LIABILITY FOR MISREPRESENTATIONS AND OMISSIONS IN THE REGISTRATION STATEMENT UNDER SECTION 30 OF THE SECURITIES ACT

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INTRODUCTION

1. *History, Sources and Purpose of the Philippine Securities Act*

The Philippine Securities Act[1] was patterned mainly after (1) the Federal Securities Act of 1933, (2) the Federal Securities Exchange Act of 1934 and (3) the Uniform Sales of Securities Act.[2]

It was enacted due to the glaring failure of the first Philippine Blue Sky Law[3] to protect the investing public during the mining boom in the mid-1930's. One Philippine authority vividly described the deplorable situation:[4]

> Some of us today will still remember the unbridled speculation that characterized securities transactions in and out of our organized stock exchanges during the middle 30's. It was a bonanza period for fly-by-night and fake corporations and get-rich-quick wallingfords. These sly operators and glib-tongued promoters mercilessly preyed upon the naiveté of a great many investors who, unschooled in the science of corporate investments and prompted largely by the desire to earn profits the quickest possible way, were easily duped into putting their money in absolutely worthless securities. The regnant quip in those days was that "gold" was to be found on the Escolta, and not in the bowels of the earth.[5]
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> The deplorable situation brought about by the mining boom, and the attendant mushrooming of irresponsible issuers of corporate securities became so alarming that the government was rudely jolted into the realization that there was a pressing and urgent need for creating an office technically manned and adequately clothed with power to protect investors, both actual and potential, and safeguard public interest.

Like its predecessor, the purpose of the Philippine Securities Act was to protect the public against "speculative schemes which have no more basis than so many feet of blue sky" and against the "sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent

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1 Commonwealth Act No. 83 was approved on October 26, 1936.

2 3 AGBAYANI, COMMENTARIES AND JURISPRUDENCE ON THE COMMERCIAL LAWS OF THE PHILIPPINES 794 (1970).

3 Act No. 2581 (1916). For the complete text, see 11 PUBLIC LAWS OF THE PHILIPPINE ISLANDS 183 (1916).

4 Yabyabin, *The Securities Act and Trading*, in ASPECTS OF PHILIPPINE CORPORATION LAW, PROCEEDINGS OF 1966, 281-282 (1966).

5 Escolta was the Wall Street of Manila at that time.

exploitations"[6] As one early Filipino author put it, "(T)he Securities Act was enacted primarily to prevent exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; and to protect honest enterprise seeking capital by honest presentation, against competition afforded by dishonest securities offered to the public through crooked promotion."[7]

2. *Scheme of the Philippine Securities Act*

In order to accomplish its avowed purpose of protecting the investing public, the Philippine Securities Act, among other things, requires (1) the registration and/or licensing of securities (Sections 4-13), (2) the registration of brokers, dealers and salesmen (Sections 4-15), and (3) the registration of stock exchanges (Sections 16-17) and contains provisions regarding (a) margin requirements (Section 18), (b) restrictions on borrowing by members, brokers, and dealers (Section 19), (c) manipulation of security prices (Section 20), (4) other manipulative devices (Section 21), (e) artificial measures of price control (Section 21-A), (f) segregation and limitation of function of members, dealers and brokers (Section 22), (g) transactions of unregistered securities (Section 23), (h) the giving of proxies (Section 24), and (i) over-the-counter markets (Section 25).

The Philippine Securities Act requires the registration of non-speculative securities and the registration and licensing of speculative securities.[8]

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[6] People v. Rosenthal, 68 Phil. 328, 342 (1939).

[7] FRANCISCO, UNDERSTANDING THE SECURITIES ACT 1.

[8] Section 2(b) of the Act defines speculative securities:

(b) "Speculative securities" shall mean and include:

1. All securities to promote or induce the sale of which, profit, gain, or advantage unusual in the ordinary course of legitimate business is in any way advertised or promised;

2. All securities the value of which materially depends upon proposed or promised future promotion or development rather than on present tangible assets and conditions;

3. All securities for promoting the sale of which a commission of more than five per centum is offered or paid;

4. All securities into the value of which the elements of chance or hazard or speculative profit or possible loss equals or predominates over the elements of reasonable certainty or safety of investment;

5. The securities of any enterprise or corporation which has included, or proposes to include, in its assets, as a material part thereof, patents, formulae, good-will, promotion or other intangible assets, or which has issued or proposes to issue a material part of its securities in payment for patents, formulae, good-will, promotion or other intangible assets; and

6. The securities of any enterprise engaged in the business of promoting, exploring, developing, exploiting or operating mineral properties and/or mineral rights; Provided, however, that the following class of securities shall not be deemed to be speculative securities:

(1) Securities issued by a person owning a property, business or industry which has been in continuous operation not less than three years and which has shown during a period of not less than two years next prior to the close of its last fiscal year preceding the offering of such securities, average annual net earnings, after deducting all prior charges not including the charges upon securities to be retired out of the proceeds of sale, as follows:

Section 4 of the Act provides for the registration of securities:[9]

> Sec. 4. *Sales and registration of securities.* — No securities except of a class exempt under any of the provisions of Section 5 hereof or unless sold in any transaction exempt under any of the provisions of Section 6 hereof shall be sold within the Philippines unless such securities shall have been registered and/or licensed as hereinafter provided. Registration of stock shall be deemed to include the registration of rights to subscribe to such stock if the registration statement filed pursuant to Section 7 of this Act includes a statement that such rights are to be issued. A record of the registration of securities shall be kept in a Register of Securities to be kept in the office of the Commission, in which Register of Securities shall also be recorded any orders entered by the Commission with respect to such securities. Such register, and all information with respect to the securities registered therein, shall be open to public inspection.
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> Notwithstanding the provisions of the preceding paragraph regarding exemptions, and any other provision of this Act or other existing laws, commercial papers as defined in Section 1 hereof shall be registered in accordance with the rules and regulations that shall be promulgated by the Securities and Exchange Commission, after approval by the Monetary Board which shall also have the power of suspension in the enforcement of these provisions, it being understood that such rules may provide for open-end registration provided certain limits be made in the public interest and for the protection of investors. The rules may also provide exemptions from registration of inter-bank call loans under such guidelines as may be necessary in the interest of the public. Section 5 enumerates the exempt securities. Section 6 provides for the exempt transactions.

The procedure for registration is contained in Section 7.[10] The procedure for updating the registration statement is set in Section 11:

> (a) In the case of interest-bearing securities, not less than one and one-half times the annual interest charged thereon and upon all other outstanding interest-bearing obligations of equal rank;
> (b) In the case of preferred stock, not less than one and one-half times the annual dividend requirements on such preferred stock and all other outstanding stock of equal rank;
> (c) In the case of common stock, not less than five per centum upon all outstanding common stock of equal rank together with the amount of common stock then offered for sale reckoned upon the price at which such stock is then offered for sale or sold.

The ownership by a person of more than fifty per centum of the outstanding voting stock of a corporation shall be construed as the proportionate ownership of the property, business or industry of such corporation, and shall permit the inclusion of the earnings of such corporation applicable to the payment of dividends upon the stock so owned in the earnings of the person issuing the securities sought to be registered.

Those securities not falling within the above definition are non-speculative securities.

[9] The second paragraph was added by Presidential Decree No. 678.

[10] Sec. 7. *Procedure for registration.*—

> (a) All securities shall be registered through the filing by the issuer or by any dealer interested in the sale thereof, in the office of the Commission, of a sworn registration statement with respect to such securities, containing or having attached thereto, the following:
> (1) Name of issuer and, if incorporated, place of incorporation.
> (2) The location of the issuer's principal business office, and if such issuer is a non-resident or its place of office is outside of the Philippines, the name and address of its agent in the Philippines authorized to receive notice.

(3) The names and addresses of the directors or persons performing similar functions, and the chief executive, financial and accounting officers, chosen or to be chosen, if the issuer be a corporation, association, trust, or other entity; of all the partners, if the issuer be a partnership; and of the issuer, if the issuer be an individual; and of the promoters in case of a business to be formed.

(4) The names and addresses of the underwriters.

(5) The general character of the business actually transacted or to be transacted by the issuer.

(6) A statement of the capitalization of the issuer, including the authorized and outstanding amounts of its capital stock and the proportion thereof paid up; the number and classes of shares in which such capital stock is divided; par value thereof, or if it has no par value, the stated or assigned value thereof; a description of the respective voting rights, preferences, conversion and exchange rights, rights to dividends, profits, or capital of each class, with respect to each other class, including the retirement and liquidation rights or values thereof.

(7) A copy of the security for the registration of which application is made.

(8) A copy of any circular, prospectus, advertisement, letter of communication to be used for the public offering of the security.

(9) The specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determinable, for which the security to be offered is to supply funds, and if the funds are to be raised in part from other sources, the amounts thereof and the sources thereof shall be stated.

(10) A statement of the amount of the issuer's income, expenses, and fixed charges during the last fiscal year, or if in actual business less than one year, then for such time as the issuer has been in actual business.

(11) A balance sheet showing the amount and general character of its assets and liabilities on a day not more than sixty days prior to the date of such balance sheet.

(12) The remuneration, paid or estimated to be paid, by the issuer or its predecessor, directly or indirectly, during the past year and ensuing year to (a) the directors or persons performing similar functions, and (b) its officers and other persons, naming them whenever such remuneration exceeded six thousand pesos during any such year.

(13) The amount of issue of the security to be offered.

(14) The estimated net proceeds to be derived from the security to be offered.

(15) A statement showing the price at which such security is proposed to be sold, together with the maximum amount of commission or other form of remuneration to be paid in cash or otherwise, directly or indirectly, for or in connection with the sale or offering for sale of such security.

(16) The amount or estimated amounts, itemized in reasonable detail, of expenses, other than commissions specified in the next preceding paragraph, incurred or to be borne by or for the account of the issuer in connection with the sale of the security to be offered or properly chargeable thereto, including legal, engineering, certification, authentication, and other charges.

(17) A detailed statement showing the items of cash, property, services, patents, good-will, and any other consideration for which securities have been or are to be issued in payment.

(18) The amount of cash to be paid as promotion fees, or of capital stock which is to be set aside and disposed of as promotion stock, and a statement of all stock issued from time to time as promotion stock.

(19) In connection with speculative securities issued by a person engaged in the business of developing, exploiting or operating mineral claims, a sworn statement of a mining engineer stating the ore possibilities of the mine and such other information in connection therewith as the Commission may, by regulations, require, which will show the quality of the ore in such claim, and the unit cost of extracting it.

(20) Unless previously filed and registered under the provisions of this Act, and brought up to date, (a) a copy of its articles of incorporation, with all amendments thereof and its existing by-laws or instruments corresponding thereto, whatever the name, if the issuer be a corporation; (b) copy of all instruments by which the trust is created or declared and in which it is accepted and acknowledged if the issuer is a trust; (c) a copy of its articles

Sec. 11. *Financial statements, circulars, and so forth, filing of.*— While any person, whose securities have been sold pursuant to registration and/or permit issued hereunder, is engaged in business in the Philippines, such person shall file with the Commission not later than February fifteen of each year, a statement under oath of assets and liabilities as of December thirty-first of the last previous year, Provided that at the request of such person or his duly authorized agent or of a member or duly authorized officer or agent of such person, the Commission may grant an extension of time not to exceed thirty days within which such statement shall be submitted to it. Such person shall also file with the Commission, before

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or partnership or association and all papers pertaining to its organization, if the issuer is a partnership, unincorporated association, joint-stock company, syndicate, or any other form of organization.

(b) In case of certificates of deposit, voting trust certificates, collateral trust certificates, certificates of interest or shares in unincorporated investment trusts, equipment trust certificates, interim or other receipts for certificates, and like securities, the Commission shall establish rules and regulations requiring the submission of information of a like character applicable to such cases, together with such other information as it may deem appropriate and necessary regarding the character, financial or otherwise, of the actual issuer of the securities and/or the person performing the acts and assuming the duties of depositor or manager.

(c) However, the Commission may by rules or regulations provide that any of the above information or document need not be included in respect of any class of issuer of securities, if it finds that requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise included in a registration statement filed in accordance with such rules.

Upon filing of such registration statement, the issuer or dealer shall pay to the Treasurer of the Philippines, a fee of one-tenth of one per centum of the maximum aggregate price at which such securities are proposed to be offered, but in no case shall such fee be less than fifty pesos nor more than one thousand pesos; and the fact of such filing shall be immediately published by the Commission, at the expense of the issuer or dealer, in two newspapers of general circulation in the Philippines, one published in English and another in Spanish, once a week for two consecutive weeks, reciting that a registration statement for the sale of such security has been filed with it, and that the aforesaid registration statement, as well as the papers attached theerto, are open to inspection during business hours, by interested parties, under such regulations as the Commission may prescribe; and copies thereof, photostatic or otherwise, shall be furnished to every applicant at such reasonable charge as the Commission may prescribe.

The filing of such statement in the office of the Commission, the payment of the fee hereinabove prescribed, and the publication made as above stated, shall constitute the registration of such security, and seven days after the expiration of the period for publication above referred to, the registration shall take effect, and the security, if not a speculative security, may be sold in the Philippines, subject however, to the further orders of the Commission as hereinafter provided. The Commission shall, upon the filing of the registration statement above referred to, determine, by order, whether or not the security sought to be registered is speculative within the meaning of this Act, and shall forthwith advise the issuer or dealer.

As to promotion fees, Section 13 provides:

Sec. 13. *Promotion fees.*— If the statement containing information as to securities to be registered, as provided for in section seven of this Act, shall disclose that any such securities or any securities senior thereto shall have been or shall be intended to be issued for good-will, or for organization or promotion fees or expenses, or that payment in cash shall have been or will be made for organization or promotion fees or expenses or for good-will, the amount and nature thereof shall be fully set forth in the notification published by the Commission as required in Section 7 of this Act, and in all prospectuses, circulars, or other advertisements of the issuer, and should also appear upon the face or on the back of the security itself.

> or at the time of the issuance for publication, copies of all circulars, prospectuses and other advertising matter to be issued from time to time by or on behalf of such person.

The Philippine Securities and Exchange Commission will grant a license to sell speculative securities under the conditions prescribed in Section 9:[11]

> Sec. 9. *License to sell speculative securities.* — With respect to speculative securities, if the Commission shall find after examination of the registration statement filed by the issuer or dealer, together with all the other papers and documents attached thereto, that the issuer is of *good repute,* and that the sale of the security would *not be fraudulent* and would *not work or tend to work a fraud upon the purchasers,* and that the *enterprise or business of the issuer is not based upon unsound business principles,* it shall record the registration of such security in the Register of Securities, and after the effective date of such registration as above stated, it shall issue to the issuer or dealer a *license to sell* those securities in the Philippines, and shall issue to such issuer a certificate of permit reciting that such person, its brokers or agents, are entitled to offer the securities named in said certificate for sale in the Philippines. Every permit shall recite in bold type that the issuance thereof is permissive only and does not constitute a recommendation or endorsement of the securities permitted to be issued.
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> With respect to speculative securities, the Commission shall, by order, duly recorded, fix the amount of commission or other form of remuneration to be paid in cash or otherwise, directly or indirectly, for or in connection with the sale or offering for sale of such securities in the Philippines in no case to exceed ten per centum of the value of the securities sold; and shall fix the maximum amount of compensation which the issuer shall pay for mining claims and/or mineral rights for which provision is made by the issuer for payment in cash or securities. It may issue the permit subject to other conditions to the end that this power may become effective. The amount of compensation which shall be paid the owner and/or holder of such mining claims and/or mineral rights shall be a fair valuation thereof, as may be fixed by the Commission, after consultation with the Bureau of Mines, and after receiving such technical information as the issuer or dealer and/or the owner or owners of such claims may care to submit in the premises.

Thus, unlike the Federal Securities Act of 1933 which makes no distinction between speculative and non-speculative securities and whose manner of registration is one of notification, under the scheme of the Philippine Securities Act, non-speculative securities are registered by notification while speculative securities are registered by qualification since the registering body (i.e., the Philippine S.E.C.) has the power to inquire into the qualifications of the speculative securities concerned before granting the license to sell under Section 9 of the Philippine Securities Act.[12]

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[11] Italics ours.

[12] The first Philippine Blue Sky Law, Act No. 2581, *supra,* note 3 at 183-185, was limited in its application to speculative securities which were registered by qualification. Upon qualification, the sale of the securities was licensed by the Insular Treasurer. See Pineda, *The Securities Act as Interpreted by the Securities and Exchange Commission,* 3 FEU L. Q. 193, 199 (1955).

Section 8 provides for the suspension of registration.[13] Furthermore, Section 12 grants the Philippine S.E.C. power to revoke the registration of securities of the license to sell.[14]

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[13] Sec. 8. *Suspension of registration.* — If, at any time, in the opinion of the Commission, the information contained in the statement filed is or has become misleading, incorrect, inadequate or incomplete, or the sale or offering for sale of the security *may work or tend to work a fraud,* the Commission may require from the person filing such statement such further information as may in its judgment be necessary to enable the Commission to ascertain whether the registration of such security should be revoked on any ground specified in section twelve, and the Commission may also suspend the right to sell such security pending further investigation, by entering an order specifying the grounds for such action, and by notifying by mail, or personally, or by telephone confirmed in writing, or by telegraph, the person filing such statement *and every dealer who shall have notified the Commission of an intention to sell such security.* The refusal to furnish information required by the Commission within a reasonable time to be fixed by the Commission, may be a proper ground for the entry of such order of suspension. Upon the entry of any such order of suspension, no further sales of such security shall be made until the further order of the Commission.

In the event of the entry of such order of suspension, the Commission shall give a prompt hearing to the parties interested. If upon such hearing, the Commission shall determine that the sale of any such security should be revoked on any ground specified in section twelve, it shall enter a final order prohibiting sales of such security, with its findings with respect thereto. Until the entry of such final order, the suspension of the right to sell, though binding upon the persons notified thereof shall be deemed *confidential,* and shall not be published, unless it shall appear that the order of suspension has been violated after notice. Appeals from such final order may be taken to the *Supreme Court* in the manner provided in this Act. If, however, upon such hearing the Commission shall find that the sale of the security will neither be fraudulent nor result in fraud, it shall forthwith enter an order revoking such order of suspension, and such security shall be restored to its status as a security registered under this Act, as of the date of such order of suspension. (Italics ours)

[14] Sec. 12. *Revocation of registration of securities and of license to sell.* — The Commission may revoke the registration of any security and the license to sell a speculative security by entering an order to this effect, with its findings in respect thereto, if upon examination into the affairs of the issuer of such security, it shall appear that the issuer:

(a) Is insolvent; or
(b) Has violated any of the provisions of this Act or any order of the Commission of which the issuer has notice; or
(c) Has been or is engaged or is about to engage in fraudulent transactions; or
(d) Is in *any other way dishonest* or has made any fraudulent representations in any prospectus or in any circular or other literature that has been distributed concerning the issuer of its securities; or
(e) Is of *bad business repute;* or
(f) Does not conduct its business in accordance with law; or
(g) Has its *affairs in an unsound condition;* or
(h) Has his *enterprise or business based upon unsound business principles.*

In making such examination, the Commission shall have access to and may compel the production of all the books and papers of such issuer, and may administer oaths to, and examine the officers of such issuer or any other person connected therewith as to its business and affairs, and may also require a balance sheet exhibiting the assets and liabilities of any such issuer or his income statement, or both, to be certified to by a certified public accountant.

Whenever the Commission may deem it necessary, it may also require such balance sheet or income statement, or both, to be made more specific in such particulars as the Commission shall point out or to be brought down to the latest practicable date.

If any issuer shall refuse to permit an examination to be made by the Commission, it shall be proper ground for revocation of registration and license.

If the Commission shall deem it necessary, it may enter an order suspending the right to sell securities pending any investigation, provided that the order shall state the grounds for taking such action, but such order of suspension, although binding upon the persons notified thereof, shall be deemed

The most potent civil sanction, however, against misrepresentations and omissions in the registration statement is Section 30 which provides:[15]

> Sec. 30. *Remedies.* — (a) Every sale made in violation of any of the provisions of this Act or wherein the purchase shall have *relied* upon any statement which at the time and in the light of the circumstances under which it was made false and misleading with respect to any *material fact contained in any application, report, or document filed pursuant* to this Act or any rule or regulation thereunder, shall be *voidable* at the *election of the purchaser;* and the *person making such sale* and *every director, officer or agent of or for such seller, if such director, officer or agent shall have personally participated or aided in any way in making such sale,* shall be jointly and severally liable to such purchaser in an action in any court of competent jurisdiction upon *tender of the securities sold or of the contract made* for the full amount paid by such purchaser, with interest, together will all taxable court costs and reasonable attorney's fees; Provided, that no action shall be brought for the recovery of the purchase price after two years from the date of such sale: And provided, further, that no purchaser otherwise entitled shall claim or have the benefit of this section who shall have refused or failed within thirty days from the date thereof to accept an offer in writing of the seller to take back the security in question and to refund the full amount paid by such purchaser, together with interest on such amount for the period from the date of payment by such purchaser down to the date of repayment, such interest to be computed:
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> (1) In case such securities consist of interest-bearing obligations, at the same rate as provided in such obligations; and
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> (2) In case such securities consist of other than interest-bearing obligations, at the rate of six per centum per annum; less, in every case, the amount of any income from said securities that may have been received by such purchaser.
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> (b) Any person having a right of action against a dealer, broker or salesman under this section shall have a right of action under the bond provided in section fourteen.

Section 29 covers the liabilities of controlling persons:

> Sec. 29. *Liabilities of controlling persons.* — (a) Every person who directly or indirectly, controls any person liable under any provision of

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confidential, and shall not be published. Upon the entry of such order of suspension, no further sale of such security shall be made until further order of the Commission.

Notice of the entry of such order shall be given by mail, or personally, or by telephone, confirmed in writing, or by telegraph, to the issuer and every dealer who shall have notified the Commission of an intention to sell such security.

Before such order is made final, the issuer or dealer shall be entitled to a hearing; and such order may be *appealed to the Supreme Court* in the manner provided in this Act. (Italics ours)

[15] Italics ours. It should be emphasized that Section 37, provides:

Sec. 37. *Effect on existing law.* — The rights and remedies provided by this Act shall be in addition to any and all other rights and remedies that may exist now, but no person permitted to maintain a suit for *damages under the provisions of this Act shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.* (Italics ours)

There is apparently a conflict between the above provision and Section 30 as far as the measure of damages is concerned.

> this Action or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
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> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this Act or any rule or regulation thereunder through or by means of any other person.
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> (c) It shall be unlawful for any director or officer of, or any owner of any of the securities issued by any issuer of any security registered in accordance with this Act, without just cause, to hinder, delay, or obstruct the making or filing of any document, report, or information required to be filed under this Act or any rule or regulation thereunder.

3. *Scope of Paper*

This paper shall merely deal with the civil liability of issuers, dealers and underwriters for misrepresentations and omissions of material facts contained in the registration statement under Section 30 of the Philippine Securities Act.

More particularly, it shall concentrate on the following problem areas in Section 30: (1) Who are the persons liable for misrepresentations or omissions in the registration statement? Are the underwriters liable? What is meant by the term 'underwriter' as used in various provisions of the Philippine Securities Act? (2) Who has the right of action under Section 30? (3) How can reliance on any part of the registration statement be proved? and (4) What is meant by a 'material fact'?

In view of the absence of Philippine decisions and the dearth of authoritative local comments on the above subject matters, we are constrained to turn to Anglo-American decisions and authorities for guidance. The Philippine Securities Act is, after all, of American origin.

I. Persons Liable

Under Section 30 of the Philippine Securities Act, the seller and every director, officer or agent of such seller if such director, officer or agent shall have personally participated or aided in any way in making such sale (as well as the controlling persons in Section 29) shall be jointly and severally liable to the purchaser of the securities for misrepresentations and omissions of any material fact contained in the registration statement filed with the Philippine S.E.C. However, Section 7 provides that only an issuer or a dealer interested in the sale of the securities to be offered to the public can file the registration statement with the Commission.

Therefore, unless the seller is an aider or abettor, the purchaser can recover under Section 30 on account of misrepresentations and omissions in the registration statement only if the seller is an issuer or dealer or a director, officer or agent of such issuer or dealer who had *personally*

participated or aided in any way in making such sale or a controlling person under Section 29. Section 2(h) defines an issuer:

> (h) "Issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions), or of the fixed restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; and except that with respect to fractional undivided rights in oil, gas, or other mineral rights, or claims or properties, the term "issuer" means the owner of any such right or property or of any interest therein (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

And Section 2(g) defines a dealer:[16]

> (g) "Dealer" shall include every person other than a salesman who *engages either for all or part of his time,* directly or through an agent, *in the business* of selling any securities issued by another person or purchasing or otherwise acquiring such securities from another for the purpose or reselling them or of offering them for sale to the public, or offering, buying, selling or otherwise dealing or trading in securities for a profit, or who deals in futures or differences in market quotations of price or values of any securities, or accepts margins on purchases or sales or pretended purchases or sales of securities: Provided, that the word "dealer" shall not include a person having no place of business for the purpose, who sells or offers to sell securities exclusively to brokers or dealers actually engaged in buying and selling securities as a business.

Unlike the Federal Securities Act of 1933,[17] a 'dealer' does not include a 'broker'. Under Section 2(j) of the Philippine Securities Act, a broker means "any person engaged in the business of effecting transactions in securities for the *account of others,* but does not include a bank."

The Philippine Securities Act does not define the term 'underwriter'. However, it mentions the term in Section 6 (c)[18] and Section 7 (a) (4).[19]

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[16] Italics ours. Section 2(i), defines a salesman so as to "... include every natural person, other than a dealer, employed or appointed or authorized by a dealer or issuer, to sell securities in any manner" and such that "(t)he partners of a partnership and the executive officers of a corporation or other association registered as a dealer shall not be salesmen within the meaning of this definition."

[17] Section 2(12) of the 1933 Act defines a dealer as "... any person who engages either *for all or part of his time,* directly or indirectly, as agent, *broker,* or principal, in the *business* of offering, buying, selling, or otherwise dealing or trading in securities issued by another person. Italics ours. 15 U.S.C. §77b (1976).

[18] Among the exempt transactions, Section 6(c) covers "(a)n isolated transaction in which any security is sold, offered for sale, subscription or delivery by the owner thereof, or by his representative for the owner's account, such sale or offer for sale, subscription or delivery not being made in the course of repeated and successive transac-

Meaning of the term 'underwriter'.

Section 2(11) of the Federal Securities Act of 1933 defines the term 'underwriter':[20]

> (11) The term 'underwriter' means any person who has purchased from an issuer with a view *to,* or offers or sells *for* an issuer in connection with, the *distribution* of any security, or participates or has a *direct or indirect participation* in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

This definition is much broader than the common meaning of the term.

In common parlance, the term 'underwriter' is limited to the 'firm-commitment' underwriter and the 'strict' or 'old fashioned' or 'stand-by' underwriter.[21] Professor Loss describes the 'firm-commitment' variety:[22]

> * * * (t)he most prevalent type of American 'underwriting' is the 'firm-commitment' variety. It is not technically underwriting in the classic insurance sense. But its purpose and effect are much the same in that it assures the issuer of a specified amount of money at a certain time (subject frequently to specified conditions precedent in the underwriting contract) and shifts the risk of the market (at least in part) to the investment bankers. The issuer simply sells the entire issue outright to a group of securities firms, represented by one or several "managers" or "principal underwriters" or "representatives". They in turn sell at a price differential to a larger "selling group" of dealers. And they sell at another differential to the public.

But legal dictionaries seem to adhere to the 'strict' or 'old fashioned' meaning of the word.[23] They define 'to underwrite' as "to insure the sale of corporate bonds or similar securities to the public by agreeing to buy

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tions of a like character by such owner, or on his account by such representative, and such owner or representative not being the *underwriter* of such security. (Italics ours)

[19] Listed among the items to be included in the sworn registration statement to be filed with the SEC are the names and addresses of the underwriters. *Supra,* note 10.

[20] *Supra,* note 17. Italics ours.

[21] In *Dale v. Rosenfeld,* 229 F. 2d 855 (2d Cir. 1956), the court held that, although the statutory definition included a best-efforts underwriter, the plaintiff-buyer had understood the phrase "underwriter (as defined pursuant to the Securities Act of 1933, as amended)" on the cover page of the prospectus as indicating only a firm-commitment underwriter which was the common meaning of the term.

[22] 1 Loss, Securities Regulation 163-164 (1961).

[23] Professor Loss, *supra,* note 22 at 159-160, illustrates this type of underwriting as the traditional English system of distribution but which is now rarely used even in England:

> This was underwriting in the strict insurance sense. For a fee or premium, the underwriter agreed to take up whatever portion of the issue was not purchased by the public within a specified time. And, just as insurance companies frequently reinsure large underwritings with other companies in order to distribute the risk, so the initial underwriter often protected himself by agreements with sub-underwriters, to which the issuer was not a party.

those which are not sold,[24] and 'underwriting contract' as "an agreement, made before corporate shares are brought before the public, that in the event of the public not taking all the shares or the number mentioned in the agreement, the underwriter will take the shares which the public do not take; underwriting being a purchase together with a guaranty of a sale of the bonds,"[25] 'underwriting' as "an agreement made in forming a company and offering its shares or bonds to the public that if they are not all taken up, the undewriter will take what remains,"[26] and an 'underwriter' as "one who has agreed to take an entire stock or bond issue as is not taken by the public."[27]

Non-legal dictionaries likewise refer to the term 'underwrite' as "to agree to take up, in a new company or new issue, a certain number of shares if not applied for by the public"[28] or "to agree to purchase (a security issue) on a fixed date at a fixed price with a view to public distribution."[29]

Section 2(11) of the Federal Securities Act of 1933 greatly expands the meaning of the term 'underwriter'. It includes, besides the firm-commitment and strict underwriters, the 'best-efforts' underwriter who is really nothing more than an agent of the issuer. This method of underwriting is often used by companies which are not well established and by those which are so well established that they can distribute their securities without any underwriting commitment.[30] The Report of the Committee on Interstate and Foreign Commerce of the U.S. House of Representative accurately portrayed the breadth of this definition:[31]

> The term (underwriter) is defined broadly enough to include not only the ordinary underwriter, who for a commission promises to see that an issue is disposed of at a certain price, but also includes as an underwriter the person who purchases an issue outright with the idea of then selling that issue to the public. The definition of underwriter is also broad enough to include two other groups of persons who perform functions, similar in character, in the distribution of a large issue. The first of these groups may be designated as the underwriters of the underwriter, a group who, for a commission, agree to take over pro rata the underwriting risk assumed by the first underwriter. The second group may be termed participants in the underwriting or outright purchase, who may or may not be formal parties to the underwriting contract, but who are given a certain share or interest therein.

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[24] BLACK'S LAW DICTIONARY 1697 (1968) citing Busch v. Stromberg-Carlson Tel. Mfg. Co., C.C.A. Mo., 217 F. 328, 330 (1914); Stewart v. G. L. Miller and Co., 161. 919, 132 S.E. 535, 538 (1926), 45 ALR 559 (1926).

[25] *Supra,* note 24 citing Fraser v. Home Telephone and Telegraph Co., 91 Wash. 253, 157 P. 692, 694 (1916); In re Hackett, Hoff and Thiermann, C.C.A., Wis., 70 F. 2d 815, 819 (1934).

[26] BOUVIER'S LAW DICTIONARY 1199 (1940).

[27] BALLANTINE'S LAW DICTIONARY 1313 (1969) citing In re Hackett, Hoff and Thiermann, C.C.A., Wis., 70 F. 2d 815 (1934); Rauer's Law and Collection Co. v. Harrel, 32 Cal. 45, 162 P. 125 (1917).

[28] THE OXFORD ENGLISH DICTIONARY 155 (1933).

[29] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 2491 (1971).

[30] *Supra,* note 22 at 171.

[31] H.R. REP., No. 85, 73rd Cong., 1st Sess. 13-14 (1933). Italics ours.

> The term 'underwriters', however, is interpreted to exclude the dealer who receives only the usual distributor's or seller's commission. This limitation, however, has been so phrased as to prevent any genuine underwriter passing under the mark of a distributor or dealer. The last sentence of this definition, defining 'issuer' to include not only the issuer but also affiliates or subsidiaries of the issuer and persons controlling the issuer, has two functions. The first function is to require the disclosure of any underwriting commission which, instead of being paid directly to the underwriter by the issuer, may be paid in an indirect fashion by a subsidiary or affiliate of the issuer to the underwriter. Its second function is to bring within the provisions of the bill redistribution whether of outstanding issue or issues sold subsequently to the enactment of the bill. All the outstanding stock of a paticular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an ofier of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act. *The concept of control herein involved is not a narrow one, depending upon a mathematical formula of 51 percent of voting power, but is broadly defined to permit the provisions of the act to become effective wherever the fact of control actually exists.*

Professor Loss had this to say regarding the statutory definition of an underwriter:[32]

> The term "underwriter" is defined *not with reference to the particular person's general business but on the basis of his relationship to the particular offering.* No distinction is made between professional investment bankers and rank amateurs. Any person who performs one of the specified functions in relation to the offering is a statutory underwriter even though he is not a broker or dealer. Conversely, even a professional investment banker is not a statutory underwriter in effecting a distribution on behalf of a person not in a control relationship with the issuer, or in arranging a *private placement* on behalf of the issuer or a person in a control relationship with the issuer.

Nor is it necessary for an underwriter to have privity of contract with the issuer. In *Securities and Exchange Commission v. Chinese Consol. Benev. Ass'n. Inc.*,[33] the United States Circuit Court of Appeals, Second Circuit, held:

> Under section 4(1) the defendant is not exempt from registration requirements if it is "an underwriter". The court below reasons that it is not to be regarded as an underwriter since it does not sell or solicit offers to buy "for an issuer in connection with, the distribution," of securities. In other words, it seems to have been held that only solicitation authorized by the issuer in connection with the distribution of the Chinese bonds would satisfy the definition of underwriters contained in Section 2(11) and that defendant's activities were never for the Chinese govern-

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[32] *Supra*, note 22 at 547. Italics ours.

[33] 120 F. 2d 738, 740-741 (1941); Cert. denied 314 U.S. 618, 62 S. Ct. 106, 86 L. Ed. 497 (1941).

> ment but only for the purchasers of the bonds. Though the defendant solicited the orders, obtained the cash from the purchasers and caused both to be forwarded so as to procure the bonds, it is nevertheless contended that its acts could not have been for the Chinese government because it had no contractual arrangement or even understanding with the latter. But the aim of the Securities Act is to have information available for investors. This objective will be defeated if buying orders can be solicited which result in uninformed and improvident purchases. It can make no difference as regards the policy of the act whether an issuer has solicited orders through an agent, or has merely taken advantage of the services of a person interested for patriotic reasons in securing offers to buy. The aim of the issuer is to promote the distribution of the securities, and of the Securities Act is to protect the public by requiring that it be furnished with adequate information upon which to make investments. Accordingly, the words "(sell) for an issuer in connection with the distribution of any security" ought to be read as covering continual solicitations, such as the defendant was engaged in, which normally would result in a distribution of issues of unregistered securities within the United States. Here a series of events were set in motion by the solicitation of offers to buy which culminated in a distribution that was initiated by the defendant. We hold that the defendant acted as an underwriter.

The same court likewise held in *Securities and Exchange Commission v. Guild Films Company, Inc.*:[34]

> Nor is it a defense that the banks did not deal directly with Guild Films. The court has recently stated that "the underlying policy of the Act, that of protecting the investing public through the disclosure of adequate information, would be seriously impaired if we held that a dealer must have *conventional or contractual privity* with the issuer in order to be an underwriter." S.E.C. v. Culppepper, 2 Cir., 1959, 270 F. 2d 241, 246, following S.E.C. v. Chinese Consol Benev. Ass'n., 2 Cir., 1941, 120 F. 2d 738, certiorari denied, 1942, 314 U.S. 618, 62 S. Ct. 106, 86 L. Ed. 497. It was held in these two cases that Sec. 4(1) "does not in terms or by fair implication protect those who are engaged in steps necessary to the distribution of a security issue. To give Section 4(1) the construction urged by the defendant would afford a ready method of thwarting the policy of the law and evading its provisions." S.E.C. v. Chinese Consol. Benev. Ass'n., *supra*, 120 F. 2d at page 741.

Central to the Federal Securities Act definition of the term 'underwriter' is what is meant by the word 'distribution'. The United States S.E.C. expounded on the concept of 'distribution' in *In the Matter of Ira Haupt and Company*:[35]

> Section 2(11) defines an "underwriter" as any person who ... sells for an issuer in connection with, the distribution of any security ... As used in this paragraph the term "issuer" shall include ... any person ... controlling ... the issuer ...

The purpose of the last sentence of this definition is to require registration in connection with secondary distributions through underwriters by

[34] 279 F. 2d 485, 489-490 (1960); Cert. denied 364 U.S. 819 (1960). Italics ours.
[35] 23 S.E.C. 589, 596-598 (1946). Italics ours.

controlling stockholders. This purpose clearly appears in the House Report on the Bill which states that it was intended:

> to bring within the provisions of the bill redistribution whether of outstanding issues or issues sold subsequently to the enactment of the bill. All of the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may want to dispose of their holdings and to make offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such redistribution reaches significant proportions, the distributor would be in a position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act.
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> "Distribution" is not defined in the Act. It has been held, however, to comprise *"the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public."* In this case, the stipulated facts show that Schulte, owning in excess of 50,000 shares, had formulated a plan to sell his stock over the exchange in 200 share blocks "at 59 and every quarter up" and that the trust, holding 165,000 shares, specifically authorized the sale over the exchange of 73,000 shares "at $80 per share or better." A total of 93,000 shares was in fact sold by the respondent for the account of the Schulte interests pursuant to these authorizations. *We think these facts clearly fall within the above quoted definition and constitute "distribution".* We find *no validity* in the argument that *predetermination* of the *precise number of shares* which are to be publicly dispersed is an *essential element of distribution.* Nor do we think that a "distribution" loses its character as such merely because the extent of the offering may depend on certain conditions such as the market price. *Indeed, in the usual case of an offering at a price, there is never any certainty that all or any specified part of the issue will be sold.* And where part of an issue is outstanding, the extent of a new offering is almost always directly related to variations in the market price. *Such offering are not any less a "distribution" merely because their precise extent cannot be predetermined.*

In contrast, one taking securities for investment is not an underwriter. The meaning of the term 'investment' as used in this context could, by itself, be the subject matter of a lengthy dissertation. Suffice it to say, however, that the United States S.E.C. has developed the 'presumptive underwriter doctrine." Jennings and Marsh explained this doctrine:[36]

> In recent years, during periods of strong new issues market, there have been instances where a wealthy investor, or an institution purchased a large block of a registered offering, presumably for investment, and thereafter resold the securities to the public without the use of a statutory prospectus. To cope with this situation, the Commission and the Staff have developed the "presumptive underwriter doctrine". The doctrine as first formulated established an administrative rule-of-thumb that any person who purchased ten percent or more of the registered offering was presumed to be an underwriter within the meaning of Section 2(11) of the 1933 Act.

[36] JENNINGS & MARSH, SECURITIES REGULATION, CASES AND MATERIALS 272-273 (1977).

> The rule was first enunciated and applied in business combination transactions under Rule 145, ... The doctrine, though never officially adopted by formal action of the Commission, nevertheless is applied in practice by the Staff. A definition of the doctrine as consistent with Commission practice has been formulated in these terms:
>
> > A person may be deemed to be an underwriter, within the meaning of Section 2(11) of the Securities Act, if such person purchases or acquires a significant percentage of the securities offered pursuant to a registered distribution, except that such purchaser is not deemed to be an underwriter if he resells such securities in limited quantities.[37]
>
> The Staff applies the presumptive underwriter doctrine on individual cases so as to prevent unrestricted resales by purchasers of large blocks of registered offerings free of the disclosure requirements generally applicable to registered offerings. Under the doctrine, such purchases followed by a resale creates the presumption that the seller is a statutory underwriter unless the burden is rebutted through showing of a change of circumstance or other justifiable cause. The Commission's practice is gleaned from no-action letters responding to interpretative requests ...

What then is the meaning of the term 'underwriter' as used in Section 6(c) and Section 7(a)(4) of the Philippine Securities Act?

We submit that the common meaning of the word is the correct interpretation of the term 'underwriter'. It is an elementary principle of statutory construction that words in a law should be construed in their plain, common or ordinary meanings unless they are clearly used in a technical context.[38] Moreover, the fact that the drafters of the Philippine Securities Act did not copy the definition of the term 'underwriter' as contained in the Federal Securities Act of 1933 when they could have easily done so in 1936 is an indication that they rejected the expanded concept of term. If the Philippine legislature wanted to depart from the common meaning of the term and adopt the broader American definition, it would have stated so in express terms.

2. *Liability of Underwriters*

Whatever meaning of the term 'underwriter' is adopted, it is clear that unless an 'underwriter' falls under the definition of 'dealer' in Section 2(g) of the Philippine Securities Act it is not liable for misrepresentations and omissions of material facts in the registration statement under Section 30 of the Act. The Section 2(g) definition of a 'dealer' includes "... every person other than a salesman ... in the business of selling any securities issued by another person or purchasing or otherwise acquiring such securities

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[37] Citing Ahrenholz Van Valkenberg, *The Presumptive Underwriter Doctrine: Statutory Underwriter Status for Investors Purchasing a Specified Portion of a Registered Offering*, 1973 UTAH L. REV. 773, 775-776.

[38] Adams v. Lansdon, 110 P. 280 (1910); 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION §46.02 (4th ed. D. Sands, 1973); RUPERTO MARTIN, STATUTORY CONSTRUCTIONS 87-88 (1976); LUIS GONZAGA, STATUTES AND THEIR CONSTRUCTION 105 (1969); SAMSON ALCANTARA, STATUTES 29-30 (1972).

from another for the purpose of reselling them or of offering them for sale to the public . . ."

Like the Federal Securities Act of 1933 definition of a 'dealer',[39] this definition of a 'dealer' does depend on the person's general activities rather than on his conduct in the particular offering.[40] Thus, a 'dealer' does not include ". . . a person having *no place of business for the purpose,* who sells or offers to sell securities exclusively to brokers or dealers actually engaged in buying and selling securities as a business." This definition evidently excludes an underwriter who is not engaged, either full-time or part-time, in the business of being a dealer or having no place of business for the purpose.

3. *Person Liable*

Viewed from the perspective of the persons liable for misrepresentations and omissions of a material fact in the registration statement, Section 30 of the Philippine Securities Act is a greatly emasculated version of Section 11 of the Federal Securities Act of 1933.[41]

Under Section 11 of the 1933 Act, the following persons can be held liable for material misstatements or omissions in an effective registration statement and prospectus: 1) Those who sign the registration statement which, according to Section 6(a), must include the issuer, the principal executive officer of the issuer, the principal financial officer of the issuer, the comptroller or principal accounting officer of the issuer, and the majority of the members of the board of directors or persons performing similar functions (or, if there is no board of directors or persons performing similar functions, by the majority of the persons or board having the power of management of the issuer).[42] 2) Every person who was a director of the issuer at the time the registration statement became effective even if the director did not sign the registration statement. 3) Every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions or partner. 4) Every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him. 5) Every *underwriter* involved in the distribution. 6) Controlling persons under Section 15 of the 1933 Act. Section 15 provides that "(e)very person who, by or through stock owner-

[39] *Supra,* note 17.
[40] *Supra,* note 22 at 557.
[41] For the complete text of Section 11, see 15 U.S.C. §77k (1976).
[42] For the complete text of Section 6(a), see 15 U.S.C. §77f (1976).

ship, agency, or otherwise, or who pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[43]

The liability of the issuer is practically absolute. He has no defenses other than showing that the statements were actually true, that the misstatements or omissions were not material facts, that the plaintiff-purchaser knew of the false or misleading statements or omissions and invested in the securities anyway (*i.e.*, lack of reliance) and the suit is barred by the statute of limitations under Section 11 itself (one year after discovery of the false or misleading statement or omission and three years after the security is first bona-fide offered to the public).

On the other hand, Section 11 develops different standards of care or diligence for the other persons liable. They escape liability under Section 11 if they meet the standards of care applicable to them. As to statements made by experts, the experts (*e.g.*, accountants who prepare and certify the issuer's financial statements) must actually believe that the statements they made are true and that belief must be reasonable. They must have made a reasonable investigation into the facts supporting the statements in accordance with the standards of his profession in order for their belief to be reasonable.

As to non-experts (*e.g.*, an outside director) reviewing statements made by experts, they must only show that they did not believe the statements made by the expert were untrue and he had no reasonable ground to believe that they were untrue. They are entitled to rely to a greater extent on the statements made by experts. Therefore, they do not need to make any investigation in this case.

Non-experts, as to their statements made in the registration statement (*e.g.*, a lawyer-member of the issuer's board of directors who drafts the registration statement from facts he collected from other officers of the issuer corporation), must actually believe that the statements he made were true and that his belief must be reasonable in order to escape liability under Section 11. A reasonable investigation is necessary to prove that his belief was reasonable. And the test in Section 11 for the scope of the reasonable investigation is what a prudent man would do in the management of his own affairs. Non-experts reviewing statements in the registration statement made by other non-experts (*e.g.*, outside directors, underwriters, etc.) are subject to the same standard of diligence required of non-experts concern-

[43] 15 U.S.C. §77o (1976).

ing statements they made in the registration statement even though they were not involved in the actual drafting of the registration statement. The courts, however, take into consideration the defendant's responsibilities with respect to the issuer and the preparation of the registration statement, his position in the issuer corporation, his background, skills, training and access to the information and other similar factors in determining what the defendant should have done in making his "reasonable investigation."[44]

In bleak contrast, under Section 30 of the Philippine Securities Act, directors, officers, or agents of the issuer or dealer making the sale are liable for misrepresentations or omissions of a material fact in the registration statement only if they shall have *"personally participated or aided in any way in making such sale."* The controlling persons under Section 29 of the Philippine Securities Act can escape liability if they prove that they "... *acted in good faith and did not directly or indirectly induce* the act or acts constituting the violation or cause of action."

Thus, the directors, officers, agents and controlling persons described above are practically immunized from liability under Section 30 for material misrepresentations and omissions in the registration statement.

If Section 30 of the Philippine Securities Act intended to compensate investors and to provide full and fair disclosure of the character of securities being floated, the persons liable under Section 11 of the Federal Securities Act of 1933 should likewise be held liable therein under at least the same standards of diligence. The officers of the issuer, especially the principal executive, financial and accounting officers, should normally take part in the preparation of a registration statement. The accountant, engineer, geologist, appraiser, or similar expert whose profession gives authority to a statement made by him does and should personally prepare the parts of the registration statement certified by him. The underwriters, particularly the managing underwriter or one with privity of contract with the issuer, are in a position to insist on full and fair disclosure of the character of the securities to be sold.

And making directors liable on the same standards of diligence as in Section 11 of the 1933 Act will be a giant step towards the elimination of dummy directors from the Philippine corporate scene. For it was intended that, through the said Section 11, the minimum duty of investigation imposed upon all directors would "have a direct tendency to preclude persons from acting as nominal directors while shirking their duty to know and guide the affairs of the corporation" and result in directors "confining their efforts to a few boards where they will actually direct."[45]

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[44] For an illustration, see Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y., 1971) and Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y., 1968).

[45] S. Rep. No. 47, 73d Cong., 1st Sess. (1933) 5.

II. PRIVITY OF CONTRACT REQUIREMENT

Under Section 30 of the Philippine Securities Act, only the immediate purchaser is entitled to sue the seller.[46] This conclusion can be clearly inferred from the fact that Section 30 requires tender of the securities sold or of the contract made. Therefore, if the purchaser has already disposed of the security to a third person, he will be disqualified to bring an action to enforce the remedies under Section 30.[47] Neither can the third person sue the issuer, dealer, the directors, officers, or agents of the issuer or dealer, or the controlling persons for material misstatements or omissions in the registration statement because there is no contract of sale between them. Nor can he sue his vendor unless the latter adopted or used the filed registration statement as a means of persuading the third party vendee to enter into the contract of sale.

Another reason why privity of contract is required for the purchaser to be able to sue the seller is that Section 30 makes the sale a 'voidable' contract at the election of the purchaser. Under the Civil Code of the Philippines,[48] only one privy to a contract can sue for the annulment of such contract. Thus, the Civil Code provides:

> *Article 1398.* An obligation having been annulled, the *contracting parties* shall restore to each other the things which have been the subject matter of the contract, with their fruits, and the price with its interests, except in cases provided by law.
>
> In obligations to render service, the value thereof shall be the basis for damages.
>
> *Article 1402.* As long as one of the *contracting parties* does not restore what in virtue of the decree of annulment he is bound to return, the other cannot be compelled to comply with what is incumbent upon him.

This is indeed an unfortunate situation especially when viewed in the light of the fact that only issuers, dealers, their directors, officers or agents who have personally participated or aided in any way in making the sale can be held liable for material misstatements or omissions in the registration statement under Section 30 of the Philippine Securities Act.

Section 11 of the Federal Securities Act of 1933, the provision dealing with civil liabilities on account of false registration statements, requires no privity of contract. Any person acquiring a security may sue under the said section provided, of course, he is able to trace the securities he purchased back to the defective registration statement.[49]

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[46] See Sibal, *Defects and Loopholes in the Securities Act*, 5 LAWYERS J. 487, 628 (1937).

[47] 4 MARTIN, COMMENTARIES AND JURISPRUDENCE ON THE PHILIPPINE COMMERCIAL LAWS 1928 (1961).

[48] Article 18 of the Civil Code provides that "(i)n matters which are governed by the Code of Commerce and special laws, their deficiency shall be supplied by the provisions of this Code."

[49] See 3 LOSS, SECURITIES REGULATION 1731 (1961) at note 160 in which the author clarifies the meaning of this tracing requirement:

> Presumably, however, the open-market buyer must be able to trace his

Professor Loss remarked in his treatise that, "(i)t is in its assault on the citadel of privity that Section 11 marks its great departure from precedent" and that "... Section 11 increases the number of potential plaintiffs by considerably broadening the common-law exception to the extent that it permits the ultimate investor to sue both the issuer and the underwriter notwithstanding a chain of title from issuer to underwriter to dealer to investor, and gives the same right of action even to a buyer in the open market, all without the plaintiff's proving that the misrepresentation was addressed to or intended to influence him."[50] This was indeed a sharp departure from the common-law requirement of the remedies available to a defrauded purchaser that the plaintiff must show that there was privity of contract between himself and the defendant. This liability to persons beyond the contract had to be imposed by the U.S. Congress because the courts dared not to embark on such a radical departure from the traditional and well-settled common-law insistence on privity.

On the other hand, Section 12 of the 1933 Act, which deals with offers or sales in violation of Section 5 (*i.e.*, a sale of unregistered securities, failure to deliver the required prospectus, making an illegal offer in the pre-filing period, etc.) and untrue statements or omissions of a material fact in connection with an offer or sales of a security (whether or not the sale is exempted from registration), requires direct privity of contract between the plaintiff-purchaser and the defendant-seller. Professor Loss explains this requirement:[51]

> Subject to these exceptions involving controlling persons and agents, it seems quite clear that Section 12 contemplates only an action by a buyer against his immediate seller. That is to say, in the case of the typical "firm commitment underwriting," the ultimate investor can recover only from the dealer who sold to him. But the dealer can in turn recover against the underwriter, and the latter (with some caveat by reason of the "preliminary negotiations" clause of Section 2[3]) against the issuer; and each defendant can bring in his predecessor in the chain of distribution as a third-party defendant under the Federal Rules of Civil Procedure.... Moreover, in the case of "best-efforts" distributions, in which the distributors act as the issuer's agents, and title passes from the issuer directly to the ultimate investor, we have already seen that the investor can hold the issuer liable under 12(1).

Section 12(2) of the 1933 Act is a generic section providing for liability in cases of offers or sales of securities by means of a prospectus or oral communication, which includes an untrue statement of a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.[52] Hence, the imposition of

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particular securities to the registration statement when it covered additional securities of an outstanding class. And, when a registration statement relates to only one class of securities, holders of another class of the same issuer still cannot sue under Section 11. x x x x

[50] *Supra*, note 49. Footnotes omitted.

[51] *Supra*, note 49 at 1719-1720. Footnotes omitted.

[52] For the complex text of Section 12, see 15 U.S.C. §771 (1976).

the privity of contract requirement under the said Section 12 may have been justified under these circumstances. For the seller in Section 12(2) may have misrepresented or omitted a material fact only to the immediate purchaser.

However, Section 30 of the Philippine Securities Act covers only "... false or misleading statements with respect to any material fact contained in any application, report, or document *filed* pursuant with this Act or any rule or regulation thereunder...." And, as we had explained earlier, under Section 7 of the Philippine Securities Act, only the issuer or the dealer interested in the sale of the securities can file a sworn registration statement with the Philippine S.E.C. It is obvious that, by filing such registration statement with an administrative agency and publishing the fact of such filing under Section 7, the issuer or dealer represents to the public that the contents of such registration statement provide full and fair disclosure of the character of the securities to be offered for sale to the public and that, nothing in such registration statement is false or misleading with respect to any material fact. Therefore, if the issuer or dealer misrepresents or omits a material fact to the public, any person acquiring the security covered by the registration statement must be able to sue him, as in Section 11 of the 1933 Act.

However, the requisites of rescission under Section 12 of the 1933 Act are imposed upon the plaintiffs in Section 30 of the Philippine Securities Act. The same criticism by Professor Shulman can be levelled against Section 30:[53]

> But rescission can be invoked only against the buyer's immediate seller. It is available only to the person who buys from the misrepresentor. The investor who buys a security in the market, either directly on the strength of representations in a prospectus or circular or at a price in which such representations were obviously factors, cannot invoke this remedy against either his seller or the issuers of the prospectus or circular. And in the sale of securities, unlike the sale of goods, this limitation excludes a large number of buyers. The corollary requirement that rescission effect a restora-

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[53] Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 231-233 (1933). Footnotes omitted.

The term 'voidable' under Section 30 is more appropriate than the term 'rescissible'. Under the Civil Code of the Philippines, both voidable and rescissible contracts are valid until annulled or rescinded. However, a rescissible contract is rescinded due to an extrinsic defect consisting of an economic damage or injury to third persons (such as creditors) and to one of the contracting parties. See Articles 1380-1389 of the Civil Code for provisions governing rescissible contracts.

The defect of a voidable contract is more or less intrinsic, as in the case of consent of one of the parties being considered as defective either because it is vitiated by mistake, violence, intimidation, undue influence or fraud or because of want of capacity even though no damage has been inflicted on the contracting parties. See Articles 1390-1402, for provisions governing voidable contracts. See also, 4 PARAS, CIVIL CODE OF THE PHILIPPINES ANNOTATED 516 (1976); 4 TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES 535 (1973). However, in both rescissible and voidable contracts, the remedy is normally the restoration to the *status quo ante*. Hence, an early authority on the Philippine Securities Act described the remedy in Section 30 as "rescission of sale". See FRANCISCO, THE SECURITIES ACT 258 (1951).

> tion of the status quo provides additional pitfalls: that the plaintiff did not or cannot return or tender to the seller the subject-matter of the sale, that he did not act promptly and is guilty of laches, that he did something which may be taken as a ratification of the sale and as inconsistent with a desire to rescind. And, again, because of differences already mentioned, these limitations are much more exclusive in the case of securities than in the case of commodities. But even after the buyer has negotiated the slippery rungs of this ladder, he is yet unable to reach the seller unless the ladder is placed on the foundation that the seller misrepresented a material fact upon the truth of which the buyer relied. What is fact as distinguished from opinion, what is material as distinguished from the trivial, what is reliance as distinguished from indifference, are questions which are raised also in connection with other remedies and will be discussed below. The answers lie largely in individual choice or judgment. The foundation may thus be difficult or easy to find. In the case of securities it has not been more easy than difficult.

He adds:[54]

> But underlying the above discussion, as a foundation without which no part of the superstructure can be raised, is the legal issue of the *reach of the defendants duty*. Both in negligence and in deceit, the issue as to whether or not the defendant owed any duty to the particular plaintiff with respect to the representations is primary. And just as in the cases of warranty or rescission, that issue has insulated a large class of persons involved on the seller's side in the sale of securities against misrepresentation suits by a large class of investors. *Lack of privity, here as in warranty or rescission, is the verbal insulating matter.* The deceit action is maintainable, we are told, only by one to whom, or to influence whom, the representation is made. A purchaser of securities on the exchange, who had not read the prospectus, may not sue in deceit for a false statement therein because it was not the inducing factor in this purchase, even though it was a factor in the market valuation at which he bought. He may not maintain the action even if he had read and was influenced by the prospectus, because, it is said, the prospectus is addressed ony to the initial buyers of the security and not to remote buyers in whose purchases the prospectus issuer has no interest. The ambit of duty could, of course, be extended, particularly in the negligence action where foreseeability of harm is a traditional measure....

Indeed, if the registration statement filed by the issuer or dealer is addressed not only to the initial buyer of the security but also to the buying public in order to provide such buying public a full and fair disclosure of the character of the securities to be sold, then any person acquiring such security should be able to sue the issuer or dealer for material misrepresentations or omissions in the registration statement. It should also be emphasized that the Philippine Securities Act covers not only the initial distribution of but also the trading in securities.[55] The removal of the privity of contract requirement under Section 30 insofar as the liability for misrepresentations or omissions of material facts in the registration statement is concerned will be a great step towards the realization of the goal of the Philippine Securities

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[54] *Supra,* note 52 at 238-239. Italics ours. Footnote omitted.
[55] *Supra,* note 46 at 488.

Act: to provide full and fair disclosure to the public of the character of the securities to be sold.

III. PROOF OF RELIANCE

Section 30 of the Philippine Securities Act requires that the plaintiff-purchaser must have relied upon the false or misleading registration statement. Proof of reliance by the purchaser is a condition precedent to recovery of the full amount paid by him for the securities. But how can the plaintiff prove reliance?

Section 7(a)(8) provides for the filing of "a copy of any circular, prospectus, advertisement, letter or communication to be used for the public offering of the security" and Section 11 of the Philippine Securities Act provides for the filing ". . . with the Commission, before or at the time of their issuance for publication, copies of all circulars, prospectus and other advertising matter to be issued from time to time by or on behalf" of ". . . any person, whose securities have been sold pursuant to registration and/or permit issued hereunder. . . ." But these provisions are clearly directory and do not really require the filing of a prospectus with the Philippine S.E.C. when the issuer or dealer has not used one in the first place.

And, under Section 7(c) of the Act, only the fact that a registration statement for the sale of such security has been filed with the Philippine S.E.C. and that the said registration statement, together with all the papers attached with it, are open to public inspection during business hours by interested parties, under such regulations as the Commission may prescribe, and that copies thereof may be furnished to every applicant at such reasonable charge as the Commission may prescribe, is published in the newspapers.

Thus, under the present state of the Philippine law, it is almost impossible for the purchaser to prove reliance on the registration statement under Section 30:[56] But why is proof of reliance required at all? The short of the matter is that proof of reliance is nothing more than a showing by the plaintiff that the misrepresentation or omission was the cause of the purchaser's buying the securities. The problem then lies in the determination of the transaction causation. Jennings and Marsh explain the connection between the concepts of 'reliance' and 'causation' in cases involving affirmative misrepresentation:[57]

> In a simple case involving an affirmative misrepresentation by a defendant to a plaintiff in connection with this sale of securities to the plaintiff, or purchase of securities from the plaintiff, the concept of 'reliance' by the plaintiff would seem to embody two separate questions both of which are designed to determine whether the utterance by the

[56] *Supra*, note 46 at 629-630.
[57] *Supra*, note 36 at 1063-1064:

> defendant caused the plaintiff to enter into the transaction and therefore his losses which allegedly flowed from the transaction. These two questions are: Did the plaintiff believe what the defendant said?; and, was this belief the cause (or a cause) of the plaintiff's action in entering into the transaction? (one can of course argue about the meaning of the word "cause", as lawyers are so fond of doing. For example, does it mean that "but for" this belief he would not have entered into the transaction, or only that it was a "substantial factor" or an "important factor" in his doing so?)
>
> Obviously, if the plaintiff knew from other sources the truth about the matter allegedly misrepresented, he cannot have believed the defendant and acted upon that belief. By the same token, if the plaintiff regarded the defendant as an inveterate liar, whom he wouldn't believe on a stack of Bibles, and so admitted on the witness stand, it would be impossible to conclude that the plaintiff "relied" on the defendant's misrepresentation. It may also be true that the plaintiff was entering into the transaction for reasons having nothing to do with the matter allegedly misrepresented, admits that if he had been told the truth rather than a falsehood about that matter, it would not have influenced his decision at all. It is of course naive to expect such admissions to be forthcoming very often in a litigated case, but the truth of the plaintiff's assertion to the contrary can be tested by cross-examination and the surrounding circumstances may be such as to permit the trier of fact to arrive at these conclusions despite any present contention to the contrary by the plaintiff.
>
> Any statement in this situation that "reliance" is not required, but only proof of "causation in fact" is nonsensical and self-contradictory. Utterances cannot cause anything, except a small disturbance of the air, unless they are traced through the mind of the person to whom they are directed, however difficult that may be, and that of course is what the concept of reliance attempts to do.

Thus, although when a fact is material, there is a strong likelihood that the purchaser would rely on it and would be a substantial factor in causing the plaintiff to purchase the securities, reliance does not necessarily follow materiality and vice-versa. A material fact may be misrepresented and the purchaser know about it and yet buy the securities anyway. Or the purchaser may not know about a material fact and yet it may be shown that even if he knew the plaintiff would still have bought the securities anyway. In either case, no reliance is shown.

The same authors continue their discussion:[58]

> In the case of *non-disclosure*, the process becomes not only subjective but hypothetical. If the concept of reliance has any meaning in that context, it must be put in the form of a hypothetical question: Would the plaintiff have acted differently if he had known the undisclosed fact? This is a question which can be asked of anyone who did or didn't do something during the time that the information remained undisclosed, and *seems to differ little from the question of materiality*, i.e., would (might?) a "reasonable person" or the "average investor" have considered the information important?
>
> However, on closer analysis this difference tends to disappear. For example, if the plaintiff knew from other sources what the defendant did

[58] *Supra*, note 36 at 1064. Footnote omitted.

> not disclose to him, then his conduct could not have been caused in any sense by the defendant's non-disclosure (although this may have been unknown to the defendant, and therefore his conduct may have been "equally reprehensible" as in a case where the plaintiff was in ignorance). And it is just as possible that the particular matter undisclosed was of no consequence to the plaintiff as in a case where he was told a lie about it. *Probably the difference boils down to the fact that the statistical probability of proving non-reliance is much less in a non-disclosure case than in an affirmative misrepresentation case.*

In *Affiliated Ute Citizens of Utah v. United States,*[59] two employees and the employer-bank were sued by eighty five Indian sellers alleging a violation of Rule 10b-5,[60] the U.S. Supreme Court held:

> Under the circumstances of this case, involving primarily a failure to disclose, *positive proof of reliance is not a prerequisite to recovery.* All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision. See Mills v. Electric Autolite Co., 396 U.S. 375, 384 (1970); Securities and Exchange Commission v. Texas Gulf Sulfur Co., 401 F. 2d 833, 849 (CA2 1968), cert. denied, sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969); L. Loss, Securities Regulation, 3876-3880 (Supp. 1969); A. Bromberg, Securities Law, Fraud—SEC Rule 10b-5, pts. 2.6 and 8.6 (1967). This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. Chasins v. Smith, Barney and Co., 438 F. 2d, at 1172.

In a class action brought on behalf of numerous purchasers who bought in an organized market transaction, positive proof of reliance is next to impossible.

In Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,[61] the U.S. Court of Appeals, Second Circuit, simply dispensed with the element of reliance even in a face-to-face transaction:

> * * * While the concepts of reliance and causation have been used interchangeably in the context of a Rule 10b-5 claim, the proper test to determine whether causation in fact has been established in a non-disclosure case is *"whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."* List v. Fashion Park, Inc., supra, 340 F. 2d at 463. See Chasins v. Smith, Barney & Company, supra, 438 F. 2d at 1172. *Cf.* Chris-Craft Industries,

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[59] 406 U.S. 128, 152-154 (1972); rehearing denied. 407 U.S. 916. Italics ours.

[60] Rule 10b-5, 17 C.F.R. §240.10b-5 (1978), provides:

Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a *material fact* or to omit 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

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. (Italics ours)

[61] 495 F. 2d 228, 239-240 (1974). Italics ours.

> Inc. v. Piper Aircraft Corp., 480 F. 2d 341, 373-375 (2 cir.), cert. denied 414 U.S. 319 (1973).
>
> Even on the basis of the pre-*Affiliated Ute* decisions discussed above, therefore, we would reject defendants' essential causation argument, namely that, absent an allegation that plaintiffs' purchase of Douglas stock was induced by defendants' non-disclosure of material inside information, the requisite element of causation is lacking. On the contrary, the Rule 10b-5 causation in fact requirement is satisfied by the plaintiffs' allegation that they would not have purchased Douglas stock if they had known of the information withheld by defendants.
>
> Defendants argue that the *Affiliated Ute* rule of causation in fact should be confined to the facts of that case which involved face-to-face transactions. We disagree. *The rule is dependent not upon the character of the transaction — face-to-face versus national securities exchange — but rather upon whether the defendant is obligated to disclose the inside information.* Here, as we have held above, defendants were under a duty to the investing public, including plaintiffs, not to trade in or to recommend the trading in Douglas stock without publicly disclosing the revised earnings information which was in their possession. They had breached that duty. Causation in fact therefore has been established.

However, in *Titan Group, Inc. v. Faggen,*[62] the same second circuit again adopted the objective test laid down in *Mills v. Electric Auto-Lite Co.*:[63]

> On this appeal, Titan argues that reliance is no longer a requisite element in Rule 10b-5 actions involving omissions alleged to be material when it is shown that facts alleged to be material were not disclosed. This result derives, it is contended, from the Supreme Court's decision in *Affiliated Ute Citizens v. United States,* . . .
>
> By this language, the Court, rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in proving, as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury. The parallel elements of materiality and reliance both serve to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists a causation in fact between the act and injury. . . . *Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements, in instances of total non-disclosure, . . . it is of course impossible to demonstrate reliance, and resort must perforce be had to materiality, i.e., whether a reasonable man would attach importance to the alleged omissions in determining his course of action.*

This objective test may well be adopted in cases of material omissions in the registration statement under Section 30 of the Philippine Securities Act.

In cases involving affirmative misrepresentations in the registration statement, the purchaser under the said Section 30 can prove that (a) he actually read and relied upon the filed registration statement or (b) the seller's statements have affected the market price at which purchaser bought

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[62] 513 F. 2d 234, 238-239 (1975).

[63] 396 U.S. 375 90 S. Ct. 347, 24 L. Ed. 2d 371 (1969). We shall discuss this objective test at length in Part IV of this paper.

his securities. In the latter case, the purchaser need not prove that he actually read and filed registration statement. In other words, actual and personal reliance need not be proved.[64] This is especially so if the misrepresentation was a substantial factor in determining the purchaser's course of conduct.[65]

It should be noted that the proposed Federal Securities Code provides in Section 1703 (d)[66] regarding sales and purchases by fraud or misrepresentation that ". . . (r)eliance on an omission is proved by proof of reliance on the particular filing or document and ignorance of the omission; but reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff read a particular filing or document."

To require proof of actual reading of the filed registration statement as the only means of proving the element of reliance may, especially in the absence of a prospectus requirement, well render Section 30 of the Philippine Securities Act a useless remedy. Moreover, we should examine whether the element of reliance should be required at all under Section 30.

In general, the plaintiff need not prove that he purchased in reliance on the misrepresentation or omission in order to recover under Section 11 of the Federal Securities Act of 1933. The only exception to the above rule is if the issuer sends out an earnings statement covering the period of one year after the effective date of the registration statement, then the purchaser must prove reliance on the misrepresentations or omissions in the registration statement in order to recover. However, reliance may be established without proof of the reading of the registration statement by such person.[67]

One writer praised the abolition of the element of reliance as a requirement to recovery under the said Section 11:[68]

> The most striking innovation is, of course, that dispensing with any requirement of privity and permitting "any person acquiring" the security to sue the persons enumerated. To this provision are incident the second and third features mentioned which dispense with the requirement of proof of reliance or causation. For these incidents, there is ample justification if the desirability of the principal object be assumed. *Administratively, reliance and causation are very troublesome subjects of inquiry. Whether the plaintiff read or knew of the statement and whether he relied upon it in making his purchase, are questions rarely, if ever, subject to exact answer. The plaintiff himself can rarely identify the individual factors which influenced his judgment.* If proof of reliance is required, he can be trusted in any case, with or without counsel, to allege and testify that he did rely. The question of reliance tends to merge with that of materiality and the answer to the latter is generally also the answer to the former. The plaintiff's assertion that he relied upon the statement, unless taken on faith, will be

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[64] See Green v. Wolf Corporation, 406 F. 2d 291 (2nd Cir., 1968). This involved a class action suit.

[65] See Mitchell v. Texas Gulf Sulfur Co., 446 F. 2d 90 (10th Cir., 1971).

[66] The American Law Institute Proposed Federal Securities Code (March 15, 1978).

[67] See Section 11(a) at *supra*, note 41. The paragraph providing for the exception was added by Public No. 291, 73d Cong.

[68] *Supra*, note 53 at 249-250. Italics ours. Footnote omitted.

> believed if it appears reasonable that such reliance was had. If the statement relates to something trifling or inconsequential, an inference that reliance was placed upon it seems unreasonable. If it relates to something material or important, the inference seems reasonable and supports the plaintiff's assertion. The inquiries are merged, then, in the question, Was the statement material?
>
> Section 11 puts the plaintiff under the burden of establishing materiality. If it is desirable to extend the liability beyond the parties in privity of contract or sale, there seems to be little point in requiring proof of reliance in addition to that of materiality. *Granted that in some cases materiality and reliance can be separated and that the plaintiff's claim might be defeated for lack of the latter, the gain in point of judicial administration is probably worth the loss in prejudice to some defendants.* Moreover, requirement of proof of reliance would not mitigate the liability in any determinate amount. It would simply provide a talking point in litigation, with the outcome entirely conjectural. The risks of liability would substantially be the same. The absence of requirement, whatever bearing it may have on the issue of fairness in particular litigations, can hardly be advanced as ground for the claim that the Act makes the floatation of securities unduly burdensome.

However, commentators have observed that there is less justification for so weighing the scales in the investor's favor when the information in the registration statement becomes outmoded and discounted by a host of other factors.[69] Douglas and Bates wrote before Section 11 was amended in 1934 by Public Law No. 291:[70]

> As stated above the protection given to investors by Section 11 fills a long felt need in so far as it shifts the burden of proof. This is particularly desirable during the early life of the security. At that time the registration statement will be an important conditioner of the market. Plaintiff may be wholly ignorant of anything in the statement. But if he buys in the open market at the time he may be as much affected by the concealed untruths or the omissions as if he had read and understood the registration statement. So it seems wholly desirable to create a presumption in favor of the investor in this regard. If carried out logically, however, some time limitation might be placed upon this presumption, for in most cases after a year or so the statements made in the registration would have become outmoded and wholly discounted by a host of other factors. *In other words, the present provision for reliance provides an excellent rule of thumb during the early life of the security. It has less justification the longer the security is outstanding.*

But even the amendment does not escape criticism from Jennings and Marsh:[71]

> * * * However, by a curious provision at the end of subsection (a), if the corporation sends out to its shareholders an earnings statement covering a period of twelve months after the effective date of the registration statement, a person thereafter acquiring the security must prove reliance in order to recover under Section 11. This may be established "without proof of

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[69] *Supra,* note 49 at 1725. Footnotes omitted.

[70] Douglas and Bates, *The Federal Securities Act of 1933,* 43 YALE L.J., 171, 176 (1933). Italics ours. See also, H.R. Rep. No. 1838, 73d Cong., 2d Sess. (1934) 41.

[71] *Supra,* note 36 at 833.

> the reading of the registration statement"; but since at that point the prospectus need no longer be delivered to anyone (unless there is an unsold allotment), proof of such reliance would appear to be very difficult.

The removal of the proof of reliance as a requisite for holding the issuer or dealer liable for material misrepresentations and omissions in the registration statement will more effectively promote the objective of full and complete disclosure of the character of the securities being sold to the public. After all, when the issuer or dealer files a registration statement with the Philippine S.E.C. and publishes the fact of such filing in two newspapers of general circulation, he impliedly issues the contents of such registration statement for the public's reliance.

In the course of drafting Sections 11 and 12 of the Federal Securities Act of 1933, the U.S. Congress recognized this position. Thus, a passage from the House Report states:[72]

> * * * Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance. The responsibility imposed is no more less than that of a trust. It is a responsibility that no honest banker and no honest businessman should seek to avoid or fear. To impose a lesser responsibility would nullify the purposes of this legislation. To impose a greater responsibility, apart from constitutional doubts, would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public.

The above passage appears to have equal applicability in the context of Section 30 of the Philippine Securities Act.

IV. MATERIAL FACT

Section 30 of the Philippine Securities Act requires that the misrepresentations or omissions in the registration statement be that of a material fact. In order to determine what is a 'material fact', we must first seek out the meaning of the term 'fact'.

1. *Fact*

We shall examine here whether opinions and forecasts or statements as to future conduct are 'facts' under Section 30 of the Philippine Securities Act. Pre-1933 cases in the United States generally held that these were not 'facts'. Professor Shulman summarized the decisions:[73]

> * * * Likewise with respect to the issue of fact or opinion. Sellers are expected to be enthusiastic about their wares and to have exaggerated opinions about them, particularly in the course of a sale. Buyers, that is, reasonable buyers, know this and put no stock in sellers' talk and sellers' opinions. If a buyer relies on an opinion expressed by a seller, he is a fool and has his own folly, not the seller's deceitfulness, to blame for his

[72] H.R. Rep. No. 85, 73d Cong., 1st Sess. at 9-10.
[73] *Supra*, note 71 at 236-238. Footnotes omitted. Italics ours.

> loss. Reasonable men may differ as to what is a statement of fact and what of opinion. But the law is clear.
>
> The law is clear, but it is not always fact. Statements as to legal matters, it has been held, are statements of opinion, since no one knows with certainty what decision will be made by a court before the court makes it. If this is too realistic and it is insisted that law must be fact because everyone is presumed to know the law, then the buyer knows it as well as the seller and therefore knows when the seller is misrepresenting it and when the representation should not be believed. At any rate statements to the effect that certain stock is non-assessable, or that, under its charter and applicable law, the corporation is empowered to do certain things, have been held by some courts to be not actionable because they were opinions on legal problems. In other cases, however, false statements on legal matters were held actionable if the other elements of a cause of action were made out. Statements as to value are the preeminent illustrations of non-actionable representations of opinion, although here, too, it has been held that, under some circumstances, the statements were more of fact and less of opinion and consequently actionable. *Non-actionable also are forecasts or statements as to future conduct. Since they look into the future they are not representations of fact.* Non-actionable, therefore, were held statements to the effect that certain dividends would be earned or paid; that the stock would be worth a stated amount in a given time; that the proceeds of the issue would be applied to particular objects; that a stated amount of assets would be maintained for the benefits of the preferred stockholders; and similar statements as to future events. In other cases the courts were apparently able to delve into the defendant's state of mind at the time he made the representation and found that it did not include an intention to live up to the representations at the appointed time, or that it did not entertain an opinion of the kind expressed. They regarded the statements, then, not as forecasts, promises or opinions, but as misrepresentations of the defendant's present intention, of his present state of mind — a fact. Or they found the prediction so related to existing or past facts that it was to be interpreted as a representation of fact.

Rule 14a-9, note (a) of the General Rules and Regulations under the Federal Securities Exchange Act of 1934 gave as one of the example of what may have been misleading within the meaning of the section "(p)redictions as to specific future market values of dividends."[74]

Section 7 of the Philippine Securities Act and the rules promulgated by the Philippine S.E.C. pursuant to the Securities Act sparingly include forecasts or forward-looking information. For example, section 7(9) includes, as among the items to be included in the sworn registration statement "(t)he specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determinable, for which the security to be offered is to supply funds. . . ." Section 7(14) requires the inclusion of "(t)he estimated net proceeds to be derived from the security to be offered." Section 3A-10 of the "Rules and Regulations on Registration and Sale of Contracts, Plans, or Schemes of Similar Nature By Persons, Corporations and Partnerships" requires that information on "(t)he esti-

[74] 17 C.F.R. §240.14a-9 (1978).

mated net proceeds to be derived from the plans or contracts to be offered,..." be included in the sworn registration statement to be filed with the Philippine S.E.C.[75]

As to opinions, aside from the usual accountant's certifications, Section 7(19) provides that "...(i)n connection with speculative securities issued by a person engaged in the business of developing, exploiting or operating mineral claims, a sworn statement of a mining engineer stating the ore possibilities of the mine and such other information in connection therewith as the Commission may by regulation, require, which will show the quality of the ore in such claim, and the unit cost of extracting it." And the Memorandum of Agreement between the Bureau of Mines and the Securities and Exchange Commission requires mining companies to submit in support of their registration statement, *inter alia* a "...(g)eological report on the properties prepared by a Bureau of Mines geologist and/or a licensed geologist under contract by the corporation."[76]

Article 1341 of the Civil Code of the Philippines provides that "(a) mere expression of an opinion does not signify fraud, unless made by an expert and the other party has relied on the former's special knowledge." This seems to be in keeping with the modern legal trend to regard opinions as 'facts' provided they are made by experts.

An eminent authority expounded on the matter of expert opinions:[77]

> *Expert Opinions.* Another exception to the general rule of non-liability for misstatement of opinions has been resorted to even more frequently than the previous one. In fact, the exception nominally is well-settled, although the content may be different in some jurisdiction from that which prevails in others. *This is usually expressed in the rule that where the parties are not dealing upon equal terms but one of them has or is presumed to have special knowledge or experience regarding the subject-matter, then the misstatement of opinion or belief is actionable or is, at least, sufficient for rescission.* These cases seem to be capable of classification into two general kinds. *In the first class are those cases in which one of the parties can properly be called an expert:* as where a jeweler gives a false statement of his opinion concerning the value of a diamond ring, or where a stock-broker represents that certain bonds are first-class securities. Other examples of experts are doctors, lawyers, and engineers. In this connection, the distinction between an expert and a non-expert might be a very difficult one on occasion; for this reason, the distinction should be avoided if possible. In the second class the situation is not that of an expert, but one who merely has more information than the other, and this discrepancy is, therefore, regarded as putting the parties on an "unequal footing."

He questioned the distinction between statements of 'facts' and 'opinions':[78]

> * * * Why have the courts adopted one result with respect to statements of fact and the opposite result as to opinion statements, and whatever may

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[75] 12 SEC BULLETIN 28, 30 (1978).
[76] 10 SEC BULLETIN 54, 55 (1976).
[77] Keeton, *Fraud: Misrepresentation of Opinion*, 21 MINN. L. REV. 643, 467-648 (1937). Footnotes omitted. Italics ours.
[78] *Supra*, note 77at 650. Italics ours.

> the answer be to the query, is the distinction sound? *It is said that misstatements of opinion are not actionable because the person to whom the statement is directed has no right to rely thereon.* This is based on the argument that a person should rely upon his own judgment about matters over which there can be a difference of opinion. *It is often assumed, but fallaciously it would seem, that the reason for this is that the ordinary prudent person would rely upon his own judgment rather than upon the judgment of someone else, and therefore, a person who relies on the opinion of another is negligent.* But it would seem that the attitude which the courts took toward opinion statements was probably the result of the individualistic attitude of the common law, resulting in the position that each person should be the best judge of his own interest, and therefore, ought to be required to judge for himself.

In Feit v. Leasco Data Processing Equipment Corporation,[79] the District Court considered the defendant's estimate of the target company's 'surplus surplus' (*i.e.*, the portion of the cash reserve of the insurance company that could be transferred to it) a material fact.

Professor Loss notes that the Commission "... regards valuation, geological reports and the like, although they may be expressions of opinion, as based on implied representations that appropriate standards have been followed; hence a failure to observe those standards by one who is held out as an expert involves a misrepresentation of fact."[80] And, of course, an accountant's certification is regarded as a material fact which "signifies that the contents of the financial statements to which it is appended have been checked and verified within the limits stated in the certificate."[81]

The RESTATEMENT (SECOND) OF TORTS distinguishes between 'fact' and 'opinion':[82]

> Comment C. Fact, opinion and law distinguished. Strictly speaking, "fact" includes not only the existence of a tangible thing or the happening of a particular event or the relationship between particular persons or things but also the state of mind, such as the entertaining of an intention or holding of an opinion, of any person, whether the maker of a representation or a third person. Indeed, every assertion of the existence of a thing is a representation of the speaker's state of mind, namely, his belief in its existence. There is, however, a marked difference between what constitutes justifiable reliance upon statements of the maker's opinion and what constitutes justifiable reliance upon other representations. Therefore, it is convenient to distinguish between misrepresentations of opinion and misrepresentations of all other facts including intention.

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[79] 332 F. Supp. 544 (E.D.N.Y., 1971).

[80] *Supra,* note 49 at 1437 citing Hadden Distillers Corp., 1 SEC 37, 42 (1934); Big Wedge Gold Mining Co., 1 SEC 98, 107 (1935); Oklahoma-Texas Trust, 2 SEC 764, 782 (1937), aff'd sub nom., Oklahoma-Texas Trust v. SEC, 100 F. 2d 888, 894 (10th Cir., 1939); Breeze Corporations, Inc., 3 SEC 709, 717 (1938); Fall River Power Co., Sec. Inc., SEC Ex. Act Rel. 57531 (1958) 9.

[81] *Supra,* note 49 citing Interstate Hosiery Mills, Inc., 4 SEC 706 (1939); Cornucopia Gold Mines, 1 SEC 364, 367 (1936); American Terminals and Transit Co., 1 SEC 701, 706 (1936).

[82] AMERICAN LAW INSTITUTE RESTATEMENT (SECOND) OF TORTS, Sec. 525, comment c (1977).

> A statement of law may have the effect of a statement of fact or a statement of opinion. It has the effect of a statement of fact if it asserts that a particular statute has been enacted or repealed or that a particular decision has been rendered upon particular facts. It has the effect of a statement of opinion if it expresses only the actor's judgment as to the legal consequence which would be attached to the particular state of facts if the question were litigated. It is therefore convenient to deal separately with misrepresentations of law.

In any event, the same RESTATEMENT states that "...(o)ne who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or refrain from action in reliance thereon in a business transaction is liable to the other for the harm caused to him by his justifiable reliance upon the misrepresentation."[83]

It is also interesting to note that Section 256 of the proposed Federal Securities Code provides that a 'fact' includes "(b) a statement of intention, motive, opinion, or law...."[84]

More controversial, though, is the issue of to what extent should forecasts or forward-looking, 'soft'[85] information be considered as within the scope of the disclosure system envisioned by the Federal Securities Act of 1933. Should disclosure of 'soft' information, particularly earnings projections, be made mandatory? Under what circumstances should the issuer be held liable if these projections turn out to be wrong?

In *Marx v. Computer Sciences Corporation,* the U.S. Circuit Court of Appeals, Ninth Circuit, found no difficulty in regarding an earnings forecast as a 'fact' and held:[86]

> That a forecast, essentially a prediction, may be regarded as a "fact" within the meaning of the Rule is settled by G & M, Inc. v. Newbern, 488 F. 2d 742 (9th Cir. 1973). In that case this court rejected the defendant's argument that his representations as to future earnings of a corporation were not actionable under Rule 10b-5 because they were mere opinions. We said:
>
> > Under the securities law a reasoned and justified statement of opinion, one with a sound factual or historical basis, is not actionable. Here, however, considering the gross disparity between prediction and fact, and also considering Newbern's other misrepresentations and failures to disclose, which were relevant to the accuracy of his prediction, we have no difficulty in finding this 'prediction' to be actionable....

Similarly, in *Beecher v .Able,*[87] the court treated an earnings forecast as a 'fact' which could be materially misleading.

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[83] *Supra,* note 82 at Sec. 525.
[84] *Supra,* note 66.
[85] The term has been used by Carl Schneider in Nits, Grits, and Soft Information SEC Filing, 121 U. PA. L. REV. 254 (1972).
[86] 507 F. 2d 485, 489 (1974).
[87] 374 F. Supp. 341 (S.D.N.Y. 1974).

Even the U.S. S.E.C., whose initial hostility to the inclusion of management's projection of future earnings is exemplified in the above-mentioned note (a) to Rule 14a-9, began to change its attitude towards 'soft' information. Jennings and Marsh summarized this development:[88]

> * * * Despite the general hostility of the SEC to projections of earnings in Commission-filed documents, there has always been an implied exception in the case of a selling document if the projection is negative or pessimistic. Prospectuses have been sprinkled with "no assurances" that the company is likely to survive for more than a week or, if it does, ever to make a profit. When American securities experts were testifying in England before the Jenkins Committee (considering a revision of the English company law), they were questioned closely about the SEC prohibition of projections, since *management's projection of future earnings is routinely included in all English prospectuses and the committee members had difficulty in understanding the policy basis for their exclusion.* Finally, one of the committee members asked what would be the SEC's attitude if the management thought that the earnings were going to go down: and the reply was that, well, if they really thought earnings were going to go down, then they had better say that. The committee member replied: "It is rather a curious position. The trend (of earnings upward) might be continuing, in which case you would say nothing, or the directors might think it was going up in which case you would also say nothing. But if it is going down you cry stinking fish.[89]
>
> The Commission increasingly came to realize, not only the logical inconsistency of this approach, but also the fact that, whenever there is a pre-existing public trading market for the securities being sold, any disclosure document may be used as a basis for action by the sellers as well as buyers. Therefore, an unwarrantedly pessimistic disclosure can harm public investors as much as an overly optimistic one. And counsel for issuers increasingly came to realize that in attempting to protect their clients from liability to the purchasers of the particular issue under Section 11 of the 1933 Act, they might be exposing them to liability under Rule 10b-5 to sellers in the market. . . .

And on February 2, 1973, the U.S. SEC issued a Statement by the Commission on Disclosure of Projections of Future Economic Performance[90] in which it abandoned its previous objection to disclosure in filings of projections. Furthermore, in its statement of general views in Securities Act Release No. 5699,[91] the Commission indicated that it would not object to disclosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are presented in an appropriate format and accompanied by information adequate for investors to make their own judgments. Moreover, in Securities Act Release No. 5992 issued on November 7, 1978,[92] the Commission set Guides for

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[88] *Supra*, note 36 at 922-923. Italics ours.

[89] Citing the *Minutes of Evidence Taken Before the Company Law Committee* 1031 (14th Day, Dec. 16, 1960) (Her Majesty's Stationery Office 1961).

[90] Sec. Act Rel. No. 5362 (Feb. 2, 1973).

[91] 41 F.R. 19986.

[92] Sec. Act Rel. No. 5992 (Nov. 7, 1978), 16 SEC DOCKET 81, 85 (1978). Footnotes omitted. Italics ours.

Disclosure of Projections of Future Economic Performance and discussed the merits of voluntary and mandatory disclosure:

> In the proposed guides published in Release 33-5699, the Division of Corporation Finance set forth its view that management should have the option to present in Commission filings its good faith assessment of a company's future performance. The Advisory Committee and the commentators are in accord with the view that a *voluntary projection system is more appropriate than a mandatory system.* The Advisory Committee noted that a mandatory system would require the adoption of specific disclosure rules and regulations and felt that the Commission did not yet have an appropriate basis for formulating such requirements. In addition, the Committee did not believe that all companies should be required to sustain the expenses and burdens that might be associated with mandatory disclosure. Further, the Committee was of the view that many companies would find it difficult to prepare adequate projections due to lack of operating history, general economic factors, or industry conditions and should not be compelled to subject themselves to possible risks of liability for inaccurate projections.
>
> In view of the Advisory Committee's recommendation and the comments received, the proposed guides continue to reflect the position that disclosure of projections and other items of forward-looking information in Commission filings is *permitted but not required.*

The same release discussed the basis for management's assessment of a company's future economic performance, disclosure of assumptions, items to be projected third party review, revision and updating of projections and the time period for projections:[93]

> Although the 1975 proposals were ultimately withdrawn, the guides proposed in Release 5699 indicated the Division's view that a history of operations or experience in projecting may be among the factors providing a reasonable basis for management's assessment of a company's future economic performance. Nevertheless, it would not appear that such history and experience would be necessary in all instances to provide reasonably based projections. *Accordingly, the revised guides do not provide reporting, operating history, or other status criteria for those public companies desiring to make public projection disclosure.*
>
> *Disclosure of Assumptions*
>
> While the Division believes that disclosure of assumptions would help investors to comprehend projections and assist in establishing a reasonable basis for projections disclosed, there may be instances where reasonably based and adequately presented projections would significantly add to the mix of information available to investors in the absence of disclosure of underlying assumptions. However, the Division believes that under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. *For example, where projected results are based to a significant degree upon the introduction of a new product or service meeting certain anticipated levels of sales and contribution to earnings, disclosure of the projection without this information might be misleading.*

[93] *Supra,* note 92 at 85-87. Footnotes omitted. Italics ours.

Items to be Projected

Paragraph (b) of the proposed guides indicated that traditionally projections have been given for three items generally considered to be of primary interest to investors: *sales or revenues, net income, and earnings per share.* These items usually are presented together in order to avoid any misleading inferences that may arise when individual items reflect contradictory trends. Although these three items usually are the key elements in an appropriate presentation of a projection, the Division recognizes that there may be circumstances when company management should be given flexibility in determining other or additional financial items should also be presented.

Third Party Review

The proposed guides suggested that additional support for projections could be furnished through an outside review. If such a review were to be included, disclosure of the reviewer's qualifications, the relationship of the reviewer to the registrant, and the extent of the review would be required. A reviewer would be deemed an expert and an appropriate consent would be required to be filed with a registration statement under the Securities Act, if the reviewed projection and report were included therein.

...In this regard, a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection.

Revision and Updating of Projections

In Release 33-5699, the Commission reminded issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition, and that this responsibility may extend to situations where management knows its previously disclosed assessments no longer have a reasonable basis. In addition, the proposed Guides recommended that investors be informed of management's intentions with respect to furnishing updated projections. Although the Advisory Committee concluded that periodic updating of projection information should not be required, it recommended that this position again be noted.

Time Period for Projections; Discontinuance and Resumption

The proposed guides did not suggest a specific time period that may be appropriately covered by a projection. Due to factors that may vary among industries, companies disclosing projections should have the responsibility for selecting the most appropriate time period depending on all facts and circumstances. The Advisory Committee concurred in the approach taken by the proposed guides and the final guides reflect this position.

The Advisory Committee was also of the opinion that the use of projections would be encouraged if companies were permitted to discontinue making projections. Changed business conditions may make sound projections possible in one year and impracticable in another. Accordingly, the final guides incorporate the Advisory Committee's recommendation, but indicate that companies should not discontinue or resume making projections in Commission filings without a reasonable basis for such action. In the view of the Division, *if the registrant were to furnish projections only when they are favorable and not when they are unfavorable, this pattern of disclosure might be viewed as misleading.*

Finally, the Proposed Safe-Harbor Rule for Projections[94] provides that "... for purposes of the liability provisions of the federal securities laws a statement containing a projection of revenues, income (loss) and earnings (loss) per share, shall be deemed not to be an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act practice, course of business, or an artifice to defraud as those terms are used in the applicable statutory provisions or any rules thereunder if the statment: (1) was prepared with a reasonable basis; and (2) was disclosed in good faith." The proposed rule casts the burden of proof on the defendant to prove that the projection was prepared with a reasonable basis and was disclosed in good faith.[95] Otherwise, the burden imposed on the plaintiff, including the Commission, could be insurmountable. Besides the issuer would likely be in a better position to prove that the projection was prepared with a reasonable basis and disclosed in good faith by virtue of its access to all the facts and circumstances surrounding the disclosure of a particular projection.

The proposed Federal Securities Code follows more or less the same trend of legal thought when it provides that "fact" includes "(a) a promise, prediction, estimate, projection, or forecast..."[96] and that "... (a) statement of a fact within the meaning of section 256(a) is not a misrepresentation if it (1) is made in good faith, (2) has a reasonable basis when it is made, and (3) complies with any applicable rule so far as underlying assumptions or other conditions are concerned."[97]

The Philippine S.E.C. can very well consider the above guidance on 'soft' information when it promulgates rules on the matter in the future.

2. *Materiality*

The Philippine S.E.C., in its "Rules Requiring Disclosure of Material Facts by Corporations Whose Securities Are Listed in any Stock Exchange or Registered/Licensed under the Securities Act", has defined a 'material fact' as one which "... induces or *tends* to induce or otherwise *affect* the sale or purchase of its securities..."[98] According to the above rule, a material fact shall include the following:[99]

a. Acquisition of mining claims, patent or formula, real estates, or similar capital assets;
b. Discovery of mineral ores, oil, etc.;
c. Declaration of cash or stock dividends;

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[94] Sec. Act Rel. No. 5993 (Nov. 7, 1978), 16 SEC DOCKET 90, 91-92 (1978). Footnote omitted.
[95] *Supra*, note 94 at 92-93.
[96] *Supra*, note 66 at Section 256(a).
[97] *Supra*, note 66 at Section 297(b).
[98] SEC RULES AND REGULATIONS 86. Italics ours.
[99] *Supra*, note 98. Italics ours.

d. Result of operation;
e. Executing contract of merger, consolidation or joint venture; or contract of management, licensing, marketing, distributorship, technical assistance or similar agreement;
f. Financing through loans;
g. Offering of rights; or granting options to any individual or institution specifying the terms and conditions thereof;
h. Making new project or investment in another product line, business or corporation;
i. Transferring of assets, except in the normal course of business;
j. Stopping of operation; and
k. Any other important event or happening.

Under the above standard, the events listed in the Philippine S.E.C. "Rules Requiring Filing of Minutes Approving Certain Corporate Actions of Interest to the Public"[100] will be construed as material facts. The rule provides:

> 1. All corporations whose securities are listed in any stock exchange or with permits to sell shares to the public or with twenty (20) or more stockholders shall hereafter submit to this Commission within thirty (30) days after approval of the corporation action, certified true copies of the following documents evidencing the same, to wit:
>
> a. Minutes of meetings —
>
> 1) Calling for payment of unpaid subscriptions;
> 2) Increasing or decreasing the capital stock;
> 3) Changing the nomenclature of shares of stock or certificates of indebtedness;
> 4) Authorizing the borrowing of material sums of money; and
> 5) Authorizing material expansion program.
>
> b. Other documents, such as:
>
> 1) Certificates changing the composition of the board of directors and officers;
> 2) Certificates changing the ownership of the controlling interest in the corporation;
> 3) Management contracts duly approved by the stockholders.

The above Philippine S.E.C. rule defining a "material fact" seems to follow the 'might' or 'possibility' test. The use of the words "tends to induce or otherwise affect" leads us to this conclusion. As we shall point out below, the use of this lower standard of materiality exposes the defendant-seller to unwarranted liabilities. Moreover, the said rule leaves the issue of to whom or from whose point of view is a fact 'material' unanswered.

The 'might' rule was laid down in *Mills v. Electric-Auto-Lite Company*[101] wherein the U.S. Supreme Court casually referred to a material fact as being one "... of such character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to

[100] *Supra*, note 98 at 122.
[101] *Supra*, note 63 at 384.

vote." Although the issue of materiality was not before the court in that case, this rule has been followed by several lower courts.[102]

A different test is provided for in Regulation C, Rule 405 of the General Rules and Regulations under the Securities Act of 1933 which states that ". . . (t)he term "material", when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investors ought reasonably to be informed before purchasing the security registered."[103]

In one of the few Section 11 cases, *Escott v. Barchris Construction Corporation,*[104] the District Court of New York explained this SEC definition of materiality by emphasizing the need to know "facts which have an important bearing upon the nature or condition of the issuing corporation or its business." However this case cannot be regarded as an authority on the definition of 'materiality' because it never really involved a close question of materiality since the facts misrepresented or omitted in the prospectus were facts which indubitably gave clear danger signals of an imminent financial debacle of the business of the issuer and the real issue was whether the defendants established their 'due diligence' defenses in accordance with the applicable standards set forth in Section 11 of the Federal Securities Act of 1933.

Some lower courts have evolved a 'would' or 'objective' test of 'materiality'. This test is sometimes called 'probability' or 'realistic' or 'reasonable and objective' test of 'materiality'. Thus, in *Feit v. Leasco Data Processing Equipment Corporation,*[105] Judge Weinstein of the District Court of New York explained this test:

> Some probability that the investor's decision would be affected by disclosure is a prerequisite to a finding of materiality. The degree of probability that it would have such an impact has been differently stated by the courts. They have focused on the effect on the *reasonable purchaser,* variously asking whether he "might" or "would" or "might well have been" affected by the information; they have asked whether it is "reasonably certain" that the information would have had a "substantial effect" or whether it "might" have had a "significant propensity" to affect him.
>
> What is called for is "(s)ome sort of *reasonableman, objective test* of investment judgment, intrinsic value, or (in the case of a publicly traded security) significant market effect." 2 A. Bromberg, Securities Law: Fraud SEC Rule 10b-5 Sec. 8.3, p. 199 (1970).
>
> A fair summary of the rule stated in terms of *probability* is that a fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question. What is statistically

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[102] See Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa, 1970); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill., 1970); Gould v. American Hawaiian Steamship Company, 331 F. Supp. 981 (D. Del., 1971).

[103] 17 C.F.R. §230.405 (1978).

[104] 283 F. Supp. 643, 681 (S.D.N.Y., 1968).

[105] *Supra,* note 79 at 569-572. Italics ours.

> significant will vary with the legal situation. *Cf.* Rosado v. Wyman, 322 F. Supp. 1173, 1180-1181 (E.D.N.Y. 1970), aff'd 437 F. 2d 619 (2d Cir. 1970). Being a formal and legally required document, a prospectus must satisfy a high standard of disclosure — i.e., disclosure is required when only a relatively small percentage of traders would want to know before making a decision. Anything in the order of 10% of either the number of potential traders or those potentially making 10% of the volume of sales would seem to more than suffice.
>
> Since no data except the unpersuasive suppositions of opposing experts were produced at the trial to show how potential traders would have viewed the information at issue, we are forced to analyze the facts in terms of alternative courses of conduct available to a hypothetical *reasonably prudent shareholder* constructed by the Court. In non-quantitative terms a fact is "material" in a registration statement whenever a *rational connection exists between its disclosure and a viable alternative course of action by any appreciable number of investors.* Materiality is then a question of fact to be determined in the context of a particular case....
>
> The information with respect to the availability of tens of millions of dollars of surplus is so significant that under any test proposed it is material. A substantial percentage of the reasonable persons holding shares of Reliance would want to know what Leasco's estimate and plans were respecting this asset before deciding to exchange on the terms offered. It would be unrealistic to expect an *average shareholder* of Reliance to know what the 'surplus surplus' position of the company was; no proof was submitted suggesting that he would know this. Leasco did have this information as the result of its own detailed studies which had required a substantial outlay of money and executive time.

Another District Court of New York seemed to have followed this 'would' test in *Beecher v. Able*:[106]

> Consequently, this court holds that an earnings forecast must be based on facts from which a *reasonably prudent investor would* conclude that it was *highly probable* that the forecast would be realized Moreover, any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a *reasonably prudent investor,* if he knew of the disclosure of such underlying assumptions is '... necessary to make... (the forecast) ... not misleading...'

And in *Gerstle v. Gamble-Skogmo, Inc.*[107] the U.S. Court of Appeals, Second Circuit, through Judge Friendly, held:

> We think that, in a context such as this, the "might have been" standard mentioned by Mr. Justice Harlan sets somewhat *too low a threshold;* the very fact that *negligence suffices to invoke liability argues for a realistic standard of materiality.* Justice Harlan's next sentence in *Mills,* that the defect must "have a *significant propensity to affect the voting process,*" 396 U.S. at 384..... comes closer to the right flavor. While the difference between "might" and "would" may seem gossamer, the *former* is too suggestive of *mere possibility, however unlikely. When account is taken of the heavy damages that may be imposed,* a standard tending toward *probability* rather than toward *mere possibility* is more appropriate.

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[106] *Supra,* note 87 at 348. Italics ours.
[107] 478 F. 2d 1281, 1302 (1973). Italics ours.

However, the U.S. Supreme Court, in *TSC Industries, Inc. v. Northway, Inc.*, adopted neither the 'would' nor the 'might' tests:[108]

> We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. x x x x Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to *bury the shareholder in an avalanche of trivial information* — a result that is hardly conducive to informed decision-making. Precisely these dangers are presented, we think, by the definition of a material fact adopted by the Court of Appeals in this case — a fact which a reasonable shareholder *might* consider important. We agree with Judge Friendly, speaking for the Court of Appeals in *Gerstle*, that the "might" formulation is "too suggestive of mere possibility, however unlikely." 478 F. 2d, at 1302.
>
> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a *substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.* This standard is fully consistent with the *Mills* general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process." It does *not require* proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to *change his vote.* What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have *assumed actual significance in the deliberations of the reasonable shareholder.* Put another way, there must be a *substantial likelihood* that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly altered the "total mix" of information made available.*

The above 'substantial likelihood' phrase has been inserted in Section 293(a) of the proposed Federal Securities Code which provides that "... (a) fact is "material" if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action."[109]

In view of the great potential liability under Section 30 of the Philippine Securities Act for material misrepresentations and omissions in the registration statement, the 'might' test adopted by the Philippine S.E.C., being too suggestive of a mere possibility rather than probability, is too low a threshold for the imposition of such liability on the issuer or dealer. It may, as the U.S. Supreme Court feared in the *TSC case*,[110] expose the issuer or the dealer to substantial liability for insignificant misstatement or omissions and may thus constrain them to bury the potential purchaser with a mass of trivia in the registration statement and its accompanying documents.

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[108] 426 U.S. 438, 448-449 (1976). Italics our.
[109] *Supra*, note 66.
[110] *Supra*, note 108.

As we had noted earlier, the Philippine S.E.C. rule defining a 'material fact'[111] supplies no answer to the question of to whom materiality is addressed.

Regulation C, Rule 405 of the U.S. Securities & Exchange Commission uses the 'average prudent investor' as the vantage point of materiality.[112] This is the same language used in the 1895 Lord Davey report which stated that the "... contract or fact is material which would influence the judgment of a prudent investor in determining whether he would subscribe for the shares or debentures offered by the prospectus."[113] In *Beecher vs. Able*,[114] materiality is also addressed to the "reasonably prudent investor".

Both the *Mills*[115] and the *TSC*[116] cases use the terms 'reasonable shareholder'. The proposed Federal Securities Code also uses the 'reasonable person' standard.[117]

The "average prudent investor' or 'reasonable person' standard seems to have been adopted also in the *Gerstle* case. Judge Friendly explained that "(w)hile "corporations are not required to address their stockholders as if they were children in kindergarten," Richland v. Grandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967), it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts."[118]

However, Professor Loss explains that "... (a)s bearing on the definition of materiality, the courts do not consider whether the scheme to defraud would have deceived a person of ordinary intelligence, since the securities laws were "enacted for the very purpose of protecting those who lack business acumen"[119] and that hence, "the monumental credulity of the victim is no shield for the accused."[120]

This 'average prudent investor' or 'reasonable shareholder' or 'reasonable person' standard may well be adopted as the standard of materiality under Section 30 of the Philippine Securities Act. After all, the filing of a registration statement under the Philippine Securities Act is also intended to provide full and fair disclosure of the character of the securities to be offered to the investing public.

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111 *Supra*, note 98.
112 *Supra*, note 103.
113 Cmd. 7779 (1895) Sec. 14(5).
114 *Supra*, note 106.
115 *Supra*, note 101.
116 *Supra*, note 108.
117 *Supra*, note 109.
118 *Supra*, note 107 at 1297.
119 *Supra*, note 49 at 1438 citing United States v. Monjan, 47 F. Supp. 421, 425 (D. Del., 1942); aff'd, 147 F. 2d 916 (3d Cir., 1944); cert. denied, 325 U.S. 859 65 S. Ct. 1191, 89 L. Ed. 1979 (1944) SEC v. Time Trust, Inc., 28 F. Supp. 34, 42-43 (N.D. Cal., 1939).
120 *Supra*, note 49 citing Deaver v. United States, 155 F. 2d 740, 744-745 (D.C. Cir., 1946); cert. denied, 329 U.S. 766 67 S. Ct. 121, 91 Ld Ed. 659 (1946). This was, however, a mail fraud statute case.

However, one eminent commentator has criticized this approach:[121]

> In short, even a sophisticated person reading a lengthy prospectus and supplemental information on a given company will not have the answer to his basic question — whether the proposed security offered is a good buy. Every possible investment for the investor's dollar is in competition with the investment proposed by the prospectus, and no sensible answer can be made *unless the investor has significant knowledge of a substantial number of alternative choices. The only meaningful answer is comparison to other available investments.* No one can intelligently make an investment unless he has a sufficient knowledge of a reasonable range of other offerings in the trading market for companies in the same field and for other companies in different fields, and that information can only come from a *professional, not from a prospectus.*
>
> How does the investor invest? Leaving aside the naive investor or the speculator who is attracted by the name of a company or the romantic aura of an industry as described in current publicity, the person seeking to act intelligently invests by obtaining the advice of a professional. Only by *comparing* the information available on one company with the opportunities available for competing investments, by contact with someone who maintains a broad contact with these opportunities, can an informed choice be made.
>
> We are forced to the conclusion that the *basic purpose* of the Securities Act to furnish a prospectus to the individual investor on one security so that he may make an informed choice of its investment merits is based on a false assumption. A security has no investment merit except by comparison with numerous other available opportunities for investment. Any effort to rationalize the legislation must start from that reality. *The individual who makes his own choice without professional help is not the individual who does or could usefully read the prospectus.* The *first casualties* of this reasoning should be all of the efforts designed to *make the prospectus short and readable by a layman.* The goal is inconsistent with the reality of the complexity of modern securities and the fact that *the prospectus should not really be addressed to the layman.*

The above admonition on what a prospectus should contain and to whom it should be addressed may well be applied to a registration statement. Materiality from the point of view of a layman who seeks the aid of a professional may well be an alternative approach which the Philippine S.E.C. should consider before embarking on another definition of what may constitute a 'material fact'.

CONCLUSION

The plaintiff-purchaser is confronted with almost insurmountable obstacles under Section 30 of the Philippine Securities Act if he tries to sue a seller for misrepresentation or omission of a material fact in the registration statement. First of all, only issuers or the dealers who filed the

[121] Kripke, *The SEC, The Accountants, Some Myths and Some Realities,* 45 N.Y.U. L. REV. 1151, 1169-1170 (1970). Italics ours. Footnotes omitted.

registration statement under Section 7 and their directors, officers or agents if such directors, officers or agents have personally participated or aided in any way in making such sale and the controlling persons under Section 29 are liable to the purchaser for material misstatement or omissions in the registration statement. Not even the underwriter is liable, unless he falls under the definition of a 'dealer' in Section 2(g) of the Act. Secondly, only the immediate purchaser with privity of contract with the seller is entitled to sue the above-named persons. Thirdly, the purchaser has to prove the element of reliance. Proof of reliance, however, is made practically impossible because of the absence of a prospectus requirement under the Philippine Securities Act. Finally, the lack of emphasis on soft, forward-looking information under Section 7 and the Philippine S.E.C. Rules and Regulations is contrary to the philosophy of disclosure embodied in the Philippine Securities Act. Two eminent authors aptly described this philosophy of disclosure:[122]

> There is nothing in the Act which would control the speculative craze of the American public, or which would eliminate wholly unsound capital structures. There is nothing in the Act which would prevent a tyrannical management from playing wide and loose with scattered minorities, or which would prevent a new pyramiding of holding companies violative of public interest and all canons of sound finance. All the Act pretends to do is to require the "truth about securities" at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.

And Professor Kripke's emphasis on forward-looking information is an appropriate reminder to the Philippine S.E.C. and to those who will draft a new Philippine law on securities:[123]

> If the SEC really expects that the documents which are produced under its command will be the guide to securities investment decisions, it has to change its emphasis from the past and from threats of liability, by providing broader safe harbors by rule and encouraging efforts to present guides to the future — the sensitivities I have mentioned, forecasts, opinions, what Carl Schneider has called "soft information."[124] On the other hand, it may be that, as Carl Schneider's article,[125] Harry Heller's article,[126] and Bruce Mann's article,[127] have hinted, the SEC has never really believed its rhetoric and has never believed that its documents could be the basis for securities decisions, and it has merely been trying to give us a solid objective collection of past information, *leaving it to the investor and the analyst to look the future.*

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[122] *Supra,* note 70 at 171.

[123] Kripke, *A Search for a Meaningful Securities Disclosure Policy,* 31 BUS. L. 293, 316-317 (1975).

[124] citing *supra,* note 85.

[125] Citing *supra,* note 85 at 258-260.

[126] Citing, Heller, *Disclosure Requirements Under Federal Securities Regulation,* 16 BUS. L. 300, 301-302, n. 6 (1961).

[127] Citing Mann, *Prospectuses: Unreadable or Just Unread? — A Proposal to Re-examine Policies Against Permitting Projections,* 40 GEO. WASH. L. REV. 222, 225-227 (1971).

> *In that case filed documents are not going to be the basis on which investment decisions are made.* Then we all have to ask ourselves whether the enormous amount of time and expense and effort of lawyers and accountants and the best minds in Wall Street to produce these documents under great pressure is justified, if all that is created in the long run is a free government-compelled hand-out competing with Standard and Poor's yellow sheets. That, I think, is the big challenge on which the SEC sometimes has to make up its collective mind.

On the other hand, the adoption by the Philippine S.E.C. of the 'might' rule in its definition of a 'material fact' is an advantage to the purchaser but may expose the issuer or dealer to unwarranted liabilities for material misrepresentations and omissions in the registration statement under Section 30 of the Philippine Securities Act.