

MEMORANDUM

September 19, 1979

TO: Commissioner Loomis

FROM: Beverly

RE: ALI Code

SUBJECT: Commission Meetings of September 13, 17,
and 18, 1979

The following is an attempt to summarize the series of meetings held between the Commission and its staff on the ALI Code during the past week. I took notes throughout the meetings and tried to keep track of which issues raised by the staff the Commission thought were of true critical significance, which were interesting, but not critical and which were totally unexciting. I hope this tallies with your recollections.

1. Definition of a Security The only remaining issue is whether or not the Commission should have jurisdiction over futures contracts based on securities. The Commission consensus was adamantly in favor of Commission jurisdiction (concurrent with that of the CFTC) over futures contracts on indexes of securities and on non-exempt securities. Further, the Commission indicated that it would, of course, want jurisdiction over futures on all securities but it felt that exempt securities futures were less critical.

2. Exempted Securities The Commission did not understand why the commercial paper exemption had been lowered from \$100,000 to \$50,000 in this age of inflation but that did not rise to the level of a true critical issue. Similarly, the Commission noted the expanded definition of "non-profit corporation."

On the issue of industrial development bonds, the Commission reiterated its firm support for its legislative proposal which would remove the exemption for IDB's where the municipality really bears no obligation for the bonds that are issued.

3. One-Year Registrant This is a true critical issue. There was general agreement that merely being registered with the Commission for one year was not sufficient to ensure that relevant corporate information was available to the marketplace. The Commission seemed to agree with Stan Sporkin and Bob Pozen that a realistic objective definition of qualified registrant could be worked out and be made acceptable to Loss. Relevant objective factors could include requirements for a real trading market, adequate float, a certain number of shareholders and filing reports for three years.

4. Limited Offerings The Commission felt strongly that it ought to have the authority to require persons making a limited offering to supply investors with the corporation's latest annual report.

Another issue which seemed to cause great concern was the point made by Investment Management that investment companies which sell only to institutions via the limited offering exemption (which could encompass most money market funds) would not be regulated under those sections of the Code equivalent to the Investment Company Act.

Another issue which was raised but generated a less conclusive discussion was whether any person who used general advertising should thereby lose the limited offering exemption. You seemed to think that the exemption should not necessarily be lost. Commissioner Karmel felt that use of radio or television ads could not be inadvertent and, therefore, that use of such ads should mean loss of the exemption.

5. Secondary Distribtuions Currently, the Code provides only that the secondary distributor provide a limited "distribution statement" and a certification by him that he does not know any additional information which should be disclosed to prevent misrepresentation. As it decided in discussing the limited offering exemption, the Commission agreed strongly that it ought to be able to require that the secondary distributor deliver a copy of the corporation's latest annual report.

From there, the discussion moved to the issues of who, if anyone, should be liable for events which have changed since that annual report was issued and the general duty of issuers to update annual reports. The Commission seemed to feel that it ought to have the power to require delivery of more than just annual reports for the continuous disclosure philosophy to be meaningful, but the liability issue remained unresolved.

6. Local Distributions The Commission seemed satisfied with what the staff viewed as Loss' apparent willingness to increase the percentages of local purchasers and securities they purchased to qualify for the local distribution exemption. Specifically, a "local distribution" would be one in which 98% (up from 95%) of the purchasers holding 95% (up from 80%) of the securities are residents or have their primary employment in a single state (or contiguous area if so designated by Commission rule).

7. Tender Offers No discussion was held because there seemed to be general agreement that a new approach to the entire area was needed. Apparently, OGC and CF are working on such an approach.

8. Insider Trading The staff raised five issues:

- (a) whether the requirement that the person know "a fact of special significance" is too rigorous, given the already strict definition of "materiality" (of course, in Commission actions, only the materiality standard applies);
- (b) whether tipping without trading should also be prohibited;
- (c) whether limiting liability to "insiders" (and their tippees) is appropriate;
- (d) whether just saying buy or sell, without telling any facts at all, should be prohibited; and
- (e) whether there should be an affirmative defense that the person knew the particular fact of special significance by means other than his status as an insider.

The only issue the Commission discussed was that of the "fact of special significance" which everyone seemed to agree was too strict. Ralph Ferrara then ended the discussion (the hour was getting late) by saying that discussions with Loss should start with this issue, see how he reacts and then the Commission or staff could decide which other insider trading issues to raise.

9. Fraudulent Acts and Misrepresentations The major part of this discussion centered on Section 262(c) of the Code which includes within the definition of a "fraudulent act" a requirement that the person act with knowledge or recklessness. The Commission did agree that questions of

knowledge and/or recklessness belong in the provisions on remedy and not in a definitional section. But there was no agreement reached on what mental state should be required in private actions for damages for fraud or misrepresentation.

The Commission did agree (without saying that it rose to the level of a critical issue) that the definition of "misrepresentation" contained in Section 297(a) ought to track the language of Section 17(a)(2) of the Securities Act. Section 297(a) now provides that "misrepresentation" means "(2) on omission to state a material fact necessary to prevent the statements made from being misleading in light of the circumstances under which they are made."

The Commission was also quite concerned that there be express civil liability for failures to correct filings which would be required by Section 602.

While the Commission was pleased with its broad grant of rulemaking authority to prevent fraudulent and manipulative conduct, it did agree with certain drafting changes suggested by the staff. In particular, the staff wants to delete "in a manner not inconsistent with the conditions and restrictions of part XVI" and substitute the more usual phraseology of "in a manner not inconsistent with the purposes of this Code." Apparently, Loss is receptive to this change.

10. Manipulation This discussion was a bit incoherent but I think the Commission agreed with the staff that Section 1609(c) should not include language comparable to that in current Section 9(a)(2) of the Exchange Act prohibiting transactions which raise or depress securities' prices for the purpose of inducing the purchase or sale by others. The Commission did not agree with the staff that the section should be broadened to prohibit purchases or sales effected "for the purpose of maintaining the price of securities." As OGC pointed out, Loss is willing to add a general anti-manipulative section, Section 1609(f), which would make unlawful any manipulative act, whether or not prohibited by Section 1609(a) through (e).

11. Liability for False Registration Statements, Offering Statements, Annual Reports and False Publicity The critical issue here is whether to hold directors to Section 11-type liability for the annual report (under Section 1704 of the Code). The ALI itself was split on whether Section 1704 should apply to both outside and inside directors. In Loss' current version of the Code, Section 1704 liability is imposed on all directors.

Section 1704(g) of the Code contains a standard of reasonableness which gives factors that are relevant to a determination of whether a particular defendant reasonably believed that the filing in question contained a misrepresentation or material omission. The staff had been concerned that Section 1704(g) permits syndicate members to avoid liability by relying on the managing underwriter while the manager would only be liable in damages for the amount of the offering that he took down. The Commission focused on the amount of liability rather than the various possible defenses and reliances Loss had set out. In the Commission's view, someone must be liable for the total amount of the offering; the underwriters can then divide up their responsibility by contribution or any other contractual method, but the Code should not let them off the hook so that no one pays.

12. Liability of Fiduciaries The Commission strongly agreed with the staff that there should be no scienter requirement here.

13. Limitation on Civil Liabilities The Commission agreed that Section 2007 of the Code, the general mitigation defense, should be eliminated given the fact that the Code already contains many carefully-tailored defenses to civil liability.

There was a lot of inconclusive talk about these provisions but the only section with which the Commission took strong exception was that limiting the measure of damages to be assessed against a defendant (unless the plaintiff could prove that he "made a misrepresentation with knowledge"). The Code currently provides a limit for corporate defendants of 1% of gross income to a maximum of \$1 million. The Commission seemed to agree that some limitation was probably appropriate but that \$1 million was too low. The \$100,000 limit for individuals caused less concern; the Chairman specifically stated that whether such an amount was too little really depended on the individual but that, in general, \$100,000 was a lot of money. I don't think any consensus was reached on the \$100,000 figure.

14. Mini Accounts The Commission seemed to agree with IM's analysis that Loss' efforts in this area do more harm than good in that they are essentially a codification of the disparate treatment currently accorded investment companies, investment advisers and banks. IM believes that an entirely new approach to this area is sorely needed.

15. Commission Orders and Adjudicatory Proceedings The Commission agreed with MR that Section 1817(b)(2) of the Code which specifies which proceedings must be held "on the record" is both fuzzier and broader than current law. Particularly troublesome is Section 1817(b)(2)(B) which requires an on the record proceeding whenever the Commission denies, revokes or adversely terminates a registration status or privilege, including, presumably, such status for a national securities exchange.

16. Judicial Review of Commission Orders In general, the standard of judicial review of Commission orders is good for us. However, OGC raised one troublesome matter. On review, the court has the power to take additional evidence (Section 1818(a)(6)) and this goes beyond the current version of the law. The Commission was opposed to such an extension.

17. Accounting and Auditing Standards The critical issue here was the Commission's desire that its authority to establish auditing standards be made explicit.

Discussion was also held as to whether the Commission should have access to accountants' workpapers without a formal order. The Commission was divided on the need for such authority and decided not to push the matter, especially give the importance of obtaining authority over auditing standards.

18. Relation to Foreign Countries The Commission directed the staff to restudy these provisions because something like an IOS case would appear to be outside of our jurisdiction.

19. Private Rights of Action The Commission was quite concerned that the Code provide as many express private rights of action as possible. This is especially true in the trading and advisory practices area (part IX of the Code) where certain violations have express right of action analogs in Section 1715 and others do not.

In Section 1722(a), the Code contains conditions under which a court can find an implied private right of action. Apparently, Loss is willing to make certain changes which the staff has suggested (see critical issue 21-2).

20. Court Jurisdiction in Civil Actions (This does not apply to Commission injunctive actions). The Code provides for concurrent state and federal jurisdiction. The Commission initially shared the staff's concern over this provision but its worries were assuaged upon learning that a defendant sued in state court could easily remove the case to federal court under the general federal removal statute. However, to make this point clear, the Commission felt that the Code itself should contain a liberal removal provision.