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Introduction: The Federal Securities Code—Its Purpose, Plan, and Progress

*Louis Loss**

The first generation of federal securities statutes, vintage 1933-40, has sprouted tentacles in so many areas of the American *corpus juris* that it is not easy to think of any field in which so much law—and lore—have been built on so flimsy a statutory base.

The nineteen-page grandfather statute, the Securities Act of 1933, goes on, with a continually enhanced fertility that belies its years, to yield esoterica like the "140 series" of rules: professed "safe harbors" whose entrances are guarded by Cerberus atop Scylla and a bevy of Sirens cavorting in Charybdis.

In the area of "fraud" that peripatetic (some would say picaresque) jack-of-all-trades, rule 10b-5—a child of the American legal house that the Supreme Court seems not to have wanted to acknowledge until it had almost reached its majority—has produced many hundreds of cases, two full-blown treatises,[1] elation (at least until the Court's recent expressions) among academic circles and the "plaintiffs' bar," and a certain wringing of hands by corporate management and those lawyers whose duty it is to guard and defend them.

Civil liability has become a jungle as the lush growth of the "implied" actions—not only under rule 10b-5 but also under the proxy rules, the tender offer provisions of 1968, the Federal Reserve credit rules and section 36 of the Investment Company Act—has dwarfed, upstaged, outshone, and made wide end runs around, the express civil liability provisions.

It has become trite to observe that the net result of this interaction of the legislative, administrative and judicial processes—with the federal courts apparently exhilarated at their emancipation from the shackles of *Erie*—has been the development in a real sense of a federal corporation law. What is perhaps not so widely realized is the extent to which the field of Securities Regulation (a combination of words that did not exist, so far as I can recall, until I chose it as the title of my treatise in 1951) has taken over the larger subject of Corporations, of which it is essentially a branch. This has happened not only in the legislative and judicial arenas but also in the law schools, some of whose teachers are so infected by the "10b-5

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1. A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1975); A. JACOBS, THE IMPACT OF RULE 10b-5 (1974).

bug"[2] that they are assigning to the whole world of close corporations about as much importance as is customarily given to defective incorporation or ultra vires. After all, who wants to be a professor of arithmetic when extraterrestrial exploration beckons?

What else? A securities lawyer used to be able to get along with a basic knowledge of the 1933 and 1934 Acts, tempered by a modicum of familiarity with Corporations, Administrative Law, and perhaps Equity and Criminal Law. But in the past decade or so there has been a gradual convergence of Securities Regulation with Banking, Insurance, Antitrust Law, and even—witness the recent surge of cases testing the extraterritorial reach of the statutes—International Law.[3]

All this has evolved while the Commission, the courts and all of us have had to struggle with seven separate statutes (including the Securities Investor Protection Act of 1970)—with their often conflicting definitions of the same terms, their multifarious fraud provisions, the nuances among their provisions on the use of interstate commerce, on controlling persons' liability, on investigations and injunctions, and so on. Beyond that, all of the Commission's valiant efforts toward a system of continual disclosure are fated to make only a dent in the archaic centrality that the 1933 Act's hit-or-miss registration scheme persists in occupying in the existing SEC universe.

There have been amendments, to be sure. Aside from the 1954 opening up of the 1933 Act's waiting period to offers and the fairly extensive amendment of the Investment Company Act in 1970, most of the changes have been in the Exchange Act: the provisions on unlisted trading and registration of over-the-counter broker-dealers in 1936; the 1938 addition of section 15A, which resulted in the creation of the National Association of Securities Dealers; the 1964 insertion of the fundamental section 12(g), the first involuntary registration provision; the Williams Act tender offer provisions of 1968, which were themselves amended in 1970; and the major amendments of 1975, which not only contemplate the development of a national market system, with emphasis throughout the statute

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2. As evidence that the "bug" may be on the way to becoming pandemic, see MULTINATIONAL APPROACHES—CORPORATE INSIDERS (L. Loss ed. 1976) (edited transcript of an Anglo-American-Franco-German conference held in London).

3. *See* ITT v. Vencap, Ltd., 519 F.2d 1001 (2d Cir. 1975); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), *cert. denied,* 423 U.S. 1018 (1975). For an essay that compares the minimum connection test and the traditional conflict of laws approach, see Sandberg, *The Extraterritorial Reach of American Economic Regulation: The Case of Securities Law,* 17 HARV. INT'L L.J. 315 (1976).

on competition, but also (among other things) give the Commission major new duties in the areas of stock clearance and transfer and municipal securities.

Nevertheless, the critically important Exchange Act—as a result of this process of patching and repatching a pretty rusty boiler—has become a monstrosity. This is so far true, in terms of sheer ability to locate what one is looking for, that a number of lawyers, as they have told me, have stumbled on what I thought was my secret formula, which is to locate the desired provision in Tentative Draft No. 5 of the Code and then go back to existing law by reference to that provision's source note!

Surely all this is reason enough for a rethinking and reworking of all the statutes (together with the codification of an appropriate portion of the Commission's rules, the thousands of court opinions and the administrative construction) and the integration of the whole paraphernalia into a code. By its nature, legislation in areas like Securities Regulation and Taxation will never make light bedtime reading. But today there is much needless complexity; there are both overlaps and gaps; there are inconsistencies among similar provisions;[4] and one almost cries out for a concordance in order to find his way around.

The need for some sort of codification became apparent quite early.[5] By late 1966—shortly after Milton Cohen's stimulating essay on *"Truth in Securities" Revisited*[6]—the American Bar Association's Committee on Federal Regulation of Securities (a unit of the Section of Corporation, Banking and Business Law) held a two-day conference on codification, which demonstrated a substantial consensus in favor of a broad codification study. And, by the time the committee held its second conference in the spring of 1969, the

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4. An egregious example is short-term notes, which § 3(a)(3) of the Securities Act of 1933 exempts from registration (not from the fraud provisions) if their proceeds are used "for current transactions," hut which § 3(a)(10) of the 1934 Act excludes from the definition of "security," not only without regard to use of proceeds but also (one would think) with the result that even rule 10b-5 does not apply. The courts have manfully striven to synthesize the two provisions. Bellah v. First Nat'l Bank, 495 F.2d 1109, 1111-12 (5th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 799-800 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973); Sanders v. John Nuveen & Co., 463 F.2d 1075, 1077-80 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972), *on the merits,* 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded on other grounds,* 425 U.S. 929 (1976); Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976), *commented on in* 30 VAND. L. REV. 110 (1977). It remains to be seen, however, whether the courts have not strained too hard; for the question may still get to the Supreme Court after the Seventh Circuit's decision on remand in *Sanders.*

5. For a history of codification efforts going back to 1940, see Loss, *The American Law Institute's Federal Securities Code Project,* 25 BUS. LAW. 27 (1969).

6. 79 HARV. L. REV. 1340 (1966).

question was no longer "whether" but "how." The "how" turned out to be The American Law Institute, which had earlier evidenced interest in the idea and had been informally assured of cooperation by both the SEC and the ABA.

The Reporter (joined in 1975 by Professor Victor Brudney as Assistant Reporter for the investment company part) has worked with three concentric circles of advisers: seven or eight ALI-appointed "Consultants" (some serving only for certain parts in which they are particularly expert), some twenty ALI-appointed "Advisers," and the entire ABA committee. Meetings with some or all of the Consultants have been frequent. The Consultants and Advisers together have met perhaps twice a year to review "Preliminary Drafts." And the product resulting from a succession of these Preliminary Drafts has been reviewed in January of each year at a well-attended, two-day meeting of the ABA committee before being presented to the Council of the Institute and then printed as a "Tentative Draft" for consideration at the Institute's annual meeting in May. At the Council and annual meeting levels the very fact that most of the lawyers (practicing and academic) and judges are *not* SEC specialists adds a valuable dimension to the critical process, in that it tends to insure against experts' self-hypnosis.

The word "superb" does not adequately characterize either the quality of these advisory groups or their spirit of cooperation. Among the Consultants and Advisers there are two federal judges (former Chief Judge Friendly of the Second Circuit and Chief Judge Fairchild of the Seventh Circuit), five law professors (from California, Columbia, New York University, Northwestern and Pennsylvania), a member of the SEC (Commissioner Loomis, who was the Commission's General Counsel at the beginning of the project and has provided continuity with the Commission throughout, although four other members of the advisory group, Messrs. Garrett, Richard B. Smith, Sommer and Wheat, have been members of the Commission at one time or another since the work has been under way), a number of former Chairmen of the Commission (Messrs. Cary, Manuel Cohen, Demmler and Garrett), the chairman of the special committee on liaison with the Code project appointed by the North American Securities Administrators Association (currently Commissioner Bartell of Wisconsin), the leading British expert on Company Law (Professor Gower, who was a member of the Law Commission when he became a Consultant), and an eminent group of practicing lawyers (including Milton Cohen of the Chicago Bar, who directed the Commission's *Special Study of the Securities Markets*

in the early 1960's and, together with Ray Garrett, Jr., in his then capacity as chairman of the ABA's subcommittee on codification, had much to do with getting the work started).

In addition, the chairmen of the two congressional subcommittees have delegated staff lawyers to attend meetings of the Advisers. All the meetings have been attended likewise by the distinguished Director of the Institute, Professor Wechsler of Columbia, whose softly offered "suggestions" have broken more than one impasse. And the Reporter has not hesitated to go outside the advisory group, either for specialized expertise (which has always been readily and promptly tendered) or to obtain the views of representatives of interested trade groups.

At least as far as the Consultants and Advisers are concerned, it is a firm Institute tradition that the persons it selects to work with its reporters, whatever their backgrounds and private interests, do not accept appointment in order to represent particular constituencies. This is a most wholesome—indeed, an indispensable—approach to a major law reform effort. And, if the Institute's multiple review processes come at a cost in time expended, it is equally true, as a comparatist in Paris well put it in reviewing one of the Tentative Drafts, that the Institute's procedure is "assez lourde, mais très sûre."[7]

In this manner, a Code has been developed in twenty parts, all of which have now been approved by the Institute in six Tentative Drafts, one each year beginning in May 1972, as follows (the IXA-C designations are temporary):

I. Legislative Findings and Declarations—TD6 (1977).
II. Definitions—TD1-6 (1972-77).
III. Exemptions—TD1 (1972).
IV. Issuer Registration—TD1 (1972).
V. Distributions—TD1 (1972).
VI. Postregistration Provisions—TD1 (1972).
VII. Broker, Dealer, and Investment Adviser Registration and Qualifications—TD5 (1976).
VIII. Self-Regulatory Organizations—TD5 (1976).
IX. Market Regulation—TD5 (1976).
IXA. National Market and Clearance-Settlement Systems—TD5 (1976).
IXB. Municipal Securities—TD5 (1976).
IXC. Broker-Dealer Insolvency—TD6 (1977).
X. Trust Indentures—TD4 (1975).
XI. Investment Companies—TD6 (1977).
XII. Utility Holding Companies—TD4 (1975).

7. Tunc, *La Révision du droit fédéral des sociétés aux États-Unis*, 25 REV. INT. DR. COMP. 693 (1973).

XIII. Fraudulent and Manipulative Acts—TD2 (1973).
XIV. Civil Liability—TD2 (1973).
XV. Administration and Enforcement—TD3 (1974).
XVI. Scope of the Code—TD3 (1974).
XVII. General—TD3 (1974).

As this goes to press, the advisory groups are scheduled to begin their review of changes in all the Tentative Drafts, with a view to submission of a Proposed Final Draft at the Institute's meeting in May 1978. And ultimately the Code, as approved by the Institute, will be published with section-by-section source notes and commentary, as well as two-way cross-reference tables from existing law to Code and vice versa, probably in two volumes, with provision for pocket supplements that will reflect whatever changes the Code undergoes in its passage (one hopes) through Congress.

One of the problems has been the pace of developments since the approval of Tentative Draft No. 1 in 1972, as well as changes that have commended themselves to the Reporter as a result of public reaction to the published drafts and the development of later parts of the Code. In order to facilitate both criticism of earlier parts and work on later parts, the Institute published in October 1974 a volume of 273 pages entitled *Reporter's Revision of Text of Tentative Drafts Nos. 1-3,* which restates the text of the first three Tentative Drafts, with "notes" indicating the changes but without repeating the "comments" in the first three drafts and without the imprimatur of the Institute. That is to say, the October 1974 draft simply reflects the text of the first three drafts in the form in which the Reporter, as of October 1, 1974, intended ultimately to discuss the changes with the advisory groups and then to present them to the Institute for approval. But it must be immediately added that the Reporter's copy even of that draft—let alone of the later Tentative Drafts—bears a considerable number of changes *since* October 1, 1974. The result, inevitably, is that this symposium to some extent will be commenting on language that no longer reflects the Reporter's master copies, which will go on changing, literally from day to day, until the job is finished. That cannot be helped.

The Reporter, obviously, is not the person to present a critique of what has been done so far. He is happy that the *Vanderbilt Law Review* is undertaking this symposium—and only hopes that he will not be too much less happy when he sees the articles in print. What the rest of this introduction will do is, first, to list some of the major

reforms and, secondly, to mention a number of basic approaches that the Code has followed.

In the disclosure area of the 1933 and 1934 Acts, the Code (Parts III-VI) substitutes a system of *company* registration, with continuous disclosure, for the registration of *securities*. Today's "registration statement" under the Securities Act, which will be subordinated in importance, will be known as an "offering statement." There is a new concept of the "one-year registrant," which, consistently with the philosophy of continual disclosure, is favored in a number of respects. The deemphasis of section 5 permits a considerable simplification of the "public offering" idea, which is being abandoned in favor of a much more objectively defined term, "distribution." There is an entirely new approach to the problem of secondary distributions, which does without the enigmatic "control" test. And the Commission is given direct authority over registered companies' reports to their stockholders, on the theory that they are a more effective disclosure device than the occasional prospectus or proxy statement.

With respect to broker-dealers, municipal broker-dealers and investment advisers, there is a single scheme of registration (Part VII) and administrative discipline (section 1507).

In the area covered by Parts VIII-IXB there is an integration of the treatment of all four "self-regulatory organizations": the exchanges, the NASD, the clearing agencies, and the new Municipal Securities Rulemaking Board.

With respect to Part IXC, which was drafted in collaboration with the General Counsel of SIPC and with the benefit of the bankruptcy expertise of Professor Countryman of Harvard in his capacity as special Consultant, the Code will reflect the amendments now being considered by the Congress.

So far as the three more specialized statutes are concerned—the Trust Indenture, Investment Company and Public Utility Holding Company Acts (Parts X-XII)—it was originally contemplated that they would be integrated structurally into the Code but without the thorough substantive review that would be given the more basic acts. As matters have turned out all three parts reflect a number of significant changes of substance. It must be said of the Investment Company Act, however, that the study has eschewed (because of the several additional years that would be required) the preparation of an entirely new statute that would consider various

types of commingled money management such as real estate investment trusts, variable annuities and life insurance, and oil and gas funds. When that job is done, as it should be, it should fit quite readily into the Code structure. The Code is not meant for the Medes and the Persians.

So far as trust indentures are concerned (Part X), the Code shifts from contract to statute: instead of requiring, as the Trust Indenture Act now does, that all qualified indentures contain specified provisions, the Code simply declares those provisions to be the law with respect to qualified indentures. This automatically insures a uniform federal construction on such questions as the "prudent man rule." And in the process the Commission is given direct enforcement authority.

In the area of the Investment Company Act (Part XI) the Code does break new ground in an attempt to solve the problems of the "inadvertent investment company" and "mini-accounts" as administered by banks and others.

In the area of the Holding Company Act (Part XII), which amazingly has withstood the test of time better than any of the other statutes, there has been some relatively minor but nevertheless significant simplification.

Part XIII, on fraud and manipulation, collects in a ten-line subsection all of the fraud provisions now scattered throughout the Securities Act, the Exchange Act and the Advisers Act, as well as the proxy rules. This is apart from the world of rule 10b-5, where what has been done will have to be given a fresh look in the light of the recent Supreme Court decisions. There the approach has been not to attempt a *complete* codification but to allow for a continuation of development at the judicial level. Even so, in an attempt to put that development on a higher plateau, the Reporter's 1974 revision of the first three Tentative Drafts enumerates no fewer than twenty-two instances of codification, all of which entails a fair amount of change in the law.

Perhaps one of the greatest reforms is the reordering of the civil liabilities (Part XIV) and the codification of the more common of the implied liabilities. In the process the Code (among other reforms) distinguishes between face-to-face and market transactions, basically treats buyers and sellers alike, offers a workable approach to the perplexing problem of the extent to which violation of the rules of the self-regulatory organizations creates a private right of action as a matter of federal law, and addresses itself to the various

elements of fraud-type actions with which the courts have been struggling over the years: materiality, reliance, causation, privity, measure of damages, *in pari delicto,* and ancillary relief, not to mention statute of limitations.

With respect to administration and enforcement (Part XV), three sections are particularly noteworthy: section 1503, which gathers together all the accounting provisions in a manner that seems to be satisfactory to both the Commission and the profession; section 1513, which rationalizes the Commission's adjudicatory procedure; and section 1514, on judicial review, which (among other things) avoids today's jurisdictional problem as between the District Courts and Courts of Appeals by throwing all review, whether of "orders," "rules" or other "final action," into the appellate courts.

So far as the *scope* of the Code is concerned (Part XVI), a considerable degree of federal-state coordination is achieved in a manner that there is reason to believe will be approved by the North American Securities Administrators Association, and there is a substantial section addressed to the complex problems of extraterritoriality.

All these (and other) substantive changes aside, the Code reflects a number of devices that reduce complexity and enhance comprehensibility. By universalizing the Commission's plenary exemptive authority that is today found in the two 1940 Acts and portions of the other statutes—so that (with a few exceptions) the Commission, by rule or order, may exempt from any portion or all of the Code—it becomes possible to avoid untold numbers of curlycues in individual sections. Again, there is not a single reference to the mails or interstate commerce throughout the Code until one comes to section 1601, where the constitutional nexus for the whole Code is achieved by resort to a number of formulas. Similarly, instead of repeating *ad nauseam* the "public interest" and "protection of investors" standards, section 1502(b) simply requires the Commission to determine, in adopting *any* rule or order, that its action meets those standards in addition to satisfying whatever special standards are made applicable by particular provisions.

On a more formal (but by no means unimportant) level: Part II collects in alphabetical order some 170 definitions: the only terms not found in that part are those defined for purposes of a single section. Not only every section, but every subsection, carries a bracketed heading. There are frequent cross-references, right in the text of the Code, from one section to another. And there are also

narrative summaries (road maps as it were) at the beginning of a few of the more complex parts. Finally, there has been a determined effort to avoid "legal English"—the frequent resort to "such," "said," "hereinabove" and similar gibberish that seems to mesmerize so many reasonably decent speakers of the national tongue when they leave college for the study of law.

On the policy level: It is probably fair to say that there is a mild shift toward the objective end of the subjective-objective continuum that has always marked man's quest for justice. And, since we are not writing on a clean slate, there has been a decent (though, one hopes, not an excessive) regard for precedent. In general, moreover, the Code is not presuming to make major decisions of an essentially political nature. That is to say, the substantive changes are fundamentally in the area of what might be called "lawyers' law." To that extent one likes to think that the result of all this work will be entitled to some deference in Congress. Conversely, there is no particular reason why Congress should look to The American Law Institute in deciding, for example, to what degree the Commission should regulate management fees or sales loads in the investment company industry, or where the line should be drawn between regulation generally and competition reinforced by the antitrust laws. On this account the reforms and political compromises embodied in the 1975 amendments of the Exchange Act and the 1970 amendments of the Investment Company Act have been accepted for the most part as givens. Needless to say, however, "lawyers' law" and whatever its antonym may be do not occupy watertight compartments.

In terms of level of regulation, by hypothesis any codification effort is going to tighten in some areas and loosen in others. But there need be no concern that The American Law Institute has appointed itself to preside over the liquidation of the securities regulatory structure of the United States.

Will all this find favor in Congress? One cannot have put in a decade of work (as it will turn out) without being optimistic. A generation ago codification would not have got off the ground. Today it seems to be an idea whose time has come. Indeed, the Code is already affecting the law in the sense that it has been repeatedly cited by the courts as an indication sometimes of what the law should be and sometimes of what it is. Judge Friendly, in recently addressing the troublesome question of the extent to which a promissory note involves a "sale" of a "security," said: "A more desirable solution would be for Congress to change the exclusions to encom-

pass 'a note or other evidence of indebtedness issued in a mercantile transaction,' as is proposed in the ALI's Federal Securities Code, § 297(b)(3), and complement this by a grant of power to the SEC to explicate the quoted phrase by rule much as § 216A of the ALI Code does with respect to the exemption for commercial paper."[8] And, if Judge Friendly's position as an Adviser on the Code may be considered to give him a bias in the Code's favor, there is this "unsolicited commercial" from Judge Gorbey: "Issues such as this [civil liability under § 17(a) of the Securities Act] will continue to plague courts as long as the present patchwork of securities statutes is the basis for regulation of the nation's capital markets. It is the necessity of dealing with such issues, which cannot be resolved satisfactorily, that reflects the need for prompt enactment of the proposed federal securities code."[9]

Of course, if every witness before the legislative committees takes the position that codification is a fine idea except as a particular provision rubs his industry or his client, the net impression may be one of a morass from which there is no escape. On the other hand, one hopes that legislators will be no less likely than others to be attracted by the sheer imaginativeness of the Code venture.

Certainly this much is true: that, by its very nature, this is not the sort of job that could be done piecemeal; that it would be a sad reflection on our governmental processes if this sort of comprehensive legislative reform were simply not doable; and that, if this ten-year effort fails, it will be a long time before anybody tries again.

"Where there is no vision, the people perish."[10]

8. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976).
9. Crowell v. Pittshurgh & L.E.R.R., 373 F. Supp. 1303, 1310 (E.D. Pa. 1974).
10. *Prov.* 29:18.