TOWARDS A NEW SECURITIES ACT*

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The first and foremost task facing our Securities and Exchange Commission (SEC) is to lobby for the enactment of a new securities act.

The present Securities Act (Commonwealth Act No. 83 which was approved on October 26, 1926) was patterned mainly after the Federal Securities Act of 1933 (1933 Act, for short), the Federal Securities Exchange Act of 1934 (1934 Act, for short) and the Uniform Sales of Securities Act. As the late Senator Francisco put it, it 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".[1]

However, even at birth, the act suffered from many fundamental infirmities. To begin with, its drafters combined the 1933 and 1934 Acts without taking into consideration the fact that the 1933 Act dealt with the original distribution of securities and the 1934 Act covered the *trading* of securities after their original distribution. Even for the 1930's, the act offered inadequate protection to the investing public. It is therefore incredible that the law has not undergone substantial amendment up to the present.

The SEC and the U.P. Law Center are independently drafting a new securities act. Whatever draft is submitted to the Batasang Pambansa should take into account the deficiencies of the present law and remedy them.

This article attempts to discuss the most serious flaws of the present Securities Act, suggest some solutions and pose questions which should be answered by the drafters of the new securities act.

WHAT IS A "SECURITY"?

Section 2(a) of the Securities Act provides for a rather lengthy definition of what constitutes "securities".

Basically, the 1933 Act defines three categories of securities: (1) Any interest or instrument commonly known as a security (such as bonds, stocks,

* Some of the author's comments and materials used in this article were taken from an earlier work of the author. See Ricalde, *Liability for Misrepresentations and Omissions in the Registration Statement Under Section 30 of the Securities Act*, 55 PHIL. L.J. 159-204 (1980).

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etc.), (2) Securities specifically mentioned therein (such as pre-organization subscriptions, fractional, undivided interests in oil, gas or other mineral rights) and (3) Investment contracts and certificates of interest or participation in any profit sharing agreement. The proposed *Federal Securities Code* (*ALI Code, for short*) drafted by Professor Louis Loss of the Harvard Law School for the American Law Institute follows the same scheme. The words "investment contract" constitute the broad, *catch-all* phrase which the American SEC and courts have applied to include many financial schemes not included in the first two categories as "securities". The phrase is the *core* of the definition of a "security".

The traditional test of what constitutes an "investment contract" was laid down by the U.S. Supreme Court in *SEC vs. Howey*.[2] The Supreme Court ruled that the test for an investment contract is whether a person invests money in a *common enterprise* and is led to expect profits solely from the *efforts of a third party.*

The American SEC and courts have recently expanded this test to cover situations where (1) investors participate in the management of the common enterprise but control of capital still principally rests with a third party (risk capital test) and (2) the form of benefit derived by the investor may be something other than cash profits (such as appreciation of capital, services, etc.).[3]

Questions have been raised lately as to whether a "commodity futures" contract is a "security". Moreover, the SEC has recently been toying with the idea of including "commodity futures" in the new definition of "securities".

I submit that a "commodity futures" contract, *per se,* is not a "security".

Not every contract where "capital" (used in the generic sense) is risked is a "security". "Capital" is risked in ordinary savings and time deposit accounts, and even in orthodox insurance and annuity policies. And yet it would be utterly ridiculous to consider these, *per se,* as "securities".

Section 299.53(b) (8) of the ALI Code expressly excludes, among others, as commodity futures contract, *per se,* from what constitutes a

[2] 328 U.S. 293 (1946).

[3] *See* S.E.C. vs. Koscot Interplanetary, Inc., 497 F. 2d 473 (1974) which held that "the admitted salutary purposes of the (securities acts) can only be safeguarded by a functional approach to the Howey test".

The Silver Hills Country Club vs. Sobieski case, 361 P. 2d 906 (1961), first articulated the "risk capital" aspects of promotional memberships in certain private clubs and emphasized the expectation of material benefits, even though a profit motive was lacking.

See Securities Act Release No. 5347 (January 4, 1973) which explained that "an investment contract may be present in situations where an investor is not wholly inactive, but even participates to a limited degree in the operations of the business" and that the "profits" that the purchaser is led to expect may consist of revenues received from rental of the unit and the tax benefits resulting thereon.

"security". Professor Loss commented that this exclusion reflects the case law on the matter.[4] The reason is not hard to find.

A commodity futures contract is simply an agreement for the delivery of a specified quantity of a commodity (like sugar, gold, copper, etc.) on any given future date. It is essentially a means of *purchasing* commodities. It is thus primarily a *mercantile* rather than an *investment* transaction.

The purchaser in a commodity futures contract normally gains no share in a *common enterprise.* He merely acquires the power to exercise absolute dominion and control over the specified commodities. Moreover, it involves no reliance on the *efforts* of a *third party.* The prices of the commodities at a future date are not determined by the efforts of promoters, managers, employees of the common enterprise or any third party but by the laws of supply and demand which are often global in nature.

The expected return or profit is not contingent upon the continuing efforts of another, but upon the purchaser's *own ability* to predict the market forces which will determine the price of the commodity at the specified future date.

The mere presence of a speculative motive on the part of the purchaser or seller does not make an agreement an "investment contract" within the meaning of securities laws. Otherwise, any one who buys or sells a race horse, a house, or a fuel-efficient automobile in the hope of realizing a profitable "investment" would be entering into an "investment contract".

Neither should a commodity futures contract *per se* be included in the new definition of "securities". The SEC would stretch its resources to their breaking point in attempting to regulate *mercantile* or even possibly *consumer* transactions. The costs of policing such contracts would far outweigh any possible benefits that the public may acquire. And this attempt may lead to an unwarranted diversion of the SEC's meager resources from investment to mercantile transactions.

Note that an orthodox commodity futures contract should be distinguished from *options* on commodity futures contracts and *discretionary* commodities trading accounts. The latter may constitute an "investment contract"[5] because there may be a common enterprise and it may involve reliance on the efforts of a third party.

SPECULATIVE SECURITIES

The Securities Act requires that "speculative" securities be registered by qualification since it grants the SEC the power to inquire into the qualifi-

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[4] *See* ALI CODE March 15, 1978 Proposed Official Draft at p. 162 for Prof. Loss' comments.

See Sinva, Inc. vs. Merill Lynch, 253 F. Supp. 359 (1965); Berman vs. Orinex Trading, Inc. 291 F. Supp. 701.

[5] *See* Anderson vs. Du Pont & Co., 291 F. Supp. 705; SEC vs. Continental Commodities Corp., 497 F. 2d 516.

cations of the "speculative" securities before granting the license to sell under Section 9 of the act. Section 2(b) of the Act provides for a lengthy definition of speculative securities. But I believe Section 2(b) (4) describes them best as "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". Once the SEC is convinced upon examination of the registration statement and other documents filed by the issuer, or dealer that the securities to be offered to the public are "speculative", then Section 9 of the Act requires that the Commission grant a license to sell the speculative securities if it finds that the issuer is, among others, of "good repute" and that the enterprise or the business of the issuer is not based upon "unsound business principles".

One can ask the following questions regarding this scheme.

First of all, is our SEC capable of determining whether a security is speculative? Is not the law giving the SEC too much discretion when it empowers the Commission to classify a security as "speculative" when "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" [(Section 2(b)(1)] or if "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" (Section 2(b)(4))?

Secondly, can our SEC assure the public that the issuer is "of good repute" or that the issuer's business or enterprise is not based upon "unsound business principles"? It cannot and does not. In accordance with Section 9 of the Act, "every permit shall recite in bold type that the issuance is permissive only and does not constitute a recommendation or endorsement of the securities permitted to be issued". Then, we may ask, of what possible value can this inquiry into the qualifications of the issuer be to the investing public?

The 1933 Act makes no distinction between speculative and non-speculative securities. The manner of registration is simply one of *notification.* A registration statement disclosing all material facts regarding the issuer and its business is simply filed with the American SEC. To paraphrase then Professor, later Chairman of the U.S. SEC and Associate Justice of the U.S. Supreme Court, William Douglas and Professor Bates, there is nothing in the 1933 Act which would control the speculative craze of the public, or which would eliminate wholly unsound capital structures 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 the truth about the offering is adequately disclosed, the matter is left to the investor.[6]

Perhaps our securities act should have followed the same simple scheme.

After all these recent scandals, our SEC is hardly capable of acting as an investment adviser to the investing public. Besides, the SEC has already saddled itself with powers that it cannot possible chew, let alone digest.

DISCLOSURE PROVISIONS

The Securities Act provides for a mandated system of disclosure of information only in the registration statement to be filed with the SEC under Section 7 which governs the original distribution of securities. Section 7 does not require the disclosure of all material facts related to the securities offering.

The ALI CODE, in accordance with the recent American jurisprudence on the matter, defined a fact as being "material" if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action.[7]

In this regard, Section 7 of the present law requires much less information than Schedule A of the 1933 Act. For example, no information is required regarding the names and addresses of the vendors and the purchase price of the property or goodwill to be acquired which is to be defrayed in whole or in part from the proceeds of the security to be offered and the nature and extent of the interest of the principal shareholders, officers and directors in any property acquired, not in the ordinary course of business of the issuer, within two years preceding the filing of the registration statement.

The new securities act must also attempt to deal with the controversial issue of whether and to what extent should forecasts, forward-looking or, what Carl Schneider[8] called, 'soft' information, be considered as within the scope of the disclosure system envisioned by the law. 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 recent cases, American courts have regarded earnings forecasts, under certain conditions, as 'facts'. The ALI CODE provides that a "fact includes a promise, prediction, estimate, projection, or forecast".[9] Even the U.S. SEC has abandoned its long-time objection to disclosure of

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[6] *See* Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933).

[7] *See* Sec. 293, ALI CODE. The "substantial likelihood" phrase traces its origin from TSC Industries, Inc. vs. Northway, Inc., 426 U.S. 438 (1976).

[8] *NITS, GRITS, AND SOFT INFORMATION* SEC Filing, 121 U.P.A. L. REV. 254 (1972).

[9] *See* Sec. 256(a), ALI CODE.

projections in registration statements and similar filings. In securities Act Release No. 5992 (November 7, 1978),[10] the U.S. SEC set "Guides for Disclosure of Projections of Future Economic Performance". The guide viewed a voluntary projection system as more appropriate than a mandatory system and provided for, among other matters, disclosure of underlying assumptions behind the projections, items to be projected (sales, net income, earnings per share, etc.), third party review and revision and updating of projections.

The ALI CODE follows the recent attitude of the American SEC when it provides that "a projection or estimate 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".[11]

And Professor Kripke's emphasis on forward-looking information is an appropriate reminder to the Philippine SEC and to those who will draft a new Philippine law on securities:[12]

> 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, opinion, what Carl Schneider has called "soft information". On the other hand, it may be that, as Carl Schneider's article, Harry Heller's article, and Bruce Mann's article, 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 ot the investor and the analyst to look the future.
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> 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.

As it is, our present securities law not only leaves it to the investor and his adviser to look into the future. It does not even provide the investor with a solid, objective, and adequate collection of *past* information.

Our law, like the 1933 Act, provides for registration of securities *offering*. The drafters of the new securities act should consider adopting the registration scheme of the ALI Code. It provides for the registration of

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[10] 16 SEC Docket 81, 85 (1978).

[11] *See* Sec. 297(b), ALI CODE.

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

a *company* instead of a securities offering. There is only one registration statement and one file for a given company. The ALI Code, having in mind President Roosevelt's call for securities regulation "with the least possible interference to honest business",[13] shifts the emphasis from the "occasional, hit-or-miss, static registration statement under the 1933 Act to permanent company registration followed by *continuous disclosure,* on as current a basis as practical, more along the lines of the 1934 Act". This change was made in view of the "crying need for a scheme of continual disclosure that is not keyed to the fortuity of a public offering".[14]

TENDER OFFERS

The present law, unlike the 1934 Act, does not specifically provide for reporting requirements in cases of tender offers. A "tender offer" is not defined in the 1934 Act. However, it is commonly understood to be public offers made by a person (tender offeror) directly to shareholders of the issuing company (target company) in order to gain control of that company. For example, a tender offer exists when an offer is made by Corporation A directly to the shareholders of Corporation B to purchase the securities of the issuer Corporation B.[15]

This offer may be made in cash or in the stock of Corporation A and may be made with or without the cooperation of the management of Corporation B.

Sections 13 and 14 of the 1934 Act require that the purchaser of more than five percent of a class of equity securities registered under the Act must file certain information with the SEC, the issuer of the securities and the exchange wherein said securities are traded regarding, among others, the background and identity of the purchasers of the shares, the source and amount of funds or other consideration used to purchase the securities, any plans it may have to acquire more of the same securities and to attempt to change the issuer's business or corporate structure such as to sell its assets to or merge it with any other entity.

There are two principal purposes for this forced disclosure requirement. First, it informs the shareholders of the target company at an early stage of the plans of the tender offeror regarding the target company once he gains control of it. Thus, the target company's shareholders could make an

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[13] *See* Rep. No. 47 at 607, 73d Cong., 1st Session (1933).

[14] *See* Introduction of the ALI CODE scheme by Prof. Loss.

[15] Sec. 299.68(a) of the ALI CODE defines a "tender offer":

Sec. 299.68 [*Tender offer.*] (a) [*General.*] "Tender offer" means an offer to buy a security, or a solicitation of an offer to sell a security, that is directed to more than thirty-five persons, unless

(1) it (A) is incidental to the execution of a buy order by a broker, or to a purchase by a dealer, who performs no more than the usual function of a broker or dealer, or (B) does no more than state an intention to make such an offer or solicitation, and

(2) satisfies any additional conditions that the Commission imposes by rule.

intelligent decision on whether or not to sell their shares to the tender offeror. For example, if the tender offeror (Corporation A) informs Shareholder X of Corporation B that once it gains control of Corporation B, it will grant a much-needed loan (on easy terms) to Corporation B and will give Corporation B access to its valuable patent rights, then Shareholder X may intelligently decide to sell just 50 of his 100 shares in Corporation B and wait for his remaining 50 shares to appreciate. If Corporation A later on backs out of its announced plan with no justifiable reason, it is liable to Corporation B and its shareholders for its misrepresentation. Second, it enables the target company and its management to make an intelligent decision at an early stage on whether or not to resist the tender offer with all the legal means at its disposal. For example, if Corporation A discloses that it plans to merge Corporation B with its subsidiary Corporation C and the management of the target Corporation B believes that Corporation C is simply on the verge of bankruptcy, then it can conduct a campaign informing its shareholders not to sell their shares to Corporation A.

Section 14 of the 1934 Act likewise provides for (1) a period wherein the tender offeree may change his mind and withdraw the securities which he tendered with the offeror, (2) a pro-rata purchase by the tender offeror from each offeree should the offeror tender *less* than all of the issuer's (target corporation) outstanding stock and a greater number of shares are offered than the offeror intends to purchase, and (3) a system wherein, if the offeror changes the terms of his offer, then the same terms, if *better* than offered to prior tender offerees, must be offered to those *previous* offerees-sellers.

Section 24 of the present law provides for regulation of proxies by the Commission. But said proxy rules may be of limited applicability to cases of tender offers since tender offers do not necessarily involve solicitation of proxies. In fact, in many tender offers, no solicitation of proxies takes place.

INSIDER TRADING

The rampant use of inside information in the trading of securities in and out of the exchange is too well-known an occurrence here in the Philippines to be the subject of serious dispute.

Section 26 of our law was taken from Section 16 of the 1934 Act. Section 16 was designed to prevent "insiders" (i.e., as mentioned in the first paragraph, these are directors, officers and principal stockholders) from using inside information to make "short-swing" profits in the purchase and sale of the issuer's securities which are registered under the act.

Both Section 26 and 16 require that these insiders report to the stock exchange wherein such security is traded and the Commission their beneficial interest in registered securities and any purchases or sales thereof. But here the similarity ends.

Section 26(b) of our law provides that "Any profit realized by a beneficial owner, director, or officer, through the unfair use of information received as such, from any purchase and sale, or any sale and purchase, of any security of such issuer (other than exempted security), within any period of less than six months of the issue thereof, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer". Section 16(b) of the 1934 Act provides that *"For the purpose of preventing the unfair use of information* which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, *irrespective of any intention on the part of such beneficial owner, director, or officer* in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months". The difference between the two provisions is apparent. In Section 26(b), the burden of proof is with the plaintiff to show that the short-swing profit of the insider was realized through the unfair use of information. This is an extremely difficult task for the plaintiff.

Section 16(b), on the other hand, provides for *strict liability*. There are no defenses available to such insider if the plaintiff can prove that such insider bought and sold or sold and bought a registered security within six months at a profit. The rationale of the 1934 Act is that such insiders by nature of their relationship to the issuers, are assumed to possess material information about the issuer and such information may be used as a basis for trading on the issuer's security at an undue advantage over outsiders.

However, Section 16(b) has loopholes. It is confined to directors, officers and principal stockholders. Also, if a director becomes aware of unfavorable conditions in the issuer firm which are not disclosed to the public, he may sell his shares in the firm on the basis of this undisclosed inside information if he has owned the shares for more than six months. He will not incur liability under Section 16(b).

In order to plug the above deficiencies, I believe it is necessary to incorporate Rule 10b-5 of the U.S. SEC into the new securities act. Rule 10b-5 simply provides:

> It shall be unlawful for any person, directly or indirectly, x x x (a) to employ any device, scheme, or artifice to defraud, (b) to make

[16] *See* SEC vs. Texas Gulf Sulphur Co., 401 F. 2d 833 2d Cir. (1968), cert. denied, 394 U.S. 976 (1969).

> 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.

The basis of this rule is Section 10 of the 1934 Act which provides for the regulation of the use of manipulative and deceptive devices and which is substantially reproduced in Section 21 of our law.

Although Rule 10b-5 does not specifically mention "insiders" or specifically require a person possessing inside information to disclose this information in a securities transaction, the American SEC and courts have frequently used this "disclose or refrain" rule to cover such transactions.[16] Under Rule 10b-5 jurisprudence, "insiders" include not only principal stockholders, directors and officers but also, among others, tippers, tippees, and brokers who receive inside information and who use it to assist their customers. The rule covers market professionals and amateurs alike. Even an "outsider" can be considered "insider" if the person has a relationship giving *access*, directly or indirectly, to information about the securities which is intended to be available only for a business purpose and not for the personal benefit of anyone and if it would be *inherently unfair* for him to take advantage of such information, knowing that such information is unavailable to the investing public.[17]

The origin of this anti-fraud rule lies in the idea that the "insider" occupies a fiduciary relationship with the "outsider". Thus, he must disclose the relevant information to the "outsider" or refrain from trading. Both efficiency and equity dictate the above conclusion.

According to Professor Brudney[18] the anti-fraud provisions serve several functions. The first is the protective function — to prevent over-reaching of public investors. The second is the efficiency function. Candor is essential to restore the public's trust in the securities markets. The anti-fraud rule will create a flow of information which will enable investment decisions systematically to reflect relevant facts and expectations by improving the quality of publicly available information. This will improve the efficiency of the securities market so that price reflects value and therefore the real resources of the economy will be optimally allocated. The securities market will function efficiently to allocate savings to enterprises which are more profitable and divert them from enterprises which are less profitable. Finally, the rule serves a regulatory function. As Professor Brudney succinctly put it:

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[17] *See In Re Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).

[18] Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. REV. 322, 334-339 (1979).

> The notion is that people will refrain from engaging in some kinds of conduct of corporate affairs (apart from trading on inside information) which may or may not be illegal, but which will embarrass them if disclosed. Hence, they will divert less to themselves in self-dealing transactions (or be more likely to discontinue bribery) than they would if there were no disclosure requirement. In part also, the notion is that the sooner information about corporate prospects must be disclosed and the more information insiders must disclose about their dealings in the corporation's securities, the less will be the temptation to manipulate the affairs of the company and the release of its information in order to create an impression of value that will facilitate insiders' personal trading in securities. In short, the less insiders may be able to compensate themselves covertly from corporate assets — by diversion or by trading — the less will investors be required to spend to police them. Hence, it is fair to conclude that a prime function of the disclosure system, including the anti-fraud provisions, is to prevent a costly breach of a fiduciary duty to the corporation and its stockholders, entirely apart from preventing overreaching transactions in the market.[19]

The idea behind the reporting and registration requirements which mandate disclosure and the anti-fraud rules which implicate disclosure in particular circumstances is that "sunlight is.... the best of disinfectants".[20]

CIVIL LIABILIY PROVISIONS

Fundamental though are the deficiencies of present Securities Act in the areas discussed above, they pale into insignificance when compared to those in the civil liability provisions of the act.

The heart of the civil liability sanction of our present law lies in Sections 30 and 29 (governing liabilities of controlling persons).

PERSONS LIABLE

Under Section 30 of the 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 SEC. 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, 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.

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[19] *Supra*, note 18 at 335-336.

[20] BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (1933 ed.)

Viewed from the perspective of the persons liable for misrepresentations and omissions of a material fact in the registration statement, Section 30 is a great emasculated version of Section 11 of the 1933 Act.

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 of persons performing similar functions, (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 any report or valuation which is used in connection with the registration statement, (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 ownership, 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." (Emphasis added).

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.

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 can prove* that they met the standards of care applicable to them. As to statements made by expert, the experts (e.g., accountants who prepare and certify the issuer's financial statements) must actually believe that the statements they made were 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., outside director) reviewing statements made by experts, they must prove that they did not believe the statements made by the experts were untrue and they 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, under normal circumstances, 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 they made were true and that their belief must be reasonable in order to escape liability under Section 11. A reasonable investigation is necessary to prove that their 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 not involved in the actual drafting of the registration statement when reviewing the statements made by fellow board members who are also non-experts) are subject to the same standard of diligence required of non-experts concerning 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."

In bleak contrast, under Section 30 of our law, 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 easily escape liability by proving 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 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 1933 Act should likewise be held liable therein under 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.

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 our corporate scene. It was intended by the U.S. Congress 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".[21]

UNDERWRITERS

Crucial to the disclosure scheme of the 1933 Act is the concept of an underwriter.

Section 2(11) of the 1933 Act defines the term 'underwriter':

> "(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."

Section 2(11) 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. The House Report accurately portrayed the breadth of this definition:[22]

> 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

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21 Senate Report No. 47, 73d Cong., 1st Session (1933) 5.

22 *See* Report of the Committee on Interstate & Foreign Commerce of the U.S. House of Representatives, H.R. Rep., No. 85, 73rd Cong., 1st Sess. 13-14 (1933). Italics ours.

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.

x x x 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 subsidairy 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 particular 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 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 a redistribution reaches significant proportions, the distributor would be in 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.*

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.[23] No distinction is made between professional investment bankers and rank amateurs. Nor is it necessary for an underwriter to have privity of contract with the issuer.[24]

Central to the concept of an underwriter is the existence of a "distribution" of any registered security. Distribution has not been defined in the 1933 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.[25]

It is clear that unless an 'underwriter' falls under the definition of a 'dealer' in Section 2(g) of the Securities Act it is not liable for misrepresentations and omissions of material facts in the registration statement under

23 1 Loss, SECURITIES REGULATION 547 (1961).

24 *See* S.E.C. vs. Chinese Consol. Benev. Ass'n. Inc., 120 F. 2d 738, 740-741 (1941), cert. denied 314 U.S. 618, 86 L. Ed. 497 (1941). See Also S.E.C. vs. Guild Films Company, Inc., 279 F. 2d 485, 489-490 (1960), cert. denied 364 U.S. 819 (1960).

25 *See* In the Matter of Ira Haupt & Company, 23 S.E.C. 589 (1946).

Section 30. The Section 2(g) definition of a 'dealer' includes "... 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 of reselling them or of offering them for sale to the public ..."

Like the 1933 Act definition of a 'dealer', this definition of a 'dealer' does depend on the person's general activities rather than on his conduct in the particular offering. 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.

This situation makes it easy for controlling shareholders of the issuer to evade the disclosure provisions of the law. They can distribute their shares in massive quantities in what appears to be a secondary distribution without being held liable under the present law. Through such a "secondary" offering, securities of publicly-held corporations can be marketed to the public without the benefit of registration. Such a "secondary" offering, to repeat the House Report, possesses all the dangers attendant upon an original offering of securities.

It would also be easy to evade the registration requirements of the law with the distribution of securities of a shell corporation by means of simple "spin-off" devices.[26]

For example, Corporation A, with little business activity, issues its shares to a publicly-owned Corporation B for a nominal consideration. The acquiring Corporation B subsequently "spins off" the shares of Corporation A to its shareholders as a dividend distribution. Corporation B's controlling shareholders would keep their stock. Immediately after the dividend distribution, Corporation B's other shareholders would begin active trading on the Corporation A shares whose price would go up. The controlling shareholders would then unload their shares at a profit. A trading in the shares thus begins with no information on the issue being available to the investing public through the registration process. Under the 1933 Act, the acquiring Corporation B may be held liable as an underwriter since it "purchased from an issuer with a view to .... the distribution of any security" or since it "has a direct or indirect participation in any such undertaking". Under the present law, it will not be held liable as an underwriter, issuer or dealer.

[26] S.E.C. vs. Datronics Engineers, Inc., 490 F. 2d 250 (4th Cir., 1973), cert. den. 416 V.S. 937.

PRIVITY OF CONTRACT REQUIREMENT

Under Section 30, only the immediate purchaser is entitled to sue the seller. This conclusion can be clearly inferred from the fact that Section 30 reuqires 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. 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 omission in the registration statements because there is no contract of sale between them.

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 Articles 1398 and 1402 of the Civil Code, only a privy to a contract can sue for the annulment of such contract.

Section 11 of the 1933 Act requires no such 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.

Professor Loss remarked in his treatise that, "it 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".[27] This liability to persons beyond the contract had to be imposed by the U.S. Congress because the courts did not dare to embark on such a radical departure from the traditional and well-settled common-law insistence on privity.

Section 30 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..." It is obvious that, by filing the 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,

[27] 3 LOSS, SECURITIES REGULATION 1731 (1961).

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 our law. The same criticism by Professor Shulman, can be levelled against Section 30:[28]

> 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 either against 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 restoration of the status quo provides additional pitfalls...

It should also be emphasized that the Securities Act covers not only the initial distribution of but also the trading in securities. The removal of the privity of contract requirement under Section 30 will be a great step towards the realization of the goal of the Securities Act: to provide full and fair disclosure to the public of the character of the securities to be sold.

PROOF OF RELIANCE

Section 30 expressly 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?

Unlike the 1933 Act, our Securities Act does not impose any prospectus requirement. 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 Commission and that the said registration statement is open to public inspection during business hours by interested parties is published in the newspapers.

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.

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

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

that even if he knew he would have bought the securities anyway. In either case, no reliance is shown.

Under ordinary circumstances, it would be extremely difficult for a purchaser to prove reliance on a filed registration statement alone. 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 general, the plaintiff need not prove reliance to recover under Section 11 of the 1933 Act. 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 reading the registration statement by such person.

Professor Shulman praised the abolition of the element of reliance as a requirement to recovery under the said Section 11 *(Ibid.)*:[29]

> 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.... *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.* ...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.* (emphasis added).

The removal of the proof of reliance as a requisite for holding persons 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 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 1933 Act, the U.S. Congress recognized this position. Thus, a passage from the House Report 85 states:[30]

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[29] *Supra*, note 28 at 249-250.
[30] H.R. Rep. 85, 73d Cong., 1st Sess. at 9-10.

> 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.

The above passage appears to have equal applicability in the context of Section 30 of our law.

RECOMMENDATIONS ON CIVIL LIABILITY PROVISIONS

First of all, the new securities act should adopt Section 11 of the 1933 Act. Section 30 of the present law is a paper tiger.

Secondly, the SEC should formulate specific civil liability sanctions to give more teeth to other registration, reporting and anti-fraud (e.g., insider trading) provisions of the new act. For example, under Section 12(1) of the 1933 Act, liability attaches for, among others, sale of unregistered securities. Section 12(2) provides that any person who offers or sells a security (whether or not the securities are registered, whether or not the securities are exempt from registration, and whether the offer or sale was made orally or in writing) and misrepresents or omits a material fact in connection therewith and who cannot sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known such misrepresentation or omission, is liable to the purchaser of such security.

Thirdly, the SEC should formulate provisions which will prohibit indemnification by an issuer corporation or similar entity to the principal shareholders, directors, and officers for their liability under the reporting, registration and anti-fraud provisions and which will mandate the recovery of damages paid by such issuer corporation from the above persons arising from the violation of these provisions. This will protect the interests of the minority shareholders of the issuer.

Finally, the new securities law should provide for mandatory TREBLE DAMAGES in case of violations of the registration, reporting and anti-fraud provisions. Violators of these provisions are clearly guilty of the worst kind of economic sabotage in view of the importance of the securities market in the optimum allocation of our country's resources. Fraud distorts this allocation mechanism to the detriment of our economic development.

CONCLUSION

The defects of the present securities law are too fundamental to be cured by mere amendments. An entirely new securities law is needed to restore the public's trust in the securities market.

The objective of the registration, reporting and anti-fraud provisions of the securities act is to provide potential investors with all the information necessary in order to make an intelligent investment decision. Candor is necessary to restore the public's trust in the securities market to encourage investment and to discourage speculation. Once the truth about the securities is told to the potential investor, the matter should be left to him.

Adequate liability provisions are needed to enforce the registration, reporting and anti-fraud provisions. These and the excellent use of its rule-making powers make the American SEC respected and even feared by the best minds of Wall Street.

It took the collapse of the stock market in 1929 and 1930 and the Great Depression for the American Congress to enact the 1933 and 1934 Acts. I hope it will not take more than the Agrix, Santamaria, Pascual and Philfinance disasters for the Batasang Pambansa to enact a new securities act.

One prominent lawyer remarked in a symposium that our SEC is the most powerful one outside of the Soviet bloc. In recent years, our SEC has amassed tremendous powers without even noticing the fundamental defects of our Securities Act. In the meantime, scandal after scandal eroded our public's confidence in the securities market. Capital formation has thus been slowed down.

Perhaps our SEC should return the resolution of intra-corporate disputes to the regular courts and instead concentrate on its prime duty — the enforcement of the securities act. Its American counterpart does not possess its awesome powers — certainly not the powers to resolve intra-corporate disputes and take over the management of ailing firms in certain cases. And yet it has managed to command the respect of the American public and the securities industry.

The SEC is hampered by a fundamentally defective enabling act, an excess of power, an insatiable penchant for regulation and a dearth of *qualified* personnel.

I believe that our S.E.C., the U.P. Law Center and the securities industry should sit down together and draft a new securities act. No administrative body — not even the SEC — can claim a monopoly of knowledge of securities laws. Securities regulation can easily compare with anti-trust legislation in terms of the complexity of its subject matter. The SEC, after all these fiascoes involving the securities industry, certainly needs all the help it can get.