UNCERTAIN SECURITY

Brief Comments on the Securities Act

BY GEORGE E. BATES

DESPITE NUMEROUS statements which have appeared both in support and in adverse criticism of the Federal Securities Act there has, unfortunately, been no real joining of arguments and consequently little opportunity for the lay reader to resolve the issues presented. Proponents have endeavored to reassure the business community with such generality as, "Business honestly conceived and competently administered has nothing to fear and much to gain." Other matters they have implicitly dismissed as involving detail rather than broad principle.

Adverse criticism, which has become increasingly articulate, makes no attack upon the avowed principle of the Act. It maintains that details *are* important, that an objective no matter how laudable is no more than a "good intention" without appropriate means for its accomplishment. They make clear, furthermore, that "appropriate" does not comprehend means analogous to the headache remedy of amputation, however effective.

Test of the unsupported conclusion that honest and competently managed business has nothing to fear is of the essence. While there is fair accord upon the principles involved, their practical application to business realities causes deep concern. The Act does not stop with their accomplishment, furthermore, but goes much further, and seldom proceeds either clearly or consistently.

Reasonable clarity and consistency are minimum standards for legal drafting, and have never fettered courts in adapting legislation to changing conditions. Inability to find competent counsel who can interpret into a workable and consistent whole the obscure and ambiguous provisions of the Act may well cause honest and responsible business to hesitate.

The Act so bristles with ambiguity and uncertainty that in selecting examples one is embarrassed by choices and made fearful that citation of a mere two or three, rather than spreading to view the whole number, will leave the impression of a teapot tempest over "details."

A committee is formed (in some cases it acts gratuitously) to solicit deposits of maturing bonds to exchange for other bonds in connection with a refunding program. Deposits are to be made with fiscal or transfer agents. The committee itself effects no exchanges. Yet the members of the committee, the fiscal agents, and the transfer agents may be held "underwriters" under the Act. If they are, they are liable for the whole issue either in rescission or damages of unspecified amount. This is a liability in addition to the possible liability of directors. The Act is drawn so vaguely and broadly as to include or exclude them, depending upon the point of view and temperament of various interpreters.

A company desires to carry the risk of selling its own securities and to manage their distribution through local dealers or brokers who would merely confirm sales for a small commission. While such dealers are exempt from liability as "underwriters" if some "underwriter" intervenes between them and the issuer, in the above instance they would probably be held "underwriters" under the Act and so liable for the whole issue. The language of the Act is so inapt that many unwary persons acting in good faith may be held for untold damages.

A dealer buys securities from an "underwriter" for resale at a normal selling commission. One provision of the Act would lead to the inference that such a dealer was not an "underwriter," another provision is so obscurely worded that it is nowise clear, and a third implies that he would be an "underwriter" (and so liable on the entire issue).

The term "public offer" is in itself sufficiently vague (though probably not susceptible

to statutory definition), but there is no consistency in its use throughout the Act. Other and more vague terminology is substituted and the word "public" is frequently omitted with reference to "offer," so that the "point of take-off" of the Act probably is not the *public* offering.

Upon one highly important point there has already been conflict between two of the highest authorities yet to interpret the Act. The Act provides that those entitled to sue may bring suit "either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or (2) for damages if the person suing no longer owns the security." The problem relates to the measure of those damages. Are the "damages" analogous to the rescission permitted to those owning the security? According to one of the reputed authors of the bill they apparently are, for he says, "Since the remedy is in the nature of a rescission, it avoids the inquiry, practically impossible, as to the extent of the damages due to the misrepresentation and the extent due to other causes." On the other hand, the Federal Trade Commission takes the view that the damages recoverable must flow from "material, misleading, or inadequate statements" as distinguished from "trading losses." Though either of these views may be given weight they are not controlling. The Commission has no jurisdiction to interpret such provisions of the Act. That function rests in the courts. Nor is there certainty of uniformity in holding one way or the other, for interpretation is to come not only from the federal but all the state courts.

If the former view should be held, a multiplicity of suits might result in claims far in excess of the original issue price. The amount of damages recoverable by any one plaintiff is clearly limited to the price at which the security was offered to the public. Thus the original purchaser of 10 shares at $100 each could recover no more than $1,000. Those shares might, however, pass through several hands, and if market fluctuations were wide several purchasers of the same shares might sustain losses which in the aggregate would considerably exceed $1,000. Thus an "underwriter" who sold $100,000 of securities out of a $10,000,000 issue for a gross profit of $3,000 would not only be liable for the entire $10,000,000 but conceivably for many times that amount.

The immediate point is to urge merely the desirability of specifying in advance the measure of risk. All risks cannot be resolved into certainty, but if the general range of risks remains hazy the psychology of those whose assets back the venture degenerates from caution to fear. One can understand and appreciate this psychology of business men who, because of the statute's uncertain meaning, may be submitting themselves as guinea pigs for an experiment which seems wholly unnecessary and may be wholly disastrous to them.

It is safe to assume that in a decade or two the courts would resolve most of the uncertainties. Courts have the habit of pumping common sense into vague and uncertain legislation. But the interim can be beneficial solely to the legal profession. When Congress can do in a day what it will take years for courts to accomplish, Congress should act.

It seems an essentially simple matter to accomplish the general purpose of the Act (in so far as legislation may be effective). In fact it is. It has been made complicated by the Securities Act, however, in a way that promises to defeat the fundamental purposes.

Within the limits of this article it is no more feasible to discuss all the provisions which cause concern to honest and competent business men than to cite all the ambiguities and inconsistencies. A few examples may suffice to indicate some of the difficulties.

The director whose company contemplates the issuance of securities has the alternative of accepting the responsibilities imposed by the Act or of resigning. If the honest director of financial substance is not driven to the latter course by the inability of competent counsel to advise him with any degree of certainty, he may well be when he learns that, if in the registration any fact was misstated or any fact was omitted and required to be stated, or necessary not to make statements made misleading, and it was "material," he would be subject to liability for the entire issue unless he could prove, not only (as in the English Companies Act) that he had reasonable ground to believe and did believe the statements to be true, but also that they were adequate and that in many instances his reasonable ground for belief was

founded upon the reasonable *investigation* (not *care*) required of a fiduciary. Counsel would probably advise him, however, that strategically most initial suits would be brought against the issuer, rather than directors or others, because the issuer could not avail itself of the defense that reasonable investigation had been made. This would not be true, however, if the issuer were insolvent; and, furthermore, if the issuer passed into other hands, it might seek to recover contribution from directors and others made liable.

Such advice would meet with the variety of responses which might be expected from directors in differing positions. The director and manager of a small company would not find onerous the duty of thorough investigation. Neither would the directors of even large companies the nature of whose business made verification of all required statements relatively simple. "Investment trusts" might be cited as falling within this category — and it is significant to note that securities of such investment companies to date comprise the bulk of registrations under the Act (to the concern of many who look upon them as the chief class of "manufactured" securities of recent years, as providing but little new capital to industry, and as a class of securities in which investors have lost no less and possibly more money than in many others). The promotional enterprises whose complexities do not arise until the stage of operation is reached constitute another example — and such enterprise accounts for the next largest group of registrations (and no class is subject to greater risk for the investor).

It is the director of the large going-concern, especially in the industrial field, who will become most alarmed. Even the director who is also an officer-employee and engaged in the actual conduct of operations will have qualms. The other directors whose duties realistically are to pass only upon questions of major policy will feel that they cannot expect compensation for the investigation required, aside from the tremendous risk assumed. The risk might be that a jury deciding in the light of hindsight would hold that a given contract was "made, not in the ordinary course of business," that it was "material," and that the reasonable investigation required of a fiduciary should have disclosed it as such. If competently advised, this type of director will elect the alternative of resigning.

One of the purported authors of the Act writes that, "The civil remedies of the Securities Act are correlated to the standards of responsibility and competence to be exacted." We are given no clue, however, to whence those standards were derived; it is certain that they spring from neither the Companies Act nor experience with business realities, in view of the undiscriminating responsibility placed upon a host of widely dissimilar persons under the blanket of "underwriters." Mention has been made of the probable inclusion thereunder of protective committee members, brokers, and fiscal agents. Among the securities merchants themselves there is discrimination only between "underwriters" and "dealers" (in one instance "brokers" are separated from "dealers"), and as has been indicated this distinction is none too clear. As between classes of "underwriters" there is none. The Companies Act confines liability of investment bankers, as such, to those authorizing the issue of the prospectus, thus avoiding the complexity and difficulty introduced by the Securities Act.

A prospective "underwriter" in St. Louis, willing and able to underwrite the sale of $50,000 of bonds for a commission of from $250 to $2,000, obviously cannot afford to duplicate the investigation made by the "underwriter" originating the issue. His gross profit is not large enough to justify either the investigation or the risk which would yet remain after investigating if the issuer conducted other than a very simple business or operated at a distance. His practical opportunities for investigating are much less than those of directors, yet he is held to the same standard. They are infinitely less than those of the "underwriter" originating the issue, who is in direct contact with the issuer and actually makes the investigation upon which the offering is based.

Underwriters of this latter sort who originate the issues or are in close relationship with the issuers and are thus in a position to make the required investigations (most responsible originating houses would make far more searching investigations than are probably called for in the Act) will feel relatively free from liability on the registration statement.

The insufficiency of their capital to provide for the underwriting needs of industry without

the distribution of risk accomplished through sub-underwriting of large issues by several hundred such houses as the hypothetical St. Louis underwriter mentioned above, however, may sharply curtail their business and place upon the issuer or some other agency the functions of security underwriting and distribution.

The twenty-day "waiting period" inserted between the filing and effective dates for registration of an issue likewise will affect the ability of an issuer to obtain real underwriting. It may be administratively useful for a superficial check of the completeness of statements, but it would seem that other more effective safeguards had been provided for the investor. It is naïve to assume that such a "waiting period" would be of much direct benefit to the class of small investors for whose protection the Act was primarily designed. They would undertake neither the initiative nor the expense of getting the information during that period, and issuers or underwriters, even were there no risk of their being made liable as soliciting offers to buy, would not send them advance prospectuses if they considered that their securities would not stand such scrutiny or that selling "pressure" should be applied at the time of offering.

As "dealers" rather than "underwriters" under the Act, security merchants and brokers incur innumerable legal risks and are bound by restrictive provisions entailing added business risks. Most of the legal risks apply to "any person who sells" as well as the "dealer." When selling (in interstate commerce or the mails, as elsewhere in the Act) such a security as a railroad bond exempt from registration he apparently must, if he makes any representations, be prepared to give essentially all the data required for a registration statement and to exercise reasonable care lest material facts be misstated or omitted if necessary not to make those made misleading. (His liability, however, is limited to those to whom he sells.) Unless the security is obtained from the issuer who can supply this information, risk of making representations will be prohibitive. The seller must be in a position to make a full and accurate statement or say nothing. Intermediate declarations are hazardous. Such a requirement would involve little difficulty were periodic reports required of all issuers, past and future, but no such basis is laid for representation which may be made by dealers or casual sellers.

Even these random observations, which might be multiplied almost endlessly before exhausting every incidence of the Securities Act upon the delicately adjusted business organism, should indicate that honestly and competently conducted business has much to fear.

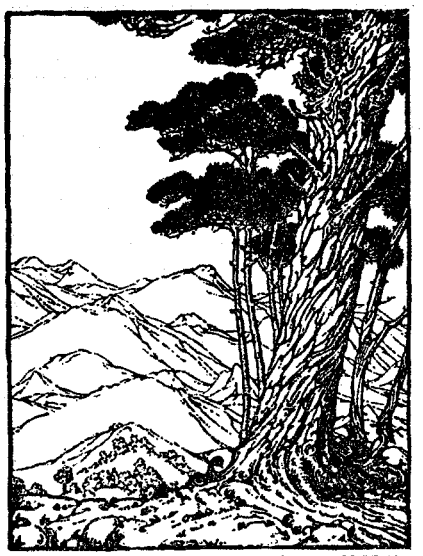
Honesty and mere competence are not the criteria of the Act. Civil liability is imposed upon persons who act in good faith and not negligently. Were there greater certainty in determining what are the "material facts," the liability imposed would be less onerous, but the Securities Act goes beyond the Companies Act, quite properly perhaps, and imposes liability not only for untrue statements but for omissions of material facts — obviously matters of judgment. The nebulous question of materiality to be judged long after the event with little predictability of result may well cause honest directors and bankers of substance to hesitate before assuming the terrific penalties imposed.

It would seem reasonable to suppose that "fraudulent" securities could be attacked with penalties for fraud, and that "recklessly issued" securities could be controlled similarly by penalties for failure to exercise due care. The shrapnel introduced by the Act to kill foxes is very likely to kill the geese. Such was the effect of the Bubble Act in England of which Berle wrote, "Legitimate business suffers, illegitimate business goes right on. The crook will take a chance of being indicted; the honest man will hesitate to move."

For normal business to continue, the ambiguity in the Act should immediately be removed by Congress. Uncertainty can but deter the process of business rehabilitation.

In the second place the penalties imposed should be appraised anew. The present ones supply deterrents out of all proportion to the requirements of the situation. Standards for those held responsible should be gauged to capacity and ability to measure up to them.

A realistic approach to the problem of amendment will preserve the general principles of the Act and resolve it into a practicable and workable system that will accord with the desire of the President as expressed to Congress, "The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business."



Drawing by Dugald Walker

A PLACE OF YOUNG PINES

Up here in the house it is like a battlefield
Where I struggle forever with myself
And am only victorious by defeating myself.

Here too come voices and passions,
All that would urge me against myself
And draw out the wearisome conflict.
All things uncertain and unhappy,
All that is noisy, assault me here.

But sometimes I step from my room,
Walking quietly so that none shall hear me,
And go and stand in a place of young pines.

In winter it roars with living waters,
But now in summer it is dried up and silent.
Where ran the water lie polished stones
And nooks of clean brown sand,
And above that are the stiff dead pine needles
And the rough stems of the young pines.

They are so still, they live so contentedly,
Holding the hard rock, going down into darkness,
And lifting such gay green plumes to the sun.
They do not argue, they do not talk of success,
And if they want to excel it is only in growing.

So for a little time I stand among the pines
Above the clean dry watercourse
Where all sounds are hushed, all conflict still.
There I am at peace, there I am at one with all things.
But up here I am not at peace,
Never truly and wholly at one with all things.
And for that I yearn — to be at one, to be at peace.

Down there among the pines I am at peace:
Not questioning I accept and am accepted,
And live in peace of life.
But up here I doubt if there is peace of life:
And sorrowfully and in dismay I question,
Asking if what I seek is not rather peace of death,
The lapse, the going forth, the peace
After all the waters have passed beneath the pines.

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