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# An Overview of the Proposed Code's Treatment of Private Causes of Action and Damages

ROBERT C. POZEN\*

## I. Introduction

I will discuss the part of the Code<sup>1</sup> that I think is the most controversial and perhaps, in some respects, the most important. The area to which I refer is Part XVII on damages and private actions.<sup>2</sup> I will give an overview and leave to subsequent speakers the opportunity of providing particular expositions on problems of significance.

In terms of the whole Code, the two questions most worthy of note are:

1. whether the Code objectifies and therefore improves the registration and exemption process, and
2. whether the Code successfully sorts out the private liability question. The Code attempts to order the area of private liability by setting up a discrete set of express rights of action, with the requisite mental state and damage consequences for each action.<sup>3</sup>

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The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

1. ALI FED. SEC. CODE (1980) (Official Draft). References in this speech are to the 1980 draft. 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].

2. ALI FED. SEC. CODE §§ 1701-1728 (1980).

3. *Id.*

### A. Sources of Substantive Violations

At first glance, the method by which you find a private action in the Code is complex. Once you become adept at tracing the substantive violation through to Part XVI and then through to the damage provision, however, it becomes apparent that the Code does present a coherent picture. Part XVII does not in itself create many violations; it creates private rights of action. The substantive violations, for the most part, appear elsewhere in the Code, mostly in Part XVI.

Generally, the methodology is as follows: look for a violation of substantive law in Part XVI, and then look to Part XVII for its analogue which grants a private damage action. Look also to Part XVIII for the action's administrative analogue—a Securities and Exchange Commission injunctive action or administrative proceeding. But remember that Part XVI is not the only section that establishes violations: Parts V, VI, and VII, for example, supply the substantive law with respect to registration violations, and Parts VIII and IX, the substantive law with respect to broker-dealer violations. Thus, in order to properly analyze Part XVII on private damages, one must first locate the violation of substantive law in some other parts of the Code and then return to Part XVII.

### B. Recognition of Implied Private Rights of Action

Although the Code has set up several express private rights of action, it also has a unique provision in section 1722(a) which might be called an express recognition of implied private rights of action.<sup>4</sup> Basically, it is a restatement of the *Cort v. Ash*<sup>5</sup> test

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4. ALI FED. SEC. CODE § 1722(a) (1980). This section provides in relevant part:

(a) IMPLIED ACTIONS.—A court, considering the nature of the defendant's conduct, the degree of his culpability, the injury suffered by the plaintiff, and the deterrent effect of recognizing a private action based on a violation of this Code, may recognize such an action even though it is not expressly created by part XVII, but only if (1) the action is not inconsistent with the conditions or restrictions in any of the actions expressly created or with the scheme of this Code, (2) the provision, rule, or order that is the basis of the action is designed for the special benefit of a class of persons to which the plaintiff belongs against the kind of harm alleged, (3) the plaintiff satisfies the court that under the circumstances the type of remedy sought is not disproportionate to the alleged violation, and (4) in cases comparable to those dealt with in section 1702(e)(2) or 1708(c)(2) or a

for implied private rights of action. In this context, the Code, if enacted, would provide the express Congressional authority necessary to justify a court's implication of private rights in appropriate cases in this area. This express Congressional recognition could be decisive in view of recent Supreme Court decisions.<sup>6</sup> Without this provision, one could argue that the Code is such a tightly written document that the authors meant to exclude all private rights of action not expressly included. But section 1722 anticipates and answers this argument by recognizing that implied private rights of action are appropriate as supplements to the private rights of action that follow through from the other parts of the Code.

### C. *Statute of Limitations*

Another thing of a general nature that should be kept in

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similar provision that specifies a maximum measure of damages, a comparable maximum is imposed.

5. In *Cort v. Ash*, 422 U.S. 66 (1975), the Court formulated a four-part test for implying private rights of action in federal legislation when Congress is silent:

First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted," . . .? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States . . .?

*Id.* at 78 (citations omitted).

Section 1722 of the proposed Code, however, does not mention one factor considered important in *Cort*: the availability of a state cause of action. Comment (12) to section 1721(c) explains as follows:

The criteria do not include the availability of an action under state law, because in the Code's context that criterion runs in both directions: On the one hand, why needlessly add a federal action? On the other hand, the very availability of a non-statutory action might be thought to bespeak uniform federal coverage in a Code that regulates the conduct of brokers and dealers.

ALI FED. SEC. CODE § 1721(c), Comment (12) (1980).

6. See, e.g., *Touche, Ross & Co. v. Redington*, 442 U.S. 560 (1979). The court did not imply a private right of action under § 17(a) of the Securities Exchange Act of 1934. "The ultimate question [for the implication of private causes of action] is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law." 442 U.S. at 578. See also *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979). In this case the Court held that no private cause of action for damages can be implied under § 206 of the Investment Advisers Act of 1940. "The dispositive question remains whether Congress intended to create any such remedy." 444 U.S. at 24.

mind is that the Code clearly sets out a statute of limitations.<sup>7</sup> I think this would be very helpful, especially in the 10b-5 area, where the problem of determining the statute of limitations has been a technicality that has plagued many courts.<sup>8</sup>

## II. A Comparison of Causes of Action in the Proposed Code with Those Presently Available

### A. Failure to File a Registration Statement

To obtain a complete picture of the Code's proposed scheme for the area now regulated by section 12(1)<sup>9</sup> it is necessary to group together the various registration provisions found in the new Code. The analysis starts with section 1702.<sup>10</sup> This is quite similar to the present handling of liability on registration under section 12(1).<sup>11</sup> Liability under section 1702 arises when the requirement to file a registration or offering statement has not been obeyed.<sup>12</sup> This duty to file a registration statement may

7. ALI FED. SEC. CODE § 1727 (1980).

8. A number of federal courts, in dealing with implied § 10(b) claims, have adopted the applicable state law period of limitations. This has had the effect of limiting the commencement period. *See, e.g.,* Forrestal Village, Inc. v. Graham, 551 F.2d 411, 413 (D.C. Cir. 1977); Berry Petroleum Co. v. Adams & Peck, 518 F.2d 402, 409 (2d Cir. 1975); Hudak v. Economic Research Analysts, Inc., 499 F.2d 996, 1000-02 (5th Cir. 1974); Vanderboom v. Sexton, 422 F.2d 1233, 1236-38 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). *Cf.,* Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 128 (7th Cir. 1972) (employing an equitable tolling doctrine to determine when the Illinois Securities Law three-year statute of limitations runs).

9. Securities Act of 1933, § 12(1), 15 U.S.C. § 771(1) (1976).

10. ALI FED. SEC. CODE § 1702 (1980).

11. Compare Securities Act of 1933, § 12(1), 15 U.S.C. § 771(1) (1976) with ALI FED. SEC. CODE § 1702(a) (1980). Comment (1)(a) to § 1702(a) states:

Those non-fraud-type violations that have to do with sales or purchases of securities are treated in this section on the model of S12(1) if . . . they are designed essentially to protect the buyer or seller in the particular transaction rather than to regulate the industry generally.

ALI FED. SEC. CODE § 1702 (a), Comment (1)(a) (1980).

12. ALI FED. SEC. CODE § 1702(a) (1980). This section provides:

(a) TRANSACTIONS NOT EFFECTED IN THE MARKETS.—If the transaction is not effected in a manner that would make the matching of buyers and sellers substantially fortuitous, any of the following sellers or buyers is liable to his buyer or seller for rescission or damages:

(1) a person who sells or confirms a sale of a security, delivers a security after sale, or accepts payment for a security in violation of section 504(a);

(2) a person who sells a security in violation of section 1402, 1405, 1408, 1411(b)(1), 1414, 1416(a), 1421(a), 1422, 1423, or 1504(a), or a rule under section

arise under section 504, or other sections, of the new Code.<sup>13</sup> All of the registration violations in the new Code feed into section 1702 which establishes strict liability for these violations.<sup>14</sup> This is similar to present law, in that the failure to register leads to strict liability; however, there are a few curlicues in section 1702 that make it different from the strict liability now present in section 12(1). First, certain good faith defenses are found in several of the registration sections of the proposed Code which create the substantive violations. For example, if you violated what is now the intra-state exemption but could show a good faith defense, you would not be strictly liable.<sup>15</sup> Second, a special defense, called the "mitigation defense," appears in section 1702(c) of the Code.<sup>16</sup> It is not really a defense but is a provision which empowers the court, assuming you meet the requirements of section 1702(c), to reduce significantly, or eliminate, the amount of damages.<sup>17</sup>

Thus, to understand fully the Code's proposed scheme for the area now covered by section 12(1) and to get a general sense of the Code's treatment of strict liability for registration violations, all the various registration provisions must be put together. This would include a consideration of the good faith

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1418(b) or 1418(c)(2);

(3) a person who buys a security in violation of section 1405 or 1411(b)(2), or a rule under section 1418(b); or

(4) a person who sells or buys a security while in violation of section 402 or 403 with respect to that security.

13. *Id.*

14. ALI FED. SEC. CODE § 1702 (1980). Section 1702(c), however, contemplates a limited good faith defense to strict liability for a violation of § 1702(a), in order to mitigate unduly harsh results which may arise "because [of] the indefiniteness of much of the underlying substantive law." *Id.* at Comment (2). This subsection, § 1702(c), has been entirely deleted in CODE RECOMMENDATION, *supra* note 1, at 1497. The comment to section 1702(c) explains the deletion as follows:

Section 1702(c) is deleted because (1) it would concededly have complicated litigation under the otherwise strict liability approach of § 1702, and (2) the Code reduces much of both the vagueness and the absolutism of the underlying substantive law.

15. ALI FED. SEC. CODE § 514(d)(2) (1980). This section provides:

An original seller or a reseller in good faith accepts from this buyer a written undertaking that is reasonably designed to avoid an illegal distribution and complies with any rule adopted under this section is not considered to be a participant in any such distribution.

16. *Id.* § 1702(c).

17. *Id.*

defenses available elsewhere in the Code and would include a consideration of the reduction of damage provision available in section 1702(c).

## B. *Sales and Purchases Tainted with Fraud and Misrepresentation*

The second part of the proposed Code's treatment of private liability that I will discuss involves the treatment of sales and purchases tainted by fraud or misrepresentation.<sup>18</sup> Sections 1602,<sup>19</sup> 1603,<sup>20</sup> and 1613<sup>21</sup> establish the substantive violations for

18. ALI FED. SEC. CODE §§ 1601-1614 (1980). The Comment on the Scheme of Part XVI states:

This part gathers all the existing provisions (and a few new ones) that smack of fraud, misrepresentation or manipulation, as distinct from provisions like X Rule 10b-10 (on confirmations) or X9(b)-(d) (on puts and calls) or X10(a) (on short sales and stop-loss orders) or various manifestations of the "shingle theory" as applied to dealers . . . all of which, though found with the provisions on fraud and manipulation, are more appropriate for Part IX (Market Regulation).

ALI FED. SEC. CODE, Comment on the Scheme to Part XVI (1980) (citations omitted).

19. *Id.* § 1602(a). This section provides:

(a) GENERAL.—It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders with respect to a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) any activity or proposed activity by an investment adviser with respect to a client or a prospective client.

20. *Id.* § 1603. This section provides:

(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.

(b) For purposes of section 1603, "insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person within section 1603(b) (including a person within section 1603(b)(4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), to treat the person within section 1603(b)(4) as if he were within section 1603(b)(1), (2), or (3).

which damages can be obtained by a private plaintiff under section 1703.<sup>22</sup> Sections 1602 and 1603 establish the general anti-fraud prohibitions<sup>23</sup> and the insider trading provisions of the Code.<sup>24</sup>

These sections draw a distinction between face-to-face transactions and anonymous market transactions. In face-to-face transactions defenses are available and the measure of damages is basically limited to the defendant's profit.<sup>25</sup> Query: what happened to the rescission right contained in section 29(b) of the 1934 Act?<sup>26</sup> Right now you can argue that under the *Lewis* case<sup>27</sup>

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The CODE RECOMMENDATION makes major changes in this section. "In the introductory portion, 'material fact' has been substituted for fact of 'special significance.'" CODE RECOMMENDATION, *supra* note 1, at 1495. A new subsection, § 1603(a)(3), has been added to provide a defense. The comment explains:

[T]he plaintiff need allege and prove only materiality, after which . . . the burden of going forward will shift to the defendant to show lack of special significance.

21. ALI FED. SEC. CODE § 1613 (1980). This section provides:

The Commission, in order to prevent violation of section 1602(a)(1), 1603(a), or 1604(c) by a registrant buying a security of which it is the issuer, may require by rule that the registrant provide holders of securities of the class with whatever information (including source of funds, number of securities to be purchased, price to be paid, and method of purchase) the Commission considers necessary and material to a determination whether the security should be sold. For purposes of section 1613, a purchase by a registrant's controlling, controlled, or commonly controlled person, or a purchase subject to the control of the issuer or any such person, is considered to be a purchase by the registrant. See also section 607(b).

22. *Id.* § 1703. This section provides:

(a) TRANSACTIONS NOT EFFECTED IN THE MARKETS.—If the transaction is not effected in a manner that would make the matching of buyers and sellers substantially fortuitous, a seller or buyer who violates section 1602(a)(1), 1602(b)(1)(A), 1603(a), or 1613 is liable to his buyer or seller for rescission or damages.

(b) TRANSACTIONS EFFECTED IN THE MARKETS.—If the transaction is effected in a manner that would make the matching of buyers and sellers substantially fortuitous, a seller or buyer who violates section 1602(a)(1), 1602(b)(1)(A), 1603(a), or 1613 is liable for damages to a person who buys or sells during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and ending at the end of the day when all material facts (or facts of special significance in the case of section 1603(a)) become generally available.

23. *Id.* § 1602. For the text of this section in relevant part, see note 19 *supra*.

24. *Id.* § 1603. For the text of this section, see note 17 *supra*.

25. *Id.* § 1703(d) (Defense of Correction), § 1703(e) (Defense of Plaintiff's Knowledge), 1703(f) (Defenses Based on Defendant's Conduct), 1703(i) (Measure of Damages).

26. Securities Exchange Act of 1934, § 29(b), 15 U.S.C. § 78cc(b) (1976).

27. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 18 (1979). This case is discussed in another context at note 6 *supra*.



there is a rescission right in section 215 of the Advisers Act<sup>28</sup> that could be extended to section 29(b) of the 1934 Act where there is similar language which says that all contracts could be void. One could ask whether, at least in face-to-face transactions, the Code should have an analogue to this rescission right. I think you would expect that if such a right were to appear anywhere in the Code, it would appear in face-to-face transactions involving fraud. Section 1703(a), the basic damages provision for fraud in face-to-face transactions, does not provide a rescission right because of the defenses provided in the rest of section 1703. While section 1722(c) provides a rescission right, it is quite limited in scope.<sup>29</sup> So while the Code expands the pre-

28. Investment Advisers Act of 1940, § 215, 15 U.S.C. § 80b-15 (1976).

29. ALI FED. SEC. CODE § 1722(c) (1980). This section provides:

(c) **ILLEGAL CONTRACTS.**—(1) When one party to a contract (herein "the first party") would be liable to another party under any provision of part XVII (other than section 1722(a)) if the contract were consummated, or when a broker, dealer, municipal broker, municipal dealer, or investment adviser makes a contract in violation of section 702(a) or 919(a), the contract is not enforceable by the first party or by the broker, dealer, municipal broker, municipal dealer, or investment adviser (or by any nonparty to the contract who acquired a right under the contract from the first party or from the broker, dealer, municipal broker, municipal dealer, or investment adviser with knowledge of the facts by reason of which that person would be so liable) unless the plaintiff satisfies the court that under the circumstances enforcement would further the purposes of this Code better than nonenforcement.

(2) Any other contract is enforceable by a person specified in section 1722(c)(1) notwithstanding a defense of illegality under this Code unless the defendant satisfies the court that under the circumstances nonenforcement of the contract and the deterrent effect of nonenforcement would not be disproportionate to the violation and the degree of culpability on the part of the plaintiff (or the alleged violator from whom the plaintiff as a nonparty to the contract acquired a right under the contract).

(3) Violation of a rule of a national securities exchange or a registered securities association or clearing agency that is not actionable under section 1721(a) is not made a defense to an action on a contract by this Code.

(4) Section 1722(c)(1) to (3) inclusive does not apply for purposes of sections 504(b) and 1724(e)(2) and (3).

The CODE RECOMMENDATION suggests the deletion of § 1722(c) and the substitution of the following language:

(c) **ILLEGAL CONTRACTS:**—(1) A contract that is made, or whose performance involves, a violation of this Code (or of a rule of a self-regulatory organization within section 1721(a)) is unenforceable by either party (or by a nonparty to the contract who acquired a right under the contract with knowledge of the facts by reason of which the making or performance violated or would violate this Code) unless the plaintiff satisfies the court that under the circumstances enforce-

sent law by establishing more express private rights of action than we have now, it seems to cut back from present law by not having a provision similar to section 29(b) of the 1934 Act which constitutes a rather broad rescission right.

Now let us look at the Code's handling of anonymous market transactions.<sup>30</sup> The problem here, one that we all have seen, is that when someone trades in an anonymous market, it seems unfair for a defendant who has made a small profit, say ten thousand dollars, to suffer a large liability, say two to five million dollars. Furthermore, it is often very difficult for a plaintiff to trace the purchase or sale to a particular person on the other side. Professor Loss has confronted this problem, and the Code effectively limits the damages to the defendant's profits, by providing that in any action under section 1703, damages are measured as if all plaintiffs bought or sold only the amount of securities defendant bought or sold.<sup>31</sup> The Commission's staff has

ment would produce a more equitable result than nonenforcement and would not be inconsistent with the purposes of this Code.

(2) To the extent that a contract described in section 1727(c)(1) has been performed, the court may not deny rescission at the instance of any party unless the defendant satisfies the court that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent with the purposes of this Code.

(3) Section 1722(c)(1) and (2) does not apply (A) to the extent that the unlawful portion of the contract may be severed, (B) to preclude recovery against any person for unjust enrichment, or (C) for purposes of sections 504(b) and 1724(e)(2) and (3).

CODE RECOMMENDATION, *supra* note 1, at 1501.

30. ALI FED. SEC. CODE § 1602 (1980).

31. *Id.* § 1708(b). 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).

Comment 5 explains the theory as follows: "a seller (or buyer) who misrepresents should have the same liability whether he sells (or buys) face to face or in the market." *Id.* at Comment 5. The CODE RECOMMENDATION has added a new subsection, § 1708(b)(4), which is intended to deter an insider from "going into the marketplace on the basis of inside information that he *knows* . . . is undisclosed" by providing that a court may, in those circumstances, increase the measure of damages. CODE RECOMMENDATION, *supra*

expressed some doubt that a sufficient deterrent effect is provided by a section requiring only that the defendant return his profits.<sup>32</sup> This creates a situation in which one who has inside material information and trades on the basis of it must, at worst, relinquish profits and may, at best, remain undetected. This, as a practical matter, will happen often. While the Commission staff believes that open-ended liability may not be appropriate, the staff has publicly recommended to Professor Loss that he use a concept, such as double damages, which would provide substantial deterrence.<sup>33</sup> Double damages, essentially, is a nice way of saying punitive damages. But since double damages are related mathematically to defendant's profits, such a measure cannot result in astronomical figures. Any figure used in these situations will always be arbitrary. A specific, and reasonable, figure is preferable, but it should be large enough to provide a deterrent effect.

I should also mention the substantive provision of the proposed Code which deals with insider trading, section 1603.<sup>34</sup> While current law is concerned here with "material facts,"<sup>35</sup> Professor Loss does not use that term in this section. He uses the term a "fact of special significance."<sup>36</sup> Under the Code, a plaintiff would have to prove that the defendant had a "fact of special significance" rather than a "material fact." One could debate for a long time whether these standards differ. Thus, it is

note 1, at 1499.

32. See Schorr, *Plan to Rewrite Federal Securities Law Appears Close to Being Endorsed by SEC*, Wall St. J., July 31, 1980, at 3, col. 2.

33. The Securities and Exchange Commission recommends an alteration in the code [which] would make things tougher for persons illegally trading in securities on the basis of inside information by allowing federal courts to award injured parties twice the amount of an inside trader's profits. The original version would have limited recovery to the actual gain achieved by the insider. *Id.* at 3, col. 3. The version of the Code agreed upon by the Commission and Professor Loss would permit an increase in damages of up to 150 percent of the lost profits. CODE RECOMMENDATION, *supra* note 1, at 1499.

34. ALI FED. SEC. CODE § 1603 (1980). For the text of this section, see note 20 *supra*.

35. See, e.g., 17 C.F.R. § 240.10b-5(b) (1979), which renders it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . ."

36. ALI FED. SEC. CODE § 1603(a) (1980). For the complete text of this section and changes recommended by the Commission and Professor Loss, see note 20, *supra*.

not clear to me why Professor Loss has changed what is a well known and much litigated standard. The courts have used the materiality standard, especially since *Northway*,<sup>37</sup> in a sensible way, and I am not sure how many cases it would take for us to understand what the term "fact of special significance" means.

### C. *False Registration Statements, Offering Statements, and Annual Reports*

My analysis now turns to section 1704<sup>38</sup> which provides for liability roughly equivalent to that found in section 11 of the 1933 Act.<sup>39</sup> Section 11 liability applies to false registration statements, offering statements and annual reports. Section 1704 must be seen in connection with the Code's movement toward continuous disclosure and reliance on the annual report.<sup>40</sup> Since the entire system is geared to the annual report, there should be a duty imposed on officers and directors to read the report carefully. The imposition of what can be considered section 11 liability for the false preparation of an annual report is a logical result in the Code.<sup>41</sup>

The similarity between section 11 liability and the Code liability is not complete; under the new Code, liability in this context is watered-down section 11 liability. This is because there are more defenses in section 1704 than in section 11.<sup>42</sup> There are

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37. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). "The general standard of materiality . . . is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449.

38. ALI FED. SEC. CODE § 1704 (1980).

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

40. ALI FED. SEC. CODE, Introduction, at xxvii-xxviii, xxxiv (1980).

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

42. Securities Act of 1933, § 11, 15 U.S.C. § 77k (1976). The defenses, under section 11, include: (1) an affirmative defense that plaintiff knew of the alleged untruth or omission, 15 U.S.C. § 77k(a); (2) a "due diligence" defense, 15 U.S.C. § 77k(b)(3); (3) a partial affirmative defense that the decrease in value of the security was not caused by the particular misstatement or omission in the registration statement, 15 U.S.C. § 77(e). See, e.g., *In re Gap Stores Sec. Litigation*, 79 F.R.D. 283, 297 (N.D. Cal. 1978) (affirmative defense of plaintiff's knowledge); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 n. 26 (1975) ("due diligence" defense); *Emmi v. First-Manufacturers National Bank of Lewiston and Auburn*, 336 F. Supp. 629, 634 n. 6 (D. Me. 1971) (partial affirmative defense of lack of causal relationship).

Section 1704 establishes a defense not presently provided in section 11. ALI FED. SEC. CODE § 1704(d) (Defense of Correction) (1980). The section 11 defenses, good faith

a defense of correction, a defense of plaintiff's knowledge, and a defense based on defendant's conduct.

There has been a tremendous debate about whether this watered-down liability should apply to directors.<sup>43</sup> Some, including Professor Loss himself, think that directors should have that liability with respect to the annual report. In the latest version of the proposed Code, Professor Loss has reached a compromise; he has established a scienter-type liability but has required the defendant to prove lack of scienter rather than requiring the plaintiff to prove its presence.<sup>44</sup> Thus the plaintiff puts forth the prima facie case but the defendant has the burden of proving he did nothing wrong.<sup>45</sup> Whether this is a successful compromise is a question that can be answered only after the Code has been in operation for some time.

#### D. *Filing Requirements Other Than Those Required by Section 1704*

In addition to establishing the filing requirements just discussed, the Code also provides for other filings. Section 1705<sup>46</sup> deals with filings other than those required for offerings or annual reports, such as the 8K and the 10Q. In this section, Professor Loss has established a liability standard that some of us refer to as scienter plus; you must have a misrepresentation made

and due diligence, are found in the Code at § 1704(f) (Defenses Based on Defendant's Conduct). *Id.* § 1704(f). The section 11 defense based on plaintiff's knowledge is found in the Code at § 1704(e) (Defense of Plaintiff's Knowledge). *Id.* § 1704(e).

43. *See, e.g.,* Patrick, *Some Practical Questions Concerning the Effect of the Proposed Federal Securities Code on Civil Litigation*, 32 VAND. L. REV. 551 (1979).

44. ALI FED. SEC. CODE §§ 1704-1705 (1980). The Code provides two alternatives for liability for the filing of a false annual report. In the introductory comments to sections 1704-1705, Professor Loss states that

[t]he basic differences between §§ 1704 and 1705 have to do with (i) burden and standard of proof on falsity and (ii) persons liable:

(a) Whereas the § 1704 plaintiff shows merely a misrepresentation under § 1704(a) in order to shift to the defendant the burden of going forward under § 1704(f) with the several due care defenses modeled on [Securities Act of 1933, § 11b, 15 U.S.C. § 77k(b)(1976)], § 1705(a) requires proof of scienter as defined in § 202(147).

*Id.* at Introductory Comment (3) §§ 1704-1705.

45. *Id.*

46. *Id.* § 1705.

with scienter.<sup>47</sup>

One of the interesting questions that has always bothered me about this provision is whether a complete failure to file would make you liable under section 1705. It appears that this is not fully taken care of by the Code. If you filed and misrepresented a fact, you probably would be liable under section 1705. But if you had an obligation to file, and you entirely failed to file, I am not sure you would be liable under this section. To me, it seems illogical that a total failure to abide by the rule would not be actionable while submitting a filing which included a mistake would be actionable.

### E. Other Code Provisions

Liability for false distribution statements is covered in section 1706 of the proposed Code.<sup>48</sup> While section 1704 covers the issuer making an offering, section 1706 reaches the secondary distributor and delineates his liability.<sup>49</sup>

Section 1604(c) defines the substantive law with respect to false publicity;<sup>50</sup> section 1707 provides the cause of action;<sup>51</sup> and

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47. *See id.* § 1705(a).

48. *Id.* § 1706. This section provides that

(a) PORTION SUBJECT TO SECTION 1704 LIABILITY.—With respect to those contents of a distribution statement described in section 510(c)(1) and (3), the secondary distributor and every underwriter have the same liability that a registrant and underwriter, respectively, have under section 1704 to the extent that an offering statement covers a distribution by or for the account or benefit of the issuer, except that an underwriter is not liable for a false certification under section 510(c)(3) without proof of scienter.

(b) PORTION SUBJECT TO SECTION 1705 LIABILITY.—With respect to the contents of a distribution statement (other than those contents referred to in section 1706(a)), including reports that are identified or physically attached, the secondary distributor and every underwriter have the same liability that a registrant has under section 1705.

(c) MEASURE OF DAMAGES.—The measure of damages under section 1705 is stated in section 1708(c), and the measure of damages under section 1705 is stated in section 1708(d).

49. Compare ALI FED. SEC. CODE § 1706 (1980) with ALI FED. SEC. CODE § 1704 (1980).

50. *Id.* § 1604(c). This section provides that

It is unlawful for any company, or a person acting on its behalf, to engage in a fraudulent act in connection with, or to make a misrepresentation in, a press release or other form of publicity (other than a filing) relating to the company if it is reasonably foreseeable that such conduct will induce other persons to buy, sell, or not to buy or sell securities of the company or of a controlling, controlled, or com-

section 1708 delineates the damages and the calculation of damages.<sup>52</sup> False publicity statements, according to section 1604(c), must be made with scienter to be actionable.<sup>53</sup>

The applicable damage provision sets a ceiling on the damage liability that can be imposed on a defendant for most cases involving false filing and publicity.<sup>54</sup> The ceiling can be lifted, however, if there has been misrepresentation with knowledge; this, I guess, is to be distinguished from misrepresentation with scienter, required initially for liability to arise.

Another provision that you should be aware of is section 1709, which covers investment adviser liability when there is no purchase or sale.<sup>55</sup> If there is a purchase or sale you look to section 1703 of the Code,<sup>56</sup> not to section 1709. Section 1709 deals with the situation where the adviser himself is not actually

monly controlled company.

51. *Id.* § 1707(a).

52. *Id.* § 1708(d).

53. *Id.* § 1604(c).

54. *Id.* § 1708(c)(2). This section limits the damages with respect to a particular filing so far as each defendant is concerned, to the greatest of:

(A) \$100,000;

(B) 1 percent (to a maximum of \$1,000,000) of gross revenues in the defendant's last fiscal year before the filing of the action if the defendant is a company; or

(C) any profit specified in section 1708(a)(1)(B) or 1708(a)(2)(B), but section 1708(c)(2) does not apply if the plaintiff proves a misrepresentation made with knowledge by the particular defendant, nor does it apply with respect to the registrant to the extent that an offering statement or amendment covers a distribution by or for its account or benefit, or with respect to an underwriter.

55. *Id.* § 1709 (c)(1). This section provides that

[a]n investment adviser who—

(1) violates section 1602(a)(4) by means of a fraudulent act, or a misrepresentation made with scienter; or

(2) fails to correct a statement of a material fact (A) as required by section 1602(b)(1)(D) if he acquired scienter with respect to the subsequent event there referred to as of a time sufficiently in advance of his client's acting on the basis of the statement to have had a reasonable opportunity to make the correction, or (B) to reflect the investment adviser's acquisition of scienter, as of such a time, with respect to a misrepresentation previously made,

is liable to his client for any loss caused by the violation or failure to correct.

CODE RECOMMENDATION suggests a change from the scienter test now present to a test which looks to an act "without reasonable justification or excuse." CODE RECOMMENDATION, *supra* note 1, at 1500.

56. ALI FED. SEC. CODE § 1703 (1980). For the text of this section, *see* note 22 *supra*.

purchasing or selling, but where there is fraud or misrepresentation in the advising relationship, and the advisee is selling or purchasing.<sup>57</sup>

Section 1710 covers manipulation and stabilization.<sup>58</sup> Another provision you should note is section 1713, which covers proxy solicitations, acquisitions and tender offers.<sup>59</sup> Again, if you actually purchase and sell, you look to section 1703, not to section 1713. If there is a misrepresentation or fraud where you have not actually purchased or sold, you look to section 1713.<sup>60</sup>

Section 1714<sup>61</sup> is the analogue of section 16(b),<sup>62</sup> the short

57. *Id.* § 1709(c). The changes suggested by the Commission and Professor Loss are set forth at note 55 *supra*.

58. *Id.* § 1710.

59. *Id.* § 1713. This section provides that

(a) **PROXY SOLICITATIONS.**—On proof in an action by the issuer, or a security holder who has been or is about to be solicited or circularized within the meaning of section 603(a), that the defendant has violated, is violating, or is about to violate section 603, 604, 1602(a)(2), or 1602(b)(1)(B), a court may (1) enjoin a violation or further violation, (2) require compliance, (3) enjoin the use of proxies solicited or given in violation or the consummation of action authorized by their use, (4) set aside action so consummated, (5) award damages against the violator for any loss caused by his violation, or (6) grant other appropriate relief (preliminary or final), including a combination of the types of relief set forth in section 1713(a).

(b) **ACQUISITIONS AND TENDER OFFERS.**—On proof in an action by the issuer of a security that is the subject of a tender offer (or a proposed tender offer) or whose acquisition requires a filing under section 605(b), a holder of such a security (or of another security whose interests are adversely affected), a person who has tendered a security pursuant to a tender offer, or a person who has made or proposes to make a tender offer, that the defendant has violated, is violating, or is about to violate section 605(b), 606, 607(e), 1602(a)(1) or (3), 1602(b)(1)(A) or (C), 1603(a), or 1613, a court may (1) enjoin a violation or further violation, (2) require compliance, (3) enjoin the voting of securities acquired in violation or the consummation of action authorized by their having been voted, (4) set aside action so consummated, (5) award damages against the violator for any loss caused by his violation, or (6) grant other appropriate relief (preliminary or final), including a combination of the types of relief set forth in section 1713(b).

(c) **ACTIONS BY BUYERS AND SELLERS.**—Section 1713 does not apply to the extent that any of sections 1703-1707 inclusive applies.

60. *Id.*

61. *Id.* § 1714(a). This section provides:

(a) **LIABILITY.**—For the purpose of preventing the unfair use of information that may have been obtained by a person within section 605(a) by reason of his relationship to the issuer, any profit realized by him from a purchase and sale (or sale and purchase), within a period of less than six months, of securities of a class subject to that section inures to and is recoverable by the issuer without regard to any intention on his part, in entering into the transaction, to hold the security purchased or not to repurchase the security sold for at least six months.



term trading section. Professor Loss does change 16(b) considerably.<sup>63</sup> He nullifies the effect of three Supreme Court decisions in one section, two of which are favorable to the plaintiff,<sup>64</sup> and one of which is favorable to the defendant.<sup>65</sup> He clearly has a

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62. Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1976). This section provides in relevant part:

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.

63. ALI FED. SEC. CODE § 1714, Comments (1) and (2) (1980). These comments provide:

(1) The initial question is whether X16(b) should be preserved at all. Some favor its repeal on several grounds: (a) that it is needlessly arbitrary to the point of being quixotic; (b) that it has acted as a trap for the unwary; (c) that the Commission has made insufficient use of its exemptive authority; and (d) that, most of all, the jurisprudence that has developed under X Rule 10b-5 (and that is being codified in large part) has rendered obsolete the concept of *automatic* recapture of *certain* short-term profits of *certain* insiders.

(2) The Code proceeds on the theory, however, that X16(b) has a symbolic significance that must be, and deserves to be, recognized. It accordingly codifies the most important areas of the X16(b) jurisprudence, smoothing some of the rough edges in the process without derogating from the basic genius of the section. This partial codification—for example, the defenses in §§ 1714(g) and 1714(h)(1)—is not meant to preclude further judicial inventiveness in areas (like options and rights) that remain uncoded. And, particularly with respect to the uncoded portion of the jurisprudence, the Commission is expected to use its expanded rulemaking authority in order to play a greater quasi-legislative role in this area than it has in the past. See §§ 303 (exemptive authority) and 1804 (general rulemaking authority, including authority to adopt interpretative rules).

64. *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418 (1972). *McKesson* held that a purchase, in a purchase-sale sequence, which results in that purchaser's holding more than ten percent, does not fall within § 16(b). 423 U.S. at 235. Section 1714(d)(1) expressly abrogates this case. See ALI FED. SEC. CODE § 1714, Comment 5 (1980).

*Reliance* held that a ten percent owner who sells his stock within six months of purchase by two sales, where the first sale reduces the holdings to less than ten percent, is not liable under § 16(b). 404 U.S. at 420. Section 1714(d)(1) also expressly overrules this case. See ALI FED. SEC. CODE § 1714, Comment 6 (1980).

65. *Blau v. Lehman*, 368 U.S. 403 (1962). In *Blau* the Court stated that a partnership may deputize an individual partner to represent its interests as director of a corporation. Section 220(40) of the proposed Code overrules this by excluding "from the definition of 'director' a person who 'deputizes another person to be a director.'" ALI FED.

view of what 16(b) should be like, and his view differs from that of the present law. Personally, I think that those changes are good.

### III. Summary

The main point to keep in mind when studying the proposed Code is that section 1702 is the analogue of section 12(1) strict liability and covers registration violations. Section 1703 is the basic fraud and insider trading provision with important differences between the face-to-face deal and the anonymous market transaction. Section 1704 covers annual reports and offerings by the issuer. The liability here is similar to section 11 liability, but there is an arbitrary limit in section 1708(c) which can be removed in certain circumstances. Section 1705 applies to filings other than annual reports and offering statements. Section 1706 is the liability provision for what are basically secondary distributions. If you keep this overview in mind and then look to section 1708 for your measure of damages, you will have the basic framework of the Code.

Part XVII is complex, but so is the present law. The Code had the benefit of containing the complex law in one volume. Someone new entering the field will not have to read one thousand rule 10b-5 cases to find the standard. This is a real advantage to new lawyers beginning the study of securities law.

I think Professor Loss should be commended for carefully tailoring the mental state and the measure of damages to each cause of action. He treats substantive violations in groups that do make some sense, and he does resolve certain problems such as the problem with the statute of limitations and other technical problems. It is an orderly scheme. If there is an argument for the Code, I think one of the strongest is that this really is a codification of what Professor Loss and his advisers believe is a consensus position in these areas. It is set out so that someone who has never known anything about the securities law could read it. It is an incredible drafting accomplishment. You and I may disagree with certain treatments of specific things. But it is orderly; once you learn how to trace the substantive violations

first to Part XVII and then to the damage provisions, it does present a coherent picture.

#### IV. Discussion

*Question:* Do you think the Code has a chance of being passed?

*Mr. Pozen:* I really can't say whether or not it would pass. I think that it should be given full consideration. I thought that you were going to ask me another question which I will answer anyway and that is, whether the Code is generally a good idea. My position on the Code depends very greatly on what actually winds up in it at the end. If there are twenty provisions that are changed in a certain way I might think that the Code is a great document. If, on the other hand, there are twenty other provisions that change in another way I might think that the Code is a terrible document. I find the whole notion of having two days of generic hearings on the Code to be somewhat fruitless. Even a person like Lew Lowenfels, who has very strong feelings about the Commission's rule-making powers, might think the Code is a good thing if two or three of those rule-making powers were changed. It is a complex document, and I find it very hard to take generic positions for or against the Code.