Speech

A D D R E S S O F

B A L D W I N B. B A N E

CHIEF, SECURITIES DIVISION

of the

FEDERAL TRADE COMMISSION

on

THE SECURITIES ACT OF 1933

Before the

NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS

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MILWAUKEE

Mr. Chairman, Gentlemen:

Of major importance in the concerted drive for recovery launched by President Roosevelt is the Securities Act of 1933 which was passed at his request and approved by him on the 27th day of last May. This legislation aims definitely and for good to shut the door upon those financial methods of the past that wreaked disaster upon thousands of investors and destroyed the broad base of public confidence upon which our economic structure and our very livelihood depend. As a program for the future it opens the way to a rebuilding of public confidence along new lines, along lines that promise incalculable benefit not only to the great number of investors who have their savings to invest, but also to those business and industrial organizations which merit that confidence and stand ready to deal with their investors as copartners in a common enterprise. To those who say that the requirements of this Act stand in the way of financial recovery the reply is that recovery is impossible unless confidence in methods and institutions be restored to the great number of large and small investors whose savings make possible the existence of those institutions. And once that confidence has been restored it is unthinkable that the irresponsible practices of the earlier era shall be allowed to lead us blindly to the same tragic outcome. To those who say that the needed reforms must come from within the financial world itself, the reply is that the government waited many long years, too long some think, for reforms to come from that quarter; and when 1929 arrived the futility of that expectation was made so clear that we should not again be asked to sit idly by still hoping for that which was not to arrive.

Doubtless it is unnecessary to explain to this gathering that the Securities Act of 1933 differs in many respects from the security laws administered by you. The sole purpose of the Federal law is to require truthful representations of security issues offered for sale to the public. It aims to accomplish that purpose by three chief requirements: First, that those who sell a new issue of securities shall set down in a registration statement and in a prospectus the material facts concerning the security; second, that purchasers of securities shall have a right of action to recover by rescission or in damages from those who offer or sell securities without disclosing truthfully the material facts concerning them; and third, that violation of the requirements as to the filing of registration statements and the furnishing of prospectuses to purchasers may be stopped by injunction proceedings or may subject the violator to criminal prosecution. It is clear to you that the Securities Act confers no power upon the Federal Trade Commission to control the securities that may be sold. The Commission is not called upon to pass judgment on the soundness of investment value of any security. Indeed, there is nothing in the Securities Act which prevents the most speculative type of security being offered for sale. All that the Act does is make certain that its highly speculative character shall be made clear to prospective purchasers. Following the injunction of the President that no action be taken by the Federal Government which might be construed as approving or guaranteeing an issue of securities, this law contents itself with bringing the whole power of the Federal Government to bear in insisting that the facts with reference to an issue shall be an open book to the investor.

The outstanding purpose of the Securities Act is that full disclosure shall be made of all material facts concerning an issue of securities that is offered to the public. It stands squarely upon the belief that an investor whose savings are solicited is entitled to be told just what it is he

is being asked to do. It proceeds upon the assumption that those who accept the trust of using other people's money in the conduct of business must let those people know how and the purposes for which their money is to be employed. Surely there is no element of startling radicalism in this requirement. It is the simplest requirement of common honesty. Common honesty, which consists of telling all the truth and not only the savory part of it, is enacted as the legal standard to which those who offer securities for public investment must conform. The amazing part of it is only that the enactment of this standard of fair dealing has brought forth from some quarters the cry that it is dangerous and destructive. This, I believe, is a cry which comes only from those whose hold upon the standards of the old finance gives way reluctantly before the more candid and more forthright standards of the present.

Almost two months have now passed since the flotation of new security issues has been governed by the Securities Act. Those two months have been months of stress and strain for the Federal Trade Commission. It is still too early to give a complete accounting of the work of the Commission. But it is possible now to observe some tendencies and to comment upon some apparent effects of the Act. It is also possible to deal with some of the issues that the Act has raised, to allay some of the genuine misunderstandings arising out of the complexities of the situation with which it has had to deal, and to see truly its purposes and the possibility of their realization in the face of a new attempt to insist that the morality of high finance is not the concern of democratic government.

To deal adequately with these issues requires a few minutes to bring out some of the principal features of the Act. In order to float a new issue it is now necessary to file with the Federal Trade Commission a statement setting forth certain prescribed facts which are basic to even an elementary judgment upon the value of a security. That statement cannot become effective so as to permit the security to be offered until twenty days have elapsed since its filing. During those twenty days, the Federal Trade Commission makes a preliminary check of the statement and if it finds it untrue or incomplete or inaccurate on its face, and the issuer fails to make the necessary corrections, the Commission will enter an order preventing or stopping the sale of the security.

Falsity in making representations in the registration statement is penalized primarily by holding the persons concerned in the flotation of a security responsible to the buyer for their untruths. Many misunderstandings have arisen as to the character of this liability. It is placed upon four classes of persons - the corporation that issues the security, the directors and chief officers of that corporation, the experts proclaimed as being associated with the security, who consist primarily of accountants, appraisers, engineers and lawyers, and, finally, the underwriters of the security. Certain defined statements are to be made by these persons or, if not actually made by them, these persons are held responsible for these statements. That responsibility, except for the issuer of the security, is not one of guaranteeing their accuracy. It is one of taking due care that they are accurate - that, considering the trust placed by investors in them, they used such care as can reasonably be expected of them to check the truth of these statements. To be satisfied with a lesser standard is impossible. To do so would be to invite again the misfortunes of an era that most of us would like to forget except for our determination that we shall build better. To say that such a standard is impractical is to deny experience.

These requirements have been compared, by way of criticism of the Act, with the methods formerly employed in floating securities. The critics, or some of them, say that heretofore the large banker informed himself at length and in great detail of all of the pertinent facts, of more comprehensive facts, indeed, than the Securities Act requires on behalf of investors. From these facts the large bankers selected for a circular of only four pages the more important and pertinent facts for the information of the public. The contrast is very clear, is it not? Formerly it was left to the judgment of the underwriting firms what the prospective investors should or should not be told; now it is prescribed by law that at least certain minimum requirements shall be met, and that those charged with this responsibility shall be liable for the exercise of due diligence. There is no criticism levied against this Act on the ground that it aims to inform the investor; but it is attacked because it takes from the financial houses their ancient prerogative of deciding what information shall be given and what shall be withheld. The answer is, "Let the record speak for itself."

Some misunderstanding has arisen over the fact that the standard is couched in negative as well as positive terms. Omissions of material facts are penalized as well as misstatements of fact. This, it is argued, makes for unreasonableness because no one can ever be sure that he has stated every fact material to the value of a security. But such a contention neglects both the wording of the Act and its historical genesis. Omissions to be a ground for liability are those which make actually untrue, statements that are made and are literally correct. Congress saw fit to make it clear that half truths, which have been the stock in trade of many in the recent past, are untruths.

A second misunderstanding apparently has arisen as to the extent of this liability. Fear is expressed as to the amount of damages that will be recoverable, should a violation occur. But the measure of liability is as reasonably determined as the nature of the liability. It springs not from mere misstatements but from untruths of a material character - from asserting facts the falsity of which has added values where none exist. Losses that do not reflect the deflation that the discovery of the truth has brought are thrust upon the shoulders of those who speculated for gain. But those losses that flow from the reliance of the investing public in the character of the statements that the sponsors of the security have made, these the Act shifts to the sponsors whose carelessness or malfeasance was their cause. This is accomplished by giving the investor a right to demand back from any of them the price he paid for his security, but never in excess of the offering price because that value is the outside measure of the sponsor's representations. Or to an investor who has been forced to dispose of his security before he could avail himself of such a tender, a right of damages, measured in the same terms, is given.

Under Section 11 (g) of the Securities Act, the amount recoverable is limited to the price at which the security was offered to the public. This means that if a plaintiff purchased 100 shares of the security, his recovery from the underwriter would be limited to an amount equivalent to one hundred times the price at which each share was offered to the public.

The question as to whether it is at all possible for an underwriter's liability to exceed the total amount raised from the public plus interest

thereon, must be approached with one *caveat*. Our legal system, adequate or inadequate as it may be, on occasions does bring about the conviction and execution of the innocent despite the safeguards with which we surround the accused. This question must then be reduced to the more reasonable one as to whether such a legal happening is at all likely.

Such an occasion could happen only as the result of a series of suits occurring under paragraph (2) of Section 11 (e) upon the same security by different plaintiffs, because, the individual recovery granted to any one plaintiff could not exceed the price at which the security was originally offered to the public by the underwriter. Examination of the basis for liability under Section 11 shows that liability is rested upon damage consequent to material misstatements or misleading or inadequate statements of a material character in the registration statement. "Material" in this connection, as is abundantly illustrated by the cases under the English Companies Act, has a relationship to the purported value of the security as reflected in the offering price. Of course, everything that is required to be stated in the registration statement is *prima facie* material, but it takes little ingenuity to find matters required to be stated in that statement which, even though misstated, could not be deemed as material misstatements with reference to the particular security. Pursuing this thought further, one sees immediately that trading losses as distinguished from losses due to material, misleading, or inadequate statements as of the time of offering the security, afford no ground for action. Totalling the former type of losses in the hands of successive holders of the same security may very well bring a sum in excess of the offering price of the security. But totalling the latter type of losses as a maximum can theoretically never exceed the price at which the security was offered to the public. Thus traders whose successive transactions have been liquidated prior to the market's discovery of any fault in the registration statement would have no claim for market losses. Theoretically there may, indeed, be successive actions for "faulty registration losses", but practically one doubts whether the first such action will not in almost every case absorb the entire amount of such loss. Thus both theoretically and practically there is no probability of one's liability exceeding the aggregate amount at which the securities were offered to the public.

This is a summarization of the investors' rights and the sponsors' liabilities. Its intrinsic fairness makes one somewhat impatient with the outcries against it. One fails to understand the complaints, the legal manifestations of an insistence upon misinterpreting plain meanings, unless one realizes that the irresponsible and reckless selfishness that launched the host of unsound securities is not dead. Unlike the small stock jobbers who scurry from the reach of the law, it often masquerades in a costume of righteousness, hopeful that beneath its folds its past will lie concealed.

Fortunately, there are many willing to assume the responsibilities of fair dealing. To them the Commission has consistently offered such aid as it can. Its attorneys have put their knowledge and their experience at the service of all inquirers. Its examiners have worked to aid those wishing to comply with its requirements, suggesting appropriate amendments, offering suggestions to facilitate more adequate disclosure, and assisting in the drafting of forms responsive to the various needs. But such cooperation stops and stops rightly whenever there is resistance to meeting the requirements of the Securities Act. Five stop orders have already been issued and the sale of

securities thereby halted. But more than this, twenty-seven registrants have at the suggestion of the Commission withdrawn their registration statements to avoid stop order proceedings being taken against them, thus suspending of their own accord the sale of securities until full disclosure is made.

The story of the acceptance of the responsibilities of the Securities Act is told somewhat in the registrations that have been filed with the Commission. To September 17, 227 registration statements have been filed, 115 of which are now effective, 27 of which have been withdrawn, 5 against which stop orders have been issued, and 80 of which are now being examined. These registration statements cover issues aggregating approximately $226,200,000. The character of these issues varies much. First to register were the investment trusts - a fact necessitated by the circumstance that these organizations are continuously offering new securities to the public. There followed a series of highly speculative issues, consisting mainly of breweries, gold mines and oil participations. Within the past few weeks, staid and conservative issues have been registered. Similarly recently a number of registrations have been received for certificates of deposit issued in connection with reorganization proceedings.

The sequence of these registrations and their rapidly changing character was to be expected. Hesitation naturally attends new legislation and the assumption of new responsibilities. But the speculative pressure in breweries and gold mines, intensified by the times, made flotation of securities in these industries irresistible. As the necessities for reorganization and refinancing pressed, registration in these fields ensued, and as hesitation disappeared and understanding of the Securities Act grew, new and conservative financing appeared upon the docket.

In the face of these facts, to talk of a capital strike induced by the Securities Act is either idle or deliberately intended to falsify. It neglects wholly the fact that the state of the capital market is such that financing is hesitant for reasons that go far beyond the Securities Act. Even in issues exempted from the registration requirements of the securities act the lack of financing is apparent. The hesitancy of short term financing has become a matter of national concern, and only last week the Reconstruction Finance Corporation launched the project of placing one billion dollars at the disposal of commercial banks at low rates of interest in order to stimulate short term financing of business requirements. Municipal long term issues have practically disappeared. Railroad financing, expressly exempted from registration under the Act due to its supervision by the Interstate Commerce Commission, is stagnant, and for refinancing the railroads turn to the Government and not to the public. These facts are significant in demonstrating the shallowness or the motives of those who proclaim that the Securities Act is a brake to needed financing.

Comments of this character deserve condemnation not only for their absence of foundation in fact but for their want of a theoretical justification. The requirements of the Securities Act are equally as stimulative of new and sound financing as they are protective of the investor. The facts required to be disclosed are neither voluminous nor burdensome except as unsound past corporate practices may have made them so. Top-heavy and intricate corporate structures, with confused and confusing layers of various different types of securities, require many words to tell the story of the relation of a particular

security to the earnings of the company. If indeed, as has been charged, it is impossible to secure the information required, or the assembling of all the information is impracticable in these elaborate organizations, then certainly it is time that this much at least be made clear to the investing public. If the ramifications of finance have become so intricate that not even those responsible for the condition can gather the facts concerning it, no apologies are necessary for a law that promises to bring this situation to light and start us on the road to correcting it. But if it be true that analyzing these multitudinous facts be as difficult as a Chinese puzzle, shall the unsophisticated investor be required to gamble his little thousands that the answer is right? Again, from some quarters have come complaints that the requirements of independently certified financial statements are unduly onerous. But shall we permit companies and their bankers to appeal to the public for funds without rendering an adequate stewardship of their handling of other people's money in the past? Or if in the past the statements that have been made have falsified, shall we now say that they have a vested right in concealing their wrong? It is not denied that bankers who formerly sought information on prospective issues solely for their private enlightenment required an independent audit of the company's affairs.

The facts called for in registration statements are concerned for the most part with two general questions: First, the present capital structure and financial condition of the issuer; Second, the purposes for which the money contributed by the public is to be employed. What part of the purchase price paid by the public is distributed in commissions or profits on the sale of the issue must be told in order that the investor may know what net proceeds will be available to the issuer for its stated purposes. If it can be said that the requirement of stating such facts will hamper honest business, then it must be concluded that the unhampered honest business and the informed investor are incompatible and cannot both continue to exist. The idea is preposterous; it smacks of that specious plea for liberty which is a plea for license to do as one may wish regardless of the rights of others.

The legislative program of the last Congress was born out of the experience of the last few years. It might be said to focus as a whole upon two main ideas. The first springs from a determination that the economy of the nation can be ruled by the men who comprise it. It turns its back upon the conception of economics as at best a dismal science, of mankind as incapable of averting or altering the economic plagues that at intervals overtake a nation. And because of the rejection of such a conception, it is hope and not despondence that marks our progress. The second idea might appropriately be termed a moral idea, a realization that our ills have been due also to the weakening of our moral fibre, leading to easy temporizing with traditional and tried standards of right and wrong. The permeating character of such forces was slow to be comprehended, but with its discovery came a grim determination to restore to a numbed national conscience some semblance of sensitivity. It was of a spirit such as this that the Securities Act was born, free from the vindictiveness that might easily have been attached to it, reasonable in its demands and built upon tried experience in their formulation. It would be idle to pretend that it does not ask something of the security world, but it also promises much in return - the opportunity of creating a true and honorable profession by the assumption and adequate discharge of public responsibilities.

The Securities Act is not predicated upon the theory that the interests of investors are in conflict with the interests of issuers. On the contrary, it embodies a recognition of the fact that the investor and the corporation are mutually dependent. Neither can continue to prosper at the expense of the other. A law which is founded upon this view of the matter and which seeks to give a practical meaning to the interdependence of these two interests, assuredly is a law that will work to the benefit of those corporations which, by telling their story to the public, can prove that they merit public confidence. Directly it will benefit them through helping to restore the confidence of their investors; indirectly also it will help them by making the distinction clearer between those concerns that do and those that do not deserve the continued support of the investing public.

I ask your cooperation, indeed, your participation, in this program. To make this cooperation productive of specific results and of reciprocal benefit to you and to us, I propose to you the following plan of collaboration:

We will furnish a copy of the registration statement to the securities commission in whose state the principal business office of the registrant is situated.

We will furnish to the securities commissions of all states current reports of registration statements filed, the effective dates of such statements, all stop orders issued, and any other actions that may delay or suspend the effective date of registration statements.

Upon request of the securities commission of any state we will furnish at low cost copies of all or any part of any registration statement in which you may be interested.

We will contribute the whole or part time, as may prove necessary, of a member of our staff, who will give particular attention to this program of collaboration with your commissions.

We ask that you furnish to the Federal Trade Commission current reports of all applications for permits filed in your states.

We ask that you furnish us, upon request, a copy of the findings and order on any application in which we may be interested.

We ask that you undertake to advise us upon request of any additional pertinent facts concerning such applications or your decisions with respect to them.

We ask that you furnish us such information as you may have with reference to any concern filing a registration statement with us.

I shall appreciate your comments upon this program, and suggest that the necessary steps be taken to put it into operation as soon as possible.

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