statement. But lacking that[201] he may dispose of the unsold inventory only in intrastate commerce and without use of the mails. If a registration is in effect he must

195. *Cf.* Douglas and Bates, *supra* note 193, 43 YALE L. J. at 50-53.

196. § 2(3). ". . . every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value . . ."

197. The broker's liability may or may not be imposed accordingly as courts do or do not interpret the undefined term "purchasing" in Section 12 (2) as the correlative of "selling."

198. See the discussion p. 202, and notes 175, 176, *supra.* An "underwriter" may incur risks under Section 12 (2) as a dealer as well as those peculiar to his position as "underwriter."

199. § 4(1).

200. § 5. It is likewise unlawful for him to make use of any such means to transmit a prospectus relating to a registered security unless it meets the requirements of Section 10. § 5(b) (1).

201. *Cf.* note 186, *supra.*

be able to furnish prospectuses meeting the requirements of Section 10[202] as long as he sells "securities constituting the whole or a part of an unsold allotment" in the distribution.[203] If he has not sold all his allotment or subscription within thirteen months after the effective date of the registration statement, he must be in a position to supply new information for his prospectus.[204]

Assuming the dealer not to be an "underwriter," however, civil liability on the prospectus arises only under Section 12. Thus as to material untruths or omissions under Section 12(2) the standard applied is merely that of "reasonable care."[205] Presumably the dealer might rely on the registration statement during the thirteen months following its effective date. To sustain the burden of proof placed on him, however, he would probably have to compare carefully with the registration statement any prospectus he used. The dealer might also be safe in relying upon the annual report of the issuer for subsequent information. Annual reports might be satisfactory for financial statements, though even these might not be in the form required, and would not be apt to include other of the statements needed. Under Section 12(1) a prospectus need only fail to conform in any particular to the requirements of Section 10 to subject the dealer to absolute liability. Thus, with respect to a prospectus used more than thirteen months after the effective date of the registration, the omission of the "dates of and parties to, and the general effect concisely stated" of any "material contract made, not in the ordinary course of business" more than twelve months[206] prior to the issue of the prospectus would subject the dealer to liability to the person purchasing from him. The dealer would have no defenses. He would have no recourse against the issuer under the Act if the contract were made after the effective date of the registration statement. Obviously suits against dealers on transactions during the year or more[207] following the effective date of the registration and thereafter against dealers selling unsold allotments will be brought under Section 12(1) rather than Section 12(2).[208]

Even though a dealer is not "selling" part of an unsold allotment (and may never have participated in the distribution) his transactions

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202. § 5(b).

203. § 4(1).

204. § 10(b) (1). See discussion, p. 207, *supra*.

205. The burden is placed on the dealer, however, to prove "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." The standard of reasonableness is not here defined as in Section 11(c) and presumably is somewhat less exacting. It will also vary, presumably, with the position occupied by the vendor.

206. § 10(b) (1); Sch. A(24).

207. *Cf.* note 209, *infra*.

208. If brought within two years of the violation upon which based. *Cf.* last sentence of § 13.

are subject to Section 5 for "one year after the last date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under Section 8 is in effect as to the security)."[209] During such a period he must be in a position to furnish prospectuses meeting the requirements of Section 10. A registration statement must be in effect if he is to "sell"[210] by means of interstate commerce or of the mails.[211] By negative implication, however, a dealer's transactions in securities *privately* offered are not subject to Section 5 even within the year following the offering.[212]

In making statements[213] in connection with the sale of any security, other than those of the United States government, states, municipalities, and banks exempt under Section 12(2), plaintiff not proving lack of knowledge of such untruths or omissions, he must be able, as noted

209. § 4 (1). This date is extremely vague and its uncertainty involves great hazard for dealers prior to definitive and uniform interpretation by the courts. The risk continues as long as unsold securities of the registered issue remain in the hands of the issuer or "underwriters"—and for one year thereafter.

210. It would also be unlawful for him to "offer to buy" [§ 5(a) (1)], but the only liability would be a criminal one under Section 24 if the violation were willful, for the vendor is given no rights under Section 12 (1). But see note 163, *supra*.

211. The "dealer" will be placed in a curious position with respect to securities whose issuance is exempt from registration under Section 4 (3), since the securities themselves are not exempt. Because of the liabilities invoked by registration most such issues would not, in view of the exemption, be registered unless either underwriting were required or the ambiguity of the exemptions were considered such as to make risky the failure to register. Thus dealers who inadvertently acquire unregistered securities issued "to the existing security holders or other existing creditors of a corporation in the process of a bona fide reorganization of such corporation under the supervision of any court" [§ 4 (3)] will be unable to sell them by means of interstate commerce or of the mails during the year or more following the issuance of those securities. But see the recent announcement that such securities are exempt. Note 60, *supra*.

An innocent dealer may be held liable under Section 12 (1), furthermore, if he should acquire and sell securities which are discovered within two years to have been "underwritten" and sold less than a year prior to his acquisition by any person who may be held to have been in control of the issuer, or under control of, or in common control with, the issuer. § 2 (11). He would, however, have a right of action against the person from whom he purchased, but he would run the risk that a judgment against such a person might be worthless and that more than two years might have elapsed between the time of his purchase and the time when he would bring suit. Unless a dealer traces back for a year or more the title to every security acquired and determines the status of every vendor he will not be protected from this risk, for such securities usually would not be differentiated from others of the same issue outstanding. By reason of this difficulty of tracing title, however, such suits would probably be infrequent.

212. § 4 (1).

213. One of the greatest dangers to dealers under Section 12 (2) will arise through their use of salesmen, since this subsection applies to oral statements as well as to prospectuses. If their salesmen make any oral statements it may be exceedingly difficult for dealers to control omissions which may be held to render misleading the statements which were made.

above,[214] to sustain the burden of proof that as respects untrue statements or omissions he did not know,[215] and in the exercise of reasonable care could not have known, of them. In addition to the civil liabilities imposed, dealers are subject to criminal penalties for willful violations of the Act or of "rules and regulations promulgated by the Commission under authority thereof."[216] Section 17, which provides a basis for criminal liability in addition to that under Sections 5, 23 and 24, contains no exemptions.

## V

### ADMINISTRATION

From the foregoing description three general observations can be made. (1) There are many uncertainties and obscurities in the Act. Hence the ultimate interpretation as to its scope or applicability to many transactions and individuals is of necessity unpredictable. (2) Once a transaction is held to fall within the Act the nature and extent of liability remain uncertain. And (3) the effect of the Act on future financing, conditioned as it is on so many imponderable factors, remains unknown. But this much is certain. A large group of businesses today want assurances which counsel cannot give. To those who want such assurance exhortation that courts and juries will deal fairly with them is of little avail.[217] They have their own ideas as to legitimate risks. They have their own fears that public disapproval of financiers and big busi-

214. See note 205, *supra*.

215. Question may be raised whether the insertion with reference to omissions in Section 12 (2) of the phrase, "in the light of the circumstances under which they [the statements] were made," may not be a two-edged sword. Conceivably it would permit a vendor merely to name a security and state its price (if the transaction were not subject to Section 5) without requiring further representations. May it also be employed to require of vendors disclosure of any material facts peculiarly within their knowledge? *Cf.* note 213, *supra*. If so, the requirement in Section 12 (2) goes considerably further than the somewhat similar one in Section 11. See note 92, *supra*.

216. § 24.

217. There is no provision in the Act comparable to that of the Companies Act, *supra* note 27, § 372, which gives protection against blackmailers and some assurance against severe judgments in hard cases. It provides that "(1) If in any proceeding for negligence, default, breach of duty or breach of trust against a person to whom this section applies it appears to the court hearing the case that the person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit." The section provides further for a declaratory judgment and gives the court discretion as to allocation of costs. It applies to directors, managers and officers of a company, and to persons employed by a company as auditors, whether they are or are not officers of the company.

ness in times of falling prices will be reflected in adverse verdicts. These notions and ideas may appear idle and foolish to those on the sidelines. But they constitute a fact which no Securities Act can ignore. They exist as a reality.

On the other hand clients who want only assurance that they are not beyond all doubt violating the Act, or clients who desire assurance that they have better than an even chance of not being held liable, or clients who want competent counsel's advice that if they act in good faith and reasonably under all the circumstances the chances are good that they will incur no liability, can proceed to do most of the legitimate things which they want to do. Many of those in this group are impecunious and have everything to gain by taking a chance. Others have "rich wives." Some are launching new enterprises where the set-up is so simple as to render remote the likelihood of misstatement. And still others in the group are substantial men who, if wise, expect compensation for the risks assumed. To them the theoretical possibilities of liability under the Act are of little concern; to them a clarified Act would be desirable but unnecessary.

Which group is the larger it is difficult to say. Whether the attitudes of the first group will change is also difficult of prediction. It is clear, however, that the effect of the Act on legitimate business is measured, not in terms of what courts will ultimately hold obscure provisions to mean, but in terms of the attitudes of business. If, therefore, it is the desire of Congress "to protect the public with the least possible interference to honest business" in accordance with the President's mandate, the Act should be amended promptly not so as to change its fundamental principles but in order to make it unambiguous, clear, and consistent.

Curiously enough, however, an ambiguous statute might have great advantages, since it would give the enforcing agency a powerful weapon for control. Arnold has described the relation of the criminal law to the prosecutor "not as something to be enforced because it governs society, but as an arsenal of weapons with which to incarcerate certain dangerous individuals who are bothering society."[218] By the same token an ambiguous Act might give the enforcing agency a full "arsenal of weapons" with which to control financial practices deemed inimical to the public interest. But this would be true only if the power of administration were fairly well concentrated in one agency. This is not true of the Act. The enforcing agencies under the Act are the Federal Trade Commission and the courts. Civil as well as criminal penalties are enforceable by the courts. The Commission on the other hand is the administrative agency. Its powers in general are of four kinds: (1) to

218. Arnold, *Law Enforcement—An Attempt at Social Dissection* (1932) 42 YALE L. J. 1, 9.

issue stop orders;[219] (2) to obtain injunctive relief against violation of the act;[220] (3) to interpret accounting and trade terms;[221] and (4) to make rules and regulations, including those governing registration statements and prospectuses.[222]

The power to issue stop orders has been discussed in an accompanying article.[223] One need not agree with all that is said there to affirm that a most salutary effect on security buyers would flow from a wise exercise of this power. Prevention is always better than compensation. Nevertheless this power is exercisable only if the registration statement on its face is incomplete or inaccurate in any material respect or if it contains 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.[224] In contradistinction to some state laws[225] the stop order is not issuable on the grounds that the security is deemed to be unsound. Being limited as it is the most that can be expected is that it will be employed (1) to assure that complete and unambiguous schedules are filed and (2) to catch flagrant omissions and patent misstatements. It is idle to expect more. In the twenty day waiting period the Commission's check cannot but be superficial. And the subsequent exercise of the power could hardly be more pervasive. The Commission can never be so well acquainted with the internal affairs of thousands of different companies as to be able to appraise critically the truth of the intricate and detailed mass of facts from which the registration statement is drawn.[226] At very best the power is a check on flagrant abuses and excesses. And with the possible exception of cases where the Commission has made an investigation of particular statements and not issued a stop order, counsel would be wise at the present stage of developments not to advise parties prospectively liable under Section 11 that they have thereby acquired additional defenses. A contrary assumption could not be founded on any realistic capacity of the Commission to analyze and investigate.

The power of the Commission to obtain injunctive relief is probably of secondary importance from the viewpoint of investors. It is not a

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219. § 8.

220. § 20(b). Also of importance is the availability of mandamus. § 20(c). More significant is the power to investigate alleged violations of the Act. §§ 8(e), 19(b), 20(a), 21 and 22(b) and (c).

221. § 19(a).

222. *Ibid.*

223. Rodell, *Regulation of Securities by the Federal Trade Commission* (1933) 43 YALE L. J. 272.

224. § 8(b), (c) and (d).

225. *Cf.* Cal. Laws 1917, c. 532, as amended by Laws 1931, c. 423, and Laws 1933, c. 898.

226. § 23.

means of concentrating the power of interpretation and administration, for it preserves the duality of control between commission and court. But in case of interpretation of accounting and trade terms the power is more effective since it is lodged solely in the Commission. It has been asserted that this gives extensive control, since scarcely a term is not "a trade term in view of the fact that its meaning is rightly significant only in relation to the 'trade' of floating securities."[227] It is idle to speculate on the extreme limits to which a tolerant judiciary might permit such power to be carried. But it seems more likely that such words will be interpreted to mean business, financial, or street terms. Thus "distribution,"[228] "open or counter market,"[229] "distributors' or sellers' commission,"[230] and the like are the kind of words fairly described as trade terms. It is inconceivable that the measure of damages,[231] "fiduciary relationship,"[232] "reasonable investigation,"[233] "supervision of any court"[234] and the like fall within "trade terms." In fact a review of the Act, section by section,[235] will show far more terms which the Commission does not have power to interpret than otherwise. This power should not, however, be confused with the general power of the Commission to interpret the Act, arising incidentally out of its power to administer it. As has been admitted this power has not the force of law, but at very best rests on the somewhat tenuous ground of estoppel.[236]

More important, however, than any of the foregoing powers is the power to make rules and regulations governing registration statements and prospectuses for various classes of securities and issuers. While the power does not enable the Commission freely to exempt securities from registration,[237] it does give it some discretion in adjusting the registration and prospectus to the needs and requirements of various situations. To date the Commission has taken significant action in several directions. For example, in the case of protective committees it has ruled that certain information respecting the company being reorganized, if not known by the committee, may be given from the most reliable source available. As has been seen, however, committees have no defense of good faith, reasonable care, or even reasonable investigation. They are absolute

227. See Landis, *supra* note 7, at 10.
228. See particularly §§ 2 (11) and 4 (1).
229. § 4 (2).
230. § 2 (11). Query, whether "public offer" is a trade term.
231. § 11(e) (2).
232. § 11(c).
233. § 11(b) (3) (A).
234. § 4 (3).
235. Accounting terms probably present no great problem. And Schedules A and B of the Act probably constitute the greatest source of trade terms for interpretation by the Commission.
236. Landis, *supra* note 7, at 10.
237. Tae power to exempt from registration is strictly limited. § 3(b).

guarantors of the registration statement. Nevertheless it is absurd to think that having given secondhand information pursuant to the regulation of the Commission they would be held liable for inaccuracies in it, except under two circumstances. The first is that the information given was not a true copy or statement of the data relied upon. The other is that the information obtained was not the most reliable which was available. The Commission obviously would have the power to rule that no facts respecting the company need be given. Having that power it certainly has the lesser power to rule that certain information need be given only in an unverified condition. In other words, by its regulations concerning the registration and the prospectus it can condition the meaning of the word "untrue" in Section 11. By the same token it can, if it so desires, relax or tighten up on the registration requirements for any other class of issuer or for any other type of security. But at this point its powers cease. It has no power to regulate the types of information which must be substantiated by directors, officers, underwriters and experts except as its regulations of issuers and various types of securities incidentally affect those persons. In large measure Congress has supplied an iron-clad standard of conduct which may not be relaxed or tightened up by the Commission. It must act within the rather narrow ambit prescribed for it.

Incidental to its powers to administer, is its power to interpret. And if in particular instances it rules that a transaction or person does not come within the Act it seems fairly safe to predict that courts will later not impose civil or criminal penalties on those who relied upon the ruling.[238] But that relates to rulings only on particular and immediate situations. By accretion of judicial decision the jurisdiction of the Commission will be expanded or restricted and the course of conduct for the future established. This means that the residuum (constituting the bulk) of problems under the Act falls upon the courts for interpretation. Those courts are not only the federal but also the state and territorial courts.[239] It is idle to predict the extent of the agreement between the Commission and these many different courts. The only thing certain is that there can be no semblance of uniformity for many years. That is the major misfortune of the present Act. It has a profound unsettling effect on business activities. And from the point of view of administration it is equally unfortunate. It is not uncertainty in definition but the wide dispersion of authority with its attendant uncertainty which creates confusion in administrative control.

Much has been written respecting needed amendments to the Act. If the Act is not remodelled, the only temporary expedient is to make it clear, consistent and certain. The earlier parts of this essay indicate

238. Landis, *supra* note 7, at 10.
239. § 22.

most of the points of friction and obscurity. As so amended the Act would leave much to be desired. But it would at least present a definite code of conduct under which some experience could be gained. Another definite step which should be taken whether or not the Act is clarified is the adoption of the provisions in Section 372 of the Companies Act.[240] This would not interfere at all with the prophylactic purposes of the Act. In substance it probably would add but little. Nevertheless it would give some assurance to honest and reliable business which is now lacking. It would also give some protection against blackmailing which though overestimated by some is a positive factor so far as business attitudes go.[241]

Along with these makeshifts there might also go an extension of the powers of the Commission so as to enable it further to adapt the Act to the requirements of particular situations. In conjunction therewith or in lieu thereof the powers of the Commission might be extended to adjudicate at least some of the civil disputes arising under the Act. Or enforcement of those rights might be concentrated in one other tribunal. The necessity for one tribunal is especially acute in cases of contribution, for, as has been seen, under the present system such actions would be almost endless in number, and would entail many different suits on the same or similar issues in many separate courts.

But if the problem were presented de novo it would be urged that the Act be recast to accomplish the same results in much simpler and more direct fashion and in a way which would permit of a more flexible, and accordingly a more effective, administration. The classes of persons to whom the Act applied would be stated in simple and clear terms. The nature of liability would be determined in light of the realities of the circumstances under which it was imposed. Furthermore, the scope of liability would be set within more definite limits so as to make the risks more predictable and hence more legitimate. And penalties placed on various persons would be adjusted in light of their capacity reasonably to bear them as well as with a view to securing the greatest protection to investors—two things by no means incompatible. Specifically this would mean a reduction in the *in terrorem* aspects of the Act. Those are important from a preventive angle. But they soon reach a point where their effectiveness ceases. If their purpose is to prohibit certain transactions, the end could be reached more directly and with less doubt that the ancillary effects might exceed in importance the ones desired. Furthermore, the *in terrorem* means are feeble instruments of continuous administration. It is difficult to make them survive political attack. Traditionally they have been the object of extensive judicial emasculation. And they breed ways for circumvention—whether it be

240. See note 217, *supra*.

241. *Cf.* Frankfurter, *supra* note 4, at 111.

the advent of impecunious persons or of men who transfer their assets to their wives or the conjuration of more subtle devices. The most a statute should be expected to do in an *in terrorem* way is to make it provident for the various parties to act reasonably and in good faith. The standards of good faith and reasonable conduct should supply an adequate deterrent.

Furthermore, regulation in this field is and will remain relatively unimportant from a compensatory angle. Civil and criminal suits can never compensate for losses suffered in improvident investments. Reparation can never serve the same high purpose as prevention. In this connection it should be remembered that man's habit of sleeping on his legal rights is notorious. That is due not always to ignorance but to his judgment of the futility of spending a thousand dollars to get a thousand dollars. The truth of this generalization is apparent from the extremely small number of claims actually prosecuted in some of our recent and more notorious scandals.

This leads to the conclusion that the only effective agency in continuous administration is the power to control access to the market. Hence if the Act were recast along the lines suggested, a greater administrative control would be one of its most salient features. With a definite but broad legislative text as a basis, it would have within its limits a more pervasive and flexible power to deal with the wide variety of matters that would confront it.[242] Its discretion to classify, interpret, impose conditions, or exempt would be exercised in light of the public interest and the protection of investors. Such an agency as finally and fully developed would be comparable to few which we know today. An agency for control in the security field would have a maze of different and diverse enterprises with which to deal. There are no simple and clear categories into which the problems fall. They are as complicated as the entire social and industrial system. They are essentially kaleidoscopic. So it is no easy task to set up an administrative agency which would adequately and effectively exercise control in this field. But if the Securities Act is a mere harbinger of additional regulation over finance the problem of administrative control will become more and more acute as years pass. It is therefore essential that the main structural features of that agency be set with a view not only to its immediate needs but also its later requirements.

The foregoing is, however, subject to the one important practical qualification that no legislative or administrative control in this field can be evolved overnight with any expectation of measurable success. Such

242. As Commissioner Landis has stated in another connection, "The control of financing inherently bristles with complex situations adaptable far better to particularized administrative action than to the generalities that must of necessity characterize the legislative process." Landis, *supra* note 7, at 10.

control cannot spring full grown like Minerva. Rather the problem is one of slow and gradual evolution with each step being taken in light of tested expedients.[243] The result is that the most that can be immediately expected is the prevention of excesses and fraudulent practices. But the ultimate range of a more thoroughgoing control would extend, so far as practicable, from "unsound" securities to high pressure salesmanship. That would eventually mean administrative control over access to the market, whatever temporary expedients are adopted.

243. The English experience in connection with the Companies Act is very much in point.