Securities Regulation Reform: Past, Present and Future

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SECURITIES REGULATION REFORM: PAST, PRESENT AND FUTURE

Although our markets are still flourishing and continue to be the best in the world, the securities industry is beset with a myriad of problems which, if not solved, could have a severe impact on the continued viability of our financial marketplace. What is of particular concern is the way we are attempting to deal with them. In many instances, we seem to be just watching these problems as they erode the confidence of investors and the integrity of our great system. In other instances, we are dealing with Band Aid solutions. Much more is required.¹

INTRODUCTION

Over fifty years ago, a national emergency presented the need and opportunity for a scheme of federal securities regulation. Hurried and uncoordinated recovery-oriented legislation created an inefficient patchwork of laws which to this day remains in substantially the same basic form as when enacted.² Although such legislation may have been adequate at the time, there have been significant changes in the securities industry and the capital markets which indicate a need for changes in the securities laws. These changes are needed to protect the continued vitality of the U.S. markets in a global environment. The capital markets have become more volatile and international in scope, and there have been major changes in capital allocation, the types of securities offered and distribution techniques.³ In order to compete in the international capital markets and provide for the optimum allocation of resources in the U.S. capital markets, the scheme of federal securities regulation must adapt to the realities of the current market and the indications of modern economic theory.

A major problem in securities regulation continues to be the duplicative nature of the securities laws, despite the benefits of the integrated disclosure

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² “The securities laws, however, have retained not only their support but also their structure. They had and still have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter.” Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669 (1984).
³ The markets have changed in two important ways. The proliferation of new types of securities and distribution techniques has put increasing pressure on the 1933 Act listing of ‘exempt securities’ and ‘exempt transactions,’ while developing internationalization of the securities markets has created tension between the regulated domestic market and the ‘unregulated’ Eurodollar market. McLaughlin, 1933 Act’s Registration Provisions: Is Time Ripe for Repealing Them?, Nat'l Law J., Aug. 18, 1986, at 44, col. 1.
system. A For example, the Securities Act of 1933 regulates particular offerings of securities in the primary securities markets while the Securities Exchange Act of 1934 regulates securities in the secondary trading markets. The two Acts contain different or redundant disclosure requirements, conflicting liability provisions and inconsistent filing requirements and procedures.

Another major problem of securities regulation is its continued emphasis on the scheme and premises of the original legislation, disregarding modern economic theory and circumstances. For instance, the goal of disclosure for the individual investor continues to be paramount even though individual investors do not use such disclosures, relying instead on financial intermediaries and an efficient capital market. These and other problems can best be rendered intelligible with a background of the federal securities laws and a chronicle of the events that shaped them.

I. FEDERAL SECURITIES REGULATION

Federal securities law is largely a patchwork of six statutes enacted between 1933 and 1940, and one enacted in 1970, as amended. The first statute, the Securities Act of 1933, essentially mandated disclosure and created antifraud provisions in the initial distribution of securities. The Securities Act of 1934, 8

4. See infra notes 167-99 and accompanying text.
5. See infra notes 245-81 and accompanying text.
6. See id.

In summary, the Commission's disclosure system cannot be given high marks either for performance or on a cost/benefit basis during its first forty years. The system was founded not on disclosure of 'all material facts,' but on disclosure of events in the past which the Commission could objectively verify. This historical perspective was assumed for the inefficient purpose of preventing blatant securities fraud . . . and for the less apparent purpose of protecting the Commission from criticism for issues that turn sour . . . . In recent years, while the Commission has shown commendable willingness to try to modernize the system, developments and economic theory have outrun adaptation of the system. A large apparatus of disclosure which serves little purpose still remains. The disclosure mandated for large companies by the Securities Act does not reach the public in any more useful fashion than the same information already reaches the public through the companies' reports to stockholders and the Securities Exchange Act disclosure system. The purpose of mandated disclosure, when so many investment decisions turn on subjective factors dependent on each investor's time frame and portfolio position, has not been completely thought through . . . . The 1933 Act and the purposes of mandated disclosure need fundamental rethinking as we embark on a new fifty years; however, signs that this rethinking is in process are not visible.


7. See infra notes 200-43 and accompanying text.
a more comprehensive act, regulated the secondary securities markets and dealt with other aspects of the securities industry. The remaining statutes apply to narrower concerns of the securities industry. The Trust Indenture Act of 1939\(^\text{10}\) requires the qualification of trust indentures, even for trust indentures of securities qualified under the Securities Act of 1933. The Investment Company Act of 1940\(^\text{11}\) governs investment companies and the Investment Advisers Act of 1940\(^\text{12}\) regulates covered investment advisers. The Securities Investor Protection Act of 1970\(^\text{13}\) establishes the Securities Investor Protection Corporation for the protection of customers of certain broker-dealers who encounter financial difficulties. The largely obsolete Public Utility Holding Company Act of 1935\(^\text{14}\) completes the patchwork of federal securities regulation. This Comment will focus on the 1933 and 1934 Acts since they are the principal federal statutes which address securities regulation.

The key substantive provision of the 1933 Act is Section 5\(^\text{15}\) which provides that no security may be offered to the public via the mails or interstate

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\(^{11}\) Id. §§ 80a-1 to 80a-64 (1982 & Supp. III 1985).

\(^{12}\) Id. §§ 80b-1 to 80b-21 (1982 & Supp. III 1985). “The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's.” SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).


\(^{15}\) 15 U.S.C. § 77e (1982 & Supp. III 1985). Section 5 is the heart of the 1933 Act: Section 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

2. to carry out or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

2. to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any
commerce unless a registration statement has been filed with the Securities Exchange Commission.\textsuperscript{16} Section 5 also prohibits any sale to the public unless this registration statement has become effective. An offer for the sale of securities in violation of Section 5 gives the investor a right to rescind the contract or sale.\textsuperscript{17} The form and content of the registration statement is prescribed by the 1933 Act and SEC rules thereunder. These rules require that the registration statement contain certain exhibits and the issuer's prospectus.\textsuperscript{18} The prospectus\textsuperscript{19} must contain all information material to investors deciding whether or not to purchase the securities offered. Section 10\textsuperscript{20} of the 1933 Act, along with specific rules and forms issued by the SEC, prescribe the disclosures required. Section 5\textsuperscript{21} of the 1933 Act prohibits the delivery of securities through the mails or interstate commerce unless preceded or accompanied by this statutorily prescribed prospectus.

\textit{Id.}

Generally, § 5 of the Securities Act of 1933 'forbids the use of any means of interstate commerce or of the mails to sell or offer to sell securities without having first filed a registration statement with the [SEC].' However, this 'broad and all-encompassing prohibition . . . must be read in conjunction with the claimed exemptions which are in the nature of exceptions to the overriding purposes of the Act.' The Securities Act of 1933 'carefully exempts from its application certain types of securities transactions where there is no practical need for its application or where the benefits are too remote.'

SEC v. Continental Tobacco Co. of South Carolina, 463 F.2d 137, 155 (5th Cir. 1972) (citations omitted).


The objective of a prospectus is to solicit investment by the general public. Mandatory registration of such materials with the SEC is intended to ensure that the factors entering into prudent investment decisions are depicted in a standardized, comprehensible, and accurate manner. Thus, the intended audience will be extremely broad, encompassing both sophisticated financial analysts and untutored lay persons. As the principal goal of the Securities Act is disclosure, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 . . . (1963), close questions will generally be resolved in favor of the inclusion of information.

Given these factors, disclosure in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither oversubtle nor overplayed, its meaning accurate, yet accessible.

Greenapple v. Detroit Edison Co., 618 F.2d 198, 210 (2d Cir. 1980).


Technically, it is an “issue” or offering of securities which is registered rather than the security itself. Thus, unless an exemption is available, a purchaser, in many cases, is required to file a second registration statement under the Act in order to publicly resell the securities. The 1933 Act, therefore, creates a static registration and disclosure system for securities which is dependent upon the event of an offering or issue. The 1933 Act, however, provides exemptions for certain securities and transactions in securities.

The 1933 Act exempts two categories of securities from registration. Certain types of securities are deemed exempt in and of themselves under Section 3, and Section 4 exempts certain specified transactions. Section 3 authorizes the SEC to exempt securities offered up to an aggregate of $5 million pursuant to a rule or regulation, in addition to the securities specifically enumerated in that section. Under this authority, the SEC has adopted Regulations A and D. Regulation A, which exempts up to $1.5 million of securities sold by an issuer during a twelve month period, is available only if the issuer complies with certain simplified registration procedures. Regulation D consists of three substantive rules including: Rule 504 which permits an issuer to sell $500,000 of securities to any number of purchasers in a twelve month period; Rule 505 which provides that $5 million in securities may be issued without registration to an unlimited number of “accredited” investors and to thirty-five other persons; and Rule 506, promulgated under Section 4, which is discussed below.

Section 3 also exempts securities which are part of an issue offered and sold only to persons resident within a single state or territory. However, as interpreted, the issuer must be a resident of and doing substantial business only in that state. The SEC has created a safe harbor provision for intrastate offerings in Rule 147.

Section 4(2), the private placement exemption, affects transactions by an issuer that do not involve a public offering. Rule 506, under Regulation D, provides a safe harbor for such offerings. This rule allows sales of an

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27. See supra note 25.
30. See infra note 34.
unlimited dollar amount of securities to any number of accredited investors and thirty-five other purchasers, similar to Rule 505 offerings. These non-accredited purchasers or their representatives, however, must be financially sophisticated so as to avoid having the offering deemed public.\footnote{See infra notes 40-56 and accompanying text.}

Section 4(1),\footnote{15 U.S.C. § 77d(1) (1982 & Supp. III 1985).} known as the resale exemption, contains the most commonly used transaction exemption. This section exempts transactions by any person other than the issuer, underwriter or dealer.\footnote{Id.} This exemption also allows the ordinary investor to resell securities purchased on the open market. Absent such an exemption, the resale would have to be registered under the 1933 Act since the issuer’s registration statement would have covered only the initial offering of the securities.

Violation of the 1933 Act may result in civil\footnote{See infra notes 40-56 and accompanying text.} or criminal\footnote{See, e.g., Diskin v. Lomasney & Co., 452 F.2d 871, 876 (2d Cir. 1971) (violation of Section 5(b)(1) prospectus delivery requirement).} liability. Section 12(1)\footnote{15 U.S.C. § 77l(1) (1982 & Supp. III 1985).} provides that any person who offers or sells a security in violation of Section 5 shall be liable to the purchaser for damages. Section 12(1) also provides for an automatic right of rescission. Liability attaches to any person who violates Section 5 by selling, for instance, unregistered securities or failing to deliver a prospectus.\footnote{See, e.g., Winter v. D.J. & M. Inv. & Constr. Corp., 185 F. Supp. 943 (S.D. Cal. 1960).} This section requires the seller and dealer to be in privity.\footnote{15 U.S.C. § 77l(2) (1982 & Supp. III 1985).} Whether or not such securities must be registered under Section 5, Section 12(2)\footnote{See Franklin Sav. Bank of New York v. Levy, 551 F.2d 521 (2d Cir. 1977); Wilko v. Swan, 127 F. Supp. 55 (S.D.N.Y. 1955).} establishes civil liability for material omissions or misstatements in any offer or sale of securities. Sciente of the seller and privity by the purchaser must be shown under Section 12(2).\footnote{15 U.S.C. § 77k (1982 & Supp. III 1985).}

Section 11\footnote{"The civil liabilities imposed by the Act are not only compensatory in nature but also in terrorem (footnote omitted). They have been set high to guarantee that the risk of their invocation will be effective in assuring that the ‘truth about securities’ will be told." Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 173 (1933).} of the 1933 Act, together with Section 12, provides an intended in terrorem\footnote{Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a) (1982 & Supp. III 1985).} scheme of civil liability. First, it imposes absolute liability on the issuer of securities for any material defects in the registration statement.\footnote{Kripke, Securities Law Reform and the ALI Federal Securities Code, 33 U. Miami L. Rev. 1453, 1459 (1979).} "Neither proof of good faith nor a lack of negligence frees the issuer if there is a material misstatement [sic] or omission. There is absolute liability, subject only to the defense of truth."\footnote{Kripke, Securities Law Reform and the ALI Federal Securities Code, 33 U. Miami L. Rev. 1453, 1459 (1979).}
Section 11 of the 1933 Act allows purchasers of a registered security to sue certain enumerated parties in a registered offering when false or misleading information is included in a registration statement. The section was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering. If a plaintiff purchases a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case. Liability against the issuer is virtually absolute, even for innocent misstatements (footnote omitted).

The only defenses available to the issuer are purchaser's knowledge of the defects, lack of materiality or expiration of the statute of limitations. Second, Section 11 imposes liability upon other persons for negligence unless they are able to establish due diligence and reasonable investigation. The persons liable include signatories of the registration statement, present and prospective directors of the issuers, underwriters and certain experts involved in the registration statement.

Section 11 remedies are available only to the purchaser whose securities "trace back" to those sold under the registration statement. In addition, Section 13 provides for a short statute of limitations which bars suits brought after one year from discovery of a defect or three years from the date the issue was first offered.

Section 17 of the 1933 Act contains a general antifraud provision that supplements Section 5 and the express civil liability provisions. This section prohibits fraud, material misstatements and omissions of fact in connection with the sale of securities. Section 17 applies whether or not the securities are registered or exempt from registration. The courts are divided on whether Section 17 allows an implied private remedy.
In contrast to the focus on issuers and the static registration scheme of the 1933 Act, the 1934 Act\(^5\) is a much more comprehensive act which regulates securities in the secondary markets and deals with all aspects of the securities industry. The 1934 Act imposes registration and reporting requirements upon issuers of certain securities,\(^6\) national securities exchanges,\(^7\) self-regulatory organizations,\(^8\) and others. Section 12(a) of the 1934 Act\(^9\) requires registration with the SEC of securities traded on a national exchange. Section 12(g)(1)\(^10\) and SEC Rule 12g-1\(^11\) require SEC registration of over-the-counter equity securities having more than five hundred shareholders and more than $5 million in total assets. In addition, Section 15(d)\(^12\) requires that issuers, required to register under the 1933 Act, file with the SEC all the periodic reports required by Section 13\(^13\) of the 1934 Act.

Section 13 of the 1934 Act and the accompanying rules\(^14\) require issuers of securities registered under the Act to file annual,\(^15\) quarterly\(^16\) and current\(^17\) reports with the SEC, as well as other reports in certain circumstances.\(^18\)

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13. 17 C.F.R. § 240.12g-1 (1986). The Securities Act Amendments of 1964, supra note 62, required registration of companies with assets of more than $1 million. The SEC under this rule has exempted issuers with assets under $5 million.
14. 15 U.S.C. § 78o(d) (1982 & Supp. III 1985). The periodic reporting requirements are suspended in any year in which the securities issued, pursuant to registration under the Securities Act of 1933, are held by less than three hundred shareholders. Id.
Furthermore, beyond the periodic reporting requirements, registration under the 1934 Act triggers other disclosure provisions. Section 14(a),71 for example, requires the filing of proxy material with the SEC. Further reporting requirements also exist for tender offers,72 transactions of insiders73 and purchasers of five percent of any class of registered securities.74

Several sections of the 1934 Act impose civil and criminal liability for violations of the Act’s substantive provisions. Section 18(a)75 imposes liability upon anyone responsible for material misstatements or omissions of fact in any document which is required to be filed with the SEC under the 1934 Act. This section provides that any person who makes a false or misleading statement in a filing is liable to:

any person (not knowing that such statement was false or misleading) who, in reliance on such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.76

Practically, Section 18 does not provide a viable remedy for 1934 Act violations because of several burdens of proof placed on the plaintiff and the good faith and other defenses available to the defendant.77 The limitations of Section 18 suits have led plaintiffs to seek recovery under Section 10(b) of the Act and SEC Rule 10b-578 for alleged violations of the 1934 Act. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, or (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.79

In contrast to the in terrorem liability provisions of the 1933 Act,80 a remedy under the 1934 Act generally requires a showing of scienter.81 Thus,

76. Id.
78. Id.
80. See supra notes 38-54 and accompanying text.
81. Although the extensive legislative history of the 1934 Act is bereft of any explicit
the plaintiff must prove that the defendant either knew the statement was false or misleading or that the defendant acted with a reckless disregard for its truth or falsity.\(^2\)

Section 11 places a relatively minimal burden on a plaintiff. In contrast, Section 10(b) is a 'catchall' antifraud provision, but it requires a plaintiff to carry a heavier burden to establish a cause of action. While a Section 11 action must be brought by a purchaser of a registered security, must be based on misstatements or omissions in a registration statement, and can only be brought against certain parties, a Section 10(b) action can be brought by a purchaser or seller of 'any security' against 'any person' who has used 'any manipulative or deceptive device or contrivance' in connection with the purchase or sale of a security. 15 U.S.C. § 78j (emphasis added). However, a Section 10(b) plaintiff carries a heavier burden than a Section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate or defraud.\(^6\)

In addition to Sections 18 and 10(b), other provisions of Section 10 along with Sections 9 and 15 prohibit fraudulent and manipulative practices in certain narrowly defined circumstances. Section 9\(^{84}\) outlaws manipulative practices in securities trading on a national exchange and provides a private remedy for investors injured by such conduct. Section 10(a)\(^{85}\) prohibits short sales and stop order loss orders in violation of SEC rules. Section 15(c)\(^{86}\) prohibits brokers and dealers from participating in manipulative, deceptive or fraudulent acts and practices in connection with sales, or attempts to induce sales of securities.

II. LEGISLATIVE HISTORY OF SECURITIES REGULATION

The Securities Act of 1933 and the Securities Exchange Act of 1934 were generally regarded as responses to abuses in the securities industry which were believed to be partially responsible for the stock market crash of 1929 and the subsequent depression.\(^87\) The prosperity and rising stock market of

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\(^2\) See supra note 77.
\(^4\) Id. § 78j(a) (1982 & Supp. III 1985).
\(^5\) Id. § 78o(c) (1982 & Supp. III 1985).

The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have
the 1920s brought many new investors into the market. This growth was encouraged by the securities industry through aggressive advertising and promotion, high pressure sales tactics and the encouragement of high financing by speculation on margin. The increase in investors and demand further increased stock prices. Public expectation that the market would advance indefinitely was shattered in the October 1929 stock market crash. In the following five years, the securities market suffered great outflows of capital due to the lack of investor confidence. The declining demand for securities led to a further decline in prices.88

Some believed that the great drop in security value was the result of a failure to tell the "truth about securities."89 The congressional hearings disclosed many instances of fraudulent and unethical conduct by the securities industry including manipulation of stock prices, conflict of interests, self-dealing, overinflated claims of issuers, and misleading, fraudulent, or inadequate disclosures. The hearings indicted the entire securities industry for its failure to fulfill the fiduciary standards that governed the conduct of those handling other peoples' money. There was also a perceived failure of both state regulation and industry self regulation.90

contributed to the stock market crash of 1929 and the depression of the 1930s. It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

Id.


From 1920 to 1933 some $50 billion of securities were sold in the United States. By 1933 half were worthless. In 1934, the American public also held over $8 billion of foreign securities, of which $6 billion had been sold in the years 1923 to 1930. By March, 1934, $3 billion were in default. The aggregate value of all stocks listed on the New York Stock Exchange on September 1, 1929 was $89 billion. In 1932, the aggregate figure was down to $15 billion—a loss of $74 billion in two and one-half years. The bond losses increased the total drop in values to $93 billion.

1 L. LOSS, SECURITIES REGULATION 120 (2d ed. 1961). See also United States v. Morgan, 118 F. Supp. 621, 635-50 (S.D.N.Y. 1953) (historical perspective of securities industry and laws in connection with investment banking business). The stock market also “crashed” on October 19, 1987. “The Dow Jones Industrial Average plummeted an astonishing 508 points, or 22.6%, to 1738.74. The drop far exceeded the 12.8% decline on the day of Oct. 28, 1929, which is generally considered the start of the Great Depression.” Wall St. J., Oct. 20, 1987 at 1, col. 6. It is generally understood today that the stock market crash in 1929 was not the cause of the following depression. In fact, it was the following government fiscal and monetary policy which caused the depression. Id. at col. 5. The much greater percentage drop in the stock market in 1987, in spite of the pervasive federal securities laws and mandatory disclosures, also casts substantial doubt upon the government's notion that the cause of the 1929 crash was the failure of securities laws and of company disclosures. See infra notes 88-89 and accompanying text.


90. See Landis, The Legislative History of the Securities Act of 1933, 28 GEO. WASH. L.
Franklin Roosevelt's 1932 platform for office included a plan for federal regulation of the securities industry and for securities disclosure. In a message to Congress, he stated that "[t]here is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public." The lawyers who were assigned to draft such a statute were determined to remain true to the concept voiced by President Roosevelt in this message. Using their familiarity with the English Companies Act and state securities laws, the lawyers, over a weekend, prepared a "hurried draft" which later became the "core" of the Securities Act of 1933. The Act was passed within the first 100 days of the Roosevelt administration, less than two months after President Roosevelt's message to Congress.

The Securities Act of 1933 imposed antifraud and mandatory disclosure requirements on issuers of securities in the primary markets. The putative

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Rev. 29, 30 (1959) (James M. Landis was Professor of Legislation at Harvard law school in 1933 when he was asked by Felix Frankfurter, then also a Harvard law school professor, to help write the 1933 Act); infra note 107 and accompanying text. It is too early to tell what the scapegoat will be for the 1987 stock market crash. "In addition to investigating the causes and effects of volatility, [the SEC Chairman] Mr. Ruder told Congress that the SEC plans to look into five areas: the role of index-related trading; market-making capacity; operational capacity of the securities markets; financial integrity of brokers-dealers; and the effects of the internationalization of the markets." Wall St. J., Nov. 16, 1987 at 6, col. 1. Cf. Wall St. J., Nov. 17, 1987 at 33, col. 4 ("It's not necessary to search for a cause [of the crash] hidden in the mechanics of trading, in the capital requirements of specialists and brokers, in the existence of futures-index markets, in program trading or in increased electronic assistance in trading . . . . These are scapegoats, not fundamental causes." This article suggests that booms, busts and volatility are inevitable and are an inherent part of the function of valuing securities over time by the market.).

91. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). The full quote is as follows:

I recommend to the Congress legislation for federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

Of course, the federal government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

Id.

92. Landis, supra note 90, at 34.

93. Id.

94. Id. at 49. In response to a Presidential message urging that there be added to the ancient rule of *caveat emptor* the further doctrine of "let the seller also beware," Congress passed the Securities Act of 1933. Designed to protect investors, the Act requires issuers, underwriters, and dealers to make full and fair disclosure of the character of securities sold in interstate and foreign commerce and to prevent fraud in their sales. Wilko v. Swan, 346 U.S. 427, 431 (1953).
goals of the Act were "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." 95 The Act was based on the premise that the small investors, unable to fend for themselves, could best be protected by requiring "full and fair disclosure," upon which they could make intelligent investment decisions. 96 "Disclosure was intended . . . to serve two primary and correlative functions. It was believed that disclosure (1) would provide investors with a sound basis for making informed and rational investment decisions; and (2) would deter those in control of public business enterprises from fraudulent and unethical conduct." 97 The disclosure requirements were not only proposed for the purpose of information, but also were intended to serve with the antifraud provisions to protect investors from forms of fraud which relied on secrecy and misinformation. 98 Although it has been suggested that the real purpose of the 1933 Act was to restore public confidence in the securities markets and to lift the country out of a depression, 99 the SEC accepted the stated

97. HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION, 95th Cong., 1st Sess. 347-49 (Comm. Print 1977) [hereinafter ADVISORY COMMITTEE REPORT]. See also SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").
98. Douglas & Bates, supra note 46, at 172. See also Colonial Realty Corp. v. Brunswick Corp., 257 F. Supp. 875, 879 (S.D.N.Y. 1966) ("The legislative history of the 1933 Act reveals that the underlying purpose of the Act was 'to protect the public with the least possible interference to honest business.'") S. REP. No. 47, 73d Cong., 1st Sess. 6-7 (1933)); Reader v. Hirsh & Co., 197 F. Supp. 111, 113 (S.D.N.Y. 1961) ("The Securities Act of 1933 was designed to protect investors").

The problem of the Depression in 1933 was not that investors were being defrauded by misleading information and that a federal law to protect them was necessary. The problem of the Depression was that people with money had lost confidence in the securities markets because of the stock market crash of 1929. It was to regain this confidence that the Securities Acts were created . . . . Their goal was to restore investor confidence in the securities markets because the source of funds for financing American business had dried up to a mere trickle. It was investor confidence they were after, not protection of helpless and defenseless people.

Id.

An introduction summarizes the article:

Professor Morton and Professor Booker point out several inconsistencies which exist between the intended purposes of the Federal Securities Acts and their actual effect. Originally the Acts were meant to stimulate financing of American business by restoring investor confidence lost during the Great Depression of the 1930s. The Acts require the issuer to disclose information concerning his reliability and his
goal of protecting the individual investor through mandatory disclosure. This
stated goal remains the major objective of the SEC today. 100

The 1934 Act extended many of the disclosure requirements of the 1933
Act to previously issued securities listed on stock exchanges. 101 "The 1934
Act was intended principally to protect investors against manipulation of
stock prices through regulation of transactions upon securities and in over-
the-counter markets, and to impose regular reporting requirements on com-
panies whose stock is listed on national securities exchanges." 102 The regis-
tration and periodic reporting requirements are intended to provide useful
information to the individual investor and to protect against stock market
manipulations which depend on secrecy and misinformation. 103 Therefore,
the putative and adopted purpose of the mandatory disclosure requirements
of both the 1933 and 1934 Acts is disclosure for investment purposes and
investor protection. Unlike the more hurried 1933 Act, however, the 1934

business purpose as a means of protecting the small investor. Ironically, this attempt
to increase the flow of capital has actually hindered investment because trading in
securities is viewed by the SEC as speculation which must be curbed rather than
recognized as the primary purpose of the Act. The authors argue that buying and
selling securities should be recognized for what it is—speculation—and encouraged
because it channels risk capital into business development. They show that the data
which the Acts require to be disclosed obscures more than it informs . . .

Id. at 479. See also Kripke, supra note 6, at 260 (discussing Morton & Booker).
The authors' thesis is that the real purpose of the Securities Act of 1933 was to
restore public confidence in the securities markets to lift the country out of de-
pression. Morton and Booker believe that the 'pecadillos' or frauds in the securities
markets in the period before the Great Crash of 1929 were no worse than those of
prior periods; however, more persons and classes of society were hurt by the Great
Crash than in prior periods because more people had been speculating. The authors
believe that Congress' real purpose in passing the Securities Act was getting the
markets working to finance business, but the Act was sold to the public under the
more attractive guise of protecting the individual investor by preventing fraud.
Eventually, the SEC began to believe its own publicity and started to concentrate
on the antifraud function, even at the expense of the flow of capital. The SEC
undoubtedly came to believe its own rhetoric.

Id.

100. See Advisory Committee Report, supra note 97, at 347-48.
Disclosure was intended by the framers of the Securities and Exchange Act to serve
two primary, and correlative functions. It was believed that disclosure (1) would
provide investors with a sound basis for making informed and rational investment
decisions; and (2) would deter those in control of public business enterprises from
fraudulent and unethical conduct.

Although it is at least arguable that the statutory disclosure system created by
the 1933 and 1934 Acts was perceived by Congress and commentators as being
particularly suited to the interests of sophisticated investors and securities profes-
sionals, for many years the disclosure policy of the (SEC) was based on the belief
that the relevant constituency was the unsophisticated investor.

101. See McCauley, infra note 107 and accompanying text.
103. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934); see also Anderson, supra note 87,
at 328.
Act states the need for the legislation due to "national emergencies, which . . . are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets . . . ."104 Like the earlier Act, the 1934 Act may also have been enacted to help lift the country out of a depression.105 Neither Act was repealed after the recovery, and both acts continued to be enforced and expanded, even into the prospering markets of the 1940s and 1950s. Except for some changes which began in the 1960s (to be discussed below),106 the basic structure of both Acts, as originally enacted, remains intact.

III. BACKGROUND OF MOVEMENTS FOR REFORM

In the early 1960s, changes began in the scheme of federal securities regulation. In a 1960 report to President-Elect Kennedy, one of the original drafters of the Securities Act of 1933 identified significant problems in the administration of securities regulation and recommended simplification and reform.107 In 1961, Congress directed the SEC to conduct a study which culminated in the 1963 Report of Special Study of the Securities Market.108

104. Securities Exchange Act of 1934, § 2(4), 15 U.S.C. § 78b(4) (1982 & Supp. III 1985); see also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975) ("The primary purpose of the Acts was to eliminate serious abuses in a largely unregulated securities market . . . and the need for regulation to prevent fraud and to protect the interests of investors."); SEC v. Southwest Coal & Energy Co., 624 F.2d 1312, 1318 (5th Cir. 1980) ("The federal securities laws were enacted mainly to serve two distinct goals: 1) to promote or require sufficient disclosure of information to allow those in securities markets to make intelligent investment decisions, and 2) to control fraud and manipulation in the trading of securities."); SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476, 480 (9th Cir. 1973) ("The 1933 and 1934 Acts are remedial legislation, among the central purposes of which is full and fair disclosure relative to the issuance of securities."); SEC v. Continental Tobacco Co. of S.C., 463 F.2d 137, 154-55 (5th Cir. 1972) ("These statutes constitute a comprehensive plan to protect investors by requiring the filing of a registration statement containing material facts bearing upon the investment merit of securities which are publicly offered or sold through the use of the mails or through instrumentalities of interstate commerce."); Surowitz v. Hilton Hotels Corp., 342 F.2d 596, 602 (7th Cir. 1965) ("[T]he policy of the federal securities laws is to protect investors, including the uninformed, the ignorant, and the gullible."); SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 455 (N.D. Tex. 1971) ("Congress passed the securities laws in order to establish the means and standard through which the public can rely on fair, honest and prudent conduct in the maintenance of a securities market free from fraudulent practices.").

105. See supra note 99 and accompanying text.

106. See infra notes 107-35 and accompanying text.


This study resulted in the 1964 amendments\textsuperscript{109} to the securities laws, the first step toward a conceptual merging of the 1933 and 1934 Acts.\textsuperscript{110} The 1964 amendments extended the registration requirements of the 1934 Act beyond securities traded on national exchanges to include over-the-counter securities, which, unless exempt, had always been subject to the static registration requirements of the 1933 Act.

In a seminal article in 1966, Milton Cohen noted the duplicative nature of the disclosure systems under the 1933 and 1934 Acts and espoused the concept of a coordinated disclosure law which would give rise to a constant disclosure system through continuous registration.\textsuperscript{111} In 1967, the SEC re-

\begin{itemize}
\itemsep0em
\item 109. See supra note 62.
\item 110. McCauley, supra note 107, at 1095.
\item 111. Cohen, “Truth in Securities” Revisited, 79 Harv. L. Rev. 1340 (1966). THE AUTHOR’S CONCLUSIONS SET THE STANDARD FOR SECURITIES REGULATION REFORM FOR THE NEXT 15 YEARS:
\begin{enumerate}
\item A. General—In a coordinated disclosure law and its administration primary emphasis should shift from the 1933 Act’s sporadic ad hoc disclosures to the 1934 Act’s continuous disclosure system. It follows that the “1933 Act” concepts should have altogether different application to issuers that are fully subject to the continuous disclosure system (“continuous registrants”) and to the issuers that are not.
\item B. The Continuous Disclosure System—Within the limits of practicality, the continuous disclosure system of the 1934 Act should be solidified and strengthened in terms of quality, currency, and accessibility of filed data, to the end that there may be available in the public file at all times, in readily identifiable and accessible form, substantially the equivalent of a current prospectus for every continuous registrant.
\item C. Continuous Registrant—(1) a continuous registrant’s material transactions in its own securities, purchases as well as sales, should be considered in the first instance as items for disclosure in its continuous file, for the benefit of investors generally, and any special procedures for the benefit of offerees should be considered ancillary.
\item (2) Provisions of the 1933 Act and rules that are designed to assure maximum reach and scope of the special disclosure requirements for public offerings should be greatly relaxed in respect of offerings (whether by the issuer or by other persons) of securities of continuous registrants . . . .
\item (3) In connection with a public offering of securities of a continuous registrant, the required filing in the continuous disclosure file should not call for any information that merely duplicates (as distinguished from correcting, supplementing or updating), what already appears in the public file.
\item (4) In connection with such offerings, the general presumption should be against requiring the use of any prospectus, or the inclusion in a prospectus of any particular information, that is not of materially greater interest or utility to offerees than to other investors in the registrant’s securities. In practice, this should mean that the occasions when a prospectus will be required for securities of continuous registrants will be substantially fewer than at present, and the contents of required prospectuses will be considerably reduced.
\item D. Issuers other than Continuous Registrants—(1) A “first” public offering—any offering of securities of which the issuer is not already a continuous registrant (but will ordinarily become such as a result of the offering)—should, as in the past, be the occasion for comprehensive “1933 Act” disclosures, not only for the benefit of immediate offerees through a prospectus but as the foundation of future contin-
responded by adopting Form S-7 for certain registrants. Form S-7, a 1933 Act registration statement, was shorter than the standard Form S-1 and relied upon information available from the 1934 Act filings. The SEC Commissioner, Francis M. Wheat, also appointed an internal study group, with Milton Cohen as chairman, to further evaluate the disclosure system under the Acts. The resulting Wheat Report made extensive recommendations for integration of the two disclosure systems. In 1970, the SEC made another minor change and adopted Form S-16, which permitted certain registrants under the 1933 Act to incorporate by reference information which was filed under the 1934 Act.

Earlier, in 1964, economist George Stigler made a more fundamental challenge to the 1933 Act’s mandatory disclosure system. Based on economic and statistical studies, he suggested that the mandatory disclosures of the 1933 Act did little, if anything to protect investors from fraud and had no significant effect on the quality of securities publicly offered. There-
after, Henry Manne\textsuperscript{117} and George Benston\textsuperscript{118} expanded this theme through a series of articles and books using economic and statistical data. They contended that the mandatory disclosures of the 1933 and 1934 Acts were not useful to investors and that a mandatory disclosure system served neither to protect nor to inform investors. As the basis for these assertions, Benston argued that there was little evidence of any increase in fraud in the period preceding 1933. Secondly, Benston argued that voluntary corporate disclosures before the 1933 and 1934 Acts provided investors with sufficient investment information. Lastly, he argued that mandatory disclosures were not material to investors, or that they were too untimely to be of any value, because most of the data was already disclosed through voluntary corporate disclosure and other means.\textsuperscript{119} Benston’s arguments were supported by his prolific empirical and statistical studies. His series of articles presented evidence and arguments of the following: (1) that corporate financial statements were not less misleading since the passage of the 1934 Act; (2) that the 1934 Act disclosure requirement did not enable investors to predict future security price movements more accurately or provide investors with information to increase the safety of their investments; and (3) that investor confidence in the securities markets failed to increase.\textsuperscript{120}

In 1970, Professor Homer Kripke began to advocate a “fresh rethinking” of mandated disclosure using these empirical studies and modern economic theory.\textsuperscript{121} Professor Kripke proposed that mandated disclosures cannot enable a lay investor to achieve an informed investment decision.\textsuperscript{122} He continued to articulate his proposals in several articles.\textsuperscript{123} During this period,\textsuperscript{124} the

\begin{itemize}
  \item \textsuperscript{119} See Seligman, \textit{supra} note 108, at 12-18.
  \item \textsuperscript{121} Kripke, \textit{The SEC, The Accountants—Some Myths and Some Realities}, 45 \textit{N.Y.U. L. REV.} 1151 (1970).
  \item \textsuperscript{122} \textit{Id.} at 1153.
  \item \textsuperscript{123} Kripke, \textit{A Search for a Meaningful Securities Disclosure Policy}, 31 \textit{BUS. LAW.} 293 (1975); Kripke, \textit{The Myth of the Informed Layman}, 28 \textit{BUS. LAW.} 631 (1973); Kripke, \textit{The
federal securities laws were also criticized in several other articles.

In 1976, the SEC responded by appointing an Advisory Committee (which included Professor Kripke) to reevaluate the securities disclosure system. In 1977, the Advisory Committee issued a report\textsuperscript{125} which recommended upgrading the quality of the 1934 Act reports and complete integration of the two disclosure systems. These recommendations went beyond the proposals of the \textit{Wheat Report}. The Advisory Committee's report also repudiated the criticisms of mandatory disclosure. The committee's transmittal letter to the SEC concluded that "the disclosure system established by Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934, as implemented and developed by the Securities and Exchange Commission since its creation in 1934, is sound and does not need radical reform or renovation."

Indeed, the introduction to the report stated that "[i]t appears beyond a reasonable doubt at the present time that the dismantling of the disclosure system . . . might very well result in a serious and lasting impairment of public confidence in the fairness of the securities markets . . . ."\textsuperscript{127} This "pretzel logic,"\textsuperscript{128} as Professor Kripke called it, led to his dissent from the report. Although Professor Kripke agreed with certain recommendations, he dissented because the Committee "avoided the difficult issues and expended its time . . . by engaging in overlapping the kind of patchwork improvement


125. \textit{Advisory Committee Report}, supra note 97, at 3-7.

A continuous, coordinated and integrated disclosure system for industrial issuers required to file information under the 1933 and 1934 Acts will curtail registration costs and administrative obstacles incurred by industrial issuers in raising capital, facilitate timely access to the capital markets, and simplify the exchange offer and business combination processes. Further integration is warranted at this time . . . . One caveat accompanies the recommendations for further integration . . . . Further integration by short form registration procedures which take into account information available in the market place and permit incorporation by reference of 1934 Act reports must be conditioned on the improved quality and dissemination of disclosures in periodic reports.

\textit{Id.}


127. \textit{Id.} at xxvi-xxvii.

of forms that the (SEC) had been doing for forty years129 rather than taking a fresh look at mandatory disclosure. In spite of the Advisory Committee’s conclusions, the criticism of mandatory disclosure and securities regulation continued.130 The SEC and Congress responded to the Advisory Committee Report, and continued criticism by adopting Regulation S-K in 1977. This regulation introduced a standard set of instructions for filing forms under the 1933 and 1934 Acts. In 1978, the SEC increased the availability of Form S-16 to a greater number of registrants.131 Between 1978 and 1980, Congress adopted three Acts, which increased the maximum exemption of a securities issue, under section 3(b) of the 1933 Act, from $500,000 to $5,000,000.132 In 1980, major changes were adopted for Form 10-K, Rule 14a-3, Regulation S-K, and Regulation S-X, which prescribed uniform financial disclosure requirements for most documents filed under the 1933 and 1934 Acts.133 The Advisory Committee’s report also led to the adoption of the integrated disclosure system which was proposed in 1980134 and adopted by the SEC in 1982.135

IV. ALI FEDERAL SECURITIES CODE

Milton Cohen’s 1966 article also led to a conference of the American Bar Association (ABA) which agreed to propose a codification of the federal securities laws.136 In 1968, the American Law Institute (ALI) began drafting a Federal Securities Code. Over the next ten years, a committee produced seven tentative drafts and a final draft which the ALI approved in 1978.137 In 1979, the ABA recommended enactment of the Code by Congress.138 In 1980, the SEC announced its support of the Code with certain recommended changes.139 By this time, however, a new administration and a new Congress,

129. Id.
138. Id.
unfamiliar with the Code, were in place.¹⁴⁰ The Code also had other serious problems.¹⁴¹ Thus, having never been introduced to Congress, there is little hope that the Code will ever be enacted.¹⁴² The Code, however, encourages the adoption of the SEC's integrated disclosure system,¹⁴³ and, more importantly, its achievements and failures are relevant to an understanding of the present status of federal securities laws.

The Code had three principle goals: "(1) simplification of an inevitably complex body of law in the light of almost a half-century of administration and litigation; (2) elimination . . . of duplicate regulation; and (3) reexamination of the entire scheme of investor protection with a view towards increasing its efficiency . . . ."¹⁴⁴ The Code attempted to integrate all of the federal securities laws¹⁴⁵ into one comprehensive Code. The Code in fact retains most of the basic regulations contained in several different statutes, with some changes. One technical change was the organization of the statutes into one code with cross-references and common definitions.¹⁴⁶ Some fundamental changes were achieved by reducing inconsistencies that resulted from the piecemeal adoption of seven statutes and a patchwork of amendments and regulations. The designated reporter for the Code, Professor Louis Loss, claimed that the Code thereby reduced the complexity of the federal securities laws.¹⁴⁷ The Code also attempted to reduce the complexity of the regulatory system by substituting a single system of continuous disclosure of company registration for the separate static and continuous disclosure schemes of the two existing Acts. Moreover, the Code attempted to eliminate or simplify many of the "obtuse" and "overly sophistic" rules of the SEC.¹⁴⁸

The Code also codified much of the law on extraterritorial application of the SEC legislation within the limits of international law.¹⁴⁹ On the other hand, it proposed the preemption of many state securities laws to avoid unnecessary duplication of regulation and to maximize the effectiveness of both federal and state controls.¹⁵⁰ In addition, there was substantial, though

¹⁴⁰ L. Loss, SUPPLEMENT TO FUNDAMENTALS OF SECURITIES REGULATION 6 (1985).
¹⁴¹ See, e.g., Lowenfels, The Case Against the Proposed Federal Securities Code, 65 VA. L. REV. 615, 660 (1979) ("The proposed Code does not solve many of the existing problems and creates a host of new and more serious problems.").
¹⁴² Id. at 660-61.
¹⁴³ See infra notes 167-99 and accompanying text.
¹⁴⁵ ALI CODE, supra note 144, at xix.
¹⁴⁶ Id.
¹⁴⁷ Id.
¹⁴⁸ Id. at xix-xx. See Loss, supra note 136, at 28.
¹⁴⁹ ALI CODE, supra note 144, at lvi.
¹⁵⁰ Id.
incomplete, codification and coordination of the civil liability and antifraud rules. Professor Loss described the area of civil liability as "chaotic" as a result of judicial implication of private rights of action.\textsuperscript{151} The Code made express those liabilities presently implied at law. The Code, however, also provided guidance for the implication of other liabilities.\textsuperscript{152} For instance, the Code would continue to allow an implied liability for a violation of a rule of a self-regulatory organization, but would give authority to the SEC to exempt such violations.\textsuperscript{153}

The proposed Code addressed many of the criticisms discussed in the preceding section.\textsuperscript{154} The Code was approved by the ALI, the ABA, and the SEC, yet it was never introduced in Congress.\textsuperscript{155} Many reasons exist for the Code's failure.

In many respects, the Code did not produce significant changes in the federal securities law. The Code was largely a recodification of the existing law. In the area of civil liability, the Code simply made express the liabilities already implied at law.\textsuperscript{156} Even in areas where it did propose changes, they often appeared to be mere changes in form rather than substance.

Although proponents of the Code asserted that it made major changes toward continuous disclosure, it retained many provisions which were similar to the 1933 Act. For instance, although the Code eliminated the registration statement requirement under the 1933 Act, it continued to require that the disclosure system be supplemented by an "offering statement,"\textsuperscript{157} a "distribution statement,"\textsuperscript{158} and "a prospectus delivery requirement more or less as in present law."\textsuperscript{159} Due to the continuing requirement of offering and distribution statements, the Code retained a number of exemptions which closely paralleled those of the 1933 Act in type, but with some change in form.\textsuperscript{160} However, the details of these exemptions, as well as the scope of the Code, were not specified. Instead, the Code granted the SEC broad rulemaking power to create regulations to fill in the gaps.\textsuperscript{161} Consequently, the drafters of the Code missed an opportunity to propose genuine or significant reforms.

In addition, the securities bar found a recodification inconsequential because of its years of accumulated expertise in securities laws. Support was also lacking at a more fundamental level. In 1980, the new administration

\begin{footnotes}
\footnotetext[151]{Id. at xix.}
\footnotetext[152]{Id. at xliii-liii.}
\footnotetext[153]{Id. at lii.}
\footnotetext[154]{See supra notes 107-35 and accompanying text.}
\footnotetext[155]{L. Loss, supra note 140.}
\footnotetext[156]{See supra notes 151-53 and accompanying text.}
\footnotetext[157]{ALI Code, supra note 144, at xxviii.}
\footnotetext[158]{Id. at xxx.}
\footnotetext[159]{Id. at xxxi.}
\footnotetext[161]{Lowenfells, supra note 141, at 615-40.}
\end{footnotes}
had other legislative priorities and no national emergency of the type which had spurred the initial legislation existed. Furthermore, the Code’s proposal to give broad rulemaking authority to the SEC not only presented a substantial departure from existing law, but also conflicted with the recent trend toward deregulation. Like the present statutory scheme, the Code does not consider economic, financial, or business interests, nor does it address whether the benefits of the regulation exceed the costs as a whole, or whether any of the specific areas of law would succeed in a cost/benefit analysis. The Code relied on no economic, statistical, or empirical studies concerning the value or necessity of mandatory disclosures or exemption categories. In fact, the drafters did not even consult with experts in other disciplines, such as economics or accounting. This action placed the Code in direct conflict with the critics of the present system which was castigated on the same grounds. The Code was similarly criticized because it failed to adopt a fresh rethinking of the laws on a fundamental level. It is significant, however, that the goals of the Code and its premises reflect many of the same objectives and reforms sought by the critics of present securities laws.

Shortly after the Code was completed, the SEC proposed and adopted its integrated disclosure system which employed some of the Code’s proposals. Although the Code has had some influence, the adoption of the SEC’s integrated disclosure system helped seal its fate.

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162. Id. at 656.
163. Id. at 657 (federal securities laws and the Code have been called “lawyer’s law” because they are developed by lawyers without sufficient consideration of economic, financial and business realities). Contra Throop, The Proposed Federal Securities Code: A Response to its Critics, 33 U. MIAMI L. REV. 1597, 1600 (1979).
With respect to the need for 'empirical evidence,' on which Professor Benston urges that any codification should have been based, certain observations should be made. First, the ALI is not fundamentally a ‘reform’ organization. It was initially conceived as doing for court decisions what the Code would do with respect to statutory and decisional federal securities law. But its ‘Restatements’ have been intended to be more than mere compilation and digests, and frequently reflect a thorough analysis of conflicting precedents, with rational support for a particular and occasionally new, approach to a difficult problem. Hence, it is not surprising that the Code, although reflecting the ‘lawyer’s law’ approach of ALI membership, is, as it should be, more than a mere compilation and digest.

Id.
164. Kripke, supra note 48, at 1469.
165. Id.
V. INTEGRATED DISCLOSURE AND PRESENT FUNCTIONING OF SECURITIES REGULATION

The preceding sections provide the background for the SEC’s adoption of the integrated disclosure system. On March 16, 1982, the SEC, in response to the Wheat Report, the Advisory Committee Report, the ALI Federal Securities Code, and various critics, adopted the integrated disclosure system. In the preceding 15 years, small steps were taken which ultimately facilitated and permitted the integration. The SEC had experimented with integrated disclosure on a small scale after both the Wheat Report and Advisory Committee Report recommended much greater integration. Forms S-7 and S-16 were issued. The use of the forms, however, was limited to a small portion of reporting companies. This created situations in which information in filings under the 1934 Act was relied upon or incorporated by reference in 1933 Act filings. Throughout the 1970s, the SEC expanded the disclosures required under the periodic reporting rules of the 1934 Act and reduced the inconsistencies in the disclosure provisions between the two Acts. The integrated disclosure system helped to complete this process.

The integrated disclosure system coordinates and simplifies the disclosure requirements under the 1933 and the 1934 Acts. The SEC has explained that the goal in adopting the new system is “to revise or eliminate over-lapping or unnecessary disclosure and dissemination requirements wherever possible, thereby reducing burdens on registrants while at the same time ensuring that security holders, investors and the marketplace have been provided with meaningful, nonduplicative information upon which to base investment decisions.” Under the system, transaction-specific information continues to be required whenever securities are issued under the 1933 Act. However, general registrant-oriented information may already be available under the

167. See supra notes 107-66 and accompanying text.
169. See supra notes 103-20 and accompanying text.
170. PLI, REPRESENTING PUBLICLY TRADED CORPORATIONS UNDER THE NEW INTEGRATED DISCLOSURE SYSTEM 13 (Eppler & Gilroy eds. 1982).
1934 Act reporting requirements and, therefore, may be incorporated by reference in some circumstances.\textsuperscript{173}

The greatest benefit of the integrated disclosure rules is available only to the largest companies which, under SEC standards, have a sufficient market following so as to assure that the information in 1934 Act filings has been disseminated through the marketplace.\textsuperscript{174} If qualified, these companies may use Form S-3 to register security issues under the Securities Act. This form incorporates, by reference, information included in the registrant’s annual report on Form 10-K under the 1934 Act,\textsuperscript{175} unless there has been a material change. Only the transaction-specific information need be reported to the investor in the prospectus.\textsuperscript{176}

Where a registrant is not large enough to use Form S-3, it may be able to use Form S-2,\textsuperscript{177} assuming the registrant has been a reporting company under the 1934 Act for at least three years. Although this form incorporates, by reference, information filed by the registrant on Form 10-K, an annual report must be delivered with the prospectus or the prospectus must include all comparable disclosures. Form S-1, the standard long form registration statement which does not rely on 1934 Act disclosures, is used by all other companies and may be used in lieu of Form S-2 or Form S-3.\textsuperscript{178} Similar forms with comparable requirements were also adopted for foreign issuers and investment companies.\textsuperscript{179}

In order to coordinate these disclosures, Regulations S-K and S-X were enacted as the standard rules for disclosure under both Acts.\textsuperscript{180} Integration was also achieved in the provisions under the 1933 Act in Regulation C and under the 1934 Act in Regulation 12B. This integration, however, was not complete due to the continuing differences between the Acts.\textsuperscript{181}

The integrated disclosure changes in Regulation C included a very important experimental rule. Rule 415 permits “shelf” registration of securities which the registrant reasonably expects to offer and sell within two years.\textsuperscript{182} Issuers are able to register securities on the shelf and bring the securities into the market with no further registration requirements or delays during this two year period. The rule was not initially adopted as a permanent rule due to the protests of underwriters and investment bankers. Representatives of the securities industry and former SEC Commissioner Thomas argued that the rule was a threat to the capital markets and to the protection of

\textsuperscript{173} Id.
\textsuperscript{175} See supra note 168.
\textsuperscript{177} Id.
\textsuperscript{178} Id.
\textsuperscript{179} Id.
\textsuperscript{180} Id.
\textsuperscript{181} Id.
\textsuperscript{182} Id.; 17 C.F.R. § 230.415 (1987).
investors, as underwriters would be unable to fulfill their due diligence duties and investors would not have time to study the prospectus. Regional underwriters would then face extinction and investors could retreat from the capital markets, never to return.

The SEC held many hearings, gathered empirical data to evaluate the effect of the Rule, and even extended the trial period of the Rule due to the controversy. In 1983, the SEC decided that the experiment was a success and adopted Rule 415 on a permanent basis, with some modifications. During the experimental period, the Rule did not appear to have a detrimental effect on the capital markets or investor protection. In fact, investors, issuers and the capital markets have benefitted from the rule. Former Commissioner Thomas and the securities industry, however, may have noticed a less touted consequence of the rule—that of fewer revenues for underwriters from equity underwritings. Professor Banoff, in her analysis of the effect of the Rule, concluded that:

[S]helf registration permits issuers to sell more accurately priced securities at a lower cost, increases allocational efficiency, reduces inappropriate wealth transfers from investors to investment bankers or from relatively poor investors to relatively wealthy ones, and does not pose any particular threat to the disclosure system or to due diligence.

Professor Banoff also adds that “the only valid criticism of the [SEC’s] action is that it placed too many limitations on the rule; as long as an efficient market exists for the issuer’s securities, the [SEC] should allow that issuer to use shelf registration.”

Since the adoption of the integrated disclosure system, the SEC has attempted further simplification, deregulation and integration in other areas, such as proxies and business combinations. Although not strictly part of the integrated disclosure system, the SEC also adopted Regulation D. Under statutory authority of the 1933 Act, the SEC promulgated these rules which allowed securities of up to $5,000,000 per year to be issued pursuant to an exemption under Section 3(b) of the 1933 Act.

184. Id.
187. See infra notes 188-90 and accompanying text.
188. Banoff, supra note 183, at 169-70.
189. Id. at 184.
190. Id.
194. See supra notes 26-29 and accompanying text.
The integrated disclosure system is based on two assumptions which have been proposed by various critics of or consultants to the SEC. First, the disclosures which are necessary for trading in a primary issue of securities are generally the same as those for trading in existing securities on the secondary markets. Second, the SEC partially adopted the theory that an efficient market of professional analysts, institutional investors, financial advisors and the financial press will widely and quickly disseminate the information that is available in periodic reports filed under the 1934 Act. Since this information is already widely disseminated in the marketplace and reflected in the price of the securities, its inclusion in the prospectus is superfluous. Consequently, the SEC has implicitly recognized that the individual investor does not use the information provided through mandatory disclosures, rather, the investor relies upon professional advice and market forces.

In fact, the SEC only partially accepted the theory of an efficient market. It assumed that 1934 Act disclosures would be widely disseminated only for the largest publicly held securities, with a sufficient market following by professionals. In addition, the SEC continues to superstitiously require formalistic incorporation of information, by reference, that need not be repeated verbatim.

VI. MODERN ECONOMIC THEORY

Though the adoption of the integrated disclosure system represents a partial acceptance of modern economic theory by the SEC, original federal securities legislation did not embrace modern economic theory. Much of the economic theory on which most securities law criticism is based developed after the original federal securities laws. One of these developments was the recognition that security price movements were essentially "random." The theory which developed to explain the "random walk" of security prices was the "Efficient Capital Market Hypothesis." The random price movements of securities were consistent with prices that fully reflected all available information because of efficient information processing by the capital markets. These new theories, which developed amid great controversy in the 1950s and 1960s, were contrary to the traditional assumptions about the

196. Id.
199. See supra note 197, at 949.
201. See supra notes 88-106 and accompanying text.
202. Note, supra note 120, at 1034.
203. Id. at 1035.
204. Id.
workings of the securities markets. Empirical research has since confirmed the assertions of these theories, and opponents of the theories largely lack support. Today, the theories enjoy overwhelming support in the economic, financial, and legal communities.

The premise of the Efficient Capital Market Hypothesis is that the securities markets are efficient. New information about a security is rapidly absorbed by the market and almost immediately is reflected in the price of the security. Because the information is quickly translated into price, the price of a security itself gives an investor a significant amount of information. If prices reflect all available information, subsequent mandatory disclosures would not support any profitable trading advantages in the securities. In an efficient market, therefore, investors who use any available information cannot systematically profit from identifying and trading in undervalued or overvalued securities. Assuming the market is efficient and prices reflect all available information, the only rational program is to trade as if the market is fair and the market prices are the best indication of the securities' values.

The Efficient Capital Market Hypothesis has been tested empirically under three categories: the "weak;" the "semi-strong;" and the "strong." The weak form has been successfully tested to show that past price information is not useful in predicting future price movements of securities, consistent with the "random walk" of price movements. The "semi-strong" hypothesis has also been successfully tested to show that the market reacts quickly and in an unbiased fashion to all publicly available information and that it anticipates and processes this information from all available sources before it is publicly announced.

'Semi[-]strong' tests of market efficiency show that stock prices adjusted quickly to public announcements concerning the company: the 'collective action of a sufficient number of market participants buying or selling the stock causes a very rapid, if not virtually instantaneous, adjustment in price.' The price of the stock appears to reflect all publicly available information, but not all privately held information.

205. Id. at 1034.
206. Id. at 1031, 1041.
207. Banoff, supra note 183, at 179.
208. Note, supra note 120, at 1035-41.
209. Id.; see also In re LTV Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980) ("The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.").
210. Pickholz & Horahan, supra note 197, at 943.
212. Note, supra note 120, at 1041.
213. Id. at 1044.
The last clause of the above quoted material, stating that the prices of stocks do not reflect all privately held information, refers to evidence associated with the strong form. Empirical tests on the strong form indicate that certain insiders may profitably trade on non-public information, suggesting a source of inefficiency in the capital markets and that the price of the security does not immediately and without bias reflect all available information.\textsuperscript{215}

In addition to the failure of the strong form, other anomalies have appeared.\textsuperscript{216} This indicates that there is a need for technical adjustment or that the Efficient Capital Market Hypothesis is limited in its applicability to certain narrowly defined areas.\textsuperscript{217} It does not delimit the otherwise general usefulness of the theory. """"[T]here is no other proposition in economics which has more empirical evidence supporting it than the efficient market hypothesis."""" Despite certain anomalies, numerous studies demonstrate that the capital market responds efficiently to an extraordinary variety of information.\textsuperscript{218} Realistically, no other comparable model or theory exists at the present time to support an understanding of the securities markets. Consequently, the only valid options are to accept or to reject the Efficient Capital Market Hypothesis. This, however, is not an all or nothing proposition. The hypothesis can be accepted for all purposes where empirically it has tested successfully, which warrants its application except in very limited circumstances.\textsuperscript{219} In weighing these options, almost all who have considered it have accepted the theory's usefulness in a wide variety of contexts.

\textsuperscript{215} Note, supra note 120, at 1045.  
\textsuperscript{216} Coffee, supra note 211, at 719 n.10.  
\textsuperscript{217} Id.  
\textsuperscript{219} The Supreme Court has recently approved the assumptions of the Efficient Capital Market Hypothesis:

Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well developed markets reflects all publicly available information, and, hence, any material misrepresentations. It has been noted that """"it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game? Schlanger v. Four-Phase Systems Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982). Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed (footnote omitted). Commentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory. An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.  
Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. It now commonly informs the academic literature on a variety of topics; it is addressed by major law school casebooks and textbooks on business law; it structures debate over the future of securities regulation both within and without the (SEC); it has served as the intellectual premise for a major revision of the disclosure system administered by the (SEC); and it has even begun to influence judicial decisions and the actual practice of law.220

Several courts have accepted the Efficient Capital Market Hypothesis as a basis for adopting a new theory of liability in securities law. "[A] plaintiff need not show individual reliance . . . when a 'fraud on the market' claim is raised."221 "Under this theory, a plaintiff . . . need . . . allege . . . only that the plaintiff relied upon the integrity of the market price of the security which was distorted by the impact of the particular misstatements [sic]."222 "Underlying such an approach is the 'efficient market theory,' which, briefly stated, is that in a free and actively traded market, absent compelling reasons to believe otherwise, the market price is held to take account of asset value as well as the other economic, political, and financial factors that determine 'value.'"223 "Recent economic studies tend to buttress empirically the central assumption of the fraud on the market theory—that the market price reflects all representations concerning the stock."224

As stated above by the court, "absent compelling reasons to believe otherwise,"225 the most rational course of behavior based on all the evidence is to accept the Efficient Capital Market Hypothesis, except in very limited circumstances.226 The theory should not be rejected because certain insiders are able to trade profitably on inside information or because public misre-

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220. Id. at 549-50 (footnote omitted).
222. Id.
225. See supra note 223.
presentations can distort the intrinsic value of the stock. As the courts and others have recognized, these problems should be addressed individually by sanctions for insider trading or under a fraud on the market theory of liability.\textsuperscript{227} The Efficient Capital Market Hypothesis, therefore, should be considered more a recognition of fact than theory,\textsuperscript{228} and should be useful for all purposes in evaluating securities regulation unless otherwise strongly indicated.

Economists in the 1950s and 1960s also developed the "portfolio theory"\textsuperscript{229} which, combined with the Efficient Capital Market Hypothesis, helps explain the price determinations of the capital markets. In an efficient market, modern portfolio theory indicates that the expected returns are equal for all securities having the same degree of risk.\textsuperscript{230} Under this theory, the value of a security is a function of its expected return to the investor, after adjusting for the degree of uncertainty inherent in the expected return. The expected return includes periodic payments such as interest or dividends and expected security price variations in the future.\textsuperscript{231} The market evaluates and prices all securities according to risk-return relationships. This indicates that investments should not be evaluated individually, but only in comparison with other securities, as does the market. The theory indicates that the risks of individual securities can be almost eliminated by a diversified portfolio of securities. The suitability of a particular security should be based only on its contribution to the diversification and risk of the total portfolio, and not on its individual factors alone.\textsuperscript{232}

This modern economic theory casts doubt upon the usefulness of the mandatory disclosures of federal securities laws. Portfolio theory, which teaches that diversification can almost eliminate the risk as to a particular security, delimits the value of disclosures and presents substantial cost/benefit questions regarding mandatory disclosure.\textsuperscript{233} In developed markets, information about companies, from every possible source, is widely and quickly disseminated and is reflected in the price of the security long before the information is available through mandatory disclosure. This further suggests that mandatory disclosures may have little value.\textsuperscript{234} Disclosure, on the other hand, does require a significant cost both to the issuer and to the capital market as a whole. If costs exceed the benefits, mandatory disclosure may also be counterproductive to the capital markets due to the resulting misallocation of resources.

\textsuperscript{227} See id.
\textsuperscript{228} Banoff, supra note 179, at 183.
\textsuperscript{229} Note, supra note 120, at 1034-38.
\textsuperscript{230} Id. at 1039 n.34.
\textsuperscript{231} Id. at 1036 n.25.
\textsuperscript{232} Kripke, Has the SEC Taken All the Dead Wood Out of Its Disclosure System?, 38 Bus. Law 833, 841 (1983).
\textsuperscript{234} Id. at 108.
In the modern securities markets, an entire industry of investment analysts and advisers, broker-dealers, institutional investors, arbitragers, and a sophisticated financial press sort through all sources of available information such as press and earnings releases, informal communications with management, news reports, insider trading observations, and other sources of company specific information. These sources not only provide information similar to that required by mandatory disclosure, but also less tangible information such as personal observations and expectations of management and others. Although the securities industry utilizes the mandatory disclosures of federal law, it may do so largely for validation purposes or purposes irrelevant to the valuation of securities under a modern economic theory. Whether provided to sophisticated or unsophisticated investors, the untimeliness of mandatory disclosure precludes its usefulness in the valuation of a security. Past information, reflected in the price of a security, is of no value for trading purposes or for the prediction of future performance as a security. Furthermore, as to individual investors, the quantity and complexity of mandatory disclosures and the availability of such disclosures make it impossible for an individual investor to sort through disclosure documents.

The SEC, nevertheless, has consistently focused its mandatory disclosures on the concept of fully informed individual investors. Realistically, individual investors rely on the securities industry and the capital markets to make investment decisions. Untimely, complex and multitudinous mandatory disclosures cannot compete with a fully informed securities industry and an efficient capital market. As modern economic theory indicates, subsequent mandatory disclosure is not important since the information has already been translated into the price of the security. Subsequent mandatory disclosure, therefore, is not useful for any present or future trading purposes. The market also accounts for all data: company-specific, industry-wide, economic, tangible, and intangible information. Mandatory disclosure cannot possibly hope to disclose all the information available about a specific company and its relationship to the market. Under the modern portfolio theory, it is the expected relationship of a company to the market or to a portfolio which is important, not the historical company-specific information.

Although the integrated disclosure system purports to accept the efficient market theory, the SEC has expressed considerable uncertainty about the market working efficiently as a whole. The SEC wanted to “assure that information about the issuer and the securities was available publicly and that some type of market in the securities existed . . . and [that] the market price would be established by reasonably well-informed investors in the open

237. ADVISORY COMMITTEE REPORT supra note 96, at 347-49.
The SEC, therefore, in order to assure a substantial following of the security by analysts, limited the availability of the full benefits of the integrated disclosure system to only the largest publicly held companies with a sufficient market capitalization. Although acknowledging that the market analyzes information and translates it into price, the SEC required that the information already reflected in the price of the security continue to be incorporated by reference into the prospectus from previously filed Exchange Act reports. Consequently, the in terrorem liabilities of issuers and other persons involved in the issue apply to the perfunctory disclosures which become incorporated by reference.

The position of the SEC largely conflicts with indications that the Efficient Capital Market Hypothesis can be used as a valid basis for securities regulation, except in a very limited context. The theory indicates that it is of no consequence to repeat information, however, the SEC has accepted this axiom only for the largest companies. The theory also indicates that the perfunctory incorporation by reference requirement serves no valid disclosure purpose. Therefore, it merely exists to extend 1933 Act liabilities. Furthermore, many mandatory disclosures are of limited or questionable value and cannot compete with other sources of information or the functioning of an efficient capital market. If the theory is accepted as valid for most practical purposes, then it becomes apparent that there is greater room for simplification and the elimination of redundancy and unnecessary disclosures in securities regulations. The Efficient Capital Market Hypothesis indicates the opportunity for more deregulation of mandatory disclosures. At a minimum, the Efficient Capital Market Hypothesis supports efforts toward the elimination of duplicative disclosures and procedures that continue to exist even under the integrated disclosure system.

VII. CONTINUING PROBLEMS OF SECURITIES REGULATION

For many companies, the integrated disclosure system has reduced the costs of compliance with federal securities laws without any loss of investment information or investor protection. Registrants, however, must still continue to satisfy the requirements of two or more separate acts. Static registration of an issue of securities is required under the 1933 Act, whether or not a reporting company under the continuous disclosure system of the 1934 Act. According to Milton Cohen, this result is merely a historical accident.

241. See supra note 197, at 949.
242. Id.
243. Pickholz & Horahan, supra note 197, at 956.
244. Banoff, supra note 183, at 184.

[T]here is the problem that results from what might be called the archaic centrality
If the 1934 Act had been enacted first, the result might have been different. Under this scenario, companies under the 1934 Act would not have static reporting requirements dependent upon the issue of securities, although they might have other reporting requirements under the 1934 Act.246

Another continuing problem is that securities legislation and its goals have not changed significantly since enactment in 1933 and 1934. The basic scheme of the original Acts continues to be enforced by the SEC, with an emphasis on the putative goals of the Acts, even though the original Acts were quickly enacted with an objective of short-term economic recovery.247 The SEC has generally focused on these goals in "attempting to improve the morality of the marketplace . . . [believing] that the economic effect is largely irrelevant . . . ."248 The Acts have continued to regulate the securities industry in spite of significant changes in both the nature of the economy and the securities industry.

Unlike the circumstances leading to the 1933 and 1934 legislation, there has been a substantial period of sustained investor confidence in the U.S. securities markets, in spite of greater volatility, with progressively greater amounts of capital investment. Today, there are more sophisticated institutional investors, largely nonexistent in 1933, which account for a large portion of the aggregate investment in the securities markets.249 Although today's markets include more individual investors, financing margins are limited and more investors are fully invested in the market on a long term basis. In response to the greater availability of capital and investors, a large, sophisticated industry of financial analyst intermediaries was spawned. In contrast, investment advisors were nonexistent in the 1920s.250 The SEC itself admitted that "this country has a uniquely active and responsive financial press which facilitates the broad dissemination of highly timely and material company-oriented information to a vast readership."251

The capital markets have also changed drastically since 1933. Today there are new types of securities and distribution techniques which place less

246. Cohen, supra note 111 at 1381, 1406-08.
247. See supra note 99 and accompanying text.
248. Ferber, The Case Against Insider Trading: A Response to Professor Manne, 23 VAND. L. REV. 621, 622 (1970). At the time of this article the author was the SEC's chief appellate litigator. See also Kripke, supra note 6, at 261-62 n.13.
reliance on the traditional underwriting process, creating perplexity in classifying them for registration or exemption. "Changing economic conditions and technology have led to new financial services industries. It has become increasingly difficult to distinguish among the banking, securities, and other financial services industries." These and other factors have led to decreased reliance upon underwriters by issuers and investors. There is greater volatility in interest rates, securities prices, and the movement of capital. In addition, there is a greater international scope of the capital and securities markets. More foreign investors seek capital in the U.S. and U.S. investors have a growing interest in foreign markets, especially the Eurobond market. This internationalization of the securities markets has created tension between the regulated U.S. markets and the "unregulated" Eurodollar market. Due to the U.S. securities laws, Eurodollar and other foreign securities generally are not offered in the U.S., forcing U.S. investors to find other means of investing in foreign issues. To the extent that foreign investors are reluctant to submit to the burdens and costs of U.S. securities laws, foreign investment sources become unavailable to U.S. investors and the efficient international allocation of capital is impeded.


As the world trade has increased in the last twenty-five years, many corporations have taken a more international view toward sources of capital. While American corporations have sought capital abroad, many foreign corporations have entered the United States capital markets to secure short and long-term financing . . . . The American investor may acquire securities in four basic forms: 1) 'ordinary' securities—issued in the foreign country of origin; 2) 'American' securities—issued specifically for the American market with procedural rights differing from ordinary securities; 3) American Depository Receipts (ADR)—issued by an American bank and representing the underlying 'ordinary' security; and 4) American investment funds—a domestic holding company which holds the foreign 'ordinary' security. An American investor can purchase these foreign securities in three major markets either directly or through an American broker/dealer: 1) the original foreign market—where the investor pays higher transaction costs; 2) the American over-the-counter market—through the active National Association of Securities Dealers Automated Quotation (NASDAQ) system or through the inactive National Daily Quotation Sheets, the 'pink sheet' market; and 3) the American national security exchanges—where active and widely held foreign securities can be purchased.

Foreign debt securities, known as 'Yankee' bonds, comprise the majority of the foreign securities market. Foreign governmental issuers dominate this bond market but foreign corporate issuers have recently become more active. . . . The major American purchasers are institutional investors seeking risk diversification
The securities laws have created a system whereby industry self-regulation, which generally was unsupervised prior to 1934, is now coordinated with SEC regulation. In principle, such a scheme has theoretical appeal, however, it has been largely underutilized. During much of its history, the SEC has neglected its supervisory role over self-regulatory organizations and has concentrated instead on the enforcement of its own disclosure requirements. Attempts to alleviate the evident failures in this area resulted in overlapping and confusing rules. Self-regulation, therefore, continues to be underutilized due to the unclear and overlapping responsibilities that result from inaction of self-regulatory organizations as well as the SEC.254

and attracted by the slight interest premium 'Yankee' bonds carry. These institutional investors usually have direct access to the competing Eurobond market. Thus, the 'Yankee' bond market and the Eurobond market have overlapping roles.

Equity securities play a smaller but more visible role. Foreign corporations have diverse reasons for entering the United States stock market. 

In addition to foreign corporations who voluntarily enter the United States markets by issuing new stock, other foreign corporations have stock traded in United States secondary markets. Some foreign corporations either avoid or actively discourage American trading in their shares. These corporations' shares are normally traded on the inactive 'pink sheet' market.

From its inception, the SEC required foreign firms issuing new securities to conform to substantially the same Securities Act disclosure standards placed on United States issuers. This attitude especially handicapped foreign issuers because of their unequal initial position. Many foreign corporations preferred to avoid the rigors of Securities Act registration and thus, the American markets. As business became more international in scope and more foreign firms wanted to use the United States capital markets, the SEC's Securities Act disclosure requirements became more of a barrier to the free flow of international capital.


Over the past half century, the SEC developed a split personality in administering the basic securities laws. One SEC, highly respected and highly visible to the public, administers the system of mandatory disclosure of information by publicly traded companies and enforces the laws' anti-fraud provisions. The regulatory SEC, less visible and poorly understood, is charged with a variety of responsibilities involving the overall health and effective operation of the securities markets. For thirty-five years, the regulatory SEC did little to discharge those responsibilities.

Federal securities laws continue to supplement state corporate and "Blue Sky" laws without federal preemption, in spite of the fact that most issuers, as well as the entire security industry, have become more national and international in scope. A large securities issue in a federally regulated market, however, might be required to comply with fifty different state securities laws if offered in those states. If federal securities laws are adequate for the protection of investors in the national market then redundant state regulations become unnecessarily burdensome, costly and inefficient. This state and federal redundancy results in the inefficient allocation of resources in the capital markets.

Many recent sources have been critical of the securities laws after years of acceptance. There is a general agreement among the legal, financial, and economic communities that securities laws should not impede the efficient allocation of resources in the capital markets, without substantial justification that the benefits exceed the costs of regulation. This agreement, however, conflicts with the original legislative premises which disregarded the costs and benefits of regulation. Also, overwhelming support exists for modern economic theory, which casts substantial doubt on the necessity and value of securities law disclosures. On the other hand, little empirical or theoretical support exists for the present mandated disclosure system. The SEC continues to administer laws and regulations which are subjective ad hoc means advancing the broad goals of full disclosure and investor protection. The SEC has expanded these subjective regulations in recent years to require more disclosures without any empirical studies indicating their need or

255. The federal securities acts expressly allow for concurrent state regulation under the blue sky laws, 15 U.S.C. §§ 77r, 78bb (1982 & Supp. III 1985). "Blue Sky" law is the name generally applied to a state's securities laws. See Hall v. Geiger-Jones Co., 242 U.S. 539 (1917) (these laws are known as "blue sky" laws after this opinion describing their purpose as the prevention "of speculative schemes which have no more basis than so many feet of blue sky").

256. See Campbell, An Open Attack on the Nonsense of Blue Sky Regulation, 10 J. CORP. L. 553 (1985) (suggesting that the costs imposed on the capital raising system far outweigh any benefits); Brandi, Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation, 10 J. CORP. L. 689 (1985) (finding that the inconsistency in merit review among the states is the principle part of the cost of regulation).

257. See supra notes 107-66 and accompanying text.

258. See supra notes 123-24.

259. See supra note 207 and accompanying text.

Modern economic analysis has gravely weakened, if not irretrievably damaged, the theoretical basis for the mandatory disclosure system of securities legislation enforced by the SEC. Even if it is assumed that some mandatory disclosure is necessary, any fair-minded observer must at least recognize that the rationalization for the system is so dubious that the burden of proving the need for a regulatory structure, or any part of it, has shifted from the critics to the supporters of the system.

value. Like the Federal Securities Code, most of present securities regulation is "lawyers law" with little or no consideration of other disciplines or the costs and benefits of regulation; such regulation implicitly assumes that the benefits to society outweigh the costs. Although such assumptions may be appropriate where the benefits are great and the costs are minor, in this case, there are indications that the value of the benefits is minor or nonexistent, and the cost to the capital markets as a whole is great. These indications should be considered, unless society determines that the cost of the regulation is irrelevant to the law.

The SEC has continued to emphasize disclosures for the benefit and protection of the individual investor. This misplaced emphasis has, however, resulted in an incongruous result. SEC disclosures are required to be readable and understandable by laymen. Therefore, technical language and unnecessary detail must be avoided. This oversimplification, however, makes the mandatory disclosures less useful to the professional analysts who actually use them. In its emphasis on individual investor protection, the SEC has historically prohibited anything other than "hard," tangible, verifiable, and historic data. Much, if not all, "hard" data may be worthless as it

260. See supra note 133 and accompanying text. The prohibitions on disclosure under the 1933 Act have also been argued to violate the first amendment right to freedom of speech considering the Supreme Court's extension of protections offered to commercial speech. See Schoeman, _The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933_, 41 BUS. LAW. 377 (1986).


262. _See supra_ note 100 and accompanying text.


The view that the prospectuses should be intelligible to the average small investor as well as the professional analyst, immediately raises the question of what substantive standard of disclosure must be maintained . . . .

In an industry in which there is an unmistakable 'trend toward a greater measure of professionalism . . . with the accompanying demand for more information about issuers' 'a pragmatic balance must be struck between the needs of the unsophisticated investor and those of the knowledgeable student of finance.' _The Wheat Report_ at 9-10. There are three distinct classes of investors who must be informed by the prospectus: (1) the amateur who reads for only the grosser sorts of disclosures; (2) the professional advisor and manager who studies the prospectus closely and makes his decisions based on the insights he gains from it; and (3) the securities analyst who uses the prospectus as one of many sources in an independent investigation of the issuer . . . .

The significance of these observations is that the objectives of full disclosure can be fully achieved only by complete revelation of facts which would be material to the sophisticated investor or the securities professional not just the average common shareholder.

_Id._ at 565-66. _See also_ Greenapple v. Detroit Edison Co., 618 F.2d 198 (2d Cir. 1980) (quoted _supra_ note 19).

264. _See_ Schneider, _Nits, Grits and Soft Information in SEC Filings_, 121 U. PA. L. REV. 254 (1972). The _ADVISORY COMMITTEE REPORT_ also noted this problem:

Although it is at least arguable that the statutory disclosure system created by
has no value in predicting future performance and, therefore, has no relevance to the value of a security. The SEC has recently liberalized its position on this matter by permitting and encouraging voluntary forecasts, and requiring discussion of liquidity and capital resources, i.e. "soft" data. However, unnecessary issuer involvement in this area opens up the possibility of substantial civil liability. The value of this change, therefore, is limited as registrants are reluctant to disclose anything which is not "hard," tangible, and verifiable. Consequently, registrants continue to emphasize historical data, notwithstanding its limited or negligible value.

Under the 1933 Act, Section 11 imposes absolute liability on the issuer and establishes a negligence standard for others involved in the issuance of securities. This is in contrast to the scienter standard of liability generally required under the 1934 Act. Section 12 also establishes a high liability standard. Although the in terrorem liability provision may have prevented fraudulent or misleading disclosures in registration statements, it also had an antiseptic effect on the quality of the disclosures, since it punishes as fraudulent any negligent or inadvertent noncompliance with the 1933 Act by the issuer. This liability is available in addition to the other antifraud penalties. The prospectus has become a "schizophrenic" document which

the 1933 and 1934 Acts was perceived by Congress and commentators as being particularly suited to the interests of sophisticated investors and securities professionals, for many years the policy of the [SEC] was based on the belief that the relevant constituency was the unsophisticated investor.

The disclosure objective of providing meaningful information to the investment community has, in cases of perceived conflict, been subordinated to the objective of protecting unsophisticated investors from their own ignorance. Thus, for example, the [SEC] has excluded certain types of information, although useful and important to knowledgeable constituents of the investment community, might be misunderstood and unduly relied upon by unsophisticated investors.


265. See supra notes 233-39 and accompanying text.


268. See supra notes 38-56 and accompanying text.

269. See supra notes 75-87 and accompanying text.

270. See supra notes 40-44 and accompanying text.

271. See supra notes 38-56 and accompanying text.

272. Id.


The prospectus is a somewhat schizophrenic document, having two purposes which often present conflicting pulls. On the one hand, it is a selling document. It is used by the principal underwriters to form the underwriting syndicate and a
tries to function as both a selling and a disclosure document, subject to the
in terrorem liabilities of the Act. As a result, disclosures are very conservative,
rigid in format and content and contain meaningless, standard “boilerplate”
provisions to avoid liability. The prospectus, therefore, has become somewhat
of an insurance policy against liability rather than a balanced, informative
selling document. 274

The in terrorem liabilities under the 1933 Act not only impair the quality
of disclosure under the Act, but also have other unjustified consequences.
Without a showing of need for such liability for investor protection, they
impose what amounts to absolute liability on issuers for inadvertent failures
to comply with the 1933 Act. This may not only result from an error in
disclosure, but also from a failure to comply with the exact requirements of
one of the exemptions under the Act. Such a result may occur due to
innocent and unforeseen events, such as the integration of two offerings or
may be due to mere technical disqualification rather than any substantive
transgression. 275 Therefore, there are no social policy reasons for liabilities
under the 1933 Act unless the primary securities market is so fraught with
risk that it cannot be remedied by a lesser standard of liability. The different standards under the Acts have also resulted in preferring investors in primary offerings of securities to those in the secondary market. If, as has been indicated, investors do not rely on the mandatory disclosures for investment decisions, the higher standard of liability would seem to be unjustified. As a consequence, it has the effect of inefficient resource allocation since foreign issuers are reluctant to submit to the 1933 Act liabilities. U.S. issuers also avoid the threat of liability by avoiding issuance of securities or by obtaining capital through one of the exemptions.

Certain exemptions under the 1933 Act are intended mainly to avoid the burden of registration by small companies for small financing. Due to the risk of failure to qualify, much cost and effort is often necessary to insure qualification under one of the exemptions. Because of the technical nature of the various exemptions and exceptions, which can disqualify an exemption, the cost and burden of an exempt offering for a small company may be greater than an actual registration under the Act. The 1933 Act has been described as unnecessarily "sophistic" due to the technical nature of these exemptions and the related doctrines of integration, fungibility, and restricted securities, among others. The result is that, notwithstanding the exemptions, the cost of compliance, complexity of regulations, and regulatory barriers continue to hinder small issuers and small financing. The decrease in supply increases the cost of investments to investors. The high compliance costs increase the costs of both small and large issuers. For many large U.S. issuers, the "unregulated" Eurodollar market offers an alternative by avoiding the U.S. markets and its securities laws entirely. The resulting distortion in the market causes inefficient resource allocation and burdens the U.S. capital markets as a whole. The efficient allocation of international resources is also impeded by U.S. laws.

VIII. THE NEED FOR LEGISLATIVE REFORM

Reform of federal securities laws can be accomplished without impairing the SEC goals of full disclosure, investor protection, and confidence in the


Strict liability may be sensible when you choose to keep lions in your backyard. You know that a lion is a dangerous creature, and if it escapes, negligent or not, you are going to be liable. You should be. But, when you impose strict liability on an underlying body of substantive law that is as spongy as the Securities Act, you have the worst possible jurisprudence that I can imagine.

Id.

277. Id.

278. Wolfson, supra note 259, at 149-56.

279. See supra note 148 and accompanying text.

280. Wolfson, supra note 259.

281. See supra note 253.
capital markets. The SEC has demonstrated this by adopting the integrated disclosure system. Form S-3, which eliminates duplicative SEC filings, is popular and less costly to issuers. Yet, it has not resulted in any impairment to capital markets, investors, or disclosure. The success of Rule 415 indicates further that there is no benefit in registering securities issues and that the elimination of this requirement for 1934 Act companies would benefit issuers, investors, and the capital market as a whole.\(^{282}\) Modern economic theory and empirical studies also indicate the need for continued reform.\(^{283}\)

Although the integrated disclosure system was a success, its benefits are limited. The full benefits of integrated disclosure are available only to the largest companies that can file Form S-3 and use Rule 415.\(^{284}\) Otherwise, the duplicative nature of the two separate acts continues to apply, in varying degrees, to most of the other registrants. Furthermore, the integrated disclosure system does not fully acknowledge the empirical evidence and economic theory, nor the evidence of its own success. Registration under the 1933 Act continues to be necessary for all registrants upon the event of an offering of securities, whether or not they are complying registrants under the 1934 Act. Even though integrated disclosure avoids the replication of information between filings for some companies, the information must be incorporated by reference from the 1934 Act filings. There continues to be a perfunctory requirement to deliver the prospectus to the individual investor who, in all likelihood, will not use it. However, it need not be delivered until the securities are delivered.\(^{285}\) In addition, there is the possibility of liability under the \textit{in terrorem} liability provisions of Section 11.\(^{286}\)

There is a need for comprehensive legislative reform. The bureaucratic, timid, and tradition-bound SEC took fifteen years to adopt an integrated disclosure system.\(^{287}\) The SEC did not even make this system generally available, but significantly limited its usefulness. Nonetheless, it was accused of exceeding its authority and violating the Congressional mandates of the 1933 and 1934 Acts.\(^{288}\) The SEC, therefore, is at the border of its rulemaking authority with the integrated disclosure system. It can only continue to provide more patchwork solutions. Meaningful reform requires reconsideration of securities laws on a more fundamental level.

Unlike the background of the 1933 Act, proposals for change should not be made without substantial theoretical support, empirical justification, and a consideration of the costs and benefits of regulation. The failures of the Federal Securities Code indicate that the proposals for reform cannot be mere ad hoc, subjective "lawyer's law."\(^{289}\) Legal reform of the securities laws...
laws can no longer ignore economic, financial, accounting and business interests. Although the scheme proposed by the Federal Securities Code floundered, the goals and premises underlying the Code are relevant with respect to proposals for reform.290 The criticisms detailed in previous sections291 and the problems of securities regulation,292 continue to reflect a need for further reform.

This Comment does not propose to dismantle and abandon the entire mandatory disclosure system, although there is support indicating that mandatory disclosure has little or no value.293 Such a drastic proposal would appear radical and could be challenged, as it has been in the past, with logical arguments to the contrary. Proponents of mandatory disclosure argue that it is necessary for investor confidence in the capital markets. It is argued that without civil and criminal sanctions voluntary and other sources of corporate information will not be adequate, will allow for concealment or misrepresentation of information, and will result in excessive executive and underwriter compensation.294 These arguments attempt to challenge the basis of modern economic theory and question the validity of contrary empirical studies. Furthermore, regulation by mandatory disclosure has become an institution of the securities industry. Proponents also argue that it would be unrealistic to expect Congress to abandon the philosophy of full disclosure which has been viewed historically as the “linchpin of investor protection.”

290. See supra note 144 and accompanying text.
291. See supra notes 107-35 and accompanying text.
292. See supra notes 175-99 and accompanying text.
293. See supra note 233 and accompanying text.
294. Seligman, supra note 108, at 9. In addition to this article, several others have recently stated support of present and historical securities laws in a "post-revisionist" movement. See, e.g., Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549 (1984) (questioning Benston's conclusions on the cost and inefficiency of 1934 Act disclosures); Levmore, Efficient Markets and Puzzling Intermediaries, 70 VA. L. REV. 645 (1984) (highlighting the difference in approach to securities regulation by economists and lawyers and suggesting a legal approach); Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669 (1984) (concluding that although there is no good evidence that the disclosure rules are beneficial, there is also no good evidence that they are harmful or overly costly); Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717 (1984).

We therefore may be approaching a new stage, which can be called 'post-revisionism.' Among post-revisionism's defining characteristics are (1) a recognition of the Efficient Capital Market Hypothesis as, at the least, the best generalization by which to summarize the available empirical evidence; (2) a clearer sense of the difficulties inherent in relying on aggregate statistical evidence either to prove or rebut any broad thesis about the impact and effects of disclosure; and (3) a shift in focus from continued debate over the impact the federal securities laws had fifty years ago to an examination of contemporary market structure and the needs of investors under existing conditions. Id. at 719-20. As this Comment does not recommend the abrogation of mandatory disclosure, the proposals herein should not be anathemical to adherents of "post-revisionism."

295. See Throop, supra note 163, at 1600.
and that the "empirical realities of the familiar capital markets best dem-
strate that the efficient market hypothesis is interesting but often irrelevant
to the law."296 It is argued as sufficient for the law to reflect a rational
analysis backed by experience.297 There is also evidence that the mandatory
disclosure system has been beneficial to the capital markets. One such benefit
is that mandatory disclosure subsidizes the search for similar information
by financial analysts, thereby reducing the cost of duplicative efforts and
promoting more efficient resource allocation on an overall basis.298 Although
a proposal to abandon the concept of mandatory disclosure would be
hazardous, certain broad proposals can be justified through empirical studies,
economic theory, and the results of the integrated disclosure system.

IX. PROPOSALS FOR LEGISLATIVE REFORM

Although the ALI Federal Securities Code failed, the concept of replacing
the registration of securities with the registration of companies is sound. The
Code attempted to codify all securities regulation statutes into one compre-
hensive code. This Comment does not propose a comprehensive recodifica-
tion. Many of the problems of securities laws addressed by the Code and
others can be solved more simply. A continuous company registration scheme,
much like that sought by the proponents of the Code, can be achieved by
repealing the 1933 Act and by replacing 1933 Act registrations with 1934
Act disclosures for new and current registrants.

A proposal for the complete repeal of the 1933 Act can be justified. The
present scheme of the two Acts is an anachronism due to an historical
accident.299 The success of the integrated disclosure system, especially the
results of Rule 415, shows that this can be accomplished without impairing
disclosure, investor protection, or the capital markets.300 The elimination of
the registration requirement upon the event of a securities offering, however,
can be expected to reduce the cost of offerings to issuers, investors, and the
capital markets as a whole.301 The repeal of the 1933 Act, along with its
attendant in terrorem liabilities, would remove significant impediments to
national and international capital formation.302

If this change is to be accomplished without abandoning the concept of
mandatory disclosure, additional disclosures under the 1934 Act will be
required. Rather than a registration of a securities issue, it is suggested that
a securities issue should be treated like other reportable events under the
continuous disclosure system of the 1934 Act. Such a treatment has inherent

296. Levmore, supra note 294, at 650.
297. Throop, supra note 163, at 1600.
298. See Coffee, supra note 294, at 729.
299. See Note, supra note 119.
300. See supra notes 167-99.
301. Id.
302. See supra notes 268-77 and accompanying text.
logic. The issue of securities by a registrant may be as significant to a holder of issued and outstanding securities as it is to a purchaser of the offering. The disclosures under the 1934 Act are more balanced and informative than those of the 1933 Act. They also offer the advantage of being produced periodically, compared to the static reporting requirements of the 1933 Act. It is apparent that individual investors cannot benefit from the historical accident of the two Acts if mandatory disclosure is not abrogated. The success of the common disclosure package under the integrated disclosure system supports this assertion. Further support exists in that individual investors do not use the 1933 Act disclosure documents for investment purposes. Financial intermediaries would not be affected since they would continue to have access to the disclosures under the 1934 Act.

It has been suggested by Milton Cohen that 1934 Act disclosure can be substituted for 1933 Act registration by treating events much like a "fundamental" event under shelf registration. This could be reported by filing a Form 8-K with the SEC and the Exchange or the National Association of Securities Dealers.\textsuperscript{303} Financial intermediaries would disseminate the information largely as they do now, and the market would quickly reflect the event in the market price of the stock. For new registrants, the event of an offering would require not only registration of the event, but also initial registration under the continuous reporting requirements of the 1934 Act. Unlike the Code, this Comment does not propose to continue any type of static registration statement such as an "offering statement," "distribution statement," or "a prospectus delivery requirement more or less as in present law."\textsuperscript{304} The acceptance of an efficient capital market for purposes of securities regulation supports this position.

Such a change would benefit both large and small registrants. Registrants would no longer have to register offerings and the cost benefit to all registrants is apparent. Not only would the repeal of the 1933 Act reduce


Yet I wonder whether the items of Form 8-K might not usefully be expanded... to cover some major events not presently specified. Or if additional specification is impractical, perhaps we can at least take a cue from item 512 of regulation S-K in which a new word, 'fundamental,' is introduced. A registrant in a rule 415 shelf offering must undertake to file a posteffective amendment of the prospectus to reflect 'any facts or events arising after the effective date... which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement' or must disclose the fundamental change in a 1934 Act report incorporated by reference. Would it not be practical as well as desirable to require a registrant similarly to report changes in the information contained in its continuous disclosure file that are not merely material but fundamental, rather than waiting for the next 10-K or the next public offering to do so? The point is far from trivial. To the extent that users can rely on filed data as not only accurate but current, the usefulness of continuous disclosure files is obviously enhanced... .

\textit{Id.} at 991.

\textsuperscript{304}. See supra notes 157-60 and accompanying text.
the cost of registration, it would also reduce the cost and burden of qualifying for exemptions and would eliminate the need for the unnecessarily sophisticated rules of the 1933 Act.\textsuperscript{305} It would no longer be necessary to determine if a particular offering is a security to achieve technical compliance with the various exemptions or to determine whether a particular exception to an exemption would apply. Furthermore, it would be unnecessary to worry about "jumping the gun" in advance of an offering, or about technical compliance with the statutory prospectus delivery requirements and the attendant liability for failure to do so. The only requirement would be registration and reporting under the 1934 Act.\textsuperscript{306}

The elimination of the 1933 Act registration requirements would increase the efficiency of the market and would allow the market itself to allocate resources without the effect of 1933 Act regulatory distortions. Not only would issuers benefit, but also investors and the market as a whole. The results of Rule 415 indicate that a lower cost of issuing securities, less dependence on traditional, high cost distribution methods, and increased competition of securities would reduce the cost to investors and the capital markets as a whole.\textsuperscript{307} In addition, U.S. investors would have a greater supply of offerings, not only from U.S. companies, but also from foreign issuers. Although progress toward an international jurisdictional and reme-

\textsuperscript{305} See supra note 148 and accompanying text. The most obvious benefit of such a system would be the reduced cost to issuers. When one considers the fees charged by underwriters, printers, attorneys, and accountants in connection with a registration under the 1933 Act, the savings can be significant. It would also reduce the cost to issuers, investors, and the capital markets as a whole by allowing innovative distribution techniques which are less costly than the traditional fixed-price methods which rely on underwriters and syndicates. The ability to issue securities without the ceremony of a registration would make alternative distribution methods more practicable, as is the case with shelf registration offerings. Issuers have at least three new methods: the "Dutch" auction, the dribble out, and the bought deal. In Dutch auctions, the issuer accepts bids directly from investors and does not need to use an underwriter. The issuer solicits bids on its own. Dribble outs are similarly solicited by the issuer, however, the issuer sells in small amounts of securities as buyers appear and are willing to accept the issuer's price. In a bought deal, the issuer circumvents underwriters by selling directly to one or more investment banks which then resell the securities. These techniques, where used, have reduced the cost of offerings by increasing alternatives for the issuers and increasing competition among underwriters. The ability to issue securities as necessary would give issuers the ability to take immediate advantage of changes in the market, thereby decreasing their cost of an issue. Increasing the competition among underwriters would make the market more efficient by lowering issuer and investor cost. Like shelf registration, the proposed system would also benefit investors by bringing prices in the primary and secondary markets into equilibrium. For a discussion of the realized benefits of shelf registration, see Banoff, supra note 183. For other articles discussing the benefits of alternative distribution techniques and underwriter competition, see Greene, Investment Bankers—Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System, 56 Notre Dame L. Rev. 755 (1981) and Note, Auctioning New Issues of Corporate Securities, 71 Va. L. Rev. 1381 (1985).

\textsuperscript{306} McLaughlin, supra note 3, at 45.

\textsuperscript{307} See supra note 294.
dial system will have to continue, the elimination of the burdens of the 1933 Act registration and liabilities to foreign issuers can be expected to increase the supply of securities available to U.S. investors, increase the competition in securities and distribution techniques, and increase the efficient allocation of resources in the international market to the benefit of the U.S. capital markets as a whole.  

Under this securities regulation scheme, it would not be necessary to eliminate the present *in terrorem* liabilities of the 1933 Act. Nonetheless, this is recommended as part of the proposal of this Comment. It has been

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308. *Id.*

309. See *supra* notes 268-77 and accompanying text. The extension of 1933 Act liabilities to continuous reports by section 1704 of the ALI Code caused considerable controversy:

There are at least two good reasons, however, to resist the extension of Section 11 liabilities to annual reports. First, imposition of liability upon directors, particularly outside directors, for negligence in connection with misstatements or omissions in an annual report is too severe and will discourage competent people from assuming corporate directorships . . . . Second, corporate efforts to ensure that no material information is negligently omitted from the annual report may result in substantially larger, unreadable annual reports which contain more, but communicate less, information to shareholders . . . . Expanding the Commission's injunctive powers through a strict liability standard may severely penalize parties for an innocent mistake, yet not deter future mistakes . . . . Tightening the standard of personal liability for misstatements in annual reports may deter qualified people from becoming directors and increase obfuscation in annual reports. Thus, the Code's generous expansion of plaintiffs' rights—in a field where plaintiffs already receive extensive protection—carries many dangers that require further exploration.

Lowenfells, *supra* note 141, at 654-55. Professor Kripke also commented on this extension of liability:

On another point, however, the Code adopted by the ALI in May of 1978 would depart from present law—in my mind, very much for the worse—by imposing strenuous liability provisions on the issuer for material misstatements in the annual reports . . . . The stringent liability provisions of Section 11 of that Act reach only misstatements or omissions in registration statements for newly distributed securities. The liability provisions are onerous; plaintiffs need not even carry the burden of due diligence, heretofore accepted by the financial community only in connection with Securities Act registration statements, for newly distributed securities. The attendant burden of satisfying the standard of due diligence is, therefore, episodic. If that heavy burden were imposed on routine annual reports, then issuers would be forced to institute, on a regular basis, all of the extraordinary procedures for care, investigation and detailed description of corporate activity previously required only occasionally. While this requirement...
argued that the Section 11 liability provision of the 1933 Act has had an antiseptic effect on the quality of 1933 Act disclosures. On the other hand, the 1934 Act disclosures are more balanced and meaningful. If the in terrorem liabilities are imposed on 1934 Act disclosures, these can also be expected to become pessimistic, overly conservative, "boilerplate," and unbalanced. Such cataclysmic liability has never been shown to be necessary for investor protection, especially for technical noncompliance. The antifraud provisions should guard against fraud, and the 1934 Act scienter requirement for liability has been adequate for investor protection in the secondary

would enrich the legal profession, since attorneys would be bound to give the same attention to annual reports now required for registration statements, the result would be repugnant to concerns currently being expressed regarding over-regulation and the unfortunate, ubiquitous necessity for securities lawyers . . . .

Since the primary method of disclosure has been altered from the occasional registration statement to permanent registration coupled with the annual report, it was asserted that both documents should therefore be subject to the same stringent provisions.

In my opinion, just because disclosure has become continuous under the Code, it does not necessarily follow that the cataclysmic liability provisions of Section 11 are appropriate for the annual report . . . .

Consider, for instance, how much litigation would be fomented by this provision if it survives. Every time a security price went up or down, unhappy stockholders, or former stockholders, would have an opportunity to try to shift their perceived losses to the parties liable under this section. These potential plaintiffs, having found a material misstatement or omission in the company's current annual report, would not need to prove that they had been aware of the misstated information, or that they had relied on it, or that it had caused them damages. Rather, the burden of disproving those elements would be on the defendants. Entrepreneurial lawyers who found such plaintiffs for class suits would have a field day, and the ensuing litigation would be interminable.

The situation would be far worse than it was under rule 10b-5, even before the Supreme Court required scienter, because mere negligence would suffice to impose liability under the proposed provisions. Furthermore, proof of damage would not be required in order to state a cause of action and throw the burden of proof onto the defendants. Not only would the potential liability run to a huge class of plaintiffs—all persons who traded in any of the company's securities during the currency of the annual report—but also the Code formula for limiting liability is not severely restrictive because of the large number of potential defendants. The situation thus invokes Chief Judge Cardozo's fears of unrestricted liability for negligent representation, and would not conform to the Supreme Court's interpretation that Congress is imposing liability for negligent misrepresentation carefully limited the situations to which liability was applicable. The Supreme Court has recognized that in this kind of litigation, the dangers of the litigation itself and the expense thereof cause improvident settlements. Indeed, the problem would be so serious that it might outweigh any benefits from the other provisions of the Code.


310. See supra notes 268-74 and accompanying text.
311. See supra notes 38-56 and accompanying text.
312. See supra notes 273-74 and accompanying text.
market. There is no valid reason for distinction between investors in primary or secondary offerings. Therefore, it seems plausible that the 1934 Act’s scheme of liability should be sufficient to protect investors and provide them with an adequate remedy for violations. The retention of in terrorem liabilities would continue to impede the efficient allocation of national and international resources by inhibiting securities offerings.

One question which remains open after the replacement of 1934 Act disclosures for 1933 Act registrations is the status of transaction-specific disclosure requirements under the 1933 Act. Under the proposal of this Comment, it would be necessary to report the event of a securities issue in the registrant’s periodic reports on Form 8-K and possibly Forms 10-K and 10-Q. The question is whether the same type of disclosures of risks and the resulting standard, “boilerplate” insurance policy disclosures would be necessary. The elimination of in terrorem liability should help reduce the inadequacy of such disclosures. A determination will have to be made, however, as to whether the event needs to be disclosed with the same requirements in all reports or whether the event can be reported much as other events are reported under the 1934 Act in Forms 10-K and 10-Q, with possibly full disclosure only in Form 8-K. Having concluded that the efficient market hypothesis can and should be relied on for purposes of securities

313. See Longstreth, supra note 249, at 1612.

Section 11 of the Securities Act was designed to provide substantially greater protection for investors against material misstatements in and omissions from registration statements than Section 18 of the Exchange Act provides for material misstatements in or omissions in from periodic reports. There are important differences between routine transactions in the secondary markets and sales of securities pursuant to certain kinds of registered offerings which justify the substantial protections of the Securities Act. While the registration provisions of Section 5 of the Securities Act reach many transactions for which the full panoply of protections provided by the registration process is excessive, there are at least two instances in which the self-interest of the offerors and their access to inside information are such that investors should have the full protections of the registration process. These instances are (1) primary offerings by issuers seeking funds from the market, and (2) large-scale secondary offerings by insiders which exceed the volume limitations of Rule 144 and which require the services of an underwriter and an extra selling effort. Securities sales in these instances are significantly different from ordinary market transactions or certain other kinds of sales registered under the Securities Act, such as block sales by institutional investors and sales of securities pursuant to dividend reinvestment plans and employee stock purchase plans. The risk of an issuer, eager for funds, concealing unfavorable information, and the risk of insiders, cognizant of the unfavorable information, ‘bailing out’ are too great to allow issuers and insiders to go to market without the special scrutiny provided by the registration process.

Id.
315. See supra note 276 and accompanying text.
regulation, it is apparent that full disclosure would not be necessary more than once in Form 8-K. Any repetitive information in subsequent reports would have no value. Certain limited disclosures, however, may be continued for convenience, for such purposes as to make financial information between years comparative and not misleading. The only question which remains is the type and extent of disclosure required in each of the particular forms. This Comment does not presume to answer this question. Questions regarding the propriety of disclosures need greater evaluation than ad hoc judgments.

Although this Comment does not propose to dismantle the mandatory disclosure system, some broad guidelines can be proposed. The scheme of mandatory disclosure currently in force is based on ad hoc, subjective judgments by SEC lawyers. In most cases, there has been no cost/benefit or empirical analysis of the need or value of the disclosures. Furthermore, the quality of the disclosures has been based on the SEC philosophy of easily understandable disclosure to the individual investor. Inasmuch as individual investors do not use these disclosures, relying instead on professional financial intermediaries, their value is limited. The financial intermediaries are forced to obtain "soft," intangible, and technical information, which may be excluded from mandatory disclosures. The conflict between making disclosures simple yet informative would be reduced if the disclosure requirements addressed themselves to the needs and uses of financial analysts and sophisticated investors. The financial intermediaries, financial news, and the market would disseminate the information to the individual investor and be reflected in the value of the stock. Economic and statistical studies need to be made to determine the values and costs of disclosures to decide which are necessary and useful in empirical rather than logical or legal terms. The disclosure should not be required where the cost of disclosure outweighs the benefits to investors through the financial intermediaries.

Greater use should be made of self-regulation, in connection with the determination of the need for particular mandatory disclosures. In the area of disclosure, financial intermediaries are already obtaining the information that the market insists upon, whether or not it is included in mandatory disclosures. Often, management and financial intermediaries are in a superior position to interpret the need, value, and implications of the information that a corporation makes available to the market. In addition, self-regulatory organizations, such as exchanges, independently require certain disclosures such as timely earnings releases and information about major events. In evaluating the mandatory disclosure regulations, there is an opportunity for taking advantage of voluntary disclosures, informational intermediaries, and self-regulatory organization requirements. A cost/benefit, empirical analysis again would be necessary to optimize the balance between mandatory disclosure and deferring the task of disclosure to other market sources.

316. See supra note 100 and accompanying text.
Self-regulation should also be evaluated in other contexts. Self-regulation is an alternative to deregulation, another currently popular solution to inefficient governmental regulation. Self-regulation, where possible, offers certain advantages over direct governmental regulation. The cost of self-regulation is underwritten by those being regulated, with the result that resources will flow to where they are most needed, creating better control at a lower cost to the taxpayer. Since self-regulation is undertaken by members of the industry, it is more sensitive to the regulatory needs of the community, whereas governmental regulation is more inflexible. The securities industry has a two-tiered scheme of regulation in which the SEC oversees the workings of self-regulatory organizations which have the statutory power to regulate their members. However, the opportunity to rely on self-regulatory organizations has been underutilized by the SEC, allowing the self-regulatory organizations to act independently without coordination. Recent attempts to improve this area have resulted in confusing and overlapping standards of responsibility and have resulted in inaction on the part of both the SEC and the self-regulatory agencies. There should be a greater attempt to transfer responsibility in the disclosure and other regulatory areas by the SEC through clearer standards of responsibility and sanctions. As long as the SEC does not neglect its supervisory role in such a scheme, the result should be regulation which is more pertinent to industry needs at a lower cost.

Securities regulation also should provide opportunities for greater self-governance by corporations, by allowing the shareholders to determine the need for certain disclosures and regulatory requirements. Since much of the federal securities laws are intended to protect shareholders from corporate management, it is likely that some provisions would not be elected by shareholders when the cost is considered. Therefore, where it would not be unreasonable to do so, opportunities for corporations to "opt out" of certain regulatory requirements by shareholder vote should be made available.

Lastly, the overlapping and duplicative scheme of federal and state securities regulation needs to be overhauled. The proposed federal scheme, which would no longer require 1934 Act registrants to register security offerings, could throw the present structure of state securities laws, which relies in part on 1933 Act registration requirements, into disarray. A federal scheme which protects investors in the national markets should not require additional state regulation. The present system of over fifty different registration requirements is excessively costly and burdensome to issuers.

317. See supra note 254 and accompanying text.
318. See Victor, A Brash Young SEC Commissioner, Nat'l Law J., Nov. 10, 1986, at 30, col. 2. The Advisory Committee Report indicated that management is often in a superior position to interpret the implications of the information that a corporation makes available to the market. See supra note 79; see also Weiss, Disclosure and Corporate Accountability, 34 Bus. Law. 575, 590-91 (1979).
Federal legislation should use the commerce powers and the supremacy clause to preempt all state securities regulation of registrants under the federal securities laws.\textsuperscript{319} However, an opportunity for continued state regulation of companies will exist for those companies which are not required to register under the federal securities laws. States would continue to regulate the internal affairs of firms incorporated in their states under corporate, rather than securities laws principles, which have traditionally been left to the states.\textsuperscript{320} The federal scheme should also develop an exemption from federal securities laws whereby a company with transaction-specific and company-specific characteristics under a certain level would be exempt from federal regulation. The parameters for these exemptions should be evaluated empirically, using a cost/benefit analysis, and not based on ad hoc, meaningless standards as are the present exemptions under the 1933 Act.

X. Conclusion

The background of securities legislation, the present legislative scheme, the failure of patchwork solutions and reform attempts, and the continuing problems in securities regulation all present the need for comprehensive legislative reform of securities regulation on a fundamental level. Securities regulation has traditionally been lawyer's law without a sufficient consideration of economic, financial, accounting, or other disciplines. In order for the U.S. market to maintain its status and prosper in a growing international market, securities regulation will need to adapt to the realities of the market and economic theory. Toward that goal, the Securities Act of 1933 should be repealed in favor of a continuous scheme of reporting by companies under the Securities Exchange Act of 1934. The disclosure and regulatory requirements under this Act should make optimum use of the market, informational intermediaries, self-regulatory organizations, and self-governance by corporations using empirical studies and cost/benefit analyses. Where mandatory disclosures and government regulation is deemed necessary, it should be made relevant to the actual needs of users and beneficiaries. Finally, federal securities laws should preempt state securities laws which unnecessarily impede the efficiency of the national and international markets.

\textsuperscript{319} See supra note 256 and accompanying text. There is already precedent for doing this under the present statutes. See, e.g., Edgar v. Mite Corp., 457 U.S. 624, 642, 644 (1982) (finding the Illinois Business Takeover Act preempted and unconstitutional under the commerce clause).

Although modern economic theory and empirical studies indicate the potential for greater deregulation of the securities industry, this proposal for reform attempts to balance theoretical possibilities with practical realities. Nonetheless, even reform that is practically and theoretically justified may be difficult. The reforms suggested would simplify the law and increase competition in the distribution of securities. Such results can hope to decrease the cost to issuers, investors, and the capital markets in general. These results are also a threat to an established securities bar and a securities industry which both rely on revenues from the current, convoluted status of the law, and therefore, can understandably be expected to show little interest in major changes. Hopefully, each will realize that the need to adapt the U.S. market to the needs of a changing environment will be in their best interests, as well as the capital markets as a whole.

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