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THE ultimate begetters of laws are events. A series of events culminating in the stock market crash of October 1929 were such. They begot the present Securities Law.*

The violent liquidation that ensued suddenly swept life savings as well as fortunes out of existence. The time had come to take an accounting of the stewardship of those into whose hands the American public had trusted its funds. Many investors, that is those who were interested in conserving their savings as distinguished from pure gamblers, thought they had exercised sound judgment or acted upon competent advice in the selection of their purchases. Many had purchased upon pure hunches or else "hot tips." Regardless of the character of the information, it invariably came from a stream polluted at the source. Abuses had crept into the marketing of securities that called for immediate correction. The Securities Act was a belated attempt to curb these abuses. Prevention rather than punishment is its key note.

It was not uncommon for the local banker or business man to give advice upon securities to those who sought it. More often than not he relied upon circulars, prospectuses, and radio talks which purported to reveal the essential facts necessary to an intelligent appraisal of the securities offered, but which, in fact, were conspicuous for the paucity of information conveyed. Thus it became possible for men of character and honesty to become the innocent agents for spreading misinformation rather than the true and unadulterated facts which might have changed the severity of a financial panic which for a time threatened

* Section 5 of the Securities Act of 1933, 15 U.S.C.A. S. 77a et seq., Act of Congress, May 27, 1933, c. 38, Title 1, 48 Stat. 74.

the very economic structure of this nation. There came a growing conviction that the vicious practices which bordered very close on outright fraud could only be arrested by getting at the root of the trouble. If a law could lay its finger upon the source of the evil, a good deal of the so-called "hot tips" and honest but misdirected advice would be automatically eliminated. The situation called not for a refinement of the legal redresses available but for prevention in the first instance. Judgments against judgment-proof wrongdoers was, at best, very unsatisfactory. No solemn proclamation of law can ever rid society of men disposed to be crooked or sharp, but laws can create effective deterrents by throwing light upon their operations. Requiring information and publicity before the scheme is launched is to be preferred to making investigations and bothering about extradition proceedings and coroners inquests after the public has been mulcted. And finally a law that can bridge the privity of contract doctrine and pierce the shield of corporate immunity where those legal conceptions are invoked in defense of unconscionable practices will, it is hoped, present the convincing incentives for the unscrupulous to become a bit more social minded or take the consequences.

The technic of advertising and selling securities without telling the whole truth, the schemes, "window dressings," and evasions employed to avoid giving a true picture is a long and interesting story but beyond the scope of this paper. Because of the accoutrement of legal defenses available and because of the inadequacy of the legal machinery to effectively cope with the problem, these practices grew and flourished until eventually they tainted even the respectable investment houses. State laws were inadequate. The common law actions were impotent.

State Blue Sky Laws

Those who have insisted that the securities market be made safe have demonstrated beyond doubt that state laws were wholly unsuitable and were probably doomed to failure forever. There are three types of state Blue Sky Laws: First, those requiring qualifications of the security to be issued before sale (Many of these laws permitted too many exceptions. Among the most commonly exempted were securities listed on the stock exchanges and those issued by public service corporations regulated by state commissions.); second, those listing qualifications required for licensing dealers. (A variety of requirements became a constant source of dissatisfaction. Many were ill conceived and unnecessarily burdensome.); third, the fraud statutes (These were of a punitive character and designed to lock the door after the horse had been stolen. At best they offered threats of what would happen to swindlers "if and when caught." Few were devised to curb evils in their inception. Many of these laws were inefficiently administered and poorly prosecuted.) Some of the legislation was notably efficient and honestly administered, e.g., the California Corporate Securities Act. But when such laws made their appearance they merely caused a transfer of the fraudulent manipulations to states with less rigid requirements, or to the field of interstate commerce. By arrangement of interstate sales, the Blue Sky promoter placed himself conclusively beyond the criminal jurisdiction of the state into which the securities were being sold; no extradition could be had since the promoter, never in the state where his scheme to defraud had taken effect, could not be a fugitive from justice.[1] If extradition proceedings were begun, release on habeas corpus was inevitable on proof that the promoter was not in the demanding state at the time the crime was committed.[2] By the simple device of providing clauses in contracts designating the state in which the contract was to take effect, the seller could select the field of his operations. This was accomplished by employing the conflict of laws doctrine that the law of the place of acceptance is the "lex loci contractus" governing the incidents of sale.[3] And the courts have been reluctant to depart from the established doctrine even in cases where it had obviously been used merely as a subterfuge to avoid the securities legislation of the offended state.[4] Therefore, in addition to the defects of state regulation, the greatest drawback is their jurisdictional limitations. And today, because of the vast improvements in communication and transportation, the marketing of securities is almost wholly interstate. However, the failure of state regulation has not been a total loss. Their efforts have blazed a trail, and their experiences have contributed valuable suggestions for the drafters of the Federal law.

Other Legislative Experiences

The drafters also fell heir to the written and interpreted features of the British Companies Act of 1929.[5] This statute embodied the experiences of England dating back to the 17th century. Scandals in connection with the "South Sea Bubble" brought forth the so-called Bubble Act. These earlier laws were subsequently repealed so that the present Companies Act is but a consolidation of the laws dating from 1844. Nonetheless, all show a steady perseverance and repetition in requiring exact information regarding the publication of corporate prospectuses.

1 See Legis. (1932) 32 *Columbia Law Rev.* 1411.
2 Feldman, "The New Federal Securities Act," 14 *Boston Univ. Law Rev.* 2 (1934).
3 Goodrich, "Conflict of Laws," 218, 228.
4 See Feldman, supra, note 2, at 2 et seq.
5 19 and 20 Geo. V. (1928-29) c. 23, Chitty Ann. Stat. (1928).

The tardiness in the United States in drafting a similar law may be accounted for in part by the difference in political structures of the two countries. The act in England is the general corporation law. In America the Federal government does not incorporate commercial enterprises. That is done by the forty-eight states. But the power to regulate interstate commerce and the mails was delegated to the Federal government. It is under these powers that Congress has the authority to control the distribution of securities or transactions therein across state lines. There seems little doubt that the act "based upon these Congressional powers, is, in almost all of its provisions, well beyond constitutional interdict."[6] Vague comments, in effect polite affirmations that the Act is a strain on Tradition and Principles of the Constitution, have been dismissed as being merely philosophical discussions.[7]

The experiences of England, therefore, became quite pertinent. They were drawn upon extensively in the framing of the American Act. They can also be used in administering the act and in suggesting possible legal interpretations of its various phases. A number of provisions regarding issues and securities which are of interest to Americans are at least twenty-five years old an dalready have been the subject of judicial interpretation. The discussion by the British courts as to what is a material fact, what constitutes an issue to the public, etc., are of direct relevance in the interpretation of our own law.

Nor is America entirely without history of some effort. An examination of Congressional records shows that nearly twenty-five years ago Congress made some sporadic attempts to initiate similar types of regulatory legislation. Many books and pamphlets were written urging reformation. Twenty years ago Mr. Justice Brandeis called attention to the need of such legislation. But these and similar exhortations passed by unheeded.

The Taylor bill[7a] was an attempt to require promoters, directors, and officers of corporations offering stock in interstate commerce to file with the Secretary of Treasury detailed statements containing information about their organization and its prospects. This met with the approval of President Wilson, Carter Glass, and the Federal Trade Commission. The text of the Taylor bill had a distinct influence upon the drafters of the present law.

The Volstead bill[8] introduced in the 66th Congress provided that the Attorney General investigate allegations of fraudulent practices in the sale of securities in interstate commerce and to issue stop orders.

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[6] See Feldman, supra, note 2, at 6 note 26.
[7] See Feldman, supra, note 2, at 6.
[7a] Similar provisions incorporated in Colo. Laws (1923), c. 168, at p. 577.
[8] Introduced in the 66th Congress.

The Denison bill[9] attempted to make unlawful the use of the mails or agencies of interstate commerce to defeat the purpose of the various state Blue Sky Laws. The bill died in the senate.

None of these became law. They are cited merely to show that this country was not entirely oblivious to the evils practiced, that the idea of Federal regulation was not a new one in 1933, that there had been expended considerable thought and study upon this subject, and that coming events do cast their shadows before them. Each made contributions that can be found in the present act. Among other things that gave assistance was the Transportation Act of 1920 which placed the regulation of railroad securities in the hands of the Interstate Commerce Commission. In 1930 The National Conference Of Commissioners on Uniform State Laws submitted a uniform sale of securities act. This act represented eight years of study and debate and embodied nineteen years experience of the states.

With all these efforts and experiences at hand it cannot be said that the framers were embarking upon uncharted seas. Certainly there was available ample material to use as guides. A study of the Act does not show that much, if any, was overlooked.

Marketing of Securities

The marketing of securities and their distribution is a highly technical process, as it must needs be, in an intricate economic system. Few large corporations sell their securities directly to the public. They employ what is commonly called "underwriting syndicates." No promotion of any considerable size and very few sales of large blocks of securities are made by corporations without the use of the underwriting syndicate in some form.[10] There are various types but in all at least three persons are concerned: (1) the corporation or issuer, (2) the syndicate manager or banking house that "gets up" the syndicate by arranging the conditions of purchase from the corporation and the conditions of participation by (3) the members of the syndicate or original subscribers who share among themselves what ever risk is involved in the distribution. An underwriting syndicate has been defined as "an association of persons who guarantee by subscription of the issue either wholly or partially each guarantor usually accepting the responsibility of so much to the actual contractors."[11] The Act, Section 2, 11, defines the underwriter to be any person who has purchased from the issuer with a view to sell, or sells for an issuer in connection with, the distri-

[9] Hearings on H.R. 7215, 67th Congress, 1st Session.
[10] Dewing, "Financial Policy of Corporations," 379 (1926).
[11] See Dewing, supra, note 10, at 378. For legal aspects see Machen, "Modern Law of Corporations."

bution of any security, or participation or has a direct or indirect participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' and sellers' commission.

The syndicate is the intermediate step between the issuer of the securities and the ultimate investor. Its function is comparable to the merchandise wholesaler so far as marketing is concerned as distinguished from the buying department of the original investment banker who contacts the corporation, employs auditors, engineers, appraisers and other experts to make investigations. A corporation desirous of obtaining money to expand its fixed or working capital or refinance its obligations for expenditures already made or to adjust a faltering capital structure, etc., obtains a commitment from some banking house which later organizes the syndicate. These underwriting syndicates when functioning in their true purpose have an economic justification. They make it possible for a corporation to market its securities much more economically than the company could itself were it to set up its own selling organization. In addition the fee paid is in the nature of an insurance premium that the company will realize the funds it has set out to raise. The risks that the public will not take fall upon the syndicate. Therefore substantial but reasonable profits earned by the syndicate are not necessarily incompatible with the risks incurred. There are other services the syndicates list as being their responsibility, such as the making of thorough investigations of the corporation which requested the commitment, giving experienced and individual advice to their clients or purchasing public, supporting the market a reasonable length of time after the flotation, and, in some instances, repurchasing from customers either to assist them when in distress or to preserve the reputation of the house; they also assume the risk involved of carrying the securities a long time after the money has been supplied the corporation until such time as the market is in a more receptive mood. However, there has been a conspicuous difference between what a bond house purported to do and that which it actually did.[12] Unfortunately the lure of long profits has somewhat warped this fine sense of responsibility of many investment bankers. The unscrupulous were setting the pace and the fashions, and the once conservative bankers began to ape them. This was not true of all financial houses but certainly was so with a great majority.

The apparent success of the former had a direct influence on the so-called "new marketing" methods of the latter. There occurred a decided decay in the avidity of the bond houses to tell the truth. Non-

[12] See Dewing, supra, note 10, at 411.

college salesmen were being preferred to college-bred men because the former is "inclined to look with awe upon his boss and *to take as the gospel truth everything told him* by his house and to enthuse accordingly," while the college man is "overcritical and prone to form opinions of his own concerning securities."[13]

Whatever financial risks the underwriter incurred were large in theory only. On the other hand the legal risks were whittled down to a minimum. What legal weapons the unscrupulous unearthed were soon placed in the defensive arsenal of the more or less respectable houses. As the new found legal immunities were increasing, more daring methods in marketing securities resulted. The old admonishment to guard jealously the good name of the firm was forgotten. The market was boiling. Butchers, boot-blacks, clerks, and candlestick makers were indulging in an orgy of speculation. Fabulous profits were in the offing. The boasted "thorough investigations" became less thorough and in some cases disappeared. One need only to mention the names of Kreuger and Insull to recall in what a dramatic manner these ommissions came to light. There arose a conflict between self-interest and duty. The fallacy of serving two masters became apparent, also the impossibility of supporting the market and repurchasing securities from customers when put to the real test.

Common Law Remedies

The brief sketch given above of the machinery most commonly employed in marketing the bulk of our securities brings into sharp relief the inadequacies and the impotence of the common law,—inadequate because it was uncertain and impotent because it was not designed to cope with the present intricate economic system. The common law has not discovered a fixed, definite and certain formula to deal with securities transactions in the general sense. It was groping blindly in attempting to evolve a theory of legal redress. As applied to security transactions it was constantly harking back to the historical analogy of rights and liabilities as between vendor and vendee of merchandise. A security transaction is very intricate and differs from commodity transaction in many respects. For all intents and purposes, the article, be it lumber or land, was open to inspection. The vendee could, if he chose, see and feel the commodity and be guided accordingly. The doctrine of "caveat emptor" had some justification and logic here. But a security is not an article. It cannot be examined like a horse, a book, lumber, land, etc. At best it merely represents an interest in something tangible, usually but not always, quite remote from the situs of the transaction.

[13] See Dewing, supra, note 10, at 413.

This tangible thing, viz.: the corporation in all its aspects, i.e., its charter, property, franchises, patents, etc., were theoretically open to inspection also. But few prospective investors ever make such an examination. In most cases it is a practical impossibility. Apparently this distinction was not always recognized by the court. The common law just did not consciously mould itself to cope with the problems arising out of the modern methods used in floating securities. As the general tort and contract law developed in connection with the small merchandise transaction, it was applied to securities in piecemeal. There was no comprehensive underlying policy developing to meet the problems that the present day financing of commercial enterprises on a large scale offers. These complexities were not contemplated nor anticipated. The recent trend to rise to the occasion, as manifested in some of the late cases, only made more uncertain an already hesitant and confused law.

One of the greatest stumbling blocks of the common law, in so far as the purchaser of securities was concerned, was the doctrine of privity of contract. As between the vendor and vendee of merchandise, the doctrine was plausible. The vendee had no business to rely upon statements made by others than his immediate vendor. The law would not attach liability to the vendor for statements made by a former owner of the goods. It could not be considered an inducement in the immediate transaction. Besides, the falsity of such statements could be discovered by the simple expedient of making an examination. Not so, however, in the case of a security. When a false statement has been uttered by the investment banker or the corporation, whether intentionally or not, it affects the market evaluation of such security or, at least, becomes the source of "hot tips" and indirectly becomes an inducement, if not the sole inducement, in the subsequent purchase from a dealer. Yet the law was inexorable. Statements made in a prospectus not addressed to the buyer would not ground an action even against his vendor. The law recognized no right of action in one who relies without invitation on a statement addressed to a particular class. "The plaintiff * * * was not of that class but a purchaser on the open market."[14] The plaintiff had no cause of action against his vendor because the latter did not print nor cause the false statement to be printed. The only possible remedy he had was against the person responsible for the false statement in the prospectus but only upon the theory that it had been published for public consumption with the intent to deceive. Because of the impossibility of succeeding, generally because of the difficulty in proving intent to deceive, few intelligent lawyers brought the action.

The choice of legal weapons that a plaintiff might select at common law were confined to an action in deceit either to rescind or for dam-

[14] *Cheney* v. *Dickenson,* 172 Fed. 109 (C.C.A. 7th, 1909).

ages, action for breach of warranty, and an action for negligence. The action for deceit was directed against an out and out villain. It was brought to redress a palpable fraud. If the transaction were merely shady, suspicious or in the twilight zone where the defense of being an "honest liar" might prevail to defeat recovery, it was dangerous to proceed on that theory. At common law misrepresentation was never condoned, but the law inclined to be somewhat lenient in its application to security transactions. Allowances were made for the "sanguine expectations" of the promoter.[15] Because the elements of fraud in a criminal prosecution were somewhat similar to the element of false representations in a civil suit, the courts were reluctant to attach liability unless the actor was clearly a swindler. A charge of civil liability for misrepresentation read like a criminal indictment. This when applied to respectable business men who had committed an indiscretion was too much.[16] Especially was this true when the gist of the action was a failure to disclose material information. In criminal prosecutions, charges of false representations and pretences in obtaining money or credit have rarely been held proved by evidence of mere non-disclosure.[17]

The formula for bringing deceit actions as originally conceived required that the plaintiff prove that the defendant made a false representation, knowing it to be false, concerning a material fact, to induce the plaintiff to act, plaintiff relying upon such representation did act, and to his damage. Around each element "areas" of interpretation have grown up which allow a great latitude in passing judgment upon a particular case.[18]

Whether a fact be true or false is not always easy to determine. It may be literally true but convey a different impression. It may be a half truth and misleading because it omits pertinent qualifications. It may also be ambiguous, false in one sense, true in another.[19] Assuming, however, that a false statement was made and proved, if the defendant proved that he did not know it was false at the time, he could successfully defeat the allegation of deceit. Instructing the jury that "it was their (directors') duty to know the truth and the facts stated (in the prospectus), and if they did not know, they were bound to know providing they had a reasonable opportunity to ascertain the same," was held to be an erroneous instruction because the trial court substituted as a test of the directors' liability negligence instead of the purpose to

[15] *Central Venezuela R. R. Co.* v. *Kisch,* L.R. 2 H.L. 99 (1867).
[16] *Derry* v. *Peek,* L.R. 14 App. Cas. 337 (1889).
[17] *Fleming* v. *State,* 114 Ga. 526, 40 So. 705 (1902).
[18] Green, "Judge and Jury," at 281.
[19] *Hotaling* v. *A. B. Leach & Co.,* 126 Misc. 845, 214 N.Y.S. 452 (1926); Aff'd., 247 N.Y. 84, 159 N.E. 870 (1928). See also: 45 *Harv. L. Rev.* 1078.

deceive.[20] Perhaps the plaintiff might have won had he based his action on the negligence theory. The fortuitous incident of choice of remedy oftentimes worked to defeat recovery.

If the plaintiff prove knowledge of the falsity of the statement, he must then prepare to prove that it is a statement of a material fact as his next step. A promise, a forecast, and an opinion as to law, value, future worth, etc., are not generally construed to be statements of facts. To say a stock is non-assessable is an opinion of law and, hence, nonactionable[21] as is the statement that the "preferred stock will pay interest." Stocks pay dividends.[22]

Advice from an attorney that the stock is non-assessable does not change the rule that everyone is presumed to know the law, and cannot, therefore, be deceived.[23] In a case where the corporation held out that it had certain powers under its charter to do certain things, the court held: "Subscribers to the stock of this company chartered under the general laws of the state must take notice that the company, notwithstanding any representation to the contrary, has no power to issue * * * stock in an existing or future construction company."[24] Some courts have come to a different conclusion. To say the stock is non-assessable is an assurance that all the steps necessary (to waive the statutory liability) had been taken and was therefore a statement of fact.[25] And so where the assessment is within the discretion of the directors a false statement that it is non-assessable * * * "is not a mere matter of opinion as to the law regulating such subject, and may be the basis for an action in deceit."[26]

Opinions as to value are almost universally construed not to be a statement of fact. An assertion that the stock is worth double its value is mere opinion. That an opinion as to value is a matter of individual judgment and should not be litigated appears logical; yet this same logic leads to some ridiculous results, as where promoters place a high value on lands, patents, etc., in exchange for the original issue of part or all the stock and then the next day change their "opinion," donate back the stock in large blocks for the purpose of reselling it as treasury stock fully paid and non-assessable. There are cases which have held that where the vendor has not in fact such an opinion he is conveying a false representation. The "statement of a man's mind is as much a

[20] *Reno* v. *Bull*, 226 N.Y. 546, 124 N.E. 144 (1919).
[21] *Rogan* v. *Illinois Trust & Savings Co.*, 93 Ill. App. 39 (1901).
[22] *Zeh* v. *Alamenda Community Hotel Corp.*, 122 Cal. App. 366, 10 P. (2d) 190 (1932).
[23] Cases collected in Note (1932) 32 *Col. L. Rev.* 1018.
[24] *Russel* v. *Alabama Midland Ry. Co.*, 94 Ga. 510, 20 S.E. 350 (1894).
[25] *Merchants Realty Co.* v. *Kelso*, 46 Cal. App. 218, 189 Pac. 116 (1920). See also: *Cooper* v. *Empire Security Co.*, 227 Ill. App. 161 (1920).
[26] *Brown* v. *San Gabriel River Co.*, 22 Cal. App. 682, 136 Pac. 542 (1913).

fact as the state of his digestion."[27] The difficulty with this rule is that it is hard to prove a state of mind. There are indications that the courts are becoming a bit more liberal in construing opinions as to value where it is peculiarly within the knowledge of the vendor or refers to the existing market value. Representations by high-powered salesmen as to the market price of some oil stock made to unsophisticated farmers were not considered mere dealer's talk or expression of opinion. They were held to be positive declarations of present value.[28] While different conclusions have been reached under varying fact situations, the weight of authority today supports the proposition that representations of market price are not necessarily mere representations of opinion; they are, at least under some circumstances, representations of fact upon which fraud may be predicated.[29]

Promises and forecasts are in the same class as opinions. One should not be held liable for expressing expectations which eventually are not realized. Yet certain statements couched in the form of a promise or prediction have a peculiar faculty of ensnaring even the wary. Recitals in the prospectus that the preferred stock (offered for sale) would be protected by maintaining certain ratios between current assets and the par value of the preferred stock were held to apply to the future and hence were without effect.[30] The same result was reached where stock was purchased upon the representation that the money would be used to buy material.[31] A statement that the corporation would build a manufacturing plant does not constitute actionable fraud.[32] A statement that dividends in a certain amount and at certain intervals would be paid is non-actionable.[33] To say that, "no man stands condemned in the eyes of the law because hope springs eternal in his breast or because out of the fullness of his heart his mouth speaketh in that regard,"[34] is crass poetry to the average layman especially when asked to prove

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[27] *Matthews* v. *Hogneland,* 98 Kan. 342, 157 Pac. 1179 (1916).

[28] *Fourth National Bank* v. *Webb,* 131 Kan. 167, 290 Pac. 1 (1930).

[29] Note 71 A.L.R. 622 (1931).

[30] *Mandelbaum* v. *Goodyear Tire & Rubber Co.,* 6 F. (2d) 818 (C.C.A., 8th, 1925).

[31] *Field* v. *Seubert Bearing Co.,* 179 App. Div. 780, 167 N.Y. Supp. 294 (1st. Dept. 1917).

[32] *City National Bank* v. *Mason,* 192 Ia. 1048, 186 N.W. 30 (1922).

[33] *Farmers Loan & Mortgage Co.,* v. *Langley,* 166 La. 251, 117 So. 137 (1928); *Milwaukee Brick & Cement Co.,* v. *Schoknect,* 108 Wis. 457, 84 N.W. 838 (1901); *Stalnaker* v. *Jones,* 68 W.Va. 176, 69 N.E. 651 (1910); *Farewell* v. *Colonial Trust Co.,* 147 Fed. 480 (C.C.A., 8th, 1906); *Chambers* v. *Mitchel,* 123 Ill. App. 595 (1908); *Lowry National Bank* v. *Hazord,* 223 Pa. 520, 72 Atl. 889 (1909); *Huffseller* v. *Our Home Life Ins. Co.,* 67 Fla. 324, 65 So. 1 (1914); *Kimmel* v. *Eastern Coal Co. & Mining Co.,* 97 W.Va. 154, 124 S.E. 661 (1924); Cf. *Cuckovich* v. *Buckovitch,* 82 Mont. 1, 264 Pac. 930 (1928); *Electric Hammer Corp.* v. *Dedders,* 206 Ky. 232, 267 S.W. 207 (1924); *Faust* v. *Parker,* 204 Ia. 297, 213 N.W. 794 (1927).

[34] *Zeh* v. *Alamenda Comm. Hotel Corp.,* supra, note 22.

that the seller's heart was not full of hope but perfidy. Unless the transaction borders very close to a situation heavily laden with the odor of fraud, there is little likelihood of the plaintiff prevailing.

After the plaintiff has shown that the statement was one of fact, his next step is to prove that it was a misstatement of a material fact and that he relied upon it. Materiality and reliance are closely akin but not necessarily so. Non-reliance on a misstatement of a material fact cannot in legal theory work to the purchaser's prejudice as where a false statement on the caption of the certificate of stock was held to be immaterial where the subscriber did not see it until after he had completed the purchase.[35] As an abstract rule of law, no one can deny its logic and expediency; however, it does not meet the problem inherent in the sale of securities. Here reliance is worked out indirectly. The misstatement has a direct influence upon the market evaluation of the security, and the market price is invariably the determining factor in the purchaser's decision. Yet the common law, because of the privity of contract doctrine, does not afford any practical relief in such a situation. The common law says that it is within the means of the investor to protect himself. The privilege of a personal investigation must be exercised at his peril. He cannot aver reliance upon a misstatement of a material fact by a third person. It needs no argument to show that the analogy between persons dealing in merchandise and those dealing in securities is not applicable. If every purchaser of securities would insist upon his obligation to investigate, the present method of marketing securities would quickly disappear.

If a misstatement of fact is made by the immediate vendor, whether or not it is material is a problem difficult to solve. In the past the doubts have been resolved more often in favor of the vendor; that is, if the cases reaching the courts of ultimate appeal serve as an indication. A statement that all the stock had been subscribed for where, at the time, less than 10% had not been subscribed for was held not to have been a material misstatement.[36] A circular representing that there existed an advisory board made up of influential citizens was held to have been of a collateral inducement only, " . . . and collateral inducements, although fraudulently made, of themselves, afford no ground for damages. Actionable fraud must relate to material matters."[37]

If the matter is material, the plaintiff must prove reliance. Even proof of reliance can, in some circumstances, avail the plaintiff nothing for he had no business relying upon the misstatements. It has been held that even though he relied upon the statements made in a prospectus,

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[35] *Parnes* v. *Gnome Mfg. Co.*, 93 N.J. Eq. 470, 117 Atl. 148 (1922).
[36] *National Leather Co.* v. *Roberts*, 221 Fed. 922 (C.C.A., 6th, 1915).
[37] *American Building & Loan Assoc.* v. *Bear*, 48 Neb. 455, 67 N.W. 500 (1896).

"it was addressed to the initial buyers (syndicate members) and not to the remote purchasers."[38] Misrepresentations made to a state commission in an application for a permit to sell stock were not intended for the prospective purchasers and "cannot, therefore, be availed of."[39] It matters not that the plaintiff knew and relied upon the same,[40] nor that he made a personal examination of the records on file in the state department.[41] It is not a strained inference to suggest that the vendors knew that such information would be disseminated throughout the selling zone. It has all the characteristics of a premeditated design, yet, under the above rules a perfectly safe one. The same objectives were accomplished by employing the device known as the "tipster sheet or tipster radio talks" purporting to be made by independent and disinterested analysts. Nothing is more difficult to cope with in the law of frauds and yet nothing needs more correction in our present economic system. Any plausible theory must have as its starting point a preventive rather than redressive hypothesis and this, of necessity, must take the form of legislation.

In the realm of commodity transactions the greatest change in the shifting of risks from the buyer to the seller has taken place in the law of warranty. Upon the mere sale the seller may now be held to a warranty to his buyer not only of his title, but also of the merchantable quality of the goods or of their fitness for a particular purpose.[42] If a defect in the goods caused a physical injury, some cases have "endowed the warranty concept with a capacity to hurdle the forbidden notion of privity of contract"[43] in an attempt to make the manufacturer liable. Reference is made to the famous *McPherson* v. *Buick Co.*[43a] case. It is also comparable to the "res ipsa loquitor" presumption. While there has not been an overbearing curb upon the seller's enthusiasms over his wares, some bounds of limitation are indicated. Warranties need not take any particular shape or form. Certain statements, acts, attitudes and even silence will spell out deceit.[44]

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[38] For a comprehensive discussion of common law remedies see, Shulman, *Civil Liability and the Securities Act* (1933) 43 Yale L. J. 239. *Cheney* v. *Dickenson*, supra, note 14; *Brackett* v. *Griswold*, 112 N.Y. 454, 20 N.E. 376 (1889); *Green* v. *Mercantile Trust Co.*, 60 Misc. 189, 111 N.Y. Supp. 802 (1908); *Nichol's Case*, 3 De G. & J. 387, 438 (1859); Cf. *Gerner* v. *Mosher*, 58 Neb. 135, 78 N.W. 384 (1899); *Huston* v. *Thornton*, 122 N.C. 365, 29 S.E. 827 (1898).

[39] *Dinsmore* v. *National Hardwood Co.*, 234 Mich. 436, 208 N.W. 701 (1926).

[40] *Hunnewell* v. *Duxbury*, 154 Mass. 286, 28 N.E. 267 (1891).

[41] *Hindman* v. *First National Bank*, 112 Fed. 931, 57 L.R.A. 108 (C.C.A., 6th, 1902).

[42] Uniform Sales Act, Sections 13 to 15; Williston, Sales (1924).

[43] See Shulman, supra, note 38, at 228.

[43a] 217 N.Y. 382, 111 N.E. 1050 (1916).

[44] See: "the natural tendencies of such affirmations or promises, etc.," Uniform Sales Act, supra, note 42.

It is contended by some that the law of warranty also protects the buyer of securities. Theoretically this is true, but in reality, because of the difference between goods and securities, such protection is insignificant. In a security the defect is not discovered as quickly as is a defect in goods. Securities are not purchased for consumption, etc., and, therefore, discovery is delayed until such time as the loss incurred is interminably interwoven with other complex factors. How much of the loss is due to a fall in the market value as distinguished from the loss due or resulting from the original defect can only be a matter of conjecture. The law of warranty has had little application in the sale of securities. Only a warranty of title and that it is a general security of the kind it purports to be is imposed on the seller by implication of mere sale. No warranty is implied as to the quality or value or that the security was not issued in contravention of the constitution, statute law, or corporate character.[45] There have been very few actions for breach of warranty in security transactions. This is significant when one considers that the liberality in treating representations in sales of goods as warranties is absent in the securities cases.

A buyer in the merchandise mart has a sort of extra legal protection that a buyer of securities does not enjoy. In competing for buyers, sellers frequently make sales on approval, thus affording ample time to inspect and approve. No one ever offers to sell a security on approval. There are some bond houses which will occasionally repurchase in order to retain the customer's patronage and to preserve its reputation for sound judgment. It is too much for many investors to hope to be included in this select list, and besides in times of stress it would become impossible to meet the great number of demands likely to be made. Neither is a pledge to support the market very assuring because that also becomes an impossible undertaking during a crisis.

The courts have used some elements found in the law of warranty in deciding actions brought to rescind the contract to purchase. In rescission, as in warranty, if the buyer proves that the seller made a false statement of a material fact, he need go no further. It is immaterial whether the seller knew or not, or that he did not intend to deceive, or that he honestly believed in the truth of his statements and that he had very reasonable grounds for such belief. This doctrine is well established. In many cases, however, it is paid only lip service. The object of rescission being to restore the status quo before the sale, the question as to the cause of damages becomes immaterial. It is in effect not taking money from the seller but merely calling all bets off. Rescission is only available against the immediate vendor. Therefore, as a

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[45] Shulman, supra, note 38, at 230. Also *Goodwyn* v. *Folds*, 30 Ga. App. 204, 117 S.E. 335 (1932); *Burwash* v. *Ballou*, 230 Ill. App. 34, 82 N.E. 355 (1907).

remedy to security purchasers, it is limited to very few, because, as pointed out before, the misstatements are generally circulated by others than the immediate vendor. The corollary requirement that "rescission effect a restoration of the status quo provides pitfalls: that the plaintiff did not or cannot return or tender back the subject matter of the sale; that he did not promptly act and is guilty of laches; that he did something which may be taken as a ratification of the sale and inconsistent with a desire to rescind, such as, retention of dividends, voting of stock, attempts to sell stock, etc., if occuring after the buyer became aware of, or had reason to suspect, the falsity of the representation.[46]

The only practical relief an investor had against false and misleading statements was the negligence action. This action resembles the action in deceit in all elements but the one pertaining to the knowledge of the falsity of the statement on the part of the defendant. This element varies in the different jurisdictions. "A number of substitutes were developed in the American cases. A requirement of scienter is satisfied, it is variously said, if (1) the defendant knew of the falsity of the statement, or (2) did not believe it to be true, or (3) made it recklessly, careless whether it be true or false, or (4) the defendant made the statement as of knowledge when he knew he had no knowldge of its truth, regardless of his belief, provided that the statement is of a matter susceptible of knowledge, or (5) the defendant was in a special position to have knowledge of the truth of the statement and the plaintiff had no means of knowing, or (6) the defendant, though innocent of falsehood, had not made a reasonable investigation and had no reasonable grounds for such belief in the truth of his statement. This formula thus disposes of the element of scienter and substitutes negligence."[47]

Here we have a formula that spans the privity of contract notion. It may even reach experts who have prepared some of the information contained in the statement. Although no case has been found in which a security holder sued an expert for false information negligently given upon which the purchaser relied, yet there are numerous cases in which credit has been extended, property bought, or some other action taken by plaintiffs in reliance upon similar reports made by third persons. Auditors have been held liable for false information contained in a balance sheet where such falsity was due to their negligence in checking certain assets.[48] A recent case (1930) held a bank liable for negli-

[46] *Martin* v. *Burns Wine Co.,* 99 Cal. 355, 33 Pac. 1107 (1893); *Stockmen's Guaranty Loan Co.* v. *Sanchez,* 26 N.M. 499, 194 Pac. 603 (1921); *Brennan* v. *National Equitable Investment Co.,* 247 N.Y. 486, 160 N.E. 124 (1928).

[47] See Shulman, supra, note 38, at 234.

[48] *Ultrameres* v. *Touche, Niven & Co.,* 255 N.Y. 170, 174 N.E. 441 (1931). Cases dealing with other experts are collected in the many comments on the above

gently certifying certain bonds while acting as a trustee. In deciding against the defendant the court said, in effect, that it could not be regarded as the guarantor of the quality of the paper but it certainly is responsible for signed certificates without authority. It had authority to certify only that dealer paper (i.e., the collateral as security of the bonds issued by its customer corporation) .was deposited not paper signed by a lawyer, bond salesman, ticket agent, and a mining corporation. The certificate was made with the very end and aim of shaping the conduct of others, i.e., the purchasers of the bonds.[49]

The limitations of the negligence action is defined by what one judge or another conceives to be the orbit of duty owed the ultimate purchaser. And just as in the cases of warranty or rescission that issue has "insulated a large class of persons involved on the seller's side in the sale of security against misrepresentation suits by a large class of investors."[50]

The foregoing represents a brief synopsis of the common law liability. In certain aspects the liability of the seller is rather all inclusive and severe. Statements may be made and fraud proved even where the seller may be perfectly frank. A good deal depends upon the circumstances, and "circumstances may damn where the conscience is pure." Yet, in reality, the common law is not overly harsh upon the seller. Many indulgences were granted and many doubts resolved in his favor. Those lacking a sense of social responsibility have discovered and taken advantage of many loop-holes in the law. They did not respond to the dictates of common honesty and fair dealing. If good faith and full disclosure would not come forth spontaneously, the theory is that much of it can be extracted; hence, the Securities Act of 1933.

THE SECURITIES ACT OF 1933.

The salient feature of the securities act is compulsory information. The evils of the past found their roots in darkness. Not so much what was disclosed but what was not disclosed proved to be the viciousness of the modern marketing methods. The premises of the present reformatory act is that the whole story must be told. To draw out pertinent information usually withheld, new liabilities were created and old ones enlarged, procedural difficulties were simplified, and the burden of proof shifted.

The Act restricts any person directly or indirectly to make use of any means or instruments of transportation in interstate commerce or

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case,—see Note, 30 *Col. L. Rev.* 1066 (1930); Notes, 44 *Harv. L. Rev.* 134 (1930).

[49] *Doyle* v. *Chatham & Phenix National Bank,* 253 N.Y. 369, 171 N.E. 574 (1930).

[50] Shulman, supra, note 38, at 239.

of the mails to sell securities unless effectively registered.[51] There are certain securities and transactions specifically exempted such as bonds issued by the Federal Government, States, political subdivisions of the states, national banks, etc. Transactions between private persons are exempted and sales not with a view to a public offering. Issues not exceeding $100,000 may be exempted upon approval. Brokers transactions executed upon customers orders and securities exchanged in the process of a bona fide reorganization are also exempted.[52]

Registration consists of filing a statement of required information with the Federal Trade Commission. These facts or any additional information requested by the Commission must be signed by the issuer, its principal executive officers, etc., and by a majority of its board of directors.[53] The effective date of registration is the twentieth day after the filing thereof.[54]

The more important information required includes the names and addresses of directors, or persons performing similar service, chief executives, chosen or to be chosen; names and addresses of the underwriters; persons owning more than 10% of any class of stock; the amount of securities held by the persons above specified; the general character of the business; a statement of the capitalization of the business; proportions of paid up stock; a description of the respective voting rights, preferences, conversions, and exchange rights; a statement of the securities covered by options outstanding; amortization provisions; specific purposes in detail, so far as determinable for which the sums sought are to be employed; preferential lists; remuneration, including bonuses and commissions paid or estimated to be paid directors and officers exceeding $25,000 per year; a statement of the commissions and discounts to be paid the underwriters; understandings and contracts in lieu of cash commissions; a list of all material contracts not in the ordinary course of business; detailed accounts of its assets, liabilities, holdings, and prior earnings; interest of stockholders, directors, officers in the property purchased; an account of pending litigation which may materially affect the value of the security. The above is indicative of the general type of information commonly withheld. It is quite possible that the majority of investors will never examine this statement. However, their protection will be indirect in that the markets and those who specialize in advising prospective investors will be guided accordingly. Competitors will make sure that all unfavorable features will be properly disseminated. Newspapers, financial publications and expert analysts will also be factors in spreading pertinent

[51] Section 5 of the Securities Act of 1933.
[52] Section 4.
[53] Section 4 (2).
[54] Section 6 (a).

information; and, what is of more importance, because of the risk involved, it will become extremely difficult to launch bogus enterprises. Not that the act prohibits speculative enterprises, but that the information required will advise the investor before hand of its speculative nature.

The American Act has improved upon the old English Companies Act in that it requires a prospectus containing a condensation of the essential information in the registration statement. All registered securities must, if sold through the mails or instruments of interstate commerce, be accompanied by a prospectus.[55] The Commission has authority to dictate the minimum essentials as well as any additional information it deems necessary in the prospectus. For illustration, the government is particular in emphasizing that the mere fact of registration in no way signifies governmental approval of the worth or prospects of the issuer. To avoid such an understanding, the Commission has required that bold face type be used in every prospectus to call the buyer's attention to the fact that registration does not indicate governmental approval of the securities, nor a warranty as to the truth of the facts contained therein.[56]

The Act contains three sanctions viz: (1) the commission's authority to prevent by stop order or injunction the sale of securities because of false or untrue material statements subsequently discovered, or the failure to furnish material information required. (2) Civil liabilities imposed upon those responsible for the misstatements of material facts, or their omission to state facts necessary to give a true picture. (3) Imposition of criminal liability for the willful use of a fraudulent scheme or device, or a willful misstatement of material fact or a willful omission to state a material fact necessary to prevent the fact stated, in view of the circumstances under which it is stated, from being misleading.[57]

The criminal liability feature is directed against all palpable fraudulent transactions as distinguished from misrepresentations of material facts not willfully made. To a certain extent this is not a novelty. Fraudulent transactions by use of the mails have been subject to federal prosecution for some time.[58] However, some of the difficulties of procedure have been removed.[59] Sanctions against fraud have been extended to include transactions in interstate commerce

[55] Section 5 (b) 2.
[56] Federal Trade Commission Release, July 6, 1933, Art. 16.
[57] Bane, "The Federal Securities Act of 1933," 14 *Boston Univ. L. Rev.* 35, 36, (January, 1934). Baldwin B. Bane is now chief of the Securities Division of the Federal Trade Commission.
[58] 18 U.S.C.A. § 337-8, R.S. 3851, March 4, 1909, c. 321, § 214, 35 Stats. 1130.
[59] Malcolm A. MacIntyre, "Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes," 43 *Yale Law Jour.* 254 (1933).

without the use of the mails. Willful fraud must be clearly established before it can be marked a crime. As previously stated a mere failure to communicate certain material information was not generally regarded as competent evidence in proving a criminal intent; under the Act that may be shown and to this extent is an innovation. Undoubtedly this feature was suggested by the famous Kylsant case in England.[60] It is interesting to observe that Lord Kylsant was not prosecuted under the English Companies Act but under a larceny act of 1861.

The fraud provision makes no exemptions. The exemptions listed above have reference only to registration requirements. To determine what are violations of the fraud provision, reference need not be made to the Act, but rather to the existing body of case law dealing with fraud in the sale of securities. The only departure is, as pointed out above, that willful omissions of material facts can be made the basis of a criminal action.

In the civil liabilities imposed[61] are found the most startling innovations. The making of certain individuals vicariously liable is, it is said, unheard of and unduly severe. It may be that some features are unduly severe, but they are not unheard of. The tendency to redefine the rights and duties in our modern economic society has been devlopinge in the case law for some time .Reference is made to the negligence actions. Nor do we find in the negligence actions much ado about the disproportion between possible gain and the extent of liability. Duties bear no relationship to the profits involved. The duties devolve because of the voluntary relationship one has knowingly assumed. One's profits may be insignificant; at the same time his capacity to do great harm may be enormous.

As stated before the primary objective of the Act is preventive vigilance. It seeks to secure accuracy in information that is volunteered to investors in order to protect them from being misled or duped while making selections of the investment channels into which their funds are to be placed. If one so desires, he can exercise his privilege to speculate. The Act places no restrictions upon appeals to the speculative instincts which are to be encouraged in a developing country; however, it decrees that such appeals are no longer permitted to masquerade as tried and sound propositions.

It has been said that the civil liabilities imposed are not only compensatory in nature, but that they also have "in terrorem" features which are unnecessarily severe and may have the effect of retarding business now in its recovery cycle. If the principal objective be kept in mind, it will be readily seen that the liabilities imposed are necessary

[60] *Rex* v. *Kylsant,* 23 Crim. App. 83 (1931), [1932] 1 K.B. 442.
[61] Sections 11 and 12.

to accomplish the avowed purpose and to "guarantee that the risk of their invocation will be effective in assuring that the truth will be told."[62] If an enterprise, seeking other peoples money to operate with, cannot tell such people the bare essentials necessary to make a sound decision, it cannot be honestly launched at all. Legitimate business has nothing to fear or lose; it has everything to gain. It is economically unsound to force it to compete with the unscrupulous for the savings of the country. An economic concept based upon any other premise will ultimately perish.

The civil liability section is designed to meet two distinct situations, viz: one involving the sale of securities that must be registered, the other regarding the sale of any securities whether registered or not. Under the first the natural inquiry is as to the persons who may be sued, the extent and scope of their liability, the defenses available, and the damages recoverable.

If any person acquiring stock, which has been issued under a registration statement, seeks to recover the consideration paid or damages sustained upon the ground that the statement contained a misstatement of material fact, or an omission of a material fact, he may proceed against any or all persons who have signed such statement. Thus he has a choice of defendants, ranging from the corporation or issuer to an independent expert supplying the misstatement.

One striking innovation is that the plaintiff need not aver that he relied upon the misstatement. This refers only to securities that need to be registered. Undoubtedly this idea was foreshadowed by an old English case[63] which permitted an action at the suit of a purchaser on the open market against a company which had made a false representation to the stock exchange. It is designed to circumvent the rule that unless the purchaser was of a class which had been invited to read the prospectus or the report to the state official, he cannot aver or prove reliance. There still exists the defense that the plaintiff had knowledge of the untruth or omission.

As has been shown before, a purchaser could rescind even though the misrepresentation was innocently made but only against his immediate vendor. The act permits him to rescind, so to speak, against the issuer regardless of the number of hands the security passed before reaching the purchaser. Just how this is accomplished will be shown later. Suffice it to say for the present that the remedies afforded have, in this respect, disposed of the privity of contract doctrine.

Another new feature of the act is that it permits the purchaser to

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[62] Douglas and Bates, "Federal Securities Act 1933," 43 *Yale Law Jour.* 171 (1933).

[63] *Bedford* v. *Bakshaw,* 4 H. & N. 538, 157 Eng. Rep. 951 (1859).

go behind the cloak of corporate immunity. Officers and directors can be held personally liable, under certain circumstances for a violation of their obligations as laid down by the act. This is really an extention of the negligence doctrine. The executive officers are in the best position to know the facts. All that is asked is that they make a full and fair disclosure. The burden imposed is not incommensurate with the positions they hold. Their liability is limited to those parts of the registration statement not purporting to be a copy or abstract from a report of an expert or a public document. They have in addition the defense that they have exercised the care required of them. Incidentally this defense is not available to the corporation or issuer. Although only a majority of the directors are required to sign the registration statement, all can be held liable. There are certain exceptions not pertinent here. This liability is not entirely novel. When issuing public statements concerning a security they are under a duty to be accurate. Some directors are merely figureheads. They lend their names to give the corporation prestige. Some are merely "watch dogs" for a creditor bank. Others serve upon the board because of their specialized knowledge in certain branches of the business. For one reason or another they are not all active. Query, why make them vicariously liable for the negligence or misdeeds of others? It is urged that the directors are not sought to be held vicariously liable but for their own neglect properly to perform the duties of their offices; that their consent to become directors binds them to certain affirmative obligations, and it is in violation of these duties which are inseparably attached to their offices upon which liability is justly imposed. The effect of the act may cause a disappearance of many directors from the boards of corporations which they graced. Yet it is difficult to see how the abolition of the "dummy directors" can be a thing deeply regretted. It is not unreasonable to ask that they live up to the responsibilities of their office or resign.

Another group amenable to the civil liabilities provided for under the act is the underwriter. At first blush this appears to be a startling innovation, yet if one carefully reviews the part played by the underwriters it will readily be seen why the framers have deemed it advisable to include them among those responsible.

It is the underwriter, as pointed out before, who makes the invesgigation of the financial condition and prospects of the corporation seeking the loan. Those who are familiar with the inside workings know it is he who prepares the "president's letter." The broker's circulars and prospectuses are really condensations of his findings and aspirations and they appear at a time "when the corporation and the bankers or promoting group are probably the sole possessors of facts pertaining to an accurate appraisal of the security."[64] Having in mind that the banker makes the research and he or his attorney draws up the circular it is not "difficult to point to the fact that the banker has assumed a relationship to the corporation so intimate that the two can almost be regarded together in fixing the liability."[65] This is the primary reason for making the underwriter responsible for misstatements in the registration statement. There are, however, different types of underwriters as indicated above. Not all make examinations nor do they pretend to do so. The definition of an underwriter in the act is sweeping and possibly includes persons never so regarded. Every person buying or agreeing to purchase from the issuer with a view to sell is deemed an underwriter.[66] Apparently this section requires clarification, unless it is the intention of Congress to revise the methods employed in distributing securities.

The next important group which can be held liable is the experts. Undoubtedly the purpose is to prevent using the experts as a shield in making misrepresentations, or to deter the experts from allowing the size of the fees offered to color their judgment. Experts know, or should know, that their reports will guide the conduct of others. Again this is an extention of the negligence doctrine where the scope of duty defines the extent of the liability.

It is to be noted that the liability of the issuer or the persons controlling him is absolute. Not so with the directors, executive officers, underwriters, or experts. They can escape liability if they can sustain the burden of proof that they were without fault. The only defense available to the issuer is that the plaintiff knew of the falsity of the statement or that the statute of limitations has barred recovery. Section 13 provides that "no action shall be maintained to enforce any liability * * * unless brought within two years after the discovery of the untrue statement or the omission, or after such discovery should have been made. * * * In no event shall any action be brought * * * more than ten years after the security was bona fide offered to the public."

The directors, executive officers, experts and others can avoid liability if they sustain the burden of proof that they resigned before the

[64] Berle and Means, "The Modern Corporation and Private Property," 301 (1932).

[65] See Berle and Means, supra, note 64, at 304. Directors can be held liable on the theory of negligence. See *Chapple* v. *Jacobsen,* 234 Mich. 558, 208 N.W. 754 (1926); *Solomon* v. *Bates,* 118 N.C. 311, 321, 24 S.E. 748 (1896); *Cornell* v. *Seddinger,* 237 Pa. 389, 85 Atl. 446 (1912). Often they have escaped liability on the theory that if they took no part in the preparation of the false statement they did not mislead the investor. *Rives* v. *Bartlett* 215 N.Y. 33, 109 N.E. 83 (1915). *Ottman* v. *Blaugas Co. of Cuba,* 171 App. Div. 197, 157 N.Y. Supp. 413 (1916); *Sugar Land Industries* v. *Parker,* 293 S.W. 609 (Tex. Civ. App., 1927); *Arthur* v. *Griswald,* 55 N.Y. 400 (1874).

[66] Section 1 (11).

effective date of the registration statement, or ceased or refused to act in the capacity in which they were described in that statement and so advised the Commission and the issuer, or if such part became effective without their knowledge, they advised the Commission accordingly soon after they became aware of it and gave reasonable notice to the public. They may also put in defense that they had after reasonable investigation grounds to believe and did believe that the statements were true or were unaware of misleading omissions. The standard of reasonableness shall be that required of a person occupying a fiduciary relationship.

The liability of experts is limited to the statements they make. The standard of a fiduciary must be maintained in selecting these experts.[67]

The stringencies of the above liabilities are somewhat assuaged by the right given the various persons to contribution. Section 11 (f) permits every person who becomes liable to recover contribution as in the cases of contracts from any person who, if sued separately, would have been liable. This right is denied any person who is found guilty of having made a fraudulent misrepresentation.

One contention often advanced in respect to Section 11 is that there is no standard set as to what facts must be disclosed by an issuer. It is stated that the failure to disclose any material fact may involve the persons designated liable. In answer, Mr. B. Bane, Chief of the Securities Division, has this to say: "Frankly, it is difficult to see just how such conclusion can even be seriously advanced in view of the explicit language used in Section 12. Section 11 places liability for omissions where one has omitted to state a material fact required to be stated therein (i.e., the registration statement) or necessary to make the statement 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 the untrue statements or omissions to state material facts. This phrase has been clarified in the final bill enacted to make the omissions relate to the statement made in order that these statements shall not be misleading; rather than

[67] The standard of a fiduciary is defined by the Restatement of the Law of Trusts by the American Institute of Law to be that of a trustee. "The trustee is under the 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 the duty to exercise such skill as he has. 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 into question."

make mere omissions a ground for liability where no circumstances existed to make the omission 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 (by schedule A of the act), or it must be an omission of a fact which renders the statement made in the registration statement misleading, and, in both of these instances the omission must be of a material fact. To say in the light of this that the practical effect of the Act is substantially to make anyone a guarantor against a 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 absolves 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."[68]

Upon the discovery of the misrepresentation the purchaser may, if he still has the security, tender it back and recover the purchase price. To protect the purchaser who has already disposed of it, Section 11 permits him to sue for damages measured by the difference between the amount he paid for it and the amount he sold it for. But in no case can the amount recoverable exceed the price at which the security was offered to the public. Thus the action is derivative from the action of rescission. The object is to have the purchase price returned just as though the security was tendered back.

Some contend that this section admits of two different interpretations as to the amount recoverable. An illustration is put in which the purchaser bought on the market for say $125. The public offering price was $100. Now the stock drops to $50 and the misrepresentation is discovered. Under the one view the purchaser can recover $75, an obvious injustice. Under the other he can recover only $50 (if he has disposed of his security at the $50 mark). Under the first view the contention is that the $75 does not exceed the public offering price, and according to the language of the act such a measure is possible. However this view neglects the relationship of part 2 of Section 11 to part 1. Part 2 gives an alternative remedy for damages only where the person suing no longer owns the security. Where he owns it he can recover back the consideration paid for it. Where he no longer owns it he can recover back a sum which cannot exceed the price at which it was offered to the public. The alternative method is provided in order not to compel him to hold on to the security until he can 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 the right which he would possess if he continued to hold the security. The alter-

[68] See Bane, supra, note 57, at 39, 41.

native right given by part 2 is derivative from part 1, and consequently the damages recoverable under the two sections must be computed on the basis of cost to the plaintiff not exceeding the price at which it was offered to the public. If the plaintiff had disposed of the security at a price in excess of the offering price, no damages would be recoverable.[69] Under this view it would necessarily follow that in the above illustration, the damages would be limited to $50 per share. It needs no argument to demonstrate that this is clearly the intention of Congress. Those holding to the opposite view admit as much.[70] It is difficult to understand the necessity of any other construction.

Conclusion

The Act places the responsibility upon those occupying strategic positions. It is setting up a standard of common honesty which those desiring to bid for other people's money should be ready and willing to assume without the requirement of any law. Many have engaged in the investment banking business without a conscience. Important investment interests, speaking before the House Committee, frankly admitted past abuses and welcomed the principles of the security legislation "as the dawn of a new era, now that full, free, and honest information is to be required before any one can sell securities to the public * * * and investment bankers can again raise their heads and hold them high."[71] If any one shrinks from assuming the responsibilities of a fiduciary he has no business becoming one.

The civil liabilities of the Act are deemed by some to be too harsh. They are drastic in the sense that they have created innovations. Yet they are not to be over emphasized. Creation of legal requirements without sufficient sanctions is but a futile gesture. The prime-purpose of the Act is not to punish, hinder, or impede, but to create a new relationship between investors and those who ask to use his savings.

As has been pointed out before, it is not an experiment into new and untried legislation. Railroads have, for years, been compelled to get consent of the Interstate Commerce Commission to issue securities. England has exercised the same type of control for a long period. It is not apparent that the effect of the English Companies Act has had a deleterious influence over commerce and industry in that country.

The Securities Act is not predicated upon a theory of fundamental conflict between investors and issuers. On the contrary they are mutually dependent. When "confidence takes flight, it can be coaxed to

69 See Bane, supra, note 57, at 38, 39.
70 Douglas and Bates, supra, note 62, at 175.
71 See Frankfurter, "The Federal Securities Act: II." (1933) 8 (2) Fortune 53, 54, 55.

return permanently only by erecting prudent safeguards against future devastation." Twenty years ago eminent jurists warned against the pitfalls that beset the investor and pointed to the protection afforded in other countries. Justice Brandeis, in his "Other Peoples Money" reminded his readers of the legislative advancements made in England. "But in calling for full and complete disclosure in the intricate business of marketing securities, his was the voice crying in the wilderness."

The Act should give new heart to legitimate business enterprises. It is difficult to see how the bare requirements of common honesty and fair disclosure can hinder them. At least they are afforded the opportunity to compete for the savings of a nation on an even basis.

A security is essentially an intricate piece of "goods." It does not lend itself to the common attributes of other merchandise around which the common law developed. The case law was gradually beginning to orient itself to cope with the special problem involved. It may have over a period of years in a less systematic and scientific manner quietly developed into a satisfactory working basis. But the American people became impatient. A series of events occuring during the latter part of the last decade in which some shocking practices were dramatically revealed spurred them to action. As a result the Securities Act was enacted and a new chapter in the financial history of America was written.