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The Securities Exchange Commission

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THE SECURITIES EXCHANGE COMMISSION

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The Securities and Exchange Commission was established by the Securities Exchange Act of 1934¹ after the Securities Act of 1933² had been administered for a year by the Federal Trade Commission. Since its establishment, it has been given a wide range of responsibilities in the field of securities regulations.³ This article will examine the more important developments in this field during the 1960s.

I. GROWTH OF SEC RESPONSIBILITIES

In order to appreciate the nature of some of the problems that the SEC encountered during the decade, it is necessary to examine the changes in the securities markets over that period. Perhaps the most impressive growth statistics over the past ten years have been those

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¹ 15 U.S.C. §§ 78a-hh (1964).

² 15 U.S.C. §§ 77a-aa (1964).

³ The Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 et seq. (1964); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbb (1964); the Investment Company Act of 1940, 15 U.S.C. § 80a (1964); and the Investment Advisors Act of 1940, 15 U.S.C. § 80b et seq. (1964). The SEC also acts in an advisory capacity under the corporate reorganization provisions of Chapter X of the Bankruptcy Act, 11 U.S.C. § 572 et seq. (1964).

relating to the stock exchanges. On December 31, 1959 the aggregate value of all stock listed on exchanges was \$338.4 billion.⁴ On December 31, 1967 this figure had grown to \$652 billion,⁵ an increase of over 130 percent. During the year ending June 30, 1960, the transactions on all exchanges involved 1.457 billion shares and a dollar volume of \$47.795 billion.⁶ During the year ending December 31, 1968, the number of shares traded had increased to 5.312 billion shares involving \$196.4 billion,⁷ an increase in number of shares traded of almost 250 percent. This growth not only increased the volume of work for the Commission, but also caused certain mechanical difficulties in the operation of the stock markets which will be examined later in this article.

In addition to the supervision of trading on exchanges, the SEC must regulate the activities of brokers and dealers in the over-the-counter market. On June 30, 1968 there were 4,397 broker-dealers who were registered under the Securities Exchange Act of 1934.⁸ In contrast to the marked increase in volume of trading, these are substantially fewer registrants than there were in 1960, when 5,288⁹ broker-dealers were registered. It is estimated that there are about 125,000 registered representatives connected with these broker-dealers.¹⁰ Although no comparative figures are available, this is unquestionably a much larger number than would appear in 1960, if for no other reason than the recent expansion of the life insurance companies into the mutual fund and variable annuity fields. There are no available statistics as to the volume of transactions in the over-the-counter market and it is impossible to trace the growth of such activities. However, there is little doubt that such statistics, if available, would show substantially the same growth as do the statistics for exchange transactions.

II. ADMINISTRATIVE AND GUIDANCE PROCEDURE

A. *Registration Statements*

Under the Securities Exchange Act of 1934, the SEC is required to police registration statements of securities traded on the exchanges and over-the-counter markets.¹¹ One of the principal duties of the Commission is to insure that the registration statements filed with

⁴ 26 SEC Ann. Rep. 68 (1960).

⁵ 34 SEC Ann. Rep. 183 (1968).

⁶ 26 SEC Ann. Rep. 69 (1960).

⁷ Information supplied to the author by the SEC staff.

⁸ 34 SEC Ann. Rep. 79 (1968).

⁹ 26 SEC Ann. Rep. 89 (1960).

¹⁰ Information supplied to the author by the SEC staff.

¹¹ 15 U.S.C. § 78j(g)(1) (1964).

it are truthful and complete.¹² Such statements, with certain exceptions,¹³ must be filed by every corporation whose securities are to be offered for sale to the public, and must contain such corporate information as the statute and the SEC rules describe as material and necessary to enable the proposed purchaser to make an informed investment decision. The increase in market activity has had a direct impact on the Commission's responsibility for registration statements. The tremendous growth during the decade in the volume of filings and securities trading greatly increased the pressure on the Commission and its staff, whose workload was already heavy in 1960. In the fiscal year ending June 30, 1960, there were 1,628 such registration statements filed with the SEC.¹⁴ This compares with a total of 4,706 filings in the fiscal year 1969.¹⁵ Not only did the number of statements which the SEC was called on to review show this very large increase, but the dollar amounts involved increased even more notably. The registration statements during the fiscal year 1960 involved only \$15.8 billion while the comparable figure for fiscal 1969 was \$86.9 billion.¹⁶ The SEC is also concerned with the registration of investment companies, including open-end investment companies, that is, mutual funds. During the fiscal year ending June 30, 1960, there were 570 such companies registered, having assets with an estimated market value of \$23.5 billion.¹⁷ At the end of the fiscal year 1968, there were 967 such companies and the market value of the assets had increased to \$69.7 billion.¹⁸

The increased volume of registration statements has resulted in problems in processing these statements. The 1933 Act provides that registration statements become effective on the twentieth day after filing the statement or twenty days after the final amendment to the statement.¹⁹

By 1960 the practice of reviewing each registration statement and furnishing a letter to the issuer detailing the amendments which would be required before the registration statement could become effective had become traditional in the operation of the SEC. This time limitation has put the Commission's staff under a tremendous burden because of the large number of registration statements filed. Consequently, the Commission has decided that positive assurance of the facts reported

¹² See 15 U.S.C. § 78l(a)-(e) (1964); 15 U.S.C. §§ 77e-77h (1964).

¹³ 15 U.S.C. §§ 77c-77d (1964).

¹⁴ 26 SEC Ann. Rep. 35 (1960).

¹⁵ Information supplied to the author by the SEC staff.

¹⁶ 26 SEC Ann. Rep. 35 (1960). The 1969 figure was supplied to the author by the SEC staff.

¹⁷ 26 SEC Ann. Rep. 168-69 (1960).

¹⁸ 34 SEC Ann. Rep. 115 (1968).

¹⁹ 15 U.S.C. § 77h (1964).

would involve so great an undertaking in time and money as to impede business financing by a public sale of securities.²⁰ Thus, the Commission has streamlined its registration procedures in a number of respects and generally will notify the registrant only when the statement is unnecessarily long, complex or verbose or otherwise presents serious problems.²¹

Some observers feel that the Commission's modification of its routines to provide more streamlined procedures to cope with the increased volume of work has been at the expense of its traditional effectiveness. A management survey conducted by independent consultants in 1960 recommended to Congress that the Commission needed, at that time, additional manpower to prevent deterioration of its regulatory standards.²² In the decade since this report was issued and in the face of the rapid expansion of the securities industry, Congress has not aided the Commission by increasing budget allocations. In fiscal 1960 the Commission's budget called for a total of \$8,100,000 encompassing 954 positions.²³ For the fiscal year 1969 the budget was \$17,830,000 encompassing 1,303 positions²⁴—a staff smaller than the 1,468 positions provided in the 1964 budget.²⁵

B. *Development of Regulation of Exchanges*

Prior to the 1960s, there was relatively little tendency on the part of the SEC to interfere with the machinery of the stock exchanges even though the Commission has considerable power to do so under the 1934 Act.²⁶ However, in 1960 an investigation by the SEC into the activities of some of the members of the American Stock Exchange disclosed that the self-regulation of at least that exchange left a great deal to be desired.²⁷ The situation in the American Exchange was rectified by a negotiated reorganization, whereby a new constitution was adopted significantly modifying the administrative procedures of the Exchange. This reorganization tightened the requirements for listing

²⁰ SEC, Work of the SEC 4 (1969).

²¹ SEC Securities Act Release No. 4934 (Nov. 21, 1968), CCH Fed. Sec. L. Rep. ¶ 77,627. See also SEC Securities Act Release No. 4936 (Dec. 9, 1968), CCH Fed. Sec. L. Rep. ¶ 77,636; SEC Securities Act Release No. 4475 (April 3, 1962), CCH Fed. Sec. L. Rep. ¶¶ 3925-27, 4507.04.

²² See 27 SEC Ann. Rep. 6 (1961).

²³ 26 SEC Ann. Rep. 226 (1960).

²⁴ 34 SEC Ann. Rep. 173 (1968).

²⁵ 30 SEC Ann. Rep. 161 (1964).

²⁶ 15 U.S.C. § 78f (1964).

²⁷ SEC, Staff Report on Organization, Management and Regulation of Conduct of Members of the American Stock Exchange 53 (1962) concludes:

There can be little doubt that in the case of the American Stock Exchange the statutory scheme of self-regulation in the public interest has not worked out in the manner originally envisioned by Congress.

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companies on the Exchange, placed greater restrictions on the specialists,²⁸ and required that listed companies solicit proxies for all shareholders' meetings and publish quarterly earning reports.²⁹

Negotiations between the exchanges and the SEC are continuing and a number of important changes in the procedures of the exchanges have been effected. One such change involved the abolishment of customer-directed give-ups,³⁰ and the institution of a minimum commission scale, under which the seller of a very large block of stock is charged a smaller commission per share than is charged for smaller transactions.³¹

Another problem which arose more recently involved the previously noted increase in the volume of trading during the decade. This increase caused very serious delays in brokers' deliveries of securities traded (known technically as "fails") and in brokers' bookkeeping entries. These delays often result in substantial inconvenience or damage to the public customers. Various steps were taken by the exchanges and by the SEC to reduce such delays. Thus, the exchanges have shortened the time during which they are open,³² and the SEC has labelled as fraudulent the activities of a dealer who is aware that he cannot make delivery or payment within a reasonable time because of delays caused by administrative difficulties.³³ The Commission has imposed sanctions in some cases, and has exerted constant pressure on the broker-dealers in formal and informal statements.³⁴ While it cannot be said that the problem has been solved, both the SEC and

²⁸ Specialists are floor traders who generally deal in one security. Their function is to assure an orderly market in that security by matching purchasers and sellers.

²⁹ See SEC Securities Exchange Act Release No. 7774 (Dec. 30, 1965), CCH Fed. Sec. L. Rep. ¶ 77,316. See also SEC Securities Exchange Act Release No. 7566 (April 8, 1965), CCH Fed. Sec. L. Rep. ¶ 77,226, which extended proxy rules to the over-the-counter market.

³⁰ On Dec. 5, 1968, the national exchanges adopted rules abolishing customer-directed give-ups. This give-up procedure involved permitting a customer to direct payment of part of a broker's commission to another broker. See letter from Robert W. Haack (President of the New York Stock Exchange) to Manuel F. Cohen (Chairman of the SEC), Nov. 19, 1968, reprinted in [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,631. See also SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968), CCH Fed. Sec. L. Rep. ¶ 77,523.

³¹ Letter from Robert W. Haack to Manuel F. Cohen, Aug. 8, 1968, reprinted in [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,585.

³² The SEC is given power to regulate the trading hours of the exchanges by 15 U.S.C. § 78s(b)(4) (1964). Prior to 1968 the hours for trading on the New York Exchange were from 10:00 A.M. to 3:30 P.M. After numerous measures were employed in 1968 to reduce these hours, in 1969 the Exchange reduced trading hours by an hour and a half by setting the trading hours from 10:00 A.M. to 2:00 P.M.

³³ SEC Securities Exchange Act Release No. 8363 (July 29, 1968), CCH Fed. Sec. L. Rep. 77,583.

³⁴ SEC Securities Exchange Act Release No. 8484 (Dec. 26, 1968), CCH Fed. Sec. L. Rep. ¶ 77,648.

the exchanges, prodded by the SEC, have substantially reduced delays and are studying possible improvements in the exchange machinery to conform with the structure of modern business. It is impossible to foretell the direction which such improvements will take, since the problems are immensely intricate. The securities markets and the bookkeeping methods of the broker-dealers were designed to cope with the demands of business as it was conducted prior to 1960. There has, of course, been some utilization of computer techniques, but transferring and delivering the paper representing the tremendous volume of trades in today's market is extremely complex. The SEC is very much aware of these problems and is interested in protecting the position of the public investors. Thus, it is in constant contact with the exchange representatives working in this area. This is indicative of the increased concern of the SEC in the activities of the exchanges in the past ten years, and of the increased control exercised by the Commission over the exchanges.

C. *Member Firms*

Broker-dealers have, from time to time, become insolvent to the detriment of their customers. The SEC and the exchanges have stringent rules regarding a broker-dealer's capital position,³⁵ which they apply in unscheduled audits. Nevertheless, failures do occur, and prior to 1960 the customers had to rely upon the actions of the bankruptcy court.

A member firm of the New York Stock Exchange, Ira Haupt, developed serious financial problems in 1963, and its customers were faced with heavy losses. The Exchange came to the rescue and made payments totalling \$12 million to Haupt's customers.³⁶ Shortly thereafter the Exchange established a trust fund, and the policy is now firmly established that a New York Stock Exchange customer is protected from financial loss by reason of a member firm's insolvency. The New York Exchange has recently indicated that the trust fund will be increased from the present level of \$25.9 million to \$100 million.³⁷

III. STATUTORY AND RULE CHANGES

A. *The Special Study*

The rapid growth and changing nature of the securities market during the years after the Commission's formation made many stat-

³⁵ Basically these rules require that the indebtedness of the broker-dealer not exceed 20 times his net assets (assets minus liabilities), see 17 C.F.R. § 240.15c3-1 (1969).

³⁶ Information supplied to the author by the New York Stock Exchange.

³⁷ Wall Street Journal, May 1, 1970, at 4, col. 3.

utory and rule changes necessary. It became clear, however, that before any major changes could be instituted by the Commission, a detailed analysis of the securities markets and the Commission itself had to be undertaken. Probably the most important development in the field of securities regulation during the past decade was the *Special Study of the Securities Markets* which was authorized by Congress early in September, 1961.³⁸ A number of factors contributed to the institution of this study, but behind them all was the realization, which the SEC managed to convey to Congress, that it had too little information and data in its files regarding the securities industry. Without such data, no meaningful analysis preliminary to amendment of the six statutes administered by the SEC was possible. The Commission therefore decided to undertake a special study of the securities industry. As soon as the enabling act was effective, the Commission retained Milton H. Cohen as director, who was assisted by a staff averaging about 65 persons—some retained specially and some borrowed from the regular personnel of the Commission. This study resulted in a monumental report³⁹ which ran to over 3,000 pages of text, charts, tables, and data, the first chapters of which were sent to Congress on April 3, 1963.

The report of the *Special Study* made numerous recommendations in connection with many of the activities of the securities business and the SEC. It suggested some legislation and made recommendations regarding many of the SEC rules and numerous other reforms of one type or another. The *Study* placed special emphasis on the activities of broker-dealers, and recommended that a system of licensing and registering brokers and other personnel be implemented to assure a continuous record of background information and other qualifications.⁴⁰ The *Study* also recommended that broker-dealers be regulated and supervised by internal regulations of exchange members⁴¹ and by requiring them to join self-regulatory groups as a prerequisite of registration.⁴² A final recommendation of the *Special Study* relating to broker-dealers was that the New York Stock Exchange establish standards governing the representations of the quality of a member's research and advisory departments to prevent irresponsible and deceptive representations.⁴³

Other of the many important recommendations of the *Special*

³⁸ See 15 U.S.C. § 78s(d) (1964).

³⁹ SEC, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 85th Cong., 1st Sess. pts. 1-5 (1963) [hereinafter cited as *Special Study*].

⁴⁰ *Special Study* pt. 5, at 46-47.

⁴¹ *Id.* at 45-46.

⁴² *Id.* at 54.

⁴³ *Id.* at 59-60.

Study include: (1) a proposal to establish rules to prevent artificially high premiums on primary issues,⁴⁴ (2) a proposed rule to assure that specialists maintain an orderly market,⁴⁵ (3) the abolishment of floor traders,⁴⁶ (4) a proposal to increase the Federal Reserve Board's control over margin requirements,⁴⁷ and (5) a proposal to improve the New York Stock Exchange by extending voting rights to "allied" members rather than limiting them to "seat" members.⁴⁸ Undoubtedly, the *Special Study* is the most comprehensive examination ever undertaken of the securities market and has influenced the activities of the Commission during the decade.

B. *The 1964 Amendments*

The *Special Study* recommended amendments to expand the coverage of the Securities Acts in the over-the-counter security market.⁴⁹ The first step in the implementation of the *Study's* recommendations came in 1964 when Congress enacted a bill containing numerous amendments to the 1934 Act.⁵⁰ These amendments had two important goals. Before these amendments, the requirements under the 1934 Act for registration statements,⁵¹ periodical reports,⁵² proxy statements,⁵³ and reports of beneficial stock ownership by directors, officers and 10-percent shareholders⁵⁴ were not fully applicable to securities traded in the over-the-counter market. The first important aspect of the amendments was to make these provisions applicable to issuers with total assets over one million dollars and more than 500 shareholders whose securities are traded in the over-the-counter market.⁵⁵

⁴⁴ *Id.* at 87.

⁴⁵ *Id.* at 88.

⁴⁶ *Id.* at 97.

⁴⁷ *Id.* at 159-60.

⁴⁸ *Id.* at 183.

⁴⁹ *Id.* at 151-56.

⁵⁰ Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).

⁵¹ 15 U.S.C. § 78l (1964).

⁵² 15 U.S.C. § 78m (1964).

⁵³ 15 U.S.C. § 78n (1964).

⁵⁴ 15 U.S.C. § 78p (1964).

⁵⁵ 15 U.S.C. § 78l(g) (1964), amending 15 U.S.C. § 78l (1964); 15 U.S.C. § 78n, formerly ch. 404, § 14, 48 Stat. 895 (1934); 15 U.S.C. § 78p (1964), formerly ch. 404, § 16, 48 Stat. 896 (1934). The purpose of the amendments relating to over-the-counter markets was to:

(1) Extend to issuers of securities traded in over-the-counter markets, where the issuers have over \$1 million in total assets and 750 stockholders of record (reduced to 500 after 2 years), the same requirements that now apply to issuers of securities which are listed on an exchange, namely:

(a) Registration requiring disclosure of certain information about the issuer including financial statements (sec. 12);

(b) Periodic reporting (sec. 13);

(c) Information, including financial statements, to accompany proxy solicitation; or if no solicitation, equivalent information to be supplied (sec. 14);

The second aim of the amendments was to strengthen the power of the Commission to impose qualification standards and disciplinary control upon over-the-counter brokers or dealers. This was accomplished by numerous amendments to Sections 15 and 15A of the 1934 Act.⁵⁶ The amendments gave the Commission power to register a broker, dealer or any person "associated with" such broker or dealer,⁵⁷ and to assure that brokers or dealers and all persons associated with them meet appropriate standards of training and experience.⁵⁸ The Commission was also empowered to censure, suspend, or revoke the registration of a broker or dealer,⁵⁹ and to censure, bar or suspend any person associated with a broker or dealer.⁶⁰ Finally, the amendments relating to brokers or dealers expanded the Commission's power over securities dealers associations by requiring qualification standards for membership,⁶¹ and by providing Commission review of disciplinary actions by these associations against their members.⁶² In short, the amendments greatly expanded the Commission's controls over brokers or dealers and their associates.⁶³

(d) Reporting of changes in stockholdings in an issuer by officers, directors, or 10-percent stockholders of the issuer, and making any short-term profits resulting from transactions in the stock subject for a period of 2 years to recapture by the issuer (sec. 16).

H.R. Rep. No. 1418, 88th Cong., 2d Sess. 2 (1964).

⁵⁶ 15 U.S.C. §§ 78o, 78o-3 (1964), amending ch. 404, § 15, 48 Stat. 895 (1934) & ch. 677, § 1, 52 Stat. 1070 (1938).

⁵⁷ 15 U.S.C. §§ 78o(a)(1)-(b)(1) (1964).

⁵⁸ 15 U.S.C. § 78o(b)(8) (1964).

⁵⁹ 15 U.S.C. § 78o(b)(5) (1964).

⁶⁰ 15 U.S.C. § 78o(b)(7) (1964).

⁶¹ 15 U.S.C. § 78o-3(b)(5) (1964).

⁶² 15 U.S.C. § 78o-3(g) (1964).

⁶³ The House Report on the amendments describes them as an attempt to: Strengthen the regulation of over-the-counter broker-dealers, including qualifications, standards and disciplinary controls by:

(a) Requiring such association [the National Association of Security Dealers] to establish standards of training, experience, and competence for members and employees, and capital requirement for members;

(b) Permitting the Commission, and the securities association in a disciplinary action to proceed directly against an employee of a broker-dealer, in lieu of against the firm, and permitting the Commission to employ sanctions, such as suspension, short of revoking registration;

(c) Requiring that registered securities associations must have rules designed to produce fair and informative retail quotations for unlisted securities;

(d) Broadening of the Commission's power to alter or supplement association rules relating to organization, discipline, and eligibility for membership eliminating in the case of registered broker-dealers the necessity for proving that the mails and instrumentalities of interstate or foreign commerce were used in a particular prohibited transaction; authorizing a registered association to adopt rules under which it might exclude from membership persons who had been suspended or expelled from a national securities exchange; shortening the period for appeals to the Commission from action taken by a registered securities association from 60 to 30 days;

The enactment of these amendments had a profound effect on the SEC and the securities industry—an effect which is still being felt in Washington and on Wall Street. One obvious result was to remove the incentive of many issuers to refrain from listing their securities on an exchange, since under these amendments the unlisted issuers are subject to almost the same disclosure requirements as the listed issuers. Another important result has been to pinpoint responsibility for broker-dealer shortcomings, and to strengthen the self-regulatory position of the National Association of Securities Dealers. The most significant result, however, has been a rather indirect but nonetheless effective increase in the regulatory power of the SEC over the entire securities industry.

C. *The Wheat Report*

For many years there has been great dissatisfaction among individuals dealing with the Securities Acts concerning the relationship of the private offering exemption⁶⁴ to the concept of control under the 1933 Act,⁶⁵ and concerning the lack of unity between the requirements for disclosure under the Securities Act of 1933 and those under the Securities and Exchange Act of 1934. The underlying theory of both Acts as originally enacted was to compel "full disclosure" of corporate affairs, and both Acts have specific provisions for this purpose, although there was little or no coordination between them.

While the dissatisfaction with the Acts' discrepancies was adequately expressed when the reporting requirement of the 1934 Act applied only to listed securities, it became even more intense when the 1964 Amendments brought many more corporations under SEC control. Therefore, responding to the suggestions of the Bar, the SEC, under the leadership of Commissioner Francis Wheat, attempted to find methods of administratively settling these problems. This committee filed its report with the Commission in 1968, making some scholarly, logical recommendations for rule changes which would do away with much of the uncertainty and complexity which have plagued practitioners under the Securities Acts from the time of their adoption,

(e) Granting the Commission power to regulate brokers and dealers who choose not to become members of registered securities associations in order to insure that all brokers and dealers will be subject to the expanded regulation provided by this act either through a registered association which they voluntarily join or alternatively by the Commission itself.

H.R. Rep. No. 1418, 88th Cong., 2d Sess. 2-3 (1964).

⁶⁴ 15 U.S.C. § 77d(2) (1964) exempts "transactions by an issuer not involving any public offering" from the registration requirements of 15 U.S.C. § 77e (1964).

⁶⁵ 15 U.S.C. § 77b(11) (1964) places a person having a controlling stock interest in the position of an issuer thus making the controlling shareholder subject to the requirements of registration in 15 U.S.C. § 77e (1964).

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and which would encourage the widespread dissemination of the information required to be filed under the 1934 Act.

"The Study determined to explore what could be done within the '33 and '34 Acts as they presently exist,"⁶⁶ because the Commission was certain that complete statutory reform would take many years. The *Wheat Report* contained 61 specific recommendations as to rule changes and procedure modifications. Some of the more important recommendations are those regarding prospectuses, the small offering exemption, the underwriter and control provisions of Section 2(11) of the 1933 Act⁶⁷ as they affect the registration exemption of Section 4(2) of the 1933 Act,⁶⁸ and registration requirements.

The *Report* recommends that the content of prospectuses required by the 1933 Act⁶⁹ be expanded to include the sales and earnings of "separate lines of business," a statement of the sources and uses of funds, and a statement indicating management's background and experience.⁷⁰ In addition, the *Report* recommends that unreasonably long, complex or verbose prospectuses not be commented upon or approved by the Commission as is presently the case with registration statements,⁷¹ and that long prospectuses contain summarized information regarding the issuer.⁷²

Under Section 3(b) of the Securities Act of 1933,⁷³ the Commission is given discretion to exempt securities from the registration requirements of the 1933 Act⁷⁴ if the amount of the offering is less than \$300,000. The *Wheat Report* recommends that this provision be made less restrictive by adopting various changes in Regulation A governing the small offering exemption.⁷⁵ The effect of these amendments would be to allow a person who is not the issuer or an "affiliate" to resell less than \$100,000 of the securities if held less than one year.⁷⁶

A very important recommendation attempts to clarify the test employed in determining who is an underwriter under Section 2(11) of the 1933 Act.⁷⁷ The restriction placed on the marketability of stock

⁶⁶ SEC, *Disclosure to Investors—A Reappraisal of Administrative Policies under the '33 and '34 Acts* (1969) [hereinafter cited as *Wheat Report*].

⁶⁷ 15 U.S.C. § 77b(11) (1964).

⁶⁸ 15 U.S.C. § 77d(2) (1964).

⁶⁹ 15 U.S.C. § 77j (1964).

⁷⁰ *Wheat Report* 89-94.

⁷¹ See SEC Securities Act Release No. 4934 (Nov. 21, 1968), CCH Fed. Sec. L. Rep. ¶ 77,627.

⁷² *Wheat Report* 80-81.

⁷³ 15 U.S.C. § 77c(b) (1964).

⁷⁴ 15 U.S.C. §§ 77e-77h (1964).

⁷⁵ 17 C.F.R. §§ 230.251-262 (1969).

⁷⁶ *Wheat Report* 301-04.

⁷⁷ 15 U.S.C. § 77b(11) (1964).

by the definitions of that section adopted by the SEC⁷⁸ and the courts⁷⁹ caused a great deal of uncertainty and confusion in dealing with control stock and stock which was originally sold in a nonpublic offering under Section 4(2) of the 1933 Act.⁸⁰ This problem arose primarily because the definition of underwriter in section 2(11) includes a person purchasing "with an intent to participate in a distribution," thus establishing a subjective test of intent which is difficult to administer. The *Wheat Report* recommended a number of rule changes to clarify such problems arising in secondary distributions.⁸¹ For example, the *Report's* proposed rule 163⁸² would establish an objective test of intent by specifying those situations in which a person would be considered an underwriter.⁸³

A final recommendation of the *Report* was a proposal to interrelate the disclosure provisions of the 1933 and 1934 Acts. Thus the *Report* recommends that if there has not been full disclosure of a company's business earnings and financial conditions under Sections 13 or 15(d) of the 1934 Act,⁸⁴ then a sale to the public should be subject to the same disclosure provisions required for registration statements under the 1933 Act.⁸⁵ Conversely, if a security is registered under Section 13 of the 1934 Act, then secondary sales to the public with certain exceptions should be allowed without imposing the registration requirements of the 1933 Act.⁸⁶ To implement such a rule, the *Report* also noted that safeguards must be adopted to prevent the sale to the public of unregistered securities by utilizing a private purchaser. Thus in a private placement, the private purchaser would be required to hold unregistered securities for one year⁸⁷ unless the transaction is exempted under Section 3 of the 1933 Act.⁸⁸

Although these recommendations are greatly oversimplified here, the effect of the proposals relating to registration is to establish an objective test upon which an issuer, private purchaser or controlling stockholder can rely to determine whether a distribution or sale vio-

⁷⁸ See, e.g., SEC Securities Act Release No. 3825 (Aug. 12, 1957), CCH Fed. Sec. L. Rep. ¶¶ 2165.15, 2850.25, 2850.81.

⁷⁹ See, e.g., *Gilligan Will & Co. v. SEC*, 267 F.2d 461, 468 (2d Cir. 1959).

⁸⁰ 15 U.S.C. § 77d(2) (1964).

⁸¹ *Wheat Report* 152-247.

⁸² *Id.* at 203-05.

⁸³ "The test of Rule 163 is an objective one. Its components . . . have been defined by other rules. It will not be necessary to prove that a person lacked investment intent in order to find that he is an underwriter of securities" *Id.* at 204.

⁸⁴ 15 U.S.C. §§ 78m, 78o(d) (1964).

⁸⁵ 15 U.S.C. § 77g (1964).

⁸⁶ *Wheat Report* 19-20.

⁸⁷ *Id.* at 21-23.

⁸⁸ 15 U.S.C. § 77c (1964).

lates Section 5 of the 1933 Act.⁸⁹ The *Wheat Report* has been accepted by the Commission, and if its recommendations are adopted, the decade of the 1970s could see a profound change in the administration of the Securities Acts.

D. *Proposed Mutual Fund Legislation*

Shortly before the 1960s, a study of the mutual fund industry was commenced by the Wharton School of Finance. This study was filed with the Commission in 1962.⁹⁰ Certain aspects of this industry were also reviewed by the *Special Study*.⁹¹ After these two reports had been completed, the Commission submitted an extensive report on mutual funds to Congress.⁹² This report analyzed the Investment Company Act of 1940⁹³ and concluded that it had prevented the most serious abuses by mutual funds.⁹⁴ However, the report indicated that amendments were needed to assure the reasonableness of management fees and sales charges.⁹⁵ In May, 1967, the Commission submitted a bill to Congress recommending amendments to the Investment Company Act.⁹⁶

In general, the proposed bill seeks to insure that management fees, including salaries of the directors of the fund, will be reasonable by leaving the determination of reasonableness to the courts. In addition, the proposed bill would have a profound effect on sales charges, particularly the fund's use of a front-end load, whereby the bulk of the sales charges are collected during the first year of an installment payment program. The proposed bill would provide for a maximum sales charge of 5 percent of the market value of the fund shares purchased, but the Commission would have the power to set higher charges. The bill also would abolish the front-end load by requiring that all sales charges be spread equally over all installments.⁹⁷ The mutual fund industry has rather violently and so far successfully opposed some of the proposed amendments,⁹⁸ and at this writing the future of the proposals is uncertain. Clearly, however, some regulation is needed to correct the existing abuses.

⁸⁹ 15 U.S.C. § 77e (1964).

⁹⁰ H.R. Rep. No. 2274, 87th Cong., 2d Sess. (1962).

⁹¹ Special Study 63.

⁹² SEC, Report on the Public Policy Implications of Investment Company Growth (1966), reprinted as H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as *Investment Co. Report*].

⁹³ 15 U.S.C. § 80a (1964).

⁹⁴ *Investment Co. Report* 13.

⁹⁵ *Id.* at 21.

⁹⁶ The text of the bill appears in Hearings on S. 1959, Sen. Comm. on Banking & Currency, 90th Cong., 1st Sess., pt. 2, app. 1,897 (1967).

⁹⁷ *Id.* pt. 1, at 21-41.

⁹⁸ *Id.* at 186, 372.

E. Regulation of Floor Traders and Specialists

Two of the areas which were the particular targets for investigation by the *Special Study* were the activities of floor traders and specialists on the exchanges. The *Special Study* report included specific proposals to abolish almost all floor traders and more closely regulate specialists.⁹⁹ As a result of extended discussions between the SEC and the exchanges, the SEC promulgated rules under Section 11 of the 1934 Act¹⁰⁰ requiring the exchanges to adopt rules radically changing their approach to these two problems. The rule governing floor trading prohibits such trading with exceptions for specialists, odd-lot dealers and arbitrage transactions.¹⁰¹ The rule governing specialists requires national securities exchanges to establish registration requirements and rules regulating specialists' transactions.¹⁰² The rule also empowers the Commission to suspend specialists for violations of exchange rules or failure to maintain an orderly market.¹⁰³

In practice, the exchange rules which the SEC insisted upon all but abolished floor trading and have materially improved the exchange standards governing the activities of specialists. In fact, there were only about 30 floor traders on the New York Stock Exchange after the adoption of these rules as compared with 300 or more in prior years.

F. Regulation of Tender Offers

At the opening of the 1960s the general procedure for a person who wanted control of a corporation because he was dissatisfied with the management or for some other reason was to start a proxy contest in an attempt to oust the incumbent directors by convincing the shareholders to vote for a new slate of directors. This was always a highly speculative course of action because the stockholders almost always prefer the known management to the unknown, and because a proxy fight is far more expensive for the interloper than for the entrenched management since the latter can use the corporate treasury to finance a proxy battle. It should also be noted that the interloper adopting this course of action had nothing to show for his time and money if his slate of directors was defeated. Comparative statistics show the difficulty which non-management persons have had in proxy contests. In the year ending June 30, 1960, there were 25 proxy contests.¹⁰⁴ Non-management persons were unsuccessful in all 12 completed con-

⁹⁹ Special Study 87-91, 97-98.

¹⁰⁰ 15 U.S.C. § 78k (1964).

¹⁰¹ 17 C.F.R. § 240.11a-1 (1969).

¹⁰² 17 C.F.R. § 240.11b-1(a) (1969).

¹⁰³ 17 C.F.R. § 240.11b-1(b) (1969).

¹⁰⁴ 26 SEC Ann. Rep. 88 (1960).

tests involving control of the board of directors, and in the 9 cases where non-management personnel sought representation on the board of directors, management retained all directorships in 7 elections.¹⁰⁵ The results were no better later in the decade. During the fiscal year ending June 30, 1968, non-management persons won control in only one of twelve completed elections.¹⁰⁶

As the futility of a proxy fight became more evident, the corporate raiders turned from proxy fights to tender offers of cash, securities or of some combination of the two. Naturally, if the raider could raise the money, he would prefer the cash offer since a registration statement covering any securities he offered in exchange for the target company's stock would not be required. Even if the effort to obtain control in this manner is unsuccessful, the offeror, unlike the proxy contestant, is left with a substantial block of stock, upon which, if his estimates of the corporation's potential are accurate, he can realize a handsome profit.

The almost universal failure of persons making cash tender offers to make public any material information as to their reasons for making the offer or any of the other details of the offer raised grave questions in the minds of the SEC and Congress as the practice became more prevalent. Thus, in 1968 Congress amended Sections 13 and 14 of the 1934 Act¹⁰⁷ and the SEC adopted rules thereunder¹⁰⁸ to control tender offers. These provisions now require persons who have acquired on the open market 10 percent or more of the stock of a company registered under Section 12 of the 1934 Act,¹⁰⁹ or those making tender offers to the shareholders, to file information with the SEC disclosing the plans and intentions of the persons filing, the personalities involved, and the details of the tender offer. Certain other limitations were placed on tender offers, such as requiring a withdrawal privilege for the offeree,¹¹⁰ a pro rata acceptance by the offeror,¹¹¹ and an equal price treatment to all offerees.¹¹²

Since the enactment of this legislation and the adoption of the rules thereunder, there have been a number of such takeover bids, some of which have been bitterly contested in the courts.¹¹³ In one

¹⁰⁵ Id. at 88-89.

¹⁰⁶ 34 SEC Ann. Rep. 42 (1968).

¹⁰⁷ 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (Supp. IV, 1969), amending 15 U.S.C. §§ 78m, 78n (1964).

¹⁰⁸ 17 C.F.R. §§ 240.13d-1, .14d-1 (1969).

¹⁰⁹ 15 U.S.C. § 78l (1964).

¹¹⁰ 15 U.S.C. § 78n(d)(5) (Supp. IV, 1969).

¹¹¹ 15 U.S.C. § 78n(d)(6) (Supp. IV, 1969).

¹¹² 15 U.S.C. § 78n(d)(9) (Supp. IV, 1969).

¹¹³ See, e.g., *Electronics Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969).

recent case, *Susquehanna Corp. v. Pan American Sulphur Co.*,¹¹⁴ Susquehanna alleged that Pan American Sulphur (PASCO) failed to disclose, as required by section 13(d), that it sought control of Susquehanna's board of directors.¹¹⁵ The court rejected this contention since PASCO had stated in the tender offer that it desired working control of Susquehanna to operate it as a subsidiary. The court indicated that a reasonable stockholder or investor would realize that Susquehanna "intended to exercise strong control over [PASCO]."¹¹⁶ The court held, moreover, that although sections 13(d) and 14(d) require the offeror

fairly to disclose its plans in the event of a takeover, it is not required to make predictions of future behavior which may cause the offeree or the public investors to rely on them unjustifiably.¹¹⁷

Although the law is too new to establish concrete standards, it is clear that the courts may require only full and fair disclosure of possible or probable actions to be taken if the tender offer is successful, rather than exact specificity.

G. *Developments in Accounting Rules*

One of the most important effects of the Securities Acts was to introduce responsible accounting practices into corporate financial statements and reports. The SEC was given plenary power over such accounting methods in both the 1933 Act¹¹⁸ and the 1934 Act,¹¹⁹ and it has specified in some detail the form of the reports required to be filed.¹²⁰ In general, the Commission requires that such reports follow currently recognized accounting practices which truly reflect corporate financial conditions. In the past decade, this concern has been growing because of the increasing emphasis on full disclosure of all corporate affairs.

1. Product Line Accounting

Until 1960 most corporations kept records enabling them to determine whether their manufacturing operations in producing a given product were profitable, and were very careful not to expose such figures to the public. The general attitude of the reporting companies

¹¹⁴ Current CCH Fed. Sec. L. Rep. ¶ 92,610 (5th Cir. March 13, 1970).

¹¹⁵ 15 U.S.C. § 78m(d) (1964).

¹¹⁶ Current CCH Fed. Sec. L. Rep. ¶ 92,610, at 98,754.

¹¹⁷ *Id.* at 98,757.

¹¹⁸ 15 U.S.C. § 77s(a) (1964).

¹¹⁹ 15 U.S.C. § 78m(b) (1964).

¹²⁰ Regulation S-X, 17 C.F.R. § 210 (1969).

was that such breakdowns were valuable only for internal purposes, and that their publication would be interesting only to their competitors.

This attitude became increasingly widespread and met with increasing criticism by the SEC and by accountants as the tendency of large corporations to acquire unrelated businesses became more pronounced during the 1960s. Corporate diversification became the goal of a large number of entities controlling major aggregations of capital, not only among manufacturing and service corporations, but also among railroads and banks. In order to enable the public to analyze the effects of this diversification upon securities, the SEC, with the concurrence of the preponderance of the accountants, has adopted accounting rules requiring detailed information of the activities of subsidiaries and a separate profit and loss statement for subsidiaries contributing 10 percent or more to sales or earnings of diversified corporations.¹²¹

2. Equity Equivalents

Until shortly after 1960, the accounting problems raised by convertible securities¹²² were of relatively little importance to the financial community. There had been some use of the conversion feature, but general accounting practice did not require special treatment in financial reports indicating that the outstanding preferred stock or debentures could be converted into another security, and that their market price was largely dependent upon the price of the securities into which they could be converted.

In connection with the rash of corporate acquisitions which began in the 1960s, the acquiring companies in some instances utilized convertible securities in order either to offer them in exchange for the securities of the acquired company or to raise cash for the purpose of making such acquisition. The tax advantages to the issuer combined with an increasing awareness on the part of the investors of the advantages of convertible securities caused more corporations to use this method of raising capital. Since the financial community and investors attach great importance to the per share earnings on common stock and, in fact, continually study the per share price-earnings ratio¹²³ in arriving at the fair value of a given security, the SEC finally came to the conclusion that if the market price of the conver-

¹²¹ SEC Securities Act Release No. 4988 (June 14, 1969), CCH Fed. Sec. L. Rep. ¶ 77,729.

¹²² Convertible securities are preferred stock or debentures with fixed rates of return which are convertible into common stock during a specified time period for a specified price.

¹²³ The price-earning's ratio is the ratio of the price per share of the stock to the per share earnings of the corporation.

tible security was heavily influenced by the conversion feature, the per share earnings should be computed on the assumption that the convertible security was completely converted into the underlying security.¹²⁴

3. Merger Accounting

The rise of the corporate conglomerate has given birth to another problem—currently the subject of some rather acrimonious discussion among corporate managers and accountants—involving the proper treatment of the respective balance sheets of the merging corporations and of the resultant corporation. For many years, two radically different concepts of accounting for business combinations effected through exchange of stock have been considered acceptable by the accounting profession. Under “purchase accounting,” the fair value of the property or other consideration exchanged for the stock is accounted for in the proper asset item of the statements of the resulting enterprise. The difference between the total value of the consideration given and the value of the property acquired and so entered is then segregated and generally referred to as goodwill.

In “pooling of interests” accounting, the amounts at which assets and liabilities are recorded in the accounts of the predecessor companies are simply carried forward to the accounts of the continuing enterprise. As originally conceived, this technique had a rather limited application, but in the flurry of business combinations during the decade, the SEC and the accounting profession found that this method of accounting was in almost general use. The pooling of interests approach lends itself to a number of questionable uses since the fair value of the property at the date of acquisition is not reflected on the books. In 1963 and 1968, the American Institute of Certified Accountants published studies in which the pooling of interest concept was seriously criticized and the difficulties inherent in the purchase approach to the determination and amortization of accounting goodwill were analyzed.

The difficult problems in this controversy have not yet been settled. The entrepreneurs are vitally interested in preserving their earnings which, of course, would be decreased by amortization charges. On the other hand, the independent accountants and the SEC are equally anxious that the financial statements be accurate and not misleading. The eventual outcome of this controversy is at this point uncertain, but Commission action will undoubtedly be forthcoming.

¹²⁴ SEC Securities Act Release No. 4910 (June 18, 1968), CCH Fed. Sec. L. Rep. ¶ 77,567.

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H. *Variable Annuity Rules*

Prior to the 1960s, the SEC prevailed in the Supreme Court in its contention that variable annuities¹²⁵ issued by life insurance companies were securities subject to the Acts it was administering.¹²⁶ Having won this point, the Commission devoted the next few years to trying to fit such securities into its regulatory framework. After struggling with the problem and facing innumerable applications for exemptions from the Investment Company Act¹²⁷ as the insurance business edged into the mutual funds area, the Commission recently adopted new rules standardizing such applications for exemptions.¹²⁸

I. *Other Rule Changes*

The SEC has always been quite flexible in exercising its rule-making powers under the various acts. Thus, during the past decade it has been prompt to propose amendments to its rules whenever problems arose which could not be readily solved in any other way. It has also been increasingly sensitive to the criticism that it does not publish its administrative policies. In 1967 and 1968, for instance, it amended its proxy rules in numerous respects not only to make some desirable substantive changes, but also to include numerous accrued administrative interpretations.¹²⁹ Similarly, in 1968 it published new guidelines for drafting its registration Forms S1 (for general use by manufacturing, mercantile and service corporations) and S5 (for use by investment companies).¹³⁰

IV. DEVELOPMENTS IN CASE LAW.

Ever since their adoption the Securities Acts have been a fruitful source of litigation. This is most certainly true of the ten years just ended. Not only has the SEC been constantly in court as plaintiff or defendant, but civil actions where the SEC is not a party are commonly brought under the Acts. For example, by June 30, 1960 the

¹²⁵ A variable annuity is an annuity whose payout is fixed by the value of the equity securities in which the premiums are invested as they are paid. This differs from the traditional annuity whereby the insurer agrees to pay the annuitant a stated periodic sum after he reaches a given age.

¹²⁶ SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). See also SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

¹²⁷ 15 U.S.C. § 80a (1964).

¹²⁸ See SEC Investment Company Act Release No. 5738 (July 10, 1969), CCH Fed. Sec. L. Rep. ¶ 77,727. These rules specify the sections of the Investment Co. Act from which an issuer of variable annuities may be granted complete or partial exemption.

¹²⁹ SEC Securities Exchange Act Release No. 8206 (Dec. 14, 1967), CCH Fed. Sec. L. Rep. ¶ 77,507.

¹³⁰ SEC Securities Act Release No. 4936 (Dec. 9, 1968), CCH Fed. Sec. L. Rep. ¶ 77,636.

SEC had brought through the years 986¹⁸¹ injunctive proceedings in the district courts, principally under Section 20 of the 1933 Act¹⁸² and Section 27 of the 1934 Act.¹⁸³ This figure had grown to 1,648 by June 30, 1968¹⁸⁴ or an average of 83 cases a year from 1960 to 1968. It would extend this survey to unwarranted length to adequately describe all of the Securities Acts litigation reported over the past decade, and it must suffice to examine only the more important decisions to trace the most important developments.

A. 1933 Act Cases

Although many cases were brought in the 1960s under the 1933 Act,¹⁸⁵ only two were of particular significance. The outstanding development during the decade under the Securities Act of 1933 was unquestionably the decision in *Escott v. BarChris Const. Corp.*¹⁸⁶ Although the opinion in this case came as no particular surprise to sophisticated practitioners, and really did not establish any new or extraordinary principle, it did involve some well-known persons and was very effective in reminding the securities industry of the necessity for adequate care in the drafting of a prospectus. The case centered around an issue of debentures marketed by a bowling alley construction corporation and the defendants included some of the company's officers and directors, its lawyers, the underwriters and the company's auditor. After a careful analysis of the prospectus and the testimony, Judge McLean held that the prospectus contained materially false statements and omissions, and that all the defendants failed to sustain their burden of proving due diligence.¹⁸⁷ He also found that the damage suffered by the plaintiffs was not caused solely by factors other than the materially false statements and omissions,¹⁸⁸ and consequently found the defendants liable for damages.

The *BarChris* case resulted in a number of emphatic warnings through various media to lawyers and to the securities industry that anyone who signs a registration statement should assure himself that the statements made therein are accurate by independently checking its contents. Thus its primary importance was making corporate officers aware of their duty to assure full and fair disclosure.

¹⁸¹ 26 SEC Ann. Rep. 288 (1960).

¹⁸² 15 U.S.C. § 77t(b) (1964).

¹⁸³ 15 U.S.C. § 78aa (1964).

¹⁸⁴ 34 SEC Ann. Rep. 189 (1968).

¹⁸⁵ Professor Loss enumerates approximately sixty 1933 Act cases in 6. L. Loss, Securities Regulation 3820-24 (Supp. 1969).

¹⁸⁶ 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁸⁷ *Id.* at 683-703.

¹⁸⁸ *Id.* at 703-04.

In *Globus v. Law Research Serv., Inc.*,¹³⁹ a case which aroused somewhat less pothor, but which perhaps deserves more attention than it has thus far received, the court settled two problems which had for many years intrigued practitioners and commentators. This case involved a security issue allegedly exempt under Section 3(a) of the 1933 Act.¹⁴⁰ The jury in the lower court found that the offering circular was materially false, and that the underwriter knew this fact when it sold the issue. Consequently, the plaintiff was awarded compensatory and punitive damages.¹⁴¹ The court of appeals found that the power to impose punitive damages was not necessary to effectuate the purposes of the 1933 Act.¹⁴² The court also noted that Section 28(a) of the 1934 Act¹⁴³ confined the plaintiff to compensatory damages, and held that since the 1933 Act should be construed to be compatible with the 1934 Act, punitive damages should not be allowed in an action under the 1933 Act.¹⁴⁴ The case also upheld the long-standing contention of the SEC that an agreement by the issuer to indemnify the underwriter is contrary to public policy and unenforceable if the underwriter has "actual knowledge of the misstatement" and demonstrates "wanton indifference" to his obligations.¹⁴⁵

Aside from these two cases, the scope of the 1933 Act had been at least reasonably well-defined by 1960, and the reported cases have, in general, not established any particularly startling principles.

B. 1934 Act Cases

The 1933 Act is principally concerned with the original issuance of securities by corporations and their sale to the public, and would not be expected to generate as much important litigation as the 1934 Act, which deals with the purchase and sale of securities after their issue. The dollar amounts involved in even a relatively small original issue are apt to be astronomical, and extreme (and often expensive) care in its processing is the general rule. The 1934 Act, on the other hand, applies to all stock exchanges, all broker-dealers and all persons buying or selling securities. The 1934 Act, therefore, involves in one way or another every person who owns or comes into contact with a security.

¹³⁹ 418 F.2d 1276 (2d Cir. 1969).

¹⁴⁰ 15 U.S.C. § 77c(a) (1964).

¹⁴¹ *Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968).

¹⁴² 418 F.2d at 1284-85.

¹⁴³ 15 U.S.C. § 78bb(a) (1964).

¹⁴⁴ 418 F.2d at 1286.

¹⁴⁵ *Id.* at 1288-89.

1. Rule 10b-5

Probably the most important developments in the field of litigation involving the securities business during the 1960s occurred in litigation under Rule 10b-5 promulgated under the Securities and Exchange Act of 1934.¹⁴⁶ This rule, strangely enough, was originally drafted in 1942 merely to correct the inadvertent exclusion of sellers from the protection of the antifraud provisions in Section 17 of the 1933 Act.¹⁴⁷ The Rule is an antifraud proscription declaring it unlawful for a person buying or selling a security to misstate or fail to state any material fact or generally to indulge in any fraudulent activity regarding the transaction. Before the opening of the decade there had been a few cases, beginning with *Kardon v. National Gypsum Co.*,¹⁴⁸ holding that the defrauded buyer or seller could sue the other party to a securities transaction under this section by implying a civil remedy not expressly provided in the Act. The difficulties in applying this concept stemmed mainly from the fact that a purchaser (but not a seller) was given specific but restricted remedies under Section 12 of the 1933 Act,¹⁴⁹ while there were no such restrictions inherent in the implied cause of action under the 1934 Act. In discussing these cases, Professor Loss in his 1961 treatise observed that:

The danger, of course, is that the continued denigration of the buyers' expressed remedy under the 1933 Act in favor of Rule 10b-5 and even Section 17(a) of the 1933 Act itself may persuade the Supreme Court—which has yet to consider any implied remedy under SEC statutes—to throw its collective hands *up* and the *Kardon* doctrine out.¹⁵⁰

At the present writing, although the Supreme Court has still not been faced with the necessity of resolving the anomalies inherent in the *Kardon* doctrine of the implied remedy under Rule 10b-5, nine out of ten circuit courts have expressed their approval of it.¹⁵¹ In fact, the decision of the Supreme Court in *J. I. Case Co. v. Borak*,¹⁵² indi-

¹⁴⁶ 17 C.F.R. § 240.10b-5, (1970).

¹⁴⁷ 15 U.S.C. § 77q (1964) prohibits devices, schemes or artifices to defraud, material misstatements or omissions, and fraud or deceit in the *offer* or *sale* of securities. Thus, only buyers are protected by the section.

¹⁴⁸ 69 F. Supp. 512 (E.D. Pa. 1946).

¹⁴⁹ 15 U.S.C. § 77i (1964) provides in part that a buyer may "recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

¹⁵⁰ 3 L. Loss, *Securities Regulation* 1790 (2d ed. 1961).

¹⁵¹ See 6 L. Loss, *Securities Regulation* 3871-72 (Supp. 1969). Professor Loss has reaffirmed his misgiving of the implied civil remedy. *Id.* at 3918.

¹⁵² 377 U.S. 426 (1964).

cates quite clearly that the Court will uphold the *Kardon* doctrine. In *Borak* it approved a cause of action based upon an implied right of civil recovery under the proxy provisions of Section 14 of the 1934 Act¹⁵³ and the rules promulgated thereunder.¹⁵⁴

The litigants in almost any securities transaction have, with increasing frequency, taken advantage of the Rule 10b-5 action wherever there was the slightest chance that it might be applicable. The extent to which these actions have proliferated is perhaps best illustrated by the fact that an eminent authority in securities law has written a full-length book on Rule 10b-5 citing roughly 700 cases.¹⁵⁵ The courts almost without exception, have been receptive to this expansion of the rule. The plaintiffs in Rule 10b-5 actions enjoy the benefit of exclusive federal jurisdiction, no diversity or minimum damage requirement, nationwide service of process and extremely broad venue provisions.¹⁵⁶ Furthermore, the federal courts apply the local statute of limitations¹⁵⁷ and there is no bond required or other limitation placed on a stockholder's suit, except where a cause of action under state law is included under the doctrine of pendant jurisdiction.¹⁵⁸ Moreover, the class action has been used repeatedly, particularly after the 1966 amendment of Rule 23 of the Federal Rules of Civil Procedure.¹⁵⁹

This tendency to expand the application of Rule 10b-5 is perhaps best illustrated by the two Rule 10b-5 cases decided by the Supreme Court during the decade. In *Tcherepnin v. Knight*,¹⁶⁰ it extended the coverage of the rule to withdrawable shares in a building and loan association. In *SEC v. National Sec., Inc.*,¹⁶¹ the Court applied the rule to an insurance company merger which had the approval of the state insurance commissioner but which involved a false proxy statement. In doing so, the Court quickly dismissed the argument that the jurisdiction under the proxy rules excluded remedies under Rule 10b-5.¹⁶²

Perhaps the most important cases under Rule 10b-5 involved actions by the SEC against brokers, dealers, corporations and corporate

¹⁵³ 15 U.S.C. § 78n (1964).

¹⁵⁴ 17 C.F.R. § 240.14a-9 (1969).

¹⁵⁵ A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5* (1969).

¹⁵⁶ See 15 U.S.C. § 78aa (1964).

¹⁵⁷ See *Tobacco & Allied Stocks v. Transamerica Corp.*, 143 F. Supp. 323, 325-28 (D. Del. 1956).

¹⁵⁸ See, e.g., *Entel v. Allen*, 270 F. Supp. 60, 67-70 (S.D.N.Y. 1967).

¹⁵⁹ Fed. R. Civ. P. 23.

¹⁶⁰ 389 U.S. 332 (1967).

¹⁶¹ 393 U.S. 453 (1969).

¹⁶² *Id.* at 468-69.

officers. Section 15 of the 1934 Act¹⁶³ gives the SEC very broad regulatory powers over the brokers and dealers, who are, of course, subject to the provisions of section 10 and Rule 10b-5. From the very early days of this regulation, the broker-dealer has been considered by the SEC to have a fiduciary responsibility to his customers, requiring him to treat them fairly and honestly. Just how fairly and honestly was clarified in the landmark case of *Cady, Roberts & Co.*,¹⁶⁴ involving the failure of a broker to disclose to the public information received by him through a corporate director concerning a decrease in dividend rates. In a wide-ranging opinion, Chairman Cary delineated the application of Rule 10b-5 to the broker-dealers industry, informing them that they could not fail to disclose material corporate developments.¹⁶⁵ Thus the Commission held there was a violation of Rule 10b-5 when a broker-dealer in possession of undisclosed unfavorable corporate information sold stock at a price higher than it could have if the suppressed information had been disclosed.¹⁶⁶

The same rationale was applied in *Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹⁶⁷ where the broker-dealer obtained advanced information about a significant reduction in earnings of a corporation while acting as syndicate manager for the corporation in a securities issuance, and where it then passed the information only to its favorite customers. The thrust of the *Cady, Roberts* case was rather strikingly illustrated in *Merrill Lynch* by the fact that the broker was concurrently buying the same stock for some of its less valued clients.¹⁶⁸ The Commission again emphasized that full and fair disclosure requires that inside information not be utilized before the information is released to the public.¹⁶⁹

In 1965 the SEC brought an injunctive action, including a prayer for ancillary civil relief, against the Texas Gulf Sulphur Company (TGS). The Commission alleged that in violation of Rule 10b-5, some of the TGS officers, directors and employees had bought TGS' securities on the basis of material undisclosed corporate information concerning a major ore discovery, and that the company had issued a false and misleading press release to allay rumors of this development. The trial court supported the holding in *Cady, Roberts* but exonerated some of the defendants on the ground that they acted before the

¹⁶³ 15 U.S.C. § 78o (1964).

¹⁶⁴ 40 S.E.C. 907 (1961).

¹⁶⁵ *Id.* at 910-14.

¹⁶⁶ *Id.* at 911-12.

¹⁶⁷ SEC Securities Exch. Act Release No. 8459 (Nov. 25, 1968), reprinted in [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 47,629.

¹⁶⁸ *Id.* at 83,349.

¹⁶⁹ *Id.* at 83,349-50.

information became material¹⁷⁰ or after the information had been made public.¹⁷¹ The lower court also held the press release not to be misleading or deceptive.¹⁷² On appeal, the circuit court reversed,¹⁷³ holding that the trial court had been too lenient in its application of the principles announced in *Cady, Roberts*. The court found that the information relating to the ore discovery was material since a reasonable investor's actions would be affected by it.¹⁷⁴ Consequently, the court held that the defendants had violated Rule 10b-5 by buying TGS stock without disclosure to all investors.¹⁷⁵ The court also held that the Commission was entitled to injunctive relief if TGS had failed to exercise due diligence thus making the press release misleading to a reasonable investor.¹⁷⁶ It has been indicated that since TGS was an injunctive action the same considerations or at least the same quantum of proof employed in *Texas Gulf* might not apply to implied private causes of action.¹⁷⁷ Once it has been conceded that a private cause of action exists under Rule 10b-5, however, this distinction is perhaps not justified if the plaintiff can show damages.

In the course of broadening the application of Rule 10b-5, the courts have gone to great lengths to construe the wording of the rule in such a manner as to include almost any transaction involving securities, directly or indirectly. In so doing they have at times appeared to be applying what was referred to in *McClure v. Borne Chem. Co.*¹⁷⁸ as a federal common law applicable to corporations. Whatever criticism may be made of this tendency, and although the Second Circuit Court of Appeals has at times balked at some rather remote extensions of this concept,¹⁷⁹ during the 1960s it became an established pattern which will be difficult to change, either by litigation or legislation. The protection afforded investors by the developments

¹⁷⁰ SEC v. Texas Gulf Sulphur Corp., 258 F. Supp. 262, 284 (S.D.N.Y. 1966).

¹⁷¹ Id. at 288-90.

¹⁷² Id. at 296. The court noted that "[w]hile, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of facts then known." Id.

¹⁷³ 401 F.2d 833 (2d Cir. 1968).

¹⁷⁴ Id. at 849-51.

¹⁷⁵ Id. at 848-52.

¹⁷⁶ Id. at 863-64.

¹⁷⁷ Some of the concurring judges in *Texas Gulf* voiced hesitation in applying the standards announced therein to private actions. Id. at 864-69. See also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963), where the Court stated: "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."

This reasoning was adopted by *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967), to allow injunctive relief to private plaintiffs under Rule 10b-5.

¹⁷⁸ 292 F.2d 824 (3d Cir. 1961).

¹⁷⁹ See, e.g., *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952); *O'Neil v. Maytag*, 339 F.2d 764 (2d Cir. 1964).

under Rule 10b-5 seems far too valuable to destroy. Thus, the lawyer reviewing a securities transaction must now be extremely careful to examine any facts which would indicate an unfairness or over-reaching by any party to the transaction.

2. Short-term Trading

Section 16(b) of the 1934 Act¹⁸⁰ makes an officer, director, or ten-percent stockholder of a corporation liable to the corporation for any profit he has made as the result of a purchase and sale or sale and purchase of the corporation's stock within a six-month period. The basic interpretations of and principles for implementing this section had been well established by 1960 and, although some corporate officers still indulge in short-term trades, the business world in general has become aware of this limitation and the cases which arose in the 1960s normally involved unusual facts. In *Newmark v. RKO Gen., Inc.*¹⁸¹ the defendant owned 56 percent of the stock of corporation A. In May, 1967 it bought 49 percent of the stock of corporation B, which had previously agreed to merge with A. The merger was effected and the defendant received additional shares of A in exchange for its holdings in B. This was held on summary judgment to be a sale of its B stock subject to section 16(b) liability.¹⁸² In measuring damages the trial court computed the plaintiff's recovery to be \$7,920,681.¹⁸³

Until 1966 the application of section 16 to a person who converted a convertible security and immediately sold the underlying stock was far from clear, although the tendency was to strip him of his profit.¹⁸⁴ Although the cases provided little clarification,¹⁸⁵ the SEC finally settled much of this confusion in 1966 by adopting an exemptive rule declaring that a conversion of an equity security (which includes a convertible debenture) is not a purchase within the meaning of section 16.¹⁸⁶ The power of the SEC to adopt such a rule has been questioned,¹⁸⁷ but at least for the present a conversion by an insider

¹⁸⁰ 15 U.S.C. § 78p(b) (1964).

¹⁸¹ 294 F. Supp. 358 (S.D.N.Y. 1968).

¹⁸² *Id.* at 362-66.

¹⁸³ *Newmark v. RKO General, Inc.*, Current CCH Fed. Sec. L. Rep. ¶ 92,480, at 98,267 (S.D.N.Y. Sept. 22, 1969).

¹⁸⁴ See, e.g., *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984, 987 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

¹⁸⁵ In *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), the court indicated that every conversion was not a § 16(b) violation since the inquiry had to be made whether the conversion "makes possible the unfair trading that Section 16(b) was designed to prevent." *Id.* at 518. The court then held that the conversion in *Blau* "was not a Section 16(b) sale . . ." *Id.* at 522.

¹⁸⁶ 17 C.F.R. § 240.16b-9 (1969).

¹⁸⁷ In *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1967), Justice Blackmun's dissent

or a corporate reorganization involving convertibles can proceed without violating section 16(b).

Another troublesome question concerning the application of section 16 has involved purchases and sales of broker-dealer firms having a partner on the board of an issuer. This question was not completely settled by *Rattner v. Lehman*¹⁸⁸ and *Blau v. Lehman*¹⁸⁹ which exonerated the partnership while holding that the partner-director violated section 16(b). The problem was somewhat clarified in *Feder v. Martin Marietta Corp.*,¹⁹⁰ where defendant Martin Marietta acquired a substantial block of stock of Sperry Rand Corporation. Shortly thereafter the president of Martin Marietta was invited to sit on the board of Sperry Rand, which he did after consulting with his own board. However, Martin Marietta's president resigned from the Sperry Rand board and Martin Marietta, thereafter sold its holdings in Sperry Rand within six months after their purchase. The court held that section 16(b) applied because the appointment by a stockholder (Martin Marietta) of a person to sit on the board of the issuer (Sperry Rand) deputizes that director as an agent and has the same result as if the stockholder himself were on the board.¹⁹¹ Thus, the court required Martin Marietta to pay to Sperry Rand the profits made on the sale of Sperry Rand stock.¹⁹²

The *Feder* case settled another question that had long been troubling securities practitioners. As indicated above the director had resigned shortly before the insider sold its holdings. Consequently the director did not have to report the transactions as required by section 16(a) of the 1934 Act,¹⁹³ because the Commission by its rules had exempted the insider under these circumstances.¹⁹⁴ The *Feder* court held that such rules were beyond the SEC's power, and that as long as the purchase and sale were within six months, it did not matter that the director had resigned during the six months.¹⁹⁵ This is a logical holding in view of the fact that the purpose of the section was to prevent the use of corporate information for private gain. *Feder* simply makes it clear that the insider cannot resign as a director or

questioned the authority of the Commission to adopt this exemptive rule. He stated: "I am not entirely sure that Congress . . . meant to give the Commission power so to legislate at will by abruptly changing the reach of the statute . . ."

Id. at 539.

¹⁸⁸ 193 F.2d 564, 565-66 (2d Cir. 1952).

¹⁸⁹ 368 U.S. 403, 409-14 (1963).

¹⁹⁰ 406 F.2d 260 (2d Cir. 1969).

¹⁹¹ *Id.* at 264-68.

¹⁹² *Id.* at 269.

¹⁹³ 15 U.S.C. § 78p(a) (1964).

¹⁹⁴ 17 C.F.R. § 240.16a-10 (1970).

¹⁹⁵ 406 F.2d at 268-69.

an officer after learning of approaching corporate events, and thus be free to buy or sell the stock. The SEC has since changed its reporting rules to conform to the *Feder* case.¹⁹⁶

Section 16(d) of the 1934 Act,¹⁹⁷ added by the 1964 Amendments, exempts a broker-dealer who is making a market in a stock from liability under section 16(b). Consequently, an underwriter who is engaged in making an "after-market" by offering to buy or sell, on the over-the-counter market, shares of an issuer which he has successfully sold to the public, is in no danger if he or one of his partners is on the board of the issuer. However, this does not apply to a broker-dealer who holds 10 percent of the issuer's securities in an investment account or trades a security listed on an exchange.

3. Proxy Rules

Section 14 of the 1934 Act¹⁹⁸ gives the SEC jurisdiction over all proxy materials sent out to stockholders and the SEC has adopted rules thereunder.¹⁹⁹ Prior to 1964 these rules applied only to listed securities, and the failure of some listed companies (which were not required to seek proxies to get a quorum) to send out adequate information as to stockholders' meetings was of relatively little importance to the SEC, since at least the New York Stock Exchange had adopted a policy requiring the solicitation of proxies and the furnishing of the proxy statement pursuant to the rules. However, at the time the 1964 amendments were adopted, not only was the scope of applicability of section 14 extended, but Congress also added section 14(c)²⁰⁰ giving the SEC power to regulate the disclosure of corporate affairs to stockholders of corporations which did not seek proxies. The SEC promptly adopted Regulation 14c²⁰¹ which compels a corporation not seeking proxies to send out an information statement containing substantially the same material as was required from other corporations under the prior rules. The net result is that all important corporations now have to report annually to their stockholders and furnish them with adequate financial data.

Prior to 1960 there had been enough litigation involving the proxy rules so that it was possible to predict with a fair amount of accuracy how the rules would be applied to a given set of facts. There were, however, two confusing types of cases relating to the standing of

¹⁹⁶ 17 C.F.R. § 240.16a-10 (1970).

¹⁹⁷ 15 U.S.C. § 78p(d) (1964).

¹⁹⁸ 15 U.S.C. § 78n (1964).

¹⁹⁹ 17 C.F.R. §§ 240.14a-1 to .14a-103 (1969).

²⁰⁰ 15 U.S.C. § 78n(c) (1964).

²⁰¹ 17 C.F.R. §§ 240.14c-1 to .14c-7 (1969).

private causes of action. It was held in *Howard v. Furst*,²⁰² for example, that there was no implied civil action arising out of a false proxy statement. A great deal of doubt also existed as to what relief the federal court could give to a stockholder if the stockholder was able to prove a violation of the proxy rules.²⁰³ Both these problems were settled by the Supreme Court in 1964 in *J. I. Case Co. v. Borak*,²⁰⁴ where the Court sustained a private cause of action under section 14 based on an implied liability,²⁰⁵ and held that the federal courts had full power to take whatever steps were necessary to remedy the situation resulting from such a violation.²⁰⁶ The other proxy litigation during the 1960s involved the question whether the proxy material therein was defective. This type of inquiry, particularly in the context of an attempt to gain corporate control, is often very bitterly fought, but the cases hinge upon the facts of the particular case and not upon any important questions of statutory interpretation.

4. Investment Companies

By 1960 the stockholders in investment companies started to bring actions attacking the administration of the mutual funds, usually on the theory that the investment advisory fees were disproportionate. Most of these cases have been terminated by settlement introducing, typically, a new scale of graduated investment advisory fees. Those which have gone to the merits have seldom, if ever, resulted in findings for the plaintiffs because the plaintiffs had difficulty establishing a cause of action. The litigation, however, resulted in one noteworthy case which greatly expanded a mutual fund shareholder's rights.²⁰⁷ In *Brown v. Bullock*, the court adopted the rationale of the *Kardon* case and held that an injured shareholder had an implied cause of action²⁰⁸ under the Investment Company Act.²⁰⁹

CONCLUSION

The SEC, during the first 25 years of its life, had attained an enviable reputation as a model of bureaucratic elasticity. Until 1960 at least, its efficiency was equally notable. During the subsequent years, while it retained its ability to mold its activities to a shifting industry pattern and to exercise its power with principal attention

²⁰² 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957).

²⁰³ See *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 210-17 (6th Cir. 1961).

²⁰⁴ 377 U.S. 426 (1964).

²⁰⁵ *Id.* at 430-31.

²⁰⁶ *Id.* at 433-35.

²⁰⁷ 294 F.2d 415 (2d Cir. 1961).

²⁰⁸ *Id.* at 420-21.

²⁰⁹ 15 U.S.C. § 80a (1964).

to the public interest, it came to suffer from budgetary insufficiency. This fact, combined with the tremendous increase in the volume of securities transactions, has limited the enforcement effectiveness of the Commission.

There is no doubt that the Commission will, in the years to come, continue to adapt itself to the realities of the industry which it regulates. The recommendations of the *Special Study* and the *Wheat Report* indicate that the Commission is examining every means possible to make its operations more efficient. Whether it succeeds in its efforts to operate efficiently and promptly is another question, the answer to which is far more in the control of Congress than within the power of the Commission.