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Hugh L. Sowards

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A Symposium on the Proposed Federal Securities Code: An Introduction

HUGH L. SOWARDS*

On April 18, 1980, a symposium on the American Law Institute's proposed federal Securities Code[1] was held under sponsorship of the Pace University School of Law. Symposium participants included recognized scholars and practitioners in the area of securities regulation and some of the most experienced and capable members of the staff of the Securities and Exchange Commission.

It is common knowledge that the road traveled by the Code has not been a smooth one. Prior to the approval of the Proposed Official Draft by the American Law Institute in May 1978, sharp controversy, especially with respect to the Code's civil liability provisions, existed among Institute members and the American Bar Association's Section of Corporation, Banking and Business Law.[2] Additionally, adverse criticism had been voiced by commentators,[3] securities regulation institutes,[4] a veteran Securities and Exchange Commissioner,[5] and the press.[6]

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* Chairman, Securities Regulation Institute, Pace University School of Law, 1980; J.D., 1966, Yale; LL.B., 1946, Yale; B.S., 1941, Trinity College; Distinguished Professor of Law, University of Miami Law School.

1. ALI FED. SEC. CODE (1978) (Proposed Official Draft). In 1980, the American Law Institute published the Official Draft of the Code. ALI FED. SEC. CODE (1980) (Official Draft).

2. In February, 1979, the House of Delegates of the American Bar Association approved the Code and unanimously recommended enactment of the Code by Congress.

3. *See, e.g.*, Lowenfels, *The Case Against the Proposed Federal Securities Code*, 65 VA. L. REV. 615 (1979).

4. *See, e.g.*, Symposium, 33 U. MIAMI L. REV. 1425 (1979).

5. 484 SEC. REG. & L. REP. (BNA) AA-2 (1978).

6. *See, e.g.*, Anreder, *Cut Your Losses? Critics Make a Case Against the Proposed Securities Code*, Barron's, Feb. 26, 1979, at 7; Schorr, *Overhauling the Securities Laws*, Wall St. J., Dec. 21, 1978, at 16, col. 4; *Codifying Securities Law*, Wall St. J., Feb. 20, 1979, at 16, col. 1.

The Securities and Exchange Commission has completed almost two years of study of the Code by its commissioners and staff. It has been reported that the proposed legislation has been viewed by Securities and Exchange officials with varying degrees of en-

The Code, of course, represents a ten-year effort to recodify, in an integrated form, the several securities laws enacted by Congress.[7] Father of the 824-page Proposed Official Draft is Professor Louis Loss, universally recognized as the foremost authority on American securities regulation.[8] Indeed, irrespective of the final results of this prodigious effort, securities attorneys everywhere owe a special debt of gratitude to this scholar for his laudable idea of treating the patchwork of federal securities laws "as a single piece of legislation,"[9] his clarity of thought, as reflected in drafting the Code, his books and articles, and, above all, his enthusiasm. ("There will be a Code. There are some things that one feels in his bones.")[10] and his persistence in

thusiasm, and that the Commission obtained significant changes in several sections of the Code in negotiations with Professor Loss and his ALI advisers. *See* 567 SEC. REG. & L. REP. (BNA) AA-1 (1980); BUS. WEEK, Aug. 11, 1980, at 36, col. 2; Schorr, *Plan to Rewrite Federal Securities Laws Appears Close to Being Endorsed by SEC,* Wall St. J., July 31, 1980, at 3, col. 2.

At a public meeting on Sept. 18, 1980, the Commission gave its endorsement to the Code. On Sept. 30, 1980, the Securities and Exchange Commission published, in an agency release, changes to the 1980 draft which were agreed upon by Professor Loss and the Commission. SEC Sec. Act Release No. 33-6242, 20 SEC Docket 1483 (1980) [hereinafter referred to and cited as CODE RECOMMENDATION]. Subcommittee hearings, after introduction of the bill, may commence in 1981. The negotiated changes include: granting the Securities and Exchange Commission the power to adopt rules requiring that prospective purchasers, both in private offerings and in secondary offerings by control persons, receive the latest annual reports of unlisted and non-NASDAQ traded companies; increasing the maximum penalty for insider trading profits from 100 percent to 150 percent; retaining the "no-scienter" requirement in Securities and Exchange Commission injunctive actions; and modifying the "materiality" standard of proof in public and private fraud actions. CODE RECOMMENDATION, *supra. See also* Wall St. J., Sept. 19, 1980, at 4, col. 2.

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

8. It has been reported that the work of Professor Loss and his panel of advisers, "if billed at normal rates, would amount to about $3 million worth of free time." 450 SEC. REG. & L. REP. (BNA) A-1 (1978). Additionally, the Commission staff "has devoted more than 8,000 hours to the painstaking process of analyzing the Code, and in private and public meeting with Loss's panel." BUS. WEEK, Aug. 11, 1980, at 36.

9. L. LOSS, SECURITIES REGULATION vi (1st ed. 1951), quoted in ALI FED. SEC. CODE at xv, n. 2 (1978).

10. Loss, *Keynote Address: The Federal Securities Code,* 33 U. MIAMI L. REV. 1431, 1450 (1979).

striving for simplified securities regulation without diminished investor protection.

It is fair to state that, at least in my opinion, the reaction of the panelists to the Code was a mixed one. Commission panelists, on the whole, voiced approval, but expressed concern that the Code jeopardized investor protection in specific areas.[11] On the other hand, the remaining panelists, for the most part, were concerned with what they view as the Code's unnecessarily broad grant of rule-making power to the Commission.[12]

Lee Spencer's comments on the one-year registrant concept are indicative of his desire for a high level of investor protection:

> the one-year registrant concept goes much further than the theories employed to date by the Commission. . . . The present Commission guidelines [for the use of abbreviated forms] are based on the assumption that logical lines can still be drawn between those companies whose periodic information can be digested by the market and other companies for which it is unrealistic to make such an assumption.[13]

He also expressed concern for what he regards as the Code's absence of protective safeguards for purchasers in both limited offerings and in secondary sales by controlling persons.[14] Similar concern, with respect to the Code's apparent limitation on damages and rights to rescission, was expressed by Robert C. Pozen.[15]

Fredric J. Klink's presentation on scienter was both scholarly and practical.[16] With respect to the Code, Mr. Klink ob-

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11. *See* Spencer, *Issuer Registration and Distributions*, 1 PACE L. REV. 299, 307 (1981); Pozen, *An Overview of the Proposed Code's Treatment of Private Causes of Action and Damages*, 1 PACE L. REV. 355 (1981).

12. *See, e.g.*, Lowenfels, *The Proposed Securities Code: A Sweeping Grant of Power to the Securities and Exchange Commission*, 1 PACE L. REV. 335, 338 (1981).

13. Spencer, *supra* note 11, at 307.

14. *Id.* at 308-09.

15. Pozen, *supra* note 11, at 361-63.

16. *See* Klink, *The Scienter Standard of Liability under the Proposed Federal Securities Code*, 1 PACE L. REV. 373 (1981). Shortly after the Pace University symposium, the Supreme Court handed down its decision in *Aaron v. SEC*, holding that the Commission must establish scienter in a civil enforcement action brought to enjoin violations of section 17(a)(1) of the 1933 Act and section 10(b) and rule 10b-5 of the 1934 Act. The Commission, however, need only establish negligence as an element of an action to enjoin violations of sections 17(a)(2) and 17(a)(3) of the 1933 Act. Aaron v. SEC, 446 U.S. 680 (1980).

served that Part XVII contains all of today's express civil liabilities as well as the most frequently implied liabilities; that section 1722 authorizes the courts, under certain conditions, to imply private actions not expressly included in the Code.[17] Scienter is traced in terms of actual knowledge as well as in the "intent to deceive" terms of *Ernst & Ernst v. Hochfelder*.[18] The closely related problem of whether scienter includes reckless behavior is capably discussed.

Arnold Jacobs gave an intelligent and careful presentation on the difficult topic of measure of damages under present law and under the Code.[19] He pointed out that there are "more than 30 measures of damages which have been identified in rule 10b-5 cases alone."[20] Rather than comparing each with the damage measures provided by the Code, Mr. Jacobs hypothesized a case and used it as a fact pattern for contrasting the extent of current legal liability with that proposed in the Code. The bottom line, so to speak, was his feeling that the former "overlapping remedies . . . which gave a plaintiff the maximum possible recovery would no longer be available . . . [and] the inclusion of precise definitions of the damage remedies in the Code eliminates judicial flexibility."[21]

To Professor David L. Ratner fell the task of commenting on the exemptive provisions of the 1933 Act and those proposed under the Code.[22] It is perhaps an understatement to say that he did a masterful job. The exemptive provisions have excited much comment, especially in recent years, for it is by using these provisions that countless new and small businesses obtain venture capital—their "seed" money.

Perhaps the most controversial of these exemptions has been the one for private offerings. The checkered career of this exemption — from the original statutory language in section

17. Klink, *supra* note 16.

18. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

19. *See* Jacobs, *The Measure of Damages Under the Proposed Code*, 1 PACE L. REV. 385 (1981). Professor Loss had this to say on the Code as it relates to damages: " 'The Code lets just about anybody sue anybody,' . . . but it imposes limits on damage awards." Wall St. J., Sept. 19, 1980, at 4, col. 2.

20. *See* Jacobs, *supra* note 19, at 385.

21. *Id.* at 394.

22. *See* Ratner, *Exemptions to the Disclosure Requirements*, 1 PACE L. REV. 319 (1981).

4(2) ("transactions by an issuer not involving any public offering"),[23] through the Supreme Court's *Ralston Purina* interpretation requiring sophistication ("able to fend for themselves"),[24] through subsequent administrative[25] and judicial[26] gloss involving access to that kind of information which would appear in a registration statement and other factors,[27] to the adoption of rules 146[28] and 242[29] — underscores the mounting confusion that grew with the passing years. Professor Ratner, after viewing this history, concluded that the infamous rule 146, which supposedly furnished a more "objective" test of exempt securities, "managed to achieve the worst of both worlds."[30] More than that, rule 146 created new levels of complexity and at the same time created a lengthy series of traps.[31]

Finally, Professor Ratner notes the adoption of rule 242 as a definite improvement.[32] Section 242 of the Code is closely parallel to the rule, but is faulted by Professor Ratner for its comparative lack of flexibility.[33] Both the section and the rule abandon

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23. Securities Act of 1933, § 4(2), 15 U.S.C. § 77(d)(2) (1976).

24. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

25. *See, e.g.*, SEC Sec. Act Release No. 33-4522 (Nov. 6, 1962); SEC Sec. Act Release No. 33-5487 (Apr. 23, 1974).

26. *See, e.g.*, Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); Doran v. Petroleum Mgt. Corp., 545 F.2d 893 (5th Cir. 1977); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971); Bowers v. Columbia Gen. Corp., 336 F. Supp. 609 (D. Del. 1971).

27. Such other factors have included: number of purchasers or offerees, dollar amount of offering, ability to bear the loss, use of underwriters, use of advertising materials, integration of other offerings, restrictions on resale. *See* D. RATNER, SECURITIES REGULATION 271 (2d ed. 1980).

28. Rule 146 was originally adopted in 1974 and has been amended since. For the current version of this rule, *see* 17 C.F.R. § 230.146 (1980).

29. Rule 242 was adopted in January 1980. For the text of this rule, *see* 17 C.F.R. § 230.242 (1980).

30. *See* Ratner, *supra* note 22, at 327.

31. *Id. See, e.g.*, Kripke, *SEC Rule 146: 'A Major Blunder,'* N.Y.L.J., July 5, 1974 at 1, col. 3; *Symposium*, 33 U. MIAMI L. REV. 1425, 1427-28 (1979).

32. See Ratner, *supra* note 22, at 328. Rule 242, which is quite similar to section 242 of the Code, permits certain corporate issuers to offer and sell up to $2 million per issue of their securities in any six month period to an unlimited number of "accredited persons" and to 35 other persons, without registration. 17 C.F.R. § 230.242 (1980).

33. *See* Ratner, *supra* note 22, at 329. In this connection, the stated purpose of rule 242 was to facilitate capital formation for small business. But, at this writing, the Commission does not include venture capitalists in rule 242 as "accredited persons." Inasmuch as venture capitalists are among the main sources of seed money for new ventures, are financially sophisticated, well financed, and have access, could they not be listed as

the *Purina* test, and, in questioning this change, Professor Ratner wonders: "Is it fair to cheat people so long as you don't cheat more than thirty-five?"[34]

With respect to the intrastate exemption afforded by section 3(a)(11) of the 1933 Act, rule 147, as well as restrictive interpretations, have narrowed the exemption to the point where its use by the careful practitioner and his business clients is highly questionable. Put another way, in its quest for objectivity, the Commission has unduly restricted issuers to the point where use of the intrastate exemption may be both undesirable and unworkable. Among other conditions, all of which must be satisfied for the exemption to be available under rule 147, the issuer, must: (1) derive at least 80 percent of its gross revenues (and those of its subsidiaries on a consolidated basis) from the operation of a business or property located or rendering services within the state; (2) have at least 80 percent of its assets located within the state prior to the first offer of any part of the issue; (3) intend to use at least 80 percent of the net proceeds of the issue in connection with the operation of a business or property or rendering of services within the state; and (4) have its principal office within the state.[35] These conditions plus the onerous burden of policing resales and the imposition of mandatory precautions, mean, that for practical purposes, there is no longer a viable intrastate securities transaction exemption. Indeed, earlier drafts of the Code did not provide for an intrastate exemption.[36]

As Professor Ratner points out, the intrastate exemption

> has now reappeared as the exemption for local distributions in section 514 [of the Code]. This, in effect, is the old intrastate offering exemption with fringes. Instead of all offerees having to be in the same state, the Code provides that as long as 95 percent of

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accredited persons, even without abandoning the elements of the *Purina* test?

34. *See* Ratner, *supra* note 22, at 329. "The most serious problem of the Code approach . . . is that specific tests would be written into the statute. . . . [F]or Congress to draw a precise line, and keep changing that line as conditions change, is very difficult." *Id.*

35. 17 CFR § 230.147 (1980).

36. "If all of these strictures were strenuously enforced, the exemption would be virtually a dead letter . . . , the exemption should either be repealed or loosened up a bit." ALI FED. SEC. CODE § 301, Comment (1972) (Tentative Draft No. 1).

> the purchasers buying at least 80 percent of the securities are within a single state or within a geographical area (which the Commission would have power to define), an offering can be made without any disclosure or registration.[37]

But he quite properly questions the effectiveness of state regulation when state lines are crossed.[38]

The sharpest criticism aimed at the Code came from Lewis D. Lowenfels.[39] Indeed, the bottom line of his criticism was: "I would oppose the Code. . . . I do not think that [it] adds anything substantial."[40] One cannot merely dismiss Mr. Lowenfels's comments; he is a leading practitioner and commentator in the field of securities regulation. Moreover, his criticisms are not emotionally oriented. Rather, they extend over a broad range of controversial areas in the Code, including: power of the Commission to exempt; expanded power of the Commission to regulate brokers, dealers and investment advisers; Commission regulation of private actions; the power of the Commission to escrow and impound; expansion of Commission powers with respect to indemnification and contribution; elimination of exemptions to rule 10b-6; the power of the Commission to modify the Code's objective standards with respect to private placements; Commission power over "one-year registrants"; and Commission power summarily to suspend trading. His central point, echoed by many of the panelists, was that the Code authorizes an unnecessary expansion of Commission rule-making power.

In sum, the Pace University School of Law and Professor Seymour Casper and his staff deserve high praise for the presentation and publication of this timely symposium on the American Law Institute's Proposed Federal Securities Code.

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37. *See* Ratner, *supra* note 22, at 329.

38. *Id.*

39. *See* Lowenfels, *supra* note 12.

40. *Id.* at 352. Lowenfels has, however, previously stated: "Whether the Code is adopted in its entirety, adopted piecemeal, or not adopted at all, the Reporter and his colleagues will have made a substantial contribution." Lowenfels, *supra* note 3, at 661.