

# THE SECURITIES AND EXCHANGE COMMISSION: ITS ORGANIZATION AND FUNCTIONS UNDER THE SECURITIES ACT OF 1933

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The Securities and Exchange Commission was created under authority of Public Act No. 291, Seventy-third Congress, approved June 6, 1934, known as "The Securities Exchange Act of 1934,"<sup>1</sup> to administer the Securities Act of 1933<sup>2</sup> and the Securities Exchange Act of 1934. From May 27, 1933<sup>3</sup> until September 4, 1934, the Securities Act was administered by the Federal Trade Commission. Since September 4, 1934, it has been administered by the Securities and Exchange Commission. Public Act No. 333, known as "The Public Utility Act of 1935,"<sup>4</sup> is also administered by the Securities and Exchange Commission. The discussion in the present article will be limited to the organization and functions of the Commission with respect to duties under the Securities Act of 1933.

The Commission is composed of five commissioners, not more than three of whom may be members of the same political party, appointed by the President, by and with the advice and consent of the Senate, one of whom is annually elected Chairman. The statutory term of office of the commissioners is five years with staggered terms in the original appointments so as to create a vacancy at the end of each year. Each commissioner receives a salary of ten thousand dollars a year.

The duties of the Commission under the Securities Act of 1933 are carried on through nine divisions and the regional offices. The divisions are: Office of the Secretary, Registration Division, Legal Division, Trading and Exchange Division, Office of the Economic Adviser, Office of the Chief Accountant, Research Division, Office of Supervisor of Information Research, and Division of Forms and Regulations. The branch offices are located in New York City, Boston, Atlanta, Chicago, Fort Worth, Denver, San Francisco and Seattle.

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<sup>1</sup> 48 STAT. 881, 15 U. S. C., c. 2B.

<sup>2</sup> 48 STAT. 74, 15 U. S. C., c. 2A.

<sup>3</sup> However, see Section 6(e) of the Act which provides that no registration statement may be filed within 40 days following its enactment.

<sup>4</sup> 49 STAT. 803, 15 U. S. C., c. 2C.

Broadly speaking, the Securities Act is based upon the proposition that the buyer of securities is adequately protected if a fair disclosure of the material facts essential to a judgment of their value be furnished by the seller. The furnishing of such information is required, and the failure to furnish it penalized, in connection with the sale of any security by use of the means or instrumentalities of interstate commerce or of the mails.<sup>5</sup> The accuracy and adequacy of the disclosure in sales of securities exempt from registration are a matter of determination by the courts, without reference to an explicit statutory standard, from the particular facts presented in individual cases.<sup>6</sup> In the case of securities required to be registered the statute specifies the character and amount of information to be furnished by the issuer.<sup>7</sup>

It is the function and duty of the Commission to assure that a fair and truthful disclosure of the material facts essential to an appraisal of the value of securities be made available to prospective purchasers or, in the absence of such disclosure, to prevent their sale. But disclosure does not occur automatically; it must be encouraged and cultivated and, in certain instances, forced. Disclosure, likewise, is meaningless and purposeless unless embodied in terms reasonably comprehended. The product of disclosure and the sufficiency of the concept of disclosure as a remedy depend to a large extent upon the effectiveness of the organization of the administrative body. Principle and policy, method and technique are in great measure but reflections of structural organization. The Commission has exercised its powers under the Act to create an organization whose primary function it is to fit the statutory theory of disclosure to the needs of a nation of investors.

A mechanical description of duties of the various divisions would add little to an understanding of the functions and work of the administrative body. In large measure the contribution of each of these divisions to the totality of work done by the Commission is indicated by the respective titles. The Legal and Registration Divisions, for lack of a more precise descriptive term, may be characterized as executive, the Legal Division being charged with the responsibility of enjoining the sale of securities in violation of the terms of the Act and the Registration Division being charged with the responsibility of enforcing compliance with the provisions of the Act and the rules and regulations governing registration of securities. Each of these divisions renders advice and makes recommendations to the Commission and, in addition, members of the staff of each division assist issuers and other persons concerned in the issuance and sale of securities in matters involving their respective jurisdictions. The other divisions contribute greatly to the work of these two

<sup>5</sup> Securities Act, §§5, 12, 17.

<sup>6</sup> A somewhat different problem will be presented where issuers claim exemption from registration under the provisions of Rule 202 of the Commission's General Rules and Regulations, which require that a prospectus setting forth certain information shall be on file with the Commission before it is used in offering the security for sale. An issuer seeking to avail itself of this exemption may be liable under Section 5 for failure to comply with the provisions of the rule creating the exemption, thus rendering the exemption unavailable, or, under Section 12 or 17, for misleading omissions or untrue statements in the prospectus.

<sup>7</sup> Securities Act, Schedules A, B.

divisions in the way of providing data and information obtained through research upon which a more intelligent and effective administration of the affirmative provisions of the Act may be erected. For example, the Research Division furnishes to the Registration Division information concerning developments subsequent to registration which enables the Registration Division to test the effectiveness of the examination technique against actual practices. The Trading and Exchange Division furnishes the Registration Division information as to markets, market conditions and activities. Thus the examination technique is sharpened through integration and coordination of the work of these divisions. The Form and Regulations Division, the division responsible for the preparation of forms and rules and regulations, is aided in its draftsmanship by the Registration Division whose experience in interpretation of the items of the various forms and the rules and regulations applicable to registration provides an invaluable test. The Chief Accountant, in ruling upon complex or intricate accounting problems, may borrow from the knowledge and information of the other divisions acquired in the course of their administration of their own duties. The branch offices perform service functions in supplying information and counsel concerning the applicability of the provisions of the Act to issuers of securities originating in their regions and likewise observe the practices and methods pursued, and the sales literature utilized, in the course of distribution.

Disclosure acquires significance not alone through organized administration operating upon issuers of securities. The Act directs that publicity be given to the Commission's rulings, regulations, opinions and findings, as well as to the filing and contents of registration statements. This requirement is fulfilled through the Office of Supervisor of Information Research who collects and makes available to the public information regarding the activity of the Commission in the administration of the Act.<sup>8</sup>

The foregoing outline of the structure of the Commission organization indicates the distribution of duties in the administration of the Act. Much more could be said of the day to day duties of each division and the contributory part of each in accomplishing the task the Commission has before it. An understanding of the nature of the Commission organization and the character of its administration is aided by a brief statement of the provisions and requirements of the Act and a discussion of special problems which have arisen in the course of its administration.

Unless a security is exempt from the requirements of registration under the Act, or is effectively registered, it is unlawful for any person, directly or indirectly, to make use of the mails or means or instruments of interstate commerce to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or to carry or cause to be carried through the mails or in interstate commerce,

<sup>8</sup> Photostatic copies of the registration statements and reports and documents filed therewith by security issuers are available to any member of the public at cost. Any Commission release may be obtained without cost.

by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.<sup>9</sup> A security may be exempt either because of the character of such security or the nature of the transaction in which it is offered for sale or sold. Section 3(a) of the Securities Act exempts securities of the classes set forth therein, and Section 4 exempts certain transactions. In addition to the exemptions thus specifically provided, the Commission may, under authority of Section 3(b), from time to time adopt rules and regulations providing for exemption from registration of securities when the aggregate amount at which such issue is to be offered to the public is not in excess of \$100,000. The Commission, pursuant to this section, has adopted rules and regulations providing exemption, subject to certain conditions, of securities issues of not more than this aggregate amount.

The mechanics of registration are governed by the terms of Sections 6 and 8 of the Act. Section 6 prescribes the details surrounding the filing of a registration statement. A registration statement is filed in triplicate, at least one copy of which shall be signed by each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or its principal accounting officer, and the majority of its board of directors or persons performing similar functions. The filing with the Commission of a registration statement is deemed to have taken place upon the receipt thereof, if it is accompanied by a United States postal money order or a certified bank check or cash for a fee of one one-hundredth of one per centum of the maximum aggregate price at which such securities are proposed to be offered, but in no case shall the fee be less than \$25.<sup>10</sup> A registration statement becomes effective by lapse of twenty days from the date of filing.

Thus the acquisition of a filing date from which the effective date may be measured depends upon the payment of the required fee.<sup>11</sup> The determination of the

<sup>9</sup> Section 5 of the Act provides:

"(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or
- (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

"(b) It shall be unlawful for any person, directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets the requirements of section 10; or
- (2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of section 10."

<sup>10</sup> Section 6(c) of the Act provides:

"(c) The filing with the Commission of a registration statement, or of an amendment to a registration statement, shall be deemed to have taken place upon the receipt thereof, but the filing of a registration statement shall not be deemed to have taken place unless it is accompanied by a United States postal money order or a certified bank check or cash for the amount of the fee required under subsection (b)."

<sup>11</sup> Rules governing the computation of the filing fee under special circumstances have been adopted. Rule 900 of the General Rules and Regulations provides:

"(a) At the time of filing a registration statement, the registrant shall pay to the Commission a fee of one

adequacy of the fee is made at the date of filing. Subsequent changes in the proposed offering price either prior to or after the effective date of the registration statement, if made in good faith would not necessitate payment of an additional fee, or, stated alternatively, if the fee paid at the time the statement is delivered to the Commission has been calculated in good faith upon the basis of registrant's then proposed maximum offering price, any later changes in the offering price of the securities would not upset the fee or the filing date. It would make no difference if subsequent to a bona fide calculation at the date the statement was submitted, the registrant because of changed market conditions or other reasons decided to offer at a unit price higher or lower than that upon which the calculation was based. In either event, the registrant would not be obliged to pay an additional fee or entitled to receive a refund of a portion of the fee paid.

Section 8 provides for the taking effect of registration statements and amendments thereto. A registration statement becomes effective by lapse of twenty days from the date of filing. An amendment filed prior to the effective date of such statement creates a new filing date unless it is filed with the consent of the Commission in which event it shall be treated as having been filed when the statement was originally filed. An amendment, not incomplete or inaccurate on its face, filed after the effective date of the registration statement becomes effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors.

Section 8 (b) provides for an order refusing to permit the registration statement to become effective if such statement is inaccurate or incomplete on its face. This section provides for a hearing after notice, within ten days of the filing date, scheduling a hearing within ten days of the date of notice. Section 8 (d) provides for an order suspending the effectiveness of a registration statement which has been found to contain untrue or misleading statements or to omit required information. Notice of hearing under this section may be given at any time, but must specify a date for hearing within fifteen days of the date of notice. In the event an order is issued pursuant to the provisions of either Section 8 (b) or 8 (d), the order shall specify the matters found to be defective. When the statement has been amended in accordance with an order under Section 8 (b), the Commission shall so declare and the registration statement shall become effective in accordance with the provisions of Section 8 (a) or upon the date of such declaration, whichever date is the later. When the registration statement has been amended in accordance with a stop order

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one-hundredth of one per centum of the maximum aggregate price at which the securities are proposed to be offered, but in no case shall such fee be less than \$25.

"(b) Where securities are to be offered at prices computed upon the basis of fluctuating market prices, the 'price at which the securities are proposed to be offered,' upon which the registration fee is to be calculated, shall be based upon the price at which units of securities of the same class were or would have been sold on a specified date within fifteen days prior to the filing of the registration statement."

Instruction 7 of the rules and instructions accompanying Form E-1 sets forth the basis for computation of the filing fee for securities to be issued in the course of a reorganization.

issued under Section 8 (d), the Commission shall so declare and thereupon the stop order shall cease to be effective.

The conduct of stop order and refusal order proceedings is governed by the provisions of the Commission's rules of practice.<sup>12</sup> Notice of any hearing under Section 8 of the Act is given by the Secretary of the Commission to the person designated in the registration statement as being authorized to receive service and notice of orders and notices issued by the Commission relating to such registration statement. Such notice is required to contain a statement of the time and place of hearing and a statement of the items in the registration statement, by number or name, which appear to be incomplete or inaccurate in any material respect or to include any untrue statements of a material fact or to omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading. Notice may be given either by personal service or by confirmed telegraphic notice and shall be given a reasonable time before the hearing. The rules also require that the personal notice or the confirmation of the telegraphic notice shall be accompanied by a short and simple statement of the matters to be considered and determined at the hearing.

The statute provides that hearings under the Act may be presided over by the Commission or an officer designated by it. The rules of practice provide for the designation of an officer and refer to such officer as Trial Examiner. Most hearings under Section 8 of the Securities Act have been conducted before a Trial Examiner who rules on the admissibility of evidence, entertains certain motions<sup>13</sup> and within ten days after receipt of the transcript of the testimony files with the Secretary of the Commission his report containing his findings of fact. Exceptions to the findings of the Trial Examiner or his failure to make findings or to the admission or exclusion of evidence may be filed within fifteen days after receipt of a copy of the Trial Examiner's report. These exceptions may be argued only at the final hearing on the merits. Any party to a proceeding may file a brief in support of his contentions within fifteen days from the date of service on such party of a copy of the Trial Examiner's report and may request an oral argument before the Commission in support of such contentions. If oral argument before the Commission is not requested, the matter will be considered without argument by the Commission on the

<sup>12</sup> These rules are applicable likewise to proceedings held pursuant to certain sections of the Securities Exchange Act of 1934 and the Public Utility Act of 1935. See Rule III (b) of the Rules of Practice and S. E. C. Release No. 661 (SA), Feb. 12, 1936; S. E. C. Release No. 482 (SEA), Feb. 12, 1936; and S. E. C. Release No. 95 (PUA), Feb. 12, 1936.

<sup>13</sup> Rule V (b) of the Rules of Practice provides:

"(a) Motions before the Commission or the Trial Examiner shall state briefly the purpose thereof and all supporting affidavits, records and other papers, except such as have been previously filed, shall be filed with such motions and clearly referred to therein.

"(b) Motions in any proceeding before a Trial Examiner which relate to the introduction or striking of evidence may be ruled on by the Trial Examiner. Exception to any such ruling must be noted before the Trial Examiner, in order to be urged before the Commission. All other motions, including motions to dismiss, in any proceeding before a Trial Examiner shall be reserved and shall be ruled upon by the Commission."

Trial Examiner's report, exceptions thereto, and the respective briefs submitted. The Commission may adopt the findings of fact in the report of the Trial Examiner in the absence of exceptions that are sustained or of ascertained error, or the Commission may embody in a written opinion its own findings of fact in respect of deficiencies in the registration statement.

The nature and function of the Trial Examiner's report containing findings of fact and its procedural significance deserves more detailed treatment than is possible here. The report is an aid to the Commission in making its findings, advisory but not binding.<sup>14</sup> Fundamentally, the Trial Examiner is an officer essential to a practicable administration of the statute and his report an expedient of the Commission in the collection and correlation of evidence which the Commission itself must consider and act upon.<sup>15</sup>

<sup>14</sup> The Commission has on several occasions stated the effect of the Trial Examiner's report. See, e.g., *In the Matter of Continental Distillers and Importers Corp.*, 1 S. E. C. 54, 56 (1935), wherein it is pointed out that the report of the Trial Examiner is not binding upon the Commission. Also see *Arrow-Hart & Hegeman Electric Co. v. Federal Trade Comm'n*, 63 F. (2d) 108 (1933). This case involved a motion by the Federal Trade Commission for an order striking from the petition the paragraphs thereof consisting of reference to and quotations from the Trial Examiner's report and a motion by petitioner for the inclusion of the Trial Examiner's report in the record certified to the court. The motion of the respondent was granted, and the motion of the petitioner denied, the court saying, at p. 109:

"Such report seems to be prescribed by the rules of practice adopted by the Commission under the general statutory power. Federal Trade Commission Act, 38 Stat. 721, §6(g), 15 USCA §46(g). These reports are for the assistance of the Commission, and are kept in the files of the Commission for reference. The review and the findings thereon, the statute provides, are for the Commission and not the trial examiners. The reports of the trial examiners are not binding upon one charged with violation of the act. Indeed, the act does not require the Commission to employ examiners to proceed with hearings or to make reports; it authorizes the Commission to employ examiners among other officers. 38 Stat. 718, §2, 15 USCA §42. The statute authorizes such examiners to administer oaths and affirmations, examine witnesses, and receive evidence. 38 Stat. 722, §9, 15 USCA §49 (and notes) p. 283. This is not exclusive authority, but discretionary. We assume that the examiner's reports are used as of some assistance to the Commission, but the result or conclusions of the Commission, we must assume, are found in the findings adopted by it."

<sup>15</sup> An interesting case in this connection is *Morgan v. U. S.*, decided May 25, 1936, in the United States Supreme Court, 298 U. S. 468. The case arose under the Packers and Stockyards Act, 42 Stat. 159 (1921), 7 U. S. C. §§181-229. A proceeding was instituted by an order of the Secretary of Agriculture directing an inquiry into the reasonableness of existing rates charged by market agencies for buying and selling live stock at the Kansas City Stockyards. On appeal from a judgment of the District Court sustaining the order of the Secretary of Agriculture prescribing maximum charges for selling live stock plaintiffs contended, *inter alia*, that they had not been accorded the hearing which the statute required and alleged as to the failure to give a proper hearing that at the conclusion of the taking of the testimony before an Examiner, a request was made that the Examiner prepare a tentative report, which should be subject to oral arguments and exceptions, so that a hearing might be had before the Secretary without undue inconvenience to him, but that the request was denied and no tentative report was exhibited to plaintiffs and no oral argument upon the issues presented by the order of inquiry and the evidence was at any time had before the Secretary. . . . That the Secretary at the time he signed the order in question had not personally heard or read any of the evidence present at any hearing in connection with the proceeding and had not heard or considered oral arguments relating thereto or briefs submitted on behalf of the plaintiffs, but that the sole information of the Secretary with respect to the proceeding was derived from consultation with employees in the Department of Agriculture out of the presence of the plaintiffs or any of their representatives. On motion of the Government, the District Court struck out all the allegations of the bill of complaint summarized above and the plaintiffs were thus denied opportunity to require an answer to these allegations or to prove the facts alleged. The court stated that while it would have been good practice to have the Examiner prepare and submit a report to the Secretary and the parties and to permit exceptions and arguments addressed to the points thus presented; that that particular

It will be noted that administrative control of registration procedure to assure that securities shall not be offered unless fair disclosure of the material facts is made is provided for only by way of summary process through formal proceedings. The Act provides no informal method of bringing about correction or supplementation of the contents of a registration statement. Many registration statements are defective as filed. A literal application of the procedure outlined in Section 8 would result in the issuance of either a stop or refusal order against many such statements. It is apparent that such an administration of a new and technical statute, largely unwelcome to those whom its administration would most directly affect, would create an impossible situation resulting in a destruction of many of the most useful purposes of the Act. Thus early in the history of the Act<sup>16</sup> an informal administrative device was evolved which has developed into the necessary supplement to the express provisions of Section 8. This device has come to be known as a letter of deficiency. The evolution of the letter of deficiency strikingly illustrates the fluidity and adaptability of the administrative process. The theory of a letter of deficiency is that a registrant will voluntarily make corrections of, or additions to, the registration statement if the corps of experts on the Commission's staff cite the particulars in which it appears on its face to be inaccurate or misleading. The statement of deficiencies contained in the letter is neutral. The Commission does not say that the registrant's claims or representations are untrue or demand a particular manner of presentation; it merely says that judging by the information contained in the

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type of procedure was not essential to the validity of the hearing. The court also cautioned against confusing the fundamental question with one of mere delegation of authority, saying that if the Secretary had assigned to the Assistant Secretary the duty of holding the hearing and the Assistant Secretary accordingly had received the evidence taken by the Examiner, had heard the argument thereon, and had then found the essential facts and made the order upon his findings, there would then have been simply the question of delegation. But the court went on to point out that while the Assistant Secretary heard the argument he did not make the decision and the Secretary who, according to the allegation, had neither heard nor read the evidence or argument undertook to make the findings. The Assistant Secretary, who had heard, had assumed no responsibility for the findings or order and the Secretary, who had not heard, did assume that responsibility. The opinion teaches that the officer who makes the findings must address himself to the evidence and upon that evidence conscientiously reach the conclusions which he deems it to justify. The meaning of the opinion becomes clear from the quotation of a paragraph:

"This necessary rule does not preclude practicable administrative procedure in obtaining the aid of assistants in the department. Assistants may prosecute inquiries. Evidence may be taken by an examiner. Evidence thus taken may be sifted and analyzed by competent subordinates. Argument may be oral or written. The requirements are not technical. But there must be a hearing in a substantial sense. And to give the substance of a hearing, which is for the purpose of making determinations upon evidence, the officer who makes the determinations must consider and appraise the evidence which justifies them. That duty undoubtedly may be an onerous one, but the performance of it in a substantial manner is inseparable from the exercise of the important authority conferred."

<sup>16</sup>The letter of deficiency represents a service function of the Commission which operates to make registrants aware of unfulfilled requirements of the Act and the general rules and regulations and provides a fluid medium through which standards of disclosure may be accommodated to a constantly developing subject matter. The letter of deficiency had been adopted as a general procedure within three months of the passage of the Act. It evolved from the practice immediately established of passing on to a registrant a "memorandum of errors" prepared by a member of the staff for the Chief of the Securities Division of the Federal Trade Commission. The "memorandum of errors" is now styled "memorandum of deficiency" and constitutes the foundation for the letter of deficiency.



statements in the registration statement and the great body of relevant information available to the Commission's staff, it appears that certain statements in the registration statement are inaccurate or misleading and that certain information required by the Act and the rules and regulations to be in the statement has been omitted.

The basis of selection of the particular mode of procedure in connection with palpably inaccurate registration statements is difficult to state precisely. It may be said in general that statements which evidence fraud, willful falsehood or inadequate disclosure of reckless disregard of investors' rights will be handled through proceedings under Section 8. Those statements which show evidence of sincere and honest preparation, even though deficient, are handled through a letter of deficiency.

The importance of registration in the scheme of regulation provided in the Act makes it desirable to consider briefly how registration is accomplished and the technique employed in examination of registration statements. The Act sets forth in broad outline the information which is required to be furnished in any registration statement.<sup>17</sup> The Commission has authority<sup>18</sup> to prescribe the form or forms in which the required information shall be given, including the power to prescribe methods to be followed in accounting and appraisal matters, and to make rules defining accounting, technical and trade terms. The Commission to date has adopted ten forms. Form A-1 is a general form for registration of all securities for which no other form is specifically prescribed. Form A-2 is used for registration of securities (except such securities as to which a special form is specifically provided), by any corporation which files profit and loss statements for three years and has either made annually available to its security holders for at least ten years financial reports including at least a balance sheet and a profit and loss or income statement or had a net income for any two fiscal years of the five fiscal years preceding the date of the latest balance sheet filed with the registration statement. Form C-1 is used for registration of securities of unincorporated investment trusts of the fixed or restricted management type having a depositor or sponsor, but not having a Board of Directors or persons performing similar functions. Form C-2 is used for registration of certificates of interest in securities of a single class of a single issuer, subject to certain conditions. Form D-1 is used in registering certificates of deposit in anticipation of or in connection with a plan of reorganization or readjustment. If certificates of deposit are issued in connection with a plan of reorganization or readjustment, which involves the issue of new securities to the holders of certificates of deposit, and the issuer of certificates of deposit is the original issuer of the securities called for deposit, Form D-1A is used. Subject to the rules defining the term "reorganization" and certain special rules governing the use of Form A-2, Form E-1 is used for registration of any securities, sold or modified in the course of a reorganization, except in cases in which either Form F-1, D-1, D-1A or C-1 is prescribed. Form F-1 is used to register voting trust certificates issued in the course of reorganization or otherwise. Form G-1 is used to register fractional undivided producing oil and gas

<sup>17</sup> Securities Act, Schedules A, B.

<sup>18</sup> *Id.* §19.

royalty interests. Form G-2 is used to register fractional undivided non-producing oil and gas royalty interests.

Immediately after the statement is filed and entered in the docket it is routed to one of the examining groups in the Registration Division, the statements being assigned in rotation without regard to type of security involved or the nature of the transaction in which the securities are being offered. The Registration Division is supervised by a Director, and under his supervision, in connection with duties under the Securities Act, are three Assistant Directors and five Analysts, the Analysts being in immediate charge of the various groups. One Assistant Director is charged with the responsibility of supervising all general interpretative questions arising under the general rules and regulations governing registration, questions as to the proper form and the requirements of individual items in particular circumstances and proceedings under Section 8. The remaining two Assistant Directors supervise, in accordance with the assignment of registration statements, the work of the Analysts and the group members in the examination of, and preparation of letters of deficiency on, registration statements. Registration statements are given a file number for purposes of identification, the even-numbered statements being under the supervision of one Assistant Director, the odd-numbered statements under the supervision of the other.

Each examining group is composed of an analyst, who is in charge of the group, an attorney, an accountant and four or five examiners. In addition to the examining groups, there is in the Registration Division a group of experts including oil engineers, mining engineers, geologists, valuation experts and industrial engineers, from which the groups obtain advice and counsel with respect to technical problems arising in the course of examination of the statement. All the technical experts, except oil experts, are under the direction and supervision of the Principal Engineer. The oil experts are grouped in a unit known as the Oil and Gas Unit. This group examines prospectuses and oil offering sheets filed under the provisions of Regulation B of the General Rules and Regulations, and is available for consultation with other members of the staff of the Registration Division in connection with any technical problem arising in the course of an examination of a registration statement involving oil organizations.

The registration statement is assigned to an analyst who in turn delivers a copy to an examiner, the accountant and the attorney of the group. The examiner determines whether the statement is filed on the proper form and whether the information required to be in the statement has been furnished in the form prescribed by the General Rules and Regulations and the instructions with respect to particular items of the form. The examiner also applies a test of intelligibility and clarity of presentation of the material in the registration statement and prospectus. The rules and regulations permit the omission from the prospectus of information contained in answer to certain items of the registration statement, the issuer being free, subject to

the requirement of intelligibility and clarity, to select any order or arrangement for the information required to be in the prospectus.

Upon the basis of his examination, the examiner prepares a memorandum designated "Initial Report by the Examining Group." This report includes a brief history of the issuer, a statement of the capital structure as at the date of filing, a statement of the securities proposed to be offered and an identification of their source, a description of the method of offering, the price at which the securities registered are to be offered and details of the underwriting data, a statement of any of the securities to be offered at prices below the offering price to the public, a summary of any options to persons other than underwriters or dealers, the names and addresses of officers and directors and underwriters, a statement of any affiliation between the issuer and the underwriter, a statement of listing and trading data, a summary of denials by any state regulatory body prohibiting the sale of issuer's securities and, finally, a memorandum of the material questions raised and the deficiencies noted in the registration statement as filed. This initial report and the memorandum of deficiencies are reviewed by both the accountant and the attorney, with the object of ascertaining the effect and influence of the deficiencies cited upon the accuracy and completeness of the financial statements contained in the registration statement and upon the legality of the issue. When the preliminary review of the accountant and attorney is completed, the examiner, the accountant and attorney meet with the analyst and discuss each deficiency from the standpoint of compliance with the express requirements of the Act, the Rules and Regulations and the particular form upon which the securities are registered and likewise from the standpoint of intelligible and clear presentation of the information. As a result of this conference, some deficiencies cited by the examiner may be eliminated from further consideration, while others not theretofore considered, may be raised. Upon the basis of the discussion at this conference, unless proceedings under Section 9 are directed by the Commission, a letter of deficiency is drafted, which represents the group opinion as to material deficiencies in the registration statement under consideration. This letter of deficiency then goes forward to the Assistant Director, who reviews the registration statement and the letter with the analyst, attorney, accountant and sometimes the examiner, to determine whether deficiencies have been properly cited and whether other matters should be cited as deficiencies. Two members of the Registration Division, the largest part of whose work is the reading and studying of prospectuses without previous access to the registration statement and various exhibits filed therewith, assist the Assistant Directors. The theory is that as persons to whom the securities are offered for sale will not ordinarily be familiar with the entire contents of the registration statement, but must rely solely on the prospectus, a check of this kind is usually desirable and effective.

Unless a particularly difficult or complex technical or legal problem or matter of policy in the way of procedure is involved in the review of the letter of deficiency,

the letter will be sent to the registrant or its agent. In the instances in which unusual questions or matters of policy are raised, the Assistant Director will consult with the Director of the Division, who either disposes of the problem on his own responsibility or seeks a ruling from the Commission as to the proper method of treatment to be accorded to the particular case.

The registrant, on the basis of the deficiency letter, prepares amendments supplying the information required, but omitted from the statement as originally filed, or clarifying the matters considered defective. Upon the filing of the amendments, the examination routine is repeated. If deficiencies remain in the registration statement, they are cited in an additional letter to the registrant and further amendments are filed. The statement becomes effective upon lapse of twenty days from the date of filing or twenty days from the date of the last amendment, unless such amendment be filed with the consent of the Commission, in which event the amendment is deemed to have been filed with the statement which thereupon becomes effective, as amended, twenty days from the original filing date.

Any discussion of the registration procedure is incomplete without a statement covering the right of the registrant to withdraw its registration statement. The statute is silent on the proposition of withdrawal and the extent or limit of this right is determinable only by reference to the general law in analogous situations. The right of a registrant to withdraw a registration statement was discussed by the United States Supreme Court in the case of *J. Edward Jones v. The Securities and Exchange Commission*.<sup>19</sup> On May 4, 1935, J. Edward Jones filed a registration statement on Form C-1 covering an offering of participation trust certificates. The statement under the terms of the Act was to become effective twenty days later. On the nineteenth day, however, the Commission, having already directed that stop order proceedings be instituted pursuant to Section 8(d), sent registrant telegraphic notice of a hearing in stop order proceedings to be held June 6, 1935. The hearing was subsequently postponed until June 18, 1935. Upon the latter date the registrant in a written communication to the Commission petitioned for withdrawal of its registration statement. The Commission denied this request and the question eventually came before the Supreme Court of the United States for decision. The Court held that the registrant under the circumstances of this case had an unqualified right, not subject to administrative discretion, to withdraw its registration statement.

The question of the registrant's right of withdrawal was referred to the general rule at common law and equity governing the right of a plaintiff to take a non-suit or obtain dismissal of pending proceedings. Until the registrant had acquired that for which he had instituted the proceeding, namely, a license or permit (*i.e.*, effective registration statement) to use the mails and means and instrumentalities of interstate commerce for distribution of securities, the proceeding was deemed by the court to be pending and so long as it was still pending his right to dismiss, *i.e.*, withdraw the registration statement, was comparable to the right of a plaintiff at law to dismiss

<sup>19</sup> 298 U. S. 1 (1936).

pending proceedings. While the analogy is not pursued further by the court, nor was it necessary for the decision in that case, it would seem that if the filing of a registration statement is analogous to the filing of a bill in equity or a declaration in an action at law, the effective date, *i. e.*, acquisition of a permit or a license, would likewise be analogous to the return of a verdict at law or decree in equity. Consequently, it would seem logically to follow that had Jones' registration statement become effective his right of withdrawal, if measurable by a plaintiff's right to dismiss pending proceedings, would have disappeared. The court, however, by likening the effect of the telegram giving notice of the proceedings under Section 8(d) to the effect of notice of institution of proceedings to obtain a restraining order in equity, concluded that notwithstanding the provisions of Section 8 the statement had not become effective.

The Commission has had occasion since the Jones opinion was rendered to rule upon a motion by a registrant for withdrawal of its registration statement.<sup>20</sup> In that case, the statement had been effective for over two and one-half years and securities had been offered for sale and sold before the motion for withdrawal was made. Proceedings under Section 8(d) had been instituted and the hearing was in progress when the motion for withdrawal of the registration statement was made. The motion was denied, the Commission stating in its written opinion:

"Rule 960 of the General Rules and Regulations under the Securities Act of 1933, which must govern our action upon this petition, provides as follows:

'Any registration statement or any amendment thereto may be withdrawn upon the application of the registrant if the Commission, finding such withdrawal consistent with the public interest and the protection of investors, consents thereto. The application for such consent shall be signed by the registrant, and shall state fully the grounds upon which made. The fee paid upon the filing of the registration statement will not be returned to the registrant. The papers comprising the registration statement or amendment thereto shall not be removed from the files of the Commission but shall be plainly marked with the date of the giving of such consent, and in the following manner: "Withdrawn upon the request of the Registrant, the Commission consenting thereto".'

"(1) The effect of the rule contained in Release No. 47, which at that time embodied the substance of the present Rule 960, was considered by the Supreme Court in *Jones v. Securities and Exchange Commission*, 298 U. S. [1], 80 L. Ed. 655 (April 6, 1936). In that case, on the day preceding the date upon which the statement would otherwise have become effective by lapse of the twenty-day period specified in Section 8 (a), the Commission had notified the registrant of a stop order hearing. The sending of this notice prior to the effective date, according to the Court's opinion, prevented the statement from becoming 'effective' as that term is used in the Act. The Court then held, largely on the basis of the non-effective status of that statement, that Jones had an absolute right, not subject to administrative discretion, to withdraw his registration statement. In so holding, the Court applied as an analogy the general rule at common law and equity that, unless there exists a rule of Court to the contrary, a plaintiff may, prior to decree or verdict, dismiss his bill

<sup>20</sup> In the matter of the registration statement of National Boston Montana Mines Corporation, File No. 2-108, S.E.C. Release No. 970 (SA), Aug. 10, 1936.

in equity or complaint at law as of right 'unless the dismissal would legally prejudice the defendants in some other way than by future litigation of the same kind.' Although the Court did not pass on the validity of the rule of this Commission governing withdrawals, it construed our rule not to be a restriction of the general common law or equity principles under which a plaintiff may dismiss his case without prejudice. As we read it, however, the opinion of the Court contains the clear implication that, had the registration statement there in question been effective, or had securities been sold to the public thereunder, no such unqualified right of withdrawal would have existed. At page [22] (80 L. Ed. p. 663) the Court concludes this phase of its opinion with these words:

'In this proceeding, there being no adversary parties, the filing of the registration statement is in effect an *ex parte* application for a license to use the mails and the facilities of interstate commerce for the purposes recognized by the Act. We are unable to see how any right of the general public can be affected by the withdrawal of such an application before it has gone into effect. Petitioner emphatically says that no steps had been taken looking to the issue of the securities; and this is not denied. So far as the record shows, there were no investors, existing or potential, to be affected. The conclusion seems inevitable that an abandonment of the application was of no concern to anyone except the registrant. The possibility of any other interest in the matter is so shadowy, indefinite, and equivocal that it must be put out of consideration as altogether unreal. Under these circumstances, the right of the registrant to withdraw his application would seem to be as absolute as the right of any person to withdraw an ungranted application for any other form of privilege in respect of which he is at the time alone concerned.'

"The difference between the circumstances of the *Jones* case and those of the present case seem obvious. The registrant in this case is not attempting to withdraw an 'ungranted application'. The 'application' has, so to speak, been 'granted'. The registration statement became effective more than two years before the attempted withdrawal. The privilege which registrant sought when it filed its registration statement has been acquired and utilized. Thus, using the analogy to court proceedings which the Supreme Court employed in the *Jones* case, the present case stands as if a verdict or decree had been entered upon the registrant's 'application' for the right to sell securities in and by means of instrumentalities of interstate commerce. The right of a plaintiff at law or in equity to withdraw his suit, is, of course, lost upon return of verdict or entry of decree. Similarly, the right of a registrant to withdraw, as established in the *Jones* case, ceases upon effectiveness of his registration statement, at least when, as in this case, the effectiveness of the registration statement is coupled with sales of securities thereunder."

In addition to the summary proceedings by way of stop order or refusal order under Section 8, the Act contains other sanctions designed to bring about a compliance with its requirements. The Commission is authorized<sup>21</sup> to bring an action in any district court of the United States, United States Court of any territory, or the Supreme Court of the District of Columbia to enjoin any person engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of the Act, or of any rule or regulation prescribed under authority thereof.

Section 17 (a) of the Act expresses a prohibition against any act which will con-

<sup>21</sup> Securities Act, §20.

stitute fraud. The only departure from the common law in this section is the provision rendering unlawful the obtaining of money by misleading omissions. The criminal penalties apply only when there has been a willful misstatement or omission or a willful disregard of the direct commands or express prohibitions of the Act or the regulations adopted thereunder.<sup>22</sup>

Civil remedies are provided in Sections 11 and 12 of the Act. The liabilities under Section 11 are based upon untrue material statements and misleading material omissions in a registration statement. The liabilities set up by Section 12 arise from matters other than those in the registration statement. If a registration statement contains untrue material information or omits material information required to be included or material information without which that given is misleading, a right of action is accorded all purchasers of the securities. The remedy is against the issuer, the underwriter, all directors and all signers of the registration statement. In addition, a right of action is granted against every expert, who has, with his consent, been named as having prepared the part of the registration statement with respect to which part a material untruth or omission is claimed. The liability as to these persons is joint and several with a right of contribution among themselves. Section 11(f), however, denies the right of contribution to a fraudulent party against an innocent party.

The liability for making false or misleading statements in a registration statement is not absolute except as to the issuer of the securities. All other persons may avoid liability by establishing that after reasonable investigation they had reasonable grounds to believe and did believe that the information contained in the statements in the registration statement were accurate and complete. In determining what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness is that required of a prudent man in the management of his own property.<sup>23</sup> As to those made upon the authority of an expert, the same standard must be observed in selecting and placing reliance upon such expert.

Section 12(1) creates a right of action in favor of the immediate purchaser against the person who sells the security in violation of Section 5, the latter section prohibiting the sale of securities unless a registration statement is in effect as to such securities and prospectus meeting the requirements of the Act<sup>24</sup> is delivered to the purchaser prior to or at the time the sale or delivery of the security is made.<sup>25</sup>

Section 12(2) creates a right of action in favor of the immediate purchaser of a security against any person who sells him a security on the basis of a prospectus or oral communication which includes an untrue statement of a material fact or omits to state material facts necessary to make the statements, in the light of the circumstances under which they are made, not misleading. The seller may successfully defend any such action if he sustains the burden of proof that he did not know, and

<sup>22</sup> *Id.* §24.

<sup>23</sup> *Id.* §11(b)(3).

<sup>24</sup> *Id.* §§2(10), 10.

<sup>25</sup> Securities issued in exempt transactions or securities exempt under the Act or by rule of the Commission pursuant to Section 3(h) are not subject to the provisions of Section 5.

in the exercise of reasonable care could not have known, of such untruth or omission. This provision applies to any statements made in the course of a given sale whether or not the securities involved are included in a registration statement, and likewise applies to representations concerning securities not required to be registered. The remedy, however, is granted only to the person to whom the security was sold against the person making the sale.

The measure of damages under Section 11 is the difference between the purchase price of the security and the value thereof at the time suit is brought except to the extent that the defendant can prove that all or a portion of such depreciation in value was caused by factors other than the material untruth or omission with respect to which his liability is asserted, or the difference between the purchase price and the price at which the buyer, either before suit or after suit, if before judgment, may subsequently have disposed of the security, and, at all events, not to exceed the offering price to the public. The measure of damages under Section 12 is the amount of consideration paid for the security or damages if the buyer has disposed of such security.

Section 19(b) of the Act empowers the Commission, for the purpose of all investigations which, in the opinion of the Commission, are necessary and proper for the enforcement of the Act, to administer oaths and affirmations, subpoena witnesses, take evidence and require the production of any books, papers or other documents which the Commission deems relevant or material to the inquiry. It will be noted that broad powers of investigation and inquiry are granted by this latter section. The Commission has exercised its powers under this section in investigations of possible violations of the provisions of Sections 5 and 17.

The foregoing briefly describes the Commission's organization and operation under the Securities Act and the remedies afforded purchasers of securities sold contrary to its requirements. No consideration has been given either to the problems which the Act is designed to solve, or the magnitude of the administrative task which confronts the Commission in their solution. It may be safely stated, however, that steady progress has been made toward eliminating evils which brought about passage of this legislation through the preparation and adoption of more adequate forms for registration and the development of increasingly effective examination procedures.