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SECURITIES LEGISLATION - SECURITIES ACT - STOP ORDER PROCEEDINGS - ADMINISTRATIVE TESTS OF MATERIALITY

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SECURITIES LEGISLATION — SECURITIES ACT — STOP ORDER PROCEEDINGS — ADMINISTRATIVE TESTS OF MATERIALITY — With a view toward correcting many of the abuses which had accompanied the distribution of securities, the Congressional mandate embodied in the Securities Act of 1933,[1] together with the regulations of the Securities and Exchange Commission adopted in pursuance thereof, require the publication of much information previously withheld from the investing public. The basic objective of the act is the full disclosure of every essentially important element attending issues of securities in interstate commerce or through the mails,[2] and to that end the commission

[1] 48 Stat. L. 74 (1933); 15 U. S. C. (1934), §§ 77a to 77aa.

[2] In his special message to Congress recommending securities legislation, President Roosevelt said: "There is . . . an obligation upon us to insist that every issue of new

is empowered to issue a stop order suspending the effectiveness of a registration statement if it appears that the statement contains any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.[3]

There can be no objection to the essential purpose of the act, but for a registrant and its counsel to determine in advance what is an "essentially important element" or a "material fact" is a problem fraught with difficulties. While the registration forms and accompanying regulations promulgated by the commission are a substantial aid in drafting a registration statement, it must be apparent that they by no means solve the lawyer's difficulties. He may misconceive the meaning of a particular word or item, and the result thereof may range from a technical deficiency of minor importance to one which so belies the trustworthiness of the statement as to subject it to rejection by the commission. His task comprises more than merely including in the registration statement all that is required by the particular form on which the securities are registered; he must be sure not only that each item as answered states the full truth in the sense that it omits no facts necessary to make the facts stated not misleading, but also that all the items together are so answered as not to give a misleading picture of the enterprise as a whole. The fact that the misrepresentation or omission represent mere bona fide mistakes in judgment on his part is entirely immaterial, because in a stop order proceeding the truth or falsity of the statement is in issue regardless of the good faith of the parties. That the standard of competent and adequate disclosure imposed by the act cannot be met by good faith alone is stressed by the commission as follows:

> "The Securities Act of 1933 requires more than good faith; it requires, as well, that those who seek trusteeship of the public's money on the basis of information in the registration statement and the prospectus, must live up to certain minimum standards of ability and due care in their preparation. It will not suffice that a registrant has attempted to prepare a registration statement to the best of its ability. It is necessary that it meet the standards imposed by the law."[4]

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." N. Y. TIMES 1:6 (March 30, 1933); 77 CONG. REC. 937 (1933).

[3] 48 Stat. L. 79 (1933); 15 U. S. C. (1934), § 77h (d).

[4] In the Matter of Herman Hanson Oil Syndicate, S. E. C. Securities Act Release No. 1555, p. 3 (Sept. 15, 1937). See also In the Matter of Unity Gold Corp., 1 S. E. C. 25 (1934).

Any attempted definition of a "material fact" must necessarily be of little aid in the preparation of a registration statement, for in each instance it is wholly a matter of the peculiar circumstances involved. While the commission has said in a general way that "the term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered,"[5] and that a material fact is one "which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question,"[6] it has never attempted a more precise or all-inclusive definition. The search for administrative tests of materiality resolves itself, therefore, into a consideration (1) of the unofficial proceedings before the registration division of the commission which take place before the actual filing of a statement, and (2) of the official proceedings of the commission in which stop orders have been issued. The former comprise the greater part of the work of the commission, since relatively few statements ever reach the stop order stage; conferences between counsel for the registrant and the members of the registration division and the issuance of "deficiency letters" suffice in most cases to settle any differences of opinion which may exist and to satisfy the requirement of full disclosure of all material facts.[7] This comment will not undertake an inquiry in this direction, but will confine itself to a consideration of the tests of materiality indicated in the written opinions of the commission in connection with stop order proceedings before it.[8]

I.

To date, the commission's stop order proceedings have been concerned principally with the issues of small, newly-organized companies —especially those of the mining and investment type—whose registrations have been on "Form A-1." It is in this kind of corporation that the activities and compensation of the promoter are of special significance, and for that reason the promotional aspect has figured largely in the commission's insistence upon full and fair disclosure.

Payments to promoters for services rendered or properties transferred to a new corporation are likely to account for a large dilution

[5] Rule 455, GENERAL RULES AND REGULATIONS UNDER THE SECURITIES ACT OF 1933 (1937), CCH SECURITIES ACT SERVICE, ¶ 5455.

[6] In the Matter of Charles A. Howard, 1 S. E. C. 6 at 8 (1934).

[7] See Dean, "The Lawyer's Problems in the Registration of Securities," 4 LAW & CONTEMP. PROB. 154 (1937).

[8] The question of materiality with respect to financial statements and accounting problems is not considered within.

of the security issue; and since this is of vital interest to the prospective investor, the lawyer's rule of action is to set forth in the registration statement all the promotion costs so that the investor may estimate their worth. To disclose these charges, the elements serving as a basis for comparison must be designated for what they are,[9] and care must be taken to disclose the names of, and payments to, all persons connected with the promotional scheme. *In the Matter of Oklahoma-Texas Trust*[10] exemplifies the sort of information which the commission requires. One Hall had purchased oil properties in anticipation of their sale to the registrant, and to that end he transferred them at a fifty per cent profit to the Southwest Company, a trust owned by several of the issuer's trustees; on the same day the Southwest Company sold them to the issuer, likewise at a large profit. The evidence at the hearing showed that the issuer was to pay directly to Hall the amount owed him by the Southwest Company, but it was liable to pay only to the extent that it could sell the securities to be registered; the Hall-Southwest contract provided that Hall should give title to so much of the property as corresponded to the proportion of the total purchase price which the Southwest Company should pay. Hall's profit was thus made dependent upon the sale to the public of participating units in the registrant. Holding as material the omission to name Hall as a promoter and to disclose the payments to him, the commission said:

> "Although the term [promoter] has never been judicially defined with respect to the Securities Act, it has generally been construed to apply to a person who enters into a common enterprise with other persons to form a corporation, transfer property to it, and sell stock to the public. . . . When almost the entire assets of an enterprise consist of properties bought from one who was not dealing at arm's length with the issuer, the investors are entitled to be apprised of that fact. True, the property may be worth the amount paid the insider, but a prospective investor is apt to discount the purchase price as an index of value if he is informed that the price was not reached by bargaining."[11]

It is clear, then, that the registrant must disclose as a promoter anyone who, in concert with the actual incorporators, purchases property with the intent to sell it to the corporation when it is formed and to receive payment therefor from the purchase price of the securities to be sold. Moreover, the omission to name a person who first directs the principal promoter's attention to the properties, who secures the

[9] MacChesney and O'Brien, "Full Disclosure Under the Securities Act," 4 LAW & CONTEMP. PROB. 133 at 140 (1937).

[10] S. E. C. Securities Act Release No. 1563 (Sept. 23, 1937).

[11] Ibid. at p. 10.

first option agreement for assignment to him, and who aids him in preliminary negotiations in return for a share in the stock which the principal promoter is to receive, is an omission of a material fact;[12] and the statement that shares of stock are issued to promoters in consideration of lease and option agreements is misleading in the absence of disclosure of the fact that such shares were merely allocated on the basis of a pre-incorporation agreement for dividing the control among the promoters.[13] Deliberate overvaluation of property to disguise promotional payments is obviously such a misstatement of a material fact as to require a stop order.[14] The courts of some states hold that the formal action of a board of directors in placing a certain valuation upon property is, in the absence of fraud or bad faith, a defense against actions by creditors or stockholders; the commission, however, requires that the true value be stated, regardless of the good faith of the board. Here, as elsewhere, the requirement of full and fair disclosure is not satisfied by bona fide acts or omissions.[15]

In its treatment of promotional problems, the commission has likewise attacked trick selling schemes, the true character of which was not disclosed by the registration statements. *In the Matter of Wee Investors Royalty Company*[16] involved a chain selling device for the sale of participating certificates in a trust for investment in oil properties. The scheme was one whereby each investor, besides being assured of a one hundred per cent profit on his own investment, was to share in the earnings of the fourth person to whom he sold and of the first three of those to whom his fourth vendee sold, and so on; and the representation was that if carried to the sixth stage, the original subscriber from the issuer would receive $729.65 from an investment of one dollar. The omission to state that the estimated profits would allow such a return to only one person in a thousand, and that it could be carried to the sixth stage only if a small number of persons carried on the chain, was an omission of facts necessary to make the representations not misleading. "Step-up" prices constitute another device which is sometimes used, consisting simply in fixing in advance of actual issue a table of graduated prices at which it is proposed to offer successive blocks of shares to the public. Where the step-up has no relation to increases in the value of properties behind the stock, the arbitrary in-

[12] In the Matter of Snow Point Mining Co., Inc., 1 S. E. C. 311 (1936).

[13] In the Matter of Franco Mining Corp., 1 S. E. C. 285 (1936).

[14] In the Matter of Unity Gold Corp., 1 S. E. C. 25 (1934); In the Matter of Haddam Distillers Corp., 1 S. E. C. 37 (1934).

[15] In the Matter of Unity Gold Corp., 1 S. E. C. 25 (1934); In the Matter of American Gyro Co., 1 S. E. C. 83 (1935). See further, MacChesney and O'Brien, "Full Disclosure Under the Securities Act," 4 LAW & CONTEMP. PROB. 133 (1937).

[16] 1 S. E. C. 202 (1935).

creases are misleading in the absence of a statement that the device is used merely to aid sales of the securities.[17] Perhaps the nature of the real purpose behind such a scheme accounts for its frequent omission from registration statements. In one case the registrant advanced, as reasons for the use of the device, certain comments on the speculative possibilities resulting from development work to be done with the proceeds of the issue, and concluded that if preliminary work should confirm the probability of the existence of valuable ore, the quantity and quality thereof would further enhance the value of the property and the investors would be entitled to the "added value" so developed. The commission held that this answer gave a false impression in omitting to state as an alternative that the exploration and development might not justify the enhanced prices proposed to be charged, and pointed out in addition that

> "The stock salesman is able, until disposition of the final block of stock is undertaken, to offer continually for sale a security which will in a short time be more expensive to purchase. Nor can we close our eyes to the fact that the foundation is thus knowingly laid by the registrant for its salesmen to argue that an increasing worth of the corporation's assets justified the increase in price, when, in fact, no such increase in worth exists. . . . The failure to disclose that the only purpose and basis of the 'step-up' was to facilitate stock sales, if, indeed, there could be any other purpose, results in a definitely misleading omission."[18]

2.

Realizing that the average investor is not equipped to understand the lengthy, technically-drafted documents which are appended to the registration statement, the commission has provided for a summary in the registration statement of the salient features of the underwriting and other "material" agreements. As in the case of promotional items, the registration statement must give a complete and unbiased presentation of all the essential facts and circumstances which may have a bearing upon the distribution of the securities. It is clear that the absence of a written agreement to distribute securities does not preclude the existence of an underwriter, nor is it necessary that there be a definite commitment to purchase a specific number of shares from the issuer.[19] As is shown in a recent case,[20] it is necessary to disclose

[17] In the Matter of Snow Point Mining Co., Inc., 1 S. E. C. 311 (1936); In the Matter of Avocalon Extension Syndicate, Ltd., 1 S. E. C. 657 (1936).

[18] In the Matter of Snow Point Mining Co., Inc., 1 S. E. C. 311 at 319 (1936).

[19] In the Matter of Kinner Airplane & Motor Corp., Ltd., S. E. C. Securities Act Release No. 1644 (Dec. 17, 1937).

[20] In the Matter of Kinner Airplane & Motor Corp., Ltd., S. E. C. Securities Act

facts which amount at most to an informal understanding. The registration statement said that there was to be no underwriter. The evidence at the hearing showed, however, that one Porter, the president and a director of the issuer, had purchased from the issuer and from brokers large blocks of the registrant's securities issued in the past, and had sold the same in the open market, his personal holdings remaining almost constant. Regarding Porter as an underwriter with respect to the past issues, the commission inferred from such activity a probable repetition under the issue in question and stated its conclusions as follows:

> "But we find no justification for holding that the salutary function of Items 31 *et seq.*[21] in requiring the disclosure of the scope and terms of the underwriting and the identity of the underwriters does not extend to underwriting arrangements which do not take the form of a firm commitment to purchase securities from the issuer. The items of the registration statement calling for information relating to underwriting are necessarily prospective, and if a registrant knows that certain persons will buy and distribute its securities then being registered, that information should be disclosed. . . . the unqualified statement that there was to be no underwriter was misleading in the absence of a statement of the facts giving the registrant reason to believe that Porter would probably purchase a substantial portion of the registered issue with a view to distribution." [22]

Any factor affecting the success of distribution necessarily bears upon the risk which the investor assumes, and for that reason the registration statement must not create the impression that the named underwriter is experienced in financing and possessed of facilities to effect successful distribution when such is not the fact,[23] or that the underwriting is to be done by a person who in fact has surrendered all control over the marketing of the securities to other individuals.[24] While the items in the registration statement are designed to present

Release No. 1644 (Dec. 17, 1937).

[21] The commission refers to certain items of Form A-1 dealing with various aspects of distribution, including the names of the underwriters, the amount of stock each agrees to take, the price it will pay, and the price at which the stock is to be offered to the public.

[22] In the Matter of Kinner Airplane & Motor Corp., Ltd., S. E. C. Securities Act Release No. 1644, p. 4 (Dec. 17, 1937).

[23] In the Matter of Bering Straits Tin Mines, Inc., S. E. C. Securities Act Release No. 1498 (July 2, 1937).

[24] In the Matter of Trenton Valley Distillers Corp., S. E. C. Securities Act Release No. 1658 (Jan. 18, 1938).

only a summary of the formal underwriting agreements, it is of course necessary that they summarize the agreements as they really are; they must not imply that the underwriter has bound itself to purchase the issuer's securities when it has committed itself to nothing. In one case, for example, the registrant stated that the underwriter "is purchasing" and "agrees to take down" stock at a certain price per share. In reality all the agreement amounted to was an option to buy as many of the registrant's shares as the underwriter could sell at a specified price. In pointing out the misleading character of these statements the commission said:

> "The terms of the underwriting agreement in a case of this sort in large measure determine the nature of the investment which purchasers of securities are asked to make. The investor's risk is entirely different where the underwriter has made a firm commitment than it is where the underwriter has merely agreed to do his best to sell the issuer's securities. Where there is a firm commitment by a responsible underwriter the issuer is assured at the outset that it will receive sufficient funds to commence work on the properties, whereas, where the underwriter merely contracts to sell the issuer's securities if it can, the investor has no assurance that the issuer will ever secure sufficient funds to enable it to proceed." [25]

Again, if the device of "step-up" prices is used to facilitate market sales and the underwriter's profit is made dependent upon the price at which the securities are offered to the public, it is apparent that the underwriter has a device which lends itself as a persuasive argument for purchasing at the price at which securities are currently being offered, since the price will be greater upon the offering of the next block of stock. A material omission results unless the investor is apprised of the underwriter's progressive increase in profit and the peculiar advantage to it in making an offering by means of such an arrangement.[26]

The item in the registration form calling for a statement of the public offering price, or of the method of computation if no price is fixed, is apt to cause some difficulty where the answer given is merely "over-the-counter market" or "at market price." Where the persons in control of the corporation already possess substantial blocks of securities of the same class as those being registered, the registrant must disclose to the investor any distortion of the market which will result from "stand-off" agreements between the underwriter and the issuer, restricting or preventing the sale or disposition of such securities during

[25] In the Matter of Livingston Mining Co., S. E. C. Securities Act Release No. 1368, p. 7 (April 3, 1937).

[26] In the Matter of Avocalon Extension Syndicate, Ltd., 1 S. E. C. 657 (1936).

the period of flotation of the securities underwritten.[27] Similarly, when the securities are to be offered at the current over-the-counter market price, the issuer is required to state what market is meant and to reveal any influences upon the same by or for the seller, other than the normal forces of supply and demand. Failure to do so constitutes an omission to state a material fact necessary in order to make the statement of the offering price not misleading[28] because, as the commission has indicated,

> "The investor who is solicited to purchase a security at the market price is entitled to knowledge of any artificial restraints upon the flow of the security into the market and of any past or possible future artificial demand for the security, so that he may for himself determine to what extent the market price represents the collective judgment of buyers and sellers as to the merits of the security, rather than a price induced by abnormal demands for, and abnormal restraints upon, the supply of the security."[29]

3.

With respect to experts whose reports are used in connection with the registration statement, the commission has pursued two distinct lines of inquiry. In the first place, if the expert has any interest or relationship of employment in or with the issuer, its subsidiaries or affiliates, a full explanation must be made so that the validity of the information supplied or the reliability of any expression of opinion contained in the registration statement may be appraised by the investor with the knowledge of the existence of that interest. The type of relationship or anticipated relationship which the commission deems to be material enough to require disclosure is exemplified by the *Plymouth Gold Mines* case,[30] where the engineer who prepared the

[27] MacChesney and O'Brien, "Full Disclosure Under the Securities Act," 4 LAW & CONTEMP. PROB. 133 at 141 (1937).

[28] In the Matter of Rickard Ramore Gold Mines, Ltd., S. E. C. Securities Act Release No. 1476 (June 16, 1937); In the Matter of Canusa Gold Mines, Ltd., S. E. C. Securities Act Release No. 1507 (July 15, 1937); In the Matter of Old Diamond Gold Mines, Ltd., S. E. C. Securities Act Release No. 1576 (Oct. 8, 1937). In the latter case the prolix statement of the offering price was so worded as to create the misleading impression that the current market price was far greater than it actually was. The registration statement declared that its shares outstanding were "currently" offered at thirty cents, and that a large number had been sold at prices varying from eight to forty-eight cents; but it omitted to disclose that as of the effective date of the registration statement the market was only three cents bid and three to five cents asked.

[29] In the Matter of Rickard Ramore Gold Mines, Ltd., S. E. C. Securities Act Release No. 1476, p. 7 (June 16, 1937).

[30] In the Matter of Plymouth Consolidated Gold Mines, Ltd., 1 S. E. C. 139 (1935).

reports, while not an employee of the registrant, was interested in the prospect of being employed by it and was also the general manager of a mining company which the registrant proposed to acquire at the time the report was made. Where independence is required—as is true of accountants who certify to the financial statements forming part of the registration statement—the independence must be real and not colorable merely. In the *Cornucopia Gold Mines* case[31] the registration statement declared that the relation between the issuer and the accountants was the "usual relationship of independent accountants to their client." In reality the accountants had agreed, for a stipulated annual payment plus one per cent of the gross proceeds of the registrant's sales, to install an accounting system, make the necessary audits, and furnish office space for the registrant; moreover, one of the accountant's employees, who was also a stockholder in the registrant, was made comptroller of the registrant. Under these circumstances the commission regarded as irresistible the inference that the employee could not cast aside his relationships with the issuer and view the accounting problems with the objectivity of an "independent" accountant criticizing the accounting practices of the corporation's own staff, because in making an audit he would in part be reviewing his own work. The accountants themselves could not be independent because they received their information from their employee and because they had a continuing substantial pecuniary interest in the corporation for the term of the contract. The explanation given in the registration statement was therefore an untrue statement of a material fact requiring the issuance of a stop order, in spite of the fact that no error was found in the financial statements. And where the evidence reveals that the accountants completely subordinated their judgment as accountants to the desires of their client in setting up items in the financial statements, the requirement of independence obviously is not fulfilled.[32] Even though there is no relationship of the type involved in the *Cornucopia* case, the falsification by an accountant of an item in the balance sheet, for whatever motive, destroys the basis for an inference of an approach to his work with independence and complete objectivity free of alliances with the corporation.[33]

The second line of inquiry has to do with the qualifications and

[31] In the Matter of Cornucopia Gold Mines, 1 S. E. C. 364 (1936). To the contention of counsel for the registrant that a certification by and of itself is not a material fact but a mere "tag" attached to the financial statements certified to, the commission replied that it is a material fact, that the real function performed by a certification is the submission to an independent and impartial mind of the accounting practices and policies of registrants. Ibid. at 367 (1936).

[32] In the Matter of Metropolitan Personal Loan Co., S. E. C. Securities Act Release No. 1594 (Oct. 28, 1937).

[33] In the Matter of American Terminals & Transit Co., 1 S. E. C. 701 (1936).

integrity of the experts themselves and with the methods and standards which they employ in carrying on their work. While the commission has not designated rigid qualifications characterizing the expert, it has indicated that training, integrity, intelligence and experience are included among them, and that one who is an expert brings to his work knowledge and skill which are the substance of his profession and which are evinced by his use of the principles and procedures normal to others in his field.[34] To represent as an expert one who does not measure up to this standard is therefore a misrepresentation of a material fact.[35] Not only must the expert himself meet the qualifications named, but also the conclusions which he expresses in a report must be based upon an exercise of technique and procedure common among the class of experts with which he identifies himself. Thus, it is held that valuations contained in an appraisal purporting to follow certain norms are representations that these norms have been followed; if they are not fairly observed, the valuations finally arrived at are in essence misrepresentations of fact because they describe untruthfully the basis upon which the valuations are made.[36] Again, a material misrepresentation of fact results from a report on ore bodies which neglects fundamental principles of scientific method, disregards and fails to reveal known facts, and conceals from the investor the information that many of the conclusions reached are the product of mere guesswork.[37] Still another attack may be directed at the report if the method followed by the expert is unsound, as illustrated by the *La Luz Mining Corporation* case.[38] The description in the report of the depth and width of ore veins and the gold content thereof was based upon an "examination" of the property by an alleged scientist who used a mineral indicator consisting of a leather cylinder suspended from a thong, the oscillations of which were supposed to determine

[34] In the Matter of Gilpin Eureka Consolidated Mines, Inc., 1 S. E. C. 752 (1936); In the Matter of Consolidated Mines Syndicate, S. E. C. Securities Act Release No. 1448 (May 20, 1937).

[35] In the Matter of Gilpin Eureka Consolidated Mines, Inc., 1 S. E. C. 752 (1936).

[36] In the Matter of Haddam Distillers Corp., 1 S. E. C. 37 (1934); In the Matter of Gold Dust Mining & Milling Co., S. E. C. Securities Act Release No. 1654 (Jan. 12, 1938).

[37] In the Matter of Big Wedge Gold Mining Co., 1 S. E. C. 98 (1935); In the Matter of Franco Mining Corp., 1 S. E. C. 285 (1936); In the Matter of Livingston Mining Co., S. E. C. Securities Act Release No. 1368 (April 3, 1937); In the Matter of Gold Dust Mining & Milling Co., S. E. C. Securities Act Release No. 1654 (Jan. 12, 1938).

[38] In the Matter of La Luz Mining Corp., 1 S. E. C. 217 (1935). At page 222 the commission says, significantly: "Science and common sense combine to tell us that gold cannot be located by the use of 'doodle bugs.' It would be well for the investing and speculating public's pocketbook if this lesson could be thoroughly learned. It is in the hope that something to this end may be accomplished that this opinion is written."

the location and content of ore veins. On the basis of evidence introduced by its own experts the commission characterized the method employed in using this "doodle bug" as ludicrous, and held the description misleading in the absence of a disclosure of the exact nature of the examination of the ore veins.

4.

The registration forms call for a statement of the uses which the registrant proposes to make of the proceeds to be obtained from the sale of the registered securities. In cases where the proceeds are used for working capital, it is often quite impossible to state detailed uses in the case of established businesses. In new enterprises, however, the item relating to the proposed use of proceeds is of much greater significance and is closely allied to the item calling for a statement of the business done or intended to be done. That such facts are material is not open to question, since investors must have a forthright statement of the registrant's plans and intentions in order to be informed accurately as to the character of the proposed investment.[39] The commission has made it clear that the item is not completely answered by mere general statements which present no program from which the investor may adequately judge the possibilities of an early return upon his investment or the length of time his capital must remain unproductive.[40] Consequently, where it is said that the funds will be used for "operation and administration expenses until the mining properties are on an income producing basis," the absence of any reference to the fact that the condition of the properties may make unwarranted a prompt expenditure of such nature is held to be misleading.[41] But while a misrepresentation or omission may result from a statement too general in nature where a more detailed one is possible, the same consequences follow a statement which goes to the other extreme and gives excessive detail where such certainty is not possible.[42] If overdone, details can mislead rather than inform, and if there is a reasonable probability that the corporation will have no use for a portion of the funds which it is seeking, the truth of the situation requires that the investor be informed of this fact. The allocation, in other words, must show a concrete plan of development or operation and not an arbitrary list of estimates which are the product of guesswork.[43]

[39] In the Matter of Corporate Leaders Securities Co., S. E. C. Release No. 1534 (Aug. 21, 1937).

[40] In the Matter of Lewis American Airways, Inc., 1 S. E. C. 330 (1936).

[41] In the Matter of Consolidated Mines Syndicate, S. E. C. Securities Act Release No. 1448 (May 20, 1937).

[42] In the Matter of Snow Point Mining Co., Inc., 1 S. E. C. 311 (1936).

[43] In the Matter of Emporia Gold Mines, Inc., S. E. C. Securities Act Release No. 1401 (April 23, 1937); In the Matter of Crusader Aircraft Corp., S. E. C.

Stop orders are certain to result where the registration statement presents a distorted picture of the work to be done with the proceeds of the security issue. In the *Major Metals Corporation* case[44] the registrant stated that it intended to carry on an examination of certain mining properties and to bring them into profitable production. Because of the omission to disclose that examination of properties requires a long time, that production of ore for shipment may be delayed as long as two years after acquisition of the property, and that a still greater length of time must elapse before any dividends can be paid, the commission held that this optimistic outlook without any substantiating evidence constituted a misrepresentation of fact. In the *Yumuri Jute Mills* case[45] the registration statement conveyed the impression that certain franchises, privileges and exemptions for the manufacture of burlap bags in the Cuban sugar industry were monopolistic in character, when in fact they were dependent upon the fulfillment by the registrant of many conditions precedent. Since failure or inability to perform such conditions would materially affect the estimated profits and success of the business, the inadequate character of the disclosure constituted an omission to state material facts necessary to correct the misleading impression. Past failure of a business is likely to color the use which will be made of the proceeds, and obviously enough any misdescription of such past business which holds out an allure of possible future profit while concealing previous difficulties is materially misleading.[46]

5.

Because the prospectus presents in condensed form the information set forth in the registration statement and because it is primarily a selling document, it requires careful drafting in order to be free from misrepresentations and omissions of material facts.[47] Within the general

Securities Act Release No. 1677 (Feb. 11, 1938); see also MacChesney and O'Brien, "Full Disclosure Under the Securities Act" 4 LAW & CONTEM. PROB. 133 at 147, 148 (1937).

[44] In the Matter of Major Metals Corp., S. E. C. Securities Act Release No. 1280 (Feb. 25, 1937).

[45] In the Matter of Yumuri Jute Mills Co., S. E. C. Securities Act Release No. 1303 (March 4, 1937).

[46] In the Matter of Virginia City Gold Mining Co., S. E. C. Securities Act Release No. 1615 (Nov. 16, 1937); In the Matter of Kinner Airplane & Motor Corp, Ltd., S. E. C. Securities Act Release No. 1644 (Dec. 17, 1937); In the Matter of Crusader Aircraft Corp., S. E. C. Securities Act Release No. 1677 (Feb. 11, 1938).

[47] "The prospectus is meant to be an epitome or summary, and, obviously, cannot be as discursive as the longer registration statement. The rule [Rule 821, GENERAL RULES AND REGULATIONS UNDER THE SECURITIES ACT OF 1933 (1937) CCH SECURITIES ACT SERVICE, ¶ 5821] clearly indicates that the prospectus is not to contain the same degree of particularity as the registration statement. It is patent, therefore,

requirements of fair disclosure set by the act itself, the registrant is permitted an almost unlimited choice of method of presentation. Although all the essential facts are presented at some point within the prospectus, the statutory standard may still be violated through artful arrangement of presentation. This is so where untrue statements made at one point are sought to be cured by subsequent contraditions elsewhere in the document[48] and where an inexact statement is not qualified at the exact point where it is made, even though it is susceptible of correction from information supplied elsewhere.[49] The same type of arrangement renders a prospectus deficient if it diverts the attention of the reader from the fact that disclosure of material facts is being made.[50] Generally speaking, the combination of the items in the prospectus will reveal the character of the offering being made; but if the cumulative effect of the individual items is intentionally concealed by their segregation in the prospectus so that the impression created is fundamentally untrue and misleading, the commission may challenge it on the basis that its general effect as an entirety is to create an untrue picture.[51]

There are, however, a variety of ways in which specific items render the prospectus deficient. Especially subject to condemnation is the use of a common term in a sense differing substantially from the generally accepted meaning, as it has in itself the capacity to mislead.[52] In one instance the prospectus, as well as the investment certificates themselves, stated that the certificates had a "maturity value" of $2,000 for each $1,200 which the investor agreed to pay; nowhere in the prospectus was there a clear statement of the fact, which appeared only

that condensation or summarization involves omission; for it is not to be assumed that surplusage is contained in the registration statement itself." S. E. C. Securities Act Release No. 874 (July 2, 1936).

[48] In the Matter of Continental Distillers and Importers Corp., 1 S. E. C. 54 at 80 (1935); In the Matter of Mining & Development Corp., S. E. C. Securities Act Release No. 1090 (Oct. 22, 1936).

[49] In the Matter of Gilpin Eureka Consolidated Mines, Inc., 1 S. E. C. 752 (1936); In the Matter of Bankers Union Life Co., S. E. C. Securities Act Release No. 1278 (Feb. 23, 1937).

[50] In the Matter of Income Estates of America, Inc., S. E. C. Securities Act Release No. 1480 (June 29, 1937). The prospectus was divided into two parts: "General Description," containing sales talk which glossed over the important facts; and "Technical Information," disclosing the material facts but couched in legal phraseology and prefaced with a statement to the effect that it contained information included in the registration statement filed with the commission.

[51] In the Matter of National Educators Mutual Assn., Inc., 1 S. E. C. 208 (1935).

[52] In the Matter of National Educators Mutual Assn., Inc., 1 S. E. C. 208 (1935); In the Matter of Bankers Union Life Co., S. E. C. Securities Act Release No. 1278 (Feb. 23, 1937).

from a careful reading of the registration statement, that the so-called $2,000 maturity value was the sum which the investor might obtain only when, as and if the market value of the underlying securities to be purchased with the investors' funds reached $2,000.[53] Of this the commission said:

> "the prospectus evidences a unified endeavor to distract the attention of the reader by importing to the concept of 'maturity value' a specious reality. . . .
>
> "The terms 'maturity' and 'maturity value' appear in this prospectus approximately twenty times. It is this constant reiteration of the terms which leads the reader to an acceptance of the terms with a meaning which they lack." [54]

It is likewise misleading for the registrant to use a name for the purpose of associating itself with some prominent organization,[55] or for a newly-formed organization to trade on and stress the name of its better-known trustee.[56] Specific items again play an essential part in respect to estimated profits to be made by the registrant. Obvious it is that in estimating profits for a new enterprise, the registrant cannot be held to too strict a standard; but when the estimated profits are unusually out of line with those of established concerns in the same business and the prospectus offers no data to support its forecast, the representation is misleading.[57] As to the objection that an estimate of profits, if erroneous, is not an untrue statement of fact since it relates only to the future and purports to be no more than a statement of opinion, the commission has said:

> "We cannot agree to this. The same considerations which apply to an engineer's report apply in lesser degree to estimates in a prospectus. Each derives whatever weight it has from an assumption that the known facts have been investigated and reasonable

[53] In the Matter of Income Estates of America, Inc., S. E. C. Securities Act Release No. 1480 (June 29, 1937).

[54] Ibid. at pp. 6-7.

[55] In the Matter of National Educators Mutual Assn., Inc., 1 S. E. C. 208 (1935).

[56] In the Matter of Income Estates of America, Inc., S. E. C. Securities Act Release No. 1480 (June 29, 1937). In the Matter of National Invested Savings Corp., 1 S. E. C. 825 (1936), the prospectus included an ostentatious display of pictures, names and biographies of nationally-known persons comprising the "General Committee of National Founders." They were entirely without advisory capacity, their primary function being the promotion of stock sales. The prospectus was held misleading as giving the impression that the group named were expending time and effort in the interests of the organization and that the investors were safeguarded thereby.

[57] In the Matter of American Kid Co., 1 S. E. C. 694 (1936).

conclusions drawn from them, and each is implicit with a representation to that effect." [58]

It has been the purpose of this comment to discuss the bases of stop orders issued by the Securities and Exchange Commission, with a view toward indicating the rules of action to be followed in supplying the information required by the registration forms. A study of the registration statements which have been accepted for filing by the commission would illustrate further what must be apparent from the decisions considered above, that the concept of "materiality" under the Securities Act is more comprehensive than ever before. The great majority of such registration statements undoubtedly evince an effort on the part of counsel to include every fact as to the materiality of which there might be any reasonable doubt; the treatment accorded the remaining few is fairly well indicated by the foregoing discussion.

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[58] In the Matter of American Terminals & Transit Co., 1 S. E. C. 701 at 739 (1936).