PENAL AND INJUNCTIVE PROVISIONS OF THE SECURITIES ACT

The vital human problem present in the application of penal and injunctive laws necessitates the careful and clear draftmanship of such enactments. Lawyers and interested parties should be afforded an adequate comprehension of the rights and duties imposed by the legislation. It is the purpose of this note to present the general penal and injunctive provisions of the Securities Act of 1933, and to point out the significant factors which have influenced, or which may influence, the courts in interpreting these provisions.[1]

1

In the famous case of *Rex v. Lord Kylsant*[2] the defendant was indicted for violating the English Larceny Act of 1861 which imposed criminal liability on a director or officer of a corporation who

> * * * shall make, circulate or publish * * * any written statement or account, which he shall know to be false in any *material particular* * * * with intent to induce any person—to intrust or advance any property to such body corporate or public company. (Italics supplied).

The complaint was founded upon the circulation of certain prospectuses which had been distributed for the purpose of inducing the public to purchase a forthcoming bond issue. The prospectuses were true as regards the statement of facts contained therein, but were very carefully worded so as to create as a whole an erroneous impression, namely, that dividends had been paid from the yearly earnings of the company, when in fact they had been taken from a reserve, hidden fund. The prospectus also led the reader to believe that the company had been continuously operating at a yearly profit, which impression was equally untrue. The court, in interpreting the statutory phrase, "false in a material particular," said

> * * * the document as a whole may be false not because of what it states but because of what it does not state, because of what it implies.[3]

The rationale of *Rex v. Kylsant* was the most influential factor

1. For other treatment of this problem see MacIntyre, Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes (1933) 43 Yale L. J. 254; Herlands, Criminal Law Aspects of the Securities Act of 1933 (1933) 67 U. S. L. Rev. 562-75, 615-27.

2. (1932) 1 K. B. 442, 48 T. L. R. 62.

3. Id. at 445.

in determining the character of legal duty to be imposed under the Securities Act.[4] Section 24, referred to in the Act as the penalty provision, provides as follows

> (1) Any person who *wilfully* violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or
> (2) Any person who *wilfully*, 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, shall upon conviction be fined not more than $5000 or imprisoned not more than five years, or both. (Italics supplied.)

The requirement of wilfulness as a prerequisite to criminal liability should afford little difficulty in application. A wilful act may be described as one done intentionally, knowingly, or with recklessness or gross negligence, as distinguished from an act done carelessly or inadvertently.[5] The framers entirely rejected the proposed provision of the Uniform Sale of Securities Act[6] which does not require the element of wilfulness, but provides that only violations done "in good faith and on reasonable grounds for believing it not to be a violation," shall be excused from the penalty.[7] It is the obvious purpose of the Securities Act to punish only those who flagrantly disregard the provisions of the Act.

Section 20(b) empowers the Securities and Exchange Commission to transmit such evidence as may be available concerning any violations of the Act, or of any rule or regulation, to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under the Act.

Section 22(a) provides that any of the criminal proceedings arising under the Act may be brought in the district wherein the defendant is found, is an inhabitant, transacts business, or in the district in which the sale took place. In *United States v. Kopald, Quinn & Co.*,[8] however, the jurisdictional requirement of this section was held to refer only to the offense of using the mails for transmitting a prospectus or security and not to other violations of the Act. Other violations were held to fall within

4. MacIntyre, *op. cit.*, 256.
5. Wharton, *Criminal Law* (1932) 1782, sec. 1511; State v. Caldwell (1909) 55 Tex. Cr. 164, 115 S. W. 597; State v. Clifton (1910) 152 N. C. 800, 67 S. E. 751, 28 L. R. A. (N. S.) 673.
6. Herlands, *op. cit.*, 565.
7. 9 U. L. A. 408, sec. 17.
8. (D. C. N. D. Ga. 1937) C. C. H., Securities Act, 648, par. 4624 (.03).

the general penalty clause of section 24, and since no special venue had been provided other than that set out in section 22(a) it was decided that the venue should be determined by the general law applicable. Under the general law it was held that a crime may be prosecuted either in the district in which it was commenced or in that in which it was completed.

II

The Securities & Exchange Commission is given authority to obtain injunctive relief against anyone "who is engaged or is about to engage in any acts or practices which will constitute a violation of the Act or any rule or regulation."[9] The element of wilfulness necessary to effectuate criminal responsibility should be contrasted with the fact that injunctive relief may be obtained without establishing the wilful character of the violation. The original bill as proposed by the President had lodged an injunctive power in the Attorney General similar to that given to the Commission.[10] This relief has been denied where the impending violations were not shown to be "imminent."[11] In *Securities & Exchange Comm. v. Torr*[12] this principle was applied to deny an injunction where it had been shown that the defendant had clearly violated the Act, but that there was no likelihood of a resumption of such action. In *Securities & Exchange Comm. v. Robert Collier & Co., Inc.*[13] it was held that the federal district attorney was not a necessary party to an action seeking an injunction, and that such relief could be obtained by the Commission through its solicitors. In *Securities & Exchange Comm. v. Jones*[14] the defendant was enjoined from violating certain provisions of the Act, although the information concerning the defendant's conduct had been obtained by an unlawful investigation by the Commission. The efforts of the Commission have generally been directed to the exercise of this more effective and preventive power in instances of impending or active violations of the Act, rules, and regulations, rather than to the instigation of criminal proceedings.

III

The penal and injunctive provisions involve all types of violations and are therefore as extensive as the statute itself, together

9. Sec. 20 (b).
10. Herlands, *op. cit.*, 624.
11. Securities & Exchange Comm. v. Stock Market Finance, Inc. (D. C. S. D. N. Y. 1936) 10 F. Supp. 95.
12. (C. C. A. 2, 1937) 87 F. (2d) 446.
13. (C. C. A. 2, 1935) 76 F. (2d) 939.
14. (D. C. S. D. N. Y. 1936) 15 F. Supp. 321.

with rules and regulations properly promulgated under its authority by the Securities & Exchange Commission. The nature and extent of the prohibitions imposed by the Act, therefore, is all-important.

Section 17(a) of the Act provides that

> It shall be unlawful for any person in the sale[15] of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[16]

By other legislation, Congress has provided that the use of the mails to promote frauds shall constitute a federal offense.[17] In *United States v. Alluan et al.*[18] the defendants urged that section 17(a) embraced the provisions in the fraudulent use of the mails statute, and therefore, repealed that enactment by implication. The court rejected this argument and sustained a conviction of violation of both section 17(a) and the fraudulent use of the mails statute.

> The fraudulent use of the mails was a completed offense before any securities were floated, or any securities were sold. The violation of the Securities Act was not completed until the sale actually took place. The two statutes, therefore, operate upon different portions of the same act, or the same fraud; the first for the punishment of the fraud itself, and the second for the sale of the fruit of the fraud. The first is complete without a sale; the second requires it. And

15. The type of "sale" required for a violation of this section is defined by section 2(3) of the Act to be "every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value."

16. This section imposes a prohibition and safeguard beyond the primary purpose of the Act, namely, to compel an issuer of new stocks or bonds to fully and fairly disclose sufficient facts concerning the enterprise so as to enable the prospective investor to form an independent judgment as to its merits and desirability as an investment.

17. (1909) 35 Stat. 1130 (1927) 18 U. S. C. A. sec. 338.

18. (D. C. N. D. Texas, 1936) 13 F. Supp. 289. The case involved an open fraud of selling stocks in a prospective gold mine. In fact the whole scheme was a notorious swindle.

that is true though "sale" includes some transactions not ordinarily understood as sales.[19]

Section 17(a) is directed not only to transactions of an interstate character, but to *any* use of the mails in violation of its provisions. This latter feature has been held constitutional on the basis that the mails are under national control and therefore Congress has the power to forbid their use for deceptive transactions.[20]

In *Coplin v. United States*[21] the defendants were indicted and convicted of using the mails to defraud, as well as for violating section 17(a) of the Act. The scheme employed was that commonly known as the "boiler room method of selling." The prospective "sucker" was called by telephone and urged to purchase certain listed securities on the representation that they were going up in value. He purchased these listed securities, and their value went up, due to exchange manipulations by the defendants. Using this rise of value as a means of gaining the customer's confidence, the defendants called back, and induced him to "sell the listed securities and switch" to another unlisted stock which was speculative and worthless. The court held that the defendants' omission to state that the market rise was due to their own market manipulations was misleading, and that such "half-truths" operated as a fraud and deceit on the purchasers in violation of the Act. It was further ruled that a telephone conversation constituted a "communication" within the meaning of the Act.

In *Seeman v. United States*[22] the defendants were convicted under section 17(a)(3) for shipping forged imitations of genuine bonds to purchasers, pursuant to a purported sale of valid bonds. Although the conviction was reversed because of prejudicial remarks to the jury, the court held that the section applied to such forged bonds and was not intended to prohibit only the fraudulent sale of genuine securities.

One case involved such an open and notorious instance of selling "watered stock" that the prosecution was brought directly under the more severe statute prohibiting the use of the mails to defraud, without regard to section 17(a).[23]

19. Supra, at 292. Thus if A in Missouri sends stock to a confederate in Illinois pursuant to a plan to defraud, this act would constitute a violation of the fraudulent use of the mails statute, but not a violation of this section, since there has been no "sale" of these securities.

20. United States v. Bogy et al. (D. C. W. D. Tenn. 1936) 16 F. Supp. 407, where the defendants sent letters to prospective purchasers requesting them to buy fraudulently represented and worthless securities.

21. (C. C. A. 9, 1937) 88 F. (2d) 652.

22. (C. C. A. 5, 1937) 90 F. (2d) 88.

23. United States v. Rollnick (C. C. A. 2, 1937) 91 F. (2d) 911.

In *Securities & Exchange Comm. v. Torr*[24] the defendants were enjoined from selling and representing securities as a good investment because the defendants failed to inform the purchasers that they were receiving compensation for the sale. The court held that such action led the purchasers to believe that the defendants were disinterested and were giving impartial information as to the worth of the security. This action was held to constitute a failure to state a material fact which in turn created a misleading general impression. The fact that the purchaser had obtained full value for his money was held to be immaterial, since section 17(a) makes no mention of pecuniary loss to the public and persons may be deceived and yet suffer no financial loss.

In another case the court held that the offer of the defendant of 4,918 shares of stock "at the market price" could refer only to stock exchange quotations, and that this implied "a price standard which normally reflects the operation of a free and open market in the sale and purchase of securities."[25] The failure of the defendant to inform its customers that the defendant's vendor had agreed to withhold 17,000 of 60,000 outstanding shares from the market while the defendant was disposing of its shares constituted an omission of a material fact and consequently was enjoinable as a violation of section 17(a) (2).

Additional instances in which injunctions have been granted for acts which were held to constitute a violation of section 17(a) are the following: a representation that a gold mine was a "proved mine" and that it contained "unlimited gold ore," when in fact it had never been run at a profit;[26] a representation that 300,000 bottles of Q-623 had been sold, when only a few thousand bottles had actually been sold;[27] a circular which stated "that there is only a small block of stock of defendant corporation available," when in fact, the entire stock was still available;[28] a report that a semi-annual dividend of 6% would be paid on the class "A" stock in December of 1936, whereas in truth and fact, the defendant corporation had no earnings from which a dividend could be paid and no reason to anticipate that any such

24. (D. C. S. D. N. Y. 1936) 15 F. Supp. 144.
25. Securities and Exchange Comm. v. Otis & Co. (D. C. N. D. Ohio 1936) 18 F. Supp. 100.
26. Securities & Exchange Comm. v. McDowell Mines, Inc., et al. (D. C. D. Colo. 1937) C. C. H., Securities Act, 654, par. 4761 (.11).
27. Securities & Exchange Comm. v. Associated Pharmacists of Baltimore, Inc., et al. (D. C. D. Md. 1937) C. C. H., Securities Act, 655, par. 4761 (.12).
28. Supra, at 655, par. 4761 (.13).

earnings would be available for dividend payments by December, 1936;[29] an untrue representation that the corporation whose securities were being sold was and had been operating at a profit;[30] a failure to state to purchasers that dividends paid on securities had not been paid from the profits and earnings of the corporation, and had been paid from the capital funds of the corporation issuing such securities;[31] a representation that the securities being sold were treasury-owned securities of the corporation issuing them, when such securities were not in fact treasury-owned securities of such corporation;[32] an exaggerated statement as to the number and nature of the defendant's oil and gas wells.[33]

Section 17(a) applies to those securities which are otherwise exempt from the operation of the Act under section 3.[34] Section 17(b) provides that

> It shall be unlawful for any person, by the use of any means or instrument of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, or such consideration and the amount thereof.

This provision was primarily designed to meet the evils of "tipster sheets" and articles in newspapers and periodicals which purport to give unbiased opinions although in reality such opinions have been purchased.[35] In interpreting this section the Commission has ruled that when a statistical service company publishes ratings for securities and advice as to their purchase, sale or retention even though it receives from the issuing company only a flat, non-contingent fee, such compensation must be disclosed although it is an ordinary expectation of profit.[36] This provision also applies to such securities as are exempt from the Act under section 3.[37]

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29. Supra, at 655, par. 4761 (.14).
30. Securities & Exchange Comm. v. The Krystal Chemical Co. Inc. (D. C. D. C. 1937) C. C. H., Securities Act, 657, par. 4761 (.16).
31. Supra, at 657, par. 4761 (.19).
32. Supra, at 657, par. 4761 (.20).
33. Securities & Exchange Comm. v. Hertz & Co. Inc. (D. C. D. C. 1937) C. C. H., Securities Act, 655, par. 4761 (.15).
34. Sec. 17 (c).
35. See H. R. Rep. No. 85, 73rd Cong., 1st Sess. (1933).
36. (1933) Securities Act Release No. 97.
37. Sec. 17 (c).

The following prohibition is imposed by section 5.

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly
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> (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
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> (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 security 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 transport any prospectus relating to any security registered under the title, unless such prospectus meets the requirements of section 10.

The power of Congress to exclude such securities from the mails unless a true statement describing them has been filed with the Commission was declared constitutional as a reasonable method of preventing the use of the mails to promote and consummate sales of misrepresented securities.[38] *In Re Matter of Brooklyn Manhattan Transit Corporation*[39] most clearly illustrates the extensive control by the Commission over the sale of securities under this section. A purchaser who authorized his broker to deliver to him through the mails bonds purchased for him was held to have *indirectly* caused the bonds to be carried through the mails for the purpose of delivery after sale in violation of section 5(a). The Commission also ruled that in a sale to a brokerage house a seller is chargeable with knowledge that he may be selling to an agent and that the agent may use means or instruments of transportation for the purpose of delivery to the purchaser; and that the seller may thus be held to have indirectly caused such delivery in violation of section 5(a)(2). And in its final and most drastic ruling the Commission denied a temporary registration on the Securities Exchange to *any* security neither registered nor exempt from registration under the Act. The following reason was advanced to sustain this action:

> * * * because of the ultimate and unbroken relationship or transaction on such exchange to the interstate "flow" of

38. Jones v. Securities & Exchange Comm. (C. C. A. 2, 1935) 79 F. (2d) 617.

39. (1935) Securities Act Release No. 260.

> securities through such exchange, it is in itself to be regarded as a means or instrument of communication or transportation in interstate commerce.

In preparing literature to be circulated among prospective clientele prior to the effective date of the statement applied for, the General Counsel of the Commission has declared that such literature may be distributed, providing it does not constitute "selling literature."[40] This latter type of circulation, of course, must be preceded or accompanied by a prospectus meeting the requirements of the Act. The following suggestions were advanced by the General Counsel of the Commission as prerequisites to proper, advance literature: (1) it must contain no recommendations or opinions upon the security; (2) it must present a fair summarization of the salient information contained in the registration statement; and (3) it must not constitute an offer or inducement to purchase or sell the security.[41]

In another opinion by the General Counsel of the Commission, it was held that the party who sends "selling literature" need not be the one who sent the prospectus ahead to the purchaser, it being sufficient that such prospectus was in fact received. Such literature, however, must conform to the prospectus, and the party sending it assumes this risk both civilly and criminally.[42]

The provisions of section 5(a) and 5(b) do not apply to the sale of any security if the issue of which it is a part is sold only to persons resident within a single state or territory, or if the issuer of such securities is a person resident and doing business within or, if a corporation, is incorporated by and doing business within such state or territory.[43]

Section 23 of the Act imposes this prohibition.

> Neither the fact that the registration statement for a security has been filed or is in effect, nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the Commission has in any way passed upon the merits, or given approval to, such security.

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40. (1935) Securities Act Release No. 464; (1936) Securities Act Release No. 802.
41. Ibid.
42. (1936) Securities Act Release No. 828.
43. Sec. 5 (c). For some of the problems which may arise under this exemption and their suggested solution see Throop and Lane, Some Problems Of Exemption Under The Securities Act Of 1933 (1937) Law and Contemporary Problems, 87, 107-109.

> It shall be *unlawful* to make, or cause to be made, to any prospective purchaser any representation contrary to the foregoing provisions of the section. (Italics supplied.)

The affixing of any signature to a registration statement without the authority of the purported signer constitutes a violation of the Act.[44]

IV

For purposes of investigation the Securities & Exchange Commission and its agents are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which are deemed relevant or material to the inquiry.[45] In case of contumacy or refusal to obey a subpoena issued by the Commission, any United States court, within the jurisdiction of which the subpoened person is found or resides, may upon application by the Commission issue to such person an order requiring him to appear before the Commission and to produce the evidence demanded. Any failure to obey such an order of the court may be punished by the court as a contempt thereof.[46] This extensive investigatory power granted to the Commission is one of the most commendable features of the Act. The section, however, has been criticized for its failure to contain a like provision which would enable the Attorney General to compel a witness to testify before the grand jury. It is pointed out that although a majority of the investigations will probably originate with the Commission, after the case has been turned over to the Attorney General it will probably be necessary or desirable for him in the course of his further investigation, or in connection with the preparation for trial, to examine additional witnesses before the grand jury.[47]

The Act further provides that no person shall be excused from attending and testifying or from producing evidence before the Commission, or in obedience to the subpoena of the Commission, or in any cause or proceeding instituted by the Commission on the ground that the testimony or evidence may tend to incriminate him or subject him to a penalty or forfeiture. It is further provided that no individual shall be prosecuted or subjected to any penalty or forfeiture on account of any transaction concerning which he is compelled, after having claimed his privilege

44. Sec. 6 (a).
45. Sec. 19 (b). See Note (1935) 44 Yale L. J. 819 for an extended discussion of the Commission's inquisitorial powers.
46. Sec. 22 (b).
47. Herlands, supra, note 1, at 625.

against self-incrimination, to testify or produce such evidence, except that the individual so testifying shall not be exempt from prosecution and punishment for perjury committed in so testifying.[48]

In *McMann v. Securities & Exchange Comm.*[49] the court held that a customer was not entitled to prevent his broker from complying with subpoenas issued by the Commission to produce copies of the customer's account. The court rejected the contention that such subpoenas infringed the customer's immunity from unreasonable searches. The evidence showed that the Commission's motive was a lawful investigation limited to transactions as to which the Commission had evidence of violations of the statute and was not merely a "fishing excursion." The search, therefore, was not "unreasonable," as being out of proportion to the end sought.

The Act does not expressly provide for the criminal liability of officers, directors, accountants and other persons coming in contact with the promotion, underwriting, issuance, and distribution of a particular security. Such parties, however, can be prosecuted effectively under general criminal provisions which makes anyone aiding, abetting, counseling, inducing, or procuring the commission of a crime guilty as a principal.[50]

The Act provides that any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of the Act or of the rules and regulations shall be void.[51]

V

It is apparent that the few criminal convictions to date have been for violations of a most flagrant, dishonest, and conniving nature. Those violations which have been enjoined, however, although detrimental to the investors, were not primarily a scheme to cheat or defraud him. This latter type of violation is equally subject to criminal liability, although the element of "wilfullness" would probably be more difficult to prove. It is submitted, however, that the Commission seems to have indicated a policy not to invoke penal liability except in flagrant instances of violation.

Thus viewed, the penal and injunctive provisions of this complicated Act are for the most part clear and unambiguous. The decisions interpreting these sections have added little difficulty.

48. Sec. 22 (c).
49. (C. C. A. 2, 1937) 87 F. (2d) 377.
50. (1909) 35 Stat. 1152 (1927) 18 U. S. C. A. sec. 550.
51. Sec. 14.

The future, of course, will bring new problems and unexpected complications. It is believed, however, that if the purposes of these carefully drafted penal and injunctive provisions are borne in mind, and subtle, exculpatory distinctions are not permitted to develop, these vital problems under the Act will remain relatively simple.

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RADIO DEFAMATION—LIBEL OR SLANDER?

Homines qui gestant, quique auscultant crimina,
Si meo arbitratu liceat, omnes pendeant,
Gestores linguis, auditores auribus.[1]
Plautus Pseudolus I. 5. 12

I

A survey of the modern law of libel and slander will expose the scars wrought by time in the visage of defamation. The sixteenth and early seventeeth centuries witnessed the development of slander as a tort through the action on the case.[2] Juristic attempts to discourage the action on the case, however, resulted in certain defects in the law of slander. In order to remedy these defects, judicial fecundity produced the law of libel in the latter part of the seventeenth century.[3] The cases, as they arose, were decided not on general or theoretical grounds, but rather for reasons which seemed most expedient and sufficient to the judges at the time to dispose of the particular case in hand.[4] In their development libel and slander were not scientifically cultivated. Theirs was a haphazard growth influenced by the events of each century, such as the widespread employment of printing. Important political developments of the eighteenth century resulted in a somewhat clear-cut division of the tort of defamation into libel and slander. This division has formed a good starting point for the development of, and a satisfactory framework for, the many detailed rules made necessary by the nineteenth century methods of communications.[5]

The twentieth century is witnessing the development of a new

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1. Your tittle tattlers, and those who listen to slander, by my good will should all be hanged—the former by their tongues, the latter by their ears.
2. 8 Holdsworth, *History of English* Law (1926) 367.
3. Ibid.
4. 8 Holdsworth, *History of English Law* (1926) 362.
5. 8 Holdsworth, *History of English Law* (1926) 378.