

## PROTECTING THE INVESTOR

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The current battle on the Securities act is being waged on political lines. The points at issue are not neatly drawn in business or legal terms. The arguments on both sides are often distinguished by their emotional quality rather than by any deep insight into the requirements for protection of investors and for control of the security business. Those in opposition to the Act frequently point with alarm to certain of its dire consequences. Bankers, directors, officers, and even stockholders are driven into retirement. New capital cannot be obtained. Refunding operations are made impossible. Business must be financed by commercial bank loans or out of its own profits. In many instances, this means that the only practicable alternative is bankruptcy. The upshot is that this Act is retarding recovery. These points are argued, not proved. Little or no substantiating evidence is offered. Those points cannot be proved at present. The Act has been in force for too short a time; and so many other factors are affecting business that some time will pass before the incidence of the Act in any particular respect may be determined. These arguments are often earmarks of stubborn and resentful opposition, not of informed judgment.

On the other hand, supporters of the Act often are unconcerned with that the Act does to directors, officers, stockholders, brokers, dealers, and bankers. They also lose sight of what it really does for investors. They visualize the Act as a corrective of the evils that obsessed the financial world in the last decade. They assume that the Act would prevent the recurrence of many if not all of the discreditable things which have occurred. Those discreditable things are associated in their minds with big business men and bankers. In those two groups they have lost confidence. The Securities Act is their attack on the citadels of high finance. The religious fervor of their attack is equaled only by the obstinate resistance of their opponents.

Therefore, curiously enough, what the Act contains, what it actually does, the soundness of its method of protecting investors are not particularly important. The nature and quality of the arguments mean only that the Act is significant politically. It is symbolic of a shift of political power. That shift is from the bankers to the masses; from the promoter to the investor. It means that the government is taking the side of the helpless, the suckers, the underdogs. It signifies that the money-changers are being driven from the temples. These factors are dominant and controlling. Among other things they mean that it is sheer nonsense to talk of repealing the Securities Act or even of making substantial amendments. To open

it up for amendments might end in disastrous emasculation. The Act has been in effect only nine months, and that is too short a period to teach old dogs new tricks. Bankers have not changed miraculously overnight. Their feet should be kept "close to the fire" a while longer. In fact, it might be desirable to move them a bit closer.

What follows is not germane to this political issue. It is not directly addressed to the problem of immediate amendment. It deals with the larger and more difficult problem of protection of investors. It envisages forms of supplementary legislation dealing directly with the forces which must be controlled if high finance, as Mr. Berle would say, is to be the servant not the master of society. On this broader issue, there are three propositions which seem to me tolerably clear. First, that the Securities Act falls far short of accomplishing its purposes. Second, that in any programme for the protection of investors and in any genuine and permanent correction of the evils of high finance an Act like the Securities Act is of a decidedly secondary character. And, third, that a vigorous enforcement of the Act promises to spell its own defeat because it is so wholly antithetical to the programme of control envisaged in the New Deal and to the whole economy under which we are living.

As to the first, all that the Act requires is the disclosure of certain types of information about certain securities when the mails or agencies of interstate commerce are employed in their sale. This information must be registered in Washington. From that compendious mass of data certain parts are presented in abridged form in a prospectus. This is the document employed in the sale, as it must accompany or precede the delivery of the security. For misstatements or omissions of material facts in the registration statement, buyers may sue for damages, or they may rescind, that is, return the security and get back what they paid for it. These remedies are available against such persons as the issuer, its officers and directors, underwriters, and experts such as accountants, engineers, and appraisers, as well as against anyone who "controls" any of the foregoing persons. This procedure and remedy are provided for securities which must be registered. Comparable remedies are given the purchaser of any securities (except federal, state, and municipal bonds and certain bank stocks) against the person who sold him the security and who made any misstatements of material facts or omitted to state facts necessary to make those stated not misleading.

The truth about securities having been told, the matter is left to the investor. The Act presupposes that the glaring light of publicity will give the investors needed protection. But those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant. And wise and conservative investors will find the

Securities Act useful but not necessary and from it will gain but little real protection against an occasional Kreuger or Insull. This means that the results of the Act so far as investors are concerned are primarily twofold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity, (2) even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it. And so during the early months of the life of a security the registration statement will serve as a healthy conditioner of the market.

There are, moreover, other provisions of the Act of benefit to investors. It provides a better opportunity for reparation and compensation than the common law ever afforded. The common law with its insistence upon the presence of an intent on the part of the seller to defraud, of a causal relation between the misstatement and the damages, and of a reliance by the buyer on the misstatement, presented almost insuperable procedural barriers to recovery. However, these procedural changes and the heavy civil penalties do more than make it easier for investors to win law suits and collect judgment. They give some assurance that caution rather than recklessness will characterize the issuance of securities. In other words, the spectre of liability will have a tendency to make for conservatism in statements and presentations. It is in this latter respect that the Act is going to give or fail to give real protection. Compensation or reparation will never serve the same high purposes a prevention. Man's habit of sleeping on his legal rights is notorious and nowhere better illustrated than in many of our recent financial scandals, where the failure on the part of many with just claim to seek reparation is most conspicuous. One need not be versed in the mysteries of high finance to see the futility of spending a thousand dollars to get a thousand dollars.

But while this preventive feature is the chief virtue of the Securities Act, it is also one of its greatest weaknesses. History teaches us that terroristic methods are notoriously feeble instruments for continuous control. One of the earlier illustrations was the Bubble Act; one of the more recent the late Eighteenth Amendment and its supplementary legislation. It is clear that the requirement that the truth be told about securities would be idle unless penalties were attached to make it improvident not to tell it. But when the penalties attach even to those who act reasonably and in good faith, responsible parties will balk at assuming them. That means a resort in various degrees to dodges or subterfuges, or the conjuration of more subtle devices to escape those penalties. In some instances it means the appearance of impecunious men to do the work of the more substantial ones. Or it calls for men with "rich wives" where there is everything to

gain and little to lose. Or it means that large -- and even excessive -- premiums will be obtained for performing certain functions, and thus the investor will pay unduly for the somewhat unreal protection which he obtains. Furthermore, terroristic methods are continually subjected to political attack and seldom stand the strain of such assaults for long periods. Likewise, they have always been the objects of judicial emasculation and strict construction. At best, therefore, they stand merely as stop-gaps between an ancient evil and the development of more effective methods of control.

These factors are all accentuated in the Securities Act because penalties frequently are adjusted wholly without regard to the ability of the various parties to bear them. Directors who could not possibly make a reasonable investigation must do so. Little dealers wholly divorced from the company whose securities they are distributing are held to the same high standards of reasonable investigation as the principal underwriters or the originators. Stockholders who have large holdings or are in a strategic position in election of directors have no defenses -- not even reasonable care or good faith. The sanction and protection of limited liability are forsaken. Furthermore, persons who never sold the security, who never owned it before sale, who never received any of the proceeds of sale, and who acted in good faith may be forced to buy the securities from investors at the price the investors paid. Included in this group are officers, directors, accountants, appraisers, and the like. Also the damages recoverable are theoretically illimitable, since the trading losses are recoverable, and since rights to sue are given to each successive purchaser. The only other terroristic aspect that needs mention is the great uncertainty in the meaning of the Act. Without authoritative interpretation we cannot know with any great degree of certainty what constitutes underwriting; when registrations must be renewed, by whom and how; what refunding operations are included; what reorganizations are exempt; the extent to which parties liable may allocate their liability among themselves by contract; the liability of brokers; the measure and limitation of damages; what persons have absolutely no defenses to suits by purchasers; and so on. While an ambiguous Act may have great advantages if the power of enforcement is fairly well concentrated in one agency, that virtue is not present here. There is a wide dispersion of authority under the Act. The Federal Trade Commission has very little power of interpretation. Ultimate and authoritative interpretation must come from several hundred courts -- federal, state, and territorial. So it is safe to say it will be years before reasonable doubts can be resolved. Until then the array of swords of Damocles will appear real to some, fantastic to others.

In other words, the terroristic phases of the Act are dominant. Real protection is afforded investors by scaring other people. But investors will continue to be without real protection. In the first place, many substantial persons are afraid of the big bad wolf. Yet others less timid or more rash will be willing to take over

their functions. In the second place, it must be remembered that investment is not only an inexact science but an imperfect art even for the wise, and only a long, slow process of education can bring the investor who needs protection to the stage of obtaining substantial protection under the Act. And, finally, a substantial percentage of industrial investment will be lost in any event (if our present system of organization continues) in view of the toll taken by such factors as technology, competition, and the business cycle.

The Securities Act also falls far short of making significant progress because of the really superficial way in which it covers the object of its control. It is safe to say that the greatest impact of the Act is on well-established going concerns -- businesses with far flung units, with complicated details, with kaleidoscopic activities. To photograph these businesses on registration statements is a Herculean task. So complicated is the matter that it is hardly conceivable that the mass of data presented will prove digestible. On the other hand, the oil well scheme, the gold mine venture, the holding company set-up, or the investment trust, in fact, any enterprise which is just beginning or whose activities, assets, and relations are simple, has no difficulty in registration. It should be an easy matter to effect an honest and accurate registration in those cases. Such cases are typical and illustrative of the securities which have stood out as the horrible examples of the last decade. They embrace the classical examples of manufactured securities. They include low-grade securities, into which the conservative reservoirs of savings should not be drawn. If one lacks conviction on this point, he need only turn to some of the insidious forms of holding-company financing accomplished before or after October, 1929, and note the ease and immunity with which the same old game could still be played under the Act on the American public. Or go through the Senate hearing in the Pecora investigation and observe how slightly the Act would have touched those exhibits in our Hall of Horrors. Adventures such as these lead to the conviction that an Act which, with all its severity, deals only by indirection with the things which have made the demand for control insistent must be either inadequately drawn or misconceived. This is no more and no less than an indication of the futility of placing hope for substantial progress merely on the truth about securities. Real protection must rest on broader bases.

Thus all that the Securities Act definitely purports to do is wholly secondary in any thoroughgoing and comprehensive programme for social control in this field. In the first place, the Act merely requires the recital of certain facts at one point of time in the life of the security; that is, the date of issue. As has been indicated, this may be a healthy conditioner of the market in the early stages of the life of the security. But its effect will be dissipated very early, in fact, during a period of months rather than years. Soon the statements made will be wholly discounted by a host of other bearish or bullish factors. There is no machinery provided for obtaining subsequent reliable information either in the form of annual reports or

otherwise. In the second place, there is nothing in the Act which controls the power of the self-perpetuating management group which has risen to a position of dominance in our industrial organization. There is nothing in the Act which purports to deal with the protection of the rights of minorities. There is nothing which concerns the problem of capital structure, its soundness or unsoundness. There is nothing that deals with the problem of mobilizing the flow of capital to various productive channels. And, finally, there is nothing which deals with the fundamental problem of the increment of power and profit inherent in our present forms of organization.

This may seem to be an unfair criticism of the Act in that it merely states that the Act does not go far enough. In defense one might say that it is but a first step towards greater control of finance. But there is a more serious criticism to be made. The fact is that the Act is fundamentally inconsistent and at variance with the essential characteristics of a more thoroughgoing and comprehensive control in this field.

And this brings me to my last and salient point. The Act is based on an implied assumption that must be dragged to light and carefully examined. This assumption is that we should and must return to a simpler economy; that our large units of production should be pulverized; that business relations and organization should be made more personal; that the investor should be more closely assimilated into the enterprise; that the centrifugal force which has been separating ownership from management should be transformed into a centripetal force which will drive back closer to the business not only the investors but also those in the management who direct policy, not detail. In other words, it is Main Street business which the Act envisages and which it desires to see returned. This is evident on every hand. It explains why all directors are held to the same standard of reasonable investigation. It explains why stockholders in many instances are bereft of all defense. It explains the assumption that details of large business enterprises can be readily stated in the registration statement. It explains the great reliance placed on truth about securities, as if the truth could be told to people who could understand it -- a supposition which might be justified if little units of business were seeking funds and people were buying shares with the modicum of intelligence with which they are supposed to buy wearing apparel or horses.

So it is that the Act is a nineteenth-century piece of legislation. To understand it we must "turn back the clock" to simpler days. We must unscramble our large forms of organization. We must start anew to bring back into business organization a simplicity and directness consistent more with our beginnings than with our present status. It is sincerely felt by many that this ought to be our course. Such a course would have many obvious advantages. But it is inconceivable to me that it can be our course. We have passed through that

phase, and we are now in transition to something different and, I think, something better. Our problem is to perfect a plan for control of our present forms of organization. Such a plan when finally evolved must envisage a wide range -- from the increments of profit and control (which are incident to the constitution and form of the organization) to the terms and conditions of the organization, the kind and amount of securities which may be issued, the terms on which they may be issued, and the persons to whom they may be sold. Ultimately this may run to fascism or socialism. Intermediately it means harnessing these instruments of production not only for the ancient purpose of profit but also for the more slowly evolving purpose of service in the sense of the public good. The intermediate control logically seems to take the form of self-government coupled with a slowly increasing and more articulate form of public control to the end that such self-discipline shall not be wholly self-serving.

And so it seems that the Securities Act is antithetical to our more recent developments. Certainly the degree of collectivism present under the N.R.A. and A.A.A. is evidence of a coalescence of present forms of organization into even more stable forms. What the evolution of these new alignments will be is difficult to say. Their direction is clearly towards a more thoroughgoing programme of stabilization. . This obviously means, among other things, greater mastery of the forces of competition and monopoly, consumption and production, prices and costs, profits and losses.

Thus the Securities Act struggles against a current that is sweeping business the other way. Its strict enforcement is bound to mean in time its own end, as did the enforcement of the Eighteenth Amendment. It is apparent that the thing industry needs is constructive planning and organization conditioned by the requirements of the public good. When these become articulate, security regulation will be seen to be an integral part of the whole programme of industrial organization and regulation. They need as conspicuous a place in the present codes as labor, prices, and costs. They are inseparably a part of the control over expansion, competition, prices, and related matters which the codes set up. Any comprehensive and consistent control of the type which these parts of the New Deal envisage must inevitably embrace within it control over security issues. That in essence means control over access to the market. That control would be an administrative control lodged in the hands not only of the new self-disciplined business groups but also in the hands of governmental agencies whose function would be to articulate the public interest with the profit motive.

This would not mean setting out blindly on a wholly uncharted course. Our Capital Issues Committee gained some experience during the war in conserving investment capital for war purposes. And if we had been astute enough to follow its advice and provide a similar type of control for peace-time financing, we might have avoided some of the things which today make regulation of the issuance of

securities imperative. Furthermore, considerable experience has been acquired under many Blue Sky Laws of the states in blocking the issuance of certain securities and in permitting the issuance of others only on certain conditions. Two warnings, however, are necessary. On the one hand, the failure of the States adequately to enforce these laws should not condemn this type of control. The States had effective power only within their boundaries. And the amazing interstate complexity of the security business made action by the separate States conspicuously ineffective. It was increasingly apparent that the problem transcended state lines and that federal control was necessary. On the other hand, it should not be assumed that this type of control alone would be adequate. A governmental agency having such powers would be engaged in activity a thousand fold more complex than the analogous activity of the Interstate Commerce Commission in the railroad field. Instead of having one type of business to supervise, it would have all businesses. Those businesses are as kaleidoscopic as our whole economic and social life. A federal bureau having such power would transcend in size and complexity any which we have known to date.

The control needed is one which would combine regulation by industry with supervision by government. This would mean placing responsibility in industry for its own planning. The governmental agencies would condition this self-regulation by the requirements of the public interest. As indicated above, this would mean incorporating the matter of security issues in the codes. Industry itself through its representatives in the Code Authority would approve or disapprove of security issues. It would standardize practices, simplify security issues, and pass on the terms and conditions consonant with the requirements of the particular industry. In this way industry would take the primary responsibility for the financial practices in its field. A company which had cleared its security through the Code Authority and the supervisory governmental agency would gain the benefits of a moderated securities Act. The liability placed on it and its officers, directors, and others would be consistent with the business realities of the case. A company which obtained no such consent would then have to proceed through a securities Act perhaps even more severe and cumbersome than the present one. Or it might be prohibited from using the mails or agencies of interstate commerce to market the issue.

The adoption of such policy would require no great additions to our present machinery. For example, in the alcohol industries the machinery of the present codes could be easily utilized for that purpose. The changes necessary to make this new form of control workable would be neither great nor difficult. In that type of control we should have something much more fundamental than the truth about securities. We should be searching for the elements of soundness and stability, the absence of which caused most of the things which we so frequently attribute to fraud and deceit. At the same time, the requirement of the truth about



securities would be retained. But it would be given the secondary and relatively unimportant place which it deserves. If this preventive form of regulation were coupled with control of stock exchanges as recently proposed by the President's special committee on stock exchange regulation, and if more effective supervision over corporate organization and reorganization and over the relation of investors to the management were provided by federal incorporation or otherwise, we should have laid such solid bases for protection of investors as to make the present Act become wholly insignificant.

Moreover, it will be unfortunate if we either launch wholeheartedly on a programme of vigorous enforcement of the Securities Act or undertake patchwork amendments to it, without an immediate objective of a more pervasive administrative control. If we do so, we turn our steps to the past, forgetful of the realities of the present, and we merely delay or postpone genuine or permanent control, which eventually will come in one form or another. It is a matter of prudence to fashion that control consistently with the other integral parts of the total programme rather than to resist the relentless tide of events and to seek a return to conditions which have been wiped out in the forward sweep of our economic and social life.