

REGULATION OF THE SALE OF SECURITIES IN INTERSTATE COMMERCE

Solution of Problem of Protecting Investor Must Be Effected by System of Publicity Giving Full Information as to Securities to Be Sold and Then Leaving Responsibility of Purchase to Him—Difficulties Confronting Federal Incorporation or Licensing Plan

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SHORTLY after the Armistice was signed, the Federal Trade Commission was called on by the Capital Issues Committee, the Federal Reserve Board and representatives of the Secretary of the Treasury to invoke the Commission's jurisdiction for the purpose of aiding the Treasury Department in preventing the exchange of Liberty Bonds for what has been commonly called "wildcat securities." It was believed that unless something could be done to stop the false representation prevalent in connection with advertising the sale of such "securities," millions of dollars which were going into the purchase of these "securities" would be lost to the Government in the sale of the Victory Loan Bonds.

The Commission, after an exhaustive hearing at which representatives of various Departments of the Government were present, who argued that the Commission had jurisdiction, moved to prevent the sale of securities crossing state lines.

Since that period the Commission has been continually investigating cases of the sales by false representation of such securities. It has issued complaints where it had reason to believe that such representations had been made, and after taking testimony, and holding a hearing on the issues, has ordered offenders to cease and desist from the practices complained of.

Out of the experiences derived from the close touch with this practice, which has been the cause of ever increasing losses to great numbers who could ill afford the loss, the writer has reached the conclusion that legislation could be enacted that would protect the investing public with a minimum amount of interference to legitimate business.

As I see it, the solution must be effected through a system of publicity which shall protect the public by informing the investor as to the securities to be sold by giving the prospective purchaser a full opportunity to be enlightened and then leaving to him the responsibility of purchase.

Legislation conceived and operating along these lines in other countries has proved to be preventive, protective, practical and not paternalistic. There are those, however, who are impatient of this curative process of publicity. They argue that this is only a half-way measure, and insist that the Federal Government should embrace the remedy which it must eventually come to anyway, namely federal incorporation and licensing thereunder.

From my observation of governmental procedure,

and I am of course voicing merely my own personal opinion on this whole subject, I am not persuaded that this latter course is practical under our present governmental administration of affairs.

Generally speaking, a Federal incorporating or licensing plan would seem to be impractical for various reasons.

A special and exhaustive study would have to be made of each security that was offered by anyone of the thousands of corporations coming under such an act. There would also have to be a definite stamp of approval by a governmental officer. All this would require a very large and unwieldy staff of employees. In addition there would be the investigation and approval of the incorporation papers of thousands of concerns before a certificate could be granted. All of this would necessitate a great expense.

Furthermore, an act of that kind, I believe, would conflict with the inherent power of the individual States to create such corporations having the right thereafter to do business beyond State lines, and might therefore subject itself to the charge of being unconstitutional.

Its tendency would be paternal, thrusting the Government into business far more than it is at this time.

Finally it would fail to solve the problem that confronts the country with respect to the protection of the investing public in that even in the face of such a law, the conscienceless promoter could, after having complied with all of the terms, put on a sale of stock through false advertising just as he does now. When the same came to the knowledge of the public officials, undoubtedly his license would be revoked but that would not bother him any more than when in the present time, he has unloaded a wildcatting stock sale in one state, and leaves for other parts of the country. To revoke his license would be a good example of "locking the barn door after the horse was out."

In the search for proper legislation it would be well to consider the experience of Great Britain, Belgium, and other foreign Governments who have investigated the subject, and to inquire as to the efficacy of foreign laws enacted to meet a similar situation.

Protective Legislation in Great Britain and Belgium

Legislation enacted by the British Parliament on this subject extends over the last three decades. The British Companies Act (Companies Consolidation Act) was passed in 1908, has subsequently been amended, and is now in force. In drafting this Act, the Board

of Trade and others who were responsible for the legislation sought to frame a bill which would interfere as little as possible with legitimate business, and at the same time tend to exclude those who were seeking to secure unfairly the money of the investing public.

The situation in England is described as follows in a report printed for the United States Senate Committee on Interstate Commerce¹:

The problem before Parliament was, on one hand, the protection of the large body of the public represented in investors and creditors, and on the other hand, to avoid restricting unduly the facilities for the creation and development of corporations, which had contributed so largely to the prosperity of the country and needlessly embarrassing their administration.

Instead of adopting arbitrary rules which in some cases might effectively prevent an abuse but in others seriously interfere with the prosecution of legitimate business, it was deemed sufficient, for the time being at least, to provide for a certain amount of publicity in corporate affairs, enforcing those requirements by penalties, imposed in many cases upon the individuals who knowingly and willfully disregarded them.

So the British law provided among other things that a prospectus, which it defines as "any notice, circular, advertisement or other invitation, offering to the public for subscription or purchase any shares or debentures of a company," must be filed with the registrar of companies, and must show (1) the names and addresses of the vendors, and where there is more than one separate vendor, or the company is a subpurchaser, the amount payable to each vendor; (2) the particulars and the nature and extent of the interest of every director in the promotion of, or property to be acquired by the company; (3) the dates of and parties to every material contract, and a reasonable time and place for the inspection of such contracts; and further, that a company which does not issue a prospectus shall not allot any shares or debentures until a statement in lieu of a prospectus has been filed. A person is deemed a vendor who "has entered into any contract, absolute or conditional, for the sale or purchase, or for any option of purchase, of any property to be acquired by the company."

It also required that the one who was to promote the sale of the securities should file with a public official in detail information of the properties owned and other information which would elucidate the circumstances and business conditions of the issuing company.

The British law in its original form did not require the carrying of information in the prospectus and was therefore subject to criticism by public writers because the law failed to bring the information sufficiently to the notice of the investor. This criticism has, however, apparently been met by the additional requirement of the publicity in the prospectus now prescribed.

Subsequent to the enactment of the British law, Belgium, having for a number of years been used as an Eldorado for the promotion of false securities, began an exhaustive investigation of the question of the protection of its investors. In the course of this investigation legislative committees made a thorough study of the foreign laws and methods of protecting the public.

On May 25, 1913, legislation amending the Belgian Commercial Companies law was enacted. It has been pronounced by a number of international writers to be the best legislation on the subject up to date, and its operation has been declared to be most successful by experts who have watched it closely. It

follows in many respects the English law, in that it requires the filing of information with a certain public official by all those announcing and offering securities for public sale. But it goes into much greater detail than the British law, and while quite brief in its form, requires those offering securities for sale to lodge with the Government and to carry in their advertisements, information which will put the responsibility entirely upon the purchaser if he buys after he has had every opportunity to secure the information as to the standing of the company.

It should be noted that both in the English and the Belgian laws very heavy criminal penalties are imposed, of both jail sentences and fines, for those failing to meet the requirements of the statute before they offer their securities for investment.

It should also be noted that these laws do not require every corporation to file the information as required in their respective statutes, but only those who are about to offer their securities for public sale.

To put it briefly, the theory upon which these laws have been enacted was, as was emphasized particularly in the debates on the British law, to shift the doctrine of *caveat emptor* so that instead of letting the buyer beware, to now require the seller to beware. The latter saves himself by filing his information, advertising the same in his prospectus and offering securities which conform to this information. When he has done this and given the investor every reasonable chance to inform himself, the burden then shifts to the investor.

Hughes Committee Recommends the Filing of Statements, but not Official Verification

In 1909, the Honorable Charles E. Hughes, who was then Governor of New York, appointed a committee to inquire what changes, if any, were advisable in the laws of that State, bearing upon speculation in securities and commodities, or relating to the protection of investors. The committee, reporting to the Governor in regard to the New York Stock Exchange, particularly in relation to the subject of the filing of statements with the New York Stock Exchange by companies selling their securities on its floor, said:

We have given consideration to the subject of verifying the statements of fact contained in the papers filed with the applications for listing, but we do not recommend that either the State or the Exchange take such responsibility. Any attempt to do so would undoubtedly give the securities a standing in the eyes of the public which would not in all cases be justified. In our judgment, the Exchange should, however, adopt methods to compel the filing of frequent statements of the financial condition of the companies whose securities are listed, including balance sheets, income and expense accounts, etc., and should notify the public that these are open to examination under proper rules and regulations. The Exchange should also require that there be filed with future applications for listing a statement of what the capital stock of the company has been issued for, showing how much has been issued for cash, how much for property, with a description of the property, etc., and also showing what commission, if any, has been paid to the promoters or vendors. Furthermore, means should be adopted for holding those making the statements responsible for the truth thereof. The unlisted department, except for temporary issues, should be abolished.

Publicity the Remedy Recommended by the Hon. Louis Brandeis

The Honorable Louis Brandeis, Associate Justice of the Supreme Court, in his book entitled "Other People's Money," after analysing the results of the Pujo Financial Investigations, and other investigations, and the whole subject of the issuing of securities, said that publicity was the remedy for the protection of the investing public.

¹ Laws and References concerning Industrial Combinations, etc., Washington, 1912, p. 140.

On page 101 of this analysis, he said:

Compel bankers when issuing securities to make public the commissions or profits they are receiving. Let every circular letter, prospectus or advertisement of a bond or stock show clearly what the banker received for his middleman-services, and what the bonds and stocks net the issuing corporation. That is knowledge to which both the existing security holder and the prospective purchaser is fairly entitled. If the banker's compensation is reasonable, considering the skill and risk involved, there can be no objection to making it known. If it is not reasonable, the investor will "strike" as investors seem to have done recently in England.

Again on page 103:

The Federal Pure Food Law does not guarantee quality or prices; but it helps the buyer to judge of quality by requiring disclosure of ingredients. Among the most important facts to be learned for determining the real value of a security is the amount of water it contains. And any excessive amount paid to the banker for marketing a security is water. Require a full disclosure to the investor of the amount of commissions and profits paid and not only will investors be put on their guard, but bankers' compensation will tend to adjust itself automatically to what is fair and reasonable. Excessive commissions—this form of unjustly acquired wealth—will in large part cease.

And again on page 104:

To be effective, knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter and advertisement inviting the investor to purchase. Compliance with this requirement should also be obligatory and not something which the investor could waive.

Recommendations of the Capital Issues Committee Indorsing the Taylor Bill

During the war, there was created, under the supervision of the Treasury Department, what was known as the Capital Issues Committee. That Committee in its report to Congress on December 2, 1918, (Public Document No. 1487, 65th Congress, Third Session,) and again in their report to Congress on February 28, 1919, (Public Document No. 1836, 65th Congress, Third Session,) vigorously urged the creation of legislation to protect the investing public, and appeared before committees in Congress for the purpose of indorsing what was then known as the Taylor Bill, (House Bill 188, 66th Congress,) providing for the furnishing of information with respect to shares of stock offered to the public, and prescribing penalties.

That bill was drafted along the lines of the British law, requiring the filing of information with a public official, revealing the conditions of a corporation offering to sell its securities in interstate commerce and stating the conditions under which the securities were offered.

When the Taylor Bill was considered by the Judiciary Committee of the House, Congressman Taylor submitted evidence on the part of the States showing a desire and need for a bill to supplement the State laws.

Former President Taft in a message to Congress, January 27, 1910, transmitted to both Houses of Congress, regarding proposed legislation for a Federal Incorporation law, repudiated the idea of a compulsory licensing law, and said on page 20 of his recommendations:

A federal compulsory license law, urged as a substitute for a federal incorporation law, is unnecessary except to reach that kind of a corporation which, by virtue of the considerations already advanced, will take advantage voluntarily of an incorporation law, while the other state corporations doing an interstate business do not need the supervision or the regulation of a federal license and would only be unnecessarily burdened thereby.

The matter quoted is a digest of that which had already been discussed in the President's report,—i. e., that the kind of a Federal act proposed was voluntary

upon those doing an interstate business. Those who did not desire to accept its terms voluntarily could still function in interstate business under the State incorporation laws.

It was apparently former President Taft's idea that the legislation he was referring to would only cover very large corporations commonly known as "trusts." He says, in fact: "Only the largest corporations would avail themselves of such a law, because the burden of complete federal supervision and control that must certainly be imposed to accomplish the purpose of the incorporation would not be accepted by an ordinary business concern."

Difficulty of Administering a Federal Incorporation or License Law

If all corporations doing an interstate business were required to be incorporated or licensed under a Federal law, administration would be very difficult. As I have already suggested, such a law, to protect the investing public, would require a special and exhaustive study of each security that was offered by any one of the thousands of corporations that would have to come under this act, and there would also have to be a definite stamp of approval by a governmental agency.

Suppose a Government official were empowered to pass upon and approve of a security, and thereafter the values behind that security turned out to be worthless, and bankruptcy followed. Would not the responsibility be upon the official, and would not the normal Government officer hesitate to draw the fine line between the sound investment and the unsound? Out of this responsibility and uncertainty would come a natural retarding of the normal development of business, which might involve serious consequences.

On the other hand, suppose he should disapprove of a stock sale, as did the Capital Issues Committee working under the stress of war conditions, and let us suppose that an oil company, having been denied the right to issue stock because a Federal official would not approve of the same, could finance itself in some other way and subsequently should bring in a well of a thousand barrels production daily? Would not that fact shake the confidence of a public official in his judgment? Is it fair to thrust such a duty upon an official or a Governmental department? Is it not better to seek, by all human means possible, to inform the investor and let him take his own risk—a risk which he may well be able and desirous of taking? It is fair to assume that the most difficult thing which confronts the State commission having to do with the protection of investors, is the giving of approval or refusal to securities presented for sale, whether that approval be expressed by a definite stamp or implied by the issuance of a license.

Protecting the Public by Informing the Investor

The British and Belgian legislative bodies, after a thorough investigation, came to the conclusion that the least amount of interference with the greatest amount of protection was the solution of the question of protecting the investing public. It was their idea that the law should be prophylactic and preventive rather than paternal. Invariably the same policy has been adopted in all modern countries which have enacted legislation on the subject in recent years, including France, Germany, Japan and several of the Latin American States.

The method here suggested would not compel every corporation to file papers with a Federal official. It would only require reports from those about to offer securities for sale in interstate commerce.

The information filed should contain a full dis-

closure of the economic and financial condition of the issuing company, its plans for the investment of the money secured from the sale of the securities, and other necessary facts which would assist the prospective investor in making up his mind as to whether he should purchase such a security.

In addition, such legislation should require every person, firm, association, individual or corporation offering securities for sale to the public in interstate commerce, to print on the front page of all circulars, prospectuses, letters, literature, and in the body of advertisements describing or listing the securities, in type larger than the type otherwise used, the names of the promoters and underwriters, the rate of commission, or commissions, or bonuses received by those promoting, consolidating, underwriting, or selling said securities, and the net amount to be received by the said sale, together with a statement that more complete information could be had by writing to Federal public officials, designated as the repository for such information.

Co-operating With the State Blue-Sky Officials

Apparently our Federal Agricultural Department approaches a high form of cooperation and efficiency in joining with our State agricultural colleges in administering and developing the agricultural industry in this country. Appropriations are made, officials appointed, and the laws administered by the Federal Government in connection with the agricultural schools along joint co-operative lines which commend themselves very strongly.

Since this can be done with respect to agriculture, why can it not be done equally well with respect to administering laws which will protect the investing public?

It seems to me that in addition to having a Federal "blue-sky" repository in Washington, a Federal Officer could be attached to State blue-sky commissions, and in the absence of such a State agency, with the office of the United States District Attorney. Whenever a corporation was selling securities in interstate commerce, a duplicate of the information filed with the Federal Government could also be filed with the official associated with the State Blue-Sky Commission, or the United States District Attorney in the State where the security was being offered for sale and advertisements of those offering securities for sale would notify the investor of this additional source of information.

In addition to this means of advertising information about securities, the law could provide that wherever it was discovered in a State that a sale of securities in interstate commerce was being initiated without compliance with the Federal law, it would be mandatory upon the United States District Attorney, upon affidavit of the designated Federal official at Washington, or the Federal official attached to the Blue-Sky Commission of the State, or upon the information of the United States District Attorney, declaring that the parties offering the securities for sale had not complied with the law regarding the filing of information, to present a petition immediately to the nearest United States Federal Court for a temporary order restraining the sellers of such securities from proceeding further, until an investigation could be completed.

Such a law would also provide that those failing to meet the requirements of the law would be subject to prosecution and on conviction either fined or imprisoned, or both.

In such legislation, it would be unwise for various reasons to make any exception save as hereinafter

stated. Among others, that such a law must not only protect the investor, but must serve to promote his confidence. To develop his confidence, it is necessary to protect him in the case of all securities that are issued, excepting of course those offered by municipalities or public utilities supervised by governmental authorities.

It may be said that the Stock Exchange already supervises the securities sold upon it. Nevertheless, there have been many securities offered on stock exchanges which were subsequently found to be waterlogged or loaded by those offering them to a degree that their demise was hastened.

To restore confidence in the public, such securities as well as those of the "wild-catter," should be subject to the regulations outlined above.

Moreover, a law making exceptions might lay itself open to an attack of discrimination, and therefore, of being unconstitutional.

It is the province, undoubtedly, and duty of the Government to protect its citizens, but it is questionable whether it is the province of a democratic form of government to take away the judgment of its citizens by submitting its own judgment as to what they may, or may not do with their own money, except under very well defined limitations.

If a bill such as I have outlined could be enacted into law, and that law carried every reasonable notice to the investor relating to the value of the securities which he was about to purchase, the responsibility would then be his, and he could indulge his own judgment. To go further might mean to block the channels of finance, and embarrass investment and development in this country. At least my own personal observation and study of this subject has led me to this conclusion.

Many parts of our country have been developed through speculative enterprises. There would not have been much of the advancement that there has been except for those who were willing, able and desired to take a chance.

Such a law as is contemplated would not deprive the American citizen of that chance but would put him on notice and give him every reasonable opportunity to discount the chance.

At the same time, its requirements, while not burdensome to the honest promoter, would be such that the one criminally minded, or ill-informed, would hesitate to go ahead. There are some who might still seek to deceive the public, but people of such mind would not be stopped by any law. Light thrown upon their securities through the publicity outlined or the possibility of the application of a restraining order by Government officials who could act very quickly by the processes described, would very likely make them pause if not altogether desist.

The answers to questionnaires sent out in the investigation of cases by the Commission indicate that a great many of those deprived of their savings are farm owners or employees of farmers. From this it is reasonable to deduce that the enactment of such a law would be of assistance to this class and, by means of protecting their savings, lessen farm tenancy which is so greatly on the increase in this country.

Moreover, it is maintained that the law indicated would be of value to the rest of our investing public, and turn many of the millions that are usually lost, back into legitimate channels for safe investment.

Finally there would not only be no conflict with the State laws for the regulation of securities but harmony and cooperation with them.