

MEMORANDUM

December 3, 1979

TO : Commissioner Loomis
Commissioner Evans
Commissioner Pollack
← Commissioner Karmel

FROM: Harold M. Williams

RE : Discussion of the ALI Code

I have been considering the strategy which the Commission ought to pursue with respect to the ALI Code. I want to share my thoughts with you and describe the framework within which I feel we ought to approach the Code. I hope that the ideas set forth in this memo can serve as a guide for our discussion at tomorrow's Commission meeting.

I start from the premise that, regardless of what position we take, the Code will be introduced and there will be at least some significant support for its active Congressional consideration. Our goal should be to develop a strategy which maximizes the likelihood that any ensuing legislative action will benefit the Commission and minimizes the risk that the agency's ability to protect investors will be impaired. I believe that, to accomplish these goals, the Commission should support the Code, although not in its present form. We ought to devote our efforts at tomorrow's meeting to identifying the key changes which must be made in the current version of the Code -- before it is introduced in Congress -- as the price for that Commission support. We should also identify any changes in the Code which, because of their political sensitivity, we cannot realistically expect Professor Loss to make, but which we would advocate once the Code is under consideration in Congress. In this latter regard, Congress and Professor Loss should be informed at the outset that there are a limited number of significant changes in existing law which we support independent

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of the Code, but which might most efficiently be considered simultaneously with the Code.

Our discussion and study of the Code over the last several months has been productive and useful. I hope that, at tomorrow's session, we can reach agreement on a general strategy along the lines I describe below and on the changes necessary to the ALI's version before it is introduced. Assuming we do agree on an approach which calls for further revisions in the draft Code as it exists today, I will personally negotiate on behalf of the Commission with Professor Loss -- with assistance from the Office of the General Counsel -- in an effort to obtain those changes.

Support for a Code

My reasons for urging that the Commission adopt a general position of support for a Code are threefold. First, I believe that, in some important respects, the Code is an advance over present law. The integration of '33 and '34 Act reporting requirements, for example, is a positive step, and a number of others could be cited. In some respects, of course, the Code is clearly unfavorable: The Code perpetuates some unfavorable aspects of existing law; it makes certain unfavorable changes in the law; and the Code fails to improve upon existing law in some areas where improvement is necessary. The approach I am suggesting in this memo would deal with these problems. And, in any event, I feel that our most significant difficulties can be resolved so that the resulting document is, on balance, helpful to us.

Second, while I entertain doubts concerning whether the Code will ever be enacted, I believe that serious Congressional consideration of the Code, if it occurs, might afford us an opportunity to obtain improvements in existing law which Congress is unlikely, in the foreseeable future, to consider separate from the Code. Without the Code as a catalyst, I am not optimistic about our ability to persuade Congress to enact either less noncontroversial amendments to existing law (such as a statutory framework for a continuous disclosure system) or more sensitive alterations (such as a clarification of the Commission's jurisdiction over securities futures). Moreover, as judicial developments unfold, particularly at the Supreme Court level, the Code becomes

more and more attractive as a potential legislative vehicle to compensate for judicial trends.

Third, there is much merit to a comment made by Commissioner Evans at one of our earlier sessions -- if the Commission initially opposes the Code, we will have little bargaining leverage with respect to proposed changes during the legislative process. On the other hand, if we are Code supporters, we stand a much better chance of being able to play a significant role in any discussion of Congressional amendments to the Code. */ Similarly, I think our credibility is enhanced by appearing to be reasonable and flexible in considering new ideas rather than blindly in opposition to any change in the status quo. A general position of support for a Code will serve that end.

Key Issues

Despite my feeling that we should support a Code, the present version of the document contains a number of serious flaws which make it unacceptable. I do not, however, believe that all of the "critical issues" which the General Counsel's Office initially identified rise to that level. For that reason, I think that the most immediate task confronting us is to develop

*/ In suggesting that we "support" the Code, I do not necessarily mean that we should be in the forefront of lobbying for its passage. Once introduced, there may well be very little Congressional interest in pursuing the matter. If this is the case, the Commission will need to consider from time to time whether it wishes to take any steps in an effort to alter that situation.

On the other hand, I think that there is some risk that, given the prestige of those supporting the Code, Congress will begin to address it -- perhaps more swiftly than we anticipate. Because of Professor Loss' reputation and that of his advisers, the Code is beginning to take on a life of its own, and we should not, in my view, gamble on our ability to prevent its consideration by taking a flat stance against it.

a Commission position as to the changes that are actually important to our endorsement of the Code. These changes need to be divided into two groups -- those which I will seek to have Professor Loss make before the Code is introduced and those which, because they are politically sensitive or because they deviate substantially from existing law, we cannot realistically expect Loss to make. These latter changes we will seek independently if and when the Code comes under serious Congressional scrutiny.

While I have not finalized my own thinking on these matters, my tentative view is that the "Group One" issues should include, with two minor exceptions, */ all of the "first priority" changes listed in the Office of the General Counsel's November 15, 1979 memorandum to the Commission. **/ It would be useful if we could devote our discussion to determining

*/ The exceptions are the proposed revision to Section 1819 which would create cease and desist authority and the proposal that senior corporate officers and directors be required to sign the annual report. The former is a matter with which we cannot realistically expect Loss to deal at the pre-introduction stage because it would create a controversial new remedy, not part of existing law; accordingly, I have placed it in Group Two. The latter is a concept which the Commission rejected at its last meeting.

**/ Excluding the two points treated in the preceding footnote, these changes relate to the scope of the one-year registrant concept; the duty to correct Commission filings; the presumption that different types of exempt offerings will not be integrated; the standards governing, and extent of liability for, insider trading; the Commission's antifraud rulemaking authority; judicial implication of private rights of action; the standards for the issuance of injunctions in Commission enforcement proceedings; publicity concerning investigations; scienter in Commission administrative proceedings; scope of remedies incident to judicial review; and suspension of the Administrative Procedure Act. See OGC's November 15 memorandum at pp. 3-8.

whether any of these issues ought not to be treated as pre-introduction changes crucial to our support for the Code.

In "Group Two," on the other hand, I would include the following:

1. Definition of security - SEC/CFTC jurisdiction. Section 299.53(b)(8) should be amended to make it clear that equity futures, certain financial futures, and indexes based on securities are not excluded from the definition of "security."
2. Tender offers. The Code should be amended to integrate present Sections 13(d) and 14(d) of the '34 Act into a single scheme governing the sale of control in public companies. The Office of General Counsel is presently developing a legislative package of this nature in response to congressional inquiries.
3. Commission 2(e) authority. Section 1804 should explicitly grant the Commission authority to adopt a rule governing the discipline of attorneys and accountants.
4. Auditing standards. Section 1805 should be revised to give the Commission explicit rulemaking power to set auditing standards.
5. Cease and desist authority. Section 1819 should be revised to add a cease and desist provision which would apply to any violation of the Code by any person.

My "Group Two" issues are the same as those which the General Counsel's November 15 memorandum lists as "category four" or "separable issues," except that I have added cease and desist authority (see first footnote on p. 4, supra) and deleted industrial development bond legislation. */ I believe our time would be best spent if the Commission approached these issues from the perspective of whether any of them should be excluded from Group Two. It may, however, not be critical that we

*/ While I support our IDB proposal, it is already before Congress. I would not advocate that we risk our ability to preserve the Code as a package by asking that it be considered along with the Code.

have a definitive list of Group Two issues at this stage, since Group Two will not be a subject of my negotiations with Professor Loss.

Finally, the General Counsel's November 15 memorandum identifies a large number of additional issues which it characterizes as "second priority" and "third priority." */ My own feeling is that few of these are essential to our support for the Code and that we should resist the temptation to undermine our position by adding too many of them to either Group One or Group Two. If the Code does come under active Congressional attention, and if the dynamics of that process are favorable to additional Commission-sponsored changes (without opening the door to outside interest-group erosion of the Code), we should seek to have as many of these changes as possible made. In any event, the Commission should review these 51 issues and determine whether any of them rise to the level of either pre-introduction changes which are necessary to the Commission's support or amendments which the Commission wishes to seek formally once the Code is introduced. To repeat, however, I think it vital to the success of our strategy that we add to either Group One or Group Two very sparingly.

Commission Strategy

We also need to agree upon a general legislative strategy toward the Code. I believe this strategy should have three basic elements.

First, one of our chief objectives should be to contain the danger that the Code will be exposed to a wide variety of special interest amendments. If that process starts to occur, there is a risk that the Commission will be subjected to the kind of Congressional emasculation which the FTC is presently undergoing. While our ability to minimize that risk may be limited, an important first step is to assure that a version of the Code is introduced which we can support rather than relying on the legislative process to make favorable changes; the more changes we request, the more legitimate it will appear for others to advocate amendments of their own.

*/ See OGC memorandum, pp. 8-19.

I do recognize that the ALI-approved version of the Code will be introduced regardless of the future course of our negotiations with Professor Loss. I think, however, that, if we can reach agreement with Loss and at least some of his advisers on a modified version and have that version introduced simultaneously with the ALI draft, Congressional consideration will proceed on the basis of the SEC/Loss version and the ALI draft will become dormant. The Commission's legislative staff will need to encourage the Congressional staffs involved to follow this approach.

Second, because it is important for us to protect the Code from extensive amendments in Congress, our advocacy of the Group Two changes will put the Commission in an anomalous position. My own feeling is that the best way to approach this problem would be to propose separate legislation on each of our Group Two changes with the understanding that, if the committees involved view these proposals favorably, the Code will be amended to reflect their substance. Our strategy on this point is, however, an issue which we need not definitively resolve now.

Third, I believe that we should indicate strongly, both to Professor Loss and to Congress, that -- except for our Group Two changes -- our support for the Code is based on the Code as a package. If the document begins to erode and change shape during the legislative process, our support may be withdrawn.

Conclusion

I recognize that the concept of a code is, in many ways, not particularly palatable to us and that, if we were free to do so, it might well be a subject to which we would not wish to devote our resources at this time. Unfortunately, however, we do not have that option, and, in any event, I think there is a reasonable chance of transforming the Code into a plus for the Commission. We must, however, decide fairly quickly on our approach since, as I believe you are all aware, pressure is mounting for prompt introduction of the ALI version alone. For example, Milton Cohen has recently urged Professor Loss to cease dealing with the Commission, press for immediate introduction of the ALI version of the Code, and

resolve the issues the Commission has raised in the legislative arena. */ In my view, this would seriously jeopardize our position, force us to assume a defensive posture, and minimize our control over the process of Congressional consideration of the Code.

Finally, whatever we may decide to do, I strongly hope that it can be a position which will be unanimous -- at least as far as the public, press, and Congress are concerned. If the Commission seriously splits over its approach to the Code and over particular changes that we would or would not like to see made, and if the substance of that disagreement becomes public, our bargaining strength will be severely weakened. As a result, we would run a risk of setting in motion a process which could permanently damage the Commission and the federal securities laws.

I am looking forward to discussing with you on Tuesday your reactions to the plan I have outlined.

Attachment

A handwritten signature in black ink, appearing to read "Jack", written in a cursive style.

*/ A copy of this correspondence is attached. If we reach agreement on a strategy toward the Code, I will contact Professor Loss and let him know what our position is concerning Cohen's proposal.