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AMENDMENTS TO THE SECURITIES ACT OF 1933

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COMMENTS

AMENDMENTS TO THE SECURITIES ACT OF 1933—Title II of the Securities Exchange Act of 1934 [1] amends the Securities Act of 1933.[2] These amendments make substantial concessions to the persistent and continuous clamor against the Securities Act. They will help to allay some of the fears of corporate managements and merchant bankers. The changes affect the definition section, the exemptions, the prospectus, the civil liabilities, and administration provisions.

Definition Section [3]

Few of the definition changes are of significance. Subparagraph (1) of section 2 as amended eliminates from the term "security,"

[1] The full text of the Securities Exchange Act of 1934 is printed on pages 30 and 31 of the New York Times, May 31, 1934. President Roosevelt signed the bill on June 6, 1934. For a comprehensive discussion of the stock exchange features of the Act see Tracy and MacChesney, "The Securities Exchange Act of 1934," p. 1025, supra.

[2] 48 Stat. 74, U. S. C. A. tit. 15, sec. 77a ff. (1933 Supp.). For a discussion of the Securities Act see 32 MICH. L. REV. 624 (1934).

[3] Sec. 201 (a), (b); unless otherwise indicated references in the notes to sections are to the Securities Exchange Act of 1934.

"certificate of interest in property, tangible or intangible." "Certificate of deposit for a security" and "fractional undivided interest in oil, gas, or other mineral rights" are added as is also "any interest" "commonly known as a security." [4]

"Issuer" as defined in subparagraph (4) of section 2 no longer includes a guarantor of the principal or interest of a security.[5] From the standpoint of regular guarantor corporations this change seems desirable. The parent-subsidiary guaranty problems do not seem to justify the retention of the excluded provision.[6] "Trustees or members" of an "unincorporated" association, the articles of which provide for limited liability of members, of a "trust, committee, or other legal entity" are not liable individually as issuers.[7] Carrying out the specific inclusion of "fractional undivided interest in oil, gas, or other mineral rights" within the term "security," "the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering" is specifically made an "issuer." [8]

Exempted Securities and Transactions [9]

Paragraph (2) of section 3 (a), which exempts securities issued or guaranteed by the United States, Territories, States, etc., is amended

(1) to eliminate the dubious modification of a public instrumentality, that is "exercising an essential governmental function,"

(2) to substitute "person controlled or supervised by . . . the United States" for a "corporation created and controlled or supervised by . . . the United States,"

(3) to include certificates of deposit for securities of, or guaranteed by, the United States, a Territory, the District of Columbia, a State, a political subdivision of a State or Territory, a public instrumentality of one or more States or Territories, or a "person" as indicated in (2), and

(4) to add banking institutions organized under the laws of the District of Columbia.[10]

[4] Sec. 201 (a).

[5] Sec. 201 (b).

[6] See, for example, U. S. C. A. tit. 15, sec. 770 (1933 Supp.).

[7] Sec. 201 (b). Just what the draftsman means by "other legal entity" is elusive. *Ejusdem generis* may make the whole clause inoperative.

[8] Sec. 201 (b).

[9] Sec. 202 (a), (b), and (c); sec. 203 (a), (b); sec. 204.

[10] Sec. 202 (a); sec. 202 (b) amends paragraph (4) of sec. 3 (a) by substituting "person" for "corporation." The explanation is the same as given in the text for a similar change.

Amendments (2) and (4) are obviously corrections of draftsman's slips in the original Act. Adding certificates of deposit for the enumerated public securities is obvious enough,[11] but why the class should not include all types of securities exempted by the paragraph is difficult to see.

Paragraphs (9), (10), and (11) are added to section 3 (a) of the Securities Act.[12] Paragraph (9) exempts securities "exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." This is taken almost verbatim from old section 4 (3).

Paragraph (10) is also taken from section 4 (3) but is a decided expansion of the former provision. This exempts securities exchanged "for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash. . . ." It will be recalled that the original provision was limited to the issue to "existing security holders or existing creditors of a corporation." Also the original provision limited the issue to "bona fide reorganization[s]" while under this new paragraph the exchanged securities are exempt "where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions . . . by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority. . . ."

The provisions of paragraph (11) are taken verbatim from section 5 (c). Section 5 (c) provided that sales of securities, "where the issue of which . . . [they were] a part . . . [are] sold only to persons resident within a single State or Territory, where the issuer of such securities is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory," could be made without complying with the registration and prospectus provisions under the limitations of said section 5. However, by putting this provision in section 3, such securities themselves are now placed in the exempt class.

In addition to the broadening of the language as it now appears in paragraph (10), the addition of paragraphs (9), (10), and (11) to section 3 makes all of these securities exempt from the provisions of the Act except, of course, where the Act specifically otherwise provides.[13] Under the old provisions of sections 4(3) and 5 (c), though

[11] The draftsman likely was thinking in particular of the Municipal Bankruptcy Act which was signed May 24, 1934.

[12] Sec. 202 (c).

[13] See, for example, U. S. C. A. tit. 15, secs. 77l, 77q (1933 Supp.).

the specific transactions were exempt the securities themselves were not, and in subsequent transactions involving such securities the registration and prospectus provisions applied.[14]

Section 4, which deals with exempted transactions, has been amended in three respects. The second clause of paragraph (1) has been liberalized by exempting "transactions by an issuer not involving any public offering," thereby eliminating the additional limitation in the original Act "not with or through an underwriter."[15] The seemingly impossible provision which exempted dealers' transactions except those "within one year after the last date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter . . . " has been made workable by changing the word "last" to read "first."[16] As this provision now reads dealers can readily determine the exemption.

Prospectus[17]

The first exception to the definition of "prospectus" in paragraph (10) of section 2 has been moderated. Under the old provision a communication was not deemed a prospectus "if it is proved that prior to such communication a written prospectus . . . was received by the person to whom the communication was made. . . ." Under the amendment the exception operates if "prior to *or at the same time with* such communication" a prospectus "*was sent or given to* the person to whom the communication was made."[18] Perhaps this amendment is significant only to the extent that as an evidentiary matter the proof of *sending* is less of a burden than the proof of *receiving*.

Under subsection (b) (1) of old section 10 a prospectus "used more than thirteen months after the effective date of the registration statement" had to contain information "as of a date not more than twelve months prior to such use." This provision made possible unnecessary hardship where the user could not get the more recent information. Congress recognized this and added to this paragraph (1) the following: "so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense."[19]

[14] See "The Securities Act of 1933," 32 MICH. L. REV. 624 at 639 (1934).
[15] Sec. 203 (a).
[16] Sec. 203 (a).
[17] Secs. 201 (c), 205.
[18] Sec. 201 (c).
[19] Sec. 205.

Civil Liabilities [20]

No part of the original Act caused more comment or justifiable criticism than those sections providing civil liabilities. It is not surprising, therefore, to find some modifications of these sections. Mr. Eustace Seligman, one of the critics of the Act, estimates "that the amendments remove about four-fifths of the gravamen of the objections to the original act." [21] These changes, in chronological order, deal with (1) reliance of plaintiff upon the misstatement or omission, (2) the right of defendant to rely upon the work of experts and "official persons" and upon public documents, (3) the standard of care of defendants, (4) the elements of damage, (5) the extent of underwriters' liability, (6) blackmailing or strike suits, (7) the period of limitations, and (8) the liability of "controlling persons."

(1) *Reliance.*[22] Under section 11 as originally enacted, where the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading" persons acquiring the securities could recover from those enumerated in the section without any proof of reliance upon the misstatement or omission. The writer has pointed out the justification for such liability during some period after the original issue,[23] and those strongly opposed to the Act likewise admit this point. The paragraph added to section 11 (a) requires the plaintiff to prove his reliance upon the untrue statement or omission (1) if the issuer "has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement" and (2) if the plaintiff acquired his security after such earning statement has been so made available.[24] Thus only those plaintiffs who acquire their securities during the year following the effective date of the registration statement still enjoy the same right that they had under the original section. It is impossible to say when the impetus of the original information ceases to be operative in affecting the market price, though perhaps six months more nearly approximates the period. The amendment, however, is a considerable concession. To the extent that it aids in allaying fears of business men and bankers it is highly desirable. That issuers will issue such statements in the shortest possible time goes without saying. Self-interest will dictate this policy. Likewise no underwriter's lawyer will over-

[20] Secs. 206 (a), (b), (c), and (d), 207 and 208.

[21] New York Times, June 6, 1934, pp. 31, 37.

[22] Sec. 206 (a).

[23] "The Securities Act of 1933," 32 MICH. L. REV. 624 at 652 (1934).

[24] Sec. 206 (a).

look this point in drafting the underwriting contract. It is true the change will not help with a foreign government security, for the governments issue no such "earning statement." Mr. Seligman points out that some corporations may not be in existence to issue such statements after one year.[25] This scarcely seems of consequence under the amendment nor indeed under the theory upon which the amendment was drafted.

This amendment also provides that the plaintiff may establish such reliance without proof of having read the registration statement. The rules of evidence have long permitted such proof. The addition of this provision may, therefore, be only a codification of such rules.

(2) *Defendant's Reliance upon Experts, Official Persons and Public Documents.*[26] This amendment lightens the burden of proof of a defendant whose liability is predicated upon a misstatement or omission in a registration statement which "part thereof" purports to have been made upon the authority of an expert (other than himself) or an official person or to be a copy of a public document. It changes the language of clauses (C) and (D) of section 11 (b) (3) so as to relieve such a defendant from the burden of proving that he had reasonable grounds to believe (1) the experts' (official persons') statements, (2) that there were no material omissions, and (3) that the registration statement fairly represented the experts' (official persons') statement. Similarly the burden of proof is changed as to copies of public documents. It is sufficient in these cases under the amendment for the defendant to sustain the burden that he had no reasonable ground to believe and did not believe that the statements were untrue or that there were material omissions. This modification is decidedly fair.

(3) *Standards of Care.*[27] Measuring the defendant's reasonable investigation and reasonable ground for belief by that of a "fiduciary" was one of the bogys of the original Act. Section 11 (c) dispenses with this word and enacts the reasonableness "of a prudent man in the management of his own property," the standard of a fiduciary.[28]

(4) *Elements of Damage.*[29] While there was no agreement between the supporters of the original Act and its opponents, section 11 was capable of the construction that a plaintiff need not show any causal relation between his damages and the misstatement or omission. The amendment to section 11 (e) does not change the plaintiff's burden but it does permit the defendant to prove that the loss had no causal relation with the misstatement or omission. The original Act never

[25] New York Times, June 6, 1934, p. 37.

[26] Sec. 206 (b).

[27] Sec. 206 (c).

[28] "The Securities Act of 1933," 32 MICH. L. REV. 624 at 655 (1934).

[29] Sec. 206 (d).

should have left any doubts about this right of the defendant. No intelligent person could view the old provision with equanimity.

The new paragraph (e) also eliminates the right of rescission, leaving the plaintiff to claim damages which may be the difference between the purchase price, "not exceeding the price at which the security was offered to the public," and "(1) the value thereof at the time the suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security . . . and the value thereof at the time the suit was brought."

(5) *Underwriter's Liability.*[30] Paragraph (e) as amended also limits the underwriter's liability (except underwriters who knowingly receive from the issuer for the underwriting some benefit in which all other underwriters do not participate) to damages not exceeding the "total price at which the securities underwritten by him and distributed to the public were offered to the public." The provision in many cases may not in fact limit such underwriter's liability. One can imagine a ten per cent participation and a ten per cent loss due to a misstatement. Theoretically the underwriter might in such or similar cases be called upon to respond in damages for the entire issue.[31] This conclusion, however, does not lessen the significance of the amendment. The amendment materially lessens the former possible liability where a participant might in rescission cases have been liable for the entire issue no matter how small his participation might have been.

(6) *Strike Suits.*[32] This same amended paragraph (e) gives the court discretion, in suits brought for damages, to "require an undertaking for the payment of costs . . . including reasonable attorney's fees. . . . " Upon judgment being rendered against one of the parties litigant, if the court believes the suit or defense to have been without merit, it may upon motion assess costs against the other party "in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit. . . . " The efficacy of this amendment is its own justification.

(7) *Period of Limitations.*[33] The period of limitations on actions under sections 11 and 12 (2) is reduced from two years to one year after discovery, or after discovery should have been made by the exercise of reasonable diligence. Likewise the period is reduced from two years to one year for violations of section 12 (1). The maximum

[30] Sec. 206 (d).

[31] See "The Securities Act of 1933," 32 MICH. L. REV. 624 at 653, 654 (1934).

[32] Sec. 206 (d).

[33] Sec. 207.

period for both sections 11 and 12 is reduced from ten to three years.

(8) *Liability of Controlling Persons.*[34] Those persons who control any person liable under sections 11 or 12 are now not liable if "the controlling person had no knowledge of, or reasonable grounds to believe, the existence of the facts by reason of which the liability of the controlled person is alleged to exist." The controlling person is reasonably safe now unless he colludes in the misrepresentation or omission.

Administration[35]

By section 210 of Title II the administration of the Securities Act is transferred to the Securities and Exchange Commission established by the Act. No other action could be imagined, nor indeed is desirable. This transfer becomes effective upon the expiration of sixty days after the date upon which a majority of the members of said Commission (three of five) have qualified and taken office.

There are two amendments to section 19 (a).[36] The first empowers the "Commission" to make rules and regulations defining "technical" terms used in the Securities Act. The second is highly important. It adds the following sentence to section 19 (a): "No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." Even though the Securities and Exchange Commission shall misinterpret its powers in making rules and regulations, acts done or omitted pursuant thereto will not be penalized civilly or criminally. With the spirit of helpful co-operation which the Trade Commission has shown and the confident expectation that the Securities and Exchange Commission will so continue, this amendment should completely remove any doubts felt by some lawyers concerning action to be taken in conformity with the new Commission's rulings.

By section 211 of Title II the Commission "is authorized and directed to make a study of investigation of the work, activities, personnel and functions of protective and reorganization committees in connection with the reorganization, readjustment, rehabilitation, liquidation, or consolidation of persons and properties and to report the result . . . and its recommendations to the Congress on or before January 3, 1936." That the operation of the Securities Act has been unsatisfactory with respect to committees is generally conceded. This section

[34] Sec. 208.

[35] Secs. 209 (a), (b); 210 and 211.

[36] Sec. 209 (a) and (b).

may bring a less objectionable scheme of control. The time interval does not help committees functioning meanwhile. The importance of the problem would seem to justify refusal to take precipitate action.

These amendments will not satisfy the critics of the Securities Act. They leave many ambiguities and obscurities to the slow, tortuous course of judicial decision. That they meet in part some of the more vital criticisms is apparent. How far they will go in opening up financing and refinancing will only be answered by experience. Honest, reasonably prudent business men and bankers can now secure counsel's advice that their risks in floating issues are not too prohibitive.[37]

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[37] With the difficulties of securing these amendments so clearly in mind, the business men and bankers should make some effort to prevent the wrath of an aroused public from again descending upon them. Particularly the investment bankers should under their Code attempt some internal policing.