Pace Law Review

Volume 1
Issue 2 *1981*

Article 5

January 1981

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Lewis D. Lowenfels

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LEWIS D. LOWENFELS*

I. Introduction

The Code[1] is to me, in some ways, astounding, for lack of a better word. If I were to say, "Let's get a group of people together and draft a code which gives more power to the federal government and more power to the regulatory agencies to regulate private business," I think a good number of the people on the panel would say they do not want to participate in anything like that. To me, the Code does just that; I think that approach makes no sense, at this time, in this country.[2]

The Code gives more power to government in a number of specific and important areas. As a result of that, I could not support that Code in any form. To give more power to the Securities and Exchange Commission, to the federal bureaucracy, with respect to private business and enterprise, is a mistake. This country needs productivity, and one way to get productivity is by fewer rules and regulations. The Commission is uniquely situated in our economy because it has so much power over the private area.

This brings to mind a movie I saw a few weeks ago. I went

* LL.B., 1961, Harvard Law School; B.A., 1957, Harvard University; Partner, Tolins & Lowenfels, New York City; Lecturer, Practising Law Institute; formerly, Lecturer, Continuing Legal Education Program, University of Minnesota, 1975-76.

Substantial portions of this speech appeared in an article authored by Mr. Lowenfels which was published in the University of Virginia Law Review; this material is cited extensively herein with the permission of that Review.

1. ALI FED. SEC. CODE (1978) (Proposed Official Draft). References in this speech are to the 1978 draft. Comparison will be made with the ALI FED. SEC. CODE (1980) (Official Draft) where the changes in the 1980 draft are significant.

2. Lowenfels, *The Case Against the Proposed Federal Securities Code*, 65 VA. L. REV. 615 (1979).

to see a picture called "Being There."[3] Melvyn Douglas plays the role of an enormously successful businessman who is dying. In one scene of the movie he remarks that "every businessman in America today is at the mercy of these young lawyers from the Commission who can come in and do anything they want." Well, sadly enough, that is not that much of an overstatement. You do not always deal with reasonable people like Lee Spencer and Bob Pozen. I think you have to be very careful when you grant a government agency this kind of power.

Now, let us examine the specific provisions of the Code which delegate significant powers to the Securities and Exchange Commission.

II. An Analysis of the Proposed Code's Delegation of Power to the Securities and Exchange Commission

A. *The Power to Exempt from Any or All Provisions of the Code*

Section 303 of the Code gives the Commission plenary authority to exempt by rule or order any person, security or transaction, or any class of persons, securities or transactions, from any or all of the provisions of the Code.[4] Included within this plenary power is the power to "condition or . . . make retroactive any exemptive rule or order that it is authorized or required to adopt."[5] One might ask why anyone should get concerned about the power to exempt. I suggest to you that the

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3. The motion picture, *Being There,* was produced by Andrew Braunsberg and distributed by United Artists in 1979.

4. ALI Fed. Sec. Code § 303 (1978). This section provides:

> (a) [Commission.] The Commission, by rule or order, may exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any or all of the provisions of this Code, except that section 303(a) does not apply with respect to (1) section 1506 or 1904, (2) a provision that prohibits the fixing of minimum profits or the imposition of any schedule, or the fixing of rates, of commissions, allowances, discounts, or other fees, or (3) a rule of a bank regulator or a self-regulatory organization.

See also ALI Fed. Sec. Code § 303, Comment (1)(a) (1980). This comment states that the Commission's exemptive authority, apart from the plenary provisions in the two 1940 Acts, is already quite extensive under the other Acts—to the point where the logical solution is a Code-wide plenary authority subject to a few highly policy-oriented exceptions.

5. ALI Fed. Sec. Code § 303(c) (1978).

power to exempt A is the power to destroy B, C and D who are not exempted. The power to exempt is the power to bargain for substantial concessions in exchange for that exemption.[6]

Furthermore, the power to exempt is the power to exempt from the exemptions. There are certain provisions of this Code which provide exemptions,[7] but if the Commission has plenary power to exempt, nothing is to stop them from exempting from the exemptions. I think this proposed regulatory power is incompatible with the emphasis on disclosure which provides the primary theoretical basis of the Securities Act of 1933[8] and the Securities Exchange Act of 1934.[9] This extension of regulatory power would bring a regulatory philosophy associated with the Investment Company Act of 1940[10] into an area where it was never intended to apply.

Finally, this provision in the Code will breed a small coterie of securities lawyers who will specialize in these areas and who will be able to bargain with the Commission to get certain exemptions for their clients. Not that this is crooked, but it arises by the nature of the relationships, according to the reality of the world.[11]

6. Lowenfels, *supra* note 2, at 618.

7. Persons may be exempted under the following sections of the Code: § 242(b) (the privileges and advantages of the limited offering); § 242(c) (trading transactions); and § 514(c) (local distribution exemptions). ALI FED. SEC. CODE §§ 242(b)-242(c), 514 (1978). Professor Loss and the Securities and Exchange Commission have agreed upon changes to the proposed Code. SEC Sec. Act Release No. 33-6242, 20 SEC Docket 1483 (1980) [hereinafter cited and referred to as CODE RECOMMENDATION]. The CODE RECOMMENDATION includes a change which would grant the Commission additional rule-making authority with respect to the definition of a "limited offering." CODE RECOMMENDATION, *supra*, at 1486.

8. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a-77aa (1976)). This Act is based on a theory of investor protection through adequate disclosure of sufficient information to permit informed investment decisions. Under this Act the Commission does not have the power to prevent issuance of securities but may compel disclosure of material facts concerning the company and its securities.

9. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (current version at 15 U.S.C. §§ 78a-78hh (1976)). This Act extends the disclosure doctrine of investor protection found in the 1933 Act by regulating transactions of, and compelling disclosure by, corporations, directors, officers and shareholders.

10. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (1940) (current version at 15 U.S.C. §§ 80a-1 to 80a-52 (1976 & Supp. III 1979)). This Act regulates specific acts and transactions of investment companies and their employees.

11. Lowenfels, *supra* note 2, at 617-19.

B. *The Power to Promulgate Rules Proscribing Unfair Dealing*

Section 915(b) of the proposed Code provides:

> The Commission, by rule, may define in a manner not inconsistent with the conditions and restrictions of sections 913, 914, and 915(a), and prescribe means reasonably designed to prevent, any conduct by a broker, dealer . . . or investment adviser that is made unlawful by those sections, or any similar conduct that constitutes unfair dealing with a customer, client, or subscriber.[12]

What the Code is doing, in effect, is giving the Commission unprecedented power to promulgate rules to regulate conduct that constitutes "unfair dealing." That is far beyond anything that we have had before.[13] The reporter justifies this power by saying that he is carving out a degree of misconduct, which is well within the "proper sphere of direct regulation"[14] and yet beyond the ambit of the self-regulatory institutions, such as the New York Stock Exchange. The reporter emphasizes that the conduct reachable under this power, while "unfair," is not quite fraudulent, so there is no reason to apply a fraud rule writ to it.[15] This is all very nice, and the intention may be very good, but I suggest that what is going to happen is that the rule-making authority of the Commission will be enlarged beyond the fraud rule rubric of the "shingle" theory, which had been the traditional limit of their rule-making power.[16] Now they are going to be able to draft and promulgate rules in an entirely new area of misconduct, an area somewhere between fraudulent and unethical, the area of "unfair dealing" with the customer. I think this has very dangerous possibilities.[17]

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12. ALI FED. SEC. CODE § 915(b) (1978).

13. Lowenfels, *supra* note 2, at 620.

14. ALI FED. SEC. CODE § 915, Comment (1) (1978).

15. *Id.*

16. The "shingle" theory postulates that a dealer who hangs out his shingle implicitly warrants the soundness of stock and fair dealing. *See* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). Under the "shingle" theory, the Commission's power was limited to promulgating rules proscribing fraudulent conduct. ALI FED. SEC. CODE § 915, Comment (1) (1978). Under the Code, the outer limit of the Commission's power is no longer confined to fraud, but is extended to include "unfair dealing." *Id.* § 915, Comment (3).

17. Lowenfels, *supra* note 2, at 620.

C. *The Power to Regulate Investment Advisers*

The third provision I find troublesome is the power to regulate investment advisers. The Commission has been trying for some time to get a statute through the Congress to regulate investment advisers in a way different from that provided by the Investment Advisers Act of 1940.[18] What they primarily want to do is set up competency and financial requirements for investment advisers.[19] The Code would allow this,[20] but existing statutes do not.[21] In spite of the failure of the last Congress to enact bills which would have regulated advisers,[22] the Code reporter includes advisers among those subject to the Code's regulations.[23] The reporter justifies this by what he sees as a lack of a principled distinction between broker-dealers, who are regulated, and investment advisers, who are not.[24]

The reporter is saying that if you are going to regulate broker-dealers in certain areas, you should also be able to regulate investment advisers in the same areas. I suggest that this reasoning does not necessarily hold up. Broker-dealers differ from investment advisers in three ways. First, broker-dealers make substantial capital commitments and investments. Second, broker-dealers are intertwined in a network of trading with other broker-dealers so that if one fails there is a domino effect of fail-

18. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976 & Supp. III 1979). This Act requires registration of persons who advise others about securities transactions and requires such advisers to protect investors.

19. *See, e.g.*, Proposed Amendments to the Investment Advisers Act of 1940, S. 2849, 94th Cong., 2d Sess., 122 CONG. REC. 307-18 (1976); H.R. 13737, 94th Cong., 2d Sess. (1976).

20. *See, e.g.*, ALI FED. SEC. CODE § 705(b) (1978). This section states:

> (b) [Required rules.] The Commission shall adopt rules under section 705(a) that (1) establish minimum financial responsibility requirements, and (2) require the maintenance of reserves with respect to customers' deposits or credit balances.

21. Under the Investment Advisers Act of 1940, the Commission is granted broad discretion, including the authority to revoke an investment adviser's registration for publishing misleading information, Marketlines, Inc. v. SEC, 384 F.2d 264, 267 (2d Cir. 1967), *cert. denied*, 390 U.S. 947 (1968), but the Commission's broad discretion does not touch on financial responsibilities of investment advisers. Indicating that revocation is a "severe sanction," the court in *Marketlines* upheld the Commission's power to revoke an investment adviser's registration where "the Commission could reasonably find" that revocation "was necessary to protect the investing public." *Id.* at 267.

22. *See* note 19 *supra*.

23. ALI FED. SEC. CODE § 703(e)(1) (1978).

24. *Id.* § 703(e)(1), Comment (4).

ure which could be disastrous. Finally, broker-dealers are insured by a federal agency, the Securities Investor Protection Corporation.[25] Investment advisers, however, do not share these characteristics: they do not make substantial capital investments, they are not intertwined with other entities in a way that could cause interrelated failures, and they are not insured by the Securities Investor Protection Corporation.

In addition, I am not sure that a federal bureaucracy should set competency requirements for investment advisers. Nor do I think the bureaucracy should approve whether a particular investment adviser, who may have a technical theory or chart theory or whatever, should necessarily not be allowed to practice his trade. Let the market place determine that. If he is successful, he will do well. If he is not successful, he will not do well. That will happen very quickly.

D. *The Power to Extend Extraterritorial Application of the Federal Securities Law*

The next section of the Code I wish to discuss concerns the extraterritorial application of the federal securities law. Section 1905(c)(1) states that:

> Within the limits of international law and section 1905(a)(1)(D), and in the light of the significance or effects within the United States of particular acts or conduct, the Commission, by rule,
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> (1) may provide (A) that this Code does not apply with respect to the subject matter of section 1905(a), (B) that it does apply with respect to the subject matter of section 1905(b), and (C) that it does or does not apply with respect to any other subject matter.[26]

So, in effect, you have a provision which says there are things that shall be governed by the Code, and there are things beyond the scope of the Code, but the Commission can change that all around by rule if they want to. That presents a problem. If one section enumerates the types of extraterritorial situations to which the Code would apply and another section describes

25. *See* Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1976 & Supp. III 1979). Since broker-dealers are, in essence, insured by the public treasury, there may be justification for some regulation.

26. ALI Fed. Sec. Code § 1905(c)(1) (1978).

the types of extraterritorial situations to which the Code does not apply, why should the Commission be given rule-making power to change all that? It seems to me that in the extraterritorial area the focus is on such diverse issues as comity between nations, antitrust considerations or jurisdictional matters; these concerns may be more important in the particular situation than the protection of investors and securities, which is the primary interest of the Commission. So I suggest that in this particular area the federal courts may be more competent to weigh and evaluate the interests involved than the Commission.[27]

E. *The Power to Create Private Actions for Customers of Self-Regulatory Institutions*

Self-regulatory institutions write private rules which, in part, govern their relationships with their customers. Customers, aggrieved by a violation of these rules, may go to federal court seeking redress. Under existing law, the federal courts determine on a case by case basis whether to imply a private action for damages in favor of a customer based upon the particular rules.[28] Under section 1721 of the Code, however, the Commission would be empowered to determine in what situations a customer would and would not have private rights of action.[29]

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27. Lowenfels, *supra* note 2, at 624.

28. *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966); Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969); Gurvitz v. Bregman & Co., 379 F. Supp. 1283 (S.D.N.Y. 1974). In *Colonial,* the court found that where there is no express private cause of action under the Securities Exchange Act of 1934 for violation of exchange or dealer association rules, "the court must look to the nature of the particular rule and its place in the regulatory scheme" to determine if a private cause of action is to be implied. 358 F.2d at 182. The *Buttrey* court found that whether a private cause of action can be implied under the New York Stock Exchange "know your customer" rule depends on the factual allegations of each case. 410 F.2d at 143. The *Gurvitz* court found that allegations that stock brokers failed to keep proper records in violation of NASD rules did not constitute a private cause of action. 379 F. Supp. at 1286-87. *See generally* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules,* 66 COLUM. L. REV. 12 (1966); Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules,* 51 CORNELL L.Q. 633 (1966).

29. ALI FED. SEC. CODE § 1721(a) (1978). This section states:

> (a) [Determination of rules to which section applies.] A member of or participant in a self-regulatory organization who violates a rule of the organization, or a broker or dealer within section 905(c) who violates a rule under that section, is liable to his customer for any loss caused by the violation if

Now it seems to me, again, that this ought to be governed by the federal courts. There is presently a split of authority as to whether, and in what circumstances, private rights of action are available. Under section 1721, the Commission would have the power to decide these questions; I suggest, as in the extraterritorial area, that the Commission is not the proper party to weigh these particular interests.[30] Furthermore, why do it by rule? The creation of private rights of action is particularly suited to a case by case analysis. The plaintiff has to come into court anyway. He has to sue for damages. He has to establish causation. He has to establish fault. Why not let the court, with the plaintiff present, determine the situations under which a private right of action can be implied?

F. *The Power to Impound and Place in Escrow*

Under Section 506, the Commission may, by rule, require that any securities issued within the past three years be placed in escrow.[31] The Commission would also have the same power with respect to certain stock to be issued to a promoter at a bargain price.[32] There is also a similar provision for impounding.[33] I

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(1) the rule violated has been determined by Commission rule to be within section 1721, or

(2) a court, except when the rule violated has been determined by Commission rule to be without section 1721, decides that a private right of action under this Code should be recognized in accordance with the principles of common law and equity, applied as a matter of Federal jurisprudence, and the standards of section 1722(a).

This section remains substantially the same in the 1980 draft but "municipal dealers" and "municipal brokers" have been added as regulated parties. ALI FED. SEC. CODE § 1721(a) (1980).

30. *See* note 27 and accompanying text *supra*.

31. ALI FED. SEC. CODE § 506. This section provides:

[Escrow and impounding.] With respect to an offering statement, the Commission by rule

(a) may require that any securities issued within the past three years or to be issued to a promoter for a consideration substantially different from the offering price to other persons be placed in escrow or otherwise restricted;

(b) may require, when the distribution is by or for the account or benefit of the issuer, that the proceeds be impounded until the issuer receives a specified amount; and

(c) may specify the conditions of any escrow, impounding, or other restrictions so required.

32. *Id.*

suggest that section 506 is without precedent under the federal securities laws.[34] Here the Code is clearly discarding the traditional disclosure philosophy that has always dominated the area of public offerings of securities in favor of a regulatory approach. In addition, I suggest that section 506 authorizes a federal agency to intrude into areas of corporate finance which were previously governed by the private sector.[35]

A number of states do have escrow provisions.[36] Such provisions create problems for an offering, particularly that of a young company. When the stock is in escrow, the situation is frozen: a company has an offering, its stock is in escrow, then a year and a half down the road, when the company has run through a good portion of the money, it needs more money to finish the design on a new product, or whatever. To go out and make a private placement of securities, or to go out and find a huge company to merge with in order to get additional financing, is much more difficult when a good chunk of the company's own stock is held in escrow by some state commission. It just scares off additional venture capital. I suggest that instead of protecting the public investor, this sort of an escrow mechanism becomes an onerous government instrument which freezes the public's investment into a nonproductive limbo.[37]

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33. *Id.*

34. The only rule in the federal area which governs escrow funds in this context is rule 253. 17 C.F.R. § 230.253 (1980). Rule 253(c)(2) provides:

> (c) In computing the amount of securities which may be offered hereunder, there shall be included, . . . (2) All securities issued to and held by or proposed to be issued, pursuant to options or otherwise, to any director, officer or promoter of the issuer, or to any underwriter, dealer or security salesman: *Provided,* That such securities need not be included to the extent that effective provision is made, by escrow arrangements or otherwise, to assure that none of such securities or any interest therein will be reoffered to the public within one year after the commencement of the offering hereunder and that any reoffering of such securities will be made in accordance with the applicable provisions of the act.

35. Lowenfels, *supra* note 2, at 627.

36. *See, e.g.,* HAWAII REV. STAT. § 485-18 (1976); KAN. STAT. ANN. § 17-1259(d) (Cum. Supp. 1979); MICH. COMP. LAWS ANN. § 451.705(f) (Supp. 1980-1981); WIS. STAT. ANN. § 551.27(7) (West 1979). See Lowenfels, *supra* note 2, at 627 n. 64 for a listing of states which have escrow provisions.

37. Lowenfels, *supra* note 2, at 627.

G. *The Power to Decide Indemnification and Contribution Issues*

I would next like to examine the area of indemnification and contribution, for the Code substantially expands the Commission's power in these areas. Section 1724(e)(3) of the Code provides:

> An indemnification provision, whether contained in a statute, a bylaw or similar instrument, or a contract . . . , is valid, apart from the expenses of a successful defense, only to the extent that
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> (A) the Commission provides by rule on consideration of such factors as the respective gains and losses of the indemnitor and indemnitee and the deterrent effect of the particular type of liability, or
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> (B) a court determines in accordance with the principles of common law and equity. . . .[38]

This puts the agency on the same level as a federal court. There are additional provisions with respect to contribution and indemnification which further expand the Commission's authority.[39] Together these provisions, it seems to me, represent a substantial federal instrusion into areas traditionally governed by state law. The reporter in this area has no policy justification for what he has done. It seems to me that unless federal uniformity in this area has become a vital interest, this is an area that the Commission was not set up to get involved in or to administer. The Commission was created by Congress to administer and enforce the federal securities laws.[40] Its expertise has been developed during the past 45 years through dealing primarily with these comparatively narrow and limited statutes. The Commission was not set up to be a federal corporation commission exercising regulatory powers over corporate officers and directors through principles of federal corporate law. Moreover, questions

38. ALI FED. SEC. CODE § 1724(e)(3) (1978).

39. *See, e.g.*, ALI FED. SEC. CODE §§ 1724(f) (contribution), 1819(k) (improper indemnification), 1728(a) (filing of litigation documents for indemnification) (1978).

40. Lowenfels, *supra* note 2, at 629. The Commission was created by the Securities Exchange Act of 1934. Securities Exchange Act of 1934, § 4, 48 Stat. 885 (current version at 15 U.S.C. § 78d). *Compare* J. ELLENBERGER, & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973) *with Securities and Exchange Commission*, in 4 THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY (B. Schwartz ed. 1973).

of indemnification and contribution often involve delicate negotiations among individual officers, directors, insurance companies and their lawyers. To involve the federal government in this area adds an additional power group, so to speak, that has to be included in the negotiations. I think this is unnecessary and wrong.

H. *The Power to Alter the Code's Complete Elimination of Exemptions to Rule 10b-6*

The next Code section I wish to discuss is the one dealing with rule 10b-6.[41] Rule 10b-6 is a complicated rule under the Securities Exchange Act of 1934 and has a very substantial effect upon the trading markets.[42] In essence, rule 10b-6 makes it unlawful for a person connected with the distribution of securities to bid for or purchase any securities that are the subject of the distribution.[43] There are, however, eleven exemptions from the

41. ALI FED. SEC. CODE § 1609(d) (1978).

42. 17 C.F.R. § 240.10b-6 (1980).

43. *Id.* Rule 10b-6 states:

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the act for any person,

(1) Who is an underwriter or propective underwriter in a particular distribution of securities, or

(2) Who is the issuer or other person on whose behalf such a distribution is being made, or

(3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution: *Provided, however,* That this section shall not prohibit (i) transactions in connection with the distribution effected otherwise than on a securities exchange with the issuer or other person or persons on whose behalf such distribution is being made or among underwriters, prospective underwriters, or other persons who have agreed to participate or are participating in such distribution; (ii) unsolicited privately negotiated purchases, each involving a substantial amount of such security, effected neither on a securities exchange nor from or through a broker or dealer; or (iii) purchases by an issuer effected more than forty days after the commencement of the distribution for the purpose of satisfying a sinking fund or similar obligation to which it is subject; or (iv) odd-lot transactions (and the off-setting round-lot transactions hereinafter referred to) by a person registered as an odd-lot dealer in such security on a national securities

rule, and it is these exemptions which make the rule workable and livable within the practical everyday world of financing.[44] The Code reporter has codified rule 10b-6, but he has left out the exemptions.[45] He says that we could leave it to the good will

exchange who offsets such odd-lot transactions in such security by round-lot transactions as promptly as possible; or (v) brokerage transactions not involving solicitation of the customer's order; or (vi) offers to sell or the solicitation of offers to buy the securities being distributed (including securities or rights acquired in stabilizing) or securities or rights offered as principal by the person making such offer to sell or solicitation; or (vii) the exercise of any right or conversion privilege to acquire any security; or (viii) stabilizing transactions not in violation of § 240.10b-7; or (ix) bids for or purchases of rights not in violation of § 240.10b-8; or (x) transactions effected on a national securities exchange in accordance with the provisions of a plan filed by such exchange under § 240.10b-2(d) and declared effective by the Commission; or (xi) purchases or bids by an underwriter, prospective underwriter or dealer otherwise than on a securities exchange, 10 or more business days prior to the proposed commencement of such distribution (or 5 or more business days in the case of unsolicited purchases), if none of such purchases or bids are for the purpose of creating actual, or apparent, active trading in or raising the price of such security. In the case of securities offered pursuant to an effective registration statement under the Securities Act of 1933 the distribution shall not be deemed to commence for purposes of this subdivision prior to the effective date of the registration statement.

(b) The distribution of a security (1) which is immediately exchangeable for or convertible into another security, or (2) which entitles the holder thereof immediately to acquire another security, shall be deemed to include a distribution of such other security within the meaning of this section.

44. 17 C.F.R. § 240.10b-6(a)(3)(i) to -6(a)(3)(xi) (1980).

45. ALI FED. SEC. CODE §1609(d) (1978). The Code proposes to codify rule 10b-6 as follows:

(d) [Buying during a distribution.] (1) Except as permitted by rule or order of the Commission, it is unlawful for the issuer, a secondary distributor, an underwriter, a prospective underwriter, or any other person who has agreed to participate or is participating or otherwise financially interested in a distribution, to do any of the following acts before the completion of his participation or the termination of his financial interest in the distribution:

(A) to bid for or buy, for an account in which he has a beneficial interest, a security that is the subject of the distribution or a security of the same class (or a warrant or right to subscribe to or buy such a security);

(B) to induce or attempt to induce another person to bid for or buy such a security (or a warrant or right to subscribe to or buy such a security) from a person not participating in the distribution; or

(C) to pay or offer to agree to pay (i) any compensation to a nonparticipant in the distribution for soliciting a third person to buy such a security (or a warrant or right to subscribe to or buy such a security), or (ii) more than an ordinary salary or the customary compensation to a participant in the distribution (if it is on an exchange) for soliciting a third person to make such a purchase.

(2) "Prospective underwriter" means a person who (A) has submitted or agreed to submit a bid to become an underwriter pursuant to a public invitation for bids, or (B)

of the Commission to promulgate these exemptions as part of its rule-making power.[46] It seems to me that this is a real problem,[47] because within recent years, the Commission has jealously expanded its authority in the rule 10b-6 area through a series of many "no-action" letters.[48] Now we have a situation where the exemptions are out, the rule is stated in prohibitive terms, and we have to await the Commission's pleasure with respect to putting the exemptions back.

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has reached an understanding with the issuer or secondary distributor that he will become an underwriter, whether or not the terms of the underwriting have been agreed upon.

(3) Notwithstanding section 242, for purposes of section 1609(d)

(A) the Commission may define "distribution" by rule on consideration of such factors as size (absolute or relative) of the offering, number of sellers and buyers, selling method, characteristics of the market used, and compensation; and

(B), unless the Commission provides otherwise by rule or order, (i) a distribution of securities of a class that is immediately convertible into or entitles its holders immediately to acquire securities of another class of the same issuer (or another issuer) is a distribution also of the securities of the other class, but (ii) the fact that a class of a type specified in section 1609(d)(3)(B)(i) is outstanding is not a distribution of securities of the other class.

(4) Section 1609(d) does not apply to (A) an exempted security within section 302(a) to (c) inclusive, except to the extent that the Commission provides otherwise by rule, or (B) an investment company's redemption of a redeemable security of which it is the issuer.

46. ALI FED. SEC. CODE § 1609(d), Comment (3) (1980).

47. Lowenfels, *supra* note 2, at 631.

48. No-action letters have been described as follows:

> The SEC staff receives and replies to thousands of written inquiries about the securities laws. The inquirer must give the facts—typically a proposed transaction—and his or her opinion on the applicable law. The staff of the appropriate Division of the SEC (e.g., Corporation Finance, Market Regulation) replies, typically saying no more than that if the transaction is carried out as proposed, the staff will not (or will) recommend that the Commission take enforcement action.

A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD, Sec. 1.3(160), at 1:15 (1979) (citations omitted). *See generally* Lowenfels, *SEC "No-Action" Letters: Some Problems and Suggested Approaches,* 71 COLUM. L. REV. 1256 (1971), *reprinted* in L. LOWENFELS, SELECTED ARTICLES UNDER THE FEDERAL SECURITIES LAWS (1978); Lockhart, *SEC No-Action Letters: Informal Advice as a Discretionary Administrative Clearance,* 37 LAW & CONTEMP. PROB. 95 (1972); Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases, and Commission Releases,* 59 VA. L. REV. 303 (1973), *reprinted* in L. LOWENFELS, SELECTED ARTICLES UNDER THE FEDERAL SECURITIES LAWS (1978).

I. *The Power to Modify the Code's Objective Standards with Respect to Private Placement and Trading Transaction Exemptions*

I will discuss the private placement and trading transaction exemptions only briefly because these topics were covered in depth earlier.[49] Section 242 of the Code authorizes private placement and trading exemptions, and establishes objective criteria that must be met to qualify as a "limited offering."[50] But the Code also permits the Commission to modify, by rule, the conditions in section 242(b) or to impose additional conditions with respect to the type of issue, the kind of market and similar criteria.[51] So in effect you have a rule which provides an exemption, and, again, the Commission is given power to exempt from the exemption. I do not see that power as necessary.

J. *The Power Over One-Year Registrants*

As has been said earlier today, one of the more important aspects of the Code is the shift in emphasis from the occasional, hit or miss, static registration statement to the creation of a system characterized by permanent company registration.[52] One innovation created in connection with this change is the preferred one-year registrant status,[53] which confers a number of privi-

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49. Ratner, *Exemptions to the Disclosure Requirements*, 1 PACE L. REV. 319 (1981).

50. ALI FED. SEC. CODE § 242(b)(1) (1978). The Code defines a limited offering as an offering in which the following objectively determinable conditions are present:

> (A) The initial buyers of the securities are institutional investors or not more than thirty-five other persons or both, or the seller reasonably so believes; (B) resales . . . within three years after the last sale . . . to any of the initial buyers other than institutional investors do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase) at any one time, unless any such excess results from resales pursuant to an offering statement or an exemption; and (C) the seller and all resellers comply with any rules adopted under section 242(b)(4).

Id. The CODE RECOMMENDATION includes a change in this section which would grant the Commission additional rule-making authority with respect to the definition of a "limited offering." CODE RECOMMENDATION, *supra* note 7, at 1486.

51. ALI FED. SEC. CODE § 242(b) (1978). For a comparison with the CODE RECOMMENDATION, *see* note 50 *supra*.

52. Spencer, *Issuer Registration and Distributions*, 1 PACE L. REV. 299, 299 (1981).

53. ALI FED. SEC. CODE § 299.16 (1978).

> "One-year registrant" means a registrant that has been continuously a registrant for one year.

leges upon a company: certain exemptions from registration requirements,[54] more lenient treatment with respect to the contents of offering statements[55] and prospectuses,[56] shorter holding periods under the private placement exemption,[57] and protections against disaffirmances.[58] These privileges are valuable.

But the Code also grants to the Commission the power to take away summarily, without a hearing, the valued one-year registrant status of issuers. Under section 1808(a) of the Code, the Commission is freely authorized, as it deems necessary or appropriate, to suspend the company's one-year registrant status.[59] Only after the suspension has been implemented does the issuer have a right to a hearing.[60] Once suspended, the issuer cannot recover its one-year registrant status until it has been a registrant continuously for a period of one year after the suspension has been vacated.[61] I think it is dangerous to give a government agency this kind of unfettered right. The leverage which the Commission would obtain over every registered public company in this country would be incalculable. Consider, for example, an agency investigation, when a company is locking horns with the Commission's enforcement people in an adversary proceeding. The company views the situation one way, and the enforcement people view it another. If the enforcement division has the power to take away the company's one-year registrant status, by recommending that action to an agreeable Commis-

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Id.

54. ALI Fed. Sec. Code §§ 502(b), 512(c), 512(g), 512(h) (1978). These sections remain substantially the same in the 1980 draft at sections 502(b), 512(3), 512(7), 512(8), respectively, except that in the 1980 Code § 512(7) and 512(8) refer to "a transaction in a security" rather than the "offer or sale of a security" language used in the 1978 draft. ALI Fed. Sec. Code §§ 502(b), 512(3), 512(7), 512(8) (1980).

55. ALI Fed. Sec. Code § 502(c) (1978).

56. *Id.* § 505(a).

57. *Id.* § 242(b)(2).

58. *Id.* § 504(b).

59. *Id.* § 1808(a).

60. *Id.* § 1817(b)(5). This section provides as follows:

The Commission or a bank regulator shall give prompt notice of the issuance of a summary order under section 1808(a), (f) or (h), 1809(f), 1810(a)(2) or 1811(c), and of opportunity for hearing within not more than fifteen days on whether it should be vacated.

61. *Id.* § 299.16. For the text of this section, *see* note 53 *supra*.

sion, enormous power is given to the government.[62]

K. *The Power to Suspend Trading Summarily*

Under existing law, the Commission has the power to suspend trading summarily, but only for a period of ten days.[63] For years, the Commission, not being satisfied with the ten-day power, would issue a suspension for ten days, then renew the ten-day suspension ad infinitum. Well, somebody got the courage and financing together and decided to challenge the Commission's tactics. The United States Supreme Court agreed with the challenge and, in *SEC v. Sloane,* held that only one ten-day suspension was permissible.[64]

Under the Code, that is changed. The Code reverses *Sloane,* and it gives the Commission power to "by order . . . summarily suspend trading in any security other than a Government or municipal security" without any ten-day limitation.[65] This, I suggest, is something we do not need.[66]

L. *The Power to Regulate Trust Indentures*

Section 309(e) of the Trust Indenture Act of 1939 provides:

> Nothing in this subchapter shall be construed as empowering the Commission to conduct an investigation or other proceeding for the purpose of determining whether the provisions of an indenture which has been qualified under this subchapter are being

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62. Lowenfels, *supra* note 2, 633-34.

63. 15 U.S.C. § 78l(k) (1976). This section provides:

> If in its opinion the public interest and the protection of investors so require, the Commission is authorized summarily to suspend trading in any security (other than an exempted security) for a period not exceeding ten days, or with the approval of the President, summarily to suspend all trading on any national securities exchange or otherwise, in securities other than exempted securities, for a period not exceeding ninety days. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in which trading is so suspended.

64. SEC v. Sloan, 436 U.S. 103 (1978). The Court held that the Commission lacked authority under § 12(k) of the Securities Exchange Act of 1934 to issue a series of summary suspension orders which allowed suspension of trading beyond the stated ten-day period. The holding was based on the clear language of the statute which contains no authority for extension. *Id.* at 122-23.

65. ALI FED. SEC. CODE § 903(d)(2) (1978).

66. Lowenfels, *supra* note 2, at 635-36.

complied with, or to enforce such provisions.[67]

If you go back into the legislative history you will find that Congress specifically did not want any government interference in this area.[68] They thought that giving the power to investigate in this area would be an enormous injustice to some of the people involved.[69] Under the Code, however, that limitation is thrown out. The Commission would have the power to investigate in this area just as in any other.

III. Summary

The sections I have just discussed are only some of the more salient examples of the Code's sweeping grant of additional power to the Commission. If you go through the Code section by section, you will find one or more of the following provisions in almost every section: "To the extent that the Commission so prescribes by rule";[70] "except that the Commission may impose conditions or withdraw this exemption by rule";[71] "[i]t is unlawful for any person in contravention of the rules of the Commission";[72] "shall file whatever reports the Commission prescribes by rule";[73] "within whatever shorter period the Commission specifies by rule."[74] These provisions are, it is true, present in existing federal securities law, but they do not have the same unlimited degree of application contemplated in the Code.

In closing, I would just like to say that the grant of additional power to the Commission is hard to justify. I think that it was done for two reasons. First, the reporter wanted to get the Commission's support for the Code, because he felt that this Code was not going to go through Congress without that support. Second, in a lot of areas the world of the scholar competed

67. Trust Indenture Act of 1939, § 309(e), 15 U.S.C. § 77iii(e) (1976).

68. Lowenfels, *supra* note 2, at 637-38. Senate Comm. on Banking and Currency, Report on Trust Indenture Act of 1939, S. Rep. No. 248, 76th Cong., 1st Sess. 8 (1939); House Comm. on Interstate and Foreign Commerce, Report on Trust Indenture Bill of 1939, H.R. Rep. No. 1016, 76th Cong., 1st Sess. 26-27 (1939).

69. Lowenfels, *supra* note 2, at 637-38.

70. *See, e.g.*, ALI FED. SEC. CODE § 299.24 (1978).

71. *See, e.g.*, *id.* § 512(i).

72. *See, e.g.*, *id.* § 1311(c).

73. *See, e.g.*, *id.* § 605(a)(1).

74. *See, e.g.*, *id.* § 512(b)(2).

with the hard world of reality. While the Code was being drafted, particular provisions might have been drafted in a certain way. But when the special interests got involved in the drafting process and insisted that the Code would not pass with a certain provision in it, the reporter would just back off and say, "Well then, let's just say it shall be handled in such a way as the Commission shall provide by rule." That was a nice way of avoiding the problem and putting it under the rug until the future.[75]

I suggest, for your consideration, that this inability to make choices and this desire for the support of the Commission are hardly sound policy reasons for the Code's expansion of regulatory power in the corporate securities field. For those reasons I would oppose the Code. Furthermore, I do not think that the Code adds anything substantial; most of the improvements which the Code suggests have been enacted piecemeal by rule or statute over the past few years.[76]

In addition, a trend of contraction is apparent from recent Supreme Court decisions.[77] This limiting trend clashes with the natural bent of any bureaucracy, here the Securities and Exchange Commission, to expand its power. I think it is good that

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75. Lowenfels, *supra* note 2, at 640.

76. *Id.* at 661.

77. *See* Aaron v. SEC, 446 U.S. 680 (1980); Piper v. Chris-Craft Indus., 430 U.S. 1 (1977); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The Court in *Aaron* held that, regardless of the plaintiff's identity or the nature of the relief sought, scienter is an element of a violation of section 10(b) of the Securities Exchange Act of 1934 and of rule 10b-5. Scienter is also an element of a violation of section 17(a)(1) of the Securities Act of 1933. 446 U.S. at 697, 701. The Court in *TSC Indus.* defined a material fact as one involving substantial likelihood that a reasonable shareholder would have regarded the fact as significant in his deliberations. 426 U.S. at 449. The Court in *Ernst & Ernst* held that proof of scienter is required for a rule 10b-5 violation. 425 U.S. at 193. The Court in *Foremost-McKesson* found that there is no section 16(b) liability when the defendant is not a ten percent owner before the purchase and sale alleged to constitute a violation. 423 U.S. at 259. The Court in *Rondeau* found that there is no violation of section 13(d)(1) when the failure to disclose was made in good faith and without injury to the plaintiff. 422 U.S. at 61-62. The Court in *Blue Chip Stamps* found that plaintiffs who are neither purchasers nor sellers of the security in question have no standing under rule 10b-5. 421 U.S. at 754-55. See generally Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

the courts are containing bureaucratic expansion; the Code would, by increasing the Commission's power, reverse this judicial trend. I am opposed to that.

IV. Discussion

Question: I have asked Professor Loss the questions you raise, and his answer was as you surmised: codification is a compromise. You will not get the Code passed unless the Commission approves. My question to you is this: isn't compromise too dear a price to pay for codification, when the Code doesn't comport with the spirit of deregulation now so prevalent?

Mr. Lowenfels: First, the compromise is too dear a price to pay, and second, I see no reason for the Code. If you examine what Professor Loss has been saying time after time, he feels that we are bogged down in a morass of securities law, a thicket from which nobody can emerge. I practice every day in the field of corporate securities law, and I feel that it *is* manageable, that it is a coherent body of law that is relatively uncomplex in our complex society. I do not have a problem dealing with it. I think that his whole idea that we need a Code is a straw man.

Question: I would like to get back to your point on the Commission's power to suspend trading summarily. It is true that the Code section you cited would remove the ten-day limitation on that power. But section 1817(b)(5) states that there has to be an opportunity for a hearing within 15 days on whether that order should be vacated,[78] so it is not quite so harsh as you make it. The Commission would have to give the issuant prompt notice of the summary order and of an opportunity of a hearing within 15 days after the day of its issuance.[79] They are in pea soup, even in the worst case, for a few days, but they do have a chance for a hearing within a reasonably prompt time. This is arguably so even in the case of ongoing fraud.

Mr. Lowenfels: There are a number of answers to that. One is that you can not always prepare for a hearing within 15 days, for these things often take much longer. More importantly the

78. ALI FED. SEC. CODE § 1817(b)(5) (1978).
79. *Id.*

stigma of an article in the Wall Street Journal is almost as bad as being suspended from the "one-year registrant" status. It is going to affect your relationship with your banks and your customers.