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Seymour Arthur Casper

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A Symposium on The Proposed Federal Securities Code

Foreword

SEYMOUR ARTHUR CASPER*

A symposium on the American Law Institute's proposed Federal Securities Code[1] was held at Pace University School of Law on April 20, 1980. Distinguished panelists[2] examined the version of the proposed Code then under discussion and analyzed the possible impact the Code may have on certain substantive areas of securities law: registration and disclosure, exemptions, damages, authority of the Securities and Exchange Commission, and enforcement of private rights of action under the Code's anti-fraud and civil liability provisions. In view of recent developments,

* Professor of Law, Pace University School of Law, and Institute Chairman; LL.M., 1948, New York University Law School; 1943, New York University Law School; B.A., 1941, New York University.

1. ALI FED. SEC. CODE (1980) (Official Draft). While some speakers referred to the 1980 draft, others referred to the 1978 draft of the proposed Code. ALI FED. SEC. CODE (1978) (Proposed Official Draft). Where a speaker has used the 1978 draft, the footnotes to that speech compare the cited provisions to the parallel provisions in the 1980 draft when the changes in the latter version are significant.

2. Barbara Black, Assistant Professor of Law, Pace University School of Law; Arnold Jacobs, Esq., partner, Shea & Gould, N.Y.; Fredric J. Klink, Esq., member, Schreiber, Klink, Schreiber, Lenhardt & Carney, N.Y.; Lewis D. Lowenfels, Esq., partner, Tolins & Lowenfels, N.Y.; Franz F. Opper, Esq., Counsel, Subcommittee on Commerce and Finance, House Committee on Interstate and Foreign Commerce, Washington, D.C.; Robert C. Pozen, Esq., Partner, Caplin & Drysdale (at the time of this speech, Associate General Counsel, Securities and Exchange Commission, Washington, D.C.); David L. Ratner, Professor of Law, Cornell University Law School; Joseph B. Russell, Esq., Staff Attorney, CBS, Inc., N.Y.; Hugh L. Sowards, Distinguished Professor of Law, University of Miami Law School and Chairman of this Symposium; Lee B. Spencer, Esq., Associate Director, Division of Corporate Finance, Securities and Exchange Commission, Washington, D.C.

namely, the announced decision of the Commission to support the Code,[3] it would appear that these discussions are very timely.

The Code represents the first major attempt to integrate the present federal securities laws, which consist of seven different statutes.[4] At the behest of Professor Louis Loss of Harvard Law School, an outstanding authority on securities law, the American Law Institute agreed that a recodification of these seven securities laws was essential. In 1970, Professor Loss was appointed the Reporter to accomplish this objective, and he, with certain select advisers and consultants, completed a ten-year endeavor to consolidate these securities statutes. The American Law Institute approved the Proposed Official Draft at its annual meeting in May, 1978,[5] and in February, 1979, the House of Delegates of the American Bar Association approved the proposed Code in that form and recommended Congressional enactment.[6] In the words of Professor Loss, the "Code has three principal aims: (1) simplification of a complex body of law . . . ; (2) elimination . . . of duplicate regulations; and (3) re-examination of the entire scheme of investor protection with a view to increasing its efficiency . . . ."[7]

The Commission concluded a two-year study of the proposed Code as approved by the ALI and ABA, and, after extensive review, has recently announced its support of the Code.[8]

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3. SEC Sec. Act Release No. 33-6242 , 20 SEC Docket 1483, 1483 (1980) [hereinafter cited and referred to as CODE RECOMMENDATION].

Included in this release are the Commission's statement, *Statements Concerning Codification of the Federal Securities Laws,* and two documents prepared by Professor Louis Loss: Appendix A, which describes the changes to the Official Draft of the American Law Institute's proposed Federal Securities Code agreed upon by the Commission, Professor Loss and his advisers; and Appendix B, a letter from Professor Loss to the Advisers and Consultants on the Federal Securities Code, which contains his comments on the agreed upon changes.

4. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1976); Investment Adviser's Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1976); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1976); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1976); Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976).

5. 454 SEC. REG. & L. REP. (BNA) A-1 (1978).

6. 491 SEC. REG. & L. REP. (BNA) A-14 (1979).

7. ALI FED. SEC. CODE, at xix (1980) (footnote omitted).

8. CODE RECOMMENDATION, *supra* note 3, at 1484. The Commission has indicated

Presumably, Professor Loss and his advisers have hurdled a major obstacle. This should clear the way for introduction of the Code in Congress very shortly. The Commission's imprimatur was not, however, achieved without some compromise on the part of the Code's adherents.[9] The changes in the Official Draft, set forth in a Securities and Exchange Commission release,[10] with Professor Loss's commentary appended, represent apparent agreement among the Commission, Professor Loss and his advisers.[11] Remarkably, the vast majority of the approximately 60 changes were what Professor Loss termed either "minor" or "technical." Some of the major changes are summarized below.[12]

I. The One-year Registrant—Limited Offerings and Secondary Distributions: §202(41)(B)(iv) and §510(d)(2)

Central to the Code's registration process is the concept of a "one-year registrant."[13] A company would qualify for this status by being registered for at least a year during which time certain information about the company has been made public. Once established as a one-year registrant, a company would receive more favorable treatment under the Code; provisions relating to

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that any significant changes introduced during the legislative process may cause it to reassess its position with respect to the Code. *Id.* at 1485.

9. 571 Sec. Reg. & L. Rep. (BNA) A-1 (1980).

10. Code Recommendation, *supra* note 3.

11. Letter from Professor Louis Loss to the Advisers and Consultants on the Federal Securities Code (Sept. 18, 1980), *reprinted in* Code Recommendation, *supra* note 3, at 1509. Professor Loss summarized the advantages of Commission support as follows:

> On the one hand, the advantages of going to Congress with the Commission's support are obvious. On the other hand, the price of such support, we have always recognized, would be too high if the results were perceived to be essentially an SEC-dictated Code rather than the version approved by the ALI and the ABA. Accordingly, the working group sought to demonstrate to the people on the SEC side the logic and soundness of the positions contemplated by the Official Draft, as well as the vital necessity of maintaining a balance. And (to their great credit if I may say so) the Commission ultimately agreed with or came close to the group's position on many of the staff's proposals.

Id. at 1510-11.

12. Professor Loss categorized the changes in his letter to the members of his committee. *See* note 11 *supra*. The changes discussed in the text of this foreword are the six changes Professor Loss characterized as "more substantial." Code Recommendation, *supra* note 3, at 1511-12.

13. ALI Fed. Sec. Code § 202(113) (1980). *See generally* 567 Sec. Reg. & L. Rep. (BNA) AA-3 (1980).

registration for limited offerings and secondary distributions would apply more favorably to a one-year registrant than to a new issuer or to an unregistered company.[14]

This special treatment is premised upon the efficient market theory, which postulates that if a company has been registered for a year or more, relevant investment information would have reached the market place and would be reflected in the price of the securities.[15] The Commission, however, questioned the legitimacy of this concept when applied to any but the largest companies.[16]

To alleviate the Commission's concerns, Professor Loss agreed to add section 202(41)(B)(iv)[17] and to modify section 510(d)(2) of the Code.[18] The suggested version of section

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14. ALI FED. SEC. CODE § 202(41)(B) (1980). *See also* Spencer, *Issuer Registration and Distributions,* 1 PACE L. REV. 299, 305-07 (1981).

15. 567 SEC. REG. & L. REP. (BNA) AA-3 (1980). In this report the general counsel to the Securities and Exchange Commission articulates this philosophy in explaining the agency's approach to the Code. *Id.*

16. The general counsel explains the Commission's reservations as follows: "As a factual matter, [dissemination of information to the community about all one-year registrants] is true for only the largest companies. For the small, the regional, or thinly traded companies, the predicate is not as strong." *Id.* at AA-4.

17. CODE RECOMMENDATION, *supra* note 3, at 1486. Suggested section 202(41)(B)(iv) provides:

> (iv) When the issuer is a one-year registrant, the Commission may require, by rule, that the most recent annual report and all subsequent reports sent to security holders under section 602(a)(2) be sent or delivered, not later than the sale, to each initial buyer within section 202(41)(B) other than an institutional investor, except that section 202(41)(B)(iv) does not apply if—
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> (i) the security is traded on a national securities exchange designated by rule or order, is included in services rendered by an electronic interdealer quotations system so designated, or is a qualified security within section 1005(a); or (ii) the issuer is a three-year registrant (that term being defined as if section 202(113) referred to three years) and the offering is for the account of a person other than the issuer.

18. ALI FED. SEC. CODE § 510(d)(2) (1980). Section 510(d)(2) of the proposed Code provides:

> (d) CONTENTS OF DISTRIBUTION STATEMENT AS USED.—When a distribution statement is used, it need not contain the certification specified in § 510(c)(3) and the Commission, by rule, . . . (2) may require, if the issuer did not have at least $100,000 of total assets and one thousand holders of its securities (other than exempted securities within section 302) as of the last day of each of its two preceding fiscal years, that the most recent annual report and all subsequent reports under section 602(a) that are on file be physically attached to the distribution statement.

The suggested version of section 510(d)(2) provides:

202(41)(B)(iv) gives the Commission additional rule-making power with respect to a limited offering by a one-year registrant: the Commission may, under this section, require that annual reports be delivered to certain purchasers of securities in a limited offering or in a secondary distribution, under section 510(d)(2), if the securities were thinly traded.[19] A limited offering as defined in section 202(41)(B) would not normally have to be registered with the Commission. Under the Code's exemptive provision, sales may be made to an unlimited number of institutional buyers and up to 35 others. This change does not apply to traded securities or to a secondary limited offering when the issuer has been registered for three years.[20]

The Commission was also dissatisfied with the simplified registration procedures provided for secondary distributors of the securities of a one-year registrant in section 510 of the Code.[21] Under the Code's scheme, a secondary distributor "would be allowed to file a distribution statement . . . containing information about the distributor rather than the issuer."[22] An offering statement would not have to be filed because, theoretically, information about a one-year registrant would already be on file. The Commission voiced concern that this might allow a major secondary distribution to be made when sufficient information about the issuer was unavailable.[23] The version agreed upon by Professor Loss and the Commission would limit the exemption for secondary distributions in situations where the distributor

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(d) Contents of Distribution Statement as Used.—When a distribution statement is used, it need not contain the certification specified in section 510(c)(3) and the Commission, by rule . . .

(2) may require that the issuer's most recent annual report and all subsequent reports sent to security holders under section 602(a)(2) be physically attached to the distribution statement if (A) according to the issuer's most recent report filed or sent under section 602(a)(1) or (2) there were fewer than one thousand holders (or whatever smaller number is specified by rule) of each class of security covered by the distribution statement, or (B) the aggregate market value of the issuer's outstanding voting securities not held by its controlling, controlled, or commonly controlled persons did not equal at least whatever amount is specified by rule.

CODE RECOMMENDATION, *supra* note 3, at 1490.

19. CODE RECOMMENDATION, *supra* note 3, at 1486, 1491.

20. *Id.* at 1486, 1512.

21. *Id.* at 1491, 1511.

22. 567 SEC. REG. & L. REP. (BNA) AA-4 (1980).

23. *Id.*

has a control relationship to the issuer or is controlled by the issuer.[24] This, of course, retains the control concept which is prevalent in the existing securities laws, but which the Code seeks to avoid.[25] In addition, a stricter test was inserted to determine when a market adequately reflects a one-year registrant's continuous disclosure in order to qualify for formal treatment under section 510(d)(2).[26]

II. Insider Trading: §1603(a)

Section 1603(a)[27] of the Code was changed to reflect the Commission's preference for the current standard of a "material facts" test in any Securities and Exchange Commission injunctive or administrative actions (but not in criminal actions) involving insider trading or "tippees," instead of the Code's "fact of special significance" test, which would remain applicable in private and criminal actions under the Code. Accordingly, the Commission would continue to be able to proceed against any "insider" who trades in a security with knowledge of a "material fact" not "generally available" in the market place. But in pri-

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24. CODE RECOMMENDATION, *supra* note 3, at 1491.

25. *Id.*

26. *Id.* at 1490-91.

27. ALI FED. SEC. CODE § 1603(a) (1980). Section 1603(a) provides as follows:

> (a) GENERAL.—It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available, or (2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise.

The revised version of this section provides as follows:

> (a) General.—It is unlawful for an insider to sell or buy a security of the issuer, if he knows a material fact with respect to the issuer or the security that is not generally available, unless—
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> (1) the insider reasonably believes that the fact is generally available;
>
> (2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise; or
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> (3) the insider proves that the fact is not a fact of special significance, except that this defense is not available in an action or proceeding by the Commission under section 1809, 1810, 1811, 1812, 1815, or 1819(a).

CODE RECOMMENDATION, *supra* note 3, at 1495.

vate actions, a plaintiff would be required to prove that the misrepresentation or omitted fact was "material" to a reasonable person in making an investment decision or would be likely to affect the market for such security to a significant extent. The defendant must counter by showing that the "material fact" is not of "special significance."[28]

III. Annual Report Liability: §1705

Misstatements or omissions made with respect to a registration of securities are currently punishable under section 11 of the Securities Act of 1933, as amended.[29] Under this section, the issuer has the burden of showing that it exercised due diligence to prevent any misstatement or omission from its registration material.[30] Because of the change in the Code from registration of securities to registration of companies, with the increasing importance attached to the annual report, the Code drafters initially decided that annual report liability should be provided for in section 1704, as a successor to section 11 of the 1933 Act, rather than section 1705, the more general anti-fraud provision.[31]

After much controversy within the ALI and disagreement by the ABA, the drafters decided that the Code would not take any position with respect to annual report liability and would leave the matter to Congress.[32]

Under the compromise accepted by the Commission, a plaintiff would have the burden of proving that an annual report contains a misrepresentation or omission; but the defendant could assert lack of scienter as a defense.[33] In addition, a provi-

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28. CODE RECOMMENDATION, *supra* note 3, at 1495, 1512. BUS. WEEK, Aug. 11, 1980, at 36; Wall St. J., July 31, 1980, at 3, col. 2.

29. Securities Act of 1933, § 11, 15 U.S.C. § 77k (1976).

30. *Id.*

31. ALI FED. SEC. CODE § 1704-1705, Introductory Comments (1980).

32. 567 SEC. REG. & L. REP. (BNA) AA-5 (1980).

33. CODE RECOMMENDATION, *supra* note 3, at 1497-98. The texts of the recommended sections 1704(a), 1705(a), 1705(f) are set forth in the CODE RECOMMENDATION as follows:

Sec. 1704. (a) Scope of Section.—Section 1704 applies (whether or not the particular registration has terminated or been withdrawn) on proof that an effective registration statement, an effective offering statement as of the date specified in section 509(2) or (3), or a report filed under section 602(a)(1) and incorporated by reference in any such filing (1) contained a misrepresentation, or (2) omitted a

sion was added to section 2003 of the Code which would make it unlawful for directors, who are required by Commission rule to sign an annual report, to do so unless they had first made a reasonable investigation of the contents of that report.[34] There would be no civil liability for failure to make such investigation, except in a Commission proceeding.[35]

IV. Damages: §1708(b)(2) and §1708(b)(4)

The Code initially placed arbitrary limits of $100,000 (or one percent of gross income up to $1,000,000 in the case of a company) on the amount of the defendant's profit on the recovery that may be obtained from a single defendant for false filings, false publicity or certain other misstatements or omissions.[36] The Commission opted to increase the $100,000 to $200,000 and the $1,000,000 to $2,000,000, and then provided that these limitations shall not apply if the defendant made a misrepresentation with knowledge or omitted a material fact or

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material fact or material document required.

Id. at 1497.

Sec. 1705. (a) Scope of Section.—Section 1705(b) to (e) inclusive applies (whether or not the particular registration has terminated or been withdrawn)—

(1) on proof that—

(A) a filing by a registrant (other than a filing within section 1704(a) or 1705(f) contained, as of the date the filing was filed (or became public if it was not public immediately); or

Id.

(F) [sic] False Annual Reports.—(1) section 1705(f) applies (whether or not the particular registration has terminated or been withdrawn) on proof that an annual report under section 602(a)(1) contained a misrepresentation as of the date the report was filed (or became public if it was not public immediately).

(2) All the persons specified in section 1704(b)(1) to (5) inclusive are liable for damages.

(3) Section 1705(c)(2) to (e) inclusive applies, except that a defendant has an additional defense if he proves lack of scienter. A violation of section 2003(c)(4) does not of itself preclude such a defense.

Id. at 1498.

34. CODE RECOMMENDATION, *supra* note 3, at 1508. Section 2003(c)(4) of the suggested version provides:

(4) It is unlawful for a director to sign an annual report pursuant to section 602(a)(1) unless he has made a reasonable investigation of its contents. Section 1704(g) applies for purposes of determining the standard of reasonableness.

35. *Id.* at 1509.

36. ALI FED. SEC. CODE § 1708(c)(2) (1980).

material document with knowledge.[37] According to the Commission, the numerical limitations were doubled to give effect to inflation.[38]

The Code also limited the measure of recoverable damages from an insider or one engaging in market activities on the basis of inside information.[39] Under section 1708(b)(3) of the Official Draft, the measure of damages in such cases would be limited in terms of the amount of securities that the insider had traded, so that his only risk would be the possibility of surrendering his ill-gotten gains.[40] The Commission decided an additional deterrent was necessary to prevent insiders from taking advantage of their information to the prejudice of innocent security holders.[41] Under suggested section 1708(b)(4), the court may increase the measure of damages in such cases to an amount not to exceed 150 percent of the amount computed under section 1708(b)(1) to (3) inclusive.[42]

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37. CODE RECOMMENDATION, *supra* note 3, at 1500.

38. *Id.*

39. ALI FED. SEC. CODE § 1708(b) (1980). This section provides:

(b) FOR SECTION 1703(b).—The measure of damages under section 1703(b) is computed as in section 1708(a), except that—

(1) sections 1703(h)(1)(B), 1708(a)(1)(A), and 1708(a)(2)(A) do not apply;

(2) the measure is reduced to the extent (which may be complete) that the defendant proves that the violation did not cause the loss; and

(3) the measure (apart from any assessment of consequential damages or costs under section 1723(a) and (d)) is limited as if all the plaintiffs, together with all the members of the class in the case of a class action, had bought (or sold) only the amount of securities that the defendant had sold (or bought).

40. *Id.*

41. CODE RECOMMENDATION, *supra* note 3, at 1499.

42. *Id.* Section 1708 of the 1980 draft, *supra* note 39, has been expanded by the addition of Section 1708(b)(4) as follows:

(4) in an action for violation of—

(A) section 1602(a)(1) or 1613 in which the plaintiff proves a fraudulent act or a misrepresentation made with knowledge;

(B) section 1602(b)(1)(A) in which the plaintiff proves that the uncorrected statement became a misrepresentation made with knowledge; or

(C) section 1603(a), the court in its discretion, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), may increase the measure of damages to an amount not in excess of 150 percent of the amount computed under section 1708(b)(1) to (3) inclusive; but section 1708(b)(4)(A) and (B) does not apply to the extent that the plaintiff recovers under section 1705 or 1707, and section 1708(b)(4)(C) does not apply to the extent that section 1705(a)(2) applies.

V. Local Distributions: §514

One of the exemptions contained in the Securities Act of 1933 is the intrastate exemption found in section 3(a)(11), which provides an exemption from the registration requirements of the 1933 Act for

> [a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.[43]

Some four years later, the Commission adopted rule 147 to provide, among other things, more certainty in determining when the exemption provided by section 3(a)(11) is available.[44]

Under section 3(a)(11) of the Securities Act of 1933, the exemption is unavailable if a single sale is made to a nonresident. Section 514 of the Code, which is the proposed successor to section 3(a)(11), provides that the exemption shall be available notwithstanding the sale of up to 20 percent of the offered securities to residents outside the state or geographic region specified by rule as a local area.[45] The Commission, in viewing the Code, agreed to an increase in the percentage of securities which must be offered to residents from 80 percent to 95 percent, thus allowing 5 percent of the offered securities (instead of 20 percent) to be offered to nonresidents.[46]

VI. Good Faith Defense: §1702(c)

The good faith defense provided in the Code[47] for defendants charged with illegal sales and purchases has been deleted in its entirety. Professor Loss conceded that "it would . . . have

43. Securities Act of 1933, § 3(a)(11), 15 U.S.C. §§ 77c(a)(11) (1976).

44. 17 C.F.R. 230.147 (1980).

45. ALI Fed. Sec. Code § 514 (1980).

46. Code Recommendation, *supra* note 3, at 1492.

47. ALI Fed. Sec. Code § 1702(c) (1980). Section 1702(c) of the Code provides:

(c) Mitigation Defense.—If a defendant in an action under section 1702 proves

(1) that he acted honestly and reasonably, and (2) that any illegality on his part was inadvertent and did not substantially threaten the purposes of this Code, the court may deny or modify rescission or limit damages to the extent that justice requires.

complicated litigation under the otherwise strict liability approach of section 1702, and . . . the Code reduces much of both the vagueness and absolutism of the underlying substantive law!"[48]

As chairman of the Securities Regulation Institute, I must express my grateful appreciation to Professor Hugh L. Sowards, who acted as chairman of this symposium, and to all the other speakers and panel members: Professor David Ratner, Arnold Jacobs, Fredric J. Klink, Lewis D. Lowenfels, Franz I. Opper, Robert C. Pozen, Lee B. Spencer, Jr., Joseph B. Russell, and Professor Barbara Black, all of whom are outstanding legal scholars and who attended and participated at some individual sacrifice. *Pace Law Review* is also to be commended for its decision to publish the proceedings of this timely symposium as a contribution to current legal thought.

48. CODE RECOMMENDATION, *supra* note 3, at 1512.