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Foreword

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COLLOQUIUM

FOREWORD

MILTON V. FREEMAN

I would like to express my special pleasure of being here at Fordham Law School because about seven or eight years ago some student editor of the Law School Journal cited Rule 10b-5 as the work of the "late" Milton Freeman. Indeed, reports of my death had been "greatly exaggerated." He was very nice when I wrote him back. It was natural for a young person in law school to think that nobody could have survived from that long ago.

First about me. I graduated from City College and Columbia Law School in New York City. I worked for eleven and one-half years in the government, mostly with the SEC, and four times that long with my present law firm, Arnold & Porter, which I helped found in January, 1946.

I have done many fine things in my law practice. For example, I argued and won a case in the Supreme Court saying it was unconstitutional to abridge the right of naturalized citizens to live anywhere they wanted just like born citizens.¹ My partners and I defended extensively the rights of government employees in the McCarthy era not to be fired on the basis of unsworn anonymous accusations. The results were mixed.² I also litigated and wrote against the tendency of certain government agencies to limit the right of citizens to the assistance of counsel.³

On a personal note, the *New York Times* says I set a record when, on April 21, 1975, I secured the admission to the Supreme Court of my wife, my elder daughter, and my elder son on the assurance that each possessed the necessary qualifications.

But, however many good works I engaged in, it is clear that the action of the most consequence to the law in general was the drafting of Rule 10b-5 when I was at the SEC. Therefore, I must say something about how it happened.

I went to work one day in May, 1942, and I did my normal job as an Assistant Solicitor of the SEC. Somebody called me and said there is something wrong going on in Boston (a company president was buying in shares from his own shareholders without telling them of much improved earnings). He asked what we could do about it. I wasted no time; I got some people in, we drafted a rule, we presented it to the Com-

1. See *Schneider v. Rusk*, 377 U.S. 163, 168-69 (1964).

2. Compare *Bailey v. Richardson*, 341 U.S. 918 (1951) (per curiam) (holding against Freeman et al.) with *Peters v. Hobby*, 349 U.S. 331 (1955) (holding in favor of Freeman et al.); see Milton V. Freeman, *Abe Fortas: A Man of Courage*, 91 Yale L.J. 1052 (1982).

3. See, e.g., Milton V. Freeman, *Recent Government Attacks on the Private Lawyer as an Infringement of the Constitutional Right to the Assistance of Counsel*, 36 Bus. Law. 1791 (1981).

mission, and, without any hesitation, the Commission tossed the paper on the table saying they were in favor of it. One Commission member said, "Well, we're against fraud, aren't we?" So, before the sun was down, we had the rule that is now Rule 10b-5. (This, of course, was before the Administrative Procedure Act of 1946⁴).

I do not remember who I asked in to help me, so I have had to take the blame for this all by myself. Very happily, though, in the corridors today, I ran into Professor Victor Brudney—who at that time was working with me in the Securities and Exchange Commission—and I now offer to include him in the credits, or demerits, as a possible co-author of this rule.

To show you how innocent I was of any application of the Rule, I left the Securities and Exchange Commission in January, 1946, to form with Thurman Arnold and Abe Fortas my current law firm which was then known as Arnold & Fortas. So far as I knew, nothing had happened at that time under Rule 10b-5. I assumed that our Boston people had frightened off the bad fellow who had done the bad thing. When I left to go into practice there were no cases under the Rule.

The first case that came up was *Kardon v. National Gypsum*⁵ where a practicing lawyer in Philadelphia had decided that this Rule was the basis for a private law suit. Obviously neither I, nor the Commission that promulgated the Rule, had any such idea when the Rule was adopted. By the time the suit was decided, I had been long gone as Assistant Solicitor of the Securities and Exchange Commission. My former boss, Roger Foster, Solicitor of the Commission, filed an amicus brief. I have not been able to check, but I am sure the brief supported the view that there would be a cause of action, because the SEC has filed very few briefs in favor of defendants. I had absolutely nothing to do with that case, although I was, in fact, pleased in my law practice that within a reasonable period of time my legal services were required in connection with litigation involving the Rule.

Nothing of real consequence, however, happened until about 1966. At that time I attended a meeting in Chicago of the American Bar Association Business Law Section, later called the Codification Conference, which approved the idea that the American Law Institute should undertake to codify the securities laws. At that meeting there was gossip in the corridors about "Milton Freeman's Rule 10b-5." I believed it was necessary and appropriate to stand up and take responsibility and to say what had happened, and I did so.⁶

I thought that would be the end of it and nobody would reproach me any further. But a little later, there was a decision in a case called *Escott v. BarChris* by which Judge McLean here in the Southern District had

4. Pub. L. No. 79-404, 60 Stat. 237 (codified as amended at 5 U.S.C. § 551 (1988)).

5. 73 F. Supp. 798 (E.D. Pa. 1947).

6. See 22 Bus. Law. 921 (1967).

found lawyer directors liable under the Securities Act.⁷

Thereafter, I was called on to make a speech to a large Bar Association meeting at the Waldorf Astoria Hotel to reassure the bar that if they acted only as lawyers they were not liable under that case.⁸ To my surprise, the chairman of the meeting introduced me as the author of Rule 10b-5. My response to this was: "I am driven to quote Shakespeare: 'The evil that men do lives after them.'"⁹ I then got to be known as the "father" of Rule 10b-5. At some bar conference in Virginia I pointed out that "even when paternity is established, it is well known how little control parents have over their children when they grow up."¹⁰

At that point I was most reluctant to endorse the Rule as it was then sought to be interpreted. For I was afraid that the Rule was being subject by plaintiffs, governmental and private, to arguments for expansion to an extent that I believed it was in danger of becoming a loose cannon. For example, plaintiffs urged that the words of the Rule "in connection with the purchase or sale of a security" meant "not in connection with the purchase or sale of a security."¹¹ They urged that "fraud" meant "negligence"¹² and that "immaterial" meant "material."¹³ Furthermore, the SEC sought to say that any illegal act by a public corporation would have to be disclosed as "material" even if it would have no effect on any investment decision. I spoke and wrote in criticism of this position.¹⁴ The SEC abandoned this view and it was finally interred in *United States v. Matthews*.¹⁵

Of course, the Rule has been widely applied. Justice Rehnquist referred to the Rule as "a judicial oak which has grown from little more than a legislative acorn."¹⁶ It became the subject of extensive publications not only by Professor Langevoort, but also by Professors Loss and Bromberg, and Arnold Jacobs among others.

During this period, I was not an absentee parent. Besides writing, I participated in some of the important cases (for example, as counsel in *TSC*¹⁷ for petitioner and in *Aaron*¹⁸ as counsel for the Securities Industry Association as amicus curiae).

Fortunately, the Supreme Court and the other courts put a stop to the expansion efforts of plaintiffs, and current construction of the Rule is

7. *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

8. *See* 24 Bus. Law. 523 (1969).

9. 24 Bus. Law. 635 (1969).

10. 31 Bus. Law. 982 n.4 (1976).

11. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

12. *See Aaron v. SEC*, 446 U.S. 680, 685-86 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 189-91 (1975).

13. *See TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 441 (1976).

14. *See The Legality of the SEC's Management Fraud Program*, 31 Bus. Law. 1295 (1976).

15. 787 F.2d 38, 49 (2d Cir. 1986).

16. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

17. *See TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 440 (1976).

18. *See Aaron v. SEC*, 446 U.S. 680, 682 (1980).

much more in line with what I believe the Commission intended. Accordingly, I am no longer in doubt but, indeed, I am glad to accept responsibility for the Rule as currently applied.

About four years ago, I was in Chicago for a meeting of the American Law Institute discussing the provision of its Corporate Governance Project relating to derivative stockholders lawsuits. I proposed on behalf of a distinguished group of lawyers a relatively simple solution to the problem.

The proposal was attacked by an academic friend as follows: He said,

Now, Milton Freeman . . . is fond of simple solutions. In 1942, he gave us Rule 10b-5. Many of us make a living as a result of Rule 10b-5, and I'm sure Milton Freeman would be candid if he acknowledged that he had no idea what in fact he had given us. Forty-six years later, we are still trying to construe what it means.

I replied:

It has been alleged that in 1942 I expressed my approval of simplicity in drafting and adopting Rule 10b-5. I used to respond, as I said, by quoting Shakespeare. However, under the present attack, I shall take a different approach. It seems to me that I should be complimented rather than attacked for having, over this long period of time, continued my devotion to the advantages of simplicity over complexity. Rule 10b-5, it is true, is a very simple Rule; it outlaws fraud in securities transactions. . . . [P]eople have argued a lot about that, but nobody, not even the learned gentlemen who have taken my name in vain, have suggested any way similar to that of the reporters in this case, in which Rule 10b-5 can be improved by complexity.

Shortly after this exchange, a young lawyer came up to me and said, "I'd like to shake your hand." After this was done, I asked what his interest was in Rule 10b-5. He said "None, I just wanted to shake the hand of somebody who did *anything* forty-six years ago."

Professor Langevoort¹⁹ has indicated that Rule 10b-5 is likely to survive as a Rule for the long future. I hope this will be the case if the flexibility he attributes to the Rule is not again subjected to an attempt to expand it beyond its present scope.

One of the lesser but important questions that remains unresolved that I think is appropriate to mention is the idea of construing the rule to outlaw transactions that do not involve a fraud on investors but only on other people (a contention labelled by the SEC as "the misappropriation theory"). In the *Wall Street Journal* case,²⁰ a columnist gave personal analysis, for example "General Motors is about to move" or "IBM is going down."²¹ He accepted money for letting people know before publi-

19. See Donald C. Langevoort, in Annual Survey of Financial Institutions and Regulation, Happy Birthday 10b-5: Fifty Years of Antifraud Regulation, *Rule 10b-5 as an Adaptive Organism*, 61 Fordham L. Rev. S7 (1993).

20. See *Carpenter v. U.S.*, 484 U.S. 19 (1987).

21. *Id.* at 22.

cation what his recommendations would be. He had no connection with the management of General Motors; he did not know anything about GM or IBM or any of the others about which he wrote. His information was not inside information. It was merely analysis on the basis of public information. What he was doing was betraying his employer by revealing the information before it was published. He was indicted for mail fraud and for violation of Rule 10b-5.

In the Supreme Court of the United States, the Solicitor General argued that the publisher was entitled to have its own information kept confidential until published and that this was a property right of which the *Journal* was defrauded.

The Supreme Court unanimously sustained this argument under the mail fraud law. However, the Court divided four to four on the question of whether the reporter also violated Rule 10b-5. The issue was basically whether the Rule applied only to protect investors or did it also outlaw conduct that cheated only an employer and not any investor?

I testified before a Senate Committee that that construction of the Rule was inappropriate; that, although the conduct should be outlawed, it was not that with which Rule 10b-5 was meant to deal. I felt a rule adopted under an investor protection law should be construed to be limited to the purpose of investor protection.

I argued, therefore, that there should be a separate statute not sounding in securities fraud or investor protection, specifically outlawing trading on information improperly obtained from any source. I supplied a draft of the bill.²²

While I believed that I had the support of the SEC for this proposal, when it came to hearings, the SEC solemnly advised the Senate that they saw six reasons why they should support the draft and six reasons why they should not.²³ Of course, this failure of support killed the proposal.

In the famous Siegel, Boesky, and Milken cases, the people who were cheated were the employers of Siegel—that is, mostly, Drexel. It is easy to understand that the SEC in their anti-Milken, anti-Drexel campaign at the time was not about to say: “Drexel has been injured and we are going to see that they get a lot of money.” They were similarly not about to make a check out to the *Wall Street Journal*.

I think it is appropriate for the Congress of the United States to say that the kind of thing that Messrs. Boesky and Siegel did should be illegal. It should be made illegal independently of whether it is fraud on investors. Accordingly, I was very much impressed with the analysis that Professor Langevoort has made and I agree with a great deal of it.²⁴

22. See *The Insider Trading Sanctions Act of 1984: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 35 (1984)* [hereinafter *Hearings*]; *The Insider Trading Sanctions Act of 1984*, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

23. See *Hearings*, *supra* note 22, at 35-36.

24. See Langevoort, *supra* note 19.

But I want to say one more thing in my defense: Jim Sargent, a former SEC Commissioner and a friend, whom I know as one of the few Republicans I would trust with public office, suggested that I should be invited to your happy 50th birthday party for Rule 10b-5. Professor Langevoort has graciously allowed me the opportunity to make these observations and I thank him deeply, and I also especially thank Jim Sargent and Professor Felsenfeld.

Supplementary Comment

Two months after my appearance at Fordham, I spoke similarly at a meeting of the Securities Regulation Institute in Coronado, California. The Institute then conferred on me a certificate. It was drafted with gentle humor by two of the most prominent and sophisticated practitioners in the country (Meyer Eisenberg and Robert Mundheim). Since it refers specifically to Professor Langevoort and, in my view does not depart too far from the truth, I believe it may be worth including as an independent comment on the rule and my part in it:

On the occasion of the 50th anniversary of the adoption of Rule 10b-5 under the Securities and Exchange Act of 1934 the Securities Regulation Institute of the University of California at San Diego is pleased and honored to recognize the signal contribution of our distinguished colleague and Advisory Board member (Emeritus), Milton Freeman, to the field of securities regulation, and particularly as the Father of Rule 10b-5, whose anniversary we celebrate.

Mr. Freeman took the vague language of Section 10(b) and turned it into a sharply defined rule, which has become the SEC's weapon of choice against fraud and the most utilized basis for shareholder class actions, involving real or perceived securities fraud. The rule reaches conduct and activities far beyond what the SEC of fifty years ago or Mr. Freeman and his colleagues ever contemplated. Indeed, Mr. Freeman has made a career of containing the scope of the Rule which he fathered—with only modest success. Alas, a father can only rarely control the conduct of his children.

The members of the Securities Bar wish to thank Mr. Freeman for the opportunity he created for the expansion of their practice and the consequent financing of the college and professional education of thousands of students at this country's finest institutions of higher learning, including, of course, the University of California. Professors Loss, Bromberg, and Langevoort, among others, wish to thank Mr. Freeman for providing sufficient grist for their scholarly mill to sell tens of thousands of copies of their books and articles. The Securities and Exchange Commission wishes to thank Mr. Freeman for providing a basis for ever expanding jurisdiction, larger budgets, and more numerous staff. Finally, the Securities Regulation Institute wishes to thank Mr. Freeman, for without his work product and annual commentary, these conferences would be far less interesting and much less exciting than they have been.²⁵

25. A copy of the certificate is on file with the *Fordham Law Review*.