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THE SECURITIES LAWS—AFTER 40 YEARS:
A NEED FOR RETHINKING

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I. Introduction

As the sun sets on 40 years of federal “regulation” of the securities industry and its markets, it is a time for rethinking. There is now a need for Congress to make a thorough review, study and evaluation of the philosophy which underlies the federal securities laws, and, just as importantly, of the Securities and Exchange Commission’s regulatory, enforcement and administrative policies.1

Following the enactment of the Securities Act of 1933,2 with its thrust directed toward full and fair disclosure, the regulation of securities markets, then principally the national securities exchanges, began with the formation of the Securities and Exchange Commission through the enactment of the Securities Exchange Act of 1934.3 The principal purpose of this article is to reconsider and propose changes in philosophy and emphasis with respect to the aforementioned acts and their administration.

The Commission, Congress and interested industry and legal groups have accumulated “mountains of paper” dealing with the securities laws. Much has been done as a basis for a thorough congressional reevaluation. Following the report to President-Elect Kennedy by former SEC Commissioner James M. Landis,4 there have been published several studies of the securities markets and securities laws, some of them quite massive, including the so-called Special Study,5 the Over-the-Counter Markets Study,6 the Wheat Report,7 and the Institutional Investor Study.8

15 U.S.C. §§ 77a-77aa (1971) [hereinafter cited as the 1933 Act].
15 U.S.C. §§ 78a-78jj (1971) [hereinafter cited as the 1934 Act]. The Securities and Exchange Commission is referred to herein as the “SEC” or the “Commission.”

1 This article had hardly been completed when Representative John E. Moss (D-Calif.), Chairman of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, introduced H.R. 5050, 93d Cong., 1st Sess., on March 1, 1973, which is titled the “Securities Exchange Act Amendments of 1973.” Although it is possible that other bills may be submitted later in the session, it is reported that Mr. Moss desires to send H.R. 5050 to the Senate by the end of the year. SEC. REG. & LAW REP. No. 192, at A-1, A-2 (Mar. 7, 1973) (see the full text and summary of H.R. 5050 at F-1 to F-14).
2 J. LANDIS, REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT (1960) [hereinafter cited as the LANDIS REPORT]. Suggested remedies for problems at the SEC relating to delay, costs and agency organization are discussed in the report. Id. at 45-48.
3 Id. at 45-46.
5 SEC, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE ’33 AND ’34 ACTS (1969) [hereinafter cited as the WHEAT REPORT].
More recently, under the leadership of former Chairman William J. Casey, the SEC has published, and doubtless will continue to publish for a time, a series of reports by advisory committees and Commission staff task forces dealing with particular aspects of the Commission’s enforcement and administration of the securities laws. Two such reports of major importance deal with enforcement policies and real estate. Additionally, the Commission has effected significant administrative changes through its rule-making power, particularly the 140 series of rules.

Despite all that has been written and the studies which have been conducted, the statutory “patch quilt” which has resulted from various SEC amendment programs has not accomplished the overriding objective of the securities laws—the protection of public investors. The most recent example of these glaring shortcomings is the Commission’s legislative recommendations of 1967 through 1970 during which Congress, the Commission and the industry were mired in a tug-of-war centered principally on mutual fund sales loads at precisely the same time that billions of dollars were lost by public investors in the inadequately policed, runaway exchange and “hot issue” markets. The hoped-for mutual fund commission savings would not compare in any measure with the staggering losses which public investors suffered in the markets.

Neither the SEC’s legislative recommendations nor the enactments of Congress have been effective in solving the problems which brought on the market collapse of 1962; nor has the SEC or Congress effectively closed the door against the “back-office crunch” and broker-dealer failures of 1970. The Securities Investor Protection Act of 1970 (SIPC) will blunt the effect of such failures but there is grave doubt that enough has been accomplished to stamp out the root causes of such failures. The impetus for the latter should originate with the Commission, but Congress must prod the SEC, if necessary.

Hopefully, this article will stimulate thought and action in the following principal areas of securities regulation: disclosure philosophy, new issue distributions, markets, and enforcement and regulation. Concededly, others may contend for priorities respecting other aspects of the securities laws and regula-
tion. If they are stimulated to speak out, so much the better, for it can hardly be disputed that it is now time to step back and look again at the securities laws and their administration by the Commission and to see whether public investors are being protected. Absent dramatically innovative action, public investors again may suffer great financial losses unnecessarily through avoidable market or securities industry collapses and market manipulations.

II. Disclosure Philosophy

The recognition by Congress of the compelling need to enact statutes regulating traffic in securities followed upon almost a century of business growth and the expansion of frontiers which brought economic boom and bust, panic and recovery, and head-butting of giants of business and finance which shook the country to its foundations. Wall Street, the nerve center of America's financial empires, saw in succession the rule of the railroad barons (e.g., the Vanderbilts, Drews and Goulds), the amalgamators who were the heroes of monopoly and merger (e.g., the Morgans, Cookes and Harrimans), the new industrialists (e.g., the Fords and Durants), and the market makers, all of whom made Wall Street a "new Appian Way of the world."15 Michael J. Meehan was a principal engineer of the market activities in Radio, as Radio Corporation of America was known, and was credited with pushing Radio up 500 points.16 Also, he was involved in, and charged by the SEC with, an alleged manipulation of Bellanca Aircraft Corporation stock in 1935.17 Thereafter, he was expelled from all exchanges of which he was a member,18 and thus proved to be the SEC's first big catch.

Against this background in the marketplace, and despite the generally paternalistic pattern of state "blue sky laws,"19 Congress incorporated the full disclosure concept in the 1933 Act. However, it did move in the direction of regulation of securities markets in the 1934 Act.

Professor Loss succinctly summarized the history of the "idea of legislative reform" in his remarks to the American Law Institute in May, 1969.20 The

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15 E. Sparling, Mystery Men of Wall Street ix-xvii (1930). See also R. Warshow, The Story of Wall Street (1929). Both books are fascinating histories of the growth of Wall Street and the men who made it.
16 E. Sparling, supra note 15, at 133-52. In summary, Radio jumped from 85 to 420 in 1928 and reached a split-share value of 570 in 1929 before the crash. There were technical reasons for Radio's sensational rise. The bulk of the 1,155,400 shares of Radio was held by General Electric, Westinghouse and other corporations and were never released for trading. The floating supply available for trading was about 400,000 shares. As the stock started to rise, an enormous short interest developed and apparently the "bulls" were buying stock sold short by the "bears." This is the only possible basis to explain 300,000 and 500,000 share-days in a stock wherein only 400,000 shares were available for trading. At one point in 1928, up to 300,000 shares were sold short which precipitated a technical corner and drove the stock up 61 points in 4 days.
17 In re Michael J. Meehan, 1 S.E.C. 238, 243 (1935).
18 In re Michael J. Meehan, 2 S.E.C. 588, 630 (1937).
19 See 1 L. Loss, Securities Regulation 23 (2d ed. 1961).
20 Address by Louis Loss, American Law Institute Annual Meeting, May, 22, 1969, in Federal Securities Code, Comment (Tent. Draft No. 1, 1972), and in 25 Bus. Lawyer 27 (1969). The second tentative draft of the federal securities code will have been released at the American Law Institute meeting in May, 1973. Professor Loss' Introductory Memorandum to Tent. Draft No. 2 (1973) is reproduced at D-1 to D-5, SEC. REG. & LAW REP. No. 199 (April 25, 1973), and is summarized at A-2, A-3.
1964 amendments to the securities laws brought on the first steps in merging conceptually the reach of the 1933 and 1934 Acts. Thereafter, Milton H. Cohen, in his thoughtful, and provocative article, "Truth in Securities" Revisited, espoused the concept of a coordinated disclosure law which would give rise to a constant disclosure system through continuous registrants. Professor Loss has credited this article as the genesis of the events which resulted in the project to codify the federal securities laws under the leadership of the American Law Institute.

This author's comments respecting disclosure will hardly be accorded universal acceptance for they raise questions which have been brushed aside as challenging the full disclosure concept. Additionally, they pose questions of qualitative evaluation of companies and their securities. Certainly, they represent a departure from the thinking of the securities experts who have labored through the drafting of the ALI's proposed code. Milton Cohen titled his introductory section "The Need for a New Look." Since 1966, when the need was stated, the progress has been labored. Principally, it has been the project of "concerned citizens"; to be effective "the look" must be an in-depth review by Congress.

A. Does Every "Idea" Merit Public Financing?

The philosophy which underlies the 1933 Act encourages and permits the public financing of any new idea or unseasoned business. This is a sharp departure from the practice in England where small companies, and more particularly new ventures, are not attractive to investors. Further, it has not been the usual practice in England to finance a new business or discovery through a public company. The government has, however, encouraged the formation of a bank-financed corporation, the Industrial and Commercial Finance Corporation, to provide capital for small and medium-sized companies.

The protection of investors and the avoidance of great losses to the public would seem logically to support the view that there is a sensible middle ground between the English and American extremes. It would be intolerable to muzzle and frustrate the development of ideas. However, our system should provide ways and means of safeguarding against unwarranted risk-taking by investors. Consideration of such policies involves matters which are separate and apart from controls of markets.

B. Expanded, Controlled, Small-issue Concept

Merely to use the word "controlled" will arouse a wall of animus in many...
people. However, with patience, we may pursue this thought. At the outset, I suggest as controls that (i) unseasoned companies and so-called idea companies would be permitted to raise initially up to one million dollars and (ii) investors be limited to sophisticated persons, funds or institutions sufficiently experienced to assess the risks and financially able to suffer the possible losses. Assuming that Congress continued the legislative policy stated in sections 1827 and 3(a)(11)28 of the 1933 Act, thus continuing the role of the states in securities regulation, it follows that the intrastate exemption would continue to be legislative policy. Congress might also apply the one-million-dollar ceiling to intrastate offerings involving unseasoned companies and idea companies.29

The other conditions, as well as the ceiling in amount, could apply to so-called Regulation A offerings pursuant to section 3(b)30 of the 1933 Act. This is not to say that other restrictive criteria should not be applicable to such offerings. On the other hand, congressional study might indicate a need that small business be relatively unencumbered in raising up to $250,000. A balancing of policy considerations in these areas and in dealing with unseasoned companies is urgently needed.

The policies mentioned above would tend to develop bodies of securities purchasers who are investors rather than speculators. There is need for legislative study of these concepts to evaluate the merits and possible demerits of such restraints. Needless to say, other conditions could also preclude aggressive market-making by restricting salability and transferability of the securities of such companies, possibly along the lines being considered in proposed Section 227(b) of the tentative draft of the Federal Securities Code.31

Additional restraints should be considered, such as:

1. requiring that the initial public investors receive at least 50 per cent of the equity or the convertible right thereto;

2. eliminating so-called “cheap stock” by requiring promoters to invest cash on a basis equal to public investors or to limit insiders to a small percentage of the equity (e.g., 10 per cent) if they exchange services or the right to an idea for equity;

3. requiring that public investors as a group have a minimum representation on the board of directors (e.g., at least two directors or not less than 40 per cent of the directors); and

29 There is no limitation at the present time on the amount which may be raised in an intrastate offering. If unseasoned companies offering intrastate were limited to one million dollars, it would permit further reconsideration of the very restrictive limitations which exist. Cf. Federal Securities Code § 301, Comment (4) on Exemptions Generally. Id. at 74-76. (Tent. Draft No. 1, 1972).
30 15 U.S.C. § 77c(b) (1970). This section raised the small issue exemption to $500,000 from $300,000.
31 Federal Securities Code § 227(b) (Tent. Draft No. 1, 1972). Section 227(b) deals with limited offerings to institutions and not more than 35 other persons and restricts resales so that for three years there are no more than 35 owners.
4. restricting the expenses of such an offering, including compensation to finders.

On the other hand, management effort and ingenuity could be encouraged by liberal stock option plans which would be pegged, however, to fair value.

The foregoing types of conditions, as well as others which might be considered, would have as their purpose fairness to investors, while permitting, at the same time, the financing of unseasoned companies or ideas.

**C. Controls on Other Public Companies**

Some types of restrictions such as those mentioned above should also be applied to seasoned companies seeking public investors or as to which insiders are selling their own shares to the public. The fairness of the price paid by the public for the percentage of ownership sold by the insiders is crucial to investor protection. In England a stock exchange quotation is crucial to a successful public offering. To invest one entity with such power, whether a governmental agency or an industry group, would probably meet vocal opposition here. On the other hand, it cannot be controverted that our present system does not produce the best results. Over the years, underwriters have not displayed a generally acceptable capacity to balance fairly the price and the percentage of ownership sold to the public. The need for establishing criteria and developing workable formulae is a project which should have priority. Since such factors insert an element of control and are a departure from disclosure alone, the public’s need for such controls requires financial and economic justification. It is believed with confidence that the justification can be found. Philosophically, the concept that the door to the public purse is a privilege requiring fair dealing and is not solely a matter of right, limited only by full disclosure, can also be justified. Certainly no one prefers unbridled, bureaucratic controls, but criteria, in the form of controls, could be woven into the statute as expressions of public policy.

**D. Offering Documents**

Of course, the concept of full disclosure must continue as a part of the statutory scheme. But, how full is full? Periodically, the Commission speaks out in favor of more readable, less verbose prospectuses. Unfortunately, as may be said, this goal is like the weather—everyone talks about it, but no one does anything about it. Regulation A offering circulars, as well as prospectuses, can readily be substantially reduced in size and written more clearly and understandably. The main avenue leading to these objectives is exploitation and adoption of Milton Cohen’s continuous registration concepts. The *Landis Report* also commented along these lines:

Much of the delay that attends the registration of securities could be eliminated by providing for simpler forms of registration and a simplified

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supervision of the process of registration with respect to seasoned securities, bonds and debentures with an A or B rating and preferred stocks that for a past period have shown an appropriate ratio of earnings to dividends payable on such stocks. In the case of seasoned securities of this nature, the issuer and underwriter should be relied on to furnish full and accurate statements of fact and deficiency letters could be substantially abolished. It could also relieve from registration requirements certain admittedly technical public offerings for which registration is now technically necessary. The necessity for maintaining a currently effective registration statement on convertible securities, options and warrants, when an adequate market exists for the basic securities and adequate information is available in annual financial reports or proxy statements, is an example of a situation where registration is unnecessary. The issuance of restricted options to groups of employees not too excessive in number is another such example. More of them can be found. Relieving the Commission and the industry of the necessity for acting on registration statements in such situations would clear the Commission’s docket to some degree and relieve the industry of unnecessary costs.\footnote{\textit{Landis Report, supra note 4, at 45.}}

Despite all that has been written, the need for change continues. Prospectuses are dull, formalistic, lengthy, and prolix documents which defy the average investor’s patience to wade through to the end.

\section*{E. Venture Capital Pools}

As a compensating factor, in view of the controls heretofore mentioned, encouragement of the formation of pools of venture capital, raised through investment by sophisticated investors, should be considered.

\section*{III. New Issue Distributions}

It is when new issues of securities of unseasoned and idea companies become “hot issues,” with the violent, meteoric price rises which occur, that public investors are subjected to great risk. It is not uncommon in such a market for the stock of a company originally sold at, for example, $10 per share, to double or come close to doubling the day it is offered, or within a short time thereafter. Later, such stock prices may rise 500 per cent or more, without any material change in the business of the company. In a situation familiar to this author, the issuer’s stock reached over $60 per share from an issue price of $10, notwithstanding that the company, which was really only an idea, had not executed its first contract to sell its idea, a form of service. The company's stock is now selling in the range of $8.00 per share. Imagine the money lost by public investors who purchased the stock on the way up to $60, and others who bought in, all the way down. True, some public investors profited, but the extent of the unnecessary losses is the problem to be solved. Similar case histories have been repeated thousands of times over the past 40 years.

The first real effort by the SEC to investigate the causes and effects of “hot issue” markets originated October 20, 1971, with public hearings beginning in
February, 1972. Several proposals resulted from this study, but at this writing none of them has been adopted. In his introduction to the Commission's latest Annual Report, former Chairman Casey summarized the proposals in relation to (a) the roles of issuers, underwriters, and market makers, (b) discussions in prospectuses relating to business plans, budget projections, plans for use of proceeds, analysis of expected markets and (c) meaningless prospectus language and better organization and presentation of information.

There is hardly any economic statistical information regarding the periodic "hot issue" markets which the SEC has characterized as "disorderly" and which cause "damage to public investors." There was no such public record developed in the Commission's hot issue hearings so that there are no reliable statistics to show the great economic impact and losses resulting from the gyrations of such markets. If Congress conducts such studies, there will be abundant evidentiary support for the need for a new dramatic approach to securities regulation.

Hot issue markets may develop in seasoned companies as well as in unseasoned or idea companies. Therefore, in addition to the proposals heretofore made respecting such latter types of companies, the following additional market controls should be considered:

1. To avoid the exploitation of "hot issue fever" to the disadvantage of issuers and public investors, Congress should consider adopting the English allotment system. For example, if there is an offering of 500,000 shares and bona fide subscriptions for 1,000,000 shares, each subscriber would receive one-half of the shares for which he subscribed. This would tend to eliminate underwriter control over subscriptions, which in the United States result in high, same-day profits benefiting

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34 SEC, THIRTY-EIGHTH ANNUAL REPORT 11-12 (1972); see also SEC Securities Act Release No. 5274 (July 26, 1972).
35 SEC, supra note 34, at 11-12; see also SEC Securities Act Releases Nos. 5274-5279 (July 26, 1972). Release No. 5279 mentions again "... the Commission's continuing efforts to improve the readability of prospectuses. ..." 36 SEC, supra note 34, at xxv.
This writer has examined the New Issue Outlook's May 5, 1969 computer report of over 400 recent issues and its report of a year later, May 4, 1970, of over 400 other recent issues. As of May 5, 1969, the 25 stocks showing the largest gains from their offering prices ranged from a gain of 160% for no. 25 to 1220% for no. 1. At the same time, the 25 stocks showing the largest losses from their offering prices ranged from a loss of 38% for nos. 20 to 25 to 69% for no. 1.
The ranges a year later on May 4, 1970, were strikingly different. Nos. 24 and 25 showing largest gains from offering prices were 25% higher while no. 1 was 233% higher. At the same time, nos. 23 to 25 showing largest losses from offering were at 70% loss while no. 1 showed an 83% loss.
The New Issue Outlook also reported gains and losses on a weekly basis. Merely to scan these reports amply supports the inevitable conclusion that public investors are literally, not figuratively, throwing their money away. The federal and state regulatory agencies are just not doing the job.
38 For a detailed discussion of the English allotment procedure where an issue is oversubscribed see Knauss, Securities Regulation in the United Kingdom: A Comparison with United States Practice, 5 VAND. J. TRANSN. L. 47, 58-60 (1971). This article is the most comprehensive comparison in the literature of securities regulation in England and the United States. It is indispensable reading for anyone considering and studying major shifts in policy of the federal securities laws.
underwriters and their friends, rather than the issuing company and the investing public.

2. Consideration should be given to a moratorium on trading until a fixed period after the distribution of share certificates or of such other indicia of ownership as may be used in the future. Such a moratorium would tend to assure that trading is between real owners in their sole interests, rather than for the advantage of underwriters and their friends, market makers and even short sellers.

3. Short selling of new issues by speculating broker-dealers should be prohibited. There is no economic study yet which shows the losses caused public investors by short sellers or the profits made by such gamblers. The SEC is well behind the industry in recognizing this evil. However, neither the SEC nor the industry has really done anything about it. The short sellers damage the new issue market during periods of "cold" rather than "hot" investor appetite. In such markets the short sellers cause unnecessary damage to investors through their artificial maneuvering of the market. Industry self-regulation has failed miserably in this area. Unfortunately, the Commission's hot issue inquiry apparently failed to focus on this problem. It would seem to be one problem which may be solved quickly since it is within the reach of the existing statutory pattern.

IV. Markets

In his first public statement following his confirmation by the Senate, after having been nominated by the President as Chairman of the SEC to succeed Mr. Casey, G. Bradford Cook forecast a two-year (from February, 1973) timetable for developing a central market system in which the SEC and the exchanges must establish new regulatory machinery to govern the central market.9

There is a difference of opinion on the structure of such a market. One outspoken critic of the apparent limitations being encrusted on the concept is Donald E. Weeden.40 In the main, he favors a consolidated tape, a common quotation system, and the elimination of economic barriers, the two most signifi-
THE SECURITIES LAWS

...cant of which are fixed commission rates and limited access by all brokers to all markets.\(^4\)

The New York Stock Exchange's position has been stated by its Chairman, James J. Needham, a former SEC Commissioner. Mr. Needham and Mr. Weeden are poles apart, the Commission's Advisory Committee is divided, and since Mr. Needham proposes a system which orbits around existing exchanges it is unlikely that Mr. Weeden would characterize the system as a "radical change."\(^4\)

The question of such a central market, having been raised, requires congressional study and action. However, this author would not assign it as high a priority as apparently the Commission does. Billions of dollars are being "filched" from public investors while the industry and the Commission are having broker-dealers chasing around for fractions of points. True, the market can be made to function more effectively and efficiently in this electronic age. However, there are market activities well known to the industry, but not known to the Commission, which should have a higher priority of scrutiny and attention. Just ask some knowledgeable over-the-counter market makers how the public could be better protected in the operations of NASDAQ. Ask them how the shopping of 100 share lots, where there is a block of 2000 shares to be traded, can have the domino effect of triggering successive price quotation reductions and wipe points off the value of shares in the hands of the public. The question of the role of over-the-counter specialists or market makers must be reconsidered. Before a central system is set in motion all segments—the industry, the public and the Commission—should correct the weaknesses, and even evils, which have already developed in the electronic over-the-counter market. Doubtless, also, the central market most likely to function in the public interest is somewhere between the extremes at which Messrs. Needham and Weeden find themselves. There are strengths and weaknesses in both positions. It is for the Commission and the Congress to chart the best course, and, it is urged, the best course can only be charted following aggressive investigative cross-examination to uncover the abuses which have already surfaced. In this area of its power the Commission performs regulatory functions and its full disclosure philosophical approach is inadequate.

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41 Weeden, A Stock Trading System for the Future, The Financial Times of London, Dec. 5, 1972. In this article, Mr. Weeden stated:

Competing markets and market makers hooked into a nationwide communications system reporting transactions and quotations equals a central market. There is no place—de jure or de facto, in such a system for monopoly privileges. . . .

There is no need—certainly not any public need—to limit competition in market making. There is also no need to restrict, artificially, trading in any security only to exchange markets. The New York Stock Exchange recently endorsed the central market approach, but tried to restrict it to stock exchanges only, thereby excluding all non-member dealers who wished to make markets. They were like the maiden willing to be only a little bit pregnant. The clear fact is that the technology necessary to connect New York and Regional Exchange markets for the operation of a central market system is identical to that necessary to connect the New York, Regionals, and the Third Market.

Effective regulation based on factual understanding of the problems is the better course.

V. Regulation and Enforcement

For many years both regulation and enforcement were wed in a marriage of questionable administrative validity in the Commission’s Division of Trading and Markets. In 1966 the Commission reported its “increased emphasis...to improve the effectiveness of regulation and at the same time to reduce the burdens of compliance.” It was not until August 7, 1972, that a separate Division of Market Regulation was established by the Commission, in the words of former Chairman Casey: “...to serve notice not only on a violator but on the entire investment community as to the standards to which they will be held.” Chairman Casey pointed out the separate roles of regulation and enforcement and asserted that both are essential since enforcement operates after the laws are violated, while regulation operates at an earlier point in time, before violations occur.

Chairman Casey also commented that a Branch of Trading Practices would be established in the Division of Market Regulation and

...be charged with carrying on an educational program as well as developing regulations and providing interpretations and releases with a view to elevating professional standards and minimizing unwitting violations of securities laws and regulations. The foregoing statement of policy is to be applauded. It is well that the Commission at long last is moving away from a long-existing posture wherein enforcement proceedings, in the courts as well as in SEC administrative proceedings, were a major vehicle to effect regulation. Since former SEC Chairman Cook was the first director of the Division of Market Regulation a new emphasis and thrust were to be anticipated in the future. Hopefully, the new Chairman will champion such emphasis.

Commenting on the situation which he observed in 1960—that important regulation by the Commission had been long delayed—Commissioner Landis stated:

One serious feature of delay on the part of the Securities and Exchange Commission lies in the issuance of regulations and forms. Important regulations have been delayed for years. Some reason for this delay lies in the inherent complexities of the problems and the commendable practice of the Securities and Exchange Commission...of affording opportunities to the industry to comment on proposed regulations. But an element of delay arises from the incapacity of the Commissioners themselves to grasp the essence of these problems and the significance of their resolution to the financial community. Because of the excellence of its staff and the inherent complexities of the problems, the Commission in a sense is the captive of its

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43 SEC, THIRTY-SECOND ANNUAL REPORT 6 (1966).
45 Id.
staff. It appears to be incapable at times of resolving differences within the staff and the resultant inaction makes for delay.\textsuperscript{46}

It is in the light of these comments respecting regulation and the Commission-staff relationship that enforcement and regulation will be revisited.

A. Enforcement Policies

The \textit{Report of the Advisory Committee on Enforcement Policies and Practices} opens with a summary of 43 recommendations,\textsuperscript{47} few of which have yet been implemented.\textsuperscript{48} Recommendation 10 states that "[c]he Commission should give continuing attention to the conduct of investigations," and in numbers 1 and 11 it is recommended that a "planning office," to perform a "staff" rather than a "line" function, be established under the direction of an experienced official responsible to the Commission, not as an "ombudsman" but rather as one making an appraisal of "... whether the Commission's policy of fairness, promptness and efficiency in investigative procedures is being observed."\textsuperscript{49} The essential weakness of this suggestion is that it does not correct, but rather continues, an unfortunate situation alluded to in another context in the aforementioned \textit{Landis Report}. Rather than a Commission enforcement policy, over the past quarter-century at least, realistically, enforcement policy has been staff-dominated.

Enforcement policy will become a Commission policy only when one or more Commissioners devotes a major portion of time to directing staff action and attitude. And, this will not occur until the members of the Commission are un-shackled from the administrative burdens, some of which are trivia, in which the Commission has been immersed and unable to relieve itself. The interposition of another layer of staff, as suggested by the Advisory Committee, would merely make more difficult the accomplishment of an enforcement policy truly reflecting Commission direction and leadership—a policy which would flow downstream rather than upstream, as it has for so many years. Perhaps, under the present statutory framework it is impossible for the Commission so to free itself. It may be that another approach is not only indicated, but necessary.

Since the 1930's the securities industry has lived under the jurisprudential anomaly that the enforcement decision-maker (\textit{i.e.}, the Commission) has been at the same time the judicial decision-maker—the adjudicative body which applies the law to the facts, and sanctions those found guilty of violating the law. Throughout this 40-year span, many concerned lawyers, experienced in the administrative law specialties, have been outspoken in criticizing administrative agencies which have acted simultaneously as enforcer-prosecutor on the one hand, and as judge and jury on the other. The Commission continues to be

\textsuperscript{46} \textit{Landis Report}, \textit{supra} note 4, at 46, 47 (emphasis added).

\textsuperscript{47} \textit{Enforcement Policies Report}, \textit{supra} note 9, at i-viii.


\textsuperscript{49} \textit{Enforcement Policies Report}, \textit{supra} note 9, at iii, 24.
concerned about this dual function of apparently conflicting positions. The interposition of a hearing examiner, now an administrative law judge, did not allay the fears of such lawyers. Perhaps there is a better answer. It is submitted that it would be better jurisprudence to limit the Commission's functions so that a Commissioner acts either as prosecutor or as judge. This could be accomplished without adversely affecting the administration of the securities laws. The solution is a matter for congressional decision, after considering the contending sides. For sure, however, the present statutory scheme should be changed and the Commission should be either prosecutor or judge, but not both.

Perhaps the concept of staff enforcement, with the Commission acting solely in an adjudicative capacity, would be preferred by some. Under such a system, the Director of the Commission's Division of Enforcement could be empowered to initiate administrative proceedings while the Commission's General Counsel could be empowered to institute enforcement proceedings in court. The role of Commissioners in the enforcement area would be purely adjudicative. Others would prefer that all enforcement proceedings be initiated by the five-man Commission and that the administrative law judges be truly independent members of a separate administrative court in which the judges would hear cases arising in all of the administrative agencies, such as the Federal Trade Commission and the Interstate Commerce Commission. Appeals from decisions of the judges of such an administrative court would then be directly to the federal courts of appeals and not to the Commission.

This author prefers the latter jurisprudential philosophy because it would center in the five-man Commission administrative responsibility for securities regulation, including rule-making, as well as enforcement. It would avoid centralization of enforcement power in one man—either the Division Director or General Counsel—and it would permit the development of true Commission enforcement policies, not one-man enforcement policy. At the same time, judicial objectivity would be accomplished, particularly in the application of sanctions and penalties. Traditionally, the imposition of sanctions has been a judicial function and, in the administration of the securities laws, it would be well to retreat from the experiments initiated in the 1930's and acknowledge that the time-honored jurisprudential methods are preferred. Congress would have to establish an administrative court and relieve independent agencies such as the SEC from such adjudicative responsibilities. Past SEC Commissioners should be among the vanguard of those favoring such changes, for, almost to a man, they

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50 The Commission has stated:

[The Commission is not in a position to, in effect, adjudicate issues of fact before the proceeding has been commenced and the evidence is placed in the record. In addition, where a proposed administrative proceeding is involved, the Commission wishes to avoid the possible danger of apparent prejudgment involved in considering conflicting contentions, especially as to factual matters, before the case comes to the Commission for decision.


51 Cf. the authority given to the General Counsel of the National Labor Relations Board, a Presidential appointee, to investigate charges and issue complaints. Labor Management Relations Act, 29 U.S.C. § 158(d) (1970); NLRB v. Selwyn Shoe Mfg. Corp., 428 F.2d 217 (8th Cir. 1970); UAW v. NLRB, 427 F.2d 1330 (6th Cir. 1970).]
The Securities Laws have defaulted to the Opinion Writing Office in the articulation of policies. Very few Commissioners can claim to have reviewed the records in cases decided during their terms. Such a review is central to the judicial function in appellate matters.

During the past quarter-century very few Commissioners have had enforcement experience, and it is not unfair to state that very few Commissioners had any real interest in the theory, techniques and objectives of enforcement. If Congress relieves the Commission from performing adjudicative functions, then persons with a knowledge of industry problems or with enforcement or regulatory experience would be prime candidates for appointment to the Commission.

B. Self-Regulation by the Industry

The National Association of Securities Dealers (NASD), the independent industry body which is charged with regulating the over-the-counter markets and the broker-dealers engaged therein, was formed following the Maloney Act Amendments in 1938 to the 1934 Act. The NASD has adopted rules of fair practice which, in article III, relate to business conduct and fair dealing with customers and others. Also, it has adopted a code of procedure for handling trade practice complaints.

The National Securities Exchanges also have adopted rules and enforcement procedures, typical of which are those of the New York Stock Exchange. The Commission has only infrequently instituted enforcement proceedings against Exchange member firms following disciplinary action by an exchange. One such case is In the matter of Cady, Roberts & Co. Duplication of enforcement activity should not be a major objective. As pointed out by the Enforcement Advisory Committee, there is a present, critical need for coordination between the Commission, states, and self-regulatory agencies, the NASD and exchanges.

If Congress restructures the Commission's enforcement role, at the same time it should empower the Commission to exercise greater oversight over the NASD and exchanges. The industry groups have a place and they can regulate industry fair practices. Enforcement and discipline in public matters present problems of

52 LANDIS REPORT, supra note 4, at 47. In commenting on Commission practice in opinion writing, Mr. Landis stated:

The Securities and Exchange Commission has an opinion writing section whose quality is high, if not the highest among the agencies. Nevertheless, it should be abolished and individual Commissioners held individually responsible for the enunciation of the grounds upon which conclusions of the Commission are stated to rest. If the numerous speeches and articles of the various Commissioners are a test of their capacity for articulation, this should not be an impossible task.

Id. While this author was a member of the Commission with Chairman Edward N. Gadsby, Byron D. Woodside and Earl Hastings, the assignment of cases to individual Commissioners was initiated. It was abandoned, however, in 1961 under a new chairman appointed by President Kennedy.


54 NASD MANUAL ¶ 2151-80 (1971).

55 Id. ¶ 3001-26.

56 2 N.Y. STX. EXCH. GUIDE ¶ 1651-75 (1971). See also 1 L. Loss, supra note 19, at 1168-83 for a discussion of Exchange discipline and rules.


58 ENFORCEMENT POLICIES REPORT, supra note 9, at 52-61.
a different dimension. A Commission relieved of adjudicative functions and concentrating on regulation and enforcement would be best equipped to handle such matters.

C. Procedural Rules

If Congress were to remove the adjudicative functions from the Commission, the new administrative court could adopt fair rules of procedure consistent with those in effect in the federal courts. In the meantime, the recommendations of the Enforcement Advisory Committee should be implemented immediately in the interest of fairness, equity, and due process. Recommendation number 23 urges that the identity of witnesses and legal theories be made available at the request of a respondent; number 25 suggests emphasizing the opportunity for settlement or simplification of the issues at the prehearing stage of a proceeding. The modifications of the Commission's rules recommended by the Committee would aid in expediting the presently "unduly protracted" proceedings, in addition to adding the elements of fairness mentioned above. None of the changes recommended by the Committee require legislation.

The Commission has not yet moved to effectuate the changes recommended. Their validity, importance and need would be appreciated by the members of the Commission if one or more Commissioners would undertake to sit as an administrative law judge or at least observe the conduct of administrative proceedings. This author is convinced that the members of the Commission would be persuaded of the need for the changes recommended by the Enforcement Advisory Committee and for additional changes not mentioned in the Report, which would insure a greater degree of fairness in the trial of administrative proceedings and expedite them as well.

D. Enforcement and Professional Responsibility

The Commission is entitled to expect that professionals who practice before it, such as lawyers, accountants, engineers and geologists, should maintain high standards of ethics and professional conduct. To this end, the Commission has recently instituted court proceedings in which it has named lawyers and accountants as defendants. This author has urged the need for study of such litigation and a definition of the role of attorneys in representing public companies, and otherwise practicing before the Commission. Rules of professional conduct should not be developed through case-by-case litigation, but rather

59 Id. at 37-43.
60 No purpose is served by listing the names of cases and the courts wherein they have been initiated. See discussion in the Enforcement Policies Report, supra note 9, at 9, 10 (consultation between the Commission and professional associations is recommended).
61 SEC. REG. & LAW REP. No. 182, at A-2 (Dec. 20, 1972): The SEC has challenged the traditional role of lawyers as advocates, and has been doing so on a case-by-case basis in the courts. Presumably, it will also do so in SEC disciplinary proceedings. Lawyers' responsibilities should not be defined in this manner and the Bar should participate in establishing standards and negotiating with the Commission to effect reasonable safe-guards for clients and for the public. The challenge to the traditional, confidential lawyer-client relationship calls for the Bar
through reasoned discussion in the public interest. Lawyers have long maintained rules of professional responsibility and the courts have enforced compliance with such standards since lawyers are officers of the courts. Other professions are capable of doing likewise. The Commission's unilaterally seeking to establish its ideas or concepts of professional responsibility, or those of its staff, through litigation rather than bilaterally with the various professions does not merit commendation, but requires change. As with its failure to change its procedural rules to invest its administrative trial procedures with a needed tone of fairness, the Commission as an institution likewise has not moved expeditiously in the public interest to formulate standards of professional conduct. It would be well if the Commission would modify its posture from "headhunter" to regulator, in the sense that it looks for compliance with established standards.

E. Regulation

Over the past 40 years, the SEC conclusively demonstrated its lack of capacity to apply a rule of reason to the regulatory reach of the securities laws. Particularly, following the Supreme Court's recognition that the securities laws were remedial legislation to be liberally construed, and exemptions therefrom to be strictly construed, the Commission has been unable to resist seeking more and more power. It must, of course, be acknowledged that the courts have supported the Commission's extensions of the perimeters of its jurisdiction. Thus, only restudy and reevaluation by Congress, followed by legislative action, will result in a change in the course which the Commission has long pursued. It is time for Congress to reassess the priorities. To date the Commission has not well established its priorities—witness its inability to take effective steps to blunt or cushion the adverse effects of market gyrations while it exhausted and thinly spread its available personnel by expanding the fields which it regulates. Concededly, the SEC under former Chairman Casey made great strides in bringing order to many interpretive areas previously obscured. Despite such dynamic progress over a two-year period, reassessment is still critically imperative. There are numerous spheres of regulatory importance to which a congressional evaluation of Commission action is long overdue.

1. Small Issues

Aside from the recommendations already noted which would involve
to take steps to define the lawyers' professional responsibilities. If it is left to a litigated case-by-case development of standards, the public and the Bar will be prejudiced.

Id. 62 The use of the term does not invite the rejoinder that the professions are acting like "cannibals." Lawyers who engage in an enforcement practice before the Commission can attest to the fact that the mention by a witness of a conversation with a lawyer or accountant brings a new alertness to the questioner and a new "snap" to his questions. The atmosphere becomes electrified, and may even bring a branch chief or assistant director into the room. Pursuit of the lawyer or accountant seems to become a more compelling objective than the matter under investigation. It is an atmosphere in need of change.

64 See text accompanying note 30, supra.
a major shift in public policy in administering the provisions of Regulation A, adopted pursuant to section 3 (b) of the 1933 Act, the Wheat Report recognized in 1969 that some rigid restrictions had developed and urged that they be changed. More unfortunate is the fact that a Regulation A filing is so encumbered with requirements similar to those in a registration statement that underwriters and lawyers in the country’s financial centers are loathe to use Regulation A. It has long ceased to be an effective tool for use in small business financing. A reversal of an attitude stimulated by congressional oversight is overdue.

2. INTRASTATE OFFERINGS

Despite the clear statements of public policy set forth in sections 3 (a) (11) and 18 of the 1933 Act respecting the intrastate exemption, the Commission and its staff have been chipping away at the exemption over the years. The congressional policy was stated as intending to exempt “... sales within a state of the entire issues of local issuers.” The Commission has announced proposed Rule 147 which deals with the intrastate exemption and encrusts additional restrictions on the exemption by setting a six-month blanket to cover sales of all securities, defining doing business to require that 80 per cent of gross revenues come from the one state along with there being 80 per cent of assets within the state, requiring that 90 per cent of the proceeds also be used in the state, and restricting resales to nonresidents for 12 months. These are arbitrary and artificial limitations on the intrastate exemption and are further extensions of a trend to ignore and restrict the announced public policy set forth in the exemption. Again there is need for Congress to revisit and reevaluate public policy.

This author has reviewed this exemption heretofore and pointed out pitfalls in the use of the exemption, but he is not in sympathy with the concept that clarification and more certainty require restrictions on a statutory exemption.

3. COLLECTIVE INVESTMENT

The insurance industry first intruded into the SEC’s securities domain with the so-called variable annuity which the Commission successfully contended was not truly an insurance product, but a security. An attempt to exclude a

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70 SEC Securities Act Release No. 4434 (Dec. 6, 1961). The Commission mentions “... local financing by local industries ...” and repeats its warning (as in Release No. 4386) that “... quick commencement of trading and prompt resale of portions of the issue to nonresidents ...” may defeat the exemption. Id.
variable insurance product with guarantees from being held to be a security failed again. The insurance industry's most recent attempt to develop a variable product which would be exempt from securities regulation involved variable life insurance. The SEC concluded that the product was subject to the 1933 and 1934 Acts, but granted tentative exemptions for variable life insurance from the Investment Company Act of 1940. With autocratic chutzpah the Commission announced to the states the types of actions it expects them to take in regulating variable life insurance and promised:

The Commission will closely monitor the development of state law in this area to assure its adequacy in providing these protections and, if in the future it appears that substantial deficiencies exist and are not likely to be remedied, the Commission will then consider whether it is necessary or appropriate to modify or rescind Rule 3c-4.

This author was on both the SEC and the industry sides of the variable annuity cases as counsel and believes that the following comments are made with objectivity. The Commission unfortunately was unable to resist extending the reach of its regulatory powers and was not content to leave the control of variable products issued by insurance companies with the insurance departments of the states. This grasp for power burdens the Commission's personnel and causes the available personnel to be spread thinly, regulating an already regulated industry, while some, including the writer, question how well (or even adequately) the SEC is performing its main mission—the protection of public investors and policing the markets. In SEC v. United Benefit Life Ins. Co., the Supreme Court left open the issue of application of the 1940 Act, but in the statement quoted above the SEC leaves no doubt of its intention to oversee the actions of the state insurance commissioners. One necessarily must wonder how long Congress will allow this situation to continue without giving clear guidance to the Commission and the states, and declaring the federal public policy once and for all.

4. Real Estate Investments

In October, 1972, the Commission's Real Estate Advisory Committee issued its report, which contains a sufficient number of controversial recommendations to keep attorneys in the securities and real estate fields busy for a long time. Naturally, since it is a SEC-appointed committee, this report looks upon syndicates, partnerships, limited partnerships and condominiums through glasses

78 The billion dollar Equity Funding insurance and securities scandal will afford state insurance regulators and federal and state securities regulators much opportunity to study and correct the weaknesses in the regulation of both insurance and securities. Nothing which has been reported to date supports the theory that the SEC would be more competent than state insurance departments to regulate and prevent fraud in the insurance industry. Inspection and regulatory techniques of securities and insurance regulatory agencies have failed and require change.
tinted by an emphasis on securities law. At the same time several states are
already in, or are moving into, the "regulation act." This is another example of
a situation requiring congressional review. There is a need for definition as to
whether the public should be protected by a federal agency regulating securities
or one regulating land. Further, Congress is better able to define public policy
considerations involved between the states and the federal government, or be-
tween the states.

5. INTERPRETIVE CHANGES EXPAND COMMISSION WORKLOAD

The long-overdue and eagerly awaited clarification by Rule 144\textsuperscript{79} of the
terms and conditions under which investment stock may be sold and the rescind-
ing of merger Rule 133,\textsuperscript{80} through the adoption of Rule 145,\textsuperscript{81} continue to im-
pose added workloads to an already burdened staff. There should be an adminis-
trative solution to the continuing need for volumes of no-action letters under
Rule 144. Such requests and the added registration burdens under Rule 145
cause one to wonder if the Commission really carefully considers the effects of
the new burdens on staff which will result and whether the public interest is
really advanced by a new Rule such as 145.\textsuperscript{82}

Those who follow the interpretive development in the securities field are
inundated by the exhausting proliferation of "no-action" letters.\textsuperscript{83} In principle
the no-action letter has been a great aid to the industry and the bar, but there
tends to develop an attitude of nit-picking by both the inquirers and the staff.
Much unnecessary personnel time is thus wasted which could be eliminated by
clearer rules and guidelines. Time saved could be devoted to more critical prob-
lems for the protection of investors.

These matters are in need of administrative review. Legislation is not
necessary to accomplish a more effective utilization of the available personnel.
Perhaps more concentrated review by the Commission of positions taken by the
staff would aid in the development of new rules and guidelines. The better
appreciation the Commission has of staff problems the better the possibility of
solving them. The legal profession can help by using opinions of counsel and
relying on them. The need for a "security blanket" in the form of a "no-action"
letter should be discouraged by the Commission, the industry and the bar.

VI. Conclusion

After 40 years of experience in the administration of the federal securities
laws there is a need for restudy and reevaluation by Congress and the Commis-

\textsuperscript{80} SEC Rule 133, 17 C.F.R. § 230.133 (1972).
\textsuperscript{82} The no-sale theory had been a part of the securities lore (or law) for so long one tends
to feel that an old friend passed away. A respectable segment of the bar and the industry
favored retention of a modified Rule 133 rather than the Rule 145 registration requirements.
\textsuperscript{83} For an excellent review of the "no-action" letter procedure see Lowenfels, SEC "No-
sion as well. Some of the areas which should be revisited promptly and the questions to be raised are:

1. Does the full disclosure policy of the 1933 Act adequately protect investors?

2. Should not unseasoned companies and idea companies be limited in the amount of money they are initially permitted to raise publicly and the type of investors to whom such companies may make offerings?

3. Does not fairness require the public to receive a more equitable share of the ownership of a company by restricting "cheap stock" and setting standards to minimize dilution?

4. Does public investment merit participation in management by the public?

5. Should not the distribution of securities to the public be done more fairly, perhaps by allotment?

6. Are not "new-issue" markets in need of effective controls to eliminate artificial, manipulative, depressing factors such as short-selling of "cold issues" and to avoid the runaway markets of "hot issues"?

7. While enforcement has a necessary, proper place in the administration of the securities laws, should not regulation be more effectively used in the public interest?

8. Is there not a need for the Commission to assert leadership in the establishment of enforcement and regulatory policies?

9. Should the Commission be relieved of its adjudicative functions and be free to concentrate on enforcement, regulation and administration of the securities laws?

10. Is not an independent, separate administrative court a better system of jurisprudence than the present adjudicative procedures which involve the Commission at the same time as prosecutor, judge and jury?

11. Does not the protection of investors call for congressional direction to the Commission to fulfill the main mission of the securities laws and for Congress to return to the states the regulation of insurance companies and their products and to other agencies the regulation of real estate companies and their financing vehicles?

This author, by raising these questions, does not imply that the Commission
and its staff are inept, bumbling, or incompetent. On the contrary, as Dean Landis pointed out, the Commission's staff is extremely well qualified and devoted. Rather, the questions raised are directed toward policy and administration of policy.

The concept of controls on companies going public is apt to evoke unfavorable reaction. However, should not there be study? Are we assured that the full disclosure system cannot be improved? Should there really be no limitations on unseasoned companies going to the public for financing? On the other hand, this author is confident that most will agree that investor protection requires more effective controls over distributions of securities and over the marketplace.