Volume 33
Number 5 *Fourth Annual Baron de Hirsh Meyer Lecture Series*
Article 2

9-1-1979

Foreword

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university of miami law review

VOLUME 33 SEPTEMBER 1979 NUMBER 5

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The Fourth Annual Baron de Hirsch Meyer Lecture Series was held on February 9, 1979 under sponsorship of the *University of Miami Law Review*. The in depth discussion and papers submitted by the distinguished panelists[1] form the basis of this timely law review symposium issue on the proposed Federal Securities Code.[2]

The Code represents the first attempt to effect a major revision of the federal securities laws, which are comprised of six different statutes enacted by Congress between 1933 and 1940.[3] As might be expected, the piecemeal enactment of these statutes resulted in a legislative patchwork in which duplicate regulation, overlapping and inconsistencies are apparent. As long ago as 1951, Professor Louis Loss predicted that these statutes would be treated " 'as a single piece of legislation.' "[4] The need for their integrated codification was recognized and the project was undertaken by the Council of the American Law Institute. Professor Loss, appointed as Reporter, labored for more than nine years with selected advisors and consultants to prepare the six tentative drafts. At its annual meeting in May 1978, the Institute approved the "Proposed Official Draft." In 1979, the House of Delegates of the American Bar Asso-

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1. Professor Louis Loss, William Nelson Cromwell Professor of Law, Harvard University; Professor Homer Kripke, Chester Rohrlich Professor of Law, New York University; Professor George J. Benston, Professor of Accounting, Economics and Finance, University of Rochester Graduate School of Management; Dean Richard West, Dean and Professor of Finance, Amos Tuck School of Business Administration, Dartmouth College; Professor Nicholas Wolfson, Professor of Law, University of Connecticut.

2. ALI FEDERAL SECURITIES CODE (Mar. 1978 Proposed Official Draft) [hereinafter cited as FED. SEC. CODE].

3. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1976); Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1976); Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-*lll* (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 -52 (1976); Investment Advisor's Act of 1940, 15 U.S.C. §§ 806-1 to b-21 (1976).

4. FED. SEC. CODE xv, n.2, *quoting* L. LOSS, SECURITIES REGULATION vii (1st ed. 1951).

ciation approved the Code and recommended congressional enactment.

Members of the Securities and Exchange Commission staff have been reviewing the Code for nearly a year, and their report and recommendations to the Commission are expected in the near future. Meanwhile, however, one member of the Commission has questioned the advisability of enacting the Code. Although refusing to make any specific judgments until the staff report is submitted, Commissioner Irving Pollack, a thirty-year veteran of the SEC, suggested that "[p]erhaps the ALI should be dealing with particular issues or problems that need to be resolved"[5] instead of presenting to Congress something that may be too massive to digest.

It is obvious that the moving force behind this monumental project is Professor Louis Loss, who is and always has been recognized as the foremost scholar in American securities regulation. Although praise in that vein was duly accorded him by all panelists at the Baron de Hirsch Meyer lecture, such a virtuous opening was a prelude to strong criticism of the Code. It would be less than honest not to state that the bottom line consensus of the panelists was negative. To put it bluntly, the Code received an accolade of brickbats; equally critical assessments have appeared in the press.[6]

One criticism of the Code centered on the inadequate use of empirical data as drafting guideposts. The economists contended that empirical studies could and should have been undertaken to provide current data bases for various provisions of the Code.[7] Professor Loss responded to this criticism by stating that it would not be feasible to make empirical studies of each of the several hundred questions considered.[8] The economists also urged that existing empirical data were insufficiently employed by the draftsmen.[9] Professor Loss, however, indicated that the economists themselves do not agree on the interpretation of existing studies. Thus, an attempt to implement the data throughout the Code would have itself created dissension.[10]

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

6. *See, e.g.*, Anreder, *Cut Your Losses? Critics Make a Case Against the Proposed Securities Code*, Barron's, Feb. 26, 1979, at 7; Wall St. J., Feb. 20, 1979, at 16, col. 1; Miami Herald, Mar. 4, 1979, at F-1, col. 1.

7. *Panel Discussion, Fourth Annual Baron de Hirsch Meyer Lecture Series*, 33 U. MIAMI L. REV. 1519 (1979).

8. *Id.* at 1522-23.

9. West, *The Federal Securities Code: Some Comments on Process & Outcome*, 33 U. MIAMI L. REV. 1485, 1488 (1979).

10. *Panel Discussion*, *supra* note 6, at 1522-23.

A further criticism concerned the draftsmens' unqualified acceptance of the proposition that disclosure or trading legislation is necessary.

The economists proposed that the time-honored laws of the market place adequately protect investors and are more socially desirable than federal legislation.[11] Admitting the blind acceptance of the disclosure philosophy, Professor Loss emphasized that the philosophy underlying the federal securities laws has been established for nearly half a century, and debate before Congress on the wisdom of its retention would be a fruitless endeavor.[12]

Of the many topics debated,[13] it is not surprising that the most controversial area in the federal securities laws and in the panel discussion is the private offering exemption afforded by section 4(2) of the Securities Act of 1933. The importance of this exemption can be exemplified by the fact that in 1969 548 firms, each with a net worth of less than $5 million, obtained $1.46 billion in capital through public stock offerings. By 1977, new firms were able to raise only $30 million a year in this manner.[14] Such an alarming shrinkage underscores the urgent need for an effective method of obtaining seed money privately, within the framework of an understandable and workable exemption from the burdens of the costly and time-consuming registration requirements. It is of vital importance that the federal securities laws strike a balance between investor protection and the encouragement of venture capital. The SEC staff is reportedly angered[15] because the Code permits a "limited" offering to thirty-five individual purchasers,[16] thereby abandoning the long-standing requirements that private offerings be made only to those persons who are "able to fend for themselves" and who "have access to the same kind of information that would appear in a registration statement."[17]

If the press reports on the SEC's staff reaction to this section

11. *See* Benston, *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471, 1473 (1979).

12. Loss, *Keynote Address: The Federal Securities Code*, 33 U. MIAMI L. REV. 1431, 1451 (1979).

13. Specific areas of controversy included: (1) the liability provisions for directors; (2) the advance filing and publication requirements for tender offers; (3) the standard of proof necessary with respect to insider trading violations; (4) the problems involved in public offerings of securities by control persons; (5) the regulation of sales by block traders; and (6) the regulation of short-swing transactions by insiders.

14. Miami Herald, Feb. 4, 1979, at 26a, col. 1.

15. Schorr, *Overhauling the Securities Laws*, Wall St. J., Dec. 21, 1978, at 16, col. 3.

16. FED. SEC. CODE § 242(b).

17. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

of the Code are accurate, the reaction is most difficult to understand. First, the real meaning of the section 4(2) as well as its usefulness are still doubtful after forty-five years of judicial and administrative gloss. Indeed, one panelist described the situation as it existed a few years ago as "intolerable."[18] Moreover, some of the language in the SEC's appellate briefs in *SEC v. Continental Tobacco Co.*[19] caused many lawyers to conclude that in the Commission's view there could never be a private offering of equity securities to individuals. This confusion intensified pressure for a more objective test of what constituted a private offering and resulted in the adoption of rule 146 in 1974.[20] Although this rule was supposed to provide a "safe harbor," lawyers and business people soon discovered that the harbor was strewn with jagged reefs.[21] At best, rule 146 meant more paper work for established companies. But it proved to be a veritable nightmare to start-up companies seeking to raise venture capital from individuals. Two and one-half years after adopting rule 146, the SEC was forced to admit: "[T]he Commission is aware of criticism that the Rule is hindering the investment of venture capital, and that as an experiment the Rule is a failure and should be rescinded."[22]

Moreover, it is no answer to say that rule 146 is not the *exclusive* means of obtaining the section 4(2) exemption.[23] While it is possible to proceed under the statute, recent cases under section 4(2), with their conflicting interpretations of access, sophistication and disclosure, have made that option equally confusing.[24] Another reason the reported adverse reaction of SEC staff members to this part of the Code is difficult to understand is due to the fact that section 242(b)(3) provides that in the case of new companies (com-

18. Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1159 (1970).

19. 463 F.2d 137 (5th Cir. 1972).

20. 17 C.F.R. § 230.146 (1974). For a detailed discussion of the history leading to rule 146, see Schwartz, *Rule 146: The Private Offering Exemption-Historical Perspective and Analysis*, 35 OHIO ST. L.J. 738 (1974).

21. For a discussion of some of the problems left unresolved by rule 146, see Royalty & Jones, *The Private Placement Exemption and the Blue Sky Laws—Shoals in the Safe Harbor*, 33 WASH. & LEE L. REV. 877 (1976).

22. SEC Release No. 33-5779, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,828, at 87,178 (Dec. 6, 1976).

23. SEC Release No. 33-5487, 1 FED. SEC. L. REP. (CCH) ¶ 2710 (Apr. 23, 1974). *See generally* Comment, *Private Placement Exemptions Outside SEC Rule 146*, 25 EMORY L.J. 899 (1976).

24. *See, e.g.*, Lawler v. Gilliam, 569 F.2d 128 (4th Cir. 1978); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975); Lively v. Hirschfield, 440 F.2d 631 (10th Cir. 1971).

panies other than "one-year registrants"),[25] the Commission, by rule, may modify the private placement portion of the Code. In other words, the Commission can "rewrite" the exemption and impose a 146-type rule. Thus, instead of being indignant, the Commission should be delighted.

A frequent criticism is that the Code grants expanded rulemaking powers to the Commission.[26] If this criticism is well-founded, it is disturbing because we have entered an era in which deregulation is the order of the day.

Even more disturbing is the possible abuse of rulemaking authority combined with attendant disobedience of statutory commands. In this vein, Mr. Justice White, delivering the opinion of the Court in *Santa Fe Industries, Inc. v. Green*,[27] had this to say on rule 10b-5:[28]

> [R]ule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." . . . [The scope of the rule] cannot exceed the power granted the Commission by Congress under § 10(b).[29]

Indeed, rule 10b-5 is a case in point. It has enabled securities lawyers in civil liability cases to make an end run around the express civil liability provisions of the 1933 and 1934 Acts, and, according to one court, "[t]he use of 10b-5, as encouraged by the Securities and Exchange Commission, has lead [*sic*] to the emergence of a Federal law of corporations."[30] This use of rules to upstage the statutes was noted by Professor Loss in 1966, when he first publicly suggested a federal securities code: "What has happened to Rule 10b-5 . . . always reminds me of a cartoon of the time showing Mussolini dictating to his secretary, and the caption was, 'Miss Baccigalupi, take a law.' "[31]

Professor Loss, however, approves of the Code's broad grant of rulemaking authority to the SEC. His justification for this incongru-

25. FED. SEC. CODE § 299.16.
26. *See, e.g.*, Wall St. J., Feb. 20, 1979, at 16, col. 2.
27. 430 U.S. 462 (1977).
28. 17 C.F.R. § 240.10b-5 (1978).
29. 430 U.S. at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976)).
30. Drake v. Thor Power Co., 282 F. Supp. 94, 97 (N.D. Ill. 1967).
31. Loss, *History of SEC Legislative Programs and Suggestions for a Lock*, 22 BUS. LAW. 795, 796 (1967).

ity is that "codification is compromise."[32] Accepting that as true, one may still criticize his response on two grounds: the price of compromise is too dear and, in light of the current era of deregulation, granting such rulemaking power is simply not necessary to obtain congressional approval of the Code.

No impartial critique of the Code would be complete without mention of at least one of its many positive features: the registration of *companies* rather than securities. There would be one file per company, and all reports, prospectuses and other documents would be placed in that file. Once a company has registered, the Code merely requires the filing of simplified "offering statements" in lieu of an additional registration statement when the company later effects a "distribution" of its securities.[33] This author submits that such simplification, with the attendant reductions in expense and time, would be a welcome innovation.

In sum, the *University of Miami Law Review* deserves high commendation for its selection of the proposed Federal Securities Code as a timely topic for the Fourth Annual Baron de Hirsch Meyer Lecture Series and for its valuable contribution to current legal thought.

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32. LOSS, *supra* note 12, at 1435.
33. FED. SEC. CODE xxvi.