MEMORANDUM

May 24, 1979

TO: Chairman Williams cc: Ralph Ferrara

FROM: Commissioner Karmel Roberta

RE: ALI Code

The ALI Federal Securities Code is likely to be introduced in Congress before the end of this year, with or without the Commission's endorsement. Although the SEC and Professor Loss could reach agreement on amendments to the Code, and such an amended Code could then be introduced in Congress with the personal sponsorship of Loss and his advisors, I believe the Commission has very little time in which to achieve such an agreement. Furthermore, Loss can only go so far in accommodating the Commission without losing the support of the ALI and the ABA.

I believe that the staff's general attitude in discussing the Code with Loss has been to attempt to conserve and expand the Commission's power and jurisdiction wherever possible. While such an attitude may have served some purpose, I believe that a continuation of such an attitude at the Commission level will ultimately be very damaging to the agency. We will suffer the same loss of credibility and respect in Congress as we have suffered in the Courts. And we will ultimately lose both substantive authority and procedural flexibility.

My personal feeling about the Code is that it does not go nearly far enough in reforming, reorganizing or clarifying the law. In too many areas it complicates rather than simplifies, or reaffirms obscure and confusing principles. However, it is a marked improvement over the present state of the law. More importantly, from the Commission's institutional perspective, it is our best hope for a rational system of securities regulation in the future. In view of current judicial trends and the country's general anti-government mood, I do not believe any better legislative package is feasible. Indeed, I believe the most likely alternatives to the Code (including no securities legislation for the foreseeable future) would be decidedly worse.

It seems to me it is essential for the Commission to decide whether, on balance, the adoption of the Code as is, would be beneficial or detrimental, taking into account not only whatever narrow, current institutional concerns we may have, but the long term general public interest. Then, we should decide what amendments to the Code we wish to urge as necessary and appropriate, and give some priority to those proposals. In this context, I am attaching as Exhibit "A" my personal opinions concerning all of the issues described in the memorandum from the Office of the General Counsel to the Commission dated May 4, 1979. However, these issues are not of equal importance, and many of them are not really critical. Please note the many areas where I believe the staff has been taking the wrong position.

The sponsors of the Code are a highly respected group of eminent lawyers, scholars and judges, many of whom are former high SEC officials. While the Code's prospects in Congress are certainly much brighter with Commission support, it does not necessarily follow that lack of Commission support will defeat the Code. The Commission should recognize that it has a great deal to lose if it opposes the Code and any such opposition had better be very well founded and documented. If the Code comes to be viewed as regulatory reform, it may well pass. Further, in Congress's present oversight mood, public hearings are likely. I believe a tactic of enumerating hundreds of requested changes once the Code is introduced in Congress will open up the legislative process to the Commission's ultimate detriment.

In short, I believe the Commission's best posture with respect to the Code is to arrive at whatever agreements concerning significant amendments we can with Loss and his advisors, and then to give some general endorsement to the resulting legislative product. Further, I believe we must take action with respect to this matter very soon, and in any event, by the end of the year.

Exhibit "A"

1. Definition of a security (§299.53(a)). I do not believe this is an important issue. The present Code definition is acceptable to me, as are the changes Loss has agreed to seriously consider. In my view, the failure of the definition to include "investment contracts" will protect the Commission against having to extend its resources into questionable areas, e.g., worm farms. I would prefer to have the definition of security in §299.53(a) include "futures contracts on securities" rather than have this issue handled as an exclusion to an exclusion. (See Item #4, p. 1-2 of memorandum from the Office of the General Counsel to the Commission, dated May 4, 1979). I believe the Commission should have the power to regulate any index based on a security. I would not reargue the issues resolved by the Daniel case.

2. Exempted securities (§302). I agree that industrial development bonds should not be exempted securities, although this is a significant change from present law in a highly political area. I do not believe the Commission should push for Code changes in the definition of a security issued by a cooperative; there are not sufficient reasons for us to clash with the farm lobby on this issue. If interests in agriculture cooperatives are to be regulated by a federal agency, they should be regulated by the CFTC. I believe that the Code formulation as to a commercial paper exemption is sound. Institutional and other large investors, who are the primary purchasers of such paper, do not need the protections of the Code in connection with this type of short term financing. However, a $50,000 exemption is arbitrary and not in accord with present custom of offering commercial paper in $100,000 denominations.

3. One-year registrant (§299.16)). The concept of the one-year registrant is the only significant government deregulation in the Code. I believe that disclosure provisions directed at distributions have become outmoded by time and technology. Once information is filed with the Commission, it is public, or at least publicly available. The Commission should utilize its resources to achieve easier access to and greater dissemination of information in filed documents. This is a technological, not a legal problem. Sellers of securities should have the freedom to advertise underwritings as they choose, as long as such advertising is not inconsistent with information filed with the Commission. I would utilize §502(c) to minimize special disclosure for distributions. Any registrant which does not comply with the Commission's continuous disclosure requirements should lose its one-year registrant status under §1808(a). For these reasons, I strongly oppose the staff's proposals to give the Commission authority to classify registrants and to change the Code concept of a "one-year registrant" to a "qualified registrant." I further oppose other changes which would eliminate the so-called benefits accorded to one-year registrants. I would be willing to consider an alternative approach to the one-year registrant concept in which companies were categorized by the quality of their disclosure, but I would not be interested in any suggestions which excluded small companies.

4. Limited offerings (§242(b)). I strongly favor the Code's present formulation, although I agree that radio, TV or newspaper advertising should be a cause for losing the exemption. The staff is attempting to retain Rule 146 which has been justly criticized as useless relief from the registration provisions. I strongly believe there is a limited type of securities selling activity which does not warrant federal regulation, either because there are too few investors or the investors can fend for themselves. Also, it is precisely smaller, newer public companies which need a more meaningful exemption from registration than now exists. Accordingly, I do not believe the Code should tailor an exemption for "qualified" companies.

5. Trading transactions (§242(c)). I approve of the Code's present formulation as appropriate, and necessary to the overall statutory scheme. It should not be changed. In so concluding, I assume that the Code's present concept of a one-year registrant will not and should not be changed beyond that as I've suggested above.

6. Secondary distributions (§510). The staff's comments are another effort to undermine the one-year registrant concept. See my comments to #3 supra. I do not believe any greater disclosure burden than §510(c)(3) should be placed on secondary distributors, although perhaps they should be under some duty to make inquiry of the issuer as to whether any material events have transpired since the issuer's last SEC filing. I agree that the Code should require the distributor to give the purchaser the §510(c)(3) certificate and the annual report.

7. Block trading (§512(d)). I could go along with §512(d) as presently drafted or as redrafted by Loss (pp. 7-1 and 7-2) if the exemption applies to one-year registrants. Since 15% is a high number, some limitation on use of the block trading exemption by control persons may be a good idea. The exemption is generally needed, despite the trading transaction exclusion, because of the Commission's ability to limit trading transactions in amount specified in §242(c)(1)(D).

8. Integration (§299.13)). I feel the Code provision as drafted is satisfactory, but I do not object to the proposed changes suggested by the staff.

9. Local distribution (§514). I do not favor any changes in the present Code provision. I believe the concept of a local distribution exemption in lieu of the present intrastate exemption is sound.

10. Tender offers (§299.68)). I am indifferent to whether or not the Commission has the power to define tender offer. However, the time probably has come to formulate such a definition, which could be in a statute or a rule. However defined, there should be an exclusion for offers to less than 35 persons, especially because the Commission would be able to define "persons" for tender offer purposes. I would not foreclose integration of 1934 Act §§13 and 14, but I would have to see proposed draft legislation to endorse such integration. A 10 day pre-commencement filing and publicity requirement might be a good idea. I do not believe the Commission now has or should be given the authority to determine the fairness of issuer repurchases

(§1613). Such authority is contrary to the fundamental policy of the securities laws prefering disclosure over standard setting as a regulatory technique.

11. Trust Indenture Act (Part 13). I have no comments.

12. 1975 Act Amendments. Not having seen the appendix referred to in OGC's May 4 memo, I have no comments.

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13. Mini accounts (§§279(b)(1), 914(c), 915(b)). I have no strong views on this issue.

14. Insider trading (§1603). The Code demonstrates how complex and unwieldy the law on insider trading has become. I believe this results from the premise, which is not supportable under the securities laws, that there should be equality of information in the marketplace. For the most part, I agree with the Code's formulations as now drafted. I believe that liability should depend on whether a fact of special significance was withheld, and that a fair reading of the relevant precedents supports such a principle. I do not object to making this question a defense rather than part of the claim, as set forth in Items (b) and (c) on p. 14-2. I do not believe tipping without a resulting securities transaction should be made unlawful. I also do not believe that, as a defense, any alleged falsity should be obvious to the plaintiff, if obvious to a reasonable investor. Protection of the uninformed or foolish investor leads to a scheme of overregulation which is contrary to the general public interest. I agree that the proposed definition of "insider" set forth in Item (f) on p. 14-2 is preferable to the Code's present definition. I strongly disagree with the efforts to expand the coverage of §1603 urged by the staff and discussed in Items (g) and (h) on p. 14-3. The notion that any and every investor has an affirmative duty to the marketplace would be a significant expansion of present law which in my view would be bad policy; it would have too chilling an effect on capital formation.

14A. Fraudulent acts and misrepresentations (§1602). I regard the proposed changes indicated in Items 1, 2, 3, 4 and 6 on pp. 14A-1 and 14A-2 as technical amendments. With respect to Items 5 and 8, I agree that a duty to correct is important to a continuous disclosure system. I would prefer an explicit amendment to §602(a) (the Commission's authority to require reports) to the changes indicated to comments to §1604. However, the nature and extent of what civil liability should attach to a failure

to correct filings is a complex question which I think merits further thought and discussion. I feel that the amendment to §1614 (rulemaking authority concerning fraud and misrepresentation) regarding "any similar conduct" (Item 7) undermines the overall statutory objective of putting reasonable limits on the Commission's prosecutorial and regulatory powers. Accordingly, I object to any such amendment.

15. Short-term insider trading (§1714). In view of the extensive prohibitions against insider trading set forth in §§1602 and 1603, I believe the policy justification for what is now §16(b) of the 1934 Act has been superseded. Accordingly, I would delete §1714 from the Code in its entirety.

16. Manipulation (§1609). I am not convinced that a generalized anti-manipulative provision is necessary. However, I do not object to proposed new section 1609(f) set forth on p. 16-1. I do strongly object to the §1614 amendment ("or any similar conduct") set forth on p. 16-2. (See #14A above).

17. Liability for false registration statements, offering statements, annual reports, and false publicity (§1704). I oppose the increased liability which the changes set forth in Items (b)(c) on p. 17-3 would place on underwriters. Whatever "fat" exists in the underwriter's discount should not go to pay for such liability. I do not object to the other changes Loss has agreed to seriously consider.

18. Liabilities of fiduciaries (§1709(a)). I generally agree with the changes Loss has stated he will seriously consider.

19. Liability of controlling persons and aiders and abettors (§1724). In general, I disapprove of attaching liability for inaction or silence where the person being held liable is an aider and abettor rather than a principal.

20. Limitations on civil liability (§§1702-1708). The Code's limitations on damages in open market transactions is one of its most salutary features. The specific limitation on the open-ended liability of peripheral wrongdoers is essential to stop the substantive erosion of the securities laws now underway in the courts. I therefore strongly disapprove

of the staff's efforts to change these provisions, and especially the plea for a double or triple damages provision. Further, the broadside attack on §§1702-08 is unwarranted because the damage limitations set forth in these sections do not apply to registrants and underwriters for misrepresentations in offering statements or to persons who act with knowledge. In addition, the specific monetary damages limitations of §1708 apply only in open market transactions where liability today is unlimited. I disagree with Items 1, 2, 5 and 6, and agree with Items 3,4 and 7 on pp. 20-2-3 for reasons stated above. I do not have very strong feelings concerning Items 8 through 12 on pp. 20-3-4 but I would generally resist these efforts to increase liability. I believe the mitigation defense in §2007 should be retained.

21. Private rights (Part 17, §1722(a)). In view of the elaborate remedies set forth in the Code I do not believe any private rights should be implied beyond what is now set forth in §1722(a). It is not sound public policy to encourage the litigation of questionable claims not contemplated by Congress.

22. Court jurisdiction (§1822(a)). I am indifferent to this issue.

23. Injunctions (§1819). I do not believe the deletion of the phrase "and that there is a reasonable likelihood that he will engage" from Code provision §1819(a)(3) is meaningful because a court of equity will consider this factor before issuing an injunction in any event (Item 1). I am opposed to an unlimited, open-ended cease and desist power (Item 2) although I would endorse some new SEC administrative remedy along those lines. This needs more thought and discussion. I oppose the changes indicated in Items 3-7 on p. 23-3. Most of these are not significant. However, I believe the changes set forth in Items 6 and 7 are significant and improperly expand the Commission's authority.

23A. Costs against the Commission and parties in civil actions (§§1723(d), 1819(m)). I have no strong position concerning the awarding of costs, but I agree it would be better if costs cannot be obtained against the Commission.

24. Investigations (§1806). I prefer the present Code formulation to the proposed changes, except that I favor the change set forth in Item 1 on p. 24-2.

25. Administrative Proceedings (§§1809-1816). The Code contains some helpful clarifications and expansion of the SEC's administrative powers. Further clarification is needed.

For example, the Code should address the question of the Commission's 2(e) authority and should contain some type of authority to sanction individuals associated with issuers in §1808(c). I think that the changes set forth in Items 1 and 2 on pp. 25-1-2 are helpful. I would add to §1808(d) an ability to stop order proxy filings. I believe that it is a good idea for the Commission to be required to plead fraud with particularity (and, in fact, I believe we do). I do not think it would be appropriate for the Code to address the question of the standard of proof in administrative proceedings, or to attempt to overrule the Collins case.

26. General Rulemaking (§1804). I do not agree with the changes set forth in Items 2 and 3 on p. 26-2 if this is intended to give the Commission authority to adopt implied remedies, for e.g., Rule 2(e), or to take other action not contemplated by express statutory provisions.

27. Accounting (§1805). I do not object to the changes set forth in Items 1-6 on p. 27-2 except that I do not think we now have or should have the power to prescribe qualifications for directors. I feel the Code must clarify the Commission's power to determine auditing standards and to discipline accountants. I do not believe the Code, as now drafted, give us such power. I do not think the Commission should push for any authority over accountants who do not practice before it.

28. Commission Orders and Adjudicatory Proceedings (§1817). In general, I would resist an increase in on-the-record adjudicatory proceedings. However, the types of proceedings listed in Items 1-8 on p. 28-2 would appear to be adjudicatory in nature and appropriate for an on-the-record proceeding. I have no strong opinion as to whether the proceedings specified in Items 9-13 on pp. 28-2-3 should be on-the-record or informal proceedings.

29. Judicial Review of Commission Orders (§1818). I agree with the proposed changes in Items (a) and (b) on p. 29-1 but I am not sure review of summary orders specified under §1818(a)(8) should be precluded.

30. Administration (Part 20). I believe suspension of the APA for repromulgation of SEC rules is essential. Suspension of the Advisory Committee Act is also a good idea. Giving the Commission the power to rent space is advisable.

31. Pre-emption (§1904). Section 1904, with the changes Loss has agreed to consider, is satisfactory.

32. Criminal Prosecution (§1821). I believe the criminal provisions of the Code are basically sound but I do not object to the changes Loss has agreed to seriously consider which are indicated on p. 32-2.

33. Investment Companies (§281). I agree with the Code's provisions as proposed to be changed.

34. Public Utility Holding Company Act (Part 15). I have no comment on this.

35. **Foreign Countries** (§1905). *See* my article at 7 Conn. L. Rev. 669 (1975).

35A. Foreign Corrupt Practices Act (§1905(d)). I have no comment on this.