Michigan Law Review

Volume 50 | Issue 8

1952

Loss: SECURITIES REGULATION

Arthur H. Dean
Member, New York Bar

Recommended Citation

Arthur H. Dean, *Loss: SECURITIES REGULATION*, 50 MICH. L. REV. 1388 (1952).
Available at: https://repository.law.umich.edu/mlr/vol50/iss8/13

RECENT BOOKS

This department undertakes to note or review briefly current books on law and matters closely related thereto. Periodicals, court reports, and other publications that appear at frequent intervals are not included. The information given in the notes is derived from inspection of the books, publishers' literature, and the ordinary library sources.

SECURITIES REGULATION. By *Louis Loss*. Boston: Little, Brown and Company. 1951. Pp. viii, 1283. $17.50.

The reader of this book, be he investment banker, broker, stock exchange official, lawyer or student, will find Mr. Loss's work well worth his thorough and careful study. The author is to be congratulated on the combination of his thorough scholarship, extremely readable text, and the wealth of reference material not previously available in one volume in any other form.

Louis Loss went with the Commission in 1937. He has had many years of experience on its staff. At the time this volume was published he was Associate General Counsel to the Commission, Visiting Lecturer in Law, Yale University and Professorial Lecturer in Law, The George Washington University. Since then he has been appointed a member of the faculty of the Harvard Law School commencing with the Fall term in 1952.

Mr. Loss brings to the writing of this volume a rich and ripe experience as a Commission official and of one well skilled in the regulatory aspects of the securities, utility and investment business from the governmental standpoint.

Mr. Loss's discussions of the various acts under the administration of the Securities and Exchange Commission are clear and discerning and are supported by a host of references to the releases and regulations of the Commission, to decided cases and to law review articles.

Mr. Loss's book deals with the seven acts passed during the Roosevelt Administration, following the extraordinary decline in the quoted prices of all types of securities in the business depression following the stock market crash in October 1929.

It is interesting to note by way of prelude that both the Republican and Democratic platforms, in 1932, contained clauses favoring the enactment of legislation to regulate the issuance and sale of securities. Earlier in 1918 the old Capital Issues Committee of World War I, organized by the Federal Reserve Board under Title II of the War Finance Corporation Act, had attempted to ration capital in World War I. After his inauguration on March 4, 1933, President Roosevelt sent a message to the Congress on March 29, 1933 recommending the enactment of legislation to regulate the issuance and sale of securities, the so-called "Truth in Securities" Act. At the same time Senator Glass was pushing through the Banking Act of 1933 which was to divorce deposit and investment banking.

The draft of the act accompanying the message was a weird hodge-podge of contradictory clauses and of conflicting theories (p. 82). Huston Thompson, a member of the Federal Trade Commission under Woodrow Wilson, was called from retirement to present the proposed legislation before the House and Senate Committees (p. 65).

It soon became evident that the Administration was floundering badly and needed a theory of legislation. Mr. Loss does not describe the various drafts or the electric conflict and ebb and flow of theories which surged through the work of bringing forth the statute. It may be that this omission magnifies itself to me because I was privileged to take part in the events as the result of the memoranda which Alexander I. Henderson of the New York Bar and I, working separately but coming to similar conclusions, had submitted as to what effective securities legislation should be. As a result, I was asked to divorce myself from my clients and to take part in advising the Administration on the securities legislation, and in the discussions which followed with Averell Harriman and Raymond Moley, who was then acting as an adviser to the President, I saw the drama of theories in conflict which seems to me such a significant and fascinating part of the history of this legislation.

It has been as long ago as 1913-1914 that Justice (then Mr.) Brandeis, writing in *Other People's Money,* had advocated the theory of complete disclosure (p. 77). I felt that the legislation could proceed soundly only on that theory, and so agreed to make myself available on the express understanding that the legislation was to proceed upon the theory of complete disclosure to the public of all pertinent facts in relation to the issue, namely, the theory set forth in the President's message to the Congress of March 29, 1933. I stated I did not wish to be associated with the drafting of the legislation if it was to proceed upon the theory that the government had a veto power on the issuance of the securities or upon the theory, as one of the bills then before Congress provided, of a finding by the regulatory commission that the issuer was engaged in useful production or was not engaged in the violation of any antitrust laws.

Naturally, the President also wanted advice from someone who had not been a legal adviser to corporations and investment bankers. It was agreed that Justice Frankfurter, then a Professor at the Harvard Law School, would come to Washington to take charge of the legislation. He did so and brought with him James M. Landis of the Harvard Law School, later to become a Chairman of the Securities and Exchange Commission. The services of Middleton Beeman, head of the Legislative Drafting Bureau, and Benjamin Cohen were also enlisted. The responsibility for drafting was theirs. Advised by a host of friends with a wealth of experience (including A. I. Henderson and George A. Brownell) I had long thought a Federal Securities Act was badly needed to protect honest business and investment bankers. At the same time, there was the danger that over-severe registration requirements and the severe civil liabilities would deter financing, then badly needed in our economy. After conferences of advisers and drafters with Speaker Rayburn, then Chairman of the House Committee on Interstate Commerce, however, the Securities Act of 1933 was enacted and became effective May 27, 1933.

Broadly that act provided that new issues of securities over a certain amount, and resales of outstanding securities by persons in "control" of the issuer, had to be registered with the Federal Trade Commission and a prospectus summarizing or outlining the facts in connection with the issue and the issuer had to be sent to a purchaser of the securities at or before the time of purchase.

Unlike the English Companies Act it provided for a waiting period between filing and offering. It also broadened the common law liabilities with respect to misstatements or omissions of material facts in connection with the sale of new or outstanding securities and contained general anti-fraud provisions.

It was exceptionally fortunate that the Federal Trade Commission, without previous experience in this field, was able to place Baldwin B. Bane in charge of the Registration Division of the Securities Act of 1933. It was with him that members of the Bar were able to work out a *nunc pro tunc* theory of filing the final price amendments with respect to security issues one or two days before the effective date of a registration statement, with the request that the Commission date the filing of the amendment back to the date of the original filing. Without this device, issuers would not be able to take advantage of last minute market changes and investment bankers would have quoted prices discounting the twenty day market risk.

This is colloquially referred to as the "acceleration" of the registration statement.

At the time of the passage of the Investment Company Act of 1940, again worked out with the cooperation of the industry, we worked out with the Commission's approval an amendment giving to the Commission, when deemed to be in the interest of investors and the public, discretion to waive or shorten the mandatory waiting period of twenty days for corporate issues before clearing the issue for offering.

The theory of the waiting period between the time of filing and the effective date of the registration statement, after which securities can only be offered to the public through the use of the mails or the facilities of interstate commerce, was to inform underwriters, security dealers and the investing public. While preliminary negotiations between underwriters in privity of contract with the issuer may be entered into during this waiting period, neither sales nor offers to sell the securities can be made by sellers nor can offers to buy be made by buyers or accepted by would-be sellers. This is enforced by severe civil and criminal penalties.

It has recently been suggested by Edward T. McCormick, now President of the New York Curb Exchange and formerly a member of the Securities and Exchange Commission, that offers to sell should be permitted during the waiting period. The philosophical, syllogistic and legal distinctions between an actual "sale," an "offer to sell" and an "offer to buy" and the dissemination of information without "solicitation" during a waiting period are too much for the average dealer and salesman to digest. It is certainly beyond the comprehension of the average investor. Certainty is an essential element in all commercial transactions and it is the shortening of the waiting period rather than further syllogistic exercises that is greatly to be desired.

Just before the outbreak of World War II this power of making registration statements effective within less than a period of 20 days with respect to issuers who had filed several issues with the Commission worked well. But with the advent of World War II and the shortage of personnel, the practice went into abeyance. It is still entirely practical to hope that through cooperation of the

Commission, investment bankers and issuers, a much simpler form of registration statement than that currently in use could be worked out for well-established enterprises which have filed registration statements several times with respect to security issues or who have had securities listed on national securities exchanges and registered under the Securities Exchange Act of 1934, so that the lapse of time between the time of filing and the time of offering could be materially shortened.

The original act did not, except in the very general way outlined above, affect the trading in outstanding securities and did not regulate national securities exchanges (stock exchanges) or transactions thereon.

In the late summer of 1933 the President caused to be appointed the so-called Dickinson Committee, of which A. A. Berle, James M. Landis and I were members under the Chairmanship of the late John Dickinson, which recommended legislation regulating the national securities exchanges, the creation of a new Commission to regulate the '33 and '34 Acts and the granting of power over margins to the Federal Reserve Board.

The revelations which were being brought out by the investigation currently being conducted by the Senate Banking and Currency Committee, of which Ferdinand Pecora became counsel in late January 1933, resulted in a public demand for stock exchange legislation and the registration of dealers in securities. The Securities Exchange Act of 1934, providing for the regulation of stock exchanges, the furnishing of up-to-date information to the holders of listed securities, regulation of the solicitation of proxies and insider trading, control over margins, et cetera, became effective in June 1934. A schedule to that act amended the Securities Act of 1933 to make it workable along the lines originally recommended in 1933. Great credit goes for this to the late Robert Christie, the late George C. Matthews, later an SEC Commissioner, and Charles Freeman of Chicago, now Chairman of the Board of Commonwealth Edison Company of Chicago. That act created a new Commission to administer both the Securities Act of 1933 and the Securities Exchange Act of 1934, to be known as the Securities and Exchange Commission, as recommended by the Dickinson Report.

In 1936 the Commission's powers over the over-the-counter markets were greatly expanded and in 1938 the Maloney Act (Sec. 15A of the Securities Exchange Act of 1934) paved the way for the creation of the National Association of Securities Dealers, Inc., the quasi-official regulatory body of all dealers engaged in the underwriting and original and secondary distribution of securities. In the summer of 1934, under the able leadership of Joseph P. Kennedy, James M. Landis, George Matthews and Baldwin Bane the registration forms had been made more workable and practicable.

After the enactment of the '34 Act, there followed in fairly rapid succession the enactment of the Public Utility Holding Company Act of 1935, which regulated in explicit detail holding companies and their subsidiaries, the Bankruptcy Act of 1938, which gave to the SEC broad advisory powers in connection with bankruptcies and reorganizations, the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

The discretionary powers given to the newly created Securities and Exchange Commission under the Securities Exchange Act of 1934 were vastly greater than the rather limited powers that the Congress was willing to give to the Federal Trade Commission at the time of the passage of the Securities Act in the spring of 1933.

The Public Utility Holding Company Act of 1935 introduced a completely new concept of regulation and gave to the Commission extremely broad powers over the capital structures and the size and even life of public utility holding companies and almost complete power over their ability to issue securities, to revamp their capital structures or to operate in certain territories and, contrary to Justice Brandeis's theories (p. 77), gave to the Commission the power to determine bankers' profits. The '35 Act obviously proceeded on the theory that it is the Commission and not management which knows best. Disclosure was discarded for governmental control.

Inasmuch as there has not been a business depression since the enactment of the 1935 Act, it is still too early to tell whether the rather restrictive provisions upon which the Commission has insisted for capital structures, indentures, preferred stock provisions and restrictions on common stock dividends, will or will not work out to the detriment of security holders. Most holding companies would have disappeared in any event, as a matter of economics. But on the whole the Commission has approached its problems with great wisdom and forebearance.

From time immemorial through the fertile brain of man, there has been a spring of ingenious inventions, new tools, new processes and new ideas. In order to put these ideas to work for the benefit of society there must be capital to buy tools and to pay labor. For that capital to prosper there must be honest, wise and intelligent management. All new ideas are not necessarily good. And many new ideas necessarily displace and make bankrupt existing enterprises, as witness the automobile and bus against the street car and carriage, the telegraph against the pony express and the current war between the new synthetic fibers and wool and cotton, the displacement of silk by rayon and nylon and the war between television and the movies.

If no enterprise ever failed and if society still had to pay interest on the obligations of no longer socially useful enterprises, there could be no advancement in science or improvement in the standards of living. For society could not afford it. One of the elements of a capitalistic society is risk.

Many severe losses suffered by the public in the purchase of securities have taken place because railroads have been advanced into new territory by enthusiastic promoters before there was adequate freight revenue and airplanes have been built and airlines launched before the public was willing to travel by lighter than air machines in sufficient numbers.

Bonds issued at lower interest rates sell below their principal amount when interest rates advance and the prices of common stocks decline as the business cycle trends downward or the earnings of an individual business suffer.

Indeed, the enterprise may ultimately be sound but the current thermometer of security prices may register tremendous losses, and investors who must sell during this period naturally realize these losses even though the enterprise be sound. At page 75 Mr. Loss falls into a common error of taking the difference between market highs and lows as losses. He does not mention that an even sharper market drop occurred between March 1937 and September 1938.

In addition there is, of course, the usual percentage of completely fraudulent enterprises, get-rich schemes and ill-advised adventures.

Mr. Loss relates with a wealth of detail the earlier attempts to regulate security markets and securities in England and on the continent, the gradual growth and development of state Blue Sky laws and of the earlier attempts of the Congress to regulate securities. He surveys the field from the vantage point of a governmental official and, as is perhaps natural, looks with a somewhat amused eye upon the struggle of new enterprises to obtain capital, upon the writhings of underwriters, investment bankers, dealers and brokers, engaged in trying to cope with the actual prices in a free market, which respect no man's opinion, the intricate, multitudinous and sometimes contradictory maze of regulation and the desire to be constructive with industry and fair with investors. It is not easy. And all of the morals are not on the side of the Commission.

When the United States Government throws money away by way of mismanagement, such as in the case of Pasamaquody, Lustron and dozens of others, including the cancellation of the notes of the Commodity Credit Corporation, it can obtain the money to replenish its coffers by increasing the tax rate or increasing the sales of government bonds backed by the full faith and credit of the United States Government. No thermometer registers current governmental mistakes. The investor does not see it. When private enterprise makes a similar mistake, investors must extricate themselves from harassment or turn their shoulders to the wheels of management or suffer losses, and the market registers this distress. Unlike government projects such as TVA, private enterprise cannot charge off a large part of its capital expenditures to flood control and then claim to be a self-supporting enterprise.

Indeed, the United States Government can advertise the sale of "E" bonds by emphasizing that you get \$4 for every \$3 invested, without ever indicating that you are not getting any interest in the interim and that you may have to pay income taxes at ordinary rates on the entire difference at the maturity of the bonds. The SEC would regard this as highly objectionable if done by a private individual.

This review does not, of course, permit detailed discussion of Mr. Loss's very able work. But it may not be amiss to point out that while Mr. Loss is very critical of the fact that a definition of a "prospectus" under the '33 Act only includes written rather than oral offerings of securities, and in fact refers to this on page 48 as a "jurisdictional loophole," it is interesting to recall that in one of the drafts of the Securities Act of 1933, the word "sale" in section 2(3) included oral offerings of securities. In conversations with Professors Frankfurter and Landis, it was pointed out that since a prospectus must be delivered complete, this would require a complete reading of the prospectus over the telephone or a complete recitation of the prospectus in any discussion. In an effort to make the act workable and practicable, the act was specifically drafted so as to permit oral offerings provided that the security itself or the confirmation was accompanied or preceded by a written prospectus complying with the provisions of the act with the complete approval of the respective congressional committees. As Justice Holmes said in his dissenting opinion in *Tyson & Brother v. Banton*, 273 U.S. 418 at 446, "some play must be allowed to the joints if the machine is to work."

The Securities Act at least has the advantage that it works reasonably well. Despite the many hearings and the many debates on this subject of prospectuses, there has been no other suggestion, including many exceptionally complicated ones discussed by Mr. Loss at pages 247-255, which would work in practice half as well. It is fortunate that the people have an inherent resentment against legalisms.

Mr. Loss is also critical (page 160) as to the length of prospectuses and points with pride to the work of the Commission in this respect and to the timidity and inertia of the Bar. For many years, together with investment bankers and other counsel, I have been urging the Commission so to draw the rules and regulations, apart from financial statements, as to permit a materially shortened and condensed prospectus. Many of the ideas for which Mr. Loss gives the Commission full credit were born of necessity by the industry. Indeed, committees of the IBA and NASD have spent countless hours thinking about and working on this problem. Officers or partners of houses bringing out new issues take great pride in the conciseness and readability of their prospectuses. Where willingness to do plain hard work has been present, 100 or 150 page registration statements have often been digested into a 7 or 8 page prospectus plus financial statements.

The Commission, of course, under the '33 Act as distinct from the '35 Act does not have the power to pass upon the merits of any security or the power to approve or disapprove. Despite Mr. Loss's strictures on the ignorance of the investing public, in my judgment the Commission's powers are as they should be. But in its review of the registration statement and the prospectus before it can become effective, it has a powerful weapon in connection with the requirement of complete disclosure, to which no one in his right mind objects. But how is it to be done?

Many an investment banker and lawyer, in the hope that a prompt offering of the securities could be made once a registration is effective, has taken a chance on having all of the prospectuses printed, after the deficiency letter of the Commission with respect to the registration statement and prospectus has been received, and in advance of clearance by the Commission, only to be ordered by the Commission at the last minute to add non-essential and irrelevant detail. This requires the scrapping of the previously printed prospectuses, a complete reprinting and refiling and enormous expense and delay. Is it surprising that some feel it is easier and less expensive to play it safe, rather than to pioneer in condensation, with the Commission?

The registration requirements, of course, together with the growth of the funds of life insurance companies and now pension trusts, have contributed to the direct placement for investment of securities with institutional investors. Nevertheless, Mr. Loss indicates (pp. 78-80) that Justice Douglas, then a Professor at the Yale Law School and later a Chairman of the Securities and Exchange Commission, writing in 23 *Yale Rev.* (N.S.) 521 (1934), was critical of the "glaring publicity" theory of the act, thought it "nineteenth century legislation" and apparently believed in a moderated Securities Act for those complying with the ill-conceived and ill-fated NRA, for the clearance of security issues "through the Code Authority" and for "mobilizing the flow of capital to various productive channels." However, it is undoubtedly unfair to criticize Justice Douglas for views expressed in 1934 in the light of hindsight and his well-known opposition to cartels.

Can anyone imagine a worse obstacle to be overcome by a useful enterprise seeking new capital than to have to convince a committee made up of a bunch of its competitors that it was deserving of new funds?

Control over access to the capital markets undoubtedly would have the same fate as the Administration's wonderful potato control, which has achieved the impossible—a scarcity of potatoes. The Public Utility Holding Company Act of 1935, however, contained some of these ideas.

Mr. Loss does not do himself justice when he is discussing "Distribution Techniques" (pp. 106-120) and tends to generalize too much from inadequate data. He accepts without critical examination various unsupported charges about practices in the investment banking industry, particularly allegedly non-competitive practices (p. 265). I am sure this tendency in this respect would make the late historian Charles Cheney Hyde cry out, "Where is your evidence?" Indeed, in the current investment banking suit, the government has stated on the record that it is not trying to bring about public sealed bidding as against the negotiated underwritten method.

He apparently is not familiar with some of the trends in underwriting in the post-War II years, such as the fact that the term "selling group" and in fact even its use in very high-grade securities is tending to disappear especially in public sealed bidding.

He repeats data developed ex parte, without the privilege of cross examination, before the TNEC (p. 110, footnote 5, and p. 265) which has been called into considerable question by evidence introduced during the examination of Harry L. Stuart in the current anti-trust case *(United States v. Morgan)* brought by the government against 17 investment bankers. Because of the incomplete testimony and the distorted use of documents in the TNEC proceedings they are most unreliable. It is distressing (p. 265) to see an author of Mr. Loss's known ability relying on a phrase "proprietary interest," culled from one document, and ascribing it to investment bankers generally.

Economic changes since World War II and changes in underwriting methods have also outmoded a large part of the TNEC ex parte data. His discussion of English underwriting as contrasted with American repeats old shibboleths long discredited.

He fails to distinguish between a "market out" clause, a clause by no means used by all underwriters, and the obligation of the underwriters to make sure that what was said on the effective date of the registration statement is still true on the date of delivery of the securities, an obligation imposed by common law, section 12(2) of the Securities Act of 1933 and the vastly expanded data required by the SEC as to an issuer's relative position in an industry. In an era of governmental controls a lot can happen in a few days.

On page 109 Mr. Loss, I believe, misconceives the relationship of an underwriter to an issuer. When an issuer sells securities, it is not selling beans or baby rattles—the issuer is assuming a continuing debtor-creditor relationship with a bondholder or is allotting an aliquot interest in its earnings and assets to a stockholder. The underwriter is rendering services to the issuer in setting up, distributing and assuming the risk of the issue. The issuer is in no sense a "manufacturer" of the securities; the analogy is inept, for one thing, because the passage of title in the security does not sever the issuer's relationship to the investor.

In any legislation there must always be a reconciliation between the optimum desired and the workability of legislation. The Securities and Exchange Commission stands out as a very model of what an administrative agency should be. I agree with the conclusions of the Task Force of the Hoover Commission that the Securities and Exchange Commission has done an excellent job of administering the acts entrusted to its care. But the Commission could greatly improve its hearings and its rather ex parte way of making important findings (an entire subject not discussed by Mr. Loss) without sufficient opportunity to those involved to submit criticisms.

In two important pieces of litigation recently, important findings of fact by the Commission when exposed to the tests of evidentiary rules and judicial evaluation, have been seriously challenged.

To conclude, we are all indebted to Mr. Loss for a painstaking, informative and useful piece of work in a constantly changing field.

*Arthur H. Dean**

* Member, New York Bar.—Ed.