University of Miami Law Review

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

Article 7

9-1-1979

Comments on the Proposed Federal Securities Code: Transformation of the Securities Act of 1933

Nicholas Wolfson

Recommended Citation
Nicholas Wolfson, *Comments on the Proposed Federal Securities Code: Transformation of the Securities Act of 1933*, 33 U. Miami L. Rev. 1495 (1979)
Available at: https://repository.law.miami.edu/umlr/vol33/iss5/7

Comments on the Proposed Federal Securities Code: Transformation of the Securities Act of 1933

NICHOLAS WOLFSON*

The proposed Federal Securities Code lacks an empirical foundation; no effort was made to determine the actual impact of the many substantive changes proposed by the Code. Professor Wolfson recommends that before this massive Code becomes law, Congress should analyze its costs.

I. INTRODUCTION

The monumental Federal Securities Code[1] was approved on May 19, 1978 by The American Law Institute. This vast undertaking was brilliantly shepherded from start to completion by its Reporter, the dean of securities lawyers, Professor Louis Loss and his consultants and advisors. The creation of this Code is an impressive legal accomplishment. Professor Loss' achievements in drafting this Code, his achievements *qua* lawyer, are unique. No one except Professor Loss, with his vast knowledge, skill and experience in securities law, could have brought about this brilliant *tour de force*. Although I will have some critical comments to make, particularly with reference to the need for empirical and economic research, no criticisms can in any way detract from the truly remarkable accomplishment of Professor Loss in conceiving and drafting this Code.

The Code represents a recodification of the entire corpus of federal securities legislation.[2] It is a recodification, not a restate-

* Professor of Law, University of Connecticut.

1. ALI FEDERAL SECURITIES CODE (Mar. 1978 Tent. Draft), *supplemented by* ALI FEDERAL SECURITIES CODE (Supp. July, Sept. 1978) [hereinafter cited as FED. SEC. CODE].

2. Congress passed a securities statute almost every year from 1933 to 1940. *See* Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976) [hereinafter cited as 1933 Act] Securities Exchange Act of 1934, 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3, 78p-78hh (1976) [hereinafter cited as 1934 Act]; Public Utility Holding Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1976); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1976); Investment

ment, and, as such, contains a considerable amount of significant change in extant law. In the words of Professor Loss, the Code "has three principal aims: (1) simplification of [a] complex body of law . . .; (2) elimination . . . of duplicate regulation and (3) reexamination of the entire scheme of investor protection with a view to increasing its efficiency . . . ."[3]

In the opinion of Professor Loss, "perhaps the most dramatic" changes effected by the Code are in the 1933 Act.[4] This article will analyze those changes, particularly with reference to the new concept of a distribution presented in the Code.[5]

Fundamentally, this article will analyze the dangerous lack of connection between the brilliant drafting and the real world resulting from the fact that the Code draftsmen conducted no empirical tests or research into the potential impact of Code changes.[6]

The new Code, in a sense, illustrates a principle articulated by a great poet, Auden, who once ordered as follows: "Thou shalt not answer a questionnaire, nor quizzes upon world affairs, nor with compliance take any test; thou shalt not sit with statisticians, nor commit a social science."[7] Or, if I can illustrate with another example:

> A letter that appeared in *Science* some time ago related that some commercial egg farmers who were having difficulties raising their hens' production called in a theoretical physicist after several agricultural scientists had no success. After a few months, this pundit called a meeting and announced that he had solved

Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1976); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1976). The Investment Company Act and the Investment Advisers Act were amended in 1970, Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (codified at 15 U.S.C. §§ 80a-10(a) to -10(c), 80a-15, 80a-17(f), 80a-19, 80a-31(a), 80b-3(b), 80b-5, 80a-10(d), 80a-27, 80a-28, 80a-35 (1976)). Amendments to the 1933 and 1934 Acts were effected by the Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified at 15 U.S.C. §§ 77d, 78c, 78a-78o, 78o-3, 78p, 78t, 78w, 78ff (1976)), and the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified at 15 U.S.C. §§ 78k-1, 78o-4, 78q-1, 78kk, 77d, 77x, 77yyy, 78b, 78c, 78d-1, 78f, 78h, 78k, 78l, 78m, 78o, 78o-3, 78q, 78s, 78u, 78w, 78x, 78y, 78bb, 78ee, 78ff, 78iii (1976)).

3. FED. SEC. CODE at xv.

4. *Id.* at xxv.

5. *Id.* §§ 501-515. *See also* text accompanying note 21 *infra.*

6. As this author has noted in the past, a securities rule is often "promulgated, interpreted, applied and evaluated without any [empirical] evidence about the effectiveness of the rule in the market." Wolfson, *The Need for Empirical Research in Securities Law*, 49 S. CAL. L. REV. 286, 287 (1976). Thus, "the comparative effectiveness of one particular formulation of a rule over another remains almost pure guess." *Id.* at 286.

7. *See Auden, Under Which Lyre; A Reactionary Tract for the Times,* in COLLECTED SHORTER POEMS 1927-1957, at 221, 225.

the problem. He went to the blackboard and began to explain. 'Postulate,' he said, a 'spherical chicken.'[8]

II. Integration of Disclosure Requirements

The Code codifies the current de facto partnership between the Securities Act of 1933 and the Securities Exchange Act of 1934. It does this by replacing the concept of securities registration under section 12(a) or (g) of the 1934 Act[9] with the concept of company

8. Shuchman, *Theory and Reality in Bankruptcy: The Spherical Chicken*, 41 L. & CONTEMP. PROB. 66, 66 (1977).

9. Section 12(a) of the 1934 Act provides:

> It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective *as to such security* for such exchange in accordance with the provisions of this chapter and the rules and regulations thereunder.

1934 Act, 15 U.S.C. § 78l(a) (1976) (emphasis added), Section 12(g) provides in pertinent part:

> (1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall—
>
> (A) within one hundred and twenty days after the last day of its first fiscal year ended after July 1, 1964, on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and,
>
> (B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from July 1, 1964, on which the issuer has total assets exceeding $1,000,000 and a class of *equity security* (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons,
>
> *register such security* by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to *register a security* pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 78r of this title. Any issuer *may register any class of equity security* not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to *register a security* pursuant to the provisions of this paragraph.

Id. § 78l(g) (emphasis added). Compare the above provisions with those of the proposed Code, which requires registration of the issuer, not the security: "A *person* . . . shall file a registration statement within one hundred twenty days after the first fiscal year-end at which it has at least $1,000,000 of total assets and five hundred holders of its *securities* . . . ." FED. SEC. CODE § 402 (emphasis added). Note that § 402 refers to securities, not equity securities, as does the 1934 Act.

registration. Section 402 of the proposed new legislation requires a corporation to file a registration statement when it has at least one million dollars of total assets and five hundred holders of its securities.[10] When a company files a registration statement, it then enters the world of continuous disclosure provided for in part VI of the Code. In bottom line effect, the approach is similar to the current section 12 and section 15(d) concept in the 1934 Act.[11]

The philosophical approach of the Code reflects the current administrative practice of the SEC. When the 1933 and 1934 Acts were originally promulgated, the 1933 Act placed great emphasis upon the one-shot prospectus disclosure process accompanying the corporate sale of securities to the public to raise business capital.[12] This approach did not sufficiently take into account the need for an ongoing disclosure system whereby publicly held corporations would reveal material facts about their business on a timely and continuous basis. Although the 1934 Act provided a framework for ongoing disclosure by corporations whose stocks were listed on exchanges, over-the-counter issuers were not regulated in that respect and the SEC in general did not require adequately continuous disclosure.[13]

The new Code requires a registrant to:

(1) file,

(2) send to every record holder of whatever classes of the registrant's securities (other than commercial paper) the Commission prescribes by rule,

(3) keep for whatever periods the Commission prescribes by rule, and

(4) publish (through press releases or otherwise).

whatever annual reports (with financial statements), quarterly reports, and other reports the Commission requires by rule to keep reasonably current the information and documents contained in the registration statement or to keep reasonably current the information and documents contained in the registration statement or to keep investors reasonably informed with respect to the registrant.

FED. SEC. CODE § 602.

10. In addition to the filing required by § 402 of the Code, an issuer must file a registration statement (if it has not already filed one) whenever it is required to file an "offering statement." *See* FED. SEC. CODE § 403. Furthermore, a registration statement must be filed when a company's stock is listed on a national stock exchange or included in an over-the-counter electronic interdealer quotations system. *See id.* § 903(a), (c).

11. The filing of a registration statement which becomes effective under § 5 of the 1933 Act triggers § 15(d) of the 1934 Act. Section 15(d) requires the issuer to file with the Commission "such supplementary and periodic information, documents, and reports as may be required pursuant to section 78m of this title in respect of a security registered pursuant to section 78l of this title." 1934 Act § 15(d), 15 U.S.C. § 78o(d) (1970).

12. *See* note 15 *infra*.

13. *See Report of the Special Study of Securities Markets of the Securities and Exchange Comm.*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), *summarized in* [1963-1972 Special Studies Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 74,001 (1963). *See also* Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 620-31 (1964).

After many years of benign neglect, the 1964 amendments to the Securities Exchange Act introduced the concept of a continuous disclosure system for the over-the-counter corporations as well as exchange listed issuers.[14] As a result of this legislative impetus and criticism from the corporate bar,[15] the SEC began to integrate the disclosure provisions of the 1933 and the 1934 Acts through a profusion of administrative practices and rules.[16] At this particular juncture, then, the proposed Code does no more than reflect present administrative practice.

III. PRIMARY DISTRIBUTIONS

Two key provisions in the Code are sections 502 and 504 which correspond to sections 5(c) and 5(a) of the 1933 Act.[17] Section 502(a)

---

14. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565, (codified at 15 U.S.C. §§ 77d, 78c, 78l - 78o-3, 78p, 78t, 78w, 78ff (1976)). Exceptions are set forth in section 12(g)(2) of the 1934 Act, 15 U.S.C. § 78l(g)(2) (1976).

15. In his seminal article on this subject, Milton H. Cohen, former Director of Special Study of Securities Markets, Securities and Exchange Commission, articulated the need for coordination of the 1933 Act and the 1934 Act. *See* Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).

16. *See generally* Heller, *"Integration" of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 29 LAW & CONTEMP. PROB. 749 (1964).

17. Section 502(a) of the Code provides:

> [*Offering Statement.*] . . . [*Filing requirement.*] It is unlawful for any person in connection with a distribution by him or resulting from his offer (or for an underwriter, broker, or dealer in connection with a distribution by any person) to offer a security, or for a broker or dealer to offer to buy a security from an underwriter in connection with a distribution by or through the underwriter, (1) unless the issuer has filed an offering statement with respect to the distribution, or (2) while an offering statement with respect to the distribution is the subject of a stop order under section 1808(d) or (e) or (before its effectiveness) a public proceeding under either section or a public investigation under section 1806(d)(1).

FED. SEC. CODE § 502(a).

The corresponding provision of the 1933 Act provides:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

1933 Act, § 5(c), 15 U.S.C. § 77e(c) (1976).

Section 504(a) of the proposed Code provides:

> [*General.*] It is unlawful for any person in connection with a distribution by him or resulting from his offer (or for an underwriter, broker, or dealer in connection with a distribution by any person)
>
> (1) to sell or confirm a sale of a security, deliver a security after sale, or accept payment for a security, unless an offering statement is

makes it unlawful for any person (subject to the exemptions and exclusions described therein) in connection with a distribution by him, or for an underwriter in connection with a distribution by any person, to offer a security unless the issuer has filed an offering statement with the SEC.[18] Section 504 makes it unlawful for persons in connection with a distribution to *sell* a security unless an offering statement[19] is effective with respect to the distribution.[20] These sections apply to corporate primary offerings as well as to secondary offerings.

A distribution, a term not defined in the 1933 or 1934 Acts, is defined in section 242 as "an offering other than (1) a limited offering or (2) an offering by means of one or more trading transactions."[21] Limited offerings are substituted in the Code for the private offering exemption, and trading transactions are similar to the

---

> in effect with respect to the distribution;
>
> (2) to confirm a sale of a security unless the buyer has received a prospectus or preliminary prospectus not later than receipt of the confirmation; or
>
> (3) to deliver a security after sale or accept payment for a security unless the buyer has received a prospectus not later than receipt of the security or acceptance of payment, whichever first occurs.

FED. SEC. CODE § 504(a).

The corresponding provisions in the 1933 Act are as follows:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments or transportation, any such security for the purpose of sale or for delivery after sale.
>
> . . . .
>
> It shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

1933 Act, §§ 5(a), (b), 15 U.S.C. §§ 77e(a),(b) (1976).

18. The text of section 502(a) is set out in note 17 *supra*.

19. An offering statement, the requirements of which are set out in § 502(c) of the Code, is essentially the same as the registration statement now described under § 7 of the 1933 Act.

20. *See* text accompanying note 21 *infra*.

21. FED. SEC. CODE § 242.

rule 144[22] exemption. These terms are described below.[23]

Section 502(c) of the Code provides that the offering statement must contain a prospectus, together with whatever information, financial statements and other documents the SEC specifies by rule. Section 505 provides that the prospectus shall contain as much of the contents of the offering statement as the Commission shall specify. The Code requires the Commission to take into account the information already contained in the company's registration statement and whether the issuer is a one-year registrant.[24] This requirement is modeled after the current amendments which liberalize form S-16, the short form provision, for certain reporting companies.[25]

Relatively little change has been made by the Code in the area of primary offerings and integration of 1933 and 1934 Act disclosure requirements. The methods by which issuers raise capital from the public will not be greatly affected by the Code. The offering statement will be filed with the Commission and will be reviewed by the staff as is done today. The regulatory process is still recognizable. The Code, however, uses new words, new phrases and new sentences. These may well be a fertile ground for disagreement as to meaning, a basis for lawsuits, and of course a launching pad for new SEC regulations to implement the Code. This is a pattern which, by the nature of things, occurs throughout the Code. Even where the Code leaves old concepts in place, the chemical interaction of new language and agile lawyers may lead to future litigation. The question, of course, is whether the technical improvements rendered by the Code will outweigh the task of interpreting and implementing a new Code.

More fundamentally, the Code does not break new ground in the area of quality and modality of disclosure. As is pointed out

---

22. 17 C.F.R. § 230.144 (1978).

23. *See* notes 32-39 and accompanying text *infra*.

24. A one-year registrant, a key term in the Code, is a firm which has continually been a registrant and, therefore, has continuously reported for at least one year. FED. SEC. CODE § 299.16. Reporting for one-year registrants is not really a new concept. It is similar to the reporting now required by §§ 13 and 15(d) of the 1934 Act. 15 U.S.C. §§ 78m, 78o(d) (1976).

25. Form S-16, 17 C.F.R. § 239.27 (1978), is a form for registration of certain securities under the 1933 Act. Form S-16 is simpler and shorter than other available forms for registration of securities under the 1933 Act. Issuers permitted to use form S-16 are required to file periodic reports under the 1934 Act, containing information about their business management and financial operations. The form was recently amended to permit its expanded use in primary offerings to the public and to existing security holders. The amendment became effective May 30, 1978. Securities Act Rel. No. 5923 (Apr. 11, 1978).

later,[26] economists, lawyers and financial analysts are engaged in a lively debate over the efficacy and relevance of SEC disclosure. Many believe that SEC disclosure is useless, irrelevant and requires fundamental restructuring.[27] In this regard, SEC Commissioner Roberta Karmel has recently pointed out that some responsible experts believe that a government mandated disclosure system is unnecessary, at least in an era when the market is pervaded by sophisticated institutional investors.[28] Contrary to this, the recent SEC Advisory Committee on Corporate Disclosure indicated its belief that market forces cannot supply a sufficient degree of accurate and timely information.[29] Other observers believe that government-imposed disclosure is necessary, but argue that the Commission has failed to make an effective cost-benefit analysis of the current system of disclosure.[30]

Of course, it the current modes of SEC mandated disclosure are fundamentally flawed, then a Code which ignores these issues will run the risk of irrelevance no matter how well it is linguistically put together. The first recodification of the securities acts in forty years, however, makes no significant effort to address these issues. I hasten to add that the Code draftsmen deliberately avoided these problems. They believed that Code legislation could not and should not impose a manual of disclosure content.[31] My personal opinion is that they should have grappled with the truly fundamental problems of disclosure content. I think that the Code would have been a remarkable vehicle for a fundamental reconstruction of the contents of disclosure.

A. *Limited Offerings*

A key element in the redo of current regulations concerned with

---

26. *See* text accompanying notes 72-76 *infra*.

27. *See* Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (H. Manne ed. 1969); G. STIGLER & M. COHEN, CAN REGULATORY AGENCIES PROTECT CONSUMERS? (1971), Benston, *Required Disclosure and the Stock Markets: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCOUNTING REV. 515 (1969).

28. *See* 475 SEC. REG. & L. REP. (BNA) A-12 (Oct. 25, 1978).

29. Advisory Committee on Corporate Disclosure, Disclosure Study Report, [1977-78 Transfer Binder] FED. SEC. L. REP. ¶ 81,300 (Sept. 8, 1977).

30. *See* Kripke, *The Myth of the Informed Laymen*, 28 BUS. LAW. 631 (1973); Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. Rev. 1151 (1970); Schneider, *Nits, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972).

31. *See* Loss, *Keynote Address: The Federal Securities Code*, 33 U. MIAMI L. REV. 1431, 1440 n.38 (1979); FED. SEC. CODE § 502(c).

corporate offerings to the public is the limited offering exemption. Section 242(b) of the proposed Code exempts a "limited offering" from the definition of distribution. Limited offerings are substituted in the Code for the private offering exemption.[32] A limited offering is one in which the initial purchasers, excluding institutional buyers, do not exceed thirty-five. There is no ceiling on the number of institutional purchasers.

Professor Loss has described how the Code settled upon the number thirty-five:

> After we reached the point of saying a limited offering is an offering that results in not more than "X" buyers, we had to decide what should be the "X". Naturally, I started with twenty-five because that was more or less the rule at one time. Then, at one of the meetings of the advisory group, several of the Advisors said twenty-five might be a bit tight in some instances, because, after all, today you can rationalize an offering to more than twenty-five even without institutions. At that point, Commissioner Loomis, one of the Advisers, said: "I think I might take thirty-five," and I said: "sold"—and that is how we got the thirty-five.[33]

---

32. Section 4(2) of the 1933 Act expressly provides for such an exemption for any transaction "not involving any public offering." 15 U.S.C. § 77d(2) (1976). Rule 146 was enacted in an effort (much criticized) to bring into sharper focus the standards of the private offering exemption. The most important requirements which must be met in order to qualify for the exemption under rule 146 include: (1) each offeree must have financial sophistication or financial security such to be able to bear the economic risk of the transaction; (2) each offeree must have access to or be supplied with information necessary to analyze the risks and benefits of the venture; (3) the private offering is limited to 35 purchasers; (4) the issuer must take steps to insure each original purchaser does not make a nonexempt, public distribution of the securities purchased; and (5) no advertising or general solicitation of any kind is permitted. 17 C.F.R. § 230.146 (1978).

The SEC has recently summarized the rule as follows:

> Section 4(2) of the Securities Act of 1933 provides that offers and sales of securities by an issuer not involving any public offering are exempt from the registration provisions of the Act. Rule 146 provides objective standards for determining when the exemption is available. The main conditions of the rule require that (1) there be no general advertising or soliciting in connection with the offering; (2) offers be made only to persons the issuer reasonably believes have the requisite knowledge and experience in financial and business matters or who can bear the economic risk; (3) sales be made only to persons as described above except that persons meeting the economic risk test must also have an offeree representative capable of providing the requisite knowledge and experience; (4) offerees have access to or be provided information comparable to that elicited through registration; (5) there be no more than 35 purchasers in the offering; and (6) reasonable care be taken to ensure that the securities are not resold in violation of the Act's registration provisions.

Securities Act Rel. No. 5913, 1978 [Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,532 (Mar. 6, 1978).

33. Loss, *The "Limited Offering" under the American Law Institute's Federal Securities*

Empirical studies might have determined whether the number thirty-five could be increased without hurting investors. In any event, economists could have been invited to determine the feasibility and advisability of empirical research to determine a proper cutoff. No such effort was made here or in any other area of the Code.

The method by which the number thirty-five was reached is an example of a method of procedure which is necessary in everyday decisionmaking. Immediate decisions must be made without the effort to make serious empirical investigations. This, however, is not the method by which fundamental changes in the Code should be made. This is particularly true since the drafting of the Code took nine years.

The number of offerees is no criterion whatsoever in determining whether the offering is a public offering as it is in current judicial doctrine outside of rule 146.[34] Moreover, there are no Code requirements that the issuer prepare a special package of information for the buyers, as is currently required by the judicial gloss of rule 146.[35] The Code also eliminates the requirement that purchasers possess a certain degree of financial sophistication, affluence or access to information about the issuer. The justification for this new approach is that limited offerings affect too small a number of persons to invoke the burden of federal regulation. Furthermore, the expectation is that the antifraud provisions of the Code will provide the proper degree of *in terrorem* pressure to preserve the required degree of honesty.

In the case of issuers that are *not* one-year registrants, the SEC under section 242(b)(3) may reimpose by rule sophistication and information delivery requirements on the limited offering transaction. If the Commission utilizes that discretion, small issuers or new ventures will be subject to far more rigorous limited'offering requirements than are large issuers. This will occur because it will be new ventures or the relatively small corporations that are not the one-year registrants. As a result, there may be an invidious impact on the capital formation process for startup ventures or small issuers as compared to the larger issuers.[36] Whether there would be such an

---

Code, in FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 40-41 (R. Mundheim, A. Fleischer & J. Schupper eds. 1973).

34. *See, e.g.*, Doran v. Petroleum Management Corp., 545 F.2d 893, 900 (5th Cir. 1977); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

35. *See, e.g.* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

36. *See* Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical*

impact is an empirical question which the Code in this respect and others was not designed to solve.

The justification for permitting sophistication and information delivery requirements for the smaller issuers who are not one-year registrants is that in the absence of the continuous disclosure that results from one-year registration, investors need protection. Another argument offered by the Reporter is that small business is more fraudulent than large.[37] The absolute elimination of such requirements in the case of one-year registrants represents a judgment that such requirements are unnecessary or unduly burdensome because of the continuous reporting structure imposed upon corporations which have registered pursuant to section 402 of the Code. None of these judgments were made as a result of empirical research. They represent attorneys' hunches, rather than scientific social research.

The elimination of the sophistication and information requirements for one-year registrants (and perhaps all issuers) is consistent with the current thinking of securities lawyers. They have campaigned for years in law review articles and in statements to the Commission and staff for the elimination of such requirements. To date their campaign has met with failure. Rule 146 requires sophistication, sometimes some degree of affluence, and delivery of information in order to quality a private offering under the rule. Outside the rule, the courts have elaborated a judicial gloss on section 4(2) of the 1933 Act which requires financial sophistication and information delivery or access to information about the issuer.[38]

The sophistication concept has been said to be elusive, complex and subjective[39] and, as such, the elimination of the requirements for sophistication and delivery of information have been widely accepted by securities attorneys. The elimination of such requirements, however, represents a judgment that is hardly incontrovertible. Naive and ignorant investors may need special protection. Rule 146 and section 4(2) forces the issuer to put together a coherent package of information about itself and the deal. That package is at least arguably a great aid to the potential purchaser in a private offering because he can examine a finished and complete offering

---

Foreclosure From the Capital Market, 1977 DUKE L.J. 1139.

37. *Panel Discussion, Fourth Annual Baron de Hirsch Meyer Lecture Series*, 33 U. MIAMI L. REV. 1519, 1524 (1979).

38. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

39. Kinderman, *The Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146*, 30 BUS. LAW 921, 928 (1975).

circular about the issuer. These advantages are eliminated by proposed section 242(b).

Thus, because of the elimination of certain requirements, the limited offering exemption as to one-year registrants will be much easier to comply with than section 4(2) of the 1933 Act and accompanying rule 146. Whether Congress will agree that the benefit to securities lawyers and their corporate issuer clients outweighs the disadvantages, if any, to prospective limited offering purchasers is an important policy decision it will have to make. If the legislators in their wisdom reimpose the rule 146 and section 4(2) regulatory gloss on the Code, then a major difference between current law and Code change will have been eliminated.

It must be emphasized at this point that the changes contemplated by the Code in the area of limited offerings (or elsewhere for that matter) were made without benefit of scientific empirical studies. We do not know whether the Code changes will have a great, a minor or no impact on the American capital formation process. Perhaps the limited offering area should be liberalized well beyond that proposed by the Code. Perhaps it should not. We have no way of knowing, of course, whether moving one way or the other in this private offering area is helpful or harmful to investors and to capital formation. The SEC could ease the current burdens of private offerings to a considerable extent without need of a vast new Code. It is unwise, however, to freeze the new Code provisions in this area based upon lawyers' hunches.

B. *Local Distribution*

The intrastate offering exemption of section 3(a)(11) of the 1933 Act, as supplemented by rule 147, is preserved in modified form by section 514.[40] Section 514 is far more liberal than the current restrictive exemption. The present exemption requires the issuer to be both incorporated in the state and primarily doing business in the

---

40. Sec. 514 [*Local distribution.*] (a) [*Definition.*] A "local distribution" is one that (1) results in sales substantially restricted to persons who are residents of or have their primary employment in a single State, or an area in contiguous States (or a State and a contiguous foreign country) as that area is defined by rule or order on consideration of its population and economic characteristics, and (2) involves securities of an issuer that does business or proposes to do business primarily in that State or area, regardless of where it is organized. Section 514(a) (1) is not satisfied unless at least 95 percent of all the buyers holding of record at least 80 percent of the securities distributed are persons there described.
FED. SEC. CODE § 514.

state.[41] Concerning the nature of the issuer, only the latter condition must be met, and the place of incorporation has no bearing on the exemption. Another liberalizing change concerns the offerees and purchasers. Section 3(a)(11) and rule 147 require each offeree to be a resident of the single state of the issuer. This provision has been liberalized in two ways. First, section 514 is not concerned with offerees, but looks to the final sales of the securities. Second, the sales are not limited to purchasers residing in the state, but extend to purchasers who have their residence or primary employment in the defined legislative area. The area in which the securities may be sold has also been expanded. The 1933 Act limits the exemption to transactions occurring all within one state. The proposed exemption will increase this area to include contiguous states, as that area is defined by rule or order.

As a consequence of these liberalizing changes, an increased number of distributions will fall under the exemption as compared with the number currently qualifying under section 3(a)(11) and rule 147.

The new intrastate exemption obviously will leave more distributions under the principal regulatory control of the states.[42] Any disclosure requirements will arise from the individual state blue sky law.[43] Under the Uniform Securities Act, disclosure would normally be required.[44] This leaves open, however, the question whether state administrators will require the same, less, or more quality or quantity of disclosure as would have been required by the SEC.

I can make the same comments about the changes in the intrastate offering exemption as I did with respect to private offerings. No empirical studies were made of the present operation of the intrastate exemption. We do not know whether it is working well or working poorly. Therefore, we have no benchmark against which to measure the Code changes. Perhaps the Code should have defined the term area and removed it from the rulemaking authority of the SEC. Perhaps the exemption should have been left untouched. Perhaps the exemption should have been eliminated in its entirety. Code decisions made in this area are empirically arbitrary. As frequently occurs elsewhere, they are based upon practical hunches about what direction the securities law should take.

41. *See* 1933 Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1976); rule 147, 17 C.F.R. § 230.147 (1978).

42. *See generally* FED. SEC. CODE § 1904, Note 2.

43. *See generally,* UNIFORM SECURITIES ACT; BLUE SKY L. REP. (CCH); J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

44. *See* UNIFORM SECURITIES ACT §§ 301, 402.

That is not the best basis for a wholesale revamping of the securities laws.

IV. SECONDARY TRANSACTIONS

The linguistic and conceptual changes from the 1933 Act are more numerous in the treatment by the Code of secondary transactions than in the area of primary offerings. Whether the empirical impact of these changes will actually alter the ongoing development of the law in this area, however, I have no way of knowing.

Among these changes, section 502 requires that, absent an exemption, specific information in the form of an "offering statement"[45] must be filed with the Commission if a "distribution" is to be made. Because the Code eliminates the concept of a "control person,"[46] the only real issues to be resolved in determining if a filing with the Commission is mandated is whether the planned transaction is a distribution and whether an exemption is available. The term distribution, which is not specifically defined in the current law, is defined by the Code as "an offering other than (1) a limited offering or (2) an offering by means of one or more trading transactions."[47] These exceptions, limited offerings and trading transactions, provide escape hatches by which fortunate secondary distributors may avoid regulatory encumbrance.

Individuals and institutions[48] which have purchased securities in a limited offering are free to resell those securities within the restricted selling period[49] provided that the transactions "do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase)."[50] This raises the possibility that persons who resell early will be more likely to come within the thirty-five owner limit than their colleagues who decide to sell later in the time span. In any event, a buyer will have to rely on the issuer to determine when the thirty-five owner limit is reached and when the

45. An "offering statement" is the term substituted for the § 5 "registration statement" of the 1933 Act. *See* 15 U.S.C. § 77e(c) (1976); FED. SEC. CODE §§ 268, 502.

46. *See* 1933 Act §§ 2(11), 4(1), 15 U.S.C. §§ 77b(11), 77d(1) (1976); 1933 Act rule 405, 17 C.F.R. § 230.405 (1978).

47. FED. SEC. CODE § 242(a).

48. These terms are utilized without regard to their status as affiliates or control persons.

49. The restricted selling period is three years in the case of an issuer who has not attained one year registrant status, FED. SEC. CODE §§ 242(b)(1)(B), 299.16, and one year in the case of a one-year registrant, *id.* § 242(b)(2)(A). After the one year period runs, the seller can utilize the trading transaction exclusion described *infra*.

50. FED. SEC. CODE § 242(b)(1)(B).

restricted selling period ends. This imposes the difficult, but not insurmountable, burden on issuers to determine the number of direct and indirect beneficial owners. Additionally, the reseller would appear to be dangerously exposed to liability if he relies on incorrect information supplied by the issuer. Since, however, Code section 242(b)(7) permits the reseller to act in good faith reliance on the issuer to avoid civil liablity,[51] there appears to be sufficient certainty and safety for the reseller.

The second escape hatch is provided by the "trading transaction"[52] exclusion from distribution. This provision is similar in general outline to the current rule 144.[53] The Code exemption from filing requirements covers transations

> through a broker or with or by a dealer [when] (A) the transaction is not . . . for the account or benefit of the issuer . . .; (B) the security was not the subject of a limited offering within the one-year or three-year period . . .; (C) the broker or dealer performs no more than the usual function of a broker or dealer . . . and receives no unusual compensation; and (D) the total of all trading transactions originating with . . . the same person . . . does not exceed whatever amount . . . the Commission specifies by rule.[54]

Section 242(c)(2) provides that the Commission may add additional conditions to those set forth above when the issuer is not a one-year registrant. When compared with rule 144, section 242 is not much more "liberal," particularly in view of the recent evolution of rule 144.[55]

---

51. *Compare* FED. SEC. CODE § 242(b)(7), *with* 1933 Act rule 144(c)(1), 17 C.F.R. § 230.144(c)(1) (1978):

> The person for whose account the securities are to be sold shall be entitled to rely upon a statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required to be filed . . . unless he knows or has reason to believe that the issuer has not complied with such requirements.

52. FED. SEC. CODE § 242(c).

53. 17 C.F.R. § 230.144 (1978).

54. FED. SEC. CODE § 242(c)(1).

55. Rule 144, pursuant to an amendment effective March 12, 1979, now permits nonaffiliates in specified circumstances to ignore the volume limitations of the rule after a holding period of either three or four years. The text of the amendment is as follows:

> *Sales by persons other than affiliates.* The amount of restricted securities sold for the account of any person other than an affiliate of the issuer, together with all other sales of restricted securities of the same class for the account of such person within the preceding three months, shall not exceed the amount specified in paragraphs (e)(1)(i), (1)(ii), or (1)(iii) of this section, whichever is applicable. The limitation in this paragraph (e)(2), however, shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the

When the concept of the Code was first contemplated some eleven years ago, rule 144 was not yet on the books,[56] although its concept was discussed in many areas including the famous Wheat Report.[57] Now that rule 144 has been on the books for some years, I again ask the question whether we need a statute to do what the rule does. This is a question which is applicable to many other changes in the Code and which I have reiterated with regard to other provisions. Here, as elsewhere, the Code evidences a regulatory lag, in that it is proposing changes which are already in place. The more fundamental problem is that we have no empirical research which shows us that the trading exclusion is either a good idea or a bad idea. Although many securities practitioners think that rule 144 is working well, not all agree, and those who agree or disagree are merely relying on hunches and guesswork. Despite this, the Code would elevate this rule to a statute. This is not, for the reasons I have indicated above, the best way to engage in fundamental legislative change.

Potential problems arise if we consider a case in which the secondary distributor wishes to *distribute* the securities of an issuer which is not a one-year registrant. As indicated above, it is prima facie unlawful under the Code for a reseller, in connection with a *distribution* by him, to make an offering unless the issuer has filed an offering statement,[58] regardless of whether the reseller is either in control of the issuer, or is not an underwriter. Thus, under the Code, if the issuer refuses to file an offering statement with respect

---

time of the sale and has not been an affiliate during the preceding three months, Provided: (1) The securities have been beneficially owned by the person for a period of at least three years prior to their sale and are part of a class that is either listed on a national securities exchange or quoted in the National Association of Securities Dealers, Inc.'s electronic interdealer quotation system known as NASDAQ, or (ii) the securities have been beneficially owned by the person for a period of at least four years prior to their sale and the issuer thereof is in compliance with the requirements of paragraph (c)(1) of this section regarding the filing of reports under sections 13 or 15(d) of the Securities Exchange Act of 1934. In computing the holding period for purposes of this provision, reference should be made to paragraph (d)(4) of this section.

Further, in regard to securities that were purchased, the full purchase price or other consideration shall have been paid or given at least three or four years, respectively, prior to their sale in order to satisfy the beneficial ownership requirements of (e)(2)(i) or (ii) of this section.

44 Fed. Reg. 15612 (1979) (amending 17 C.F.R. § 230.144(e) (1978)).

56. Rule 144 became effective on April 15, 1972. *See* 37 Fed. Reg. 596 (1972).

57. SEC—DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (CCH ed. 1969).

58. This would be true assuming there is no exemption. *See, e.g.*, FED. SEC. CODE § 514(c).

to the particular securities which the secondary distributor desires to sell, the secondary distributor might be unable to sell the securities and thereby become locked into his stock position. The solution to this problem is Code section 502(b). In Draconian fashion, this provision forces an issuer which has not achieved one-year registrant status to file an offering statement on the demand of a holder of securities who proposes to make a distribution. In other words, a closely held "ma and pa" corporation can be forced to disclose all to the SEC in an offering statement on the demand of a single security holder in order to prevent a lock-in of the secondary distributor which was caused by conceptual changes of the Code. This requirement is conditioned upon the agreement of the secondary distributor to deposit "the reasonably estimated expenses"[59] of the filing in advance and to pay necessary additional expenses promptly on demand of the issuer.[60] The issuer may avoid the filing requirement if it arranges to purchase the securities which are the subject of the demand.[61] Furthermore, the demand provision does not apply with respect to securities held by a person who has signed a written waiver of his rights[62] or who is "contractually or legally bound by a restriction on transfer that would be violated by the proposed distribution."[63]

The filing on demand requirement obviously represents a significant change from the philosophy surrounding the 1933 Act. As Professor Loss has pointed out, this provision is the necessary result of the Code filing requirement for all secondary offerings;[64] and the limit to non-one-year registrants is the result of the liberal provisions available to secondary distributions involving the securities of one-year registrants under which offering statements are not required as a condition to sales.[65]

Although this Code provision represents a skillful lawyer's handling of the problem, its empirical results are far from clear. For example, a majority of issuers may try to obtain the written waiver. If they succeed, the filing on demand provision will be rendered a dead letter. This is a matter of some concern because, on the way to becoming a dead letter, the pressure this provision puts on issuers to obtain the waiver could impact on the price of the offering as a

59. *See id.* § 502(b).
60. *Id.* § 502(c).
61. *Id.* §§ 502(b)(6)(C), 502(b)(7).
62. *Id.* § 502(b)(6)(A)(i).
63. *Id.* § 502(b)(6)(A)(ii).
64. *See* Loss, *supra* note 31, at 1440-43.
65. *Id.*

result of the inevitable bargaining process which I believe would ensue. We must also concern ourselves with the possible adverse impact, in terms of demands on the time and effort of key company officers that the preparation of an offering statement requires, upon issuers who do not obtain the waiver.

Imagine a typical negotiation involving a non-one-year registrant. The issuer's officers and counsel will most likely want the purchaser of securities to sign a written waiver. Without this waiver, purchasers would enjoy the privilege of filing on demand. Prospective purchsers, however, will be very reluctant to waive their rights because of their awareness of the limitations this would impose upon their freedom to resell the securities in the future. Suppose that a corporation offers its stock to a limited group of persons at fifteen dollars per share and, in addition the corporation demands a written waiver of their rights. It is conceivable that the purchasers might agree to sign the waiver only if the offering price is discounted. In other words, "we will give you a written waiver if you sell to us at seven dollars per share rather than fifteen." In advance of the enactment of the Code, we do not know if negotiations of this kind will actually occur or, if they do, what impact they will have on the capital formation process of the comparatively small issuers which will be subject to this provision. Here, as in many other provisions of the Code, there have been no scientific attempts to analyze the empirical consequences of a new provision.

The filing on demand provision is an example of an area in which the Code has potentially increased the regulatory burden placed upon a certain class of issuers. Conversely, other provisions amount to a loosening of the regulatory harness.[66] No empirical evidence has been presented to suggest that we should tighten regulation in one area and loosen it in another; yet, we are prepared to enter unknown territory with provisions based solely upon predetermined fears of future occurrences without any knowledge of what the impact of those provisions will be. The fear that has led to the regulatory tightening in the case of filing on demand is based upon the fear that, given the construction of the Code, secondary distributors may be "locked-in." This fear, in turn, is based upon a hunch which results from the conceptual, as opposed to the empirical, approach to secondary distributions adopted by the Code.

Another crucial section which must be considered is section

66. *See, e.g.*, FED. SEC. CODE §§ 242(b), which replace § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1976).

510, which covers secondary distributions by holders of securities issued by one-year registrants.[67] Secondary distributors[68] of such securities may elect to comply with the requirements of this section for securities of a class in excess of those acquired through a limited offering which are still within the one-year restrictive period provided in section 242(b)(2) on limited offerings.[69] When such an election has been made, the necessity for an issuer's offering statement is eliminated. No issuer filing or consent is mandated. Instead, the secondary distributor need file only a limited statement termed a distribution statement. That document merely contains whatever information, underwriting contracts and other documents concerning the secondary distributor that the Commission establishes by rule. The secondary distributor must also certify that he is unaware of any adverse material or significant facts about the issuer that have not been made public. More or less information may be permitted or required in specific cases as mentioned in the section.

The philosophy in this section is consistent with the overall approach of the Code. Since one-year registrants are required continually to make disclosures under the Code, there is assumed to be no need to generate a new financial document about the issuer in the case of a secondary distribution no matter how large. This approach is consistent with recent SEC moves to shorten prospectuses for sales of securities issued by companies reporting under sections 13 or 15(d) of the 1934 Act. In any event, there is always the *in terrorem* effect of the antifraud and civil liability provisions of the Code. The basic assumption may be questioned by representatives of investor and "Nader" groups when the legislation is considered in Congress. They may assert that there is a value to investors in requiring issuers to prepare special disclosure documents in the case of large secondary sales.

The secondary distributor in the case of a one-year registrant has another escape route. Section 512(d) provides that a secondary distribution, no matter how large in dollar amount or how many commissions are paid to brokers, is exempt from even the liberal provisions of the distribution statement when the distributor *owns* not more than fifteen percent of the voting securities of the one-year

67. *See* note 48 *supra*.

68. " 'Secondary distributor' means a person (other than the issuer) by or for whose account or benefit a distribution is made." FED. SEC. CODE § 299.51.

69. Section 510(a) creates an election for a secondary distributor of securities issued by a one-year registrant. The election does not apply to securities acquired during the one-year restrictive period provided for limited offerings under § 242(b)(2).

registrant. The exemption applies only to securities in excess of securities acquired in a limited offering during the one-year restrictive period.[70] In a sense, this amounts to a reintroduction of the old control concept into the Code. Under present law a secondary distribution by a person not in control, and who is not an underwriter, is exempt from any disclosure-filing requirements. A person in control cannot distribute publicly through brokers unless the issuer registers with the Commission.

The Code, in effect, applies a conclusive presumption of control to holdings in excess of fifteen percent and requires a distribution statement in that case. The section 512(d) exemption was designed to facilitate so-called block trading, which apparently would be hindered by the Code mechanics of distribution statements. Obviously, it goes beyond that purpose by permitting certain secondary distributors to sell their stock without any filing with the Securities Exchange Commission. A person who owns less than fifteen percent of the voting securities of General Motors could sell twenty-five million dollars worth of stock without any public filing with the SEC. On the other hand, a primary sale by a relatively small issuer of a million dollars of stock would require the filing of an offering circular and the preparation of a prospectus. Of course, there is a distinction between secondary distributions and primary offerings. Primary offerings involve the raising of capital. This, in turn, involves a change in the capital structure of the issuer and disclosure complexities with respect to use of proceeds. Some primary offerings, however, involve very simple changes in capital structure and equally simple use of proceeds. Large secondary distributions of twenty-five or fifty million dollars may involve thousands of buyers and extraordinary brokerage selling efforts. There may be a significant prophylactic value to investors in requiring some type of organized, specially prepared, disclosure package for the multitude of offerees and purchasers. Although they can use the continuous disclosure dcuments which are on file with the SEC, we know that they almost always will not.

There is yet another exemption for secondary offerings applicable in this case to all issuers whether one-year registrants or not. Section 512(e) provides an exemption for a transaction incident to an offering of not more than \$100,000.[71] This exemption does not

70. *See* FED. SEC. CODE § 242(b).

71. Section 512(e) provides:

> [*Small Offerings.*] a transaction incident to an offering of not more than \$100,000 except that (1) the Commission, by rule with respect to any class of

apply to a transaction in a security that was the subject of a limited offering within the one or three year restricted period as the case may be. The Commission by rule may reduce the amount to not less than $50,000 in any twelve month period. In addition, the Commission may impose conditions or withdraw the exemption when the offering exceeds $50,000.

Although attorneys may analyze the language of changes from present law in the Code in the area of secondary distributions, it is unclear what the bottom line economic impact of these changes will be. For example, it is not apparent whether elimination of the old control concept coupled with the reintroduction of a de facto control test, *i.e.*, the fifteen percent provision, will have a small, a considerable, a great or even a zero impact on the functioning of the capital markets.

V. THE CODE IN PERSPECTIVE

Although the foregoing represents an overview of the Code proposals for the regulation of securities distributions, there are many other provisions applicable to the codification of the Securities Act of 1933.[72]

The Code project was initiated some ten years ago. Since then, the SEC and Congress have engaged in a vast regulatory effort to modify the Securities Acts and to rectify the problems that led to the initiation of the project. Commissioner Pollack said recently, "[t]he Code has been under development for over 10 years and things have dramatically changed. It almost has a regulatory lag in it."[73]

The 140 series of rules, the Securities Acts Admendments of 1975, the SIPC legislation, the efforts to improve continuous disclosure by reporting companies, the development of short-form pros-

---

> issuers, securities, or offerings, may (A) reduce the amount to not less than $50,000 in any twelve-month period or (B) impose conditions or withdraw this exemption when the offering exceeds $50,000, and (2) this exemption does not apply to a transaction in a security that was the subject of a limited offering within the one-year or three-year [for non-one year registrants] period, as the case may be, specified in section 242(b).

FED. SEC. CODE § 512(e). This exemption covers both primary and secondary offerings. *See also* the power given to the SEC to exempt transactions by § 303. FED. SEC. CODE § 303.

72. For example, the Code in § 512(f), (g), & (h) contains with some changes the exemptions now in § 3(a)(9), & (10) of the 1933 Act. Also, the definitions of exempted securities in § 302 of the proposed Code parallel those of § 3(a) of the 1933 Act. *See* Cheek, *Exemptions, ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345, 359 (1978).

73. 484 SEC. REG. & L. REP. (BNA) AA-2 (Jan. 3, 1979).

pectuses for reporting companies and the recent efforts to eliminate onerous filing requirements for smaller issuers have involved countless hours of congressional and SEC time and significant efforts by the practicing bar. There has been substantial criticism of some of the efforts, particularly in connection with rule 146.[74] A case can be made, however, for the relative success of many of these innovations. Furthermore, the Commission could, under its current rule-making authority, make even greater strides toward simplicity and effective disclosure without new legislation.

A question (albeit raised with some reluctance) is whether this is the proper time to evaluate and legislate a totally new securities code. The securities industry is in an exceptionally dynamic stage. The Supreme Court is making significant changes in securities law.[75] The Commission and the industry are grappling with revolutionary changes in capital market structure and problems in disclosure philosophy. The Commission and the securities bar are attempting to understand and implement the massive changes produced by the Securities Acts Amendments of 1975. Even under the best of circumstances, it would be a difficult task for Congress and the Commission to analyze thoroughly, review, and understand a new and complex 800 page Code. The question is whether important ongoing, current problems will be ignored while Congress and the SEC wrestle with a vast new statutory project.

Furthermore, if enacted, the Code will necessarily involve a vast new regulatory and intrepretative effort by the SEC and the bar. They may need to devote five, six or seven years to drafting new rules and solving new problems.

The securities bar and the Commission have gained an enormous amount of experience and facility with the present securities acts and their judicial interpretations. It is not self-evident that the technical improvements made by the Code will outweigh the burden of interpreting and implementing a new Code and thus on balance simplify (*i.e.*, lessen the cost of) the legal burden of individual and corporate clients of the securities bar.

---

74. *See, e.g.*, Cheek, *Exemptions under the Proposed Federal Securities Code*, 30 VAND. L. REV. 355 (1977); 8 U. TOL. L. REV. 343 (1977); 59 VA. L. REV. 886 (1973).

75. *See, e.g.*, Parklane Hosiery Co. v. Shore, 99 S. Ct. 645 (1979) (company held estopped from relitigating liability determined in SEC injunctive action in a subsequent class action for damages); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (narrowing meaning of fraud in a private cause of action under rule 10b-5 of the 1934 Act to exclude nondeceptive and nonmanipulative breaches of fiduciary duty); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (requiring scienter in a private cause of action under rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (refusing private causes of action for money damages to nonpurchasers or sellers).

The consensus of the impressive roster of securities lawyers who have worked directly on the Code enthusiastically favors the enactment of the Code. The Code, of course, is a lawyer's effort to simplify the legal complexities that have arisen in the field. No systematic or scientific effort has been made by the sponsors of the Code to evaluate the empirical effects of the changes proposed by the Code. Furthermore, the Code does not, nor was it intended to, deal with the deep divisions among economists, lawyers and financial analysts about the fundamental worth or manner of presentation of current modes of corporate disclosure.[76]

Although the Code was never intended to address the complex philosophical, empirical or disclosure issues referred to, this is not necessarily a justification for its not doing so. The technical artistry with which Professor Loss and his colleagues have drafted this monumental new Code is extraordinarily impressive. This is, however, a lawyer's code. It lacks input from other disciplines. For example, economists have not had a significant opportunity in an organized manner to evaluate this Code and to make recommendations.

The securities legislation was a 1930's answer to the perceived problems that occurred in the 1920's and early 1930's. It was a great experiment which resulted in a proud and famous agency, the SEC. It was a successful experiment because it helped to restore the confidence of Americans in the capital markets of the United States. Forty years have passed since that noble experiment. New doubts about the wisdom and direction of the 1930's statutes have arisen. We are no longer as willing as we were in prior years to accept without doubt and qualification the value of regulation in and of itself. As Commissioner Karmel has pointed out in recent speeches, there is a danger that automatic adherence to regulation will stifle the vigor and dynamism of our free enterprise system.

VI. CONCLUSION

The draftsmen of the Code have largely proceeded based upon

76. *See* Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 BUS. LAW. 43 (1968); Comment, *Utilization of Investment Analysis Principles in the Development of Disclosure Policy Under the Federal Securities Laws*, 25 U.C.L.A. L. Rev. 292 (1977) (advocating that securities disclosure laws conform to economic realities in order for them to function effectively in individual and social welfare). *See also* J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY (4th ed. 1977); Benston, *supra* note 27; Kassout, *Towards a Legal Framework for Efficiency and Equity in the Securities Markets*, 25 HAST. L.J. 417 (1974); Kripke, *A Search for a Meaning of the Securities Disclosure Policy*, 31 BUS. LAW. 293 (1975); Pozen, *Money Managers and Securities Research*, 51 N.Y.U. L. REV. 923 (1976); Wolfson, *supra* note 6, at 287.

the assumptions of the 1930's. Although they have made many significant and brilliantly conceived changes, they have not asked really fundamental questions about the direction that securities legislation should take over the next fifty or sixty years. They have tightened regulation here and loosened it there, without the benefit of scientific empirical investigation of impact. If Congress is to be put to the great burden of recodifying the entire body of securities legislation, then acceptance of regulatory philosophies of the 1930's is a questionable approach. We should reexamine the securities acts in light of our current skepticism about the inherent value of economic regulation.

I think it is essential that Congress move with deliberate speed when it reviews the Code. Congressman Eckhardt announced some months ago that, in view of the impressive skill and care with which the Code had been prepared, he was not going to establish a separate congressional staff study to examine it *de novo*. He is going to take the Code as given and move directly into hearings on provisions of the Code. That decision is a mistake. A *de novo* congressional review of the Code and of the basic policy problems that have arisen in the securities field is necessary.

In raising these reservations and questions, in all fairness Professor Loss' rebuttal must be emphasized. As he has pointed out, there is a danger that in striving for the "best," we will fail to accomplish the good. That danger must be recognized. Professor Benston has elsewhere pointed out, however, that the apparently practical may be the enemy of the good.[77] Furthermore, the proposed new federal legislation will freeze securities concepts into law for the next thirty, forty or fifty years or more. It would be a mistake to enact quickly this Code, as brilliantly drafted as it is, without a probing congressional review which would encompass all the resources and skills of economists and social scientists that lawyers, at our peril, do without.

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