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Richard Morton

Frank E. Booker

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THE PARADOXICAL NATURE OF FEDERAL SECURITIES REGULATIONS

BY RICHARD MORTON*
AND
FRANK E. BOOKER**

Professor Morton and Professor Booker point out several inconsistencies which exist between the intended purposes of the Federal Securities Acts and their actual effect. Originally the Acts were meant to stimulate financing of American business by restoring the investor confidence lost during the Great Depression of the 1930's. The Acts require the issuer to disclose information concerning his reliability and his business purpose as the means of protecting the small investor. Ironically, this attempt to increase the flow of capital has actually hindered investment because trading in securities is viewed by the SEC as speculation which must be curbed rather than recognized as the primary purpose of the Acts. The authors argue that buying and selling securities should be recognized for what it is — speculation — and encouraged because it channels risk capital into business development. They show that the data which the Acts require to be disclosed obscures more than it informs. They argue that effective small investor protection means the SEC should give up its disavowal of any evaluation of the worth of securities and make a complete critique available to the public. The authors close by suggesting that recognition of these paradoxes will help the present regulation of securities marketing evolve into a more realistic and effective system.

AS A TOOL a screwdriver, as its name indicates, is designed to do one job — drive screws. It may be used for other tasks with varying degrees of effectiveness. It can open cans, stir paint, chip ice, chisel and even cut wood. But it does those tasks secondarily and not as well as it does the task for which it was designed. It is designed and made to drive screws. The Federal Securities Acts[1] as

*Associate Professor of Law, University of Georgia School of Law; B.S., University of Denver, 1949; LL.B., University of Mississippi; LL.M., Yale University.

**Professor of Law, Stetson University College of Law; LL.B., Duke University, 1954.

[1] The Securities Act of 1933, 48 Stat. 74, *as amended,* 15 U.S.C. §§ 77a-aa (1964) [hereinafter referred to as the 1933 Act]; and the Securities Exchange Act of 1934, 48 Stat. 881, *as amended,* 15 U.S.C. §§ 78a-jj (1964) [hereinafter referred to as the 1934 Act]. [Where the two acts are referred to as a legislative plan or scheme the reference will be to the Acts.]

a legislative plan are designed (according to the Securities and Exchange Commission) to elicit the "truth in securities." In fact the early descriptions of the law in legal writings and even in reported cases called the law the "truth in securities" law. Loss refers to the underlying philosophy of the two acts as the "disclosure philosophy"[2] and cites President Roosevelt's message to Congress in 1933 as his authority.[3] Like the screwdriver, the Federal Securities laws can do other things besides make issuers and dealers disgorge the truth. They can regulate the markets, provide investor protections, stabilize prices, control the people who deal in securities, and even determine the terms upon which securities can be sold, but the thing they should do best is elicit the material facts.

Many authors think and write in terms of the Federal Securities Acts as being products of the Great Depression, which hit its low point between 1932 and 1934.[4] However, this is not quite accurate. The problem of the Depression in 1933 was not that investors were being defrauded by misleading information and that a federal law to protect them was necessary. The problem of the Depression was that people with money had lost confidence in the securities markets because of the stock market crash of 1929. It was to regain this confidence that the Securities Acts were created.

There had been cries of need for federal regulation of corpora-

[2] 1 L. Loss, Securities Regulation 127 (1961).

[3]
> I recommend to the Congress legislation for federal supervision of traffic in investment securities in interstate commerce.
>
> In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.
>
> Of course, the federal government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

President Roosevelt's message to Congress, Mar. 29, 1933, H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933).

[4]
> From 1920 to 1933 some $50 billion of securities were sold in the United States. By 1933 half were worthless. In 1934 the American public also held over $8 billion of foreign securities, of which $6 billion had been sold in the years 1923 to 1930. By March 1934, $3 billion were in default. The aggregate value of all stocks listed on the New York Stock Exchange on September 1, 1929, was $89 billion. In the break of September and October they fell by $18 billion. In 1932 the *aggregate* figure was down to $15 billion — a loss of $74 billion in two and one-half years. The bond losses increased the total drop in values to $93 billion. Whether any legislation could prevent another such catastrophe is beside the point; it is a simple fact that the developments of 1929-1932 brought the long movement for federal securities regulation to a head.

1 L. Loss, Securities Regulation 120 '(1961).

tions and corporate finance for many years prior to 1929.[5] However, during this period most states had blue sky laws[6] already on the books,[7] and the preference for state regulation was stronger. But far more important, the pre-1929 market was a rising market where all the losses suffered by investors were made up in the next wave of buying, and consequently not enough people were hurt to make the problem one of pressing public necessity. When the market crashed in 1929, the number of people who held equity or debt securities had risen to the point where the markets were no longer the exclusive stomping grounds of the robber barons of the 1870's nor those crafty traders who made money both on the rise and fall of the market.[8] The general public had entered the market in sufficient numbers to be an effective moving force on the politicians. Nevertheless, this was not the dominant factor in bringing about the Securities Acts. If it had been, then the Acts would have been written and promoted by political hacks instead of college professors, prominent

[5]

> With almost every session of Congress, to say nothing of the forty-eight state legislatures, the topic of security frauds blithely recurs. No complaint can at least be made upon the quantity of current legislation on the subject. Measured merely by their length, bulk and number, America has enough security laws to last for another century at least. Meanwhile security swindling goes on, even in the states where the distribution of securities is most drastically regulated by statute.

Meeker, *Preventive v. Punitive Security Laws,* 26 COLUM. L. REV. 318 (1926).

> During the period from 1900 to the advent of World War I, every President recommended to the Congress that legislation be enacted which would give the federal government control over corporations engaged in interstate commerce. The more far reaching of these proposals contemplated that corporations engaged in interstate commerce would be required to be federally chartered. No regulatory legislation was enacted, however, until the national emergency created by World War I when, in order to direct the flow of capital into channels which would best support the war effort, a Capital Issues Committee was established.
>
> The necessity for this Committee disappeared at the end of World War I, and it was abolished. When it was dissolved it filed a report which recommended that, "federal supervision of security issues, here undertaken for the first time, should be continued by some public agency . . . in such form as to check the traffic in doubtful securities while imposing no undue restrictions upon the financing of legitimate industry."

Gadsby, *Historical Development of the S.E.C. — The Government View,* 28 GEO. WASH. L. REV. 6-7 (1959).

[6] "They are called 'Blue-Sky Laws' because they stop the sale of stock that represents nothing but blue sky — nothing terrestrial or tangible." Cook, *"Watered Stock" — Commissions — "Blue Sky Laws" — Stock Without Par Value,* 19 MICH. L. REV. 583, 590 (1921).

> A definition of "Blue Sky Law" is necessary. The State of Kansas, most wonderfully prolific and rich in farming products, has a large population of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law.

Mulvey, *Blue Sky Law,* 36 CAN. L.T. 37 (1916).

[7] "By 1933, every state but Nevada had some sort of blue sky law on the books." Cowett, *Federal-State Relationships in Securities Regulation,* 28 GEO. WASH. L. REV. 287, 289 (1959).

[8] H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

lawyers and statesmen.[9] The terms used to convince the Congress of the need for protection for the small investor were those picturing widows and orphans losing their life savings to goldbrick salesmen. In 1933, this specter was so common in the minds of the general public, that little more than slight reference was needed to conjure up an emotional picture of desperation caused by crooked securities salesmen.

While this emotionalism may have moved those subject to pulls of the heartstrings or the votes of the losing public, it was, objectively, so irrelevant to the actual problem that it could hardly have been the motivating force of the thoughtful and responsible proponents of the Acts. Their goal was to restore investor confidence in the securities markets because the source of funds for financing American business had dried up to a mere trickle. It was investor confidence they were after, not protection of helpless and defenseless people.

The late James M. Landis, who was Professor of Legislation at Harvard Law School in 1933, was asked by Felix Frankfurter, then a Harvard Law Professor also, to help write the 1933 Act for the congressional committee then working on it. Looking back over the years, Landis wrote,

> The act naturally had its beginnings in the high financing of the Twenties that was followed by the market crash of 1929. Even before the inauguration of Franklin D. Roosevelt as President of the United States, a spectacularly illuminating investigation of the nature of this financing was being undertaken by the Senate Banking and Currency Committee under the direction of its able counsel, Ferdinand D. Pecora. That Committee spread on the record more than the peccadillos of groups of men involved in the issuance and marketing of securities. It indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money. Investment bankers, brokers and dealers, corporate directors, accountants, all found themselves the object of criticism so severe that the American public lost much of its faith in professions that had theretofore been regarded with a respect that had approached awe.[10]

The peccadillos of the Twenties seem little worse than the manipulations of the nineteenth century. It was not that the misdeeds of the market operators and corporate financiers were much worse than in previous periods, but simply that the crash of 1929 affected more than a small sector of the American economy. It infected the economy of the whole world. Business activity had receded to the point where the Government had to do something to get the

[9] Landis, *The Legislative History of the Securities Act of 1933,* 28 GEO. WASH. L. REV. 29 (1959).

[10] *Id.* at 30.

engines of industry turning. The whole structure of our polity contorted itself, twisted, turned, writhed and wriggled, never to be the same again — just to get the nation's economy going again.

One of the major factors necessary for recovery was public confidence in the economic outlook and in the business prospects of the country. Many felt it would be revived if there were better protection than the ordinary common law protections for the investor, and if the Federal Government had the power to control, oversee and regulate the securities business.

While there were state controls on the law books at the time,[11] these state acts were never very effectively administered nor financed by the states and by their local nature could not have an overall national effect. What the country was seeking was a scheme, national in scope, that would be uniform in application.

At the time there were three general theories of securities regulations: (1) anti-fraud; (2) notification (registration); and (3) qualification.

The anti-fraud type of legislation prohibits fraudulent practices as criminal and gives the private citizen a right of action as well. Sales may be made without any required action on the part of the governing agency or the issuer. The acts operate retrospectively, coming into play after the issuer or a broker or dealer has done something that is prohibited, but the naked sale of the securities is never wrong.

Anti-fraud legislation is predicated upon the general criminal theory of deterrence and is as effective as the example of punishment can be. It is not open to argument that the deterrent effect of prospective punishment has never eliminated crime and never will regardless of the severity of the punishment. Almost all states have some anti-fraud provisions.[12]

The notification type of law depends upon disclosure as its effective force, and permits the issuer great freedom and latitude. Reduced to their bare essentials, such laws require the issuer to file a statement of who he is and what he intends to do. He may then issue and sell unless the governing agency takes prescribed steps to stop the issue. The notification theory does not include any evaluation of the worth of securities nor does it require the issuer to obtain a license. All it requires of the issuer is the filing of a statement; without it sales of securities are prohibited. Once a notification or

[11] Cowett, *supra* note 7.

[12] "Thirty-nine other statutes — in every blue sky jurisdiction except California, Idaho, Maine, Montana, New Hampshire, North Carolina and Wyoming — contain assorted antifraud provisions. These provisions operate independently of the registration features." 1 L. LOSS, SECURITIES REGULATION 42 (1961).

registration is filed and no action taken by the governing agency, there is nothing to prohibit the sale of the securities. This is the theory the Federal Securities Acts have followed, and it is the most common for the states' acts.

The qualification theory is the most stringent and restrictive. It prohibits the sale of securities without the permission of the governing agency. By requiring a license for the securities the agency is in a position to refuse to issue the license unless it considers the securities sound.

The Federal Securities Acts are nominally of the notification type and were originally predicated on that concept. President Roosevelt in his message to Congress recommending the legislation not only espoused the notification theory but specifically negated any idea of qualification when he said:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.[13]

The notification theory depends upon disclosure as its effective force, both in supplying the information which is used to notify the authorities and the data upon which investors will rely and in having a deterrent effect upon possible fraud.[14]

Disclosure is the cornerstone of federal securities regulations.[15] The Acts were predicated upon and built around the idea of disclosure as the key to the proper balance between protection from fraud and freedom of investors to make legitimate business mistakes. Professor Loss says, "Congress did not take away from the citizen

[13] H.R. REP. No. 85, *supra* note 3.

[14] "Publicity is justly commended as a remedy for social and industrial disease. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Stokes ed. 1914).

> When I came to the S.E.C. I thought the philosophy of disclosure had been fully depleted. Increasingly, however, I am convinced that in a pluralistic society — where as in business enterprise so many forces are operative — disclosure is the most realistic means of coping with the ever present problem of conflicts of interest. In some instances our conduct is motivated by what we think is right, without regard to anything else. But, perhaps, equally as important, ethical behavior (and wise counseling) often results from estimating the public's reaction to full knowledge of a planned course of conduct.
>
> The requirement of disclosure in certain instances — and its possibility always — is thus the most important regulatory force in our society.
>
> In other words, disclosure restrains because of sensitivity to public reaction, and caution about response to the dividend shareholder and the possibility of legal action. I firmly believe that disclosure does operate in this deterrent manner.

Cary, *The Case for Higher Corporation Standards,* 40 HARV. BUS. REV. 53, 54 (1962).

[15] J. HAZARD & M. CHRISTIE, THE INVESTMENT BUSINESS 298 (1964).

'his inalienable right to make a fool of himself!' It simply attempted to prevent others from making a fool of him."[16]

It should be fairly clear at this point that the real purpose in 1933 and 1934 in enacting the Federal Securities Acts was to stimulate the financing of American business and government by restoring the public confidence in the markets, and the tool by which the Acts were to do this was disclosure. The Acts have certainly accomplished their purpose; American business has been financed and in turn has supplied the capital for a substantial portion of the rest of the world. However, the idea of financing business has long since left the field as a goal and the concept of investor protection has entered to replace it. Then Chairman Cary of the Securities and Exchange Commission summarized the present philosophy of the Commission in a few well chosen words in his letter to Congress accompanying the SEC Special Study of 1963 where he said:

> The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.[17]

While Professor Cary gives lip service to the idea of "facilitating the free flow of capital into the markets," there is nothing in the SEC report to indicate that there is any concept of making it easier to obtain capital in the market place. All the recommendations in the report suggest ways to tighten up laxness and close up loopholes in the law which, of necessity and by design, make the task of obtaining money on the market that much more difficult. By removing from actual consideration the goal of facilitating the flow of capital, the goal of investor protection is left as the single main thrust of the Securities and Exchange Commission and of the Federal Securities Acts. Who, then, is an investor and does he need the protection of the SEC and all the laws? Is an investor any person who holds a security?

In general and with much overlapping there are four types of holders of securities. They are management, distributors, investors and speculators. The distinguishing feature between all these holders is the view with which they purchase or acquire the securities.

Management acquires its securities for control purposes and the return it can obtain through control. Sometimes management obtains debt securities for control purposes.[18] While profit is the motive,

[16] 1 L. LOSS, SECURITIES REGULATION 128 (1961).

[17] Letter of transmittal from William L. Cary, Chairman, Securities and Exchange Commission to President of the Senate and Speaker of the House of Representatives, Apr. 3, 1963, in Part I, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess. iv (1963).

[18] Management may use convertible securities for control purposes and the indebtedness of a business in difficulty is a powerful lever for control as well.

as it is the motive with other holders, management hopes to gain its profit primarily through salaries, dividends and interest. In addition management hopes to realize profits by its own efforts in increasing the value of the securities and consequently the sales price of the securities. It can hardly be asserted or believed that the federal or state securities acts were created or are maintained for the benefit or protection of management. A quick review of the Public Utility Holding Company Act of 1935,[19] a part of this general wave of reform, should put any doubts on this score to rest.

Distributors acquire their securities for the purpose of resale. While they do fall within some of the protections of the Acts, no one would have suggested in 1933 and 1934 that Congress should pass the Federal Securities Acts to protect underwriters and stock brokers.[20] It should be noted here that no distinction is drawn between holders of equity or debt securities. The view with which a distributor holds a security is not slanted towards value except as it affects resale price, and his interest is not to hold the securities for a return. At any rate the first two categories of holders of securities were not those parties for whom the Securities Acts were passed. It remains to be seen whether the last two parties were those for whom the Acts were passed.

There is a bit of confusion, perhaps because of overlapping of goals or because of an unclear picture of the security holding populace, in regard to the distinction between investors, speculators and gamblers. The term "gambler" is not made a separate category because the idea of speculation includes the concept of gambling. It would have been easy to set up a separate classification for the institutional investors such as insurance companies, trustees, banks, funds of all kinds, and it would have made sense to do this in 1933. But this is not 1933, and the situation is not quite the same; institutional investors buy speculative securities.

Again, it stretches credulity to suggest that the Securities Acts were passed to protect the institutional investors. Indeed, Landis

[19] 49 Stat. 838, 15 U.S.C. §§ 79-79z-6 (1935). For a contemporary exposition of the government theory as to the evils at which the act was directed, see R. JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY 247-60. *See also,* Electric Bond & Share Co. v. S.E.C., 303 U.S. 419 (1938), in which Jackson led, as Assistant Attorney General for the United States, and upheld the power of the government to impede very profitable management investment control techniques. With Jackson were, among others, Cohen and Corcoran, original drafters, with Landis, of the Securities Act of 1933. *See* Landis, *supra* note 9, at 35.

[20] "[The Securities and Exchange Commission] encountered both open and under-cover resistance from brokers, investment bankers, and money powers." R. JACKSON, *supra* note 19, at 147.

maintains that it specifically was not the purpose of the Acts.[21] So we must remove from that group of security holders for whose benefit the Acts were passed, the institutional investor, that knowledgeable buyer who acts upon his own knowledge, investigation and experience.[22] It does not matter whether he is investor, speculator, or a major financial house underwriting an issue or taking a position in a security for a quick profit.

The speculator could hardly be considered the legitimate beneficiary of the federal scheme of regulation. Tracy and MacChesney writing in 1934 said:

> On examination the complaints made are found to be reducible to two general heads: one, speculation; two, manipulation. Speculation is regarded as an evil because it is, in effect, mere gambling. Manipulation refers to dishonest practices of those who use the exchanges, whether they be brokers or traders. In discussing the evils charged against the exchanges and the proposed measures for their correction, it is well to bear in mind this important distinction.[23]

In highlighting this distinction they make it clear that gamblers and speculators are in the same class, and that they were not the intended beneficiaries of the Acts.

Reviewing the situation: The Federal Securities Acts were passed to protect certain holders of securities. Eliminated from the group of primary beneficiaries are the following classes: (1) management; (2) distributors; (3) institutional and large knowledgeable investors; and (4) speculators and gamblers. This leaves only the small private individual buyer of securities who is incapable of protecting himself. Apparently he was felt to be the most important factor in financing American business.

The words "investor," "speculator" and "gambler" are nice sounds and seem to convey a real meaning, but a closer look is required to see if they convey the same meaning today as they did thirty-five years ago and whether they refer to the same parties they referred to thirty-five years ago. While there are not a large number of cases that have made and considered the distinctions between these terms, a few of them are worthy of consideration here for what light they can shed upon the subject. In examining the distinction between investment and speculation in a case arising in Oregon the court said:

> There is an element of investment as well as an unavoidable element of speculation in every business in which property, whether tangible

[21] "The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government." Landis, *supra* note 9, at 37.

[22] "[B]ureaucracy . . . could hardly equal these investors for sophistication." Landis, *supra* note 9, at 37.

[23] Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1027 (1934).

> or intangible, is regularly bought and sold. The "in-and-out" market hanger-on who buys and sells through brokers on margin is a typical example of the pure speculator. . . . On the other hand, an investor is ordinarily thought to be a person who acquires property for the income it will yield rather than for the profit he hopes to obtain on a resale.[24]

Thus the distinction drawn in this and other cases[25] is that the investor is one who places money in such a way that the prospects are for little risk of loss and a steady return while the speculator is one who places money in such a way that there is a prospect of a large return regardless of the risk involved. To put it in more current stock market jargon, the investor is concerned with the downside risk while the speculator is concerned with the upside gain.

To gamble means "To stake money or any other thing of value upon an uncertain event."[26] Gambling is distinguished from speculating by the legitimacy of the source of the gain. This is well illustrated by a Georgia court which accepted this definition of speculation:

> "The act of speculating, by engaging in business out of the ordinary, or by dealing with a view of making profit from conjectural fluctuations in the price rather than from the earnings or the ordinary profit of trade, or by entering into a business venture involving unusual risks, for a chance of an unusually large gain or profit."[27]

Is the ordinary holder of securities for whom the Acts were designed an investor? Can it be said today that the ordinary holder of securities acquires his securities for a prospect of a steady return over the years? Does he acquire high grade corporate and government securities for a long pull interest return, or is the prudent small man concerned with preserving the buying power of his dollar in the face of an ever increasing inflation? Is the prudent small investor that man who uses the view of a fiduciary or a trustee in his investment goals? Or, on the contrary, is he a person concerned not with return and interest but rather appreciation of capital? If so, is the widow of today, placing the proceeds of her late husband's insurance policies in such a way as to preserve its real dollar value, a speculator hoping for a profit on resale?[28]

[24] United States v. Chinook Inv., 136 F.2d 984, 985 (9th Cir. 1943).

[25] " 'Speculation' [is] . . . 'the act or practice of buying land, goods, shares, etc.,' in expectation of selling at a higher price.' " United States v. Kettenbach, 208 F. 209, 213 (9th Cir. 1913). " 'Invest' means . . . 'to lay out (money or capital) in business with the view of obtaining an income or profit; as to invest money in bank stock.' " " 'Speculate' — 'to buy or sell with the expectation of profiting by a rise or fall in price; often to engage in hazardous business transactions for the chance of unusually large profit.' " Clucas v. Bank of Montclair, 110 N.J.L. 394, 397, 166 A. 311, 313 (1933).

[26] State v. Berkman, 79 Ohio App. 432, 435, 74 N.E.2d 411, 413 (1944).

[27] Martin v. Citizens' Bank, 177 Ga. 871, 876, 171 S.E. 711, 714 (1933) (quoting *Webster's International Dictionary*).

[28] United States v. Chinook Inv., 136 F.2d 984 (9th Cir. 1943).

It is submitted that the meanings of these words have changed sufficiently and the nature of the national economy has changed sufficiently that the parties whom the Acts were primarily designed to protect are no longer people seeking to obtain a yield on a safe purchase but rather are people seeking a rise in value in order to hedge against inflation. This may have been defined as speculation at the time the Acts were passed, but it does not change anything more than the name of the parties who are and should be the primary beneficiaries of the Federal Securities Acts — the speculators!

As previously pointed out, there is an overlapping area between the meaning of speculation and gambling. If there be any who would argue that the Securities and Exchange Commission is concerned with investing and the flow of capital into the markets and not with supervising the biggest gambling operation in the world, he need not look any further than to the short sale.[29] The SEC certainly has the power to eliminate the short sale from the scheme of "investing" yet it retains it.[30] From the earliest history of the Securities Acts the short sale has been recognized as a gamble:

> There is no question but that a short sale is, in its essence, a gambling transaction, a gamble that the seller can later cover his sale at a lower price. It does not even bear the semblance of investment that is always present when the deal is a purchase of stocks.[31]

Yet, in the short sale the seller intends to deliver the shares he does not own because he borrows the shares and actually delivers them. Much law has been written prohibiting the sale of a commodity with no intent to deliver,[32] and the question of legality of the short sale was really put to rest only with the passage of the Commodity Exchange Act.[33] In a commodity futures transaction there is no in-

[29] "[A] 'short sale' [takes place when the] seller has not the stock he assumes to sell, but borrows it and expects to replace it when the market value has declined." Such sales are perfectly valid, provided the parties contemplate an actual purchase or actual sale by or through the broker and not a mere settlement by a payment of differences. Hurd v. Taylor, 181 N.Y. 231, 73 N.E. 977 (1905).

[30]
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

48 Stat. 891, 15 U.S.C. § 78j (1964).

[31] Tracy & MacChesney, *supra* note 23, at 1028.

[32] *Legislation,* 45 HARV. L. REV. 912, 916 nn.25, 26 (1932).

[33] 42 Stat. 998 (1922), *as amended,* 49 Stat. 1491 (1936), *as amended,* 7 U.S.C. §§ 1-17a (1964); 68 Stat. 913 (1954), 69 Stat. 375 (1955), 7 U.S.C. § 2 (1964); 70 Stat. 630 (1956), 7 U.S.C. § 6a(3)(c)(1964); 69 Stat. 535 (1955), 7 U.S.C. § 12a(4)(1964).

tent to deliver,[34] and regardless of terminology it can hardly be maintained that it is not a gamble. At least when purchasing equity and debt securities the "long" buyer contemplates obtaining the bonds or shares and the consequent interest or dividends.

Gambling, as previously defined, has to do with the outcome of an uncertain event. Manipulation,[35] of course, is making that uncertain event certain. If one were to make the course of the market certain or predetermine the outcome of the market transactions, he would be subject to investigation for manipulation.

It was stated before that the small investor was the ostensible beneficiary of the Acts, not the larger investor who could take care of himself, yet the SEC permits trading in odd lots at a higher commission rate than trading in round lots.[36] If, in fact, the Commission were concerned with the small investor it would not permit this differential but rather would make it easier for the small investor to purchase at the same cost as the larger investor. At a time when some of the largest American corporations sell from $5,000 per one

[34] "Thus trading in futures does not serve primarily to transfer possession of the contract subject matter; rather it involves mainly the assumption of the risk of price change by speculation, or the shifting of such risk by hedging." Note, *Federal Regulation of Commodity Futures Trading,* 60 YALE L.J. 822, 825 (1951).

> A futures transaction is a standardized contract made on or subject to the rules of a board of trade in which the seller or "short" agrees to sell and deliver a specified amount of a commodity in a certain month to the purchaser or "long" who agrees to accept and pay on delivery. Although the long can insist on taking and the short on making delivery — which is effected by the passage of warehouse receipts — upwards of 99% of all futures contracts are liquidated by purchases or sales of offsetting contracts in which equal long and short positions are cancelled against each other.

Comment, *Manipulation of Commodity Futures Prices — The Great Western Case,* 21 U. CHI. L. REV. 94-95 (1953).

"In practice, however, actual delivery of the commodity seldom occurs; about 99% of the contracts are offset on the exchange by making an opposite futures transaction . . . ." Campbell, *Trading in Futures Under The Commodity Exchange Act,* 26 GEO. WASH. L. REV. 215, 217 (1958).

[35] Manipulation is the setting of security prices by artificial means and the circumvention of normal market action. It is prohibited by the Securities and Exchange Act of 1934, 48 Stat. 889, 15 U.S.C. § 78i and the rules promulgated under that act, 17 C.F.R. § 240, rule 10-b-1 and rule 10-b-5. Taken all together the prohibition is that not only brokers and dealers, but all persons who use the mails or the facilities of a national exchange may not effect any transaction or use any device or contrivance or circulate any false or misleading information for the purpose of setting prices. Specifically prohibited are wash sales, artificial market activity, matched orders, rumormongering, and making false and misleading statements. There are appropriate penalties including the private right of action to anyone who purchased at a manipulated price including the injured party's attorney's fees and costs. The language of the prohibition is broad enough to encompass "any device, scheme or artifice to defraud."

[36]

> On the NYSE [New York Stock Exchange], common stock shares are sold ordinarily in units of 100 called "round lots." Preferred stocks, and a few common, usually have units of 10 for a round lot sale. Any number less than a round lot, either 100 or ten, is called an "odd-lot" order. . . . Only round lots are completed on the NYSE. Odd-lot sales take place *technically* off the exchange, although . . . the odd-lot dealer uses the floor of the NYSE to get an effective round lot price on which to base his odd-lot transaction.

G. COOKE, THE STOCK MARKETS 73 (1964).

hundred shares[37] to $50,000 per one hundred shares[38] it seems to be contradictory to require a small man to put up large sums to be able to buy at the same price a rich man does. If the SEC were concerned with the small investor it would stimulate the odd-lot purchase rather than penalize the odd-lot as it now does. It is interesting to note that the odd-lot sales do not affect the prices on the New York Stock Exchange because the odd-lot sales are not reported except in total number of shares traded during the day and the odd-lot prices are pegged to the round lot prices.

People have a tendency to believe their own publicity, and the SEC, being composed exclusively of people, tends to believe its own publicity. If it begins to think that the fundamental and exclusive purpose of the Federal Securities Acts is to protect investors, it will not be long before the concept of "flow of capital" becomes a despised slogan of the opposition. So long as gambling is considered an undesirable social disease and only permitted by the state for the purposes of the state, a racing commission can have no other purpose than to preserve the confidence of the bettors that they are getting a fair shake and thus raise income for the community by keeping the game honest. The SEC should view itself in the same light, that is as an organization created to maintain the flow of capital to American business by means of protecting all the people who "invest" money in securities. This view of itself by the Commission would be a change from the present one which appears to be that the issuance, distribution, sale and trading of securities are merely permissible business activities allowed by the federal scheme of regulation and not the primary purpose of the Acts.

The foundational concept of securities regulation in the notification type of law is disclosure. The thought was that proper disclosure would effectuate the purposes of the Act, so long as the purposes of the Act are those of protecting the small investor. As a practical matter, most of the data disclosed by command of the Acts discloses nothing to the small investor and is not likely to disclose anything to the small investor. It is doubtful that it is possible to create a scheme which could possibly disclose either the whole truth or the material truth to the small investor. Very early in the life of Federal Securities Regulations, Justice William O. Douglas, then a Professor of Law at Yale wrote:

> Some, however, have believed, apparently in all sincerity, that the great drop in security values in the last five years was the result of

[37] The current (July 10, 1967) price of one share of American Telephone and Telegraph is approximately $51.00. (High 52⅞, Low 51⅛, Close 51⅝).

[38] The current (July 10, 1967) price of International Business Machines is approximately $502.00. (High 507, Low 502, Close 503½).

> failure to tell the "truth about securities." And others have thought that with the Securities Act it would be possible to prevent a recurrence of the scandals which have brought many financiers into disrepute in recent years. As a matter of fact there are but few of the transactions investigated by the Senate Committee on Banking and Currency which the Securities Act would have controlled. There is nothing in the Act which would control the speculative craze of the American public, or which would eliminate wholly unsound capital structures. . . .
>
> But even the whole truth cannot be told in such simple and direct terms as to make investors discriminating.[39]

While many kinds of information are required to be disclosed there is but one major requirement intended to go directly to the ultimate investor, and that is the prospectus. It arrives for some strange reason just *after* the investor has made a purchase.[40]

The Securities Act of 1933 requires that a vast amount of information be accumulated and filed with the SEC as part of the registration statement. This information is boiled down to a few dozen pages in an honest and legitimate attempt to present a full and true summary to a prospective investor. The prospectus is then forwarded to the purchaser of the securities, not before he makes the purchase, but after — much as a memento of the sale.[41] How can we expect the average investor with little sophistication to intelligently use it as an aid in making an investment decision?[42] Further, if the prospectus is a device intended to disclose information to prospective investors, why are the only investors who get a prospectus *before* purchase those who are least likely to need it — namely,

[39] Douglas and Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171 (1933).

[40]
> In particular, while the prospectus must be the first written communication (other than a "tombstone" ad or an authorized summary prospectus) in connection with a public offering, the law does not require that it be delivered before orders for the registered security may be solicited, received, or even accepted, but only that its delivery precede or accompany delivery of the security to the customer "after" sale. Even if the customer is not legally committed to his purchase at (or before) the moment of delivery of the security to him, he is surely "committed" in the sense of having made his investment decision well before this moment; yet this may be (and usually is) his first opportunity to see the prospectus. At this point he can hardly be said to have derived benefit from the affirmative aspect of the prospectus delivery requirement, but only from the negative aspect of having been shielded from any prior written communication not qualifying as a prospectus.

Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340, 1350 (1966).

[41] Lobell, *Revision of the Securities Act,* 48 COLUM. L. REV. 313, 323 (1948).

[42] While personal experiences are not favored in law review articles, yet one of the authors feels constrained to point out that after a Bachelor's Degree in Business Administration, 11 years experience in corporate enterprise including publicly held corporations, a Bachelor of Laws degree, a Master of Laws degree, 15 years dealing in securities, and three consecutive years of teaching Securities Regulations, he is still unable to effectively use a prospectus as a tool for making an investment decision.

existing stockholders who receive a rights offering or an offer of an exchange?[43]

The financial statements prepared by independent accountants included in the prospectus are the usual kind of financial statements used in businesses all over the world, such as balance sheets and profit and loss statements. However, most publicly held corporations' affairs and business transactions are extremely complicated. To make statements reflect a true picture, they must be explained further. These explanations are located in the footnotes to the financial statements. The footnotes, printed in the smallest possible type, often are longer than the financial statements. Assuming the issuer has no intent to hide or confuse, the command of the law that the statements are not to be materially misleading or false necessarily makes them materially obscure, even to the initiated.

The paradox of disclosure is that every added disclosure tends to obscure rather than inform. It suggests that perhaps there is a point of diminishing return, a point beyond which we begin to defeat our fundamental purpose. Perhaps the required notices that must be placed in large type on the face of a prospectus are as good an example as any. If there were one warning, of any color type, it might be read, but the front cover of a prospectus is covered with warnings so numerous and profuse that no one takes time to read them. The prospectus has become a formalistic legal document. As a bill of lading is not a meeting of minds, the prospectus is not an inducement to buy.

There are generally two kinds of information which the 1933 Act requires to be disclosed. The first we have discussed — that intended to be disclosed directly to the customer. The second kind is the information intended to be disclosed to the SEC. This last part makes up the vast bulk of disclosures required including not only the registration statement but the periodic reports needed to keep that data current. While this information is nominally open and available to the public, the public never actually sees it. A newspaper article described the manner in which the SEC makes this data available. "[T]he focal point for much of the essential transfer of

[43] Curiously, the prospectus delivery requirement operates at highest efficiency — in the sense that the required prospectus is certain to be delivered to all offerees in advance of their investment decisions rather than at the completion of their purchases — in certain situations where a full-blown prospectus is probably least needed: a rights offering or an offer of exchange to existing stockholders. In both cases the very nature of the transaction ordinarily compels written communication of details of the offer, and therefore a full prospectus, at an early stage. Yet by hypothesis the offerees are already stockholders and thus presumably have some familarity with the company and perhaps with the class of stock being offered, so that "new" items of information would be relatively few.

Cohen, *supra* note 40, at 1351.

financial data to securities buyers is a cramped reference room in SEC headquarters here that, by actual count, provides just twenty chairs for America's seventeen million investors. What's more, only rarely is there great demand for the seats."[44] Even if an interested person did want some information, a great deal of pertinent data is filed in a warehouse across the river at Franconia, Virginia, and is not readily available. Further, if some small investor wanted to copy some of the disclosures, the article reported it would cost fourteen cents per page. Disclosure to the SEC is not, in fact, disclosure to the general public.

If there ever was a situation where the SEC forced a company into disclosing the truth it was surely the *Tucker* case.[45] Preston Tucker created a new enterprise to manufacture automobiles just after World War II. He raised about $26,000,000 from the public *after* disclosing that the automobile to be produced had not been tested, that there were probably patents needed, that Tucker had transferred corporate funds to his personal account, and had made no net cash contribution to the company but instead had already drained nearly a quarter of a million dollars of its capital to himself *prior* to approval of the registration, that there was pending litigation, that Tucker had as an associate with him in the venture a man with a criminal record and an attempt had been made to cover up this fact, that Tucker had previously violated the Securities Act in this very venture, and other facts too numerous and detailed to enter here. Yet, regardless of the facts so stated, Tucker was able to raise $26,000,000 and ultimately topple into bankruptcy.[46]

No matter what truth is disclosed, you can lead an investor to a prospectus, but you can't make him read it.[47] Moreover, if he is a gambler rather than an old fashioned investor, even if he could understand it, it would not be relevant.

If we accept the ideas introduced earlier that the protections are needed by the small man only, and that he is for the most part a speculator, then effective small investor protection requires one of two things: either the complete evaluation of securities by a competent authority so that he will at least get his money's worth or

[44] Kohlmeier, *Informing Investors,* The Wall Street Journal, Apr. 17, 1963, at 16, col. 4.

[45] *In re* Tucker Corp., 26 S.E.C. 249 (1947).

[46] One may obtain a view of these proceedings by reading *In re* Tucker Corp., 256 F.2d 808 (7th Cir. 1958). Compare particularly the view argued successfully for the debtor in the Seventh Circuit as to the management's honest belief in the adequacy of its working capital for the task in hand (256 F.2d 811) with the grim and specific warnings by the SEC *prior to registration approval,* on the same subject, *In re* Tucker Corp., 26 S.E.C. 249, 260-61 (1947). Notice also the warning by the SEC as to the dangers to purchasers of franchises, which the Seventh Circuit case eleven years later proved to have been painfully accurate. *Id.* at 252-53.

[47] Old Wall Street Proverb.

conversely adequate supervision of the game so that he can get a fair deal. If the fundamental purposes of the securities laws are in terms of investing, then the SEC should evaluate the securities as to worth. If the fundamentals are in terms of speculation and gambling, then the SEC should supervise the legitimacy of the game.

In view of the fact that to admit to the concept of the legitimacy of speculation and gambling would be against a well formulated public policy, the question of the validity of its converse is raised. Should the system of federal securities regulation evaluate the worth of individual securities?

The law does not forbid it, but the examination of the worth of securities was not a part of the plan nor is it supposed to be a part of the plan. It is hard to envision an employee of the SEC whose job it is to examine the registration excluding any personal evaluation of the worth of the securities offered for sale. Beyond that, though, one author recently has written:

> One of the outstanding accomplishments of the S.E.C. since its creation has been the "processing" of registration statements, a phenomenon of great importance that, curiously, is not even adverted to in the statute. In the interval between filing and effectiveness of a registration statement — an interval apparently designed to allow for circulation and absorption of filed information and for the Commission's use of its refusal order or stop order powers — an examination of great thoroughness is made by staff members, and their views are expressed to the registrant in a letter of comments (popularly known as a "deficiency letter") which forms the basis for the finally amended document.[48]

This process is at least a partial evaluation of the worth of the securities. One of the more interesting cases to arise in this connection involved the Hydramotive Corporation which claimed it filed a registration statement and that the SEC refused to take it seriously and ignored it. Some of the material contained in the statement filed was listed in the reported case as follows:

> (1) The present directors do not foresee the possibility of the corporation ever being in a position to pay any dividends or having any assets of determinable value. The continued existence of the corporation is questionable. Bankruptcy may result at any time.
>
> (2) Anyone considering purchase of this security must be prepared for immediate and total loss.
>
> (3) No representation is made that the possibility exists that the corporation can continue to exist.
>
> (4) No representation is made in this statement that the President and Secretary of the Company have any capability that can benefit the corporation in any way.
>
> (5) In view of the above unfavorable factors, and other unfavorable factors in every part of this offering circular, it would appear

[48] Cohen, *supra* note 40, at 1353.

> that it is self-evident that any prospective purchaser of Hydramotive Corporation stock should be prepared for an immediate total loss.

The District Court threw it out as "nothing more than a sarcastic piece of mockery."[49]

Even the *Tucker* case was in fact an evaluation of the worth of the securities involved. The paradox herein is that even while repeating over and over that it does not evaluate the worth of securities, the SEC does in fact do so. The SEC should be concerned to see that an investor cannot make an investment below a certain standard of return and can only buy securities of a certain investment quality.[50] "Compensation or reparation will never serve the same high purpose as prevention."[51]

The state of California does currently evaluate the worth of securities[52] and the idea that the federal system should evaluate the worth of securities is not a new idea. Justice William O. Douglas, in evaluating the idea of a federal system wrote in 1934:

> Any comprehensive and consistent control of the type which these parts of the New Deal envisage must inevitably embrace within it control over security issues. That in essence means control over access to the market. That control would be an administrative control lodged in the hands not only of the self-disciplined business groups but also in the hands of governmental agencies whose function would be to articulate the public interest with the profit motive. . . .
>
> In that type of control we should have something much more fundamental than the truth about securities.
>
> We should be searching for the elements of soundness and stability, the absence of which caused most of the things we so frequently attribute to fraud and deceit. At the same time, the requirement of the truth about securities would be retained. But it would be given the secondary and relatively unimportant place which it deserves.[53]

CONCLUSION

We have attempted here to set forth the rather paradoxical nature of the federal system of securities regulation and the idea that

[49] Holmes v. Cary, 234 F. Supp. 23, 24 (N.D. Ga. 1964).

[50] Joslin, *Federal Securities Regulation from the Small Investors' Perspective,* 6 J. PUB. L. 219, 223 (1957).

[51] Douglas, *Protecting the Investor,* 23 YALE REV. 521, 524 (1934).

[52] If the commissioner finds that the proposed plan of business of the applicant and the proposed issuance of securities are fair, just, and equitable, that the applicant intends to transact its business fairly and honestly, and that the securities that it proposes to issue and the method to be used by it in issuing or disposing of them are not such as, in his opinion, will work a fraud upon the purchaser thereof, the commissioner shall issue to the applicant a permit authorizing it to issue and dispose of securities, as therein provided, in this State, in such amounts and for such considerations and upon such terms and conditions as the commissioner may provide in the permit. Otherwise, he shall deny the application and refuse the permit, and notify the applicant in writing of his decision.

CAL. CORP. CODE § 25507 (West 1955).

[53] Douglas, *supra* note 51, at 531-53.

the resolution of the paradoxes would bring forth a system with less inconsistencies and a more logical approach to the concept of American capitalism.

The four basic paradoxes we have attempted to set forth are these:

1. The Federal Securities Acts were designed to stimulate the flow of capital into business by means of increasing investor protections, but each added protection is an added stumbling block to the flow of capital.

2. Gambling is illegal in most places and strongly against public policy, yet today the system of buying and selling securities maintained for the purpose of channeling risk capital into business is not really investing but gambling.

3. The concept of disclosure, designed to elicit the truth in securities, has become so formalistic as to conceal and obscure rather than disclose.

4. The theory upon which the federal system is predicated is to protect small investors by means of disclosure, but the only real protection small investors get is through an evaluation by the SEC of the soundness and worth of securities.[54]

[54] The practical effects of this paradox are well illustrated by the Tucker automobile case, discussed *supra* notes 45, 46. The picture presented is that of a shepherd attempting, at night, to protect his flock against a tiger — with a flashlight. To the inevitable slaughter, the light of :lisclosure added only the additional horror of perfect awareness of what was happening and would happen. The sheep were not warned, and the hungry tiger was not deterred. The genuine and well-founded distress of the shepherd is clearly preserved in the opinion of the SEC. Notice these excerpts:

> Under the Securities Act of 1933, this Commission does not approve or pass on the merit or lack of merit of any security offered. It is specifically made a criminal offense under the Act for any person to represent the contrary. The Commission's primary function is to require full and adequate disclosure of all material facts in connection with a public offering of securities so that investors may, on the basis of such disclosure, arrive at an informed judgment as to whether or not to purchase the securities offered. [26 S.E.C. 249.]
>
> Since January 1946, there has been extensive publicity concerning the Tucker organization and its plans to manufacture a modern automobile. In many periodicals, newspapers, sales brochures and company advertisements, which are part of the record before us, there has been widespread comment as to the radical features the Tucker car possesses, elaborate and conflicting claims as to its expected accomplishments and performance, and exaggerated statements as to the funds invested by the management. Many of the statements that have been publicized in the past appear to be grossly misleading and, in many cases, false. We. cannot ignore the impact of the misleading information contained in past publicity concerning the corporation and its officials on the minds of the investing public. Floyd D. Cerf, president of the underwriter, testified he had no doubt the present issue could be sold merely on the basis of the widespread public interest that had already been created.
>
> The contrast between the information contained in previous publicity and that contained in the prospectus, as it has now been amended, is so pronounced that we deem it necessary to warn the investing public of the danger of relying on any past judgment based on prior literature in determining whether to purchase the securities of the registrant. We urge that

> prospective investors make a careful study of the amended prospectus. [26 S.E.C. 250-51.]
>
> Preston Tucker has had complete control of the corporation from its inception. The manner in which the funds of the corporation have been administered in certain instances raises some grave questions as to whether a proper stewardship of corporate funds has been consistently maintained. [26 S.E.C. 253.]
>
> The registration statement, as originally filed, contained no intimation that further financing might be necessary. This point was considered at length in the 8(e) examination and in the 8(d) hearing. The amended prospectus now admits (1) that circumstances may arise which may require substantial additional funds for working capital purposes, (2) that no plans have been formulated for the securing of any such additional funds, nor does the corporation have any assurance of being able to obtain them when and if they are needed, (3) that if such additional funds become necessary and are obtained, they may occupy a position senior to that of the Class A common stock offered under the present registration statement, and (4) that failure to obtain additional funds, if needed, may result in substantial loss to purchasers of Class A stock. [26 S.E.C. 260-61.]
>
> Since these amendments appear to have corrected the misstatements and omissions . . . we have determined to dismiss the stop order proceedings and permit the registration statement, as amended, to become effective. . . . In taking this action, we emphasize again that we are in no way passing on the merit or lack of merit of the securities offered, the registrant's product, or the possibility of success or failure of the enterprise. These are decisions which each investor must make for himself. The limits of the Act and the Commission's job under it are to require that information be supplied which will enable the investor to arrive at an informed judgment. Investors will be supplied with the amended prospectus and we can only urge again that their decision on whether or not to purchase the securities offered be based on a careful study of the information contained therein. [26 S.E.C. 263-64.]

The flashlight had certainly been used with diligence, energy, integrity and courage, but perhaps a flashlight is not an adequate weapon with which to protect sheep against tigers.