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REFORM OF THE FEDERAL SECURITIES LAWS

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Introduction

There are enough anomalies and inconsistencies in the present Federal Securities Laws [1] to justify a significant reform effort. In November, 1966 approximately eighty lawyers specializing in the securities field met in Chicago to consider one possible route to reform —legislative codification.[2] The keynote speaker was Professor Louis Loss who proposed the adoption of a federal securities code of approximately ten titles.[3] There were several other advocates of "codification," although they were not in complete agreement as to what such a program should entail. Codification might involve anything from a mere rearrangement of existing provisions into a more orderly sequence (a project which would not involve "reform"), to a basic revision of the substantive law.

This article considers another route to reform—administrative action. The organization of a reform movement will involve establish-

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[1] The term "federal securities laws" includes the Securities and Exchange Commission's rules and practices, and court and administrative decisions, in addition to the six statutes administered by the SEC: Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1964); Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-jj (1964); Public Utility Holding Company Act of 1935, 49 Stat. 838, as amended, 15 U.S.C. §§ 79a-z (1964); Trust Indenture Act of 1939, 53 Stat. 1149, as amended, 15 U.S.C. §§ 77aaa-bbbb (1964); Investment Company Act of 1940, 54 Stat. 789, as amended, 15 U.S.C. § 80a (1964); Investment Advisors Act of 1940, 54 Stat. 847, as amended, 15 U.S.C. § 80b (1964).

[2] An edited transcript of the conference appears in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law 793 (1967) [hereinafter cited as 22 Bus. Law].

[3] Louis Loss, *History of SEC Legislative Programs and Suggestions for a Code*, *id.* at 795.

ment of priorities, allocation of energies to various activities and direction of efforts along many channels. In organizing for reform, one major question should be considered: how much of the desired result can be accomplished without the need for new legislation, capitalizing instead on the SEC's administrative authority to achieve significant reforms within the existing statutory framework?

It is not the purpose of this article to oppose legislative codification. There is no inconsistency in the concurrent pursuit of reform on both the legislative and administrative levels.[4] The proponents of codification acknowledge that a legislative revision will take many years to achieve.[5] Administrative reform can be accomplished much more quickly and without some of the other drawbacks of a legislative program, such as the risks that the legislative process will weaken investor protections;[6] that codification of the entire body of law on a single date will lead to ill-timed consideration of some problem areas;[7]

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[4] See William L. Cary, *id.* at 911; Philip A. Loomis, Jr., *id.* at 914; Louis Loss, *id.* at 919.

[5] *E.g.*, Louis Loss, *id.* at 798. Codification of the securities laws is a project which probably will not generate much grass roots public interest. As such, the project could languish in Congress for a long time, except in the very unlikely event of a codification bill which raises no significant controversies. See William L. Cary, *id.* at 912; Philip A. Loomis, Jr., *id.* at 915; Louis A. Loss, *id.* at 919.

[6] See Richard W. Jennings, *id.* at 879.

[7] One inevitable feature of the codification process—aiming at a single piece of legislation which will work its way through Congress for passage as a unified whole—is the danger that it will consider some topics prematurely and may frustrate the normal growth in other areas of law.

Consider the current fluid state of the law and the likely effect of a codification program if it were at an advanced stage today. The impact of the 1964 Amendments, Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565, is just beginning to be felt, especially in the banking and insurance industries. Other recommendations of the Securities & Exchange Comm'n, *Special Study of the Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as *SEC Special Study of Markets*] are yet to receive a definitive implementation or rejection. The Commission's Mutual Fund Study, Securities & Exchange Comm'n, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as *SEC Mutual Fund Report*], climaxing eight years of effort, has just been made public, and the SEC has introduced highly controversial legislation to implement its proposals. S. 1659, H.R. 9511, 90th Cong., 1st Sess. (1967). Certain principles are just beginning to emerge beyond the boiler room context. One example is the doctrine of "suitability," a broker-dealer's obligation to tailor investment recommendations to the financial needs of a particular customer. See First Securities Corp., 40 S.E.C. 589 (1961); Gerald L. Greenberg, 40 S.E.C. 133, 137-38 (1960); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445. Another emerging principle is the obligation of a broker-dealer to have a reasonable basis for a recommendation. See Berko v. SEC, 316 F.2d 137 (2d Cir. 1963), *affirming* Mac Robbins & Co., 41 S.E.C. 116 (1962); Ross Securities, Inc., 41 S.E.C. 509 (1963); Barnett & Co., 40 S.E.C. 521 (1961); Leonard Button Corp., 39 S.E.C. 211 (1959); SEC Securities Exchange Act Release No. 4445 (Feb. 2, 1962); Schneider, *SEC Filings—Their Use to the Professional*, 21 Financial Analysts J. 33 (1965); Note, *New and Comprehensive Duties of Securities Seller to Investigate, Disclose, and Have an "Adequate Basis" for Representations*, 62 Mich. L. Rev. 880 (1964). The standards of voluntary disclosures (*e.g.*, through press releases, annual and other reports to the public, as opposed to required filings with the SEC) are undergoing change, and the Texas Gulf Sulphur litigation, SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), will certainly have a lasting impact in this area. The relationships among the various capital markets are

and that codification will create as many problems and uncertainties as it will solve.[8] Whether or not legislative codification is undertaken, some of the available energies ought to be devoted to administrative reform efforts. The bar and various segments of the securities industry should unite with the SEC to find the most creative solutions which can be fashioned within the Commission's present authority.

Much of the Chicago discussion focused on Milton H. Cohen's germinal article,[9] which in turn was based on the Securities and Exchange Commission's Special Study recommendations concerning the integration of the disclosure requirements of the 1933 Act and the 1934 Act.[10] Mr. Cohen suggested de-emphasis of the 1933 Act's focus—disclosure through registration. Instead, 1934 Act continuous reporting would become the basic feature of the disclosure system. The principal focus of this article is also on the "disclosure system"—that part of the federal securities laws which applies to publicly owned companies and their insiders under the 1933 Act and

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shifting as a result of the relatively recent growth in importance of the third market, as well as the recent amendment of Rule 394 of the New York Stock Exchange, NYSE GUIDE ¶ 2394 (CCH 1967), permitting Exchange members to deal in listed securities, under certain limited circumstances, off the exchange. Various trading practices have been the subject of reforms in the relatively recent past, such as the restriction on "floor trading" by exchange members, SEC Rule 11a-1, 17 C.F.R. 240.11a-1 (Supp. 1966), and NYSE Rules 108-13, NYSE GUIDE ¶ 2108-13 (CCH 1967), discussed in SEC Securities Exchange Act Release Nos. 7330 (Aug. 3, 1964); 7290 (April 9, 1964), and the publication of "inside" quotations for over-the-counter stocks.

Certain other practices vitally affecting securities markets are under close scrutiny by the SEC, including the stock exchanges' minimum commission system with no volume discount, *SEC Mutual Fund Report* 156-57, the odd lot differential and "give-ups," *id.* at 169-88. Financial reporting of "conglomerate" companies is another problem which has grown to significant proportions in the past several years and which the Commission has under active study. The extent to which the issuers and insiders can purchase their stock in the market has also been explored recently. SEC v. Georgia-Pacific Corp., 66 Civ. No. 1215, S.D.N.Y. 1966, consent decree reported in CCH FED. SEC. L. REP. ¶ 96,690 (May 24, 1966); Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 154-56 (1966); Baker, *Purchases by a Corporation of Its Own Shares for Employee Benefit Plans*, 22 BUS. LAW. 439 (1967). The Supreme Court has yet to pass directly on the doctrine of implied civil liability under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), and the lower courts are still laboring to fix the limits of the doctrine.

With all of these developments going on at once, an effort to codify all of the securities laws at the present time would be inappropriate. In many areas referred to above, there is not enough accumulated experience to make meaningful decisions. In at least some areas, the Commission, as it frankly acknowledges, is experimenting. In other areas, doctrines could grow best by a common-law, case-by-case approach. Even if the status of the law as of the codification date could be codified, future growth and development might be frustrated. See Cohen & Rabin, *Broker-Dealer Selling Practice Standards*, 29 LAW & CONTEMP. PROB. 691, 714-19 (1964).

While it is true that no one expects codification to take place this year or even next year, there is the danger that whenever the bill is enacted, there will be some areas of the law where legislative action is premature or otherwise inadvisable. As a corollary, if overall codification is delayed to await the solution of problems, there will be other areas where reform is unduly postponed.

[8] See generally William L. Cary, 22 BUS. LAW. 911; F. Arnold Daum, *id.* at 819; Louis Loss, *id.* at 919.

[9] Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).

[10] *SEC Special Study of Markets* pt. 1 at 591-95.

the 1934 Act.[11] This is in contrast to those aspects of the law which directly regulate various branches of the securities industry.

Preliminarily this article will identify some of the problems of the disclosure system which a reform effort should attempt to solve. In an ideal disclosure system, investors would have readily available in useful form the maximum amount of information which could be produced without undue burden on the issuer. It would be appropriate to have the issuer's burden of compliance correspond with the public's need for information in any given situation. In contrast with routine periodic reporting, more disclosure should be required if, for example, a major underwriting by the company exposes investors to concentrated sales efforts, a significant event occurs (*e.g.*, an important acquisition of another business) or if stockholder action is requested (*e.g.*, voting at a meeting). In addition, the delay involved in complying with applicable requirements should be kept to a minimum; there should be certainty as to when various requirements apply, how compliance can be achieved and the consequences of non-compliance.

The present disclosure system is far from ideal in many respects. In terms of time, effort and expense, 1933 Act registration is probably the most burdensome of all the disclosure filing requirements.[12] Under present law, the burden of 1933 Act registration falls in a somewhat arbitrary manner. Too often the obligation to register depends on how long the securities in question have been held by the seller, or on the form rather than the substance of a transaction.[13] It would be more appropriate to consider factors such as the probable effect of the sale on the public market (in terms of how the sale is made and the amount of securities being sold), or the amount of information about the issuer already available to the investor.

The present disclosure system is also inefficient. Much of the information now being made available is neither readily accessible nor in a useful form for the investor. For example, in many cases it would be difficult to construct a current and accurate picture of a com-

[11] Securities Act of 1933, 48 Stat. 74, 15 U.S.C. §§77a-aa (1964); Securities Exchange Act of 1934 §§12-14, 48 Stat. 892, as amended, 15 U.S.C. §§77*l*-78n (1964); §16, 48 Stat. 896, as amended, 15 U.S.C. §78p (1964). The principal 1934 Act liability provisions constituting parts of the "disclosure system" are Securities Exchange Act of 1934 §10, 48 Stat. 891, as amended, 15 U.S.C. §78j (1964); §18, 48 Stat. 897, as amended, 15 U.S.C. §78r (1964); SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (1964).

[12] See Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 Bus. Law. 539 (1960).

[13] As practical examples, an investment purchaser who purchased in an exempt "private" offering under the Securities Act of 1933 §4(2), 48 Stat. 77, as amended, 15 U.S.C. 77d (1964), may sell the shares without registration if he holds them long enough; and SEC Rule 133, 17 C.F.R. §230.133 (1964), provides an exemption from registration in an acquisition taking the form of a merger or a stock-for-assets deal, but not if the same transaction is in a stock-for-stock format.

pany's business and property from its SEC filings. In addition, compliance with the disclosure requirements involves considerable delay. Months may elapse from the time of a decision to sell securities until a 1933 Act registration statement can become effective—a factor which can be an insurmountable hurdle in attempting to negotiate a transaction. This problem is heightened by the considerable uncertainty which faces an issuer, both as to the circumstances which give rise to disclosure requirements and the information which must be disclosed.

The specific proposals for reform which follow are not intended as a definitive program. Rather, they are intended to be suggestive or illustrative of a basic approach—that significant reform can be accomplished by prompt administrative action. Such an administrative reform program should be undertaken whether or not there is a concurrent codification effort.

An administrative reform effort should exploit the great ability which the SEC has shown for adapting the statutory system to meet specific needs. To illustrate this ingenuity, consider the timing aspects of the 1933 Act registration process. The act appears to contemplate the filing of a registration statement which automatically becomes effective twenty days after the date of filing or the date of the last pre-effective amendment. If the registration statement is deficient, the Commission is empowered to issue a stop order.[14] The system might have been completely unworkable, except for the Commission's creation of three techniques—the acceleration request, the comment letter and the delaying amendment.[15] The same ingenuity should be

[14] Securities Act of 1933 § 8, 48 Stat. 79, as amended, 15 U.S.C. § 77h (1964).

[15] See Securities Act of 1933 § 8, 48 Stat. 79, as amended, 15 U.S.C. § 77h (1964). The potential deficiencies in the statute were twofold. First, a twenty-day delay as envisioned by the statute was totally unrealistic. Underwriters were unwilling to fix the price for an offering twenty days before sales could commence. To solve this problem, the Commission developed the acceleration technique which permitted the registration statement to become effective on very short notice. Subsequently, the technique was given express recognition in the 1940 amendments to § 8(a),, 54 Stat. 857 (1940), 15 U.S.C. § 77h(a) (1964); *cf.* SEC Rule 460, 17 C.F.R. § 230.460 (1964).

The second difficulty with the statutory scheme was the fact that the stop order seemed to be an unnecessarily severe remedy for a deficient registration statement. Would not the public interest be better served by correcting the deficient filing rather than issuing a stop order? To serve this purpose, the staff "comment letter" or "deficiency letter" has been adopted as an integral part of the administrative process. To preclude the registration statement from becoming effective prematurely, before the staff completed its review or before the issuer finalized the disclosure documents, the "delaying amendment" was invented. See SEC Rule 473, 17 C.F.R. § 230.473 (1964).

The foregoing comment does not imply unqualified approval of the Commission's comment letter practices. The argument might even be made that Congress never intended the Commission to review filings at all. All this is beside the point, however. Given the Commission's view of its statutory role, the statutory provisions for automatic effectiveness in twenty days, subject only to the Commission's stop order powers, might have presented insuperable practical difficulties had it not been for the Commission's ingenuity in contriving the delaying amendment, the comment letter and its acceleration practice.

utilized to simplify, rationalize and generally reform the disclosure system.

Reform Tools of the Commission

The Commission has various sources of authority which enable it to accomplish substantial administrative reforms within the existing statutory framework. Even now the statutes constitute the barest skeleton of the law. The flesh and blood of the disclosure system is very largely an administrative rather than a legislative creation. Generally, this appears to be what Congress intended. The 1933 and 1934 Acts expressly delegate to the Commission the authority to promulgate operative requirements within the overall statutory plan. This delegation of authority is particularly broad,[16] and a number of commentators have noted the administrative power of the SEC to accomplish substantial reforms.[17]

The Commission has several tools at its disposal which permit substantial remolding of the substantive law within this broad statutory authority. The first of these is its power to promulgate the various disclosure forms, and determine, to a great extent, *when* they must be used. Of necessity, Congress has vested this power completely in the Commission.[18] It would be entirely unrealistic for Congress to specify the precise form and content of the registration statements, proxy statements and periodic reports which must be filed by different classes of issuers under varying circumstances. The power to determine the form, content and timing[19] of disclosure filings enables the Commission to shape and, if necessary, to reshape the actual disclosure system as it applies to various categories of issuers. Proposals for integrating the 1933 and 1934 Acts, such as those made by Milton Cohen and the Special Study,[20] must be implemented, at least in part, through the administrative promulgation of disclosure forms. Indeed, a good number of Milton Cohen's many

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[16] Hon. Henry J. Friendly, 22 Bus. Law. 901.

[17] Kenneth J. Bialkin, *id.* at 888; William L. Cary, *id.* at 911; F. Arnold Daum, *id.* at 821; Harry Heller, *id.* at 823, 826-27; Philip A. Loomis, Jr., *id.* at 914-15; James C. Sargent, *id.* at 802.

[18] *E.g.*, Securities Act of 1933 § 10, 48 Stat. 81, as amended, 15 U.S.C. § 77j (1964); § 19(a), 48 Stat. 85, as amended, 15 U.S.C. § 77s(a) (1964); Securities Exchange Act of 1934 § 12(b)(1), 48 Stat. 892, as amended, 15 U.S.C. § 78*l*(b)(1) (1964); § 13(b), 48 Stat. 894, 15 U.S.C. § 78m(b) (1964); §§ 14(a), (c), 48 Stat. 895, as amended, 15 U.S.C. §§ 78n(a), (c) (1964).

[19] For practical purposes the timing of reports under the 1934 Act is left entirely to the discretion of the SEC. Securities Exchange Act of 1934 § 13, 48 Stat. 894, as amended, 15 U.S.C. § 78m (1964).

[20] See notes 9-10 *supra*.

constructive suggestions are "mechanistic"[21] and of a type which Congress, as a practical matter, would find impossible to implement.[22]

The second Commission tool is its rule-making power, which includes the power to define terms.[23] The Commission has shown a high degree of ingenuity in solving practical problems by creative use of this power within the existing statutes. Consider the impact on the law of some of the landmark definitional rules: 1933 Act Rule 133,[24] in defining such terms as "offer" and "sale," recasts the 1933 Act registration provisions insofar as they apply to mergers and certain types of similar transactions; 1933 Act Rule 154[25] defines "brokers' transactions" to create a de minimis exemption provision permitting minor sales through brokers by controlling persons; of course, 1934 Act Rule 10b-5 presents a classic example of the vast impact rule-making might have.[26]

The power to classify[27] also can be a powerful tool for reform. The Commission has used this power to a limited extent in establishing classifications based on the type of offering,[28] the business of the issuer,[29] the type of security,[30] the amount of information available,[31] and the investment grade of the security.[32] Reform proposals have suggested registering companies rather than particular securities.[33] This approach entails special disclosure requirements for a "first" public offering or when companies "first" achieve broad public ownership. At present, provisions of the 1964 Amendments bring companies into the

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21 The word is his. Cohen, *supra* note 9, at 1376.

22 *E.g.*, Mr. Cohen's proposals for a uniform numbering system for similar disclosure "items" in various forms, *id.* at 1375, or an indexing system, *id.* at 1381, or his proposals on accessibility of information, *id.* at 1376.

23 *E.g.*, Securities Act of 1933, § 19(a), 48 Stat. 85, as amended, 15 U.S.C. § 77s(a) (1964); Securities Exchange Act of 1934, § 23(a), 48 Stat. 901, as amended, 15 U.S.C. § 78w(a) (1964).

24 SEC Rule 133, 17 C.F.R. § 230.133 (1964).

25 SEC Rule 154, 17 C.F.R. § 230.154 (1964).

26 SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964). It has been reliably reported, however, that the authors of Rule 10b-5 never contemplated the doctrine of implied civil liability for fraud spawned by the rule. Milton Freeman, 22 Bus. Law. 921-22.

27 Securities Act of 1933 § 3(b), 48 Stat. 75, as amended, 15 U.S.C. § 77c(b) (1964); § 10(d), 48 Stat. 81, as amended, 15 U.S.C. § 77j(d) (1964); Securities Exchange Act of 1934 § 12(h), added by 78 Stat. 565 (1964), 15 U.S.C. § 78*l*(h); § 13(c), 48 Stat. 894, 15 U.S.C. § 78m(c) (1964); § 23(a), 48 Stat. 901, as amended, 15 U.S.C. § 78w(a) (1964).

28 *E.g.*, SEC Forms S-8, 17 C.F.R. § 239.16b (Supp. 1966), discussed in note 37 *infra* and accompanying text; S-14, 17 C.F.R. § 239.23 (1964).

29 *E.g.*, SEC Forms S-5, 17 C.F.R. § 239.15 (1964); S-11, 17 C.F.R. § 239.18 (Supp. 1966); N-5, 17 C.F.R. § 239.24 (Supp. 1966); S-2, 17 C.F.R. § 239.12 (1964) (for promotional companies).

30 *E.g.*, SEC Forms S-19, 17 C.F.R. § 239.22 (1964); S-12, 17 C.F.R. § 239.19 (1964); F-1, 17 C.F.R. § 239.9 (1964).

31 *E.g.*, SEC Forms S-8, 17 C.F.R. § 239.16b (Supp. 1966); S-9, 17 C.F.R. § 239.22 (1964); S-14, 17 C.F.R. § 239.23 (1964); "summary prospectuses" permitted by Rule 434A, 17 C.F.R. § 230.434A (1964); SEC Forms 8-A to 8-C, 17 C.F.R. § 249.208a-208c (Supp. 1966).

32 SEC Form S-9, 17 C.F.R. § 239.22 (1964); *cf.* proposed SEC Form S-7, SEC Securities Act Release No. 4849 (Nov. 16, 1966).

33 See, *e.g.*, Cohen, *supra* note 9, at 1405; Louis Loss, 22 Bus. Law 796.

continuous reporting system when they first achieve broad public ownership.[34] The Commission's power to classify already enables it to tailor special disclosure provisions for companies upon their "first" achieving public ownership, thus accomplishing, at least in part, the basic objective (if not the form) of a system for the permanent registration of public companies instead of registering particular securities.[35]

Still another source of Commission power for reform lies in its authority to grant conditional privileges, exemptions and benefits.[36] An issuer may be given the privilege of using a limited disclosure form *if* it undertakes to make additional disclosure under prescribed circumstances. For example, an issuer must make two undertakings to supply additional information in the future as a condition to the use of Form S-8, an abbreviated 1933 Act registration form used to offer securities to employees under various types of plans.[37] Use of the shelf registration procedure is normally available only to those insurers who also agree to undertake additional disclosures at a later date.[38] Regulation A under the 1933 Act is another example of an exemption from registration, in this case for offerings of less than $300,000, conditioned upon issuers making various disclosures.[39] Finally, the conditional privilege has been used by the SEC in connection with the acceleration of registration statements under the 1933 Act;[40] such use might be expanded.[41]

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[34] The current test is that total assets must exceed $1,000,000 and there must be a class of equity security held of record by 500 or more persons. Securities Exchange Act of 1934 § 12(g)(1), added by 78 Stat. 565, 15 U.S.C. § 78*l*(q)(1)(1964).

[35] See Louis Loss, 22 Bus. Law 796; Cohen, *supra* note 9 *passim*.

[36] The SEC is granted express power under both the 1933 Act and the 1934 Act to create either absolute or conditional exemptions. Securities Act of 1933 § 3(b), 48 Stat. 75, as amended, 15 U.S.C. § 77c(b) (1964); Securities Exchange Act of 1934 § 3(a)(12), 48 Stat. 882, 15 U.S.C. § 78c(a)(12) (1964).

[37] Employees covered by the plan must receive copies of the issuer's proxy statement and reports to its stockholders and if the employees resell their stock to the general public under certain circumstances, the prospectus must be supplemented. SEC Form S-8, undertakings B, C, 17 C.F.R. § 239.16b (1964).

[38] "Shelf registration" relates to registration of securities for which there is no immediate plan of distribution.

[39] SEC Rules 251-63, 17 C.F.R. §§ 230.251-.263 (1964). In fact, the disclosures required are so extensive that the conditional exemption amounts to a short form of registration, without the need for a full set of exhibits or certified financial statements. In one respect, the Regulation A exemption process is more onerous than full registration. The offeror under Regulation A must file progress reports on the results of the offering and on the application of the proceeds, a requirement having no counterpart for a fully-registered offering. SEC Rule 260, 17 C.F.R. § 230.260 (1964).

[40] See the Commission's official note following SEC Rule 460, 17 C.F.R. § 230.460 (1964). As to acceleration, see note 15 *supra*.

[41] Of course, one treads on thin ice in treating acceleration as a "privilege" which may be conditioned. For the debate precipitated by the American Bar Association's unsuccessful attempt to curtail the Commission's discretion regarding acceleration, see Gadsby & Garrett, *"Acceleration" Under the Securities Act of 1933—A Comment*

Disclosure itself can be used as a technique of substantive reform. By framing disclosure requirements, the Commission can strongly influence, even if it does not necessarily mandate, corporate practice.[42] An example of the Commission's impact in this area is its requirement that the prospectus disclose whether the issuer will distribute certified financial statements to its stockholders.[43] The issuer is free to answer in the negative. However, the question forces the issuer to declare its intention, and has probably committed some issuers, who otherwise would not have done so, to a distribution of certified statements.

Industry self-regulation—an integral part of the federal securities law—is another potential source of reform. Many types of reform can be accomplished by appropriate action of the stock exchanges and the NASD. These institutions can and do exercise considerable influence over the disclosure system and the affairs of public companies.

The stock exchanges generally enter into contracts which obligate companies with listed securities to follow certain practices. For example, annual reports with audited financial statements must be distributed by these companies to stockholders promptly after the end of the fiscal year, and unaudited income statements must be published quarterly.[44] While the NASD does not enter into contracts with over-the-counter companies, it does establish standards which must be met before quotations may be published in newspapers.[45] Creative use of this form of industry self-regulation should be employed as part of any reform effort.

Assume, for example, that there was general support for the SEC's suggestion that insiders should not trade in stocks of their own companies for twenty-four hours after an important press release.[46] Such a standard could be implemented widely by a stock exchange

on the A.B.A.'s Legislative Proposal, 13 Bus. Law. 718 (1958); Mulford, *"Acceleration" Under the Securities Act of 1933—A Reply to the Securities and Exchange Commission*, 14 Bus. Law. 156 (1958). Practitioners, the writer included, experience resentment on those relatively rare occasions when the (implied) threat of withholding acceleration is used as a club to force compliance with the staff's view. However, the evil lies in the possibility of arbitrary and, for all practical purposes, unreviewable use of power under undefined circumstances. *Cf.* Crooker v. SEC, 161 F.2d 944 (1st Cir. 1947). On the other hand, is there an inherent objection in principle (though one may disagree as to any given decision) to the Commissioner's promulgation, after consultation with the industry, of clearly articulated standards, defining generally applicable circumstances pertinent to its statutory responsibilities under which it will withhold acceleration? Presumably, no such standards would be adopted by the Commission unless there is a reasonable consensus of outside supporting opinion.

42 See Fleischer, *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146, 1149 (1965).

43 SEC Securities Act Release No. 4666, ¶ 15 (Feb. 7, 1964).

44 New York Stock Exchange, Company Manual A-20 to -22, A-69, A-70 (1967); Listing Form L, American Stock Exchange Guide 8955 (CCH 1966).

45 NASD Manual ¶ 2155, at 2072 (CCH 1967).

46 *Cf.* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

requirement that companies, as a condition to listing, adopt a suitable by-law or other company policy on this topic. There are probably some duties which stock exchanges would find appropriate to impose but which the SEC, as a government agency with a limited mandate to control corporate affairs, might itself hesitate to establish as a condition to a privilege—for example, a requirement that certain transactions be submitted to stockholder vote even though no vote is required under state law.[47]

Another technique of reform through industry self-regulation is the integration of SEC requirements with stock exchange rules or standards. The SEC can use its rule-making power to confer benefits, such as reduced prospectus delivery requirements or reduced disclosure requirements, on companies which meet certain exchange-imposed standards.[48] This is a variation of the "conditional privilege" approach. There is also a potential for integration of the disclosure documents themselves to serve dual purposes. Basic disclosure documents should be designed to meet the requirements of both the exchanges and the SEC. This can be accomplished through incorporation by reference[49] or by permitting the use of the same document with different cover pages—techniques already used to some extent.[50]

Administrative Reform of the Disclosure System

This section of the article will consider the application of the Commission's administrative tools to reform various aspects of the disclosure system. The following discussion, illustrating the application of SEC power to reform the law, assumes that the federal securities laws will remain essentially disclosure-orientated,[51] without attempting direct regulation of the merits of securities which

[47] This practice is in use at the present time. The New York and American Stock Exchanges will not grant an application for listing shares issuable on the exercise of options granted to officers, directors or key employees, nor will they grant an application for listing of shares issuable in a major acquisition, unless the option plan or acquisition has been approved by a vote of stockholders solicited under the SEC's proxy rules, even though no such vote is required by state law.

[48] *Cf.* SEC Rule 174(b), 17 C.F.R. 230.174(b) (Supp. 1966).

[49] See the 1934 Act registration statement on Form 10 of American Cement Corp., SEC File No. 1-4716, where several lengthy items of the form were answered by incorporating by reference a designated section in a New York Stock Exchange Listing Application which was attached as an exhibit to the Form 10 filing.

[50] Stock exchange listing applications frequently consist of a cover page wrapped around an SEC filing such as a prospectus or proxy statement, but the opposite procedure is rare.

[51] Possibly a thorough-going legislative reform program would re-examine and re-evaluate every premise underlying the law, but such an undertaking is beyond the scope of this article. Professor Louis Loss also seems to feel that it is unnecessary to "refight the battle of philosophies." 22 Bus. Law. 808. *But see* Manne, Insider Trading and the Stock Market (1966) (who suggests a complete reappraisal of the traditional principles in the area of insider trading); Stigler, *Public Regulation of the Securities Markets*, 19 Bus. Law. 721 (1964).

may be sold to the public, an approach taken by several state blue-sky laws.[52]

A preliminary caveat applies to a number of the following proposals. The techniques suggested are subject to abuse. They can be used to accomplish objectives both within and beyond the purview of the federal securities laws. It is assumed that the Commission would not use these techniques in a manner not supported by the consensus of outside opinion. Past experience justifies proceeding on such a premise, at least preliminarily.[53] The Commission generally has not changed its rules, promulgated forms or taken similar formal action without significant public support. When functioning at this level, the Commission has exercised restraint. Formal SEC proposals meeting widespread opposition and little outside endorsement are generally modified or abandoned.

Some of the suggestions made below call for new types of disclosure requirements. The overall objective of a reform program, however, should not be to impose *more* burdens on public companies, but to impose *different* burdens. Hopefully, the public interest can be better served through a system imposing fewer overall burdens on public companies if the disclosure requirements can be restructured on a more rational basis.

A. *The Disclosure Documents*

There is general agreement that under certain circumstances 1933 Act registration in its present form involves expense, delay and inconvenience entirely disproportionate to the public benefit achieved. For example, assume the following typical case: a giant public company, *G* Company, with stock listed on the New York Stock Exchange, acquires a small family company, *F* Company, through an exchange of a relatively small amount of *G* stock for all of the outstanding *F* stock. Members of the *F* family have no further connection with the business other than as small stockholders of the *G* stock. A year after the transaction they want to sell their newly acquired *G* stock from time to time over the New York Stock Exchange. Other public documents, including SEC filings, annual reports to shareholders and investment manuals, make readily available in convenient form essentially all of the information relating to *G*

[52] See, *e.g.*, CAL. CORP. CODE § 25507.

[53] *Cf.* Cohen, *supra* note 9, at 1390 n.145. For a former SEC Chairman's view as to the responsiveness of the SEC and other regulatory agencies to political pressure, see CARY, POLITICS AND THE REGULATORY AGENCIES chs. 1, 2 (1967). ". . . I believe it is safe to conclude that agencies seldom take controversial steps under their rule-making power which do not have some support from Congress." *Id.* at 53.

Company which would be contained in a prospectus. Nonetheless, full registration on Form S-1 is required for this transaction under present law, even though it is unlikely that any purchaser of the *F* family's *G* stock will ever see a copy of the prospectus.[54] It may be that the entire distribution of *F* family's stock is accomplished in one or a very few transactions. In such a case, 1933 Act registration is a wasteful exercise, although it does serve a limited purpose by advising the financial community of the existence of the transaction.

The public interest would be served better, balancing burden against benefit, if 1933 Act registration relating to this transaction could be accomplished by a registration form which merely identified the transactions and the securities issued in connection therewith.[55] The form might also include a brief description of *F* Company, including its financial statements, if the acquisition meets a minimal test of materiality to *G* Company as the acquiring company. Such an abbreviated registration would continue to achieve the beneficial purpose of informing the financial community about the transaction. In most cases, this information could be disseminated through the medium of the investment manual or services.

In effect, it is suggested that for the transaction hypothesized above, the 1933 Act registration form be reduced to a simple document resembling a 1934 Act Form 8-K report on the transaction or, possibly, a stock exchange additional listing application relating to the stock issued in the transaction. Indeed, the registration statement might well take a "wrap-around" form: a cover sheet physically attached to a stock exchange listing application.

The prospectus for such an offering (assuming that one would be required) could be reduced to a short paragraph which merely identifies the securities as part of a bloc of stock issued in the transaction referred to in the registration statement. The entire prospectus might read as follows:

> These shares were issued by *G* Company on January 1, 1967, to the sellers of these shares as part of a bloc of 50,000 shares issued by *G* Company in connection with its acquisition of *F* Company. A registration describing this transaction has been filed by *G* Company with the Securities and Exchange Commission and the New York Stock Exchange.

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[54] See SEC Rule 153, 17 C.F.R. § 230.153 (1964).

[55] The SEC has the power to promulgate Registration Forms which do not cover all the items in Schedule A of the 1933 Act. *Compare* Securities Act of 1933 § 7, 48 Stat. 78, 15 U.S.C. § 77g (1964), *with* § 19(a), 48 Stat. 85, as amended, 15 U.S.C. § 77s(a) (1964). Doubts about this power should be put to rest by years of practice with abbreviated forms, *e.g.*, SEC Form S-8, 17 C.F.R. 239.16b (1964).

If use of this short, short form were conditioned on an undertaking to supply certain additional information, the issuer might be required to include in the prospectus an undertaking such as:

> *G* Company will supply upon written request copies of the following documents in accordance with the rules of the Securities and Exchange Commission:[56] its registration statement relating to these shares, its most recent annual report to shareholders, its most recent proxy statement relating to the election of directors and its most recent annual report of Form 10-K to the Securities and Exchange Commission.

Such a short form prospectus could be distributed in compliance with the law by typing it or rubber stamping it on the confirmation covering the registered shares. It could be affixed to the confirmation in the form of a gummed label. Although such a registration statement and prospectus accomplish little, little burden is involved. While a long run legislative codification program may eliminate the need for even this vestigial type of prospectus, the suggested short, short form represents, at least, a relatively painless temporary expedient which can save much time, effort and money pending a legislative reform. The short, short form suggested above is comparable to the rather ingenious requirement of the Comptroller of the Currency, who administers the 1934 Act disclosure system with respect to national banks.[57] Notwithstanding the statutory requirement that an issuer shall "register . . . by filing . . . a registration statement,"[58] the Comptroller's regulation provides that compliance with a requirement to file copies of the bank's annual report to stockholders with the Comptroller, "shall be deemed a registration" under the 1934 Act.[59]

The foregoing proposal for a short form of registration statement and prospectus relates to the stock issued in an acquisition transaction,[60] and merely illustrates the technique of tailoring the registration

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[56] Of course there would have to be many refinements. Should the undertaking be only for the benefit of buyers of the shares or should it cover any broker-dealer? Should there be a limit on the number of copies to be supplied? Use of such short forms probably should be conditioned on the issuer's supplying the specified documents to any recognized financial manual or service which covers its securities.

[57] Securities Exchange Act of 1934 § 12(i), added by 78 Stat. 565 (1964), 15 U.S.C. § 78*l*(i) (1964).

[58] Securities Exchange Act of 1934 § 12(g), added by 78 Stat. 565 (1964), 15 U.S.C. § 78*l*(g) (1964).

[59] 31 Fed. Reg. 6949 (1966), amending 12 C.F.R. § 10.1(b) (1964).

[60] Acquisition transactions present an especially fruitful area for special registration procedures and forms. At the present time there are almost as many acquisitions involving the issuance of stock as there are public offerings registered under the Securities Act of 1933.

There will be an estimated 1,300 or more acquisitions involving the issuance of stock during 1967, up from about 925 in 1966, according to figures published by The Wall Street Journal, Thursday, July 6, 1967, page 12, cols. 3 and 4. During the 5

form to the needs of the particular distribution. The Commission has already made limited use of this approach in evolving special 1933 Act registration forms for offerings made to employees and offerings of securities issued in certain transactions covered by a proxy statement.[61] The technique can and should be exploited further. Forms might take into account such variables as the type of distribution (*e.g.*, conventional underwriting, rights offering, exchange offerings for securities of the same issuer or another issuer, directly negotiated sales which are not otherwise exempt, "from time to time" sales handled as customary brokerage transactions), relative size of the offering, type of information already available about the issuer, and the type and investment grade of the security.[62] Special forms for pledge transactions present an especially fruitful field for reform.[63]

years ended June 30, 1966, the average number of 1933 Act registrations becoming effective per year was 1,382, the high being 1,844 in 1962-63 and the low being 1,121 in 1963-64. The average number for the 10 years ended June 30, 1966 was 1,265. 1966 SEC Ann. Rep. 155. Each such acquisition involves a potential 1933 Act registration problem.

[61] SEC Forms S-8, 17 C.F.R. § 239.16b (1964); S-14, 17 C.F.R. § 239.23 (1964). The latter is in the form of a "wrap-around" cover sheet over a proxy statement.

[62] See, *e.g.*, SEC Form S-9, 17 C.F.R. § 239.22 (1964), which is limited to non-convertible debt securities. While the Commission does not pass directly on the merits of securities, it can and in fact does limit the use of certain registration forms to companies which meet certain objective criteria which tend to assure that the securities will have a high investment quality. See, *e.g.*, SEC Form S-9, general instruction A, 17 C.F.R. § 239.22 (1964); Proposed SEC Form S-7, general instruction A, SEC Securities Act Release No. 4849 (Nov. 16, 1966). There is also a special SEC Form S-2, 17 C.F.R. § 239.12 (1964), to be used for promotional companies. See also SEC Form S-1, instruction A(1)(a), 17 C.F.R. § 239.11 (1964), as to financial statements.

[63] A pledge, as such, by an "investment" holder or controlling person may be an exempt transaction. However, the sale of the pledged securities by the pledgee following foreclosure may require registration under the 1933 Act. SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied*, 346 U.S. 819 (1960). Accordingly, a pledgee may be unwilling to accept unregistered securities as collateral which could not be resold freely by the pledgor. (As to the pledgee's right to sell in the shoes of the pledgor under Rule 154, see SEC Securities Act Release No. 4818 (Jan. 21, 1966).) Many bona fide business transactions are complicated or completely frustrated because of the inability of controlling persons or "investment" holders to pledge their securities. In addition, countless hours and dollars have been expended in filing registration statements (or in preparing elaborate agreements to file registration statements) solely to cover the unlikely contingency that the pledgee will desire to sell securities on foreclosure.

It is suggested that an abbreviated form of registration, or a conditional exemption from registration, be promulgated to permit public sales by pledgees on foreclosure with a minimum of delay and expense. Recognizing that most pledges are redeemed, reasonable procedures should facilitate proper transactions, even if the accommodation creates a minor enforcement problem. An airtight system from the enforcement viewpoint would be unduly stifling to legitimate business.

The procedure should be applicable only to bona fide pledges as defined. Criteria might include requirements that the pledged securities are of similar investment quality to those generally accepted by the pledgee as collateral; that the collateral value attributed to the securities does not exceed the lesser of the value generally advanced by the pledgee or, say, two-thirds of the fair market value; and that the pledge be on the pledgee's prevailing terms, including interest rates. Possibly the abbreviated procedure should be limited to banking institutions. Being subject to other regulatory procedures, there is less chance that banks, as contrasted with other types of pledgees, would be used to facilitate subterfuge transactions. The abbreviated procedure might be limited to pledges covering a maximum of five per cent

As an example of this approach, I would suggest that, within prescribed limits, prospectuses for preemptive rights offerings not require disclosure on management for issuers who solicit proxies under the proxy rules, provided that the issuer undertakes on request to supply a copy of its latest annual meeting proxy statement.[64]

B. *When Disclosure Documents Must Be Used*

A major focus of a reform program should be on questions of timing—when must the disclosure documents be used. The most important question is: when is 1933 Act registration required? Many of the problem areas revolve around the statutory definition of "underwriter" [65] and the related "private offering" exemption.[66]

One of the most perplexing problems for the practitioner is the difficulty of explaining to his client the mystique of "investment intent." Investment intent is not a statutory criterion at all. The term has evolved to express the state of mind of a person who, in the Commission's view, purchases securities without "a view . . . to distribution." [67] An investment purchaser may sell securities without

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of the class of securities or five times the average weekly trading value within the past four weeks, whichever is less; the pledgee might be limited to sales through routine brokerage transactions. *Cf.* SEC Rule 154, 17 C.F.R. § 230.154 (1964). The procedure might be limited to cases where the issuer meets tests to insure its reasonable stability (*e.g.*, net income in each of the past five years, no recent changes in the control or business activity, etc.).

In cases where the pledgee intends to sell under the abbreviated procedure, the registration statement or documentation underlying a conditional exemption, might include a simple notice form describing the surrounding circumstances. The notice would be required to include a statement that neither the pledgee nor the pledgor knows of "any material adverse information . . . with regard to the current and prospective operations of the registrant not disclosed . . ." to the public either through SEC filings or in some other appropriate manner (such as a press release or report to shareholders). The quoted phrase is from the form of representation which the Commission now requests of selling shareholders in a registered secondary distribution. SEC Securities Act Release No. 4666, ¶ 27 (Feb. 7, 1964).

64 The proxy statement contains essentially the same information as a 1933 Act prospectus. *Compare* 1933 Act Form S-1, items 16-20, 17 C.F.R. § 239.11, at 49-52 (Supp. 1966), *with* the 1934 Act proxy rules, Regulation 14A, Schedule 14A, items 5-7, 17 C.F.R. § 240.14a-101 (1964). See text accompanying note 99 *infra*. Presumably all stockholders receiving subscription rights, except new ones, will already have seen the proxy statement. Possibly a copy of the prior proxy statement should be required to accompany the prospectus, to the extent that unsubscribed shares are reoffered to non-stockholders. This approach of having a "prospectus" contained in two documents is not without precedent. See SEC Rule 431, 17 C.F.R. § 230.431 (1964).

If this special rights offering abbreviated form is adopted, exceptions might make it unavailable if there has been a major change in management within the relatively recent past (and *a fortiori* if there has been a major change since the last annual meeting proxy statement), or if the offering fails to meet other tests to insure that it is non-speculative.

65 Securities Act of 1933 § 2(11), 48 Stat. 74, as amended, 15 U.S.C. § 77b(11) (1964).

66 Securities Act of 1933 § 4(2), 48 Stat. 77, as amended, 15 U.S.C. § 77d(2) (1964).

67 Securities Act of 1933 § 2(11), 48 Stat. 74, as amended, 15 U.S.C. § 77b(11) (1964). The SEC itself has made official use of "investment" terminology. *E.g.*, SEC Form 8-K, item 7, instruction 3.

registration if there has been an intervening change in his personal circumstances. In fact, there have been registration statements filed for shareholders under circumstances where the nonpublic offering exemption would apply, except that the shareholder refuses to make the necessary investment commitment. While the purchaser has no specific intention to sell the shares, he insists upon registration in order to reserve the flexibility of having shares which may be sold or pledged freely. Years may pass without a single share being sold. Since the filing of the registration statement at the time the shares were acquired in effect negates investment intent, theoretically a current prospectus would be required whenever the shareholder desires to sell, no matter how deferred the date of sale.[68] Any determination of the need for registration which turns on changes in the *personal circumstances of the investor* gives critical significance to a factor which is irrelevant from the point of view of the public securities markets. Would not the statutory purpose be better served by focusing on factors such as: the amount of securities to be sold (measured absolutely and relatively as a proportion of the floating supply and of the entire class); the manner in which the securities are to be sold (*e.g.*, a conventional underwriting with heavy selling incentives versus routine brokerage transactions); the amount of information already available about the issuer; or, the investment grade of the security?

The Commission's current interpretation of the 1933 Act—requiring registration in many circumstances other than conventional underwritings by professionals—is not compelled by the statute or its legislative history. The statute seems to permit a much more relaxed interpretation. The prevailing interpretation of the statute has changed from time to time[69] and there is relatively little case law in this field which would freeze the status quo and preclude a less expansive reading of the act, especially in view of the SEC's broad rule-making powers.[70]

The definition of "underwriter" includes "any person who has purchased from an issuer *with a view to*, or *offers or sells for* an issuer *in connection with*, the *distribution* of any security . . . ."[71] The italicized words could be interpreted to exclude institutional investors or other persons who are not generally in the business of distributing

[68] However, as a practical matter, the shareholder can probably obtain a staff no-action letter if the entire bloc of stock has been held intact for a number of years, notwithstanding the original registration.

[69] See Cohen, *supra* note 9, at 1348.

[70] *Cf.* the Supreme Court's concession in SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953), that the Commission can use numerical tests in deciding when the public offering exemption exists.

[71] Securities Act of 1933 § 2(11), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(11) (1964). (Emphasis added.)

securities, but who acquire securities in good faith directly from the issuer for "investment" in the layman's sense. In the layman's sense, an "investment" purchaser, or investor, is one who buys securities on the open market for long-range potential rather than short-range trading, but who considers the securities readily marketable.

I would not suggest an interpretation which makes a blanket exemption for all sales to nonprofessionals in the securities business. On the other hand, I think that the SEC has ample authority to adopt a definitional rule relaxing the registration requirements considerably, especially for companies making adequate disclosures under the continuous reporting system of the 1934 Act. Possibly the exemption should be conditioned on a sufficient holding period. There could be a presumption (possibly a conclusive presumption) that securities can be sold freely after they have been held for one or two years.

The availability of exemptions is an integral part of the timing problem—when the disclosure documents must be used. The Commission has ample authority, almost entirely unused, to create exemptions for small transactions under section 3(b) of the 1933 Act.[72] Section 3(b) seems to contemplate meaningful exemptions from the registration requirement for de minimis transactions, yet, I have been informed by reliable sources that less than $20,000 of securities were involved in roughly half of the 1933 Act no-action requests received by the SEC in a representative period. By creative use of its statutory power to exempt small sales, especially "secondary" sales by existing holders, the SEC could achieve a major improvement in the disclosure system.

With a slight relaxation of the doctrine on integrating related transactions, a much higher effective ceiling could be achieved. For example, Regulation A now permits sales of up to $300,000 of securities within a two-year period,[73] and there is no express limitation on the ability to use the exemption in successive periods. The waiting period could be shortened. An exemptive rule might permit, under appropriate circumstances, sales up to the $300,000 statutory maximum each year, each month or even each day. Offerings to employees under options or other employee benefit plans present another area where formal 1933 Act registration seems to be an overly cumbersome procedure. The present Form S-8 registration process for employee benefit plans could be superseded by any better plan which the SEC

[72] The principal use made by the SEC of its Securities Act of 1933 § 3(b), 48 Stat. 75, as amended, 15 U.S.C. § 77c(b) (1964), power has been the promulgation, in effect, of a short form of registration under Regulation A. See note 39 *supra*. In fact, this short form is used most often by small companies for which the so-called "exempt" offering is usually a major rather than a de minimis transaction (although the transaction is de minimis from the overall market point of view).

[73] SEC Rule 254, 17 C.F.R. § 230.254 (1964).

can devise and promulgate under section 3(b), subject only to an extremely high maximum participation of $300,000 per employee.[74]

There also may be some problems with the timing of 1934 Act disclosure documents, but many, if not most, of these problems can be solved easily by administrative action. The Form 8-K report is now filed on a monthly basis, ten days after the end of the calendar month in which the reportable event occurs.[75] Thus the report is not due until at least ten and as many as forty-one days after the event. If there are situations where the report should be filed more promptly, the SEC has power to so require. Indeed there does not seem to be any statutory reason why a report under the 1934 Act cannot be required *before* the event.

The 1934 Act continuous reporting system does not require a disclosure filing about a material event unless the event takes one of several specified forms. The Commission should consider creating a broader requirement for reporting material events. As the law now stands, the prospectus disclosure rules apply on essentially an all-or-none basis. The SEC should find further means to identify classes of offerings where the full-dress registration procedure is not needed. For these cases abbreviated disclosure procedures should be adopted, by utilizing either shorter registration techniques or conditions to exemptions.

C. *Use of the Prospectus*

It has been suggested above that the contents of a prospectus can be tailored to fit particular needs. There remains to be considered the great anomaly of the 1933 Act which relates to the use of the prospectus. The act was designed to produce informed investment decisions. However, the prospectus normally is not seen by the purchaser until after his decision is made, and after he is psychologically and probably legally committed to complete the purchase.[76] Section 5 of the 1933 Act[77] provides, in effect, that the statutory prospectus

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[74] Since the rights of each employee under such a benefit plan typically run to him individually and are not assignable, the SEC would be justified in applying the $300,000 limit to each employee's individual participation and not to the plan as a whole.

[75] A Form 8-K report must be filed only if certain specified types of events occur—*e.g.*, a significant acquisition or disposition of property. SEC Form 8-K, item 17, SEC Security Act Release No. 4991, Security Exchange Act Release No. 3497 (Jan. 28, 1954). There is a Form 8-K, item 12, for other types of material events, but answering is optional. Apparently the Commission wanted to avoid creating liability for failure to file a report, unless the form specifies with reasonable certainty what events would trigger the reporting requirement. The SEC might consider making item 12 mandatory for events covered by the issuer's own "financial" press releases, which would tend to insure SEC quality disclosure for those events which the issuer itself chooses to disclose publicly.

[76] See Harry Heller, 22 Bus. Law. 827.

[77] Securities Act of 1933 § 5, 48 Stat. 77, 15 U.S.C. § 77e (1964).

must accompany or precede the first written communication. Since securities are normally sold orally, the prospectus is not required to be sent, and usually is not mailed, until the bill (the confirmation) for the purchase is mailed to the purchaser.

There are various techniques which can be used to advance the time of prospectus delivery, without amending the statute. For purposes of this discussion we can assume that the "prospectus" which the purchaser receives will be a substantially final preliminary prospectus, but it should be relatively easy to work out an underwriting procedure which would permit distribution of a final prospectus before the investor makes his decision. I would not advocate application of the suggested techniques to all types of offerings. However, these techniques would seem appropriate at least for first public offerings and possibly for broader categories, such as offerings of companies not subject to 1934 Act reporting.

The techniques include:

1. A stated policy of the Commission to withhold acceleration unless the prospectus has been transmitted to the intended purchaser so as to be received twenty-four hours in advance of the time when he is asked for a definite commitment. The Commission has already used this technique on an informal basis in some cases.[78]

2. A disclosure technique requiring the prospectus to indicate prominently the fact that the underwriters will not make available a final prospectus or a substantially final preliminary prospectus to retail purchasers before the purchasers are asked to commit themselves. As a variation, the disclosure might inform purchasers whether or not the underwriter will allow purchasers to rescind a purchase within a defined period after receiving the prospectus. This is an accommodation which some underwriters now make on a limited basis.[79] While a given customer who was committed before receiving the prospectus would not see the statement until it was too late for him, quite possibly underwriters would find the disclosure sufficiently objectionable to either provide a prospectus earlier or allow the purchaser to rescind.[80]

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[78] *SEC Special Study of Markets*, pt. 1, at 548.

[79] *SEC Special Study of Markets*, pt. 1, 519 n.89; see Harry Heller, 22 Bus. Law. 827.

[80] The question may be raised why this indirect disclosure technique should be used rather than a positive requirement for advance delivery of a prospectus; there might be limitations on the Commission's power to promulgate such a positive requirement, in light of the legislative history of 1933 Act § 5. Staff of Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess., SEC Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, 3-13 (Comm. Print 1942); SEC Securities Act Release No. 3224 (June 6, 1947). On the subject of prospectus delivery, Congress has been rather specific, as contrasted with certain subjects on which it has given the SEC a broad mandate

At the least, a disclosure along the lines suggested will help educate public customers to ask for prospectuses in the future.

3. This is an ideal area for industry self-regulation. The NASD could provide, for example, that fair dealing and just and equitable principles of trade require receipt of the prospectus by the customer before he is committed.

4. Fraud principles also might be used to require earlier prospectus delivery. The theory would run as follows: when a salesman sells a security orally he is going to give some information. Once he begins to tell the story, he must tell the whole story, make full disclosure without omitting any material facts. In the nature of things, such full disclosure cannot be made orally. For example, it would not be feasible to convey the financial statements in this manner. Therefore, if a salesman undertakes any oral selling efforts of a security about which there is no available public information and for which there is no established market, the duty of full disclosure would require that the full prospectus be delivered before the purchaser can be bound.[81] At a minimum, a fraud approach would place an affirmative duty on the salesman to advise that there is no source of public information, except for the prospectus which is available on request.[82]

5. At the present time, there is no requirement for advance delivery of an offering circular for an offering of less than $300,000, exempt

to shape the law administratively. A further virtue of the disclosure techniques suggested in the text above is that it gives the underwriter a choice of courses to follow.

The SEC has broad power to prohibit any practice which operates as a fraud or deceit, including particularly unfair methods of dealing by broker-dealers. *E.g.*, Securities Exchange Act of 1934 § 10(b), 48 Stat. 891, as amended, 15 U.S.C. § 78j (1964). If the Commission concluded that the sale of a speculative security in a registered offering without a prior prospectus delivery is an unfair method of doing business, it may have adequate power to prohibit such a practice.

[81] Of course, this theory, if pushed to its logical conclusion, could cover any type of oral sales activity. However, the Commission, in its expertise, could articulate a standard to support an advance delivery requirement which would cover only a limited number of cases, for example, cases where there is no reservoir of public information and no established market for the security.

Even if the prospectus were read in full over the telephone, the Commission could find that the sales technique was inherently fraudulent, notwithstanding such full disclosure. See Cohen & Rabin, *Broker-Dealer Selling Practice Standards*, 29 LAW AND CONTEMP. PROB. 691, 703 (1964).

[82] If it appears that "there is unusual lack of pertinent information necessary to reach an informed judgment as to the value of the securities, this fact would be a material fact within the meaning of the anti-fraud provisions . . .". SEC Securities Act Release No. 4352, Securities Exchange Act Release No. 6525 (April 12, 1961) (dealing with Volkswagenwerk A.G.). Compare the position taken by the Commission in another context. The Commission has indicated that brokers having transactions in foreign securities for which there is inadequate public information should "consider this fact in deciding whether they have a reasonable basis for recommending these securities to customers." SEC Securities Exchange Act Release No. 8066, at 3 (April 28, 1967).

under Regulation A.[83] Since 1933 Act section 3(b), under which Regulation A was promulgated, gives the SEC clear power to make any exemptions conditional, the Commission could certainly require advance delivery of the offering circular in a Regulation A offering.[84]

The foregoing discussion concerns means of increasing the prospectus delivery requirements in certain instances. On the other hand, there are circumstances where the prospectus delivery requirements are unduly burdensome and probably unworkable.[85] The 1933 Act requires, in essence, delivery of a prospectus by any dealer selling a registered security within forty days after the commencement of the offering, including dealers unconnected with the distribution.[86] The SEC should make further use of its administrative power to reduce these burdens.[87]

D. *Elimination of Uncertainty*

In reforming the disclosure system, the Commission should strive for much greater predictability. There is far too much uncertainty as to what the disclosure requirements are and when they apply. Some of the rules and items in SEC forms have acquired such an administrative gloss that even the most sophisticated practitioner reading the text is occasionally astounded at the Commission's interpretation.[88] The difficulty is heightened by inconsistencies among the various branches of the staff which process the filing. Needless delays, irritation, expense and embarrassment can result when a filing is deficient due to an unexpected interpretation.

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[83] SEC Rules 251-63 and the related forms constitute Regulation A. 17 C.F.R. 230.251-.263 (1964). An offering circular under Regulation A is generally equivalent to a prospectus used for a registered offering. See Rule 256, 17 C.F.R. § 230.256 (1964).

[84] Indeed, the entire Regulation A procedure, including the required filings and the use of the offering circular, are merely conditions to the availability of the exemption.

[85] *Special Study of the Markets*, pt. 1, 549-50; Albert Pratt, 22 Bus. Law. 924-25.

[86] Securities Act of 1933 § 4(3), 48 Stat. 77, as amended, 15 U.S.C. § 77d(3) (1964). The period is 90 days for "first" offerings.

[87] The 1964 Amendments modified the present Section 4(3) of the 1933 Act and granted the SEC power to shorten the period by rule, regulation or order. SEC Rule 174, 17 C.F.R. § 230.174 (1966), the only rule to shorten the period promulgated under this power, is of relatively limited applicability. *Cf.* SEC Rule 425A, 17 C. F. R. § 230.425A (1966), and SEC Securities Act Release No. 4726 (Sept. 15, 1964).

[88] To cite a not atypical case, proxy statements on mergers require a notation of the price range of listed securities on a quarterly basis over two years. SEC Reg. 14a, Schedule A, item 15(c), 17 C.F.R. § 240.14a-101 (Supp. 1966). Citing only this provision and the full disclosure requirement of SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1964), at least one staff member has insisted that the specific prices must be shown on the date the merger was announced.

The nagging uncertainty in the securities law field is especially troublesome to lawyers because of the frequent need for legal opinions.[89] In most business dealings, parties are willing to act without a formal legal opinion. In the antitrust field, for example, a transaction is rarely conditioned upon a legal opinion that it does not violate the antitrust laws. However, transactions relating to securities very often require legal opinions as to propriety. Securities lawyers frequently find that the risk in a particular case is minimal. As a business matter, they advise the client to proceed with the transaction. However, there may be such uncertainty that the lawyer (especially the more careful lawyer),[90] will not give the type of unqualified opinion necessary for the transaction to close. The common use of formal opinions no doubt explains, in part, the frequency of requests to the SEC for no-action positions.

Because of these factors, the Commission should recognize a special obligation to inform the public of new developments. Interpretive releases and published opinions of the General Counsel can accomplish a great deal in this respect. The Commission has made strides in this direction, but more efforts are needed.[91] The Commission should adopt a firm policy that no comment of general applicability (*i.e.*, not related to the particular situation of an individual filing) should be permitted on an individual filing unless the comment is approved for universal application by all branches. As soon as a new comment is adopted, efforts should be made to advise the public. Where it does not seem necessary to amend the form itself, guideline releases can be published from time to time.[92] An even less formal

[89] The common use of opinions may be due in part to the frequency of intermediaries between sellers and purchasers of securities—such as broker-dealers and transfer agents—who are paid relatively little for their services but who are exposed to serious consequences if they act improperly. These intermediaries may often insist on unqualified legal opinions which the principals to the transaction would forego.

[90] On many subjects, even to recognize the existence of a problem takes a high degree of sophistication and expertise. Unfortunately this leads to opinion shopping; if the first lawyer will not give an unqualified opinion, the client will seek another lawyer who—not recognizing the problem or being willing to take the risk—will render the opinion desired. As a practical matter, border line transactions are very rarely challenged, and the lawyer willing to render a doubtful opinion can feel reasonably safe from adverse consequences.

[91] See, *e.g.*, SEC Securities Act Release No. 4818 (Jan. 21, 1966) (interpreting Rule 154); *Registration of Foreign Offerings by Domestic Issuers*, SEC Securities Act Release No. 4708, Securities Exchange Act Release No. 7366 (July 9, 1964); *Offer and Sales of Securities by Underwriters and Dealers*, SEC Securities Act Release No. 4697 (May 28, 1964); *Broker-Dealer Participation in Proxy Solicitations*, SEC Securities Exchange Act Release No. 7208 (Jan. 7, 1964); *cf.* Cohen & Rabin, *Broker-Dealer Selling Practice Standards*, 29 LAW & CONTEMP. PROB. 691, 708-10 (1964).

[92] See *Guides for the Preparation and Filing of Registration Statements*, SEC Securities Act Release No. 4666 (Feb. 7, 1964). This technique must be used with some restraint, however, lest the Commission expose itself to the charge (already leveled at it at least once, Cohen & Rabin, *supra* note 91, at 719 n.189) that its guidelines "interpretations" amount to amendments to the forms without compliance with the Administrative Procedure Act.

approach would be the public release of extracts from comment letters (and no-action letters, as well), deleting, when appropriate, identifying names and details.[93] The commercial loose-leaf services might be willing to disseminate this type of information, possibly—as is now done on a limited basis[94]—as annotations to the rules and disclosure forms themselves. Similarly, the Commission has used the technique of sending letters to the commercial services as a means of communicating a Commission position.[95]

E. *Upgrading the 1934 Act Continuous Disclosure System*

At present, the disclosure system is inefficient. The 1933 Act produces over-disclosure on an erratic basis; the 1934 Act produces under-disclosure on a regular basis. Registration under the 1933 Act produces a composite, useful disclosure document. However, the document is required only upon the random occurrence of a registered offering. Many of the registration statements now being filed relate to offerings which have insignificant impact on the market and, furthermore, the prospectus gets little dissemination. Therefore, in many cases the 1933 Act registration process involves effort, expense and delay disproportionate to the public benefit.

Reporting under the 1934 Act produces filings which are generally unrelated to each other; there is no periodic synthesis of the bits and pieces. Thus, 1934 Act disclosure has failed to achieve its potential as a means of disseminating useful investment information. The goal should be a continuous reporting system which, with a minimum of effort, keeps the whole range of information reasonably current and accessible at all times. If the 1934 Act continually produces complete current information in useable form, 1933 Act registration can be de-emphasized as the keystone of the disclosure system. This shift in emphasis can be accomplished by use of the SEC's broad authority to specify the form, content and timing of 1934 Act disclosure filings.

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[93] Indeed, the "freedom of information" amendments to the Administrative Procedure Act, 80 Stat. 250 (1966); 5 U.S.C. § 1002 (Supp. 1967), effective July 4, 1967, will force the Commission to make many types of information available to the public —*e.g.*, staff manuals which interpret the disclosure items and list points to be covered in reviewing filings. See SEC Securities Act Release No. 4871 (June 30, 1967).

[94] The *Commerce Clearing House, Federal Securities Law Reporter* has a section on *"How to Answer Form S-1"* which gives illustrative answers to various disclosure items taken from actual prospectuses. 1 CCH FED. SEC. L. REP. ¶ 8001 (1967).

[95] Letter from the Chief Counsel of the Division of Corporation Finance to Commerce Clearing House, Inc., Aug. 1, 1962, 1 CCH FED. SEC. L. REP. ¶ 2231.22 (1967).

Most, if not all, of the information found in SEC filings falls into one of five broad categories. The full range of information appears in the basic 1933 Act and 1934 Act registration statements. Other filings contain various combinations of the categories of information:

1. Information describing the business and property of an issuer generally is disclosed adequately through official filings only in registration statements under the 1933 Act or the 1934 Act,[96] although information of this type also may appear in proxy statements dealing with certain major transactions. While the 1934 Act reporting forms produce occasional bits and pieces of information, significant changes in business and property can occur without a filing being required. Thus this type of information is not kept currently available in a form useful to the investor. Furthermore, there is no periodic synthesis of this information.[97] An important aspect of information regarding the business and property of an issuer is information regarding pending legal proceedings which must also be filed.[98]

2. Information about management and control[99] including such items as the identification of directors, officers and major stockholders; their stockholdings, remuneration, fringe benefits; and their transactions with the issuer is fully up-dated on an annual basis through the proxy statement.[100]

3. Financial information[101] is fully up-dated on an annual basis through the Form 10-K report to the SEC and in less detail, through the annual report to shareholders.[102]

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[96] *E.g.*, SEC Form S-1, items 9, 10, 17 C.F.R. § 239.11 (Supp. 1966); Form 10, items 3, 4, 17 C.F.R. § 249.10 (Supp. 1966).

[97] See Cohen, *supra* note 9, at 1357; Heller, *Integration of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 29 LAW & CONTEMP. PROB. 749, 759 (1964). The only periodic reporting disclosure requirement covering changes in business, item 4 of Form 10-K, is inapplicable to proxy soliciting companies. See the instruction preceding item 4. SEC Form 10-K, 17 C.F.R. § 249.310 (Supp. 1966). If this exception for proxy soliciting companies ever had a justification (it was apparently premised on the judgment that companies with listed securities disclosed this information adequately in their shareholders reports), the justification largely disappeared when the 1964 Amendments extended the proxy provisions to larger over-the-counter companies. Even so, item 4 of Form 10-K covers only materially important changes "during the fiscal year," and it does not purport to cover changes occurring over an extended period of time

[98] SEC Form S-1, item 12, 17 C.F.R. § 239.11 (Supp. 1966); Form 10, item 6, 17 C.F.R. § 249.210 (Supp. 1966); Form 8-K, item 3, 17 C.F.R. § 249.308 (1964).

[99] SEC Form S-1, items 16-20, 17 C.F.R. § 239.11 (Supp. 1966); Form 10, items 7, 9-13, 17 C.F.R. § 249.210 (Supp. 1966).

[100] SEC Reg. 14a, Schedule A, items 4-7, 17 C.F.R. § 240.14a-101 (Supp. 1966).

[101] The list of subsidiaries which appears in various SEC filings (*e.g.*, 1933 Act Form S-1, item 27; 1934 Act Form 10, item 2; 1934 Act Form 10-K, item 3) can be viewed as a part of the financial statement or as a separate category of information.

[102] SEC Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1964).

4. Information concerning the occasion for the filing appears in various filings. In a 1933 Act registration statement, information of this category relates to such details of the offering as to how the securities are to be sold, by whom, and how the proceeds will be applied.[103] In a Form 8-K report, the information relates to the transaction or event triggering the filing. In a proxy statement, the information concerns the calling of the meeting and the matters to be voted upon.

5. Finally, a description of the securities[104] disclosing the attributes of the securities and the rights of the holders must be filed in certain proxy statements and other filings relating to the issuance of securities.[105]

Given these categories of information, the filing requirements can be recast into an effective continuous reporting system under the 1934 Act. As one possible variation, a filing pattern might be built around five basic components, which would serve to keep the full range of information found in SEC filings reasonably current at all times.

1. A basic "identification" filing would contain information which is unlikely to undergo frequent change, such as the issuer's exact name, address, the form and place of organization and indemnification provisions for the benefit of directors and officers.[106] It would also include a description of the securities and the rights of security holders. This filing would be amended only if, and when, the information changes.

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103 SEC Form S-1, items 1-4, 17 C.F.R § 239.11 (Supp. 1966).

104 SEC Form S-1, items 13-15, 17 C.F.R. § 239.11 (Supp. 1966); Form 10, items 14-16, 17 C.F.R. § 249.210 (Supp. 1966).

105 Disclosures of this type rarely raise serious problems—either for the company preparing a filing or for a public investor who wants to obtain the information. Once a description of the security has been prepared for SEC filing, there is usually little difficulty in reproducing the description in any later filing. The basic information is generally available to the public through manuals and services. Securities holders, as such, often have the right under state law to obtain the information directly from the issuer, and the information may well appear on the physical certificate itself. Although SEC filings in this area of disclosure may be particularly weak in one respect—the extreme summarization and condensation permitted—few problems seem to have arisen. For example, a description of a convertible security may disclose that the conversion right is protected by an "anti-dilution" provision, without telling how the provisions would apply in any given case. Or, disclosure may be made that an indenture imposes restrictions on dividends by indicating the present amount available for dividend payments, without giving any indication of what will happen in future years under various contingencies. One reason such condensation is tolerated is the inherent complexity of a typical anti-dilution or dividend restriction formula, which may run several printed pages and simply defies meaningful explanation without undue length (assuming it can be meaningfully explained to the typical investor at all).

106 *E.g.*, SEC Form S-1, item 29, 17 C.F.R. § 239.11 (Supp. 1966); Form 10, item 8, 17 C.F.R. § 249.210 (Supp. 1966).

2. A proxy statement for the annual meeting would restate annually all of the management and control information. This is, in essence, what the proxy statement now does and no major changes are contemplated.

3. An annual filing (equivalent to Form 10-K) would *restate fully* each year the other pertinent information found in SEC filings (insofar as applicable). This restatement would be required even if there is no change from the information previously filed. No incorporation by reference would be permitted. In effect, the annual filing would be a complete self-contained document. This proposal is made, however, subject to two major reservations.[107]

First, the annual filing probably should not repeat the management information which appears in the proxy statement. Although it can be argued that there is a benefit in having a single document containing *all* of the current information, it should not be difficult for investors to use two current documents—the proxy statement and the annual filing—and issuers should be spared the burden of repetition.

Second, a major deficiency in the 1934 Act reporting system is its failure to produce a current business and property description. This defect should be cured. However, it may not be necessary to require a full restatement on an annual basis. A less frequent restatement cycle of about every two or three years might be sufficient, unless intervening events have made the most recent filing materially out of date.[108] Or, an existing precedent[109] might be followed requiring (or permitting at the issuer's election) the periodic business and property restatement to appear in the annual report to shareholders. Still another variation would be to require inclusion of the business and property description in the proxy statement. Being the only official filing distributed to the public on a regular periodic basis, the proxy statement may well emerge as the most important of all the SEC filings.[110]

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[107] The SEC work load now peaks in the early spring with filings which follow the issuer's year end by 3 or 4 months, such as registration statements, proxy statements and Form 10-K reports. If the business and property description is to be in an official "filing", and not a part of the annual shareholders report (an alternative suggested in the text below), a major administrative problem might be created by a further increase in the spring work load. This difficulty could be ameliorated by dividing the annual report into two parts, with the non-financial part to be filed at a different, less busy time of the year.

[108] *Cf.* Cohen, *supra* note 9, at 1374-75. In certain circumstances, an annual restatement might nonetheless be required, for example, for a stated number of years following a first public offering or a 1933 Act, Rule 133 transaction.

[109] SEC Rule 14a-3(b)(2), 17 C.F.R. § 240.14a-3(b)(2) (Supp. 1966).

[110] See 2 Loss, Securities Regulation 1027 (2d ed. 1961).

However, from several points of view, the annual stockholders report might be an even better vehicle for this type of information than an official filing. The stockholders report gets broad public distribution, as contrasted with all 1934 Act filings other than the proxy statements. Because it is a document which is distributed to the public, the annual report is normally prepared with care.[111] The annual report to shareholders is not an official "filing." [112] Thus, it would not be subject to staff review, with the consequent administrative burden on the Commission, although it can be expected that the SEC would, as now, receive "information" copies on which it could make informal comments, where appropriate for the issuer's future guidance. Nor would it be subject, as such, to statutory liabilities for defective filings.[113] It might be argued that statutory liabilities for defective filings are necessary to insure the reliability or quality of the information. Experience shows, however, that the quality of annual shareholder reports is generally satisfactory; the absence of the specific statutory liabilities for false filings should present no serious problems. In any event, a misleading annual report could still give rise to liability under general fraud provisions,[114] and the SEC would have the power to suspend trading in the issuer's stock or to seek injunctive relief until appropriate corrections are brought to the attention of the public.[115]

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[111] It has been noted that 1934 Act filings do not have the same "quality" as 1933 Act registration statements in terms of care of preparation. While differences in liability may explain this in part, there is another factor—1934 Act reports are not distributed publicly and do not convey a public image. By contrast, annual reports are typically prepared with great care and attention.

[112] Annual shareholder reports must be mailed to the Commission "solely for its information." SEC Rule 14a-3(c), 17 C.F.R. § 240.14a-3(c) (Supp. 1966). *Cf.* SEC Form 10-K, 17 C.F.R. § 249.310 (Supp. 1966), instructions as to "Supplemental Information to be Furnished . . ." at the end of the official form.

[113] Securities Exchange Act of 1934 § 18, 48 Stat. 897, as amended, 15 U.S.C. 78r (1964).

[114] *E.g.*, SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964).

[115] If material voluntarily distributed to stockholders, including the annual report, is materially deficient, the Commission has power under Securities Exchange Act of 1934 § 15(c)(5), 78 Stat. 570 (1964), added by, 15 U.S.C. § 78*o*(c)(5) (Supp. 1966), and § 19(a)(4), 48 Stat. 898, 15 U.S.C. § 77s(a)(4) (1964), to suspend trading in the security, a power which it has been exercising with increasing frequency. See, *e.g.*, SEC Securities Exchange Act Release Nos. 7980 (Oct. 18, 1966); 8026 (Jan. 19, 1967); 8061 (April 21, 1967); 8065 (April 27, 1967); 8095 (June 1, 1967). As to injunctive relief, see, *e.g.*, SEC v. First Standard Corp., CCH FED. SEC. L. REP., ¶ 91,824 (S.D.N.Y. Oct. 10, 1966); SEC Securities Exchange Act Release No. 8089 (May 26, 1967).

A similar value judgment on the need for statutory liability as a "filing" was raised in connection with foreign issuers who have securities trading in the U.S. The Commission found that the public interest would be adequately protected by requiring foreign issuers to furnish the SEC with copies of material made available to the public in their own countries, without subjecting such material to liabilities for "filed" material under Section 18 of the 1934 Act. The Commission reached this conclusion after surveying the "quality of information now being made public by foreign issuers, together with the improvements which may reasonably be expected to result from recent changes and current proposals for change in relevant requirements. . . ." See SEC Securities Exchange Act Release No. 8066, at 2-3 (April 28, 1967) (promulgating SEC Rule 12g3-2).

Based on existing precedent, the Commission should have ample power under the 1934 Act's proxy provision [116] to require a periodic business and property restatement either in the proxy statement or in the annual report. Present proxy rules require financial statements to be included in the annual report which must accompany or precede the annual proxy solicitation for the election of directors.[117] The theory is that the management must account for its stewardship in seeking to elect its nominees. By a similar line of reasoning, the management also could be required to produce a periodic "state of company" report describing the business and property.

The suggestion for upgrading the 1934 Act annual filing to cover a full range of information is not revolutionary. The Form 10-K report now updates financial information and no major substantive change is contemplated in this respect, except that a prospectus-type capitalization table probably should be added to the annual filing.[118] The principal changes would be the periodic updating of information on business and property (subject to the reservations stated above).

4. A current report (equivalent to Form 8-K) would serve to keep all information up to date during the year. Instead of merely giving bits and pieces of information, the current report would restate *in full* any item in the annual filing or proxy statement which materially changes. It would also describe the transaction or event which occasions the particular current filing. Thus, if there has been a major disposition of property, the filing would describe the circumstances and restate the entire property item. As is now the case, no current form would be required unless the change from previously filed information is material.

5. The final filing requirement would be a cross-reference or "tie" sheet which would identify by caption and number each item of information covered by the reporting documents, and would indicate the latest filing in which the responsive information can be found.[119] Each time the issuer makes any filing which changes the previous cross-reference sheet, a completely new sheet would be filed.

To make the system suggested above more effective, the SEC would have to place more emphasis on the processing of filings of 1934 Act reports to upgrade their quality and reliability, as compared with

[116] Securities Exchange Act of 1934 § 14, 48 Stat. 895, as amended, 15 U.S.C. 78n (1964).

[117] SEC Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (Supp. 1966).

[118] See SEC Form S-1, item 5, 17 C.F.R. § 239.11 (Supp. 1966).

[119] Compare the cross reference sheet now required by SEC Rule 404(c), 17 C.F.R. § 230.404(c) (1964), for all registration statements.

1933 Act filings.[120] There also would have to be internal changes in the filing system to make the current information readily accessible.[121] The system would probably require a uniform numbering system for the individual items of information as they recur throughout the forms.[122]

If the 1934 Act continuous reporting system is revised as suggested above, an important objective will be achieved. As has been previously suggested, 1934 Act filing will be upgraded to make available to the investor a full range of current information which may be obtained by consulting a limited number of filings.[123] The investor would know that certain basic information, such as the description of securities, can be found in the basic "identification" file. Reasonably current information concerning management would be found in the most recent proxy statement; reasonably current information on all other subjects would be found in the most recent annual filing (subject to the possible exception discussed above with respect to business and property information). Any major changes in the brief period since the last annual filing or the last annual proxy statement would be reflected in the current reports, if any, which would restate the applicable items on a current basis and also would describe the transaction which gave rise to the change.

The foregoing suggestions for rearranging the continuous reporting system is merely one of many possible approaches, a variation on an underlying suggestion that 1934 Act reporting should be upgraded administratively to provide, in effect, a continuously current prospectus.[124] It is meant to illustrate the type of change in the disclosure system which the Commission can achieve under its existing statutory power. Regardless of whether or not this is the best possible proposal, it is evident that the Commission's broad grants of authority under the 1934 Act give it ample power to achieve significant improvements in the disclosure system through administrative action.

It is not without trepidation that I offer the foregoing suggestions for restating certain previously filed material. I share the general

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120 See Cohen, *supra* note 9, at 1362. I would agree with Mr. Cohen's observation, 22 Bus. Law. 813, that the quality gap between 1934 Act and 1933 Act filings seems to have narrowed in recent years.

121 At present, each 1933 Act filing of an issuer is maintained separately from every other one, and also from the issuer's 1934 Act filings. In an ideal system, all current information should be kept in one place and stale information should be weeded out as it is superseded. It must be recognized, however, that to accomplish this end would present a significant logistics problem.

122 This suggestion has been made before. See, *e.g.*, Cohen, *supra* note 9, at 1375.

123 See Harry Heller, 22 Bus. Law. 827.

124 See *id.* at 823-27.

aversion to duplication of effort.[125] However, I have concluded that the burden of repetition is neither great nor disproportionate to the public benefit. Based upon a review of a cross section of prospectuses, I estimate that the non-financial, non-management material which would have to be restated would normally take an average of only three to six prospectus-size (7½" x 9") printed pages. In the case of a relatively stable company, the job of verifying and updating the descriptive textual material is a simple one and should not involve undue burden. If significant revisions are necessary, the public deserves the benefit of a composite restatement.[126]

F. *Exemptive Rules*

If the 1934 Act proxy and reporting forms are revised as suggested above, opportunities would be available for new exemptive rules. A seller of securities would be able to assemble a complete package of current information by collecting (in photocopy form from the SEC) the latest filing covering each item of information about the issuer. The package could be assembled under a "wrap-around" cover setting forth the pertinent information relating to the particular offering —such as the indentification of the seller and the plan of distribution.[127] The package should also include a cross-reference sheet which locates the information on each item. By analogy to the Regulation A procedure, the material would be filed with and reviewed by the SEC. (Alternatively, the rule might require the preparation and use of the package, but without requiring that it be filed with the SEC.)[128]

Exemptions from registration could be conditioned on the use of such a package, in much the same manner as Regulation A conditions exemption on the use of an offering circular. The seller intending to use this exemption procedure should be required to give the issuer a period of advance notice, so that the issuer can be sure that its filings are up to date. The seller could then assemble the filing with a minimum of effort and expense. In processing the filing, the SEC presumably would have to review only the wrap-around cover, since the

[125] See Cohen, *id.* at 815. For a comparable situation where a repetition of previously filed material may be required to make an amended filing more useful, see the forms changes proposed by SEC Securities Exchange Act Release No. 8125 (July 18, 1967), and SEC Investment Advisers Act Release No. 210 (July 18, 1967).

[126] As a general matter, it is much simpler to update the business and property section of an SEC filing than to update the management material, since the management material requires assembly of a considerable amount of detail (most of which is not unlikely to change slightly from year to year) regarding a number of different people. Yet the updating of a routine annual meeting proxy statement has never been considered to be a particularly burdensome chore.

[127] See, *e.g.*, SEC Form S-1, items 1-4, 17 C.F.R. § 239.11 (Supp. 1966).

[128] In effect, this alternative approach merely imposes on the seller an obligation to supply the purchaser with certain material previously filed by the issuer.

materials inside will be made up of filings already processed by the staff. The reviewing process should take only a few days.

If the SEC should adopt such a procedure, a decision would have to be made concerning the type of offering to which it would apply. The approach seems particularly suitable to "secondary" offerings not involving conventional underwritings, particularly those distributions which will involve relatively few sales because they represent a small quantity of stock or a small group of buyers purchasing large blocs.

Without attempting to suggest precise limits, the wrap-around package technique could be applied as a conditional exemption to a class of offerings somewhere between the type of sale which is now exempt and conventional underwritings. The Commission should retain some discretion as to when the technique can be used, in order to avoid packages which are unduly complex or cumbersome.[129]

The suggestion of a wrap-around cover over a package of prior filings has been made in terms of a conditional exemption. Of course, the same type of physical document could be used as a form of registration statement for a non-exempt offering. This would seem to be a very useful device if applied selectively where there is no real need for a prospectus in conventional form. The typical institutional purchaser, for example, is fully capable of dealing with the material in the physical form suggested above, and the preparation of a conventional prospectus for such a sophisticated investor represents a very burdensome, expensive and time-consuming exercise. This form of registration could be made available for offerings limited to institutions (as defined) or other single purchasers of more than a stated value of securities, for example $50,000.

The wrap-around prospectus presents complex issues of liability. If the approach is adopted as a conditional exemption from the 1933 Act registration requirements, the issuer would remain subject to liability for defective filings.[130] As a general rule, I think it is desirable to protect selling shareholders using this technique unless they are in a position of control or know or have reason to know of deficiencies in the filings which are physically incorporated. If the technique has merit, I believe that liability questions can be solved satisfactorily, although a fuller discussion is beyond the scope of this article.

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[129] The Commission now makes this type of judgment in an analogous area. A prospectus can be amended or supplemented by one or more stickers, but if the "stickering" gets overly complicated, the staff will insist on a reprinted prospectus incorporating all the changes.

[130] Specific statutory liability might arise, Securities Exchange Act of 1934 § 18, 48 Stat. 897, as amended, 15 U.S.C. § 78r (1964). Liability might also arise under Rule 10b-5. Miller v. Bargain City U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964).

G. *Civil Liability*

One of the most pressing and controversial subjects to consider in any reform effort is the general topic of civil liability, especially implied civil liability under 1934 Act Rule 10b-5.[131] To a large extent, the law in this area has been made by the courts,[132] not the Commission. Accordingly, the SEC may lack the broad power to reshape the law which it has in the other areas discussed above.[133] It could, of course, take the drastic but highly unlikely step of revoking Rule 10b-5. It might follow the example of the Comptroller of the Currency (who administers the 1934 Act with respect to national banks [134]), and attempt to negate by rule any implied civil liabilities arising under SEC rules.[135]

To a large extent, the growing body of case law on civil liability involves alleged wrongdoing—non-disclosure of material information or the dissemination of misleading information—unrelated to the registration or other filing requirements under the securities law.[136] While the problems posed by these cases are difficult and controversial, they are severable, to a large extent, from the other problems discussed herein. The SEC's limited administrative powers over civil liability questions should not deter an administrative reform program of the type envisioned by this article.

H. *The SEC as the Agency for Reform*

The preceding discussion has demonstrated the Commission's power to reform the law. A difficult question to face is whether the Commission is an appropriate agency to spearhead a reform effort.

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[131] See David S. Henkel, 22 Bus. Law. 866.

[132] *E.g.*, Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

[133] The SEC does have very broad powers under Securities Exchange Act § 16(b), 48 Stat. 896, as amended, 15 U.S.C. § 78p(b) (Supp. 1966), to effect civil liabilities under the "short-swing profit" recapture provisions of that section. See, *e.g.*, SEC Rule 16b-9, 17 C.F.R. § 240.16b-9 (1964) (reversing the principle of Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947)), and SEC Rule 12h-3, 17 C.F.R. § 240.12h-3 (Supp. 1966) (reversing the principle of Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569 (E.D. Pa. 1962)).

[134] Securities Exchange Act of 1934 § 12(i), 78 Stat. 565, added by 15 U.S.C. § 78(*l*) (Supp. 1966).

[135] "The enforcement of [the Comptroller's regulations applicable to national banks under the 1934 Act] shall be a function solely of the Office of the Comptroller of the Currency and no provision of these regulations . . . is intended to confer any private right of action on any stockholder or other person against a national bank," 31 Fed. Reg. 6949 (1966).

[136] See cases cited in note 132 *supra*. Of course, some of the troublesome implied liability cases have involved SEC filings, *e.g.*, J. I. Case v. Borak, 377 U.S. 426 (1964); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964).

Paradoxically, there is legitimate basis to fear that it will either do too much, or too little.

It is fashionable in some quarters to speak of power-grabbing bureaucratic zealots who, unless restrained, would bring disaster in an effort to advance their own view of the public good. Although there is an inherent risk in encouraging a government agency to rewrite the law, I share the confidence that the Commission would act with restraint.[137] While not dominated by the industry, the Commission has shown a healthy respect for industry opinion. The prevailing spirit of self-regulation and government-industry cooperation generally has resulted in acceptable compromises for controversial topics. The Commission has not been anxious to override firm industry opinion on major issues.

On the other hand, it may be feared that the Commission would find it impossible to dismantle and restructure its own creation.[138] In its reform efforts, it may deliver too little, too late.[139] The Commission may be so wedded to certain ideas—such as the mystique of "investment intent" which surrounds the 1933 Act's Section 4(2) "private offering" exemption—that it would not abandon them.

One should bear in mind, however, that the current problems with the disclosure system do not date back to 1933. To a large extent the burst of public financings in the late 1950's accentuated the difficulties and created the serious need for revision of the disclosure system. From the late 1950's until the market break in 1962, the Commission was so overwhelmed with filings, especially from companies making their first public offerings, that it could not devote much attention to disclosure reform efforts. Through the spring of 1963, the Special Study occupied a major portion of the Commission's time. During 1963-64 its efforts were devoted largely to the 1964 Amendments, first in drafting the legislation and guiding it through Congress, and later in promulgating the rules and forms to implement the amendments. Much of the past year or two has been devoted to investment company problems and the Mutual Fund Report. Viewed against the history of the last several years, the Commission's failure to reform the disclosure system hardly proves intransigence or insensitivity to the problems involved.

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137 Cohen, *supra* note 9, at 1390 & n.145.

138 Ralph H. Demmler, 22 Bus. Law. 840, Louis Loss, *id.* at 797; Stephen R. Miller, *id.* at 830; David S. Ruder, *id.* at 831.

139 For example, its proposed so-called short form registration form, S-7, see SEC Act Release No. 4849 (Nov. 16, 1966), proved to be something of a disappointment in that it provided relatively little shortening for relatively few companies. James C. Sargent, 22 Bus. Law. 801; W. McNeil Kennery, *id.* at 913.

Perhaps the current discussions on codification will have a catalytic effect. The bar and various segments of the industry should make a clear call for reform of the disclosure system. Hopefully, the Commission will give high priority to this area of its responsibility in the near future.

One way of achieving administrative reform would be to follow the Special Study technique.[140] This would involve creation of a special task force to work on revision of the disclosure system. The group would include members of the SEC's staff, who are almost all career civil servants having limited experience with the securities laws from the public side of the fence. It would also include qualified outsiders representing various interested parties. The group would function with a degree of independence from the staff and the Commissioners in developing reform steps for Commission adoption within the existing statutory framework. This technique exploits advantages of administrative reform, while eliminating many of the objections to a program manned entirely by the SEC staff.

CONCLUSION

There is a general consensus that the federal securities laws are in need of reform. Although legislative codification of the statutes administered by the SEC has been urged, this article suggests that very substantial reforms could and should be accomplished administratively within the existing statutory framework both by the SEC and the industry. As to some problem areas, administrative solutions through promulgation of appropriate rules and forms are probably a more suitable approach to reform than a legislative codification. Even if administrative solutions fall short of the ideal, it would still be worth attempting to find administrative remedies as temporary expedients, since they can be implemented relatively quickly as compared to legislative reforms.

This article does not purport to survey all of the trouble areas which should be considered in reforming or codifying the federal securities laws. However, if we can find acceptable administrative solutions to those problems discussed above, we will have made very substantial gains[141]—gains which would justify amply the effort of the undertaking.

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[140] This suggestion was made by Richard H. Paul, 22 BUS. LAW. 800-01, who served as Chief Counsel to the SEC Special Study.

[141] The "three problems [which] appeared clearly to be most pressing" to the Investment Bankers Association, all of which they felt could be ameliorated administratively, were (1) the need for shorter registration forms for 1934 Act reporting companies, (2) clarification on the sale of "investment stock," and (3) simplification of prospectus delivery requirements. See Albert Pratt, *id.* at 923-25.

A number of suggestions and examples of what could be accomplished administratively are set forth above. I am not so presumptuous as to believe that all of these proposals will prove workable. In drafting SEC rules and forms, it is difficult to set down two consecutive sentences without incurring difficulties. Whether or not the reader agrees with the specific proposals herein—and frankly I doubt whether many readers will agree with all of them—is not the main point of this article. Its principal purpose is to demonstrate that there are other approaches to reform beside codification, not the least of which is through administrative action.

The charge may be made that some of the proposals in this article are artificial. To this charge a demurrer is entered. Many developments in our law, both common and statutory, have this characteristic—it is part of the genius of our system. Many a well established doctrine has doubtful antecedents. I do not recommend artificial growth which leads to undue complexity and uncertainty, or arbitrary results. No doubt use of the Commission's administrative tools has resulted, to some extent, in these undesirable consequences in the past. One may feel, for instance, that doctrine overshadows practical sense insofar as the SEC applies the 1933 Act to privately placed convertible securities.[142] However, creative use of the same administrative tools can simplify the system, and can produce a reasonably rational, workable and predictable set of rules for conduct. If such a set of rules can be fit within the existing statutory mold, does it matter that the fit may seem artificial? As Holmes taught us, "The life of the law has not been logic: it has been experience."[143]

A call for reform has been issued. There are qualified experts who feel that the SEC is not the appropriate institution to lead the reform effort. It may be that in the long run Congressional action, either through a codification process or through more limited legislative programs, will be needed for optimal results. I feel, however, that the Commission has ample power to achieve substantial gains. I hope that the Commission will accept the challenge.

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142 See SEC Rule 155, 17 C.F.R. § 230.155 (1964).

143 HOLMES, THE COMMON LAW 1 (1881).