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Securities Law Reform and the ALI Federal Securities Code

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Professor Kripke was one of Professor Loss' consultants for the Federal Securities Code project. In this article, Professor Kripke expresses both his overall support for the enactment of the proposed Code and his reservations regarding some of the policies underlying the codification efforts.

I. INTRODUCTION

The Federal Securities Code,[1] drafted under the sponsorship of the American Law Institute (ALI), has been completed. I think that it should be enacted.

Discussion can best be divided into consideration of the execution and the planning of the document, and the execution can only be described as superb. Drafting the Code was a tremendous task and was primarily the work of one man, Professor Louis Loss. I would be remiss not to acknowledge Professor Loss' dedicated effort in perfecting his conception. I joined freely in the applause which the ALI accorded him in May of 1978, both on the day the Proposed Official Draft was adopted and later that evening at the Institute's annual dinner. The drafting process was a labor of love. Those of us who followed it closely were amazed and awed at the extent to which Professor Loss studied such diverse matters as the proposed criminal code, pending bankruptcy bills, international banking legislation, and the terminology of the ALI's Restatements of the Law, in order to integrate these areas with applicable Code sections. He conferred not only with his own consultants, advisors and the American Bar Association Committee on Federal Regulation of Securi-

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1. ALI FEDERAL SECURITIES CODE (Mar. 1978 Proposed Official Draft) [hereinafter FED. SEC. CODE].

ties, but also with investment company representatives, state securities administrators, spokesmen for the SEC and the securities industry, and the chairmen and staffs of key congressional committees. The work represents a tour de force and the encomia given its author are well-deserved.

Aspects of the planning and conception of the Code, on the other hand, led to problems which can be perceived in the final product. The apparent confusion and lack of consensus concerning the proper objectives of the codification program have been identified as the critical flaws in the conception of the Code.[2] I was one of Professor Loss' inner circle of consultants, but because ALI Director Herbert Wechsler would not permit me to join the project until I had completed my own work as Associate Reporter on the Review Committee for Article Nine of the Uniform Commercial Code, the key concepts of this massive task were determined before I came aboard.[3] As I learned, attempts to reopen conceptual discussions

2. A speaker at the initial Conference on the Codification of the Federal Securities Laws recently reflected on the symposium at which the recommendation to undertake a revision of the federal securities laws was made.

> Rereading the transcript of the proceedings was a pleasantly nostalgic reminder of the deep intellectual stimulation and challenge one experienced when sitting through those sessions. It also brought back some of the confusion evident in discussing the proper objectives of a codification program—a subject upon which the participants never seemed to establish a complete harmony. On the one hand, mere rewriting of the law and straightening out of confusions would not have been worth the effort. Conversely, codification could not attempt a thorough-going revision and rethinking of all problems in the securities laws, since that would have been an impossible task, tinged with political dispute and destined for conflict, and probably, failure.

Bialkin, *Issuer Registration and the Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327, 328 (1977) (footnotes omitted). Those who recommended the initiation of the project demonstrated a sense of urgency to get a project underway, even in the absence of established goals. During the panel discussion following the seminal enclave, many enthusiastic statements were made which revealed the pervasive sense of urgency in those early sessions:

> Mr. Chairman, we have had a lot of ideas this morning and received future topics to be discussed. Perhaps I have missed something in the literature that preceded this program, but assuming I haven't, I would like to see something that is a result of this conference. I would like to see how we can make a recommendation to the Institute, for example, or to the ABA—a program that they can take up and follow, suggest names such as the names who are here today. I would like us to see something get moving. These various philosophies and what should be studied are all very interesting and very important, but let's have a vehicle we can put them in and get moving.

Sterling, *General Discussion*, 22 BUS. LAW. 803, 808 (1967).

3. *See* note 2 *supra*. The Code was finally drafted by using a legal and codification approach. In my view, the key question at the outset was whether to rethink the objectives of present securities laws in light of what is now known about the market or whether simply

were ruled out of order. Although one must defer to majority judgments, I have been unable to overcome some concerns about them, despite my constant efforts as a consultant to give Professor Loss full support on the technical redrafting. Indeed, I have a two-inch thick file of correspondence with him concerning drafting points which I raised privately in order to avoid taking the time of other consultants and advisors during their meetings with him.

Regardless of these misgivings, I believe the Code will be very useful in pulling together the securities laws as they now exist. The second section of this article describes the advantages procured by the Code by integration of the 1933,[4] 1934[5] and 1939[6] Acts. The problems resulting from the vagueness and uncertainty as to the purpose and philosophy of the drafting project are analyzed in Sections III, IV, and V.

II. THE KEY ADVANTAGE: INTEGRATION OF THE 1933, 1934 AND 1939 ACTS

In my opinion, the key advantage of the Code, and one which warrants its adoption, is the integration[7] of the 1933, 1934, and 1939 Acts and the corresponding rationalization of the liability provisions of each Act.

The Code was never intended to be merely a restatement of existing law. On the contrary, the drafters intended to implement Milton H. Cohen's perception that the securities disclosure laws should be consolidated to avoid duplication of discussion.[8] This could be accomplished by requiring registration of companies instead of security issues.[9] It is recognized that while the Code was

to revise and integrate existing legislation by drafting provisions which would be compatible with the existing administrative framework. Reliance on the former approach would have required input not only from lawyers but also from economists and financiers who have learned a great deal about the securities markets over the last forty-five years, and who have very strong views about the relationship between the legal securities system and market economics. On the other hand, it is probably true that if Professor Loss and those who planned the project with him had elected to take this route, they might not have found the support which they have garnered by adopting a purely legal and codification approach.

4. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976) [hereinafter cited as the 1933 Act].

5. Securities Exchange Act of 1934, 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3, 78p-78hh (1976) [hereinafter cited as the 1934 Act].

6. Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1976) [hereinafter cited as the 1939 Act].

7. For a related discussion of how the Code integrates the disclosure requirements of the 1933 and 1934 Acts, see Wolfson, *Comments on the Proposed Federal Securities Code: Transformation of the Securities Act of 1933*, 33 U. MIAMI L. REV. 1495 (1979).

8. Cohen, *Truth in Securities Revisited*, 79 HARV. L. REV. 1340 (1966).

9. *See id.* at 1378-80 & n.110. Mr. Cohen's ideas were acknowledged by Professor Loss

being written and delayed by the extended codification efforts, the SEC, under existing statutes, made some successful attempts at implementing Cohen's idea through rulemaking and administrative changes.[10] Thus, Carl Schneider's initial argument that much of the benefit of a massive effort to draft a code could be achieved by administrative action was seemingly justified.[11]

Administrative rulemaking, however, could not substantially affect the express liability provisions of the statutes. If the SEC had so desired, it could have controlled the cancerous growth of liability under rule 10b-5.[12] When the drafting process began in 1969, rule 10b-5 was a nightmare, and its relationship with the express liability provisions of the 1933 and 1934 Acts[13] was a second nightmare. Professor Loss had rightly intimated that it was disgraceful that so extensive a jurisprudence rested on so slender a base.[14]

The drafters' early grasp of the nettle and efforts to eliminate the confusion, under the leadership of one of the most noted scholars in the field, were, therefore, both indispensable and praiseworthy. In my view, the fresh approaches adopted by the Code will improve the system. For example, the Code provides for a compulsory class action suit to define and limit liability in cases of impersonal misre-

at the ABA Conference on Codification of the Federal Securities Laws in 1966. Professor Loss commented that the answer to the problems raised by integration could be resolved by a

> system of permanent registration of some sort (I am talking very roughly) whereby perhaps, instead of registering securities, we would register companies. That is to say, any company would have to register when it went public for the first time, or when it met something like the present 12(g) standards or when it wanted to list or when it wanted to be an investment company. And then on certain contingencies, like a stock offering or an exchange listing or a reclassification, there would be something I would generically call a report. Some of these reports might be prospectuses, but the prospectus would not be central, nor would a public offering of securities be central, to this scheme as I envisage it.

Loss, *History of SEC Legislative Programs and Suggestions for a Code,* 22 Bus. Law. 795, 796 (1967).

10. The principal vehicle for this was the S-16 form, which reduced registration under the 1933 Act to a formality for certain issuers which report continuously to the SEC. The form was adopted in 1970; it requires that a registrant's annual reports, proxy or information statements, and applicable current and periodic reports be incorporated by reference. *See* SEC Release No. 33-5117, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,941, at 80,094 (Dec. 23, 1970).

11. Schneider, *Reform of the Federal Securities Laws,* 115 Pa. L. Rev. 1023, 1023-25 (1967); *see also* Schneider, *An Administrative Program for Reforming the Federal Securities Laws,* 23 Bus. Law. 737, 738-40 (1968).

12. 17 C.F.R. § 240.10b-5 (1978).

13. *E.g.*, 1933 Act §§ 77k, 77l; 1934 Act §§ 78p, 78r.

14. Professor Loss commented: "What has happened to Rule 10b-5 . . . always reminds me of a cartoon of the time showing Mussolini dictating to his secretary, and the caption was, 'Miss Baccigalupi, take a law.' " Loss, *supra* note 9, at 796.

presentations affecting the market.[15] This seems to be as good a device as any, and no better suggestion has been forthcoming.[16]

Another way in which the Code should improve the system is by its restatement of the 1933 Act transaction exemptions. The concept of a "limited offering" in Code section 242(b), which replaces the present "non-public" or "private offering" terminology, is simpler and far more appropriate, given today's revolt against overregulation, than the exemption provisions of rule 146,[17] which I have labeled a "major blunder."[18] Similarly, the Code goes far to simplify and rationalize the intrastate exemption, which is currently governed by the unjustifiably restrictive rule 147,[19] promulgated under section 3(a)(11) of the Securities Act of 1933.[20] Additionally, for secondary distributors who own not more than fifteen percent of the registrant's voting securities, the section 512(d) exemption for secondary distributions balances convenience with the need for disclosure in secondary transactions more judiciously than do the Commission's current attitudes[21] embodied in rules 144,[22]

15. FED. SEC. CODE § 1711.

16. The drafting in the area of liability, however, can be faulted. Dean David Ruder, a leading expert on liability under the securities acts, pointed out in the discussions that a key issue is whether the standard of reasonable belief implies a reasonable investigation. Professor Loss did follow § 11(a) of the 1933 Act in Code § 1704 by requiring a reasonable investigation in a registration situation; yet, in the long list of other situations requiring reasonable belief which he has usefully compiled in his notes to § 287, he repeatedly leaves open the question. *See* FED. SEC. CODE at 108-11. This invites litigation which would perhaps have been obviated by more specific drafting.

17. 17 C.F.R. § 240.146 (1978).

18. Kripke, *SEC Rule 146: A "Major Blunder"*, N.Y.L.J., July 5, 1974, at 1, col. 3.

19. 17 C.F.R. § 240.147 (1978).

20. 1933 Act § 77c(a)(11).

21. For example, rule 144 provides strict volume limitations on secondary transactions involving securities held by affiliates of the issuer. Similarly, those who acquire securities in private offerings are restricted in their resale possibilities by various conditions of the rule. These provisions evince a clear intent to restrict the resale of securities, especially on the part of control persons. This "restricted distribution" concept is based, at least in part, on the SEC-perceived need to control the trading market and to prevent any high volume trading which might disrupt the market and cause violent price flunctuations. Significantly, the Code attempts to protect the block traders by providing an exemption for those selling not more than fifteen percent of the registrant's securities. The pertinent section is as follows:

> Sec. 512. *[Exemptions.]* Sections 502 to 504 inclusive do not apply with respect to transactions in an exempted security or the following transactions:
>
> . . . .
>
> (d) [*Secondary distributions.*] a transaction incident to an offering of securities of a one-year registrant by a secondary distributor who owns (or, in good faith reliance on a statement by the registrant or its transfer agent, believes that he owns) not more than 15 percent of the voting securities of the registrant; but, if he acquired any securities of the same class in a limited offering (not otherwise exempted) during the one-year period specified in section 242(b), this exemption

145,[23] and 147.[24]

Another very valuable change is the revision of the concepts of the Trust Indenture Act.[25] Under the Code, the requisite contractual relationships and duties, currently imposed as a condition to licensing the sale of affected securities, will become status relationships imposed by federal law. Unfortunately, the repeated use of these contractual provisions in trust indentures over the past forty years has served no purpose other than providing employment for lawyers and printers.[26]

III. EXERCISE OF FLEXIBILITY TO MAKE CHANGES

Apart from the three main points of change discussed in Part I—integration of the disclosure statutes, rethinking of the liability provisions and rationalization of the transaction exemptions—the Code operates on the basis suggested in Part IV, as a restatement of the law but with a modest amount of flexibility to make changes. At this point, I would like to comment on the draftsmen's exercise or non-exercise of the flexibility to make changes.

The Code preserves certain rules of law which were considered by some persons, including myself, to be seriously debatable as a matter of policy, but which were also deemed to be sacred cows in

applies only to securities of the class in excess of those he so acquired.

Because of the "restricted distribution" attitude reflected in the current rules, the Commission is likely to take a hard look at this section.

22. 17 C.F.R. § 230.144 (1978).

23. *Id.* § 230.145.

24. *Id.* § 230.147.

25. The 1939 Act.

26. Instead of requiring the mandatory verbiage relating to the duties of the trustee to be repeated in every indenture (and in order to save young lawyers, as I once was, from the burden of going down to the printers at 2:00 in the morning and reading proofs), the Code provides that every indenture shall be deemed to contain these provisions; thus, it becomes unnecessary to state them. The advantages of economy and simplicity are so obvious that one wonders why he did not think of it himself.

Section 1305 of the Code provides in part:

> Sec. 1305. [*Relation of Code to indenture.*] (a) [*"Statutory" and "optional" provisions.*] Sections 1306 to 1315 inclusive are a part of, and govern, every qualified indenture, whether or not they are physically contained therein, except that the provisions therein that are prefaced by the phrase, "unless the indenture provides otherwise," are not a part of such an indenture to the extent that they are specifically modified or excluded. The provisions so prefaced are herein termed the "optional provisions," and the other provions of sections 1306 to 1315 inclusive are herein termed the "statutory provisions."
>
> (b) [*Additional provisions.*] Such an indenture may contain any other provision that is not inconsistent with the statutory provisions; but the statutory provisions govern over any provision that limits, qualifies, or conflicts with them.

the minds of either the SEC or the congressional committees and were, therefore, not changed. For instance, there is the question of the issuer's liability in a registration statement under section 11 of the Securities Act of 1933.[27] Neither proof of good faith nor lack of negligence frees the issuer from liability if there is a material misstatement or omission. There is absolute liability, subject only to the defense of truth. It is strange that the American law comes down so hard on the issuer, because the British Companies Act of 1929,[28] from which section 11 of the 1933 Act is largely copied, takes the opposite position. Under the Companies Act, liability does not attach to the issuer as an entity, but attaches to the individuals who may be responsible, the officers, directors, underwriters and experts involved.[29] To my mind, the British approach is clearly superior because when an issuer is in trouble, the corporate structure becomes a "diaphanous veil"[30] through which one can see live men and women, stockholders and creditors. One can see that the real interests involved are those of the individual security holders, present and future, and not those of the artificial corporate entity.

Imposing liability on an issuer, as an entity, for the material misstatement or omission attributable to individuals in positions of responsibility within the corporation—many of whom are also security holders—results in spreading the cost of wrongdoing proportionately among all security holders, both innocent and culpable. It is not always sufficient to answer that the stockholders who suffer from a judgment against the issuer obtained the benefit of the cash the issuer received upon the sale of securities. This may be true sometimes; but on other occasions, issuers register on behalf of other persons for a secondary offering in which the issuer receives nothing. In any event, due to the constant shifts in ownership of America's public corporations, the stockholders who suffer from the judgment might have been newcomers who never received any of the benefit which the corporation obtained from the offering.

For these reasons, in the recent Bankruptcy Act of 1978,[31] Congress has ensured that stockholders or subordinated creditors will not be able to lift themselves in the corporate hierarchy by suing the issuer for rescission or for damages, on the grounds of either violat-

27. 1934 Act § 77k.

28. Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 37.

29. *Id.*

30. 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE 262 (1959), *quoted in* Cote Bros., Inc. v. Granite Lake Realty Corp., 193 A.2d 884, 886 (N.H. 1963).

31. Pub. L. No. 95-598, 92 Stat. 2549 (1978), *see* note 71 *infra*.

ing the registration requirements or of fraud.[32] This legislation indicates congressional recognition of the soundness of the British position: Behind the corporation are individuals who would be capriciously affected by a statute treating their corporation as morally responsible. Consistent with its support of section 11 of the Securities Act, the SEC opposed this sound position.[33] I did my best to get this rule changed when section 11 was codified in section 1704 of the Code, but I was unsuccessful. Professor Loss' reasons for rejecting it showed that he, too, recognized the soundness of the British position, but that he was unwilling to consider seriously its adoption in the Code because he felt that neither the SEC nor Congress would accept the change.[34]

A similar example relates to section 16(b) of the 1934 Act,[35] codified in section 1714 of the Code. I proposed that section 16(b) simply be eliminated in the codification because it was a hamhanded, rough-and-ready effort to reach the problem of insider trading. For that purpose, section 16(b) is an unsatisfactory solution because it reaches *any* trading by insiders, *i.e.*, any purchase followed by a sale or a sale followed by a purchase within six months, regardless of whether, in fact, inside information was used.[36] Conversely, the insiders may have used the inside information when they positioned themselves; yet, they can avoid liability under section 16(b) simply by deferring the second half of the cycle until more than six months elapse.[37] Thus, it is seldom, if ever, that one reads a case involving section 16(b) liability and is tempted to say, "That

32. *Id.* § 510(b).

33. Prior to enactment of the Bankruptcy Reform Act, the SEC position was rejected in the only recent case to decide the issue squarely. *In re* Sterling Homex Corp., 579 F.2d 206 (1979). In that case, the claims of allegedly defrauded stockholders of a debtor corporation were subordinated to claims filed by that corporation's ordinary unsecured creditors. In support of its view, the court cited Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973).

34. *See* ALI FEDERAL SECURITIES CODE § 1602, Comment 1 at 132-33 (Tent. Draft No. 3, 1974).

35. 1934 Act § 78p.

36. *See, e.g.*, Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976) (proof of actual access to inside information, or improper use of such information, unnecessary in a §16(b) action). *But cf.* Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974) (exonerating officers and directors upon finding no actual knowledge of inside information).

37. *See, e.g.*, Colonial Realty Corp. v. MacWilliams, 512 F.2d 1187 (2d Cir.), *cert. denied*, 423 U.S. 867 (1975) (sale of stock by one officer on December 20 and purchase the following June 19, and sale by another officer on December 22 and purchase the following June 21, did not constitute short swing trading within a period of less than six months); Rosen v. Drisler, 421 F. Supp. 1282 (S.D.N.Y. 1976).

fellow got what was coming to him. His conduct was unethical and outrageous."[38] The proper cases for its application never happen; it is only hardship cases of ignorance or mistakes of law that happen. Moreover, its crude, rule-of-thumb device is unneeded in light of the subsequent, far more subtle and appropriate concepts of insider trading developed under rule 10b-5 as codified in section 1603 of the Code.[39]

At any rate, I proposed more than once that section 16(b) be eliminated from the Code and was summarily shot down each time. It was repeatedly explained to me that Congress is very fond of section 16(b), which it perceives as the symbolic deterrent, preventing the evil of insider trading and keeping the securities markets fair. Professor Loss' comments on the section reflect acceptance of this notion, rather than a consideration of the merits

> COMMENT: (1) The initial question is whether §16(b) should be preserved at all. Some favor its repeal on several grounds: (a) that it is needlessly arbitrary to the point of being quixotic; (b) that it has acted as a trap for the unwary; . . . (d) that, most of all, the jurisprudence that has developed under Rule 10b-5 has rendered obsolete the concept of *automatic* recapture of *certain* short-term profits of *certain* insiders.
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> (2) It is the Reporter's view, however, that §16(b) has a symbolic significance that must be, and deserves to be, recognized.[40]

I am unable to detect the symbolic significance of section 16(b), except that it does represent the acme of the zealotry with which certain punitive portions of the securities legislation have been praised. Its retention, even though codification provided an opportunity to sweep it away, is an adaptation of Shakespeare's insight: "The evil that men do lives after them . . . ."[41]

Notwithstanding the rejection of my efforts to achieve change in the law in these respects, the points I have made do not affect my support for the Code; the results are consistent with the concept of codification, and the retention of these existing rules leaves the

38. Of course, no one could know how many cases are prevented from arising simply because of the existence of § 16(b), but the insider trading inhibitions of rule 10b-5 are less easily avoided and are equally effective for that purpose.

39. This is particularly true since rule 10b-5 does not depend upon the timing of the cycle of purchase and sale, but depends instead upon the actual use of inside information at either end of the transaction.

40. ALI FEDERAL SECURITIES CODE § 1413, Comments 1 & 2 at 133 (Tent. Draft No. 2, 1973).

41. W. SHAKESPEARE, JULIUS CAESAR 3.2.76 (Cambridge, 1949)(First Folio, 1623).

law substantively no worse off than it is now. When the Code goes beyond codification,[42] however, and makes a bad rule—like section 16(b)—worse by breaking down a limitation by the Supreme Court,[43] my protest is somewhat sharper. The issue of principle is important, but the point involved, the purchase and sale by one who does not acquire status as a ten-percent stockholder until after the purchase, or who loses his status after a sale, is not important enough to cause me to refuse to support the Code.

On another point, however, the Code adopted by the ALI in May of 1978 would depart from present law—in my mind, very much for the worse—by imposing strenuous liability provisions on the issuer for material misstatements in the annual reports.[44] Fortunately, Professor Loss recently announced that he has recommended to the ALI that it take no position on the question of the standard of strict liability for such misstatements. He suggested that the membership leave that question open for Congress to decide.[45] Indeed, the ALI Council has already voted in favor of his recommendation.[46]

Nevertheless, the point is worthy of discussion even though, with ALI action completed and congressional action not yet begun, it is moot for the time being. The proposition is too basic and too important to accept as a part of the overall "chancering process" on the theory "that what has been produced represents no single person's preferences."[47] In this area, the Code as drafted would violate President Roosevelt's injunction, with which securities legislation began, that there should be "the least possible interference with honest business."[48]

The Securities Act of 1933 was passed both as a response to the Great Depression and as a response to the feeling that something had to be done to restore confidence in the securities market. The

42. *See* ALI FEDERAL SECURITIES CODE § 1413, Comment 6(b) at 134 (Tent. Draft No. 2, 1973).

43. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) (no liability imposed on stockholder for sale within a period of less than six months after prior sale resulting in loss of § 16 insider status).

44. *See* FED. SEC. CODE § 1704.

45. Loss, *Keynote Address: The Federal Securities Code*, 33 U. MIAMI L. REV. 1431, 1447 (1979). Professor Loss stated that his recommendation has "largely defused the problem." *Id.*

46. *Id.* The American Law Institute adopted the recommendation at its May, 1979 meeting.

47. *Loss*, FED. SEC. CODE, *Introduction* at xxii.

48. *Id.* at xv (quoting S. REP. No. 47 at 607 and H. R. REP. No. 85 at 1-2, 73d Cong., 1st Sess. (1933)).

stringent liability provisions of section 11 of that Act[49] reach only misstatements or omissions in registration statements for newly distributed securities. The liability provisions are onerous; plaintiffs need not even carry the burden of proving causation or reliance on the alleged misleading statement or omission.[50]

Section 1704 of the Code would extend the scope of the 1933 Act liability provisions to cover the regular annual reports of the issuer.[51] The provisions would apply even if the issuer had received no consideration from, and had had no privity of contract with, the person who purchased or sold securities while the annual report was outstanding and current. The same burden of due diligence, heretofore accepted by the financial community only in connection with Securities Act registration statements, would be imposed on the writing of annual reports.[52]

Securities Act registration statements are required when securities are distributed for consideration. The attendant burden of satisfying the standard of due diligence is, therefore, episodic. If that heavy burden were imposed on routine annual reports, then issuers would be forced to institute, on a regular basis, all of the extraordinary procedures for care, investigation and detailed description of corporate activity previously required only occasionally. While this requirement would enrich the legal profession, since attorneys

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49. 1933 Act § 77k.

50. Recovery may be conditioned on reliance, but only if the plaintiff acquired the security after the issuer had made generally available to its securityholders an earnings statement covering a period of at least 12 months subsequent to the effective date of registration. The issuer's top three officers and its directors and underwriters are among those who are liable (except for situations in which they have relied on experts) unless they carry the burden of proving due diligence and reasonable investigation. Plaintiffs need not prove scienter. *See id. But see* FED. SEC. CODE § 1704(d)-(f) (defenses available).

A motion made at the May 1978 ALI meeting which would have shifted *all* liability for misstatements in annual reports from § 1704 to § 1705 barely failed. Section 1705 requires a plaintiff to prove scienter.

Besides imposing liability on the issuer, § 1704 imposes liability on all parties who are not experts, with the usual differentiation in burdens of proof for experts and persons relying on experts. At the May meeting, the Institute recognized that this kind of liability would be counterproductive to the current efforts to include independent directors on corporate boards, and the Institute took no position on its applicability to them. Since this left inside directors, accountants and other experts subject to "section 11 liability" for annual reports, protests continued until a substantial majority agreed to a suggestion shifting the liability of outside directors to § 1705 "if Congress is so minded, without the Institute's recommending whether or not that should be done." FED. SEC. CODE §§ 1704(b)(3) & note 1, 1705.

51. The Code successor to the current annual report on Form 10K would be specifically included. FED. SEC. CODE § 1704(a); *see id.* § 602(a). The annual report to stockholders would also be included if it were filed with the Commission or incorporated by reference in any annual filing. *Id.* § 1704(a).

52. *Id.* § 1704(f).

would be bound to give the same attention to annual reports now required for registration statements, the result would be repugnant to concerns currently being expressed regarding overregulation and the unfortunate, ubiquitous necessity for securities lawyers.

Is there a sound basis for this proposed extension of section 11 liability to routine annual reports? The argument was made that the annual report is no longer intended to be "routine." In 1933, the registration statement was conceived as the only disclosure document. Since the primary method of disclosure has been altered from the occasional registration statement to permanent registration coupled with the annual report, it was asserted that both documents should therefore be subject to the same stringent liability provisions.

In my opinion, just because disclosure has become continuous under the Code, it does not necessarily follow that the cataclysmic liability provisions of section 11 are appropriate for the annual report. I do not mean to denigrate the importance of the integrated reporting system, but by subjecting businesses to this continuous liability, that system would unnecessarily intrude into corporate affairs.

Consider, for instance, how much litigation would be fomented by this provision if it survives. Every time a security price went up or down, unhappy stockholders, or former stockholders, would have an opportunity to try to shift their perceived losses to the parties liable under this section. These potential plaintiffs, having found a material misstatement or omission in the company's current annual report, would not need to prove that they had been aware of the misstated information, or that they had relied on it, or that it had caused them damages.[53] Rather, the burden of disproving those elements would be on the defendants.[54] Entrepreneurial lawyers who found such plaintiffs for class suits would have a field day, and the ensuing litigation would be interminable.

The situation would be far worse than it was under rule 10b-5,[55] even before the Supreme Court required scienter,[56] because mere negligence would suffice to impose liability under the proposed provisions.[57] Furthermore, proof of damage would not be required in

53. *Id.* § 1704(c).

54. *Id.* § 1704(d)-(g).

55. 17 C.F.R. § 240.10b-5 (1978).

56. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976).

57. The standard of care under § 1704 is the reasonableness that is "required of a prudent man *under the circumstances* in the conduct of his own affairs . . . ." FED. SEC. CODE § 1704(g) (emphasis added).

order to state a cause of action and throw the burden of proof onto the defendants. Not only would the potential liability run to a huge class of plaintiffs—all persons who traded in any of the company's securities during the currency of the annual report—but also the Code formula for limiting liability is not severely restrictive because of the large number of potential defendants.[58]

The situation thus invokes Chief Judge Cardozo's fears of unrestricted liability for negligent representation,[59] and would not conform to the Supreme Court's interpretation that Congress is imposing liability for negligent misrepresentation carefully limited the situations to which liability was applicable.[60] The Supreme Court has recognized that in this kind of litigation the dangers of the litigation itself and the expenses thereof cause improvident settlements.[61] Indeed, the problem would be so serious that it might outweigh any benefits from the other provisions of the Code.

I certainly hope that the Institute withdraws from the present position, and that Congress will then be influenced by the Institute's second and better thoughts.

IV. The Policy on Changing Substance

As the Code approached completion, it became increasingly apparent that the response to any proposal to change existing law was, "The SEC won't go for it."[62] To one who has in recent years been less than an enthusiast for the SEC,[63] this deference was sometimes frustrating, but it represented a difficult policy choice.

In order to get a perspective on the problem, one must recognize that, in its general work on improvement of the law, the ALI has two basic choices. On one hand, in its Restatements of the Law, the Institute is committed primarily to stating what it considers the

58. Potential defendants include the registrant, the principal executive officer or officers, the principal accounting officer, every director, every prospective director named with his consent in the report, and every expert who has filed his consent under § 2003(e) with the report. FED. SEC. CODE § 1704(b). *But see* note 50 *supra* (shift of outside directors to § 1705).

59. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

60. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

61. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-49 (1975) (action under rule 10b-5).

62. *See Panel Discussion, Fourth Annual Baron de Hirsch Meyer Lecture Series*, 33 U. MIAMI L. REV. 1519, 1541 (1979).

63. *See, e.g.*, Kripke, *Where are We on Securities Disclosure After the Advisory Committee Report?* 6 SEC. REG. L.J. 99 (1978) (also printed in 2 J. ACCOUNTING, AUDITING & FINANCE 4 (1978)); Kripke, *Rule 10b-5 Liability and "Material" "Facts,"* 46 N.Y.U. L. REV. 1061 (1971); Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970). *See also* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979).

present rule of law or, if conflicts exist among different jurisdictions, the most sound position. It has some flexibility, however, and is not firmly bound to support the prevailing or majority view.[64]

On the other hand, when the ALI drafts a model statute, it codifies a great deal of fragmentary and inconsistent statutory material and judicial development. Since it necessarily has to choose from various rules which may have been inadequately conceptualized in their inception and to discern the unifying elements behind inconsistent nomenclature, it is free to function much as a legislature, with reasonably complete latitude to decide what it thinks should be the appropriate law. It took this approach in drafting and revising the Uniform Commercial Code.[65]

The question is: Which model should have been employed in drafting the Federal Securities Code? The most closely analogous prior experience of the ALI was its drafting of the Federal Income Tax Statute, accomplished, no doubt, with the knowledge that the Treasury, the Internal Revenue Service and the appropriate committees and other vocal members of Congress had their own strong ideas. The whole process was constrained by the government's reluctance to agree to improvements in the law which could sharply diminish the revenues. In this situation, therefore, the ALI chose to go ahead with "a critical examination, overhauling and revision" of the technical provisions of the then existing law,"[66] aware that its proposal as a whole would not be adopted by Congress, but hopeful that the draft would influence the government and congressional legislation. The hope proved well-founded, and the ALI Federal Income Tax Statute had substantial influence on the Internal Revenue Code of 1954.

In the case of the Federal Securities Code, the choice was

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64. As its Director has said:

> It was, of course, no new departure in the Institute's conceptions to declare that in our system of case law any statement that the law is such and such . . . implies a normative assertion as to what should now be held, if and when the question is presented . . . . To make the point explicit . . . permits the *Restatements* to attempt to be what they have been and are in fact—a modest but essential aid in the improved analysis, clarification, unification, growth and adaptation of the common law.

Wechsler, *The Course of the Restatements*, 55 A.B.A. J. 147, 150 (1969).

65. *See* Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, 1962 U. ILL. L.F. 321.

66. ALI FEDERAL INCOME TAX STATUTE, Introduction at ix (Tent. Draft No. 2, 1950). Its current effort in the same field of law expressly asserts that the Institute ought not to encroach on political questions such as the continuation both of the tax on corporate income and the personal tax on dividends. Beyond that the draftsmen feel free to propose changes in law. ALI FEDERAL INCOME TAX PROJECT SUBCHAPTER C, *Introduction* (Tent. Draft No. 1, 1977).

harder to make. Federal securities law is administered by the Securities and Exchange Commission, which is generally recognized as a most vigorous, competent and aggressive federal agency, filled with enthusiasm for its mission and jealous of its prerogatives. The Commission is supervised by congressional committees which, in recent years, have been activist and which, to a great extent, have imposed their own views upon the Commission in the Securities Acts Amendments of 1975.[67] Thus, it was apparent that unless the ALI basically accepted the present securities legislation and the SEC rules promulgated thereunder, it could never get the support of the SEC for its proposal.[68] Also, it seemed apparent from the inception of the project that there could be no chance that this enormous Code could be enacted, or even seriously considered, by Congress against the determined opposition of the SEC.[69]

Thus, the question was whether to write a model statute which might at some future time have some effect or to draft a Code for current enactment within the constraint that it had to be generally acceptable to the SEC. Professor Loss and those who planned the enterprise with him chose the latter course. The drafters of the Code, therefore, were constrained in a manner roughly comparable to that of the Institute when drafting Restatements—they had to restate existing laws with some judicious use of flexibility. Whether the choice will prove to have been the most efficient one depends on the course of future changes in securities law, a subject discussed in the following section.

V. The Massive Codification

The notion of a securities code which would go beyond the three disclosure acts of 1933, 1934 and 1939 has the obvious advantages which Professor Loss has repeatedly expounded.[70] And now that the

67. Pub. Law No. 94-29, 89 Stat. 97 (1975) (codified in scattered sections of 15 U.S.C. §§ 77-80).

68. *See* Garrett & Weaver, *The Securities and Exchange Commission and the Code*, 30 VAND. L. REV. 441, 445 (1977).

69. Congress, in recent years, has shown increasing concern about the SEC's performance. The Bankruptcy Reform Act of 1978, 11 U.S.C.A. § 102 (West Supp. 1979) [hereinafter cited as Bankruptcy Reform Act], showed that certain changes in the law could be made in the face of determined SEC opposition; however, those changes were made on points peripheral to the SEC's main mission. It may no longer be true that changes in basic securities law cannot be enacted over SEC opposition, and it is possible that the Code will test the issue in the favorable context of approval from the ALI and the ABA of the work of the distinguished Reporter.

70. *See e.g.*, FED. SEC. CODE, *Introduction* at xv-xvii; Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969); Loss, *supra* note 45.

codification has been completed, I believe the work should be preserved by enactment. Nevertheless, even apart from the burdens of sheer size, I perceive problems which stem from the concept of codification employed in the drafting process.

For instance, the Investment Company Act of 1940[71] is a poorly drafted and badly patched statute which has been redrafted for the Code. In the process, the drafters attempted to close numerous tiny gaps in the regulation which were pointed out by the vigilant staff of the SEC.[72] Yet now the Commission is setting up a task force to relax the overpowering regulation,[73] and the efforts of the drafters may have been for naught. If the regulatory provisions do, in fact, undergo substantial change, there will be a real test of the codification concept: Will the codification help the SEC in assimilating substantially altered provisions; will it be merely neutral, or will it provide a diversionary tactic for those who resist change? There may be similar problems in the offing with respect to the codification of the Public Utility Holding Company Act of 1935[74] and of the disclosure statutes. But, in considering those problems, as distinguished from the situation with the 1940 Act, the SEC is more likely to lead the movement resisting change.[75]

I have not had occasion to use the Public Utility Holding Company Act since I left the staff of the Commission over a third of a century ago. But even casual reading tells me that the Act is *functus officio* with respect to its principal purposes of preventing abuses in, and breaking up of, the public utility holding company systems of the 1920's. It is also my impression that those provisions which successfully fought the last war are not very relevant to the public utility problems of today. If circumstances cause Congress to take a fresh look at the substance of these provisions, there could be a question raised as to the significance of the current codification.

My final question is along the same lines. In the last twenty-five years, other disciplines—economics, finance and account-

71. 15 U.S.C. §§ 80a-1 to -52 (1976) [hereinafter cited as the 1940 Act].

72. The staff furnished the draftsmen a memo containing many of the ideas published in Rosenblatt & Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 PA. L. REV. 587 (1976).

73. Karmel, *A Skeptical Regulator Looks at the Future of Regulation*, at 14 (Remarks to the Women's Economic Club, Detroit, Nov. 20, 1978).

74. 15 U.S.C. §§ 79 to 79z-6 (1976).

75. The Commission stood alone in its resistance to rethinking of the reorganization chapters of the Bankruptcy Act, although the National Bankruptcy Conference and the National Conference of Bankruptcy Judges supported the bill, which became the Bankruptcy Reform Act of 1978.

ing—have been responsible for a vast outpouring of learning and of insights as to the operations of the securities markets. I have been urging, thus far without success, that if securities lawyers paid attention to these contributions from other disciplines, the disclosure laws would require rethinking on a fundamental level.[76] Others have urged the application to securities regulation of insights from still other social science disciplines, *e.g.*, organization theory.[77] This interdisciplinary approach was automatically precluded from consideration when the ALI effort was conceived of as a codification.[78] If those who urge the taking account of non-legal insights in the securities field ultimately prevail, we will again be presented with the question of the significance of the codification of these forty year-old statutes.

When the pressure for fundamental revision arises, I hope that Professor Loss' dream will prove to have been sound—that the codification will facilitate understanding of where we are, where we should go and how to draft the changes. I would be content if the effect of codification were merely neutral insofar as future change is concerned; I would be deeply distressed if the codification lent itself to use by those who resist fundamental change, by permitting them the argument that the proposals had necessarily been considered and rejected by the Institute and Congress in the codification.[79] It is clear to me that in these rapidly changing times, those who undertake to codify statutes that are nearly two generations old have an obligation to make clear whether and to what extent they have gone beyond mere codification to consider the need for revision of substance. Happily, my conversations with Professor Loss and Professor Herbert Wechsler, Director of The American Law Institute, lead me to believe that they fully understand the point.

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76. *See* Kripke, *supra* note 63, 6 SEC. REG. L.J. at 99.

77. *See* Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977). Coffee suggests that the modern corporation is characterized by inadequate flow of information and decentralization of authority which render the board of directors ineffective. He believes that activation of an internal self-corrective system, rather than statutory regulation, is the better method for achieving corporate reform.

78. Whether the ALI would be the appropriate sponsor for an interdisciplinary effort is a question outside the scope of this paper.

79. Of course, such an argument would be legitimate in regard to changes made or rejected on substantive grounds in drafting the Code, as discussed in Section II and III of this article or as shown by the Reporter's Notes.

VI. Conclusion

If that point is made very clear, I believe that this massive effort will prove very useful in pulling together securities law in its existing condition, that it has important advantages in the changes described in Section I, and that it should be enacted.