

14.1: The Nature of Securities Regulation

Learning Objectives

By the end of this section, you will be able to:

- Recognize that the definition of *security* encompasses a broad range of interests.
- Understand the functions of the Securities and Exchange Commission and the penalties for violations of the securities laws.
- Understand which companies the Securities Exchange Act of 1934 covers.
- Explore the purpose of state Blue Sky Laws.
- Know the basic provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What we commonly refer to as “**securities**” are essentially worthless pieces of paper. Their inherent value lies in the interest in property or an ongoing enterprise that they represent. This disparity between the tangible property—the stock certificate, for example—and the intangible interest it represents gives rise to several reasons for regulation. First, there is need for a mechanism to inform the buyer accurately what it is he is buying. Second, laws are necessary to prevent and provide remedies for deceptive and manipulative acts designed to defraud buyers and sellers. Third, the evolution of stock trading on a massive scale has led to the development of numerous types of specialists and professionals, in dealings with whom the public can be at a severe disadvantage, and so the law undertakes to ensure that they do not take unfair advantage of their customers.

The **Securities Act of 1933** and the **Securities Exchange Act of 1934** are two federal statutes that are vitally important, having virtually refashioned the law governing corporations during the past half century. In fact, it is not too much to say that although they deal with securities, they have become the general federal law of corporations. This body of federal law has assumed special importance in recent years as the states have engaged in a race to the bottom in attempting to compete with Delaware’s permissive corporation law (see Chapter 21).

What Is a Security?

Securities law questions are technical and complex and usually require professional counsel. For the nonlawyer, the critical question on which all else turns is whether the particular investment or document is a security. If it is, anyone attempting any transaction beyond the routine purchase or sale through a broker should consult legal counsel to avoid the various civil and criminal minefields that the law has strewn about.

The definition of *security*, which is set forth in the Securities Act of 1933, is comprehensive, but it does not on its face answer all questions that financiers in a dynamic market can raise. Under Section 2(1) of the act, “security” includes “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a ‘security,’ or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

Under this definition, an investment may not be a security even though it is so labeled, and it may actually be a security even though it is called something else. For example, does a service contract that obligates someone who has sold individual rows in an orange orchard to cultivate, harvest, and market an orange crop involve a security subject to regulation under federal law? Yes, said the Supreme Court in *Securities & Exchange Commission v. W. J. Howey Co.* *Securities & Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946). The Court said the test is whether “the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Under this test, courts have liberally interpreted “investment contract” and “certificate of interest or participation in any profit-sharing agreement” to be securities interests in such property as real estate condominiums and cooperatives, commodity option contracts, and farm animals.

The Supreme Court ruled that notes that are not “investment contracts” under the *Howey* test can still be considered securities if certain factors are present, as discussed in *Reves v. Ernst & Young*, (see Section 24.3.1 “What Is a Security?”). These factors include (1) the motivations prompting a reasonable seller and buyer to enter into the transaction, (2) the plan of distribution and whether the instruments are commonly traded for speculation or investment, (3) the reasonable expectations of the investing public, and (4) the presence of other factors that significantly reduce risk so as to render the application of the Securities Act unnecessary.

The Securities and Exchange Commission

Functions

The Securities and Exchange Commission (SEC) is over half a century old, having been created by Congress in the Securities Exchange Act of 1934. It is an independent regulatory agency, subject to the rules of the Administrative Procedure Act (see Chapter 5). The commission is composed of five members, who have staggered five-year terms. Every June 5, the term of one of the commissioners expires. Although the president cannot remove commissioners during their terms of office, he does have the power to designate the chairman from among the sitting members. The SEC is bipartisan: not more than three commissioners may be from the same political party.

The SEC's primary task is to investigate complaints or other possible violations of the law in securities transactions and to bring enforcement proceedings when it believes that violations have occurred. It is empowered to conduct information inquiries, interview witnesses, examine brokerage records, and review trading data. If its requests are refused, it can issue subpoenas and seek compliance in federal court. Its usual leads come from complaints of investors and the general public, but it has authority to conduct surprise inspections of the books and records of brokers and dealers. Another source of leads is price fluctuations that seem to have been caused by manipulation rather than regular market forces.

Among the violations the commission searches out are these: (1) unregistered sale of securities subject to the registration requirement of the Securities Act of 1933, (2) fraudulent acts and practices, (3) manipulation of market prices, (4) carrying out of a securities business while insolvent, (5) misappropriation of customers' funds by brokers and dealers, and (4) other unfair dealings by brokers and dealers.

When the commission believes that a violation has occurred, it can take one of three courses. First, it can refer the case to the Justice Department with a recommendation for criminal prosecution in cases of fraud or other willful violation of law.

Second, the SEC can seek a civil injunction in federal court against further violations. As a result of amendments to the securities laws in 1990 (the Securities Enforcement Remedies and Penny Stock Reform Act), the commission can also ask the court to impose civil penalties. The maximum penalty is \$100,000 for each violation by a natural person and \$500,000 for each violation by an entity other than a natural person. Alternatively, the defendant is liable for the gain that resulted from violating securities law if the gain exceeds the statutory penalty. The court is also authorized to bar an individual who has committed securities fraud from serving as an officer or a director of a company registered under the securities law.

Third, the SEC can proceed administratively—that is, hold its own hearing, with the usual due process rights, before an administrative law judge. If the commissioners by majority vote accept the findings of the administrative law judge after reading briefs and hearing oral argument, they can impose a variety of sanctions: suspend or expel members of exchanges; deny, suspend, or revoke the registrations of broker-dealers; censure individuals for misconduct; and bar censured individuals (temporarily or permanently) from employment with a registered firm. The 1990 securities law amendments allow the SEC to impose civil fines similar to the court-imposed fines described. The amendments also authorize the SEC to order individuals to cease and desist from violating securities law.

Fundamental Mission

The SEC's fundamental mission is to ensure adequate disclosure in order to facilitate informed investment decisions by the public. However, whether a particular security offering is worthwhile or worthless is a decision for the public, not for the SEC, which has no legal authority to pass on the merits of an offering or to bar the sale of securities if proper disclosures are made.

One example of SEC's regulatory mandate with respect to disclosures involved the 1981 sale of \$274 million in limited partnership interests in a company called Petrogene Oil & Gas Associates, New York. The Petrogene offering was designed as a tax shelter. The company's filing with the SEC stated that the offering involved "a high degree of risk" and that only those "who can afford the complete loss of their investment" should contemplate investing. Other disclosures included one member of the controlling group having spent four months in prison for conspiracy to commit securities fraud; that he and another principal were the subject of a New Mexico cease and desist order involving allegedly unregistered tax-sheltered securities; that the general partner, brother-in-law of one of the principals, had no experience in the company's proposed oil and gas operations (Petrogene planned to extract oil from plants by using radio frequencies); that one of the oils to be produced was potentially carcinogenic; and that the principals "stand to benefit substantially" whether or not the company fails and whether or not purchasers of shares recovered any of their investment. The prospectus went on to list specific risks. Despite this daunting compilation of troublesome details, the SEC

permitted the offering because all disclosures were made (*Wall Street Journal*, December 29, 1981). It is the business of the marketplace, not the SEC, to determine whether the risk is worth taking.

The SEC enforces securities laws through two primary federal acts: The Securities Act of 1933 and The Securities Exchange Act of 1934.

Securities Act of 1933

Goals

The Securities Act of 1933 is the fundamental “truth in securities” law. Its two basic objectives, which are written in its preamble, are “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.”

Registration

The primary means for realizing these goals is the requirement of registration. Before securities subject to the act can be offered to the public, the issuer must file a registration statement and prospectus with the SEC, laying out in detail relevant and material information about the offering as set forth in various schedules to the act. If the SEC approves the registration statement, the issuer must then provide any prospective purchaser with the prospectus. Since the SEC does not pass on the fairness of price or other terms of the offering, it is unlawful to state or imply in the prospectus that the commission has the power to disapprove securities for lack of merit, thereby suggesting that the offering is meritorious.

The SEC has prepared special forms for registering different types of issuing companies. All call for a description of the registrant’s business and properties and of the significant provisions of the security to be offered, facts about how the issuing company is managed, and detailed financial statements certified by independent public accountants.

Once filed, the registration and prospectus become public and are open for public inspection. Ordinarily, the effective date of the registration statement is twenty days after filing. Until then, the offering may not be made to the public. Section 2(10) of the act defines *prospectus* as any “notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” (An exception: brief notes advising the public of the availability of the formal prospectus.) The import of this definition is that any communication to the public about the offering of a security is unlawful unless it contains the requisite information.

The SEC staff examines the registration statement and prospectus, and if they appear to be materially incomplete or inaccurate, the commission may suspend or refuse the effectiveness of the registration statement until the deficiencies are corrected. Even after the securities have gone on sale, the agency has the power to issue a stop order that halts trading in the stock.

Section 5(c) of the act bars any person from making any sale of any security unless it is first registered. Nevertheless, there are certain classes of exemptions from the registration requirement. Perhaps the most important of these is Section 4(3), which exempts “transactions by any person other than an issuer, underwriter or dealer.” Section 4(3) also exempts most transactions of dealers. So the net is that trading in outstanding securities (the secondary market) is exempt from registration under the Securities Act of 1933: you need not file a registration statement with the SEC every time you buy or sell securities through a broker or dealer, for example. Other exemptions include the following: (1) private offerings to a limited number of persons or institutions who have access to the kind of information registration would disclose and who do not propose to redistribute the securities; (2) offerings restricted to the residents of the state in which the issuing company is organized and doing business; (3) securities of municipal, state, federal and other government instrumentalities, of charitable institutions, of banks, and of carriers subject to the Interstate Commerce Act; (4) offerings not in excess of certain specified amounts made in compliance with regulations of the Commission...; and (5) offerings of “small business investment companies” made in accordance with rules and regulations of the Commission.

Penalties

Section 24 of the Securities Act of 1933 provides for fines not to exceed \$10,000 and a prison term not to exceed five years, or both, for willful violations of any provisions of the act. This section makes these criminal penalties specifically applicable to anyone who “willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.”

Sections 11 and 12 provide that anyone injured by false declarations in registration statements, prospectuses, or oral communications concerning the sale of the security—as well as anyone injured by the unlawful failure of an issuer to register—may file a civil suit to recover the net consideration paid for the security or for damages if the security has been sold.

Although these civil penalty provisions apply only to false statements in connection with the registration statement, prospectus, or oral communication, the Supreme Court held, in *Case v. Borak*, *Case v. Borak*, 377 U.S. 426 (1964), that there is an “implied private right of action” for damages resulting from a violation of SEC rules under the act. The Court’s ruling in *Borak* opened the courthouse doors to many who had been defrauded but were previously without a practical remedy.

Securities Exchange Act of 1934

Companies Covered

The Securities Act of 1933 is limited, as we have just seen, to new securities issues—that is the primary market. The trading that takes place in the secondary market is far more significant, however. In a normal year, trading in outstanding stock totals some twenty times the value of new stock issues.

To regulate the secondary market, Congress enacted the Securities Exchange Act of 1934. This law, which created the SEC, extended the disclosure rationale to securities listed and registered for public trading on the national securities exchanges. Amendments to the act have brought within its ambit every corporation whose equity securities are traded over the counter if the company has at least \$10 million in assets and five hundred or more shareholders.

Reporting Proxy Solicitation

Any company seeking listing and registration of its stock for public trading on a national exchange—or over the counter, if the company meets the size test—must first submit a registration application to both the exchange and the SEC. The registration statement is akin to that filed by companies under the Securities Act of 1933, although the Securities Exchange Act of 1934 calls for somewhat fewer disclosures. Thereafter, companies must file annual and certain other periodic reports to update information in the original filing.

The Securities Exchange Act of 1934 also covers proxy solicitation. Whenever management, or a dissident minority, seeks votes of holders of registered securities for any corporate purpose, disclosures must be made to the stockholders to permit them to vote yes or no intelligently.

Penalties

The logic of the *Borak* case (discussed in Section 24.1.3 “Securities Act of 1933”) also applies to this act, so that private investors may bring suit in federal court for violations of the statute that led to financial injury. Violations of any provision and the making of false statements in any of the required disclosures subject the defendant to a maximum fine of \$5 million and a maximum twenty-year prison sentence, but a defendant who can show that he had no knowledge of the particular rule he was convicted of violating may not be imprisoned. The maximum fine for a violation of the act by a person other than a natural person is \$25 million. Any issuer omitting to file requisite documents and reports is liable to pay a fine of \$100 for each day the failure continues.

Blue Sky Laws

Long before congressional enactment of the securities laws in the 1930s, the states had legislated securities regulations. Today, every state has enacted a blue sky law, so called because its purpose is to prevent “speculative schemes which have no more basis than so many feet of ‘blue sky.’” *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917). The federal Securities Act of 1933, discussed in Section 24.1.3 “Securities Act of 1933”, specifically preserves the jurisdiction of states over securities.

Blue sky laws are divided into three basic types of regulation. The simplest is that which prohibits fraud in the sale of securities. Thus at a minimum, issuers cannot mislead investors about the purpose of the investment. All blue sky laws have antifraud provisions; some have no other provisions. The second type calls for registration of broker-dealers, and the third type for registration of securities. Some state laws parallel the federal laws in intent and form of proceeding, so that they overlap; other blue sky laws empower state officials (unlike the SEC) to judge the merits of the offerings, often referred to as merit review laws. As part of a movement toward deregulation, several states have recently modified or eliminated merit provisions.

Many of the blue sky laws are inconsistent with each other, making national uniformity difficult. In 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act. It has not been designed to reconcile the conflicting philosophies of state regulation but to take them into account and to make the various forms of regulation as consistent as possible. States adopt various portions of the law, depending on their regulatory philosophies. The Uniform Securities Act has antifraud, broker-dealer registration, and securities registration provisions. More recent acts have further increased uniformity. These include the National Securities Markets Improvement Act of 1996, which preempted differing state philosophies with regard

to registration of securities and regulation of brokers and advisors, and the Securities Litigation Uniform Standards Act of 1998, which preempted state law securities fraud claims from being raised in class action lawsuits by investors.

Dodd-Frank Wall Street Reform and Consumer Protection Act

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is the largest amendment to financial regulation in the United States since the Great Depression. This amendment was enacted in response to the economic recession of the late 2000s for the following purposes: (1) to promote the financial stability of the United States by improving accountability and transparency in the financial system, (2) to end “too big to fail” institutions, (3) to protect the American taxpayer by ending bailouts, and (4) to protect consumers from abusive financial services practices. The institutions most affected by the regulatory changes include those involved in monitoring the financial system, such as the Federal Deposit Insurance Corporation (FDIC) and the SEC. Importantly, the amendment ended the exemption for investment advisors who previously were not required to register with the SEC because they had fewer than fifteen clients during the previous twelve months and did not hold out to the public as investment advisors. This means that in practice, numerous investment advisors, as well as hedge funds and private equity firms, are now subject to registration requirements. For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), see Thomas, “Major Actions,” Bill Summary & Status 111th Congress (2009–2010) H.R.4173, [thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@L&summ2=m&#major%20actions](https://www.thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@L&summ2=m&#major%20actions).

Key Takeaway

The SEC administers securities laws to prevent the fraudulent practices in the sales of securities. The definition of *security* is intentionally broad to protect the public from fraudulent investments that otherwise would escape regulation. The Securities Act of 1933 focuses on the issuance of securities, and the Securities Exchange Act of 1934 deals predominantly with trading in issued securities. Numerous federal and state securities laws are continuously created to combat securities fraud, with penalties becoming increasingly severe.

Exercises

1. What differentiates an ordinary investment from a security? List all the factors.
2. What is the main objective of the SEC?
3. What are the three courses of action that the SEC may take against one who violates a securities law?
4. What is the difference between the Securities Act of 1933 and the Securities Exchange Act of 1934?
5. What do blue sky laws seek to protect?

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