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Speeches. SEC staff

A D D R E S S OF

BALDWIN B. BANE

CHIEF, SECURITIES DIVISION

of the

FEDERAL TRADE COMMISSION

on

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Mr. Chairman, Gentlemen:

When the new administration came into power it was faced not only by the fact that the economic depression had reached such depths that the Government felt it incumbent upon it to take positive steps to pull us out, but it was faced also by the fact that over a period of three years what had caused these difficulties and abuses had been brought into the limelight. It was not necessary that we should be able to apportion in a definite way responsibility among a very definite set of causes for abuses which ran counter to ordinary common sense. The people, although they were interested for the moment primarily, of course, in getting out of the depression, were interested in what could be done to avert the occurrence again of such conditions.

The Securities Act of 1933 constitutes at least a step in a program designed to eradicate some of the more apparent causes of present conditions. That the former manner and methods of floating securities are to some extent responsible for the conditions of the past three years, no fair-minded person can deny.

The statute was framed by a Congressional Committee only after careful consideration of the regulations of the various states and the English Companies Act which is the result of an experience of almost a hundred years in dealing with the problem. Other bills dealing with the subject and previously introduced in the Congress, such as the Taylor Bill and the Denison Bill, and the work of the Capital Issues Committee during the War were carefully studied. The problem with which it deals was not being considered by the Congress for the first time. The question had been before Congress for many years. Few pieces of legislation have been given more careful and thoughtful consideration by any Congressional Committee. Its consideration in committees and passage through Congress was wholly devoid of any sensationalism or emotional arousal against any class or group.

Power for the enactment of the statute is derived from the commerce clause of the Constitution and from the Congressional control over the use of the mails.

The Act is directed mainly at enforcing disclosure to the investor of the elements necessary to insure an informed judgment by which he may be guided in deciding whether he will purchase a security. It has been constantly reiterated by the President, by the Congress, and by the Federal Trade Commission that the Federal Government does not guarantee either the soundness of the business principles of the persons responsible for any security, the possibilities of its success, or the truth of their statements regarding it. The Commission has required that every prospectus under the Act shall contain a conspicuous statement that neither registration nor the use of the prospectus indicates that the Commission has approved the issue or found statements regarding it true.

The Act may be said to contain three sanctions: first, the authority given the Federal Trade Commission to prevent by stop order or injunction the sale of securities because of false or untrue material statements or failure to furnish required material information; second, the civil liability of those responsible for the flotation of the issue for false, untrue or inadequate material representations; and third, the criminal liability

for the wilful use of a fraudulent scheme or device or the wilful misstatement of a material fact or the wilful omission to state a material fact necessary to prevent the facts stated, in view of the circumstances under which they are stated, from being misleading.

The Act centers about the requirement that for securities sold in interstate commerce, or through the mails, there must be on file with the Federal Trade Commission a statement containing information deemed appropriate by the Congress and the Commission. Schedule "A" requires information concerning the structure of the issuer, its capitalization, indebtedness, all material contracts, not in the ordinary course of business, detailed accounts of the nature of its assets and liabilities; interest of stockholders, officers, and directors in property purchased; an account of litigation that may materially affect the value of the security; the specific purposes for which the funds to be raised by the particular issue are to be utilized; a complete account of the expenses of flotation. It strikes at a rather widespread abuse by requiring disclosure of the interest of the directors of the issuer, and of stockholders with substantial holdings, in contracts made by the issuer and by requiring a disclosure of the persons to whom it is proposed to offer stock at less than the offering price to the public. This information may give much light on and serve to prevent what must be admitted as socially objectionable practices. Future action and legislation may have a more solid basis in fact because of such information. It may well be that the latter requirements referred to are an important factor in the professed reluctance, ordinarily attributed to the civil liability clauses of the Act, of many of the banking fraternity to float new securities.

Provision has been made for the lapse of a period of twenty days after filing before the registration statement becomes effective. This period is intended to prevent hasty and ill-advised financing, and to protect the investor and the dealer from being forced to make a decision before they have adequate opportunity to obtain knowledge of the facts and give them careful consideration. The twenty-day provision should prevent high-powered flotation requiring dealers to take a new security offered as a condition of participation in future desirable issues and thus should prevent their forcing such issues upon their clients. It also allows the Commission to make an examination of the statement. If the statement contains any material inaccuracy, or omission, the Commission may suspend its effectiveness until a proper amendment has been filed. When an amendment is filed to which the Commission does not consent or which is not filed pursuant to an order of the Commission, the entire statement is deemed to have been filed on that date. Because of the newness of the legislation, and the complexity of the situations with which it deals, the Commission in the administration of the Act has afforded registrants every opportunity to amend their statements and get them in proper shape without the disparaging effect of a stop order. This has meant an examination by the staff of the division of statements requiring amendments many times, and with the small staff available has meant continuous work without regard to days or hours. Where efforts to register have been made before the issue was ripe or the affairs of the company in such shape that the information required for registration could be furnished, the Commission has allowed the statement to be withdrawn in order to prevent a stop order.

I should like for a few moments today to discuss the civil liabilities under the Act in an effort to dispel some of the ghosts and hobgoblins that have been conjured up.

Civil liability under the Act results from the provisions of Sections 11 and 12.

The liabilities under Section 11 arise from the registration statements. The liabilities under Section 12 arise from matters other than those in the registration statement.

When a registration statement is in effect, which omits to state a material fact required to be stated therein or states untruly a material fact, either directly or through failure to state facts necessary to prevent the facts stated from being misleading, a remedy is given to all persons buying the security. The remedy is against the issuer, the principal officers of the issuer, the directors, any person whose profession gives authority to a statement made by him and who has with his consent been named as having prepared or certified that part of the registration statement, and the underwriters. These persons are jointly and severally liable, with the right of contribution among themselves. Vigorous criticism has been made of the Act for making the liability several on the ground that persons who stand to make little by the issue will run the risk of being liable for a refund of the entire amount thereof. It should be noted, however, that the right of contribution will obviate this possibility, and that protection to the investor certainly requires that the burden of distributing the responsibility be placed upon those liable rather than upon him. The English Companies Act contains a provision almost identical with this. These provisions will certainly bring the entire group, except possibly the experts, to the defense of any one of the group that may be sued. This will make the odds certainly great enough against one lone investor. As a practical matter the entire question will be tried in this suit and other possible suits settled upon the basis of that decision. Section 11 (f) of the Act expressly provides that a knowingly fraudulent director or person cannot recover contribution from an innocent person who might be liable also to the purchaser.

The cause of action under the Act is founded upon the presence of a statement which directly or by ommission conveys a false impression as to the affairs of the issuer at the time the registration becomes effective.

An ommission may be of two sorts: (1) a complete failure to give the required information, or (2) the failure to complete a disclosure begun. The difference between these two types of non-disclosure is merely one of the degree of intimacy which the statements omitted bear to those made. Failure to disclose the possibility that litigation will be commenced or is in progress that may materially affect the value of the security would be an omission of the first category. If the fact that a suit has been brought which terminated favorably to the issuer is disclosed, but information is omitted that an appeal is being taken by the adverse party, the omission is of the second sort. The latter type of non-disclosure is more in the nature of a half truth and under this Act is treated as a misrepre-

sentation. This presents no novelty or innovation in the law, as many have attempted to make it appear. There are many cases, as every lawyer knows, in this country and in England, establishing liability for the failure to disclose information of this type.

The concept of materiality is limited in its application to statements required to be made and to statements made, and to omission of statements necessary to render those made not misleading. Although all required facts are prima facie material, it requires little imagination to see that in many particulars or in many special cases some information may be clearly immaterial. A person acquiring the security may upon tender of the security recover the amount of the consideration paid but not in excess of the price at which it was offered to the public.

In case the person no longer owns the security the recovery is similarly limited as a maximum to the offering price to the public.

The contention has been advanced that Section 11 (e) of the Securities Act may permit a person who sues under part (2) thereof to recover damages in cases where he may have sold his stock at a price in excess of the offering price. This contention neglects the relationship of part (2) of this section to part (1). Part (2) gives an alternative remedy for damages only where the person suing no longer owns the security. Where he owns the security, he can recover back the consideration paid for it, and under Section 11 (g) this cannot exceed the price at which it was offered to the public. But an alternative remedy is provided, in order not to compel the holder of a security in order to have a remedy to hold that security until he is enabled to bring suit. Instead he may seek to limit his losses, so far as he is able, by disposing of the security. This obviously should not deprive him of a right which he would possess if he continued to hold the security. The alternative right given by part (2) is derivative from part (1), and consequently the damages recoverable under (2) must be computed on the basis of cost to the plaintiff not exceeding the price at which the security was offered to the public. In other words, if the plaintiff has disposed of the security at a price in excess of the offering price, no damages under this Act would be recoverable.

Any other view neglects both the relati nship of (the) one part to the other and the practicalities of the situation.

Examination of the basis for liability under Section 11 shows that liability is rested upon damage consequent to material misstatements or misleading or inadequate statements of a material character in the registration statement. "Material" in this connection, as is abundantly illustrated by the cases under the English Companies Act, has a relationship to the purported value of the security as reflected in the offering price. Facts become material when by their misstatement or omission non-existent values are attributed to a security.

Recovery against the persons liable is not compensatory in character. This represents no extraordinary principle of legal liability. I buy a chattel from you for $100 upon your representation that it has certain qualities. It does not have those qualities. The difference in value be-

tween the chattel I bought and the one you represented is $15. I can, however, tender you back the chattel and recover $100. Why shouldn't the same principle apply in the sale of securities? The persons liable because of false registration will never be forced to pay more than they as a group receive.

Another contention sometimes advanced is that there is no standard set by the Act as to what facts must be disclosed by an issuer, for it is stated that the failure to disclose any material fact may involve the persons designated in Section 11 in liability.

Frankly, it is difficult to see just how such a conclusion can even be seriously advanced in view of the explicit language in Section 11, especially when that language is contrasted with the different language used in Section 12. Section 11 places liability for omission where one has "omitted to state a material fact required to be stated therein (i.e., in the registration statement) or necessary to make the statements therein not misleading." Section 12 makes no such qualification inasmuch as it is not necessarily tied to the registration statement in the manner that Section 11 is. This conclusion is obvious on the face of the language but it gets even further emphasis from a sentence in the Statement of the Managers on the Part of the House:

> "The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. This phrase has been clarified in the substitute (i. e., the bill as enacted) to make the omission relate to the statement made in order that these statements shall not be misleading; rather than making mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances existed to make the omission in itself misleading."

In other words, an omission of a material fact in order to create liability under Section 11 must be one of two types. It must either be an omission of a fact required to be stated in the registration statement or it must be an omission of a fact which renders the statements made in the registration statement misleading, and, in both of these instances, the omission must be of material facts. To say in the light of this that the "practical effect" of the Act is substantially to make anyone a "guarantor against failure to disclose every material fact" neglects the express qualifications in Section 11 (a) itself, to say nothing of the provisions of that section which absolve a person of liability, if such person be not the issuer, if in any case he can prove that he exercised such reasonable diligence as is common to persons occupying fiduciary relationships.

The liability imposed by false or misleading registration is not absolute except as to the issuer. Liability may be avoided by proving that the standard of a fiduciary has been maintained in making an investigation of the statements in the registration, except as to those purporting to be made upon the authority of an expert, and then the same standard must be maintained with reference to the selection and reliance upon the expert. The purpose of shifting the burden of proof was, of course, to obviate the

difficulty involved in proving the state of another person's mind, as well as to place it upon those best able to bear it because in a position to know the actual facts. Similar shifts of the burden of proof have been made in many classes of actions before, and present no novelty in the law. The constitutionality of the power of Congress to so shift the burden of proof has been sustained many times by the Supreme Court of the United States. The Act imposes no fiduciary duty, except that with regard to the character of investigation to be made of the information contained in the registration statement. None of the other duties of a fiduciary is required by the Act. The expert must maintain the same standard with reference to his statements.

The Conference Report on the part of the Managers for the House of Representatives has this to say:

> "A fiduciary under the law is bound to exercise diligence of a type commensurate with the confidence, both as to integrity and competence, that is placed in him. This does not, of course, necessitate that he shall individually perform every duty imposed upon him. Delegation to others of the performance of acts which it is unreasonable to require that the fiduciary shall personally perform is permissible. Especially is this true where the character of the acts involves professional skill or facilities not possessed by the fiduciary himself. In such cases reliance by the fiduciary, if his reliance is reasonable in the light of all the circumstances, is a full discharge of his responsibilities."

The Restatement of the Law of Trusts by the American Institute of Law has the following to say of the trust relationship:

> "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 duty to exercise such skill as he has . . . .
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> "Whether the trustee is prudent in the doing of an act depends upon the circumstances as they reasonably appear to him at the time when he does the act and not at some subsequent time when his conduct is called in question."

These provisions place the liability upon those in a position to profit the most from the sale of the security, and in a position to know about the statements made. They merely set up a standard of honesty which those desiring to handle other people's money should be ready and willing to assume without any requirement of law. Every man has a right to require of those who request the use of his money the ideals and the standards imposed by this Act. It is merely the standard of common honesty. No other standard is consistent with maintaining the public confidence in a business structure which it is loudly acclaimed must be financed by the public.

Section 12 (1) gives a right of action to the immediate purchaser against any person who sells a security in violation of Section 5. Section 5 prohibits the sale of securities without an effective registration statement and unless in connection with such sale a prospectus as required by the Act is used. Of course, this provision does not apply to securities and transactions exempt from registration.

The second paragraph of Section 12 gives a right of action to the immediate purchaser against any person who sells a security by means of a prospectus or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. Such statements as the seller chooses to make must not convey a false impression.

This applies to representations as to securities not requiring registration and to statements made in addition to those required or made in the registration statement. Here the liability is only to the person to whom the security was sold by the person making the statement. The purchaser of the security may tender the security to the person who sold it to him and recover the consideration paid or he may recover damages if he no longer owns the security.

The seller, however, escapes liability if he shall prove that he did not know and in the exercise of reasonable care, could not have known of such untruth or omission, or that the purchaser knew of the untruth or omission.

This approaches very closely the responsibility that dealers in securities were under before. At common law a dealer cannot misrepresent a security and sell it without being liable to the purchaser. The plain meaning of the language of this section is that there shall be no misrepresentation either directly or indirectly - indirectly by only telling half of the truth. Section 12 (2) is largely a statutory declaration of the common law liability.

Reasonable care in the law is that care which a person of ordinary prudence would exercise under like circumstances. The circumstances surrounding the sale will therefore determine the degree of care required. Consideration should be given to the relationship between the buyer and the seller, the relationship between the seller and the corporation whose securities are being sold, the circumstances under which the statements are made, etc.

The cry that the liabilities imposed by the Act have interfered in a serious way with the flow of capital to industry seems hardly sustainable. If the liabilities give pause to the reckless flotation of securities, that would seem to be desirable. The Act is designed to make investments safer for the investor against technically legal as well as patently fraudulent practices. The claim that new security issues have practically disappeared was made before the passage of the Act, and there had been from an authoritative source a graphic presentation of the state of the securities market at its lowest ebb in ten years shortly prior to the consideration and enactment of the Federal legislation.

The Commercial and Financial Chronicle's analysis of new capital issues for the calendar year 1932, contained in the issue of January 14, 1933, has the following:

"The distinctive feature of the new financing during the calendar year 1932 was its light character, and in that respect December proved typical of the other months of the year, and in particular those for the last half. New financing has been light throughout. . . .

"The corporate issues brought out in December reached the slim total of $28,844,225, and as showing how these corporate issues have suffered contraction in recent years, it needs only to be said that in December, 1931, the corporate total was $86,330,900; in December, 1930, it was $187,643,773; in 1929, $334,946,476; and back in 1928, no less than $1,002,728,082. . . .

"In noting the diminutive character of the financing done in this country in 1932 it is necessary only to cite the figures since they tell the story of the decline more eloquently than anything else, making it unnecessary to enlarge upon them and calling for no explanation except for the enumeration of the causes for the contraction:

1928.....	9,991,845,818
1929.....	11,592,164,029
1930.....	7,677,047,291
1931.....	4,022,941,356
1932.....	1,721,392,655

"But the really prodigious falling off was in the case of the corporate issues, these having dwindled almost to the vanishing point, and footing up no more than $643,895,345 for 1932 against $2,588,965,423 for 1931; $5,473,279,043 for 1930; and no less than $10,026,361,129 in 1929. . drop in three years from $10,026,361,129 to only $643,895,345 marks indeed a gigantic collapse. Moreover, of the $643,895,345 in 1932, $318,533,720 was for refunding, that is, to take up old issues outstanding leaving $325,361,625 as the strictly new capital raised by all the corporations in the land."

"The shrinking in the volume of new capital issues brought out in the ordinary way is of course easily explained. It is due to the fact that general investment and market conditions have continued highly unfavorable, making it risky business to undertake the floating of new securities, even those of a very choice type. In a measure also, the Government has really been pre-empting the ground, and certainly it has been occupying the investment field to the disadvantage of ordinary financing, a matter of no small consequence, especially in view of the fact that owing to the prevailing loss of confidence in security values generally, the demand on the part of the investing public has been almost entirely for the highest and best type of security investment - and obviously nothing could be higher or better than a United States obligation, though that does not mean that such an obligation may not suffer sharp depreciation on occasions, as the investor has learned from sad experience."

The same source shows for the three months immediately preceding July 27 that issues not exempt from registration under this Act amounted to $209,887,000 and this includes the rush to avoid registration under the Act.

I will leave it to you gentlemen - has there been any recent rush in bringing out securities exempt from the Act? And such securities generally are those usually regarded as of the higher types. It is difficult to get much from a junior issue when a senior issue is selling at from fifty to sixty cents on the dollar.

The spirit evidenced by deliberate misrepresentation of fact and misinterpretation of law is hard to understand unless one accepts it as evidence of the fact that the reckless selfishness responsible for the quite recent notorious security frauds is not yet dead, which but further emphasizes the necessity for this Act and that it contain real sanctions.

If the recent past teaches us anything it is that some groups associated with security flotations are not induced to refrain from material omissions or misrepresentations by fear of the liability for compensatory damages at common law or fear of prosecution under the criminal law.

But we hear of a reformed profession connected with security flotations that refuses to engage in the evil practices of a few years ago. Evidence of such a sudden conversion is lacking regardless of its permanency. Examination of some of the issues that hurriedly preceded the Securities Act shows little change. The reluctance with which amendments are furnished reciting certain very relevant but unpleasant required facts in registration statements gives no strong evidence of such change, and this includes issues sponsored by persons generally deemed well within the bounds of responsibility. Some of the methods used in combating this Act certainly evidence no such conversion. Such attitudes to this most complex problem of the regulation of financing are tragic. If the issue develops into one of the public against the bankers and security dealers instead of a consideration of the best interests of the public, which still includes the banking groups, the legislation which will evolve from such a tempest is bound to be unwise and impractical.

This Act presents no novel conception of the relationship between the Government and its citizens. It is no radical departure from well-established principles. It is not an experiment into new and untried fields of governmental regulation. For years the railroads have had to get the consent of the Interstate Commerce Commission to issue securities. The decision, of course, is made largely upon information from the railroads under sanctions intended to make it accurate. The Interstate Commerce Commission not only decides whether the securities shall be issued but it sets the price at which they shall be sold, the way in which the proceeds shall be spent, etc. Many state commissions have for years made similar determinations with reference to operating utility companies. In many states security commissioners have for years required information similar to that called for by this Act, and in addition have had the authority to absolutely prohibit the sale of the securities in their states or to determine the conditions under which they might be sold.

Surely there is nothing radical about an act which requires that the truth be told about securities sold in interstate commerce, or through the mails, and holds those making the statements responsible for their truth under such sanctions as are necessary. In view of what we now know, even where many of the so-called respectable are concerned, a legal requirement without a sanction sufficient, at least, to cause the exercise of reasonable care is useless and meaningless.

The Securities Act is not predicated upon the theory that the interests of investors are in conflict with the interests of issuers. On the

contrary, it embodies a recognition of the fact that the investor and the corporation are mutually dependent. Neither can continue to prosper at the expense of the other. A law which is founded upon this view of the matter and which seeks to give a practical meaning to the interdependence of these two interests assuredly is a law that will work to the benefit of those corporations which, by telling their story to the public, can prove that they merit public confidence. Directly it will benefit them through helping to restore the confidence of their investors; indirectly, also, it will help them by making the distinction clearer between those concerns that do and those that do not deserve the continued support of the investing public. It would be idle to pretend that it does not ask something of the security world, but it also promises much in return - the opportunity of creating a true and respected profession by the assumption and adequate discharge of public responsibilities.

Let me comment upon one other aspect of the Securities Act which I think is of special import, and this is the Commission's power of molding the Act through administration and regulation. The Commission's powers of regulation have rarely been emphasized in any discussion of the Act. Practically all of the accounting regulations are subject to the Commission's jurisdiction. The entire character of the demand that the registration statement makes depends upon the wise exercise of the Commission's powers within the broad standards laid down by the Act. Relaxation or strengthening of these features of the Act lie entirely within the control of the Commission.

If half of the energy expended upon propaganda for amendments to the Act were enlisted in an effort to advise the Commission in the wise exercise of its powers, the Government and issuers, bankers, lawyers, accountants, and other experts would be far nearer to a solution of their problems. The control of financing inherently bristles with complex situations adaptable far better to a particularized administrative action than to the generalities that must of necessity characterize the legislative process. Along this road lies a better understanding between Government and finance of their common problem, remembering always according to the Congressional mandate in the Securities Act that the public interest and the protection of investors must be the guiding consideration.

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