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THE BRITISH HERITAGE OF SECURITIES LEGISLATION IN THE UNITED STATES

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IT is a common misconception that the philosophy of securities regulation and the principle of full disclosure originated in the United States under the direction of the New Deal legislators. In reality, the chief characteristics of security laws in this country bear the mark of British ancestry.

Legislators of the first security acts in the United States and the individual states drew heavily from England's experience and adopted her philosophy of "full disclosure." Even in those states where securities must be registered by qualification, the British influence is present, since disclosure is a prerequisite to qualification.[1] In order to promote an understanding of the background of securities legislation in the United States, this Article traces the major attempts of the British to control the activities of dealers in stocks from 1696 to the beginning of the twentieth century.

Nearly three hundred years ago English stockbrokers were using an open and highly organized securities market to channel the public's savings into investment opportunities.[2] In comparison with present standards, the physical facilities were deficient, but trading techniques were well advanced. The mechanics of the stock market provided for sales to unknown parties,[3] purchases on margin,[4] put and call options,[5] bull and bear sales,[6] a weekly quotation service,[7] and an established rate for brokerage commissions.[8] The coffee houses of Change Alley were the centers of trading activity until the middle of the eighteenth century when the brokers moved into their own building.[9] Unimpeded by government control, the "stock market"

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[1] Frequently, in registration by qualification, more extensive information must be filed about a company's operations than is necessary under registration by notification. The Colorado Securities Law is an exception, since the contribution of the British philosophy of full disclosure is clearly evident in the legislation of that state. See Colo. Rev. Stat. Ann. §§ 125-10-1 to -28 (Supp. 1961).

[2] See Killik, The Work of the Stock Exchange 14 (2d ed. 1934).

[3] 1 Scott, The Constitution and Finance of English, Scottish, and Irish Joint-Stock Companies to 1720, at 443 (1912).

[4] *Id.* at 358.

[5] 4 Holdsworth, A History of English Law 338 (2d ed. 1937).

[6] Scott, *op. cit. supra* note 3, at 443.

[7] *Id.* at 329.

[8] *Id.* at 345.

[9] Killik, *op. cit. supra* note 2, at 15.

of the seventeenth century had developed the mechanism for directing funds into profitable employment for the advantage of both borrowers and lenders.

The three years of 1696, 1844, and 1900 are key dates in English securities legislation. The Brokers Act of 1696[10] was the first attempt by the English to apply legislative controls directly to dealings in stocks and shares. The Report of the Board of Trade, filed in 1844,[11] has served not only as the basis of English company law[12] but also as the foundation of modern securities regulation in the Commonwealth and in the United States. Finally, the philosophy of full disclosure as outlined in the Companies Act of 1900[13] is a priceless legacy to investors. The following survey of English securities control is divided into the three periods corresponding to these dates: (1) 1696 to 1844; (2) 1844 to 1900; and (3) 1900 to the present.

I. Securities Legislation From 1696 to 1844

Following a report of the Commissioners of Trade in 1696,[14] Parliament adopted "An Act to restrain the number and ill practices of brokers and stock jobbers."[15] The principal allegations of the report were directed at the promoters, and the brokers received only minor mention. The report charged that the promoters had spread "false or misleading statements, relating to the prospects of the companies they had formed, and then, as a consequence, the shares advanced and they sold on a rising market."[16] In the same report, brokers were accused of combining in order to raise or lower stock prices for their own gain.[17]

The language of the report vividly conveys the low regard in which those engaged in the sale of stocks and shares were held:

> The pernicious art of stock-jobbing hath of late so perverted the end and design of companies and corporations erected for the introducing or carrying on of manufactures to the private profit of the first projectors, that the privileges granted to them have commonly been made no other use of by the first procurers and subscribers but to

[10] Brokers Act, 1696, 8 & 9 Will. 3, c. 32.

[11] 7 B.P.P. (1844); see Gower, Modern Company Law 41 (1954).

[12] Gower, *op. cit. supra* note 11, at 41, 57. The term "company" is used to mean a body of persons associated for purposes of business under the laws of England. The term may include the joint stock company, the limited company, or the public company (comparable to the American business corporation), depending upon its usage. For definitions, see Black, Law Dictionary 352 (4th ed. 1951).

[13] Companies Act, 1900, 63 & 64 Vict., c. 48.

[14] Gower, *op. cit. supra* note 11, at 26.

[15] 1697, 8 & 9 Will. 3, c. 32.

[16] Scott, *op. cit. supra* note 3, at 359.

[17] *Id.* at 26.

> sell them with advantage, to ignorant men, drawn in by the reputation, falsely raised and artfully spread, concerning the thriving state of their stock. Thus the first undertakers getting quit of the company by selling their shares for much more than they are really worth to men allured by the noise of great profit, the management of that trade and stock comes to fall into unskilful hands, whereby the manufacturers intended to be promoted by such grants and put into the management of companies for their better improvement come, from very promising beginnings, to dwindle away to nothing and be in a worse condition than if they were perfectly left free and unassisted by such laws and patents; an instance whereof we humbly conceive is to be found in the paper and linen manufactures, which we fear, feel the effects of this stock-jobbing management and are not in so thriving a condition as they might have been had they not fallen under this kind of misfortune.[18]

Many of the provisions of the Brokers Act of 1696, which resulted from the report, are as timely today as they were when it was passed. The principal method chosen to "restrain the number" of stockbrokers was a licensing requirement which limited to one hundred the number of licenses that could be granted to stockbrokers. These authorized brokers were provided with identification badges which they were obligated to display after completing each stock transaction. The act enjoined the brokers from "dealing in their own accounts" and compelled them to "keep books."[19] All but two of these provisions, the upper limit on the number of brokers and the identification requirement, seem to have withstood the test of time.[20]

Although it was the rage of speculative frenzy which inflated the South Sea Bubble in 1720, it was governmental control influenced by the insistence of directors of the South Sea Company[21] which helped to expand the bubble to the bursting point. The directors of the company urged that restrictions be placed on the formation of new ventures. The resulting legislation has since become known as the Bubble Act. Following the passage of that act, speculation did not cease, but it tended to concentrate on some of the "favourite companies."[22] For example, two weeks after the proclamation of the act, the stock of the South Sea Company reached its highest level of 1050 pounds. The collapse in the year 1720 began, not with the

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[18] 11 Journals of the House of Commons 595.

[19] 1697, 8 & 9 Will. 3, c. 32.

[20] This identification requirement has not completely passed from the legislative scene. Regulation 16-5 of the Nova Scotia Securities Act requires every registered salesman to produce his certificate of registration on demand of any person. Similarly, today most states require that the salesman's license be displayed in a conspicuous manner.

[21] Scott, *op. cit. supra* note 3, at 411.

[22] *Id.* at 417.

promulgation of the act, but when legal proceedings were initiated to force certain companies to forfeit their obsolete charters.[23] Public confidence and strained credit conditions were unable to withstand the shock caused by the forfeiture actions, and the unstable stock market began its historic decline.

The Bubble Act,[24] which could be called England's first securities act,[25] contained some extremely harsh provisions. Section 19 declared that any company formed after 1724 and operating without a charter, or with a charter granted for some other purpose, would be considered a public nuisance; its transactions would be voided; and it would incur *praemunire*.[26] The act also provided that merchants injured by these illegal companies could sue for treble damages and costs.[27] The penalty for brokers dealing in shares of such companies was a loss of license and a fine of 500 pounds. Moreover, brokers were careful not to deal in unregistered stock since the act encouraged detection by providing that informers would be entitled to one-half of any fines collected from brokers.[28]

In view of the severity of the Bubble Act, it is not surprising that it remained virtually a dead letter until its repeal in 1825 (by the act of Geo. IV, c. 94). Actually the act was superfluous, since public confidence in joint stock companies and their securities had been so effectively destroyed by the South Sea debacle that it was three-quarters of a century before there was even another boom. What was needed at the time of the crisis was a law which would have made incorporation easy and inexpensive; but, unfortunately, the opposite situation resulted and persisted until 1844. One authority tersely evaluated the Bubble Act in the following words: "If the legislature had intended the Bubble Act to suppress companies they had succeeded beyond their reasonable expectations; if as seems more probable, they had intended to protect investors from ruin and to safeguard the South Sea Company, they failed miserably."[29]

During the relative inactivity of the stock market for the eighty years following the passage of the Bubble Act, speculative activity and securities control remained at a virtual standstill. Prior to the

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[23] Gower, *op. cit. supra* note 11, at 29.

[24] Royal Exchange and London Assurance Corporations Act, 1720, 6 Geo. 1, c. 18.

[25] Gower, *op. cit. supra* note 11, at 28.

[26] Royal Exchange and London Assurance Corporations Act, 1720, 6 Geo. 3, c. 18, § 19. "*Praemunire*" in English law meant a non-capital offense against the king and his government. Black, Law Dictionary 1337 (4th ed. 1951).

[27] Royal Exchange and London Assurance Corporations Act, 1720, § 20.

[28] Royal Exchange and London Assurance Corporations Act, 1720, § 21.

[29] Gower, *op. cit. supra* note 11, at 30.

repeal of the act in 1825, only three further attempts[30] were made to regulate the stock market, and these were only half-hearted ventures which made no contribution to securities legislation.

At the turn of the eighteenth century, speculative activity again gathered momentum. Under the impetus of war and the growth of railroads, speculation returned with a vigor which was "nearly as wild as in the South Sea Bubble."[31] The renewed force was temporarily halted by the Panic of 1825, and it took nine years for the speculators to regain their confidence.[32]

The lack of adequate companies legislation and protection for investors was emphasized when most promoters resorted to the unincorporated entity. Since the unincorporated joint stock companies were then playing a significant part in the English economy, it became imperative that they gain legal status. Following a number of abortive attempts to provide a legal basis for those companies, Parliament in 1841 appointed William Gladstone as chairman of a committee to study the problem. The result of Gladstone's work, which earned for him the title of "father of modern company law," was the Joint Stock Companies Act of 1844—the main topic of the following period.

II. SECURITIES LEGISLATION FROM 1844 TO 1900

The Joint Stock Companies Act of 1844 is a milestone in the history of English company law. For the first time, in England, a legal distinction was made between private partnerships and joint stock companies. In addition, the act removed the costly and burdensome necessity of a special act or charter in order to gain corporate status in favor of permitting incorporation by registration. Moreover, the prospectus provision contained in the act marked the beginning of modern securities legislation.

Gladstone, as the chairman of a Select Committee on Joint Stock Companies, made a report which was to have a lasting effect on the campaign for adequate disclosure to the investing public. The report stated:

> Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality. The early publication,

[30] *Id.* at 34. The following acts are cited: Stock Jobbing Act, 1721, 7 Geo. 1, stat. 2, No. 8; Stock Jobbing Act, 1734, 7 Geo. 2, c. 8; Stock Jobbing Act, 1737, 10 Geo. 2, c. 8.

[31] Thorp, *Speculative Bubbles*, 3 Encyc. Soc. Sci. 26 (1937).

[32] Gower, *op. cit. supra* note 11, at 39.

> resulting from registration of . . . prospectus and circulars, will doubtless be useful in controlling . . . undertakings at their outset . . . .[33]

The disclosure provisions contained in the Act of 1844[34] were not as important to designers of subsequent securities legislation as was the establishment of Gladstone's philosophy of full disclosure. Judging by present standards, the requirements for prospectuses contained in the Act of 1844 were only in their infancy. The act did not define the term "prospectus" but used the word in the same sense as circular, handbill, or public notice.[35] The principal provisions of the act which related to the prospectus required that a copy of it, "or circular, handbill, or advertisement, or other such document . . . addressed to the public . . ."[36] be first submitted to the Registrar of Joint Stock Companies. The contents of the prospectus were not specified; however, promoters had to file certain information with the Registrar. The filing required: the name, location, and purpose of the company; names of the promoters, officers, and subscribers; and names of the members of the committee acting in the formation of the company.[37]

Equally important for investor protection at that time were the provisions for shareholder information, access to company books of account, selection of auditors, and limitations on activities of the directors. The companies were required to compile semiannually a "full and fair" balance sheet which was to be signed by at least three directors and "confirmed" by the auditors.[38] That document was to be made available to the shareholders who attended the general meeting.[39] If the auditors were not able to certify the balance sheet, then they were to report in person to the directors of the company.[40]

Inspection of company records by shareholders and auditors was provided for in the act but with certain limitations. Shareholders were entitled to examine the books and the balance sheet during the fourteen days which preceded the ordinary (general) meeting.[41] At other times, it was necessary for the shareholders to obtain an authorization signed by three directors. The auditors, however, were

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[33] *The Report of the Select Committee on Joint Stock Companies*, 7 B.P.P. (1844), as cited by Frankfurter, *The Federal Securities Act*, Fortune Magazine, Aug. 1933, p. 53.
[34] Joint Stock Companies Act, 1844, 7 & 8 Vict., c. 110.
[35] Joint Stock Companies Act, 1844, § 4.
[36] Joint Stock Companies Act, 1844, § 4.
[37] Joint Stock Companies Act, 1844, § 4.
[38] Joint Stock Companies Act, 1844, §§ 35, 39, 41.
[39] Joint Stock Companies Act, 1844, § 36.
[40] Joint Stock Companies Act, 1844, § 41.
[41] Joint Stock Companies Act, 1844, § 37.

granted unlimited access to the books by section 40 of the act, provided that the examinations were conducted at a "reasonable time of day."[42]

Although auditors' qualifications were not mentioned in the Companies Act of 1844, provisions for representation of stockholders by at least one auditor were made. Section 38 required that at least one auditor be appoined by the shareholders at the annual meeting. In the event that the appointee of the owners did not act or was unable to act, then the Committee of the Privy Council of Trade was authorized "to appoint an auditor on behalf of the shareholders."[43]

The other elements of the Act of 1844 which provided safeguards for the investor dealt with the activities of the company directors. The Gladstone Committee, recognizing the favored position of directors, had recommended that two major limitations be placed on directors' relations with their companies, and the restrictions were subsequently embodied in the act. First, section 27 prohibited them from borrowing from the company without shareholder approval. The second provision required members of the board who had any contracts with the company to disclose the details for scrutiny by the stockholders.

These were the main provisions of the act which were concerned directly or indirectly with securities legislation. The Joint Stock Companies Act of 1844 established one precedent for English securities control—the incorporation of the prospectus provision as part of the companies acts rather than in separate blue sky legislation. These provisions, while not advanced by present standards, represent the first principal legislative endeavors to correct stock market abuses.

Although none of the Companies Acts of the nineteenth century contained any specific reference to secondary distributions as the term is understood today, the Companies Act of 1844 did make it unlawful for any person to sell or dispose for consideration his shares until a "Certificate of Complete Registration" had been obtained by the corporation. The Certificate of Complete Registration was issued by the Registrar of Joint Stock Companies only after certain information had been filed with him. By present standards, the information filed was of limited value. For example, the promoters, in addition to giving the name and description of the company, had to reveal the amount of debt and equity capital, the number of shares, the names of subscribers and the amounts subscribed, the identity of directors, and the trustees and auditors of the company. Provided

[42] Joint Stock Companies Act, 1844, § 37.
[43] Joint Stock Companies Act, 1844, § 38.

this data and information concerning any material changes had been filed with the Registrar, it was not necessary to receive any clearance for the equivalent of a secondary issue.

After a serious setback in 1847 and one of lesser consequence in 1856, securities legislation tended to evolve gradually in answer to the needs of the time. In 1847, Parliament removed the necessity of "registration of such prospectuses and advertisements" on the ground that they were "found to be very burdensome to the promoters of such companies."[44] The omission of this important procedure was not corrected until the Companies Act of 1900.[45] More backtracking occurred in 1856 when the compulsory audit and the necessity for Board of Trade approval of the company auditors were eliminated. The annual audit was not again compelled by law until the Act of 1900; however, most companies continued to require an annual audit by including a provision for it in the company bylaws.[46]

During the remainder of the nineteenth century, only three acts had any lasting significance for securities legislation: the Companies Acts of 1862 and 1864, and the Directors' Liability Act of 1890. The Act of 1862,[47] a consolidation of previous companies acts, consisted of 212 sections and 3 schedules. Section 56 of this act empowered the Board of Trade to appoint inspectors to examine affairs of a company upon a petition of one-fifth of the company's shareholders. The results of any such examination were to be reported to the Board of Trade rather than directly to the company. The Act of 1862 also advanced the cause for adequate disclosure of public information by adoption of section 174, which gave every person the right to examine all company documents kept by the Registrar of Joint Stock Companies.

The efforts of the Act of 1864[48] to provide the public with more detailed information were soon thwarted by promoters. Section 38 of that act required that the prospectus "specify dates and names of parties" to (but not contents of) any contract made prior to the issue of the prospectus. The act not only failed to set out a time or place for examination of such contracts[49] but also failed to require that the prospectus be filed with the Registrar of Joint Stock Companies. The failure to disclose the existence of such contracts in a written solicitation (the pros-

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[44] Joint Stock Companies Act, 1847, 10 & 11 Vict., c. 78, § 4.
[45] Gower, *op. cit. supra* note 11, at 43.
[46] *Id.* at 48.
[47] Companies Act, 1862, 25 & 26 Vict., c. 89.
[48] Companies Act, 1864, 27 & 28 Vict., c. 131.
[49] Gore-Browne, A Handbook of Joint Stock Companies 128 (35th ed. 1922).

pectus was undefined at that time) to subscribers rendered the prospectus "fraudulent on the part of the promoters, directors and officers of the company knowingly issuing the same,"[50] and a subscriber relying on those statements could recover damages from any of the named parties. However, not satisfied with the loopholes contained in section 38, promoters evaded the disclosure requirements of this section by inserting a waiver of such rights in the subscriber's application for shares.[51] Another method of circumventing the disclosure requirement was simply not to make any written solicitations, although that approach was less popular because of its cumbersome nature. These two discrepancies in section 38 were to be corrected by the first two companies acts to appear in the twentieth century—the Companies Act of 1900 and the Companies Act of 1907.

In 1889, the *Derry v. Peek* case[52] emphasized the lack of protection and legal recourse available to minority stockholders against deceptions of directors. The House of Lords held in this case that a director's firm belief in a statement contained in the prospectus, in spite of the absence of reasonable grounds for belief, was a sufficient defense against the plaintiff. To close this hiatus, Parliament passed the Directors' Liability Act in 1890.[53] Under that legislation directors and others associated with the prospectus could be made liable for damages if the complaining stockholder could "show that the contract was induced by an untrue statement of a material fact, whether made innocently or not."[54] A director could still avoid liability by proving that the untrue statement was part of a report of a competent "expert."[55] The Directors' Liability Act of 1890 is now section 43 of the English Companies Act of 1948,[56] and its influence can be seen in the United States' Securities Act of 1933.[57]

III. Securities Legislation From 1900 to the Present

The Companies Acts of 1900[58] and of 1907[59] were notable from the point of view of investor protection for two reasons in particular: (1) for the first time, the acts required that the prospectus contain a respectable amount of specific information about the company and

[50] Companies Act, 1867, 30 & 31 Vict., c. 131.
[51] Gore-Browne, *op. cit. supra* note 49, at 130.
[52] [1889] 14 A. C. 337.
[53] Gower, *op. cit. supra* note 11, at 53.
[54] Gore-Browne, *op. cit. supra* note 49, at 139.
[55] *Id.* at 146.
[56] Companies Act, 1948, 11 & 12 Geo. 6, c. 38.
[57] 48 Stat. 74 (1933), 15 U.S.C. §§ 77a-aa (1958).
[58] Companies Act, 1900, 63 & 64 Vict., c. 48.
[59] Companies Act, 1907, 7 Edw. 7, c. 50.

the new offering; and (2) the acts banned the circuitous methods of avoiding many prospectus requirements. The prospectus, which was defined by section 30 of the 1900 Companies Act to include any written solicitation to the public, was required of those issuing shares on behalf of the company or on behalf of the promoters in addition to issues handled by the company itself. Section 9, filling a void left by previous legislation, made it mandatory that a prospectus be filed with the Registrar of Joint Stock Companies before being issued to the public.

The disclosure requirements of section 10 of the 1900 Companies Act marked the introduction of the prospectus as one of the most important devices of securities regulation. The "names and addresses of the vendors of any property" had to be disclosed. The number of shares or debentures issued for any property along with the disclosure of the amount paid for good will had to be set out clearly. Furthermore, the act required that the activities of directors and their business relations with the company be delineated for the information of the potential investors. Such items as names, descriptions, and addresses of directors, the number of shares each director had to own in order to qualify for that position, and the full particulars of each director's interest (if any) in the promotion had to be published in the prospectus.

Section 10 further specified that disclosures be made concerning the amount or estimated amount of organization expenses, the commissions paid for procuring subscriptions, the amounts to be paid to any promoter as well as the reason for the payment, and the names and addresses of the auditors appointed. A final item, which is considered by some to be the most important,[60] supplemented the contract disclosure requirement of section 38 of the 1867 Companies Act. The dates and parties to all material contracts (other than those entered into in the ordinary course of business) and the place where these contracts could be examined were required to be set out in the prospectus.[61]

With the aid of section 10 of the 1900 Companies Act, the word "prospectus" took on a new meaning and use for the investment world. The current prospectus requirements of securities legislation in England, the United States, and Canada may be traced to that very section.

Parliament inadvertently left open to unscrupulous promoters one major method of evading disclosure requirements. The provisions of

[60] Gore-Browne, *op. cit. supra* note 49, at 126.
[61] Companies Act, 1900, 63 & 64 Vict., c. 48, § 10(k).

section 10 applied only if a prospectus were issued. Hence if a promoter desired to evade disclosure, he could do so by confining all offers to sell to oral solicitations. Although this placed a burden on sales efforts, it made it even more difficult for a complaining stockholder to sue the promoter or directors. The situation was rectified when the Companies Act of 1907 introduced a new requirement known as the "Statement in Lieu of Prospectus."[62] It compelled any public company which did not issue a prospectus to the public to make known its affairs by filing with the Registrar a "Statement in Lieu of Prospectus." That document had to be signed by every director or proposed director and contain virtually the same information that would be required in a prospectus. Any allotment of shares or bonds made before filing a "Statement in Lieu of Prospectus" was voided by section 1 of the Companies Act of 1907.

The mass of company legislation which had been enacted after 1862 was consolidated in the Companies (Consolidation) Act of 1908. That act and the company legislation which preceded it were the major sources, up to that time, from which securities legislation in Anglo-Saxon countries has been drawn. The more recent developments in English company law have had less influence in shaping securities regulation in the United States and in Canada.

[62] Companies Act, 1907, 7 Edw. 7, c. 50.

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