Michigan Law Review

Volume 31 | Issue 8

1933

THE NEW FEDERAL SECURITIES ACT

John E. Tracy
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Securities Law Commons

Recommended Citation

John E. Tracy, *THE NEW FEDERAL SECURITIES ACT*, 31 MICH. L. REV. 1117 (1933).
Available at: https://repository.law.umich.edu/mlr/vol31/iss8/6

This Comment is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

THE NEW FEDERAL SECURITIES ACT[1]— A proper understanding of the purposes of this new Act and the reasons for its enactment can probably best be obtained by a short discussion of the manner in which the sale of securities has been regulated prior to this time.

[1] The full text of this Act, approved May 27, 1933, will be found in the UNITED STATES NEWS, vol. 1, no. 2, p. 8 (weekly issue of May 20-27, 1933).

I.

Until the year 1911 practically the only control of security sales anywhere in this country (other than the laws in the several States prohibiting frauds in general) was that exercised by the various stock exchanges of the country, particularly the New York stock exchange, in limiting securities which might be traded thereon to those which had been carefully investigated by the exchange and admitted to listing as being (at the time of listing) sound securities of sound companies.[2]

In the year 1911 the first so-called Blue Sky law was enacted in the State of Kansas, its popular name being derived from the statement of one of the sponsors of the legislation that "the operations of promoters have become so bold that they are actually trying to sell to the gullible public the blue sky above us." Following this legislation in Kansas the various other States proceeded to adopt similar statutes, with the result that, at the present time, all but two of the States of the Union have legislation on this subject.

The legislation which has been enacted will be found to be of one of two general types.

The type that has been adopted in the greater number of jurisdictions is the licensing[3] system, which provides that securities may not be sold in the State without obtaining permission for such sale from some named officer or body. Such an act also requires that an application to sell be made by the issuer and by the dealer in the securities, setting forth certain specified information as to the nature of the issuer, the type of security, and a large amount of detailed information as to the financial condition of the issuer, its properties, its past earnings, etc. The official in charge of the enforcement of the securities act, sometimes the Secretary of State, sometimes the Banking Commissioner, more often a special Securities Commission, goes over the data submitted and if the security appears sound within the requirements of the act,[4] the applicant is granted leave "to file" his application. The effect of filing is to permit the sale of the securities in that State, subject to the right of the State to revoke the authority granted.

Recognizing that there are large numbers of securities whose soundness is undertaken to be protected through other agencies and that there

[2] For a discussion of the requirements for stock exchange listings, see 19 FLETCHER, CYCLOPEDIA OF CORPORATIONS, Perm. ed., sec. 9207 (1933).

[3] The word "licensing" is used here only for convenience, as such securities acts are very careful to insist that the action of the state authorities shall not, in any respect, be regarded as a licensing of the security for sale.

[4] Such requirements usually are that the corporation shall not only have substantial assets in excess of all securities issued, but that it shall have a record of earnings sufficient to insure a return on such new securities. A security of a new company which has no record of earnings for itself or its predecessors is required to be advertised and sold only as a "Speculative Security."

are large numbers of transactions in which the State is not interested, in that the participants therein are well able to look out for themselves, such a statute will grant a large number of exemptions, commonly referred to as "exempt securities" and "exempt transactions."

Examples of exempt securities are government, state and municipal bonds, bank and insurance company stocks (the issuance of which is otherwise regulated by the State), securities of public utilities the issuance of which has been approved by a Public Utility Commission, securities listed and dealt in on the New York stock exchange and such other stock exchanges as the statute may recognize, bonds secured by a mortgage lien upon real estate where the loan does not exceed a certain percentage of the fair market value of the property, and securities issued by any corporation not for profit.

The exempted transactions include sales by an individual of his own securities for his own account, capital stock of a corporation sold to its stockholders without commissions to agents or brokers, sales made by or to any bank, sales made to any broker or dealer, judicial sales, etc.[5]

The other type of legislation, which has been adopted in a few States, is the "fraud" type, probably the best example of which is the so-called "Martin Act"[6] in New York. This act provides that whenever it shall appear to the Attorney General, upon complaint or otherwise, that in the advertising, purchase, or sale of securities or commodities fraud is being committed, he may institute an investigation and enjoin the perpetration of such fraud and may criminally prosecute the perpetrators thereof. It will be noted that the principal effect of such legislation is to lock the door after a large number of the stable full of horses have been stolen. Nevertheless, the various Attorneys General have taken their duties seriously and there is little question that a large amount of fraud has been prevented through the use of this act.[7]

[5] For a more complete discussion of Blue Sky laws of the licensing type see 19 FLETCHER, CYCLOPEDIA OF CORPORATIONS, Perm. ed., sec's 9217-9233 (1933); also Steig, "Control of Securities Selling," 31 MICH. L. REV. 775 (1933).

[6] The history of the enactment of such legislation in New York is not particularly creditable to the citizens of that State. Inasmuch as a very large percentage of all securities sold in the country originate in New York, it was contended for a great many years that many of the fraudulent practices in the sale of securities could be stopped by the enactment in New York of a wise, sound, and rigorously enforced Blue Sky law. All attempts to secure the enactment of such legislation, however, were strenuously fought by most of the prominent business men and bankers of New York, including even such reform organizations as the City Club. The reasoning of such opponents of the legislation was that its enactment would not only strangle New York as a financial center but that (apparently) New York public officials are so dishonest that to have any provision for the licensing of the sale of securities would open the door to a tremendous amount of graft. So insistent, however, became the demands for some legislation on this subject that, as a compromise, such opponents reluctantly consented to the enactment of the Martin Act.

[7] For a more complete discussion of this type of legislation see 19 FLETCHER,

The business depression which began in 1929, resulting in so many defaults in the payment of dividends and interest on stocks and bonds purchased by the investing public during the period of boom, in the belief that they were sound, has resulted in a demand from investors for more stringent laws to regulate the sale of securities. A study of the results of the Blue Sky laws in the various States showed that they had not been as effective as had been hoped. The trouble with the fraud type of legislation was apparent, in that nothing was done to protect investors until some one person had been defrauded and had made complaint. The principal defect in the legislation of the licensing type was found to have been in two of its exemptions, those for listed securities and for mortgage bonds. When first enacted, the Blue Sky statutes confined the exemption for listed securities to those listed on the New York stock exchange. In view of the very rigid listing requirements of that exchange all will probably agree that such exemption was well justified. It soon happened, however, that the legislatures, sometimes out of local pride, began to add listings on other exchanges to the exempted securities,[8] and on many of these added exchanges the listing requirements were not adequate to protect investors. For example, it frequently occurred that when it was found that a bond issue could not be licensed for sale in certain States under the Blue Sky laws because of insufficient earnings in the past, the difficulty was easily solved by having the bonds listed on one of the minor exchanges, thereby becoming exempt from the requirements of the Blue Sky laws.

Bonds were usually exempt if secured by mortgage on real estate if the bonds issued did not exceed a certain percentage of the value of the security, usually from 60% to 75%. There was no requirement that the corporation should have any earnings with which to pay interest on such bonds. It was this exemption, in the opinion of the writer, that led to so much loss by investors in bonds secured by mortgages on hotels, apartment houses, office buildings, etc. Due to the great increase in building costs during the period of the boom, it was not at all difficult to obtain appraisals of property at a figure safely in excess of the bonds issued against the same, and this exemption resulted in a large amount of so-called "100% financing" of business buildings. For example, a hotel would be purchased for $1,000,000, appraised at $1,500,000 (that being the estimated cost of reproduction new, less depreciation), and the purchase could be financed by a first mortgage

CYCLOPEDIA OF CORPORATIONS, Perm. ed., sec. 9234 (1933); see also Washburn, "Control of Securities Selling," 31 MICH. L. REV. 768 (1933).

[8] In Illinois the exchanges now include not only the New York Stock Exchange but the Boston Stock Exchange, Chicago Stock Exchange, Chicago Curb Exchange, and Chicago Board of Trade.

bond issue of $1,000,000 which would be only a 67% loan against the appraised value of the real estate.

It was felt by many that the best answer to the complaints of investors would be to remove from the list of exemptions all listed securities except those listed on the New York stock exchange and all real estate mortgage bond issues, and to have enacted and put in force in all the States of the Union a licensing procedure similar to that in effect in such a State as Wisconsin. Instead of this being done, however, it was decided that the federal government should step in. The President recommended and Congress has enacted a new federal statute.

2.

The federal statute, to be officially cited as the "Securities Act of 1933," is based on a theory different from either of the forms of legislation hitherto discussed. The Act provides that before any security can be sold in interstate commerce, advertised through the mails, etc. (with certain very limited exemptions hereinafter mentioned), it shall be registered with the Federal Trade Commission on a set of blanks containing a very large amount of information regarding the issuer, the dealer or underwriter, the nature of the security, the terms of sale, etc. Examples of the information required are the names and addresses of the directors and the chief executive, financial and accounting officers of the issuer, the names of all persons owning more than 10% of any class of stock, full information about the funded debt, the purposes for which the funds are to be used, the remuneration paid to all of its officers and directors during the past year wherever it exceeds $25,000, the price at which the security shall be offered to the public and any variation therefrom to large purchasers, all commissions and discounts to the underwriters, the amount of all expenses in connection with the issue, the names and addresses of the vendors who are selling property to the issuer, full information as to all unusual contracts of the issuer, including management and bonus contracts, a balance sheet showing, among other things, any loan in excess of $20,000 to any officer, director, or stockholder, an earnings statement for the past three fiscal years showing detailed information as to the charges against surplus and as to depreciation, depletion and maintenance charges, etc. As to securities of foreign governments or a political subdivision thereof, certain other detailed information is required to be furnished, including the price paid for the securities, the price at which they are to be sold to the public, the agreement with the underwriters, etc.

Although the Federal Trade Commission is given broad jurisdiction to investigate the registration and to determine whether fraud is being perpetrated on the public so that such registration may be enjoined, there is no requirement for licensing. If no action is taken by

the Commission to issue a stop order restraining the effectiveness of such registration within 20 days after the filing of the same, the issuer and the dealers and underwriters may proceed with the sale of such securities, subject to certain very severe penalties if any of the information contained in the registration is found to have been false or inaccurate. These penalties are not only criminal prosecution against every person having anything to do with the preparation or filing of the registration statement, but a civil cause of action by any person acquiring a security against every person who signed the registration statement, every director of the issuing corporation, accountants, engineers, appraisers, underwriters, etc., which cause of action may be either for the recovery of the consideration paid for such security or for damages, if the purchaser no longer owns the same. The liability of the director of the issuer is not absolute; he is excused if he shows that he acted upon the report or valuation of an expert and had good reason to believe that the statements therein were true.

The list of exemptions from the application of the act is a small one, including securities of the United States, the various States and the municipalities thereof, securities issued by national and state banks, securities issued in current transactions having a maturity not exceeding nine months, securities issued by corporations not for profit, securities of building and loan associations, securities of common carriers issued with the approval of the Interstate Commerce Commission, and insurance and endowment policies by insurance companies acting under the supervision of an insurance commissioner. The Commission is authorized to create additional exemptions but not where the amount of securities to be issued exceeds $100,000. The Act also is not to apply to sales of securities between individuals, to transactions by an issuer not through an underwriter and not involving any public offering, to brokers' transactions executed upon customers' orders on any exchange or in the open or counter market, to the issuance of a security by an issuer to its existing security holders exclusively where no commission is paid, and to the issuance of securities to existing security holders or creditors on reorganizations.

Like all pieces of legislation which are introduced in a certain form and, in their passage through the legislative body, are amended to suit the wishes of some particular Senator or Representative, the Act has certain ambiguities and inconsistencies which will doubtless have to be ironed out by rules of the Commission or by amendments. For example, section 3 (a) (1) undertakes to exempt altogether from the act municipal bonds, while section 17 (c) provides that no securities shall be exempt from the somewhat elaborate provisions of such section 17. Again, while section 4 (2) exempts brokers' transactions executed upon customers' orders on any exchange or in the open or counter market, it

does not exempt such transactions or orders if they were solicited. Inasmuch as the great bulk of brokers' business is solicited from customers, it is questionable what effect the Act may have on the brokerage business.

One effect of the new Act will be to make much more difficult and complicated the financing of new business enterprises, which is no real criticism of the Act if, as a consequence thereof, investors are to be better protected in their investments. The question is how far this will be the case. There is nothing in the Act which will protect either a wise or an ignorant man from loss on an uneconomic investment if there was no fraud in the representations made in the registration. For example, the registration may show that the corporation has never had a record of earnings that will assure the payment of dividends or interest on the securities sold, unless the rosy hopes of the promoters are realized, but such securities can be safely sold without fear of penalty, although they could never be sold in a State with a properly administered licensing act unless expressly labeled, "This is a speculative security."

The writer has asked himself this question: If such legislation had been in force during the period from 1919 to 1929, when a large proportion of the bonds which are now in default were issued, how effective would it have been in protecting bond purchasers from the consequences of unfortunate investments? There is probably little question that, during such period of time, certain securities were sold on the market which were either fraudulently issued or fraudulently sold; also that, during such time of prosperity, securities of certain companies were issued on a "100%" basis where the public furnished all of the money and the promoters took the profits without any of the risks of the enterprise. In such cases it might be assumed that the purchasers of bonds would not have bought if they had been given full information about the nature of the security, the commissions paid, etc., although the writer is not so certain about this if the promised yield on the bond was attractive.[9] On the other hand, it is probably unquestioned that the troubles of the holders of by far the largest amount of securities now in default are due, not to any actual fraud having been perpetrated upon them or to any lack of information which would have been supplied by the provisions of this new Securities Act, but to the fact that the enterprise in which they made their investment, either of bonds or of stock, was not economically justified. The facts will show that the great losses by holders of bonds secured by mortgages on apartment houses, hotels,

[9] The writer cannot forget that in a certain corporate reorganization in which he was consulted it appeared that a large number of investors, with a full knowledge of the facts, had deliberately chosen to purchase a 7% second mortgage bond rather than a 6½% first mortgage bond on the same property, merely that they might obtain the ½% higher yield.

office buildings, warehouses, etc., were principally due to the fact that there was such overbuilding that there were not sufficient returns from the enterprises to pay interest on the investments. There were not sufficient tenants for all the office buildings or apartment houses, not sufficient guests for the hotels, not sufficient commodities to be stored in the warehouses. It is difficult to see how, in any of those cases, the filing of information with the Commission in connection with the sale of those securities would have helped the purchaser, for such information would never have shown the conditions which made these enterprises economically unjustifiable.

Not even the most stringent of laws will protect people against *unfortunate* investments. It is to be hoped that the effect of the new Securities Act will be salutary, but it cannot be expected to accomplish the impossible.

JOHN E. TRACY