SECURITIES AS SUBJECTS OF INTERSTATE COMMERCE

Despite the Blue Sky Laws in force in all the states except Nevada,[1] the losses sustained by the investing public in this country have increased yearly to the extent that in the last decade, according to reasonable estimates, the American people were fleeced of twenty-five billion dollars.[2] The cause for such a wholesale evasion of state security laws lies in the fact that the offer and sale of securities to the people of a state, by one who never sets foot in the state, through the mediums of the mails and interstate carriers, is the prevailing means of escaping the restrictions imposed by the state laws.[3] As a result of this situation, which minimized the good to be derived from state regulation, there arose a great demand for a Federal Blue Sky Law. As early as 1922, Congressman Denison, of Illinois, presented to Congress the first Denison bill, "to prevent the use of the United States mails and other agencies of interstate commerce for transporting and for promoting the sale of securities contrary to the laws of the states."[4] However, no act was passed in pursuance of this growing need for federal regulation until the passage of the Securities Act of 1933 by the "New Deal" Congress.[5]

The Securities Act of 1933 is far-reaching in its attempt to remedy the existing evil, and is not without a constitutional question as to its validity. By compelling the registration of security issues, intended for interstate distribution, with the Federal Trade Commission, and extending the liability of those interested in these issues, the Act transcends the scope of any of the previously proposed bills on the subject.[6] Also, the Act states clearly that it is not to supersede the state laws, but rather is to supplement them.[7] To relieve a doubt as to what securities are affected by the Federal Laws, all, save for a few enumerated exemptions, are specifically included.[8] Likewise, it is clear that the constitu-

[1] Thorpe and Ellis, Manual of the Federal Securities Act (1933) pages 130-131. Reed and Washburn, Blue Sky Laws (1930).

[2] Seventy-Third Cong., 1st Sess., Senate Report No. 47; see 14 Fletcher, Cyclopedia of Corporations (1933) sec. 6736.

[3] Note (1933) 1 University of Chicago Law Review 88.

[4] Sixty-Seventh Congress, 1st Sess., H. R. No. 10,102.

[5] Act of May 27, 1933, 48 Stat. 74, 14 U. S. C. A. 77 (Supp. 1933).

[6] *Ibid.*

[7] Securities Act of 1933, sec. 18.

[8] The Act provides: "The term 'security' means 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 interest in property, tangible

tional power relied upon as the basis for this legislation derives from the commerce clause,[9] as well as from the power to regulate the mails.[10] Although it seems well settled that Congress has complete power to regulate the mails,[11] a nice question arises as to whether securities are subjects of interstate commerce so as to be within the commerce clause.

The issue as to whether securities are subjects of interstate commerce never has been decided by the United States Supreme Court.[12] There are, however, numerous precedents upon which such a decision may be based. A review of the past cases bearing on the subject shows not only a marked expansion of the scope of the commerce clause, but also a decided conflict. It is clear that the Supreme Court, in order to pass on this issue, will be forced to reconcile its prior decisions or to disregard some of them.

The first attempt to define the commerce clause is found in the celebrated case of *Gibbons v. Ogden*[13] in which Chief Justice Marshall said:

> "Commerce, undoubtedly, is traffic, but it is something more; it is intercourse. It describes the commercial intercourse between nations, and parts of nations in all its branches, and is regulated by prescribing rules for carrying on that intercourse."

Thus, the word *commerce* as used in the commerce clause was extended to its broadest sense during the early years of our government. This interpretation, which is considered by Mr. Justice Stone as Chief Justice Marshall's greatest contribution to the cause of Federal government,[14] has proven its applicability to meeting the everchanging conditions in commerce. On the basis of this decision, the Supreme Court often has included

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or intangible, or, in general, any instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscibe to or purchase, any of the foregoing." Sec. 2(1). The exempted securities include those issued by the government; notes maturing in less than nine months; securities issued by corporations operating for religious, educational, benevolent, fraternal, charitable, or reformatory purposes without profit, or by cooperative associations, or by common carriers subject to the Interstate Commerce Act, or by a receiver or a trustee in bankruptcy; and insurance contracts. Sec. 3.

[9] United States Constitution, Article I, section 8. See Securities Act of 1933, sec. 2(7).

[10] Ex parte Jackson (1877) 96 U. S. 727.

[11] *Ibid.;* 35 Stat. 1130 (1909) 18 U. S. C. 338; Public Clearing House v. Coyne (1903) 194 U. S. 497.

[12] Magruder and Claire, The Constitution (1933) page 69.

[13] (1824) 9 Wheat. 1.

[14] Note (1929) 63 United States Law Review 404.

within the sphere of intercourse, those features in business and industry which to the ordinary observer do not appear to be subjects of commerce. In the *Passenger Cases*,[15] the court held that the transportation of passengers was a part of commerce, since commerce not only included the exchange of commodities, but also "intercourse." To meet the problem presented by the rapid growth of telegraphy and the attempts of the states to regulate this new development, the court said in *Pensacola Telegraph Co. v. Western Union Telegraph Co.*,[16] after declaring the transmission of telegrams to be "intercourse," that:

> "The electric telegraph marks an epoch in the progress of time. In a little more than a quarter of a century it has changed the habits of business, and become one of the necessities of commerce. It is indispensable . . . in commercial transactions."

This opinion was followed soon by the decision in *County of Mobile v. Kimball*,[17] in which commerce was considered to be intercourse and traffic, including in these terms navigation as well as the purchase, sale, and exchange of commodities. On the basis of this broad construction of commerce as presented by the *Ogden Case* and the cases following it, it has been held, generally, that radio broadcasting is interstate commerce and may be regulated by the Federal government.[18] It would seem that on the strength of these precedents alone, which declare commerce to be intercourse, that the sale, offer to sell, or transportation of securities are such intercourse among the states as to be within the commerce clause.

However, such a deduction is questioned by decisions of the Supreme Court which ignore the expansion of the commerce clause and limit its application. Most outstanding is the case of *Paul v. Virginia*[19] in which the Supreme Court, forty-four years after the *Ogden Case*, held that insurance policies are not subjects of interstate commerce, since they were not subjects of traffic. Said Mr. Justice Field:[20]

> "Issuing a policy of insurance is not a transaction of commerce. . . . These contracts are not articles of commerce in any proper meaning of the word. They are not subjects

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[15] (1849) 7 How. 283.
[16] (1877) 96 U. S. 1.
[17] (1880) 102 U. S. 691.
[18] Station WBT v. Poulnot (D. C. E. D. S. C. 1931) 46 F. (2d) 671; New York v. Federal Radio Commission (ct. app., D. C., 1929) 36 F. (2d) 115.
[19] (1868) 8 Wall. 163.
[20] *Ibid.*

> of trade and barter offered in the market as something having an existence independent of parties to them. They are not commodities to be shipped or forwarded from one state to another, and then put up for sale."

This decision is well supported by succeeding cases,[21] and it is for this reason, perhaps, that insurance contracts are exempted from the provisions of the Securities Act.[22] It is of significance to note that *Gibbons v. Ogden* is ignored in the opinion, despite the fact that the plaintiff urged it as authority for defining commerce to be *intercourse* and not merely *traffic*. The importance of *Paul v. Virginia* lies in the fact that it restricts commerce to mean traffic, without any consideration of intercourse. In view of a decision of the Supreme Court in 1913,[23] in which the *Paul Case* was restricted to insurance contracts, it does not appear likely that the court will consider it as authority for a decision on securities.

However, the problem is complicated further by a line of decisions which hold that negotiable instruments are not subjects of interstate commerce. In 1850, *Nathan v. Louisiana*[24] declared that a state statute licensing dealers in bills of exchange did not encumber interstate commerce, since bills of exchange were not subjects thereof. Although this case may be distinguished, since the tax in question was one on business and not on bills of exchange, succeeding decisions have followed the dictum in the principal case, to the effect that negotiable bills are not commerce, but are instrumentalities of commerce. As late as 1927, in *Hemphill v. Orloff*,[25] the Supreme Court held on authority of *Nathan v. Louisiana* and *Paul v. Virginia* that the sale of negotiable notes is

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[21] Approved in Hooper v. California (1894) 155 U. S. 648; Noble v. Mitchell (1896) 164 U. S. 367; N. Y. Life Insurance Co. v. Cravens (1899) 178 U. S. 389; National Union Fire Ins. Co. v. Wanberg (1922) 260 U. S. 71; Bothwell et al. v. Buckbee, Mears Co. (1927) 275 U. S. 274; Nutting v. Massachusetts (1901) 183 U. S. 553.

[22] Securities Act of 1933, sec. 3; exempts "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

[23] In N. Y. Life Ins. Co. v. Deer Lodge County (1913) 231 U. S. 495, Mr. Justice McKenna stated that "the decision of the cases is that contracts of insurance are not commerce at all, neither state nor interstate." He then distinguished insurance contracts saying that "the Lottery case and the Pigg case were concerned with transactions which involved the transportation of property and were not mere personal contracts" as insurance is.

[24] (1850) 8 How. 73.

[25] (1927) 277 U. S. 537. In this case the court held that negotiable instruments were contracts incident to commerce and therefore not subjects of interstate commerce.

not interstate commerce. A recent text considers this statement to be a settled legal principle.[26]

There is another aspect of the problem to be considered. It is apparent that the Securities Act of 1933 is intended to regulate contracts of sale and offers to sell by persons in different states,[27] as well as the transportations of the securities. It is equally apparent that such contracts in the past have been considered as incident to, rather than as parts of, interstate commerce. Contracts by brokers for the sale of futures are not subjects of interstate commerce, and may be regulated by Congress under its police power only when such contracts encumber and burden interstate commerce;[28] likewise, contracts for advertising to appear in interstate commerce are not subjects of such commerce;[29] similarly, a broker engaged in negotiating sales between citizens of different states is not engaged in interstate commerce;[30] neither is one selling livestock coming from another state.[31] As a result of these decisions, the general rule has been recognized that "contracts incident to commerce are subjects of state regulation, since they are not interstate commerce."[32] These authorities, all based on decisions of the Supreme Court, seem to indicate that the sale and the offer for sale of securties to persons in different states are not within the commerce clause. At any rate, this inference would be conclusive if other expressions on the subject tending toward a contrary view had not found their

[26] Magruder & Claire, The Constitution (1933) p. 69. "Neither are the loan of money, the sale of bonds, or transactions connected with other negotiable instruments, interstate commerce." See also, Hammer v. Dagenhart (1918) 247 U. S. 251; American Trading Co. v. Heacock (1932) 284 U. S. 613.

[27] Securities Act of 1933, sec. 2(3); *ibid.*, sec. 5.

[28] In Ware & Leland v. Mobile County (1907) 209 U. S. 405, it was held that contracts by brokers for the sale of cotton for future delivery, where the transactions were closed by contracts completed and executed in one state although the orders were received from another state, were not in themselves subjects of interstate commerce. Later cases affirm this view. See Hill v. Wallace (1922) 259 U. S. 44; Moore v. N. Y. Cotton Exchange (1926) 270 U. S. 593. This is not taken to mean that Congress may not regulate such contracts, but that it may do so only under its police power when "manipulation of the market for futures directly burdens and obstructs commerce between the states," as was decided in Board of Trade v. Olsen (1922) 262 U. S. 1.

[29] Blumenstock Bros. v. Curtis Pub. Co. (1919) 252 U. S. 442.

[30] Ficklen v. Shelby County Taxing District (1891) 145 U. S. 1, wherein the court held that a broker engaged in negotiating sales, between residents of Tennessee and nonresident merchants, of goods situated in another state, was not engaged in interstate commerce.

[31] Hopkins v. United States (1897) 171 U. S. 579.

[32] 5 R. C. L. 784.

way into the books. It is in these newer opinions that the Securities Act will find support.

In 1903, many years after *Nathan v. Louisiana* and *Paul v. Virginia,* the Supreme Court was called upon to determine the constitutionality of a federal statute regulating lottery tickets. That issue was decided in what has proved to be a controlling authority, known as the *Lottery Case.*[33] The court upheld the statute in question under the commerce clause, although the dissenting opinion argued that since insurance contracts and negotiable instruments are not subjects of commerce, certainly lottery tickets are not. This decision has not been overruled, and is of much weight. The important feature of the *Lottery Case,* for our purposes, is that it ignored Chief Justice Marshall's broad construction and placed lottery tickets with other traffic, saying:

> "We are of the opinion that lottery tickets are subjects of traffic and therefore are subjects of commerce, and the regulation of the carriage of such tickets from state to state, at least by independent carriers, is a regulation of commerce among the states."

If we are to consider securities as being similar to lottery tickets, in the case of some securities a fair comparison, then the transportation of such securities among the states is a subject of interstate commerce.

A subsequent decision makes this analogy unnecessary, and the case for the validity of the Securities Act is strengthened by *International Text Book Co. v. Pigg,*[34] in which the court held a state tax on correspondence courses invalid since it was an encumbrance on interstate commerce. The real importance of this construction lies in the fact that it returns to the definition of commerce as viewed by Chief Justice Marshall, declaring commerce to be "intercourse." The court affirmed:

> "Intercourse or communication between persons in different states . . . relating to matters of regular continuous business, such as teaching by correspondence, and the making of contracts relating to the transportation thereof, is commerce among the states within the commerce clause of the Federal Constitution."

Thus, with a definite decision expanding the commerce clause to include all intercourse among the states, it seems that the sale, offer to sell, or transportation of securities among the states, being such intercourse, is interstate commerce subject to federal regulation. Doubt as to this conclusion fades when the opinion

[33] Champion v. Ames (1903) 188 U. S. 321.
[34] International Textbook Co. v. Pigg (1909) 217 U. S. 91.

of the Circuit Court of the Eighth District, speaking by Judge Sanborn, is considered:[35]

> ". . . all interstate commerce is not sale of goods. Importation from one state to another is the indispensable element, the test, of interstate commerce; and every negotiation, contract, trade, and dealing between citizens of different states which contemplates and causes such importation whether it be of goods, persons, or information is a transaction of interstate commerce."

Of course this is the opinion of an inferior court, and while if the decision of this court is not controlling, greater weight attaches to it, since on two occasions the Supreme Court mentioned this decision with approval; first, in the *Pigg Case,* and more recently in *Furst v. Brewster*[36] decided in 1930.

Thus far we have considered the precedents in an attempt to determine whether the past analogies offer any indication as to the fate of the Securities Act. This course was necessary for the reason that the Supreme Court has not, as yet, had the occasion to determine whether the sale and transportation of securities are within the commerce clause. However, several federal courts have been called upon to determine that issue, and they have held securities to be subjects of interstate commerce.[37] These cases have not been overruled, but, on the contrary, in similar controversies, which came before the Supreme Court in the *Blue Sky Cases,* it was held that the state laws regulating securities were not an interference with interstate commerce.[38] It is well to note in this direction, that the court had the opportunity of declaring that securities are not subjects of interstate commerce; but this was not done. While such failure is not conclusive, still there is a strong inference that the Supreme Court

[35] Butler Brothers Shoe Co. v. United States Rubber Co. (C. C. A. 8, 1907) 156 F. 1.

[36] (1930) 282 U. S. 493, 499.

[37] In Alabama & N. O. Transp. Co. v. Doyle (D. C. E. D. Mich., 1914) 210 F. 173, l. c. 182, the court stated, "We cannot doubt that stocks and bonds are now the subject of interstate commerce, and that shipments and sales of them, between the states, are interstate commerce. We do not find that this has been held expressly in any authoritative decision, but, in the present development of commerce it would be regarded as obvious." The court then went on and distinguished Nathan v. Louisiana and Paul v. Virginia. Later, in Bracey v. Darst (D. C. N. D., W. Va., 1914) 218 F. 482, the court said: "We do not think it can be longer questioned that stocks, bonds, debentures, and other securities are subject-matters of interstate commerce"; thus affirming the decision in the former case.

[38] Hall v. Geiger-Jones Co. (1916) 242 U. S. 539; Caldwell v. Sioux Falls Stock Yards Co. (1916) 242 U. S. 559; Merrick v. Halsey & Co. (1916) 242 U. S. 568. The Blue Sky cases brought only indirectly before the Supreme Court the question of whether the purchase, sale, and carriage of such securities between the states is interstate commerce.

will affirm the decisions of the lower federal courts and declare securties to be subjects of interstate commerce.

What will the Supreme Court decide if it is faced with the task of determining the validity of the Securities Act of 1933? That is a question which this writer will not assume to answer. It can be said, nevertheless, that the court, if it so desires, would find no difficulty in affirming the Act as being within the power of Congress to regulate commerce among the states. *Gibbons v. Ogden,* the *Pigg Case,* and the decisions of the inferior federal courts define commerce to be *intercourse,* so as to include the sale, offer to sell, and transportation of securities. On the basis of the *Lottery Case,* the transportation of securities is traffic subject to federal control. These authorities should prevail over *Paul v. Virginia* and *Nathan v. Louisiana* since those cases have been distinguished on other grounds.

HERMAN GORALNIK, '35.

CIVIL LIABILITIES UNDER THE SECURITIES ACT OF 1933

The purchaser of a misrepresented security, who suffers a loss thereby, would naturally hold certain groups of persons morally responsible for his having been injured. These groups would usually include the issuer, the underwriters, the persons or institutions assisting the underwriter in distributing the security, and the salesman from whom the security was purchased. The actions available to such an injured party at common law were limited to an action at law in fraud and deceit and a proceeding in equity to rescind the contract of purchase. The nature of these actions necessarily restricted the number of persons against whom the purchaser could recover. In England legislation has extended this group, and it is with this background of experience that Congress has enacted the Securities Act of 1933.[1]

In an action for fraud and deceit the burden was upon the plaintiff[2] to prove that the defendant made a material misrepresentation with knowledge that it was false, or made it recklessly without regard to its truth, and that the plaintiff relied[3] upon the

[1] "The committee is fortified in these sections (secs. 11 and 12) by similar safeguards in the English Companies Act of 1929. What is deemed necessary for sound financing in conservative England ought not to be unnecessary for the more feverish pace which American finance has developed." 73d Congress, 1st Sess. House Report No. 85, p. 9.

[2] 2 Cooley on Torts (4th ed.) par. 349.

[3] But a defendant is liable when the public is to be influenced to act by the representation: Paddock v. Fletcher (1869) 42 Vt. 389; Terwiliger v. Gt. Western Tel. Co. (1873) 59 Ill. 249.