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# CONTROL OF SECURITIES SELLING

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## I

## ANTI-FRAUD LEGISLATION

*Watson Washburn* †

PRESIDENT Roosevelt in his inaugural address stated as one of the most important immediate necessities of the country "a strict supervision of all banking and credits and investments." This statement is in line with his campaign criticism of the failure of the Republican national administration to check the inordinate inflation of security prices in 1929. There is no doubt that the President's program in this respect received a sympathetic hearing throughout the country. Many state legislatures are now considering changes in state laws regulating securities. It is interesting that some States with rigid blue sky laws seem to be quite as dissatisfied as other States which have so-called "anti-fraud laws." President Whitney, of the New York Stock Exchange, has joined in the demand for new legislation. In his address before the Cleveland Chamber of Commerce on February 28th, he urged the adoption of a federal corporation law, or failing that, of uniform state laws, strictly regulating the issuance of securities, requiring full disclosure of corporate finance and severely punishing corporate frauds. When the general public and the experts agree that something is rotten in the state of our security selling, it would seem to be time to consider the present state of regulatory statutes and how they may be modified or improved — always realizing, however, that it is impossible to create honesty by statute, and that the problem of investment is more one of education than of legislation.‡

* The article by Mr. Washburn and the one that follows, by Miss Steig, were written at the request of the Editor. Mr. Washburn was asked to present the advantages of controlling securities issued through fraud legislation; Miss Steig the advantages of control by means of state administrative regulation.

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‡ Since this manuscript was prepared for the press, President Roosevelt has recommended legislation similar to that proposed in this article. In his special message to

*Existing Types of Regulation*

The first comprehensive law regulating securities was enacted in Kansas in 1911. The picturesque name of "blue sky law" was given to this act, and to subsequent similar legislation, after a Kansas legislator exclaimed that certain swindlers would sell shares "in the blue sky itself."

Starting in the agricultural States of the Middle West, blue sky laws have now been enacted in 43 States. The essence of the blue sky law is to forbid the sale of securities until a state board or commissioner has passed upon the soundness of the issue. Some States require not only that securities be approved, but that in addition security dealers and salesmen be licensed. A few States confine the license to the dealer and do not concern themselves with the security.

New York, New Jersey, and Maryland deal with the problem from a different angle by means of the so-called fraud laws. These laws do not require the licensing of either dealers or securities, but give to the state attorney general broad powers to investigate any security dealings which he suspects may be fraudulent, to subpoena and examine witnesses and documents, to initiate proceedings to enjoin the sale of securities, and to prosecute if he finds cause therefor.

In addition, practically every State has in its penal code provisions for punishing the sale of stock by misrepresentation. These criminal laws, however, have been found in practice almost worthless in punishing complicated financial frauds on a large scale. Here, as is so often

Congress, printed along with the text of a proposed securities act in the New York Times of March 30, 1933, the President said:

> "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 a 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....
>
> "This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations." —*Ed.*

the case, the manner of enforcement is more important than the language of the law.

A striking proof of the importance of the method of enforcement is the success of the federal post office inspectors in obtaining convictions for mail fraud. Mail fraud prosecution by the federal government is now by far the most effective criminal process available against security swindlers.

In England, where there is no elaborate blue sky machinery, sellers of securities have to be extremely careful, as was exemplified when Lord Kylsant, head of the Royal Mail Steamship Line, served a year in jail after conviction on the charge of issuing a false prospectus for selling the company's debenture stock. The prospectus stated truthfully the average net income for the previous ten years, but the jury found that Lord Kylsant deliberately concealed the fact that the first three years of the ten — during the World War — were extremely prosperous as compared with the seven lean years that followed. When his sentence was affirmed by the Court of Criminal Appeal,[1] Mr. Justice Avory's opinion quoted Lord Macnaghten's aphorism in an earlier case,[2] "... sometimes half a truth is no better than a downright falsehood." He continued as follows:

> "The falsity in this case consists in putting before intending investors, as material upon which they can exercise judgment as to the existing position of the company, figures which apparently disclose the existing position but in fact conceal it.
>
> "In other words, the document implied that the company was in a sound financial position and that a prudent investor could safely invest in its debentures.
>
> "The implication arises particularly from the statement that dividends had been paid regularly over a term of years, although times had been bad — a statement which was entirely misleading; and the fact that they were not paid out of current earnings but out of earnings in the abnormal war period is omitted.
>
> "There is ample evidence upon which the jury could find the appellant knew of its falsity, knowing as he did of the means by which the dividends had been paid."

This decision will doubtless be widely cited in the United States as well as in England in litigation over fraudulent concealment in the sale of securities. But it is doubtful whether local prosecutors, judges,

[1] Rex v. Kylsant, 23 Cr. App R. 83, [1932] 1 K. B. 442.
[2] Gluckstein v. Barnes, [1900] A. C. 240 at 251.

or juries in this country will regard it as authority for criminal prosecutions, in the absence of some new legislative mandate.

*Relative Merits of Blue Sky and Anti-Fraud Laws*

The most elaborate blue sky law, if stringently enforced, certainly reduces the amount of wrongful stock selling within a State. On the other hand, it reduces the amount of legitimate security selling to at least the same extent, and probably to a greater extent, for many crooks operate in defiance of the blue sky restrictions, which of course no responsible financial firm could afford to do even if it desired.

The preceding paragraph assumes rigid enforcement. But it must be at once apparent that if rigid enforcement means a wise discrimination between good investments and hopelessly bad ones, it assumes almost superhuman foresight on the part of the state enforcement officer, whether the State be Idaho, Michigan, or New York. In Idaho most of the securities sold would be those of companies whose headquarters were in distant States or countries; the possible volume of sales would scarcely justify the expense of proving the value of securities to the Idaho official if he made a thorough investigation. On the other hand, if a blue sky commission were set up in New York City, where the volume of new financing is normally so great, one of two results must follow. If the commission conscientiously examined every proposition in detail, it could not possibly keep up with its docket; hundreds of companies would be compelled to wait years for their new money unless they went to some other nation for it, as they would be obliged to do. Or else, in order to keep up with its work, the commission would merely rubber stamp its approval on all issues submitted, and its entire labor, as well as the labor of the bankers and underwriters in preparing and filing the applications, would be worth exactly nothing.

Any commissioner or examiner who can intelligently pass on the soundness of all the security offerings in any of our great financial centers must be a man of extraordinary capacity, and it is too much to expect that such a man will be available in all the forty-eight States, or perhaps even in any one of them.

The case of the Monarch Royalty Company may be cited to show the difficulties which distant and busy blue sky commissions may find in detecting unsound practices. The Monarch Royalty Company dealt in oil royalties in the Southwest. It sold between six and seven million dollars worth of stock throughout the country, obtaining licenses in several States. It finally started an intensive selling campaign in New

York State. Prompt investigation by the Attorney General disclosed that while the company was paying monthly dividends of 1% and its statements showed ample earnings to cover the dividends, these earnings were arrived at by the simple process of frequent reappraisals of its oil royalties, the reappraisals being as a rule about double the amount paid for each royalty. The Attorney General promptly applied for a preliminary injunction, which was denied by the Supreme Court justice who was impressed with the large size of the defendant. However, the sale of its stock was effectively prevented in New York, and shortly afterwards the company went into receivership. Several of its principals have since been indicted for federal mail fraud.

The disadvantages of a rigid licensing of all securities are obviated in many States by exempting issues listed on one or more recognized stock exchanges. Unfortunately, as many States now realize better than they did in 1929, no stock exchange can wholly prevent fraudulent operations in its securities. The New York Stock Exchange is the leading exchange in this country in its standard of ethics, as well as in every other respect. Yet in the year 1930 alone ten actions were instituted by the New York Attorney General under the anti-fraud law involving the New York Stock Exchange securities or members. Most of these actions involved illegitimate pool operations.[3] The method employed is typically as follows. The manipulators who want to carry on an "operation" (as they call it) get in touch with some man who has a large block of some listed stock — very often the controlling stockholder — and obtain from him an option on all his stock on a rising scale of prices beginning at or near the prevailing market. Then they are ready to start their selling campaign. This includes one or more of the following: (1) a tipster sheet, ostensibly disinterested, which, after boasting that it recommends only listed stocks, under cover of sound advice on the general market circulates quantities of bullish propaganda on their particular stock, first by mail and later by telegraph; (2) fictitious or wash sales of the stock in large volume at advancing prices — that is, transactions in which the manipulators buy and sell to one another simultaneously, operating several accounts under dummy names in different brokerage firms; (3) the bribing of customers' men in various Stock Exchange firms to advise their own customers to buy the stock, the bribe usually being on a small percentage basis; and (4) the

[3] Mr. Howard C. Sykes, President of the New York Curb Exchange, in his recent annual report also called attention to the option evil, and asked corporate officers to exercise more care in the granting of options.

obtaining of favorable newspaper publicity for the stock, either through an advertising agency or directly through the financial writers. The worst examples of pool manipulation usually follow the granting of a call or option to an irresponsible person who then proceeds to secure distribution without being too scrupulous about the means he employs of educating public opinion.[4] These questionable, if not criminal, practices are in the long run just as inimical to the interests of the Stock Exchange as to the public at large, and the Board of Governors of the Exchange has always been ready to assist the state authorities in exposing and suppressing them. However, they do exist, and they are manifestly beyond the reach of detection by any blue sky commission in another State.

While state blue sky laws seem inadvisable so far as the licensing of securities is concerned, and while even the licensing of salesmen and dealers in a large State like New York may be too complicated for effective handling, there appears to be no sound objection to the licensing of salesmen in most States. To pass upon the competence and good character of an individual who can be personally examined and whose references can be looked up is a much easier problem than estimating the value of securities.

If it is true that the licensing of all securities sold within a State is generally beyond the capacity of any single state commission, we may ask whether there is any possible alternative remedy by legislation to prevent a recurrence of the admittedly appalling conditions of recent years.

*A Remedy — Federal Fraud Legislation*

The remedy which appears most promising is federal legislation — not a federal blue sky law, which would be infinitely worse than all the state blue sky laws put together, but a federal anti-fraud law.

By the success of its mail fraud prosecutions, the federal government has proved its ability to handle nation-wide swindles. Since 1889, when fraudulent use of the mails was made a crime, there has been a vast extension in other methods of fraud, which are equally amenable to federal jurisdiction and should be punished. It is now a commonplace practice for crooks to operate across state lines by means of the telegraph and long distance telephone; and sometimes for the express

[4] Incidentally, it might be useful to expand the law of agency in such cases by statute to provide that a stockholder or corporation giving an option on stock to facilitate its resale to the public shall be liable for any malpractices of the optionee or sub-optionees, at least to the extent of the money paid for the stock under the option.

purpose of avoiding the postal law they deliver their fraudulent wares by messenger. Radio broadcasting has already been employed, and we may be sure that television soon will be. It is a serious omission in the federal penal code that all interstate frauds are not punishable in the same way as the misuse of the mail.

But the new federal penal law should go much further. It should require that all corporations whose stock is to be offered to the public in interstate commerce or by mail should make a full disclosure of its financial condition and all facts bearing on the value of the securities offered, probably including the amount of the promotion profit or selling commission; it should prohibit the publication of tipster sheets which do not fully disclose the selfish interest of the tipster sheet in each of the securities which it recommends for purchase; and it should forbid all wash sales of stock, or sales of stock back and forth between affiliated corporations or jointly interested persons, intended to be published as bona fide sales and thereby to mislead the public.

Besides these additions to the penal code, there should be a federal anti-fraud law similar to the laws in effect in New York, New Jersey, and Maryland, giving to the Attorney General or some other federal officer power to investigate and enjoin all fraudulent practices in selling securities in interstate commerce or by mail. This federal official, with assistants strategically located throughout the country, and with the cooperation of the post office inspectors, would be in a far better position to deal promptly with large scale frauds than are the present uncoordinated state blue sky commissions. Furthermore, the federal office would be such a responsible and important one that the chances of securing the right type of incumbent would probably be better than could possibly be expected in any single State.

One activity that might engage the attention of such an officer even now when the appetite of the suckers is supposedly jaded, is the great number of gold mining promotions which are being eagerly offered to sucker lists made up of the stockholders of all the successful gold mines now operating. The Homestake Mine is probably the most successful and best known gold mine in the United States; its stockholders are now being bombarded with dozens of prospectuses and tipster sheets, mailed in distant States. Some of these may be legitimate, but, generally speaking, when a new promotion selects as its main selling point a comparison with the most successful established company in its field, we have a case calling for thorough investigation. And where stock offerings of a mine in one western State are mailed from headquarters in another western State to prospects in the East, the only agency which can promptly discover the essential facts is the federal government.

After our disastrous experiment with national prohibition (fortunately almost over now), we instinctively shrink from any new kind of federal control. However, the current banking crisis shows that nation-wide measures are required in dealing with the ramifications of finance. The proposed federal law would in general apply only to transactions beyond the boundaries of a single State. The sole exception would be the use of the mails, and the federal mail fraud law has been enforced successfully and without serious criticism for over forty years. Securities in a Michigan company, sold within Michigan, without the use of the mails, would be outside federal jurisdiction. This gap in the system is not serious, for swindlers seldom try to sell stock to neighbors. The shares in a dilapidated and abandoned gold mine in the West are invariably offered to farmers or city-dwellers further east, and vice versa. No single State can adequately supervise such transactions, and honest security dealers themselves would welcome the opportunity of dealing with one central authority instead of forty-eight.

The combination of a federal investigating office, having power both to prevent and to punish all fraudulent security practices, with state licensing or registration of individual salesmen, and state fraud laws where required by the volume of local security dealings, would serve as a formidable barrier to even the biggest and boldest financial bandits, provided always that the enforcement officials are of the right calibre.

## II

## WHAT CAN THE REGULATORY SECURITIES ACT ACCOMPLISH ?

*Olga M. Steig**

THE regulatory blue sky law has always had its critics. It is not surprising that, at a time of general business collapse, these critics should demand a new evaluation of securities regulation and that many of them should now advocate the repeal of regulative acts and the enactment of fraud laws. No one, however, so far as I know, has pointed out in precisely what respect the investor's position might have been improved under the protection of a fraud act instead of a regulatory law.

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Much of the present criticism is due to careless analysis or lack of information on the subject. Unfortunately, securities laws are under indictment because of losses incurred by investors which no legislation and no administrative body could have prevented — losses associated with changes in prices and values, with cyclic changes in national wealth. Are we to take the position that if we cannot prevent losses due to usual business hazards, or to fundamental changes in business conditions, we should do nothing to reduce investment losses due to any cause except legal fraud? Are we to close our eyes to countless unfair practices which, though they do not constitute legal fraud, are quite as potent in the toll they take from the savings of investors? We have passed through a long period — it may not yet be over — in which much of the financing was undertaken for the profit in the financing itself, not because it served any useful purpose in establishing or maintaining industry. It will take long to erase the memory of some of our inflation-mergers, of some of our holding company pyramids, of some of our so-called investment trusts. The development of our ultra convenient corporation laws,[1] and of the highly complex financial structures which became popular during the last decade, has emphasized the inadequacy of the doctrine of *caveat emptor* and demonstrated the need for controlling the securities business beyond the scope of legal fraud.

I.

The investment trusts, popular with many dealers just before and just after the 1929 collapse, offer an excellent example of the need for something more than fraud legislation. The problem is splendidly analyzed in a series of articles by John T. Flynn which appeared in the New Republic in 1930.[2] Not all of the investment trusts, of course, were unloading vehicles. But too many of them were. Before me lie the original offering circulars of two of them.

One was sponsored before the collapse by a dealer one of whose partners bears a name to which the Middle West had, for a half century or more, attached only honor and pride. The trust, the circular announces, is organized "for investment in sound equities. . . . [It] offers an opportunity for a diversified investment in the common stocks of our most important industries." I have searched in vain for information in

[1] John T. Flynn, "Why Corporations Leave Home," 150 Atlantic Monthly 268 (September, 1932), contains a noteworthy discussion of some of our "liberal" corporation laws.

[2] John T. Flynn, "Investment Trusts Gone Wrong," 62 NEW REPUBLIC, April 2 to 30, 1930 (pp. 181, 212, 240, 267, 294).

the circular as to the exact character of the portfolio. The investor, it seems, was asked to buy not on merit but on faith. More than a year after the initial offering, it became publicly known that the portfolio included a large block of stock of a corporation which for years had been in notoriously weak financial condition. Meantime the market had collapsed. The information had come too late to be of any benefit to the investor.

The other was conceived in 1930 by one of the oldest investment houses in the country, well known in the East and Middle West. The funds, so the circular says, "may be invested" in the bonds of twenty-eight companies whose names are listed. Recent examination disclosed the fact that the sponsoring house, in the boom period, had underwritten bond issues of twenty-six of these companies and that the "trust" relieved the sponsor of its holdings in these bonds at a figure substantially in excess of their market value. The other two companies, a strong public utility and a strong railroad, appear to have been included for window dressing, for the "trust" never owned any bonds of either. The bald fact is that the so-called trust was a vehicle for unloading on the public, by indirect means, securities which the sponsor well knew it could not market directly. The investor has been mulcted by practices such as these just as surely as he would have been by any outright fraud.

Of all the "synthetic" securities, as someone has aptly described securities rigged up to sell solely for the sake of the profit in their distribution, none has reflected such unsound principles in the rigging, or such misleading, if not deceptive, methods of sale as some of the fixed trusts. Their early history is tarred with secret profits, unconscionable loading charges, diversion of income to which the certificate holder was rightfully entitled, and other thoroughly nefarious practices. Such trusts, however, suited well the needs of many houses which, with their old markets gone, needed desperately something to sell. Of the two types — the accumulative and the distributive — the accumulative trust is the less objectionable. It is theoretically designed to afford the investor an opportunity to secure the advantages of investment in a diversified group of equities which are to remain unchanged throughout the life of the trust save for eliminations which may become necessary in case of passing of dividends or other conditions defined by the trust agreement. The return is limited to dividends received by the trustee on the deposited stocks. The distributive type, however, in which the distribution fund includes not only dividends on the stocks in the portfolio, but also proceeds from the sale of stock split-ups and stock dividends, presents, it seems to me, characteristics of the dishonest promotion enterprise. If it is proper to distribute to the investor, in the guise of a return on capital, the proceeds from the sale of shares of stock received on a stock split-up, then it is proper to pay dividends out of capital. There is no essential difference. The distributive type, fundamentally unsound, could not have attained any sales volume if the truth about it had been told. Competition, however, was so keen that even those sponsors that had rated as reliable houses were forced to overlook what they knew were fundamental weaknesses, and to create both distributive and accumulative trusts in order to take full advantage of marketing possibilities.

Financings such as these have had little official interference in the fraud law States, and, I confess, too little in many of the States with regulative acts. The significant point is that such financings are not fraudulent, but the unfair practices which have attended the set-up and distribution of many of them have been just as disastrous to the investor as any brazen fraud. Regulation has made marked progress in the correction of such practices and in forcing a more general acceptance of sound principles.[3] It can do more.

The failure of a Chicago real estate bond house some two years ago brought forth the startling disclosure that funds in its possession as trustee, intended for completion of buildings or for payment of interest coupons, serial maturities, taxes or insurance, were not available because the funds had been mingled with the firm's own funds and could not be identified. Investors, only a few weeks before the appointment of a receiver, had purchased "first mortgage" bonds[4] on a property in the process of construction on the assurance that the proceeds from the bond issue would be "sufficient to complete the building free and clear of liens." How would a fraud act have helped these investors? A fraud act by its very nature cannot reach matters outside the scope of fraud — that is to say, not without departing from the principle of fraud legislation and entering the field of regulation. Proper regulation, requiring segregation of funds by trustees and depositaries, would have prevented that disaster, just as it can prevent countless other unfair practices that fraud statutes cannot reach. It is not legal fraud to

[3] Wis. Stat. (1931), sec. 189.055, represents what is generally recognized as a carefully prepared code for fixed trusts. Other commissions have adopted rules and regulations somewhat similar to this code.

[4] Exempt in Illinois under Illinois Securities Act, sec. 4 (1919), Ill. Ann. Stat. (Smith-Hurd 1930), ch. 121½, sec. 99.

expend proceeds from stock sales, or to incur debts, before enough capital has been secured to afford reasonable assurance that the enterprise will actually be financed, but it is poor business and unfair to the investor. It is not legal fraud to use the proceeds from the sale of bonds to pay for construction costs of a building before sufficient junior funds have been invested, but again it is bad business and unfair — frequently disastrous — to the bond purchaser. The control of commissions paid for the sale of securities, the control of securities issued for claimed intangibles that may have little or no real value, the control of advertising matter in the distribution of securities are all of vital importance to the investor. Yet the attempt to meet these problems through a fraud act is frank admission of the need of regulation. A fraud act, designed to punish and enjoin fraud, cannot afford any real protection against the principal abuses in the securities business.

2.

I grant that existing regulation has left much to be desired. In most States there is room for improvement both in the act itself and in its administration, and the painful period through which we have just passed has brought to light many glaring inadequacies and shortcomings in both. Unless we are to take the position that the State's only function is to punish and enjoin fraud, the time is propitious for a thorough analysis of these shortcomings and thoughtful consideration of remedies. While there is little uniformity in our regulatory blue sky laws, the majority of them follow the same general pattern:[5]

1. Description of securities not subject to the act.
2. Procedure for securities subject to sale in advance of registration on notification — or subject to sale on notification without subsequent registration.
3. Registration procedure.
4. Procedure for dealers' and agents' licenses.
5. Prohibition against use of advertising that is false or misleading.
6. Civil remedies.
7. Criminal penalties.
8. Judicial review.

There is growing feeling among the members of the National Association of Securities Commissioners that one of the major weak-

[5] A more complete analysis of the regulative act is set forth in an article by Prof. Simpson, "The New York Blue Sky Law and Uniform Act," in 8 N. Y. UNIV. L. Q. REV. 465 (1931).

nesses in present laws of this type is the exclusion from the control of the act of securities for which no sound basis of exemption exists.[6] Particularly is this true, I believe, of the exemption accorded to securities because of listing on a stock exchange.[7] The exemption usually includes not only the specific security listed but also securities senior thereto. The arbitrary exemption of such securities, without any standard, because of supposed supervision, regulation, or investigation by some body other than an agency of the State, raises a serious constitutional question. In the exemption, the legislature grants to certain stock exchanges, over which it may have no control, powers far greater than it could constitutionally confer on the agency charged with the administration of the law. The powers of the administrative agency are limited to the application of the standards created by the legislature. It cannot act arbitrarily or set up its own standards.[8] Yet in the stock exchange exemption the legislature does not fix the standard. The exchange fixes it and the State accepts it.

The theory of the exemption — that listing affords the investor a ready market and adequate information concerning both the market and the financial affairs of the issuer — is not supported by the facts. The recent Insull and Krueger & Toll cases indicate not only that the investor could not obtain adequate information about these concerns but that the stock exchanges themselves had far from adequate data concerning their financial affairs. The theory that listing affords a ready market offers an excellent subject for extensive research. An analysis made in 1930 of the records of 165 issues listed on the Chicago Stock Exchange between January 1, 1926, and December 31, 1929, disclosed 51 issues in which there was not a single transaction reported on the floor during the entire period. Of 83 bond issues studied there were 33 issues in which the aggregate sales on the exchange were less than $10,000 each. There is little doubt that the listing in many of these cases was for the purpose of avoiding blue sky regulations rather than for any benefit that admission to the exchange list might create.

[6] See comments in note 9, infra.

[7] Michigan exempts only securities listed on the New York Stock Exchange. Sixteen States, including Illinois, Iowa, Minnesota, Ohio, and Wisconsin exempt securities listed on the Chicago, Boston, and New York Stock Exchanges *and securities senior thereto.* In some States the administrative body is given the right to approve the exchange. (Oklahoma, Indiana, Utah, Rhode Island, Arkansas, Mississippi.)

[8] Ex parte Kreutzer, 187 Wis. 463, 204 N. W. 595 (1925); People v. Federal Surety Co., 336 Ill. 472, 168 N. E. 401 (1929); Klein v. Barry, 182 Wis. 255, 196 N. W. 457 (1923).

The exemption extended to securities of public utilities providing the issue of the securities is regulated by a public service commission of another State[9] is also difficult to defend if the theory of adequate standards must be written into regulatory blue sky legislation. Here again the State fixes no standard. It accepts as a standard, in connection with the *sale* of such securities, the standards which another State has decreed shall control their *issue*. Nothing could be more fallacious, for the very nature of laws controlling the issuance of public utility securities is such that they do not accomplish the purposes of blue sky legislation. The disclosures in the recent *Foshay* case[10] afford a convincing example of the dangers inherent in the exemption.

Another flaw in the regulation of securities has been the lack of adequate control of advertising used in their distribution. No one will deny the need of curbing advertising matter that is false, misleading, inaccurate, or fraudulent. That, however, is not the major problem. Is there any justification for advertising that presents information unfairly, or that makes reference to matters of vital interest to the investor without presenting them with reasonable adequacy?

The subject is one to which the Investment Bankers Association has given consideration for at least a decade. In 1924 the committee on ethics and business practice outlined standards for circulars for holding company securities. At the 1925 meeting a special committee on circulars reported as follows:[11]

> "That some of the members who make a practice of dealing in securities of holding companies have given consideration to the recommendations . . . is evident. . . . It is equally apparent from the offerings of other houses that either the recommendations . . . have not been brought to their attention or that they have not carefully studied the principles defined therein."

Of industrial circulars the committee said:[12]

> "In some industrial circulars average earnings over a period of

[9] Thirty-two States grant exemptions of this character. The subject is more fully discussed in a paper delivered by Mr. George C. Mathews, Director, Securities Division, Public Service Commission of Wisconsin, at the 1932 convention of the National Association of Securities Commissioners. (Proceedings, N. A. S. C. 1932.) Mr. Mathews' address on the subject of exemptions at the 1931 meeting is somewhat broader in scope. (Proceedings, N. A .S. C. 1931.)

[10] Wilbur B. Foshay and others were convicted in 1932 in the Federal District Court in Minneapolis on mail fraud counts, involving the sale of securities of Public Utility Consolidated Corporation and other "Foshay" enterprises.

[11] Proceedings, Investment Bankers Association, 1925.

[12] Proceedings, Investment Bankers Association, 1925.

> years are given instead of actual earnings. This sometimes comes from the desire of the company not to be too explicit about its affairs, and sometimes from the desire of the bankers to avoid showing a bad year. The investor, however, is entitled to know exactly what kind of company he is going into and if it has fluctuating earnings or has had one bad year out of the last five or ten, this is part of the knowledge on which he should make his investment."

In discussing the prevailing mode of showing income available for particular charges the committee said:[13]

> "There is . . . hardly anything which shows the character of a management better than a three or four years' statement showing how all the money earned has been used. This may have gone into depreciation funds, reserves, or undivided surplus, or it may have been completely distributed or dividends may even have taken a larger amount than the company has earned. . . . [The investor] certainly is entitled to this information and it may as well be given him in the first place as after inquiry on his part."

In 1928 standards for circulars were again before the Investment Bankers Association and the committee, among other things, recommended that circulars include (a) information regarding the value of the property and the basis for the valuation, (b) balance sheet of the issuer or a clear statement as to capitalization, (c) statement of earnings, including operating ratio, information as to depreciation, ratio of net earnings to charges, and information as to the issuer's dividend record.

With such recommendations one might assume that at least on the part of the "good houses" there would be substantial compliance. The results of a study made in 1929 by the securities division of the Wisconsin Public Service Commission indicate quite the contrary.[14]

Circulars on forty-one utility issues were included in the study. There were a number of issues with national distribution and a number with more restricted distribution:

Twenty-eight circulars gave no information as to valuation.

Five gave no information as to capital structure.

Twenty-six showed the number of shares of common stock without

[13] Proceedings, Investment Bankers Association, 1925.

[14] The study referred to formed the basis of the report made by the committee on public utility securities before the 1931 meeting of the National Association of Securities Commissioners. (Proceedings, 1931, p. 163.)

any information as to the value of the equity or the amount invested in the stock.

Only eight circulars showed either the investment in the common stock or its value as measured by the market price.

Only two circulars contained balance sheets.

Only six circulars gave any definite information as to provisions for depreciation or retirement.

The excess of operating revenue over operating expense was variously called "available for depreciation, depletion, federal taxes and return," "balance," "net earnings from operation," and in one case "net profit"— the two latter obviously incorrect.

Not one circular complied with the recommendations, which admittedly are not unreasonable. If that is the performance of the better houses, what can be expected of those who are not members of the association and who have no moral obligations to abide by its recommendations or its code of ethics? Here again regulation *can* be effective. In 1925 one State stopped the use of a circular in which only average annual earnings over an eight-year period were stated, and in which nothing was said of the substantial losses in the last four of those eight years.[15] In 1929 a middle-western State effectively stopped the use of the phrase "first mortgage and collateral trust" as the designation for a million dollar bond issue, the first mortgage security for which was, to be sure, represented by all the physical property to which the corporation had title, but the property, at its own figures, had a value of only $12,000! The corporation was primarily a holding company.

Still another flaw in most regulatory acts is the failure of adequate control over the dealer. There are hundreds of dealers throughout the country who thrive by trading customers out of good securities and selling them weaker issues on which they can make a few points profit; or by selling inactive bonds on which market quotations are never published, and on which they take all the profit they dare — not two points, or even five, but ten, twenty, and even thirty! Is any dealer entitled to continue in business, with the sanction of the State, if he engages in a course of business evidencing absolute disregard of the interests of the customer? The relationship between the dealer and the investor has some of the characteristics of a fiduciary relationship. The dealer is not selling shoes or coffee or table linen. He is selling an in-

[15] A case not unlike the recent notorious English case in which Lord Kylsant was held for fraud. Rex. v. Kylsant, 23 Cr. App. R. 83, [1932] 1 K. B. 442.

tangible in the selection of which he is presumed to have greater skill than the customer. The customer places confidence and trust in him and relies on his superior knowledge and skill in the matter of investments. If the dealer accepts this situation, he assumes the moral obligation that accompanies it, that of considering the customer's interest. Again the matter is one for regulation.

The matters to which I have referred are only a few of the almost countless unfair practices that have prevailed in the securities business. They are sufficient to suggest the urgent need of a remedy that goes farther than the punishment of fraud.

There is, of course, one weakness in the present situation with which the State itself cannot deal. However far it may go in regulating the sale of securities *within* the State, its control cannot extend to transactions which take place through channels of interstate commerce. Thus securities sold through the mails, or by telephone or telegraph, are free from any control by the State. Several years ago the National Association of Securities Commissioners appealed for federal legislation, patterned along the lines of the old Webb-Kenyon liquor law, forbidding the use of channels of interstate commerce for the sale of securities to residents of a State within which such sale would be illegal. Congressman Denison of Illinois introduced bills at two sessions of the Congress dealing with the question, but they failed of passage. The present prospect of some sort of federal legislation is more encouraging.

The case for regulation has not been submerged by the swift currents of our financial affairs during the last few years. On the contrary, the experience of these years has disclosed abuses and unfair practices in the securities business which only regulation can correct. It has, to be sure, demonstrated the inadequacies of present legislation. Yet regulation has made progress and with an effective act, intelligently and fearlessly administered, it can go far to reduce losses due to unfair, deceptive, and inequitable practices, against which investors are entitled to protection.