SPEECH

of

JUDGE JOHN J. BURNS

GENERAL COUNSEL

SECURITIES AND EXCHANGE COMMISSION

before

NEW YORK STATE BAR ASSOCIATION

January 21, 1936.

ADMINISTRATIVE PROTECTION FOR THE INVESTOR

It has become extremely difficult in Washington to find time for setting down impressions about one's work in relation to the general legal order. Just as we had attained a moderate stability in our relations with the exchanges, when cooperation had become the watchword, when misunderstanding was on the way out and peace seemed to reign, the utility war broke out on all fronts. It was an unhappy development, not of the Commission's making, and has served to defer indefinitely the solution of many serious problems of our corporate life. The litigation has many interesting aspects, but it leaves little time for reflective thought about the objectives we should consciously seek. It leaves little opportunity for that essential self-analysis which is good for the soul of an important Commission as well as for the soul of the individual.

There are many who still express resentment regarding the increasing growth of governmental boards and commissions. It is seldom phrased as a conservative warning that excess in this field has its dangers. Frequently criticism takes the form of a blind unreasoning prejudice against an officialdom which usurps the prerogatives of the Court. But the issue has long since been foreclosed.

Chief Justice Hughes in 1916, speaking before the New York State Bar Association, not only sensed the turn of the times but advocated the extension of executive justice in the necessary task of protecting the varied interests which an urban civilization must secure. At the same time he called attention to the evils which should be avoided if the system is to justify itself. He said:

> "* * * there have been constant manifestations of a deepening conviction of the impotency of Legislatures with respect to some of the most important departments of law-making. Complaints must be heard, expert investigations conducted, complex situations deliberately and impartially analyzed, and legislative rules intelligently adapted to a myriad of instances falling within a general class. It was not difficult to frame legislation establishing a general standard, but to translate an accepted principle into regulations wisely adapted to particular cases required an experienced body sitting continuously and removed as far as possible from the blandishments and intrigues of politics. This administrative type is not essentially new in itself, but the extension of its use in State and Nation constitutes a new departure. * * * The ideal which has been presented in justification of these new agencies, and that which alone holds promise of benefit rather than of hurt to the community, is the ideal of special knowledge, flexibility, disinterestedness and sound judgment in applying broad legislative principles that are essential to the protection of the community, and of every useful activity affected, to the intricate situations created by expanding enterprise. But mere bureaucracy, - narrow, partisan, or inexpert - is grossly injurious; it not only fails of the immediate purpose of the law and is opposed to traditions which, happily, are still honored, but its failure creates a feeling of discouragement bordering on pessimism which forms the most serious obstacle to real improvements in the adjustment of governmental methods to new exigencies."

The American people are not well versed in the art of preventive justice - perhaps in part because the art is extremely difficult and the common law technique is essentially *a priori*. Another reason, I think, is that we are an emotional people and desire reform wrapped up in colorful drama with a stageful of competing villians. Pessimists conclude that this phenomenon of government by scandal is a manifestation of the mass mind at its worst. Despite the hysteria of the opposition press and the temporary embarrassment of those who are the goats, our national policy has always been to remove lasting political and economic abuses not by a revolutionary "purging" but by the slower and more orderly process of moderate reform.

The elusive problem of society after it leaves the primitive stage is one of controlling with reasonable efficiency the misuse of power whether it be political or economic, whether it be open or notorious or unseen and subtle. With the growing complexity of American life, the legal order has sought to adapt its technique to the demand for greater efficiency and the need for control. (This movement has been slow and, therefore, characteristically legal. The tardiness of our legal development is the reason for many of the complaints against the law.)

The statutes which our Commission administers represent the considered judgment of Congress that the common law technique and even state administrative supervision were inadequate to meet the investment problems of our modern corporate life.

Apart from a minor point affecting the power of the Commission to have its own representatives handle litigation, there has been no final decision clarifying the important questions of interpretation raised by the Securities legislation of 1933 and 1934. To be sure many suits have been brought against the Commission. For the most part, however, they concern the problem of the allocation of sovereignty as between the state and national governments. After the issue of constitutionality has been determined there will still remain an interpretative task requiring years of judicial review. I am quite confident that the law student a generation hence will have the opportunity of knowing the final answers to the numerous serious problems presented by these laws. As in the past we may expect that the courts will do much in the way of creative law-making, not only where the statute is silent, but also where the statute contains language of a most contrary nature.

In the meantime the Commission is creating a common law of its own which we hope will exert a weighty influence on the courts. In our work we have constantly in mind the views of Mr. Justice Cardoza. Speaking of the consideration to be given to an administrative interpretation, he said:

> "The interpretation of the Commission charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new" is entitled to "peculiar weight". *Norwegian Nitrogen Products Co.* v. *United States*, 288 U. S. 294, 315.

Largely because of the vitriolic condemnation adopted by critics of these two statutes, I was prepared for a radical departure from the usual type of law when I first came to Washington. I was very agreeably surprised by the essential conservatism of both acts. Frequent contact with these laws has convinced me that these laws were in no real sense a departure from the generally accepted fundamentals of the Anglo-American common law. What innovation there is apart from the administrative features can be found in the remedies given by the legislation, not in the formulation of rights and obligations.

Of course, there are some new concepts found in the statutes. By and large, however, they represent but a more realistic application of the basic principle of the common law to modern conditions. The artificial insistence upon the preservation of the corporate fiction is doomed by these statutes - the extent to be determined by the courts. The statutory concept of control (even admitting the weakness from the viewpoint of predictability) is a recognition of certain present-day features of American business life.

Tonight I am going to deal with several features of these important laws, particularly with reference to their general relation to the pre-existing law.

Let me begin appropriately at the promotional stage and discuss a subject which is indubitably an American phenomenon--at least we have given it the blessing of mass production--I refer to watered stock.

All jurisdictions condemn the practice of watering stock. The usual legislative prohibition purports to be very definite in outlawing this form of fraud. In a number of states the resentment over the early traction companies' inflationary capitalization found expression in constitutional prohibition to the effect that stock should not be issued "except for money paid, labor done or property actually received", and that "all fictitious increase of stock or indebtedness shall be void". Such enactments were defective, particularly when applied to concrete facts. A common companion provision made the judgment of the directors as to the value of the consideration other than cash conclusive in the absence of "fraud" or "actual fraud". This is somewhat like the American attitude on prohibition. We wanted the law on the book as representative of our piety and idealism; at the same time we wanted our liquor--in great volume--and had it. Similarly, by solemn declaration, we state our opposition to stock watering, but at the same time we continue to wink at promotional overvaluation which has proven to be socially most expansive.

It would be unfair to speak too harshly regarding the judicial approach to the problem of overvaluation although it must be said in all candor that the treatment of the subject of valuation by our highest courts has been nothing to write home about. This is true in the field of promotional activities as well as in the field of rate regulation. The less said about the series of Court decisions reviewing the actions of rate tribunals the better. A review of the American cases on utility regulation requires one conclusion, to wit , valuation has become nothing but a huge guess.

Many students of the subject, however, have complained that the law is a series of unrelated cases where generalization is impossible; where the court's conclusions are obviously "ad hoc" without indication of the path for future decision. John Dickinson stated that in his opinion "Every stock watering case involves a number of variables, each of which is more or less pertinent to the question of overvaluation." It is not surprising then that courts have not developed a pattern which will fit every case, or even any substantial group of cases. Stock watering is almost a "wilderness of single instances."

It should also be said in defense of courts that the infrequency of actions raising the question of stock watering plus the multiform judicial burdens which our system imposes on judges with a naive expectation of specialized skill, makes it almost impossible that a scientific approach could be formulated. The distinction which economic theory makes between the cost of a commodity and its value, the important relationship between the two for practical purposes, are seldom adverted to in the judicial discussion of overvaluation. Value in the case law of this country is referred to in vague and sterile language. There is a blind adherence to terms without any analysis of concepts -- such terms as "fair value" - "full value" - "actual value" - "real value".

There has been no lack of appreciation on the part of American legislatures of the evils of stock watering--the inevitable fraud on the investing public which follows capital inflation. Stock watering partakes of many of the evils of currency debasement. The orthodox method of setting up a balance sheet makes it inevitable that stock watering should result in misrepresentation.

Nowhere is the judicial non-interference with directorate valuation more clearly revealed than in mining promotions. The technical issues raised in a problem of stock watering in a mining promotion are usually serious and difficult. In one case recently in which the Commission was involved--a palpable case of overvaluation--the Commission's case alone occupied two months, even though not more than $100,000 was involved.

It has been suggested that no promoters who have turned over property for shares be allowed to set up a balance sheet for the first year. This, at least it is claimed, would have the advantage of restricting the numerous fraudulent schemes which absolutely need the dollar sign on the pro forma balance sheet as the basis of their sales argument.

In a recent report by a Canadian Commission, the evil of stock watering was discussed.

> "To strike at this practice" (of stock watering) reported the Commission, "we make two recommendations: first, that it should be made illegal for directors, promoters, etc., to issue fully paid-up shares unless the company receives for these shares, adequate consideration in cash, property, or services. The duty of investigating and determining the adequacy of such consideration, where such adequacy is involved in any litigation, should be placed squarely on the Courts. Although the

present legal situation is not perfectly clear it would appear that in practice, Canadian Courts show a reluctance, which amounts to virtual refusal, to inquire into the adequacy of consideration if it is in some form other than cash. If, in some way, the duty of such inquiry could be definitely placed on the Courts, a most valuable step forward would have been taken. We do not think that this would be placing any burden on the courts which they could not adequately discharge. It is a customary practice for Courts today to place a value on an arm, an eye, or a reputation. There is no reason why they should be unable to place a value on a body of assets given as consideration for an issue of stock. If the decision of the Courts should be that adequate consideration was not given, then liability for the balance of the consideration unpaid should attach to the directors concerned, if it could be shown (a) that such directors had knowledge of the inadequacy of the consideration, or (b) failed to take reasonable steps to ascertain the adequacy of the consideration."

The soft spot in our system of control to prevent stock watering has been the method of valuing the consideration exchanged for the shares. The courts have failed to develop any definite measure of value. Except in extreme cases where the "rawness" is so apparent that the transaction appears to be "smeared with fraud" the task of those who would challenge promoters' valuation is extremely tedious and difficult. In discussing this phenomenon Professor Dodd of Columbia has enumerated the following reasons for the failure of courts to develop a more definite test of overvaluation:

"(1) The common-law heritage that 'fraud' is an essential element in any legal overvaluation of property for stock-issue purposes. (2) Statutory expression of this common-law rule. (3) The fact that stock alleged to have been 'watered' has usually been issued for producers' goods of more or less unique character, or for services, each of which has lacked independent realizability in a going market and both of which are difficult to evaluate at best. (4) The absence of any statutory definition of the term 'value' and a prevalent uncertainty as to the meaning of the term. (5) The tendency of the courts, which is due to a considerable extent to the absence of objective data concerning the value of the consideration involved in many cases, to concede that 'value' means 'value to the corporation,' coupled with a tendency to indulge a presumption that the directors are best qualified to adjudge the value so defined; (6) The retrospective character of the valuation. The valuation of the court is made as of the date upon which the stock was issued. The time elapsed between the date of the stock issue and the date of the trial varies from a few months to fifteen or twenty years. (7) The fact that in many cases the facts and pleadings do not require the court to determine an exact valuation for the non-cash consideration which was given for the stock. Finally, (8) The fact that a number of courts seem to doubt whether creditors are in fact deceived by overcapitalization and for that reason tend to give the benefit of the doubt concerning the valuation to the directors. All of these factors encourage the use of a hazy and more or less flexible standard of valuation in stock-watering cases and contribute to the ineffectiveness of any system of control of excessive stock issues."

Although the Securities Act is basically but a registry statute enacted on the theory that the requirement of truthful disclosure would be adequate to control the manifold security evils, indirectly the Congress has given the Commission a few important powers of regulation. The provision which ha importance for this discussion is found in Section 19 (a), which enumerates the special powers of the Commission. "Among other things the Commission shall have authority to prescribe the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet, and earning statement, and the methods to be followed in the preparation of accounts . . . in the appraisal or valuation of assets and liabilities . . ." A similar power is given to the Commission by Section 13 (b) of the Securities Exchange Act of 1934.

The Commission is expected to take action pursuant to these powers which will permit the development of a more objective, more uniform principle of valuation. Its advantages in the long run over the haphazard control through the judicial process, where the elements I have referred to prevent a scientific technique, are tremendous. Already we see the Commission laying the foundation for a realistic control over the basic evils. In the *Brandywine Brewing* case which is found in the first volume of the Commission's reports at page 123, there is an announcement that no statutory provision regarding the conclusions of an appraisal or the good faith of the promoter or director can foreclose the Commission's right to ascertain the facts in accordance with its standards. Such a contention is sound and arises no problem of constitutional law since, ex hypothesi, the Commission is spelling out the details of Congressional action in the field where Congressional power is plenary. In this opinion the Commission stated:

"Statutory provisions in the state of incorporation making values fixed by directors conclusive for certain purposes in the absence of fraud cannot foreclose this Commission's inquiry as to truthfulness of a statement that a corporation has received service of a certain value reasonably determined, nor prevent such a statement from being tested for truth under the standards set by the Securities Act. Under these standards, if the valuation of services is so grossly and unreasonably excessive as to be outside the range of reasonable difference of opinion, this item of $71,000 in the balance sheet amounts to a misstatement of a material fact."

In the orderly evolution of the Securities legislation, one can look forward to a gradual improvement not only in the methods of accounting, but also in the technique of making appraisals--of fixing values for the purpose of security issues. There is a fine opportunity for constructive effort which would put limits to the extent of which entrepreneurs may impose on creditors and future shareholders. The advantages of the grant of power to the Commission are considerable, not the least of which will be the gradual improvement of corporate morality by the educational process implicit in government by administration. There is little reason for heading the unsupported fear that such control will discourage the assembling of capital for new enterprises. Even if we are to assume that America is not yet at maturity and may be treated as a young and unexploited country, no one can demonstrate that the national economy is advanced by permitting the unsound and reckless promotions which have characterized our history for

over fifty years. Whatever capital may be lost by the imposition of standards of elementary honesty will be insignificant compared to the huge losses to the investor which will be prevented by this method of supervision.

One of the interesting discoveries turned up by our Statistical Department in a study of representative promotions has been the recent public resistance to speculative financing. It is not urged that the Federal Securities legislation is responsible for the apparent wariness of the investor. In fact, there are many instances to prove that there are many investors who are still quite reckless. But it is not without significance that of the proposed offerings less than 5% had been taken by the public during a period of six months. Dr. Goldschmidt refers to the status of these corporations as being somewhere between life and death, not enough funds to make good on their promises, and not enough creditors to bring on liquidation. As he described the situation, the promoters are "on relief."

The Securities and Securities Exchange Acts have frequently been attacked as efforts to impose upon securities issuers and securities dealers standards of morality too high for average attainment. The opponents of this legislation have argued that it goes far beyond the common law in prescribing rights and duties and that the common law, as worked out through centuries of judicial decision, was an accurate estimate of the public morality--that the law should not require a greater standard of conduct than that which people desire and live by. It follows, they contend, that the Securities Act, as an attempt to raise the standard of business morality above that of the public, must inevitably fail, as did the Volstead Act, which sought to superimpose upon our twentieth-century civilization a mores of a kind unacceptable to the public. But these arguments are premised on the erroneous assumption that the common law closed its eyes to promoters' and business managers' frauds, that it was inadequate to remedy such injuries.

Whatever may have been the weaknesses of our system from the viewpoint of difficulties of proof from the angle of remedies, the common law at least in the statement of principles was critical of those engaged in the promotion and management of corporate enterprises who violated simple standards of fair dealing.

One of the most serious charges leveled at the framers of the securities legislation has to do with the nature of the liability imposed as a civil sanction. This charge of burdensome liability is today repeated by many people who, I am sure, never read the Act. The language, we can admit, is not orthodox--in fact, a few weeks ago in Boston it was attacked as unconstitutional because of indefiniteness. But the principle is not novel--"*or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading*". This is ancient common law dogma--that a half a truth may be a whole lie. Lord Blackburn, in the case of *Smith* v. *Chadwick*, 9 App. Cas. 187, dealt with an analogous contention in an action of deceit. He said:

"If, with intent to lead the plaintiff to act upon it, they put forth a statement which they know may bear two meanings, one of which is false to their knowledge, and thereby the plaintiff, putting that meaning on it is misled, I do not think they can escape by saying he ought to have put the other. If they palter with him in a double sense, it may be they lie like truth; but I think they lie, and it is fraud. Indeed, as a question of casuistry I am inclined to think the fraud is aggravated by a shabby attempt to get the benefit of a fraud without incurring the responsibility".

It is not my intention here to enter into a detailed discussion of the common law in its relation to corporations and corporate promoters. But I should like to direct your attention to two or three of the recent decisions of the Supreme Court which evidence the fact that judicial insight regardless of the lax ethical standards of the twenties has once again caught up with business immorality and condemned it.

There first comes to mind the *American Tobacco* cases, *Rogers* v. *Guaranty Trust Co.*, and *Rogers* v. *Hill*, which were decided by the Supreme Court in the October term of 1932. A short statement of the facts which led to the litigation will be helpful. In 1912 the American Tobacco Company stockholders passed a by-law authorizing the diversion to six senior officers of 10% of any annual profits in excess of those realized in 1910. Since 1912 the capital of the company has more than doubled; profits have increased five-fold. Between 1921 and 1930, over ten million dollars were distributed to executives under this by-law. In 1930 the president of the American Tobacco Company, Mr. Hill, received a cash bonus of more than $842,000 in addition to a stipulated salary and credits aggregating almost $350,000. Moreover, during that period the directors had, without authority from charter or by-laws, put through several stock subscription plans, the benefits of which accrued in large part to the directors. In 1930 these directors submitted to shareholders a new employees' stock subscription plan. Except that the sale of shares was to be at not less than par, the plan--though this grant of unlimited power should hardly be dignified by such an appellation--vested in the directors absolute discretion as to the distribution of the shares. And the directors submitting the plan were careful to make express provision for their inclusion. Cajoled by the promise of an extra dividend if the plan were adopted, the stockholders almost unanimously approved it. Bear in mind that this was euphemistically termed "an employees' stock subscription plan". But by the first distribution under the plan, recommended by the president and voted by the directors, the latter received 60% of the shares allotted, and at a price of $25 a share. The then market price was $112 a share. The differential represented a benefit to president Hill of well over a million dollars.

A stockholder, Mr. Rogers, considering himself aggrieved by these facts, brought separate suits attacking the bonus and stock subscription plans. The course of his litigation was long and discouraging. In *Rogers* v. *Guaranty Trust Co.*, the Supreme Court granted certiorari on the suit involving the stock subscription plan. But the majority found only that the District Court for the Southern District of New York had rightly exercised its discretion in refusing to take jurisdiction of this suit involving a New Jersey corporation, and dismissed the case. However, a stirring dissent by

Mr. Justice Stone, in which Justices Cardozo and Brandeis concurred, foreshadowed the future attitude of the Court toward such business practices. The dissenters, after finding that the Courts of the Southern District had jurisdiction, went on to state, in regard to the contention that this management was entitled to accept and retain the large cash bonuses because of the large profits made by the company:

> "Their business competence does not confer upon them the privilege of making concealed or unauthorized profits or relieve them of the elementary obligation which the law imposes on all corporate directors to deal frankly and openly with stockholders in seeking their consent to benefit personally by reason of their relationship to the corporation".

And both Mr. Justice Stone and Mr. Justice Cardozo emphasized the

> "fundamental duty of directors to derive no profit from their own official actions, without the consent of the stockholders, obtained after full and fair revelation of every circumstance which might reasonably influence them to withhold their consent".

It was to this rule that the entire Court adhered when, later in the same term, the cash bonus plan came before them in a case free from jurisdictional defects. Mr. Justice Butler, speaking for a unanimous Court, noted the presumption in favor of bonus payments made in accordance with a by-law passed by stockholders, but he further noted that this rule could not

> "be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of the corporate property":

He further stated

> "The dissenting opinion of Judge Stone indicates the applicable rule. If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders had no power to give away corporate property against the protest of the minority".

Thus, surprising as it may be, even before the enactment of Federal securities legislation, there was a duty, and a stringent duty, of full and frank disclosure of matters concerning corporate affairs by those entrusted with the management of corporate enterprise.

And this is reinforced by the decision, early this term, in the *McCandless* v. *Furlaud* case, again on certiorari from the Circuit Court of Appeals for the Second Circuit. Since this case presented problems closely analogous to those arising under the Securities and Securities Exchange Acts, I shall make a full statement of the facts. It involved a suit by a receiver of an insolvent corporation against its promoters, to recover profits pocketed by them through sales of the corporation's securities to the public. Furlaud and Company, an investment house, was interested in the promotion of gas

operations in western Pennsylvania. It acquired options on nine tracts of land in the name of its wholly-owned subsidiary, Kingston. The actual value of these properties was approximately $2,500,000, and the option price somewhat lower. But Furlaud, declined to issue the figures of an honest appraiser, succeeded in having the properties appraised at $7,000,000. Furlaud then organized another subsidiary, Duquesne, to acquire and operate the properties. It is unnecessary to relate the entire train of intersubsidiary transactions. Suffice it to say that, when the circuit had been completed, Duquesne possessed this property, worth about $2,500,000, and about $365,000 of working capital. The public had purchased bonds and notes which were liens on the property in the amount of $5,000,000, more than $2,000,000 in excess of the cost of the property to Duquesne's affiliate, and the public had paid about a million dollars more for a stock issue of the company. These securities had been unloaded on the public through Furlaud's subsidiaries. The appraisal of the properties owned or to be acquired by Duquesne at $7,000,000 was made a selling point, and the lien bonds and notes of the corporation were advertised as "issued in connection with the acquisition of properties and to provide cash for development, extensions and other corporate purposes".

To state the result summarily, the public had invested around six million dollars in securities upon the representation that the proceeds would be used for the purchase of lands and for cash capital for the business, and upon an appraisal which valued the properties to be acquired by the corporation with these funds at around $7,000,000. In fact, approximately three-fifths of the money was applied to its designated usage--the rest found its way into the pockets of the promoters through a series of sales by subsidiaries. The Supreme Court, speaking through Mr. Justice Cardozo, held the promoters of the corporation liable as trustees for the profits made by them through their intercorporate manipulations. The opinion deserves thorough perusal by every lawyer engaged in corporate practice. I will quote but a few sentences to illustrate its tenor.

Said Mr. Justice Cardozo:

> "Promoters of a corporation stand in a fiduciary relation to it, to this extent at least, that they will be chargeable as trustees if they deal with it unconscionably, oppressively or in violation of a statute".
>
> "What is here is a tort growing out of the fraudulent depletion of the assets by men chargeable as trustees if they have failed to act with honor".
>
> "Furlaud and Kingston, having made themselves partners to the scheme whereby Duquesne was to be despoiled and its creditors were to be defrauded, became accountable, we think, for anything that came to them as the result of the conspiracy in excess of the consideration furnished on their side".

Mr. Justice Roberts wrote a dissenting opinion for himself, Mr. Justice McReynolds, Mr. Justice Sutherland and Mr. Justice Butler. It was the contention of the minority that no recovery could be predicated on the record because the District Court had made no definite finding of fraud or misrepresentation and that consequently the corporation suffered no injury. The

minority opinion charged that the majority opinion was in the teeth of *Old Dominion Copper Company* v. *Lewisohn*, 210 U.S. 206, and that in substance that case must stand overruled.

> "The facts just stated clearly indicate that the decision now made in effect overrules the *Old Dominion* case. The so-called fiduciary relation of promoters may be availed of by the corporation only in virtue of the equity of innocent stockholders defrauded by the promoters' scheme. So holds the *Old Dominion* case, and so hold many authorities which are in accord."

In the Circuit Court of Appeals for this Circuit Judge Learned Hand had very strong feelings about the impropriety of the respondent's conduct but felt bound by the *Old Dominion* case to rule that no cause of action had been shown.

This is a magnificent illustration of the traditional common law mode of development. There is an attempt by the majority to distinguish the earlier case. I am quite sure, however, that when presented with an undistinguishable case another Court will say of course the minority is right, at least to this extent: the *Old Dominion* case must be regarded as overruled.

There are many variations of this case which come quickly to mind. The receiver sued as a representative of the creditors. But suppose a shareholder sued - one who purchased his security after the deal. What of a stockholder who voted approval of the transaction, but in actual ignorance of all the facts? There will be many problems of multiple recovery presented by an extension of this case. But time does not prevent further analysis.

Even at the risk of the accusation that my conclusion is one of "post hoc ergo propter hoc", I suggest that the Supreme Court of the United States was turned in a new direction by the same forces which generated the securities legislation of the last few years. True, it is that such a conclusion is beyond the powers of demonstration. But can there be any doubt but that a contrary result would not have been reached ten years earlier? You will recall the thrilling toast to the law by the late Justice Holmes:

> "When I think of the law I see a princess mightier than she who once wrought at Bayeux, eternally weaving to her web dim figures of the ever-lengthening past - figures too dim to be noticed by the idle, too symbolic to be interpreted except by her pupils, but to the discerning eye disclosing every painful step and every world-shaking contest by which mankind has worked its way from savage isolation to organic social life."

This is a poetic way of recording the slow-lagging progress of the law toward the state of identification with the moral ideals of a given era. In my opinion, our highest court by this decision has emerged from the morass of error and by putting sanctions to corporate dishonesty has set its feet on the highroad of honor among men.

The Securities Act represents a parallel philosophy to the McCandless case. In our brief history we have seen attempted similar corporate maneuverings, similar watering of assets, similar writeups, similar fraudulent misconduct. But now the Federal Government has a mechanism which will prevent many forms of corporate misconduct. But the law is novel only in remedy, not in the standard of conduct which is identical with the ancient law.

It has been pointed out in the Columbia Law Review for last month that despite the obvious difference from every practical aspect between a family corporation and one the shares of which are publicly held, the courts steadfastly refused to make a differentiation which common sense requires. The legislation we administer does not in terms make this distinction, but by necessary implication the statutes are applicable only to companies publicly owned. The Securities Act of 1933 applies only to public offerings and while there can be a public offering of securities of a privately owned company, in the usual case such a company would not retain its private status very long. In the Exchange Act the application of nearly all of the provisions to securities registered on national securities exchanges makes most of the statute inapplicable to family corporations.

The importance of this distinction cannot be developed in this address. It is perfectly clear that if this distinction were preserved courts would avoid slavish devotion to precedents articulated in a period which knew nothing of the rise of management as a separate and distinct interest - a period which was not faced with the vexing problems involved in the separation of ownership and control; a period which did not have to wrestle with a concentration which has removed many of the checks which operated to curb the misuse of wealth and power.

The path of progress in the law is nowhere more clearly portrayed than by considering the attitude of company officials today regarding disclosures and the viewpoint of issuers fifty years ago. About that time the New York Stock Exchange sought to secure financial information from issuers whose stock was dealt in on its exchange. The Delaware and Lackawanna Western Railroad Company replied with tart finality:

> "We make no reports and publish no statements, and have not done anything of the kind for the last five years."

When the Securities Exchange Act of 1934 became effective, issuers almost without a dissent made available to the public a most comprehensive statement affecting the companies' management and financial affairs.

Prior to 1934 the amount of information furnished by a corporation was largely determined by the uncontrolled discretion of the management. The listing committees of the better stock exchanges, it is true, have in recent years made efforts to secure important information for investors. Unfortunately, the standards set up by these committees - which standards were usually adequate as to the disclosure required - were not uniformly enforced. A new corporation managed by strangers to the listing committee, or a corporation which the committee had some special reason to investigate closely, was held to a rigid observance of the listing requirements. An old corporation seeking to list new securities was required to give out little information. Because of this sometimes misplaced trust securities were often accepted for listing which would not have been listed had the true facts been known. Then, too, many corporations were entitled to listing under old contracts which required very little in the way of periodic reports.

Today every corporation whose securities are listed on a national exchange, whether old or new, regardless of the reputation of the management, must furnish a fairly comprehensive amount of information with respect to its affairs. The principle has been definitely established by the Act that corporations which have been publicly financed and whose securities are owned in such substantial numbers by the general public as to be listed on a securities exchange have become at least quasi-public in nature and are under a duty to the investing public to give reasonable publicity to the results of their operations.

The necessary reversal in the practice of many corporations of disclosing very little information to the stockholders and general public has, I realize, been quite a shock to many corporate executives. The spirit with which the vast majority of corporations has accepted the new order is worthy of great praise. Managements have come to realize that they are stewards of vast interests for the investing public and consequently owe the owners of the business the duty of adequate report upon the success or failure of operations.

This requirement of publicity of corporate affairs is but another indication of the present-day realistic approach of the legislatures to the problems of the relations between corporation stockholders and the public. It is no longer fashionable to regard a corporation as an indivisible entity but rather as a conglomeration of different and often adverse interests, the existence of which necessitates an adequate disclosure of relevant facts to all parties involved.

While the general policy of the Act is one of disclosure of the required information, Congress has indicated that in certain instances all of this information need not be published. A number of interesting problems of law and business expediency arise therefrom.

Section 24, paragraph (a), of the Act prohibits the Commission from requiring the revealing of trade secrets or processes. Although a few registrants, in petitions for review in the Circuit Court of Appeals, claim that sales and cost of sales constitutes a trade secret, it is expected that the courts will limit these words in the Act to their ordinary meaning of an unpatented, secret, commercially valuable plan, appliance, formula, or process which is used for the making, treating or processing of articles or materials which are trade commodities.

Paragraph (b) of Section 24 permits any person filing an application or report to make written objection to the public disclosure of information contained therein. The Commission may, in such cases, make available to the public the information contained in any such application or report only when in its judgment a disclosure of such information is in the public interest.

The meaning and intent of this Section are somewhat confused, due no doubt to the fact that the Section represented a compromise between advocates of different philosophies. Is the burden upon the Commission to show in each specific case that publication of the particular information

is important to the public interest? The words of the statute, taken literally, might seem to permit such interpretation. On the other hand Section 12 of the Act provides only for the inclusion of such information in registration applications as the Commission shall require as necessary or appropriate in the public interest or for the protection of investors. Thus it would seem that the mere fact that registration applications are required by the Commission to contain certain information amounts to a determination that disclosure of such information is in the public interest - the only purpose, of course, of inclusion of information in an application being its usefulness to the public. It seems, therefore, that the proper interpretation of Section 24 (b) is that, in order to secure confidential treatment, a registrant must show by its written objections, or at any hearing ordered by the Commission, that the peculiar circumstances of its case are such as to render inapplicable the general rule that the public interest requires the disclosure of all information contained in registration applications.

The statute is not at all clear on the point of whether or not any appeal exists from a Commission determination that disclosure is in the public interest. Section 25 of the Act provides that any person aggrieved by an *order* issued by the Commission in a proceeding under the Act may obtain review of such order in a circuit court of appeals. Does the Commission, under Section 24 (b), issue an "order" in a "proceeding"? Section 24 (b) merely requires the Commission to refrain from making public information for which confidential treatment has been requested, unless in its judgment disclosure is in the public interest. A hearing need only be had in the discretion of the Commission. It may be argued, then, that no "proceeding" is contemplated by Section 24 (b). No "order" of the Commission issued in any event. Whether or not a hearing is held, the Commission can do no more than *determine* that disclosure is in the public interest; the actual disclosure follows by operation of law rather than by order of the Commission.

The statute further appears to rest the determination of the question of whether disclosure is in the public interest in the sole judgment of the Commission, which judgment should not be overturned in any appellate proceedings, except upon a showing of gross abuse of discretion.

The Commission, regardless of its strong feelings about the proper scope of judicial review, adopted a rule which should preserve secret the information filed confidentially until a final order of the Court. This rule provides that information for which confidential treatment has been requested shall not be disclosed until ten days have elapsed from the date of the Commission's determination, if made, that disclosure is in the public interest. During this ten day period the registrant may either withdraw its application in toto or may file notice of intention to seek review of the Commission's determination. If such notice is filed, the information is not made public until sixty days from the date of the determination or final disposition of any proceedings brought to review the action of the Commission, whichever is the later. Thus, if there is any right of review of the Commission's determination, it has been preserved by affording the registrant adequate interim protection

against disclosure.

Approximately 500 objections to public disclosure have been made to the Commission. By far the greatest number of objections were to the publication of salaries and remuneration contracts of the directors and principal officers. The next largest group constituted objections to disclosure of part or all of the profit and loss statement. Most of these objections were only to disclosures of sales and cost of goods sold. One registrant, however, objected to disclosure of any portion of the profit and loss statement above the line "net income".

No hearings were held in any case unless a request for hearing was made by the registrant. The proceedings were in the nature of an opportunity to the registrant to show special circumstances of actual or potential hardship indicating that disclosure in its case would not be in the public interest.

Chairman Landis recently considered the arguments which have been urged against disclosure:

> "Privacy as to individual income is an understandable concept. But in a public corporation, and our large corporations are truly public in character, privacy as to compensation for work done stands upon a different footing. That compensation is frequently uncontrolled, and is always payable from profits accruable to the business as a whole. Whatever argument can justly be made against such devices as pink-slip laws has no place here. If the sources of a man's income are my pocket as a taxpayer or a stockholder, some knowledge of what he is being permitted to take is my concern. True, there can be little question that the novelty of this type of disclosure has for the time being made it a matter of public comment by the curious and the idle. But little harm, if any, has resulted and the abuses that were once held up as a national scandal will hardly recur. As the novelty wears off, a fairly safe prediction would be that the objections to the disclosure of this information will look as obsolete to future Americans as those raised by corporations in 1860 to the disclosure of any financial information".

Unfortunately, time will not permit my dealing with the specific problems raised by the requests of companies to have answers to certain items kept from the public records. The extent to which the Commission has this power of compulsory disclosure and the extent to which the powers of Congress encompass this form of investor protection have been raised recently in the courts. Without expressing a view on this increasingly difficult question of how American sovereignty has been divided up between the state and the nation, it is quite obvious that no matter what our jurisprudential concept of law may be, society has by this method indicated that the management of publicly owned companies must render an account of their stewardship under pains and penalties. It is, I submit, the minimum control to be required of a complicate, corporate society.

It should be our earnest hope that the continued response of management to this easy stimulus will make unnecessary more radical interposition of the powers of the state.

We have another act to administer. It would be premature to deal with the problems of this legislation at least until the companies have been judicially declared subject to the law. There is one matter which might have some interest for you.

In one of the Commission's recent investigations there was revealed the incredible length to which a hard-pressed management was prepared to go in securing new capital for the enterprise from the unknowing public. Employees were dragooned to sell to all with whom they came in contact—linemen, meterreaders, installation men, the traffic men, accountants, equipment men. In fact, the absentee management, unresponsive to the decencies of public relationship "put the heat on" nearly every employee to sell preferred stock which had been fraudulently overvalued. Even lowly janitors were expected to do their part in the "give till it hurts" campaign to put the company over the top. Appeals to cupidity—to greed—to thrift—all were resorted to, aided by misrepresentations which were even under the existing law illegal. At one point in the testimony there appeared evidence of the gruesome work of the high-pressure gentry. A circular of the holding company which controlled the operating company read as follows:

> "One result of Mr. Y's visit was in convincing the employees any of them could sell stock. He went out with them and called on a number of different people and developed what appeared to be a number of good prospects and helped one of the pipe-line laborers close two good sales. This had the effect of stimulating some of the others who considered that if a chap in dirty overalls all day could go out after work and earn $16 commission in two evenings, they certainly could do it too."

In 1930 the sales campaign became feverish. All the employees were informed that the selling drive was to be on a sort of playful plane. It was to be regarded as a "big game hunt". A rabbit was the sale of one share and counted five points, and so on with various animals until it reached the elephant which represented a sale of twenty shares and a score of 250 points. But there were hazards in that sport, too. One of the Commission's exhibits from the files of the company was a circular on which there was a picture of a "skunk". It read:

> "Look out for a skunk: deduct five points more than originally scored".

In other words, a skunk was a purchaser who turned back the stock and demanded his money back. Although the records are silent, it is safe to assume, unfortunately, that the skunks were rare in that territory. The evidence went on to show that this customer ownership campaign involved sales to the public at 99 when the same stock was selling on the market at forty points lower.

Obviously, there is an answer today--the Securities Act of 1933 would require a registration statement, the furnishing of a prospectus, and would visit civil and criminal penalties for the kind of misinformation with which our record abounds. But that is not enough. I am sure that even with the burden of disclosure and the risk of liability there are many who would try in more prosperous times to attempt that type of cruel imposition. The Public Utility Holding Company Act of 1935 is an absolute safeguard against corporate sinfulness of this nature on the part of the Utility Holding companies. I suppose it is almost treason to mention that statute here in New York where its existence is recognized only in condemnatory phrases and law suits. Nevertheless, no honest critic will dare deny that this statute comes to grips in realistic fashion with the corporate sordidness which an apathetic legal system had fostered and encouraged.

Purposely I refrain from extended comment about the new legislation which has resulted in our becoming quite chummy with the United States Marshals. Prescinding from particular views, either legal or economic, which may be held by counsel for companies on the one hand or counsel for the government on the other, it is quite obvious that the traditional postulates of the common law have been impotent in the task of putting limits to private socialism as evidenced by the giant holding companies. The state has determined to put restraints upon a new powerful and dangerous factor in the economic life of the nation.