The Federal Securities Code

Louis Loss
Keynote Address: The Federal Securities Code

LOUIS LOSS*

In this keynote address for the Fourth Annual Baron de Hirsch Meyer Lecture Series, Professor Loss describes the process and philosophy underlying the proposed Federal Securities Code. In addition, he outlines a few of the major substantive changes made by the Code in contrast to present securities regulation and closes with a discussion of the prospects of the Code as it moves toward consideration by Congress.

It is very gratifying, ladies and gentlemen, to those of us who have worked for a long time to produce a Federal Securities Code, to see so much academic and general interest expressed in it. The only group we still have to convince is the Congress of the United States. I worry a little bit about the late Adlai Stevenson syndrome. He would have been elected unanimously, overwhelmingly, if the Europeans had voted instead of the Americans. But I am optimistic.

I do not think that I need start, with this audience and at this time, from scratch and talk about the need for a Code. As far as I am concerned, and I am biased, that was established when we started ten years ago. If other people want to debate whether there should be a Code, that is all right with me. But after ten years of work, I do not feel much like debating whether it should have been done. Instead, I shall talk about some of the basic approaches, philosophical and otherwise, that are embodied in the Code and that guided us in its drafting. Then, I shall describe some of the major changes that the Code would effect in present law, and then say something about its current status.

We had in mind several propositions by way of general approach that we have tried to follow. When you write a Code of this sort, the question is: To what extent do you codify existing law and to what extent do you change the law? A fair number of people are still under the impression that all we set out to do was to put six or seven statutes together, much in the way in which the Statutes at

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Large became the United States Code. First of all, it would be impossible to do that without making substantive changes, because there are inconsistencies. The same word, "security," for example, is defined in different ways in different statutes. Second, neither The American Law Institute nor those of us who have done the work would have needed ten years for that sort of cosmetic job. Third, we were not particularly interested in that type of job.

We approached it specifically, and The American Law Institute made this clear in approving the work, with the idea that there would be no holds barred and that we could feel free to reexamine any premises upon which the present statutes were based. It is somewhat of a heady feeling while shaving in the morning to say: "Well, how much of the Supreme Court shall we reverse today?" So, our first proposition was no holds barred.

Second, we realized that we were not writing on a clean slate and that there would be no point in cavalierly disregarding precedent. There were some things that we would have done differently, perhaps, if we had written on a clean slate.

Third, I hope we appreciated that if there is anything worse than no codification it would be overcodification. Some years ago, one of my colleagues, an international tax expert, went down to one of the Latin American countries to try to help them set up a tax structure. He came back and said: "I made a remarkable discovery. There is something worse than a government with a bureaucracy, and that is a government without a bureaucracy." Similarly, the only thing worse, as I say, than undercodification or a lack of codification would be too much of it. There is a great value in preserving, to an appropriate extent, the common law technique. One could not possibly anticipate, for example, all the problems that are going to come up in an area like rule 10b-5. We did a great deal of codification, but we also recognized that some questions were not right for codification. As I say, the common law technique is one that is essential.

I have had occasion, several times, to quote a couple of sentences from an address that Lord Devlin gave—he is retired now—at Northwestern University back in the sixties, published under the


title, *Samples of Lawmaking*. He was talking about judicial lawmaking. He put it this way—and I might say that, although I have no reason to believe that Lord Devlin ever heard of rule 10b-5, he could not have described what happened under rule 10b-5, and what has happened since he spoke, any more eloquently than if he had been addressing himself specifically to that rule:

> It is not in accordance with traditional methods of judicial lawmaking to begin by saying how far you will go. Some cases are allowed and then others are disallowed as going too far, and the formulation of principle has to wait until that process is well advanced; and during the process the common lawyer will stop, logic or no logic, when something tells him that he has gone far enough.

I suggest, too, that is exactly what has happened in the Supreme Court of the United States during the last few years with reference to rule 10b-5 and some other SEC cases.

While there are about thirty respects in which we have codified questions under rule 10b-5, let me give you one or two examples of what we left to further judicial development. The so-called “Chinese wall” problem is one area. Banks lend money. Banks also act as trustees. The lending officer of a bank is visited by someone who wants to borrow a few million dollars for his business. The lending officer decides that the business is going downhill and turns down the loan. He knows or suspects that the trust department has a good deal of the stock of that company in its portfolio for various trusts. Does he tell the trust department to get rid of the stock, not to buy any more, or does he remain quiet? These are serious problems today and nobody quite knows the answer. Banks are setting up the so-called Chinese walls between their lending and trust departments. I do not know how effective they are. I do not know what the courts ultimately are going to do. We tried hard and then gave up. So all we have said in the Code on that problem is that, whenever the courts are faced with questions of attributing knowledge from agent to principal, those questions shall be decided in accordance with the common law of agency applied federally, and in doing so, the courts shall give appropriate consideration to a “Chinese

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5. *Id.* at 10.
7. See *Fed. Sec. Code* § 1603 & Comment 3(c). *See also id.* § 287(c).
wall” (we do not use that phrase) when there is one. Perhaps twenty
years from now, somebody can codify what the courts will have done
with that.

Similarly, the measure of damages in actions by buyers or sellers based on alleged misstatements in the purchase or sale of securi-
ties is mildly chaotic. One writer not too long ago said there is no
law of damages under rule 10b-5—it is made up case by case. That
is not much of an exaggeration. We tried very hard to set down fairly
specific formulations for measuring damages in these cases, at the
price of some complex drafting, I am afraid.8 Having finished that,
we were afraid to stop there, so we added a provision saying, in
effect, if the court thinks that these formulas will produce ridiculous
results, they should do the right thing.9 I wish it were possible to
draft in that kind of English.

Next, by way of general approach, we have tried to confine
ourselves to codifying what might be loosely called “lawyer’s law,”
as distinct from questions of basic policy such as the extent to which
the antitrust laws should cut across securities regulation. Our
thought was this: We would hope that Congress would give a good
deal of respect to recommendations made by The American Law
Institute, after long study by numerous experts, when it comes to
questions like statutes of limitation,10 burden of proof11 and the defi-
nition of scienter12—lawyer’s law. But why should Congress listen to
The American Law Institute on questions of basic policy like anti-
trust or certain types of regulations in the investment company
industry? It is not an easy line; it is, however, one we tried to follow.

8. Id. § 1708.
9. (e) [Variation of defined measure of damages and definition of
rescission.] Subject to the limitations in (1) section 1702(e)(2) or 1708(c)(2) or a
similar provision that specifies a maximum measure of damages, (2) section
1708(b)(2) or a similar provision that reduces the measure of damages to the
extent that the defendant proves lack of causation, and (3) section 1723(b), the
definition of rescission and the measure of damages specified in sections 1702,
1708, and 1710 may be varied on a showing that a different definition of rescission
or measure of damages would be plainly more appropriate on consideration of
such factors as the plaintiff’s loss, the defendant’s profit, and the deterrent effect
of the particular type of liability.

Id. § 1723(e).
10. Id. § 1727 and notes following, which describe the dilemma of the authors in trying
to write the statute of limitations provision. See also ALI FEDERAL SECURITIES CODE § 1421 &
11. See, e.g., FED. SEC. CODE § 1704(c)-(e).
12. “A person makes . . . a misrepresentation with ‘scienter’ if he knows that he is
making a misrepresentation . . . or acts in reckless disregard of whether that is so.” Id.
§ 299.50.
As I have said several times during our meetings at The American Law Institute, we have tried to be principled "insofar as practicable." We were not interested in spending a decade drafting what we thought was a perfect Code that would have little chance of adoption. And so, not infrequently, we have compromised with what might be called principle. We have tried to be practical. Different people will differ about where that line should be drawn. But this is simply to say that codification is compromise. There has been a great deal of it, and I am sure there will be more before the Code becomes law.

Next, by way of drafting approach, some people have criticized what we have done because it gives too much rulemaking power to the Commission. I am not sure it gives them any more than they have now, but certainly one could not draft in this area without giving the Commission wide rulemaking authority, though I join many people in disagreeing with how it has been exercised in some respects in the past. If we tried to cut down, we would have a Code several times as long and as complex as the one we produced.

One simple technique that has kept the Code from being even more complex is the little section 303, which provides that "[t]he Commission, by rule or by order, may exempt any person, security, or transaction . . . from any or all of the provisions of this Code." There is already such a provision in the Investment Company Act.

13. Sec. 1804. [Rules and orders] (a) [Commission's authority.] The Commission may adopt, condition, amend, suspend, and repeal rules and orders to implement specific provisions of this Code. Among other things, those rules (and orders so far as 1804(a)(3) and (4) is concerned) may

(1) define technical, trade, and other terms, whether or not defined in this Code, consistently with the definitions in and purposes of this Code;

(2) prescribe the form in which required information shall be stated;

(3) classifypersons, securities, transactions, registration, offering, and distribution statements, applications, reports, and other matters, and prescribe greater, lesser, or different requirements for different classes;

(4) permit or require incorporation by reference and permit the filing of copies of documents filed with other governmental authorities (Federal, State, and foreign) in lieu of information otherwise required (all of which the rules shall permit to the maximum extent practicable and appropriate under the circumstances); and

(5) prescribe the extent, if any, to which interpretative rules apply without retroactive effect.

Id. § 1804.

14. See id. § 1804(a), Note (1). The rulemaking authority contemplates rules explicating genuine definitions rather than "rules like the '140 series' under the 1933 Act, which, regardless of their value as stopgaps pending a legislative solution of the problems to which they are addressed, would not be easy to defend as 'definitions' of 'technical' or 'trade' terms."

15. Id. § 303.

and the Investment Advisers Act\textsuperscript{17} which the Commission has lived with for almost forty years. There are similar provisions in some sections of the other acts.\textsuperscript{18} We have made it Code-wide, with one or two exceptions. I cannot tell you how many times in the course of deliberations with the advisory groups I answered some hypothetical question that was conjured up by saying: "Well, that's probably never going to arise. If it does, the Commission will be able to handle it under section 303." If there were no section 303, we could not have ignored those hypothetical questions, and I am afraid the Code would have become more and more like the Internal Revenue Regulations.

Finally, we have tried very hard to preserve a balance. As I said when we started this job, the one criticism that I will not listen to when it is finished is: "Well, you have changed something; you have tightened it or you have loosened it." That is the name of the game. There is bound to be tightening as well as loosening, loosening as well as tightening, to achieve a balance. That is why, when either the Commission staff people or Wall Street types want to change it from either here or there, I always remind them that they must consider not only that provision but also what it does by way of the general balance of the Code.

Our goal, in short, has been to deregulate and simplify insofar as that can be done without diminishing investor protection. You might say that that is carrying water on both shoulders, but one can, if he is careful, carry water on both shoulders. These aphorisms always remind me of a Harpo Marx incident in which somebody said, "You know you can't burn the candle at both ends," and he reached under his voluminous robes and pulled out a candle that was brightly burning at both ends.

So far as the organization of the Code is concerned, in comparison with the present hodgepodge, it is simplicity itself. It is divided into twenty parts. It has a table of contents, which will be de facto part of the Code, though not de jure part of the Code. There are many cross-references, which, along with the table of contents, will be included for convenience, though they are not to be aids to construction. The table of contents will be written with section headings and subsection headings so that one will be able to find things readily. All the definitions are in one grand list.\textsuperscript{19} You do have to

\begin{itemize}
\item \textsuperscript{17} \textit{Id.} § 80b-6(a).
\item \textsuperscript{19} \textit{Fed. Sec. Code} pt. II.
\end{itemize}
know the alphabet, but if you do, you will find a particular definition easily. There are even what one of my esteemed consultants likes to call "road maps." They are introductory sections to some of the rather complex parts that state in ordinary English prose, cursive prose, that this is what we are trying to do and that this is the way the part is arranged. That type of section, again, is not part of the Code for purposes of construction, but it is there for convenience. There will be, of course, as there is in the present Proposed Official Draft, a cross-reference table from present law to the Code at the end, so that people can find their way around.

Not insignificantly, I might add, I like to think that the Code is written in English. This does not mean that there are not some fairly long and complex sections. But as a matter of style we tried to write in the way in which people ordinarily write English. I do not know what there is about law students in this respect. They write reasonably good English in college. Then they come to law school and right away they begin talking about "such" this and "such" that. They must think it makes them sound like real lawyers. Whatever it is, we have tried to write English.

Well, let me give you some examples of the major substantive changes. There is not time to go into detail, but I shall give you a few examples.

When a company makes a public offering of securities, it has to file a registration statement under the Securities Act of 1933.20 Some companies have done that twenty to thirty times, perhaps more, and some companies not at all. If a company can finance itself and its growth by plowing back earnings, it does not have to go to the public; it can raise capital privately without ever registering under the Securities Act. If a company wants its securities listed on a stock exchange, it has to register separately under the Securities Exchange Act of 1934.21 Since the 1964 amendments,22 if a company has $1 million of gross assets, it must register any class of equity securities held by 500 persons, whether or not it is listed on a stock exchange. If the company happens to be an investment company or a public utility holding company, it has to register separately under one of those acts. If it is issuing a debt security, it has to qualify an indenture separately under the Trust Indenture Act. The Commission has done a great deal by way of permitting incorporation by reference, but there is a limit to what it can do within that structure.

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21. Id. § 78.
Under the Code, there will be no more securities registration as such. Instead, a company will register as a company,\(^{23}\) either on the occasion of the first distribution of its securities by anyone—and that word "distribution" will be defined shortly—or when it has $1 million in assets and 500 security holders in toto (holders of all securities, debt and equity) or when it is an investment company or a public utility holding company. There will be one file per company. All reports and all future prospectuses will go into the same file.\(^{24}\) The Commission will have authority, at appropriate intervals, to require each company to start over again and to integrate its filings, so that people will not have to go over the old reports indefinitely.\(^{25}\) In an age of electronic retrieval of information, one need not expatiate too much on what a great advantage that will be in terms of finding out what is on file, and also in terms of simplifying filings.

The Code, therefore, provides for a basic registration statement. Now, what do you do when a company makes a distribution? First of all, the Securities Act, since 1933, has exempted "transactions by an issuer not involving any public offerings"—language taken from the English Companies Act.\(^{26}\) We used to think we knew what "public offering" meant in the early days of the Commission. If you did not sell to more than twenty-five people or so, it was private. It was fairly simple. But then the courts delved into the problem and began to talk like law school professors. They discussed the purpose of the statute—having financial sophistication and having the ability to "fend for yourself"—to the point where nobody knows what a public offering is anymore. The Commission adopted a four or five-page rule,\(^{27}\) which I should think would be just a bit harder to comply with than registering. We decided to start from scratch there. We no longer use the words "public offering" at all, but use the word "distribution."\(^{28}\) When there is a distribution, there has to be an "offering statement."\(^{29}\) We cannot say "registration statement," because we preempted that phrase for the company registration statement—so there will be an offering statement.

The offering statement, we hope, will be shorter than the pres-

\(^{23}\) Fed. Sec. Code pt. IV.


\(^{25}\) Fed. Sec. Code § 602(b).

\(^{26}\) 15 U.S.C. § 77d(2) (1976); Companies Act, 1929, 19 & 20 Geo. 5, c. 23.

\(^{27}\) Nash v. Lynde, [1929] A.C. 158.


\(^{29}\) Id. § 502.
ent registration statement, because the emphasis under the Code will be shifted from the occasional hit-or-miss registration of securities to company registration and continual reporting. Specifically, we say that it is necessary to file an offering statement only if there is a distribution. Then we define distribution to mean any offering other than a limited offering\(^{30}\) or what we call a "trading transaction."\(^{31}\) Limited offering is then defined as any offering that ends up with not more than thirty-five buyers, plus an indefinite number of institutional investors.\(^{32}\)

Before we get to that, how did we arrive at thirty-five? In the early days we got along quite well by saying not more than twenty-five offerees. If it was more than twenty-five, it depended on the facts. I first thought we would just codify that rule, and in the early drafts I said twenty-five offerees. Then it occurred to me—why do we talk about offerees—because the House of Lords once said, quite logically, under the English phrase that we borrowed, that you could have a public offering to the world with only one buyer.\(^{33}\) Therefore, public offering means offeree. Yet, literally, why do we worry about protecting offerees that do not buy? Besides, when you define "offer" as it is defined today, and as it will be defined in the Code, to mean "any attempt to dispose of a security," any sneeze in the general direction of a possible buyer is an offer, and it is therefore difficult to count offerees. So, with some hesitation, I suggested to the advisory group that we say twenty-five buyers and nobody objected, including Commissioner Loomis, who has been one of the advisers right along. How did we get to thirty-five buyers? Well, somebody said it was a good idea going to twenty-five buyers rather than offerees, but occasionally today we need a few more than twenty-five to do what we need to do, and we can convince the staff that it is still a private offering. Commissioner Loomis, in his quiet way, said, "Well, I think I can go to thirty-five," and I said, "Sold." So when people want to know how we arrived at thirty-five buyers, the answer is, it is twenty-five plus ten. The Commission has already borrowed that test, as many of you know, in its rule 146.

Institutional investors are defined as any bank, registered investment company or insurance company, except to the extent that the Commission provides otherwise by rule, plus anybody else that the Commission puts into the definition by rule. In other words,

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30. Id. § 242(b).
31. Id. § 242(c); see notes 34-35 and accompanying text infra.
32. Id. § 242(b); see id. § 275 (definition of institutional investor).
33. 17 C.F.R. § 230.146(g) (1978).
banks, insurance companies and investment companies are prima facie “in” rather than prima facie “out,” and the Commission can do anything it likes by rule. We have to be flexible. I suppose the University of Miami and Harvard University are probably institutional investors, but some very small college somewhere probably should not be considered an institutional investor. Those distinctions will have to be made by rule.  

As I have said, a “distribution” is any offering other than a limited offering, which I just described, or a trading transaction. “Trading transaction” is defined, in effect, as any transaction by a broker or a dealer that is an ordinary market transaction—that looks like a trading transaction. The Commission is given rulemaking authority to change the conditions of both the limited offering and the trading transaction, or to add new conditions, but only with respect to a company that has not been registered for one year.

One of the other major reforms in the Code is that we have invented the concept of the “one-year registrant,” which is simply a company that has been registered for one year. The company has been filing reports steadily, proxy statements and so on, and the market knows something about it. Under a disclosure philosophy one is justified in treating one-year registrants, in a number of respects, more liberally than other registrants. This is one example of that proposition. If it is a non-one-year registrant, the Commission can restrict the concept of the “limited offering” or the “trading transaction.” If it is a one-year registrant, however, the Commission would be given no rulemaking power at all.

Another major reform is the treatment of secondary offerings by the Code: offerings of outstanding securities by the people who own them, as distinct from the raising of new capital by the issuing company. Today there is utterly no logic, nor is there much practi-
cality, about the scheme. Congress was faced with the problem in 1933: it wanted to protect the public when there were public offerings of securities. It was easy enough to say that no issuer could make a public offering without registration. But what did one do if Jones owned thirty or forty percent of a company and wanted to sell his stock in the company? Well, it would be nice to have registration, but how did one get the company to register unless Jones controlled the company? Congress had two choices. It could do what many of the states had done in the blue sky laws, which is to be satisfied with Jones’ signature rather than the signature of the company. Jones, however, might not have all the information the company would have if the company were filing. Or, if Congress were to insist that only the company could register, as it did, it would have to limit the coverage of the statute, so far as secondary distributions were concerned, to situations in which there was a control relationship between the seller and the company.\(^{39}\) Obviously, if I controlled the company, I could say to the directors, “Sign the registration statement,” and they would—or sooner or later there would be new directors.

There are two things wrong with the control test. First, it makes no sense to require registration when there are some relatively small control offerings that must be registered and some relatively large noncontrol offerings that, at least in principle, do not have to be registered. Second, the test is not only illogical, but also impractical, because nobody knows what “control” means. Obviously, it does not require majority ownership. It is one of the most slippery questions that we have. Nonetheless, strict liability hangs on it. In other words, we have today a Securities Act many of whose basic questions are very, very difficult to answer. What is a public offering? What is control? And yet, if you violate section 5, you are absolutely liable to the buyer—no defense.

Strict liability may be sensible when you choose to keep lions in your backyard. You know that a lion is a dangerous creature, and if it escapes, negligent or not, you are going to be liable. You should be. But, when you impose strict liability on an underlying body of substantive law that is as spongy as the Securities Act, you have the worst possible jurisprudence that I can imagine. So we have tried to make the underlying substantive law somewhat less spongy without watering down strict liability.

Now to return to the topic of secondary offerings: The new Code

\(^{39}\) For the definition of control under the present law, see 17 C.F.R. § 230.405(f) (1978).
says there really should be no difference in principle. All public offerings and all distributions of a given size are to be treated alike. The first thing we say is that anything under $100,000 is peanuts at the federal level and is exempt. The Commission can impose a limit on the exemption between $50,000 and $100,000, but under $50,000 it cannot even touch it. The Commission will continue to exempt small offerings under Regulation A, from $100,000 up to maybe a couple of million dollars. Once the offering exceeds that limit, then it will be prima facie a secondary "distribution" and something will have to be done.

If the issuing company is a one-year registrant, then we have a radical and simple solution. We say the issuer does not have to do anything. The distributor, the fellow who wants to sell, files something called a "distribution statement," which he can prepare in an hour—his name, his address, what he is trying to sell, the underwriting data, and a certificate that he knows no material inside information that would have to be disclosed under the successor to rule 10b-5. The statement becomes effective on the third day after it is filed, and since the issuer does not have to do anything, we do not have to worry about whether the distributor controls or not.

40. FED. SEC. CODE § 512(e).
41. The Code does not provide a successor to Regulation A. The exemption is expected to be created under § 303 and the Commission will have the discretion to establish the amount. See id. § 510, Note (d).
42. A "distribution statement" is defined as "the latest available document that meets the requirements of section 510(c) or (d)." Id. § 243. Section 510(c) and (d) prescribes the contents of the distribution statement as follows:

(c) [Contents of distribution statement as filed.] A distribution statement (1) shall contain whatever information, underwriting contracts, and other documents the Commission requires by rule with respect to the secondary distributor and the terms of the distribution, (2) may contain additional information and documents at the election of the secondary distributor, and (3) shall contain a certification by him that he does not know any additional information that he would otherwise have to disclose under section 1602(a) or, if he is a person subject to section 1603, that section.

(d) [Contents of distribution statement as used.] When a distribution statement is used, it need not contain the certification specified in section 510(c)(3) and the Commission, by rule, (1) may permit the omission of any of the items specified in section 510(c), (2) may require, if the issuer did not have at least $100,000 of total assets and one thousand holders of its securities (other than exempted securities within section 302) as of its last two preceding fiscal year-ends, that the most recent annual report and all subsequent reports under section 602(a) that are on file be physically attached to the distribution statement, and (3) may require that the distribution statement be supplemented or changed to identify (or physically attach if section 510(d)(2) applies) any reports filed under section 602(a) after the filing of the distribution statement and not identified therein (or physically attached if section 510(d)(2) applies).

Id. § 510(c)-(d).
Now, what about the non-one-year registrant? There we require a full offering statement. Well, how do you get it if there is no control? We simply say that, as a matter of statute, the company has a duty to file an offering statement on the demand of the fellow who wants to sell. It must be filed within sixteen months. The proposed seller has to pay the costs and indemnify against liability, and we permit waivers of that provision on the theory that anybody buying into a company with knowledge that he has no right to demand the filing of an offering statement does not deserve our sympathy. But, in the last analysis, there is what you might call a statutory registration covenant. Although that is a bit on the radical side, to my surprise, it has stayed in the Code and survived the Institute. Whether it will survive Congress I do not know. But it is essential to the major reform with respect to secondary transactions. If you want to get away from the control test, I do not know how else it can be done. A corporation will still be able to remain a close company by buying out, or arranging for somebody to buy out, the particular holder who insists on making a distribution.

Let me move from the Securities Act to the fraud area. As anybody who knows this field realizes rule 10b-5, an accidental latecomer, has taken over the fraud universe. Even with the restrictions in the last few Supreme Court cases, it is still a powerful little rule. There are other fraud provisions. There are section 17(a) of the Securities Act, section 15(c) of the Exchange Act, the proxy fraud rule, and the Advisers Act fraud provision. There are a half-dozen fraud provisions all told. The result is that anybody who files a lawsuit, whether it is the Commission or a private individual, pleads three or four different ways. You cannot have one count; rather, you need three or four counts, because you might miss a little pearl here and there. These various provisions not only differ in their fraud language but also have different language tying them into the use of the mails and other federal instrumentalities. Ideally, there should be a single provision, and the Code has a single provision which in about six lines covers fraud in a sale, purchase, proxy solicitation, investment advice or tender offer.

43. Id. § 502.
44. Id. § 502(b).
47. Id. § 78o(c).
50. It is unlawful for any person to engage in a fraudulent act or to make a
In our definitional part we have defined the word "misrepresentation" in the language of clause (2) of rule 10b-5 to mean any misstatement of a material fact or an omission of a material fact necessary to make the facts stated not misleading.\textsuperscript{51} We define "fraudulent act" basically in the terms of clauses (1) and (3) of the rule 10b-5. Therefore, whenever we use the term "misrepresentation" or "fraudulent act," those words are self-explanatory, and we do not have to worry about six or eight lines of language. We have built-in uniformity.\textsuperscript{53}

One of the incidental reforms in the area of fraud concerns brokers and dealers. Over the years, the Commission has developed the so-called "shingle theory." A dealer hangs out his "shingle"—puts his name on the door—and impliedly represents to the world, so the theory goes, that he will deal fairly. It is an incident of that implied representation, for example, that he is not undercapitalized and that he charges fair prices. If he is undercapitalized or charges prices not reasonably related to the market, and fails to admit this, then he is omitting to state a material fact necessary to make the facts stated or implied by his "shingle" not misleading. Well, this is a lovely question-begging theory, but it has been effective. If you will allow me to state the major premise in my syllogism, I assure you that I will march inexorably to the conclusion I want. Under that theory, the Commission has been able to regulate many things—prompt execution, unauthorized trades—and has achieved a wholesome result. But why should all those practices be called fraud? Not everything that is improper is fraudulent. In one way, it may make the Commission hesitant to charge fraud in order to get at a problem of unauthorized execution. Conversely, it is rather unfair to plaster the trader with a fraud charge every time he has done something that is wrong but not fraudulent in the usual sense. So, we have taken many of the shingle theory incidents and codified them in part IX, called "Market Regulation," rather than part XVI,
called “Fraud.” In the process, of course, we have put a proper foundation under the shingle theory, which, as I keep reminding the SEC staff, has never been reviewed by the Supreme Court. With the present Court and recent decisions in the area of SEC regulation, one cannot assume that anything that has not been there is secure.

Perhaps our greatest work has been in the area of civil liability, where the law today is really chaotic. This little rule 10b-5 has produced two full-blown treatises and, I suppose, several thousand cases by now. We have taken rule 10b-5 and the other areas where the courts have most commonly implied civil liabilities—the proxy rules, section 36 of the Investment Company Act, the tender offer provisions, and the Federal Reserve margin rules—and we have cod-

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54. After § 913 outlaws a number of specified trading practices (late or unauthorized executions, failure to disclose control and unreasonable spreads), and § 914 subjects a number of specified investment advisory practices to Commission rulemaking, § 915 provides:

[Trading and investment advisory practices: rulemaking authority.] (a) [Specific areas.] It is unlawful for a broker, dealer, municipal broker, or municipal dealer, in contravention of the Commission's rules,

(1) to effect a purchase or sale of a security without disclosure
   (A) that he is a marketmaker in the security, or an underwriter, participant, or otherwise financially interested in a current distribution of the security, or (B) that he, his spouse or minor child, any other relative designated by rule, or a related trust has a long or short position in the security that is substantial in relation to that person's (or trust's) total assets or normal investment or trading practices (but not the amount of any such position);

(2) to recommend a transaction in a security unless the issuer is a registrant or reasonable information with respect to the issuer and the security is otherwise available; or

(3) to recommend a transaction in a security unless he reasonably believes that it is not unsuitable for the customer on the basis of
   (A) information furnished by the customer on reasonable inquiry with respect to his investment objectives, financial situation, and needs, and (B) any other information known by the broker, dealer, municipal broker, or municipal dealer.

(b) [General rulemaking authority.] The Commission, by rule, may define in a manner not inconsistent with the conditions and restrictions of sections 913, 914, and 915(a), and prescribe means reasonably designed to prevent, any conduct by a broker, dealer, municipal broker, municipal dealer, or investment adviser that is made unlawful by those sections or any similar conduct that constitutes unfair dealing with a customer, client, or subscriber.

The purpose is “to carve out a degree of misconduct that is more than ‘unethical,’ . . . but less than ‘fraudulent.’” This section is not intended “to enlarge the Commission’s rulemaking authority with respect to brokers and dealers beyond the ‘fraud’ rubric of the ‘shingle’ theory. The design, rather, is to avoid the artificiality of that theory.” Fed. Sec. Code § 915, Note (1).

ified all those into express liabilities. Then, what do you do with the residue? Do you cut off all further implication? Well, if you do that, it requires more express liabilities. We did not cut off further implication, but we set down standards for the courts to extend liability, and, although we wrote the provisions of the Code before Cort v. Ash, we generally followed the Cort standards. More specifically, in the troublesome area of implying civil liability for violating rules of the self-regulatory organizations—the stock exchanges, the NASD—something the courts have been doing in recent years, we laid out certain principles and rules that determine when that should be done.

The one major disagreement among the ALI membership involved the civil liability that should attach to the annual report on form 10-K. This was the one question on which we were able to achieve no consensus among the advisory group, among the ABA committee or among the membership of the ALI. Some people argued that under the brave new world of the Code, where we are going to register companies and get away from the overwhelming emphasis on section 5 of the Securities Act of 1933, we should impose the stricter kind of liability represented by section 11 of the Securities Act on the annual report. Otherwise, we would be diluting civil liability.

Section 11 attaches only to Securities Act registration statements, imposing liability on directors and everybody in sight unless they have affirmatively shown (at least in some cases) that they made a reasonable investigation. Other people can be sued under

56. Fed. Sec. Code § 1713 (proxy solicitations, acquisitions, and tender offers); id. § 1716 (violation of § 918 margin rules); id. § 1819(e)-(f) (encompassing § 36 of the Investment Company Act of 1940).
57. 422 U.S. 66 (1975).
58. Fed. Sec. Code § 1721 authorizes the Commission to determine by rule whether a self-regulatory organization's rule violation falls within § 1721 and permits the courts to imply private rights of action if not specifically excluded by Commission rule. Section 1721(c) states the specific criteria to be considered by the Commission in the exercise of its authority:

(1) whether the particular self-regulatory organization rule was required by the Commission to be adopted, amended or supplemented, (2) whether the particular rule is substantially a substitute for or parallel to a rule of the Commission (other than a section 905(c) rule), (3) whether the particular rule is designed for the special benefit of a class of persons to which a potential plaintiff belongs against the kind of harm alleged, and (4) the risk, in the case of a self-regulatory organization rule, that the imposition of liability under section 1721 will discourage the organization from full performance of its intended role.

Id. § 1721(c).
59. Id. §§ 1704-1705.
rule 10b-5 in other contexts. Misstatements in annual reports, for example, may be the subject of a 10b-5 action. There, however, the plaintiff has the burden of proof and he has to prove scienter, which means at least reckless disregard of the truth, if not knowing falsity with intent to defraud. So the question is, which of these tests do you apply to the annual report on 10-K? Some people say we should apply the stricter test. Other people say: "No, that test is too strict. Directors cannot be expected every year to make the kind of investigation they make today when they file a registration statement." It was that question that split everybody. The Code, as it was presented to The American Law Institute and as it now stands, would have applied the stricter section 11-type liability to the 10-K. There was a motion to switch over, which lost by one vote. I thought that was a bit close, so I suggested a compromise. The strongest objections came from the people who were concerned about outside directors and how difficult it would be for outside directors to investigate individually. I suggested, after conversation with some of the advisers, that the ALI simply take no position, leave it to Congress, in other words, whether the one section or the other should apply to outside directors insofar as the 10-K annual report is concerned. That went through by a substantial majority.

The minority were still unhappy, and I knew we were going to have trouble with that problem when we got to the ABA committee, which met in October. At that meeting I suggested, although I could no longer change what the ALI approved, that I would recommend to the ALI Council, and ultimately to the membership in May, that it take no position as to all defendants on that point, not just outside directors. Indeed, the ALI Council has now taken that position, and I am sure the membership will go along in May when we make that recommendation. I think that has largely defused the problem. In other words, it will be a wide-open question that is presented to Congress to decide without any official recommendation by the Institute. I made it plain that my own preference would be whichever view is more likely to get the Code passed. That is one of the examples of my lack of principle.

We have also put in provisions on costs, ancillary relief, aids and abettors, indemnification, in pari delicto, indemnification-
tion, insurance and contribution, and so on—things that are not in the written law at all, but that are the subject of a great deal of needless litigation.

What else? We have simplified judicial review. In the area of the state statutes, we have achieved what I think is almost a minor miracle. After several years of negotiations with the state blue sky administrators, through their organization, the North American Securities Administrators Association, we have their agreement, with only one state dissenting, on a reasonable degree of preemption. I would like to have seen a bit more, but they have agreed to some, notably in the area of procedure. Since the Uniform Securities Act has been on the scene, and it is already the law in thirty-odd states, you simply file with the state administrator the same S-1 you file with the Commission. Unless the state administrator starts a proceeding based on his substantive standards, which occasionally happens, you are automatically effective with him when you become effective in Washington. There are only a handful of states today that require registration in the classic sense and that lack coordination machinery under state law. In those circumstances we suggested, and this has been approved by the states, that two years after the effective date of the Code there will be complete preemption of the blue sky law of any state that has not by its own law substantially incorporated this coordination machinery, and we make it plain that with rare exceptions the states will not be able to require a prospectus to include anything that the SEC does not require. There is also preemption in the “blue chip” area. We have a section that describes a fairly dark “blue chip” and says, as to that kind of security, states do not really have to fuss.

Now, where are we and what is the current status of the Code? As you have already heard, the ALI has approved this Code. The Council of the Section of Corporation, Banking and Business Law of the ABA unanimously approved it, and it was sent on to the House of Delegates, where it also received unanimous approval. In Congress, the subcommittee chairmen in both Houses have welcomed the Code enthusiastically and have said that they will introduce it. There are new subcommittee chairmen in both Houses of the present Congress; Senator Williams has given way to Senator Sarbanes, and Congressman Eckhardt has given way to Congress-

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67. Id. § 1724(e), (f).
68. Id. § 1818.
69. Id. § 1904.
70. The House approved the Code at its February 1979 meeting.
man Scheuer of New York. I do not think there is going to be any difficulty at all in getting the Code introduced.

The Legislative Counsel's Office of the House has been studying the official draft for about a month and has another month or so to go. The people there have made some extremely helpful suggestions in terms of style and have also picked up little inconsistencies that escaped all of us. Also, precisely because they are not experts in securities regulation, they have occasionally asked very good questions that eluded those of us who see what we expect to see.

Meanwhile, the SEC has been intensively studying the Code through all of its operating divisions, and about a month ago they began giving me their comments. That process will take about another month. I have four meetings set up with various staff people in the next month, along with some of the advisory group. I hope that by early March we shall know what the staff would like. Then we shall, of course, talk with the Commission to see how much of that they will insist on.

I have little doubt that we shall achieve agreement with the SEC. The question is at what price, of course. If they insist on all the suggestions made by the staff so far, without any change, the fact is that, although most of them are not outrageous suggestions, they tend to move in one direction, and that may affect the balance of the Code in a way that would make the Commission's concurrence come at too high a price. But I am cautiously optimistic that we shall end up with what we hoped for initially. We never thought we could possibly write a Code that the Commission would approve of one hundred percent. But if the Commission will come to Congress and say, "We need a Code, this is on the whole a good Code and we recommend it, but there are thirty-five or seventy-five instances in which we would do something differently," that number is not too great. The legislative committees will be able to concentrate on those sections, hear the arguments of both sides and decide. It is still simply too early to say, but we are holding up the introduction and further printing of the Code until we see where we stand with the Commission.

The staff, of course, is suspicious. That is the nature of staffs. As an ex-bureaucrat myself, who was transformed into a gentlemen ex officio by courtesy of the Harvard Corporation, I can understand how they feel. But that is simply another way of saying that no government agency can reform itself. It could not possibly have the objectivity that is necessary. Happily, there is some indication that the staff's initial suspicions are evaporating as they are becoming
more familiar with the Code. There is a natural fear of the unknown, and there is a good deal of the unknown, since it is a fairly massive Code.

The great problem is how we proceed with changes—we have no authority, nobody has authority, to change the Code and speak for the ALI. The only people to do that are the ALI, and they meet once a year in May. I do not know what we should do about that. One possibility, which will have to be discussed among the advisory group, is that we write an amended Code that reflects some of the Commission’s views and some other changes that some of us want to make. It would be introduced with a memorandum indicating how it differs from the ALI-approved Code, and stating that at the earliest possible moment we would try to get the ALI to adopt the amendments. Otherwise, you see, we might have to wait. I am not sure we can make all this by May of 1979; it might be May of 1980.

Well, what do I say in conclusion? There will be a code. There are some things that one feels in his bones. There are some things that are so right in principle—and whose time has so clearly come—that I think one can say there will be a code. I am not saying when there will be a code. I am not saying that it is going to be this Code. I am reasonably optimistic that within a short period of time, maybe five years, a short time as these things go, there will be a code, and I hope substantially this Code.

When Mr. Justice Douglas was Chairman of the SEC in the late 1930’s, he used to say that every agency should be abolished every ten years. If the President were here, he might like to do that. Well, that had as much truth as most aphorisms. Obviously, you cannot do that. But surely, one should every forty or fifty years, if at all possible, sit down and reexamine the major premises of an agency like the SEC, and put things on a higher plateau and start building from that higher plateau. Certainly this much is true: This is not the sort of job that can be done piecemeal. Some people in the Commission as well as outside of it have said: “It is much too complex to do this all at once. Why can’t we fix up this and fix up that?” That would just make things worse, not better. The difficulty with the present statutes is that every time they are changed, although maybe for the better substantively, they are made more complex, because the changes have to be worked into a structure. We are in effect patching a very rusty boiler. It would be a sad reflection on our system of government if it were not possible every three or four decades to sit back and forget the trees and look at the forest in a field as complex as this one.

Surely, if this effort fails, it is going to be quite a while before
anybody starts again. If we are already approaching chaos in some areas, and I think we are in the red zone today, and we then look ahead to another twenty-five or thirty years with several thousand more cases, releases and rules, it is too horrible to contemplate. I think that realization perhaps will be more helpful to us than almost any other.

What are the arguments being made against a Code as such? One is that it is very complex and there are bound to be "bugs." Well, of course, there are bound to be "bugs." I am sure there will be new "bugs." I can reassure the litigating bar they will not be put out of business. But one hopes that those of us who worked on this so long and so hard are sufficiently good at the job so that we have squashed more "bugs" than we have bred.

Then, there is what I call the "keep 'em guessing" school. There is a school of thought that the only way to get really effective regulation is to keep everybody guessing. You must not make the law too plain, because then you will be giving people a blueprint for fraud. Besides, we are doing well enough, and we do not know what Congress will do if we let the present Code go through. Maybe it would be all right. But, the practitioners argue, once the Code gets out of Congress, God knows what the SEC will do. I have heard this from Wall Street and I have heard this from the SEC. Of course, on that theory nobody would ever do anything. That is the nihilistic approach to law reform: Do not do it.

There is also the argument—and it is a good one, a little harder to answer—that we have not made any empirical studies before introducing a lot of these proposed reforms. Indeed, we have not even reexamined the disclosure philosophy. The only answer I can make to that is to say: (1) it would be impossible to make empirical studies of the hundreds of changes we have made—it just could not be done; and (2) Congress is not going to change the disclosure philosophy. That is just one of the facts of life. That is about as likely as repealing the income tax. That being so, we might at least fix it up and do the best we can within the existing philosophy.

I would like to take just one or two minutes more to paraphrase Professor Wechsler of Columbia, who is the Director of the ALI and has followed this work very closely. He has said this much better than I can put it. The thought is that, in an age of incredible legal proliferation at the hands of both legislatures and courts, the sense of perspective and sense of balance that arise from viewing any given subject as a whole are sorely missing and overlooked. This means, he says, that the Bar has no higher duty than continually to watch and criticize and occasionally, in some sort of systematic
way, withdraw sufficiently from its day-to-day activities in order to differentiate the forest from the trees. Although he was speaking primarily of the academic branch of the legal profession, his point applies equally well to the practitioner. He is saying that we are all trustees of the law that we profess and that we should be steadfastly concerned with its consistency, with its grace, with its improvement, by viewing the subject disinterestedly and as a whole. I do not know of any process in this country that is better adapted to doing that than the ALI. It comes ready made, with a structure of practicing lawyers, law professors and judges, and a good deal of prestige, and it has done the job.

Now that I have brought the talk to such a high level, let me go higher still and remind you of Proverbs 29:18: "Where there is no vision, the people perish."