November 6, 1964

From: Carl W. Schneider

Re: Memo dated April 21, 1964 on Codification of Securities Laws

Professor Loss has considered with the American Law Institute the possibility of codifying the various securities laws. Chairman Cary had requested me to consider the advisability of such a project from the Commission's point of view. Since Loss and others have been pushing this idea from time to time, the attached memorandum may be of some assistance in formulating a Commission position on the proposal.

MEMORANDUM

April 21, 1964

To: The Chairman

From: Carl W. Schneider, Consultant

Re: Codification of Security Laws

For your convenience, this memorandum summarizes some of the main points of our discussion on Loss' proposal for codifying the security laws as an ALI project.

(1) Codification will result inevitably in certain changes in the law, especially if the ALI attempts to codify the administrative and judicial interpretations. Loss does not deal directly with the problem which I believe to be a major one from the Commission's point of view -- will the regulatory scheme be strengthened or weakened by the codification. The codification must pass three hurdles to become law.

First, the drafting committee must prepare the bill. I would guess that the committee's result will be acceptable to the Commission, especially since Loss presumably will be the chief draftsman.

Second, the codification must be approved by the ALI. I am not quite as pessimistic about the ALI as you are, although my feelings are intuitive and not based on first hand experience.

Third, the codification would have to pass through the legislative process. If the Congress becomes to enamored with the project, it might become committed to passing the bill and the bill might then get out of hand from the Commission's

point of view. I believe that this stage is the one where the Commission risks losing the most.

One likely result of a codification might be that the overall scheme is improved but that special interest groups will be able to pressure through exemptions relating to particular industries or types of transactions.

(2) The present patchwork of legislation proves quite workable from the Commission's regulatory point of view, if not from the aesthetic and/or public points of view. Indeed, it may be the very patchy quality of the legislative scheme which contributes to the great flexibility which the Commission now enjoys. Within the very broad legislative outlines, the Commission has been able to remake the law as it sees fit. A precise codification may eliminate some of this flexibility.

Rules 133 and 155 under the 1933 Act illustrate how the Commission has been able effectively to amend the law in the guise of defining statutory terms.

The Commission also has been able to eliminate for practical purposes unworkable parts of the statutory scheme. For example, the shelf registration policy renders practically meaningless the last sentence of Section 6 (a) of the 1933 Act. The twenty day waiting period in Section 8 (a) has never been an effective part of the law. Through the acceleration technique, which evolved without the legislation (but later was codified), and the delaying amendment fiction, which was codified as Rule 473, the waiting period has always been as long or as short as was appropriate notwithstanding the specified period of twenty days. The letter of comments, which is issued in almost every case, replaces the stop order which Section 8 envisioned. At the same time, our power to withhold the letter of comments gives us enormous leverage to use in proper cases. I am sure we would not want to lose this leverage by having the letter of comment procedure codified and made mandatory.

The Commission has more effective power than certain other agencies to tailor the law without legislation. Unlike agencies which are principally engaged in enforcement, our "clients" need action from us -- action which is in large part discretionary. To a considerable degree, there is no effective remedy if we withhold such action, so we are in a position to have our own way. The conditions to acceleration set forth in Rule 460 and the note following illustrate the extent to which the Commission is now able to impose its view even without specific legislation.

Are there any changes in the law which the Commission desires which it cannot achieve without legislation? If so, does the Commission feel that such legislation has a chance of being passed? Unless both of these questions are answered in the affirmative, we stand to lose more than we gain by the changes through

codification. Of course, the Commission and the public may both gain to the extent that the scheme is simplified.

(3) It might be a mistake to attempt a codification solely by lawyers. The industry which is regulated by our various Acts has a legitimate right to participate. The ALI might not be the most effective organization for the project.

(4) Likewise, there should be a continuous liaison with the Commission As provisions jell, they become increasingly more difficult to change. I believe the Commission's point of view should be represented throughout the drafting period. Possibly this can be done best on an informal basis through individuals who are not formally associated with the Commission but who enjoy its confidence. I have in mind particularly former Commissioners and other key personnel now in private practice who can consult freely with the Commission and represent its point of view without binding the Commission in any way.

(5) One of the important developments is the emergence of a federal common law of corporations. Our Acts provide the backdrop and analogies from which the courts reach their conclusions. I believe the trend of decisions has been favorable and the development of this body of law should be encouraged. I am not sure whether a codification would help or hinder this development. For instance, if the draftsmen consider and reject a particular remedial provision, it might be harder for the law to develop in that direction. Illustrative in this context is the evolution of an implied right for defrauded buyers based on Rule 10b-5 under the 1934 Act. The buyer is able to avoid the short statute of limitations which was included in the 1933 Act, as part of the overall compromise, in return for expanded bases of liability. If the draftsmen decline to codify expressly a buyer's remedies under Rule 10b-5, the risk is increased that the Supreme Court will refuse to sanction such development when the Court ultimately passes upon the question. On the other hand, the draftsmen might do much to accelerate the pace of the judge-made law.

(6) One of the major difficulties with the present law is the lack of certainty. However, little significant improvement is likely to result from a codification, absent substantive changes in the law, on some of the more common troublesome problems. For instance, absent a substantive change, it is unlikely that a codification will make it easier to identify a private offering or to determine when investment stock can be sold.

(7) As you suggested, the goal of clarification for the benefit of the public might be achieved through techniques other than the preparation of a statute which will replace all of our present statutes. The ALI might develop a "restatement." It could be in a form of a coherent compilation of the statutory and decisional law, with appropriate references to the underlying material. Although it would lack official status, it would serve as an invaluable guide to public understanding of our terribly complex scheme of statutes, rules, decisions, interpretations,

practices, etc. The restatement approach would also avoid the hazard of having ALI's product watered down by Congress.

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Although the foregoing comments are essentially negative, they are not meant to constitute a recommendation against the project. I have attempted merely to summarize certain adverse considerations in addition to those marshaled by Professor Loss in his memorandum in favor of the project.

As I mentioned to you, I find the Loss proposal highly challenging from an intellectual point of view. If the project is to go ahead, I would be delighted to participate in any manner in which I can be of some use to the Commission.